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October Scare:
Can We Avoid a Recession in 2020?

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A slowdown in the third quarter, losses in manufacturing, weakness in the service sector and a moderation in employment have sent a chill through financial markets and renewed fears of recession. The impeachment inquiry in-and-of itself should not feed those concerns, but it has added to policy uncertainty. No one is quite sure what can be accomplished before the end of the year, given the heightened (understatement) partisanship in Washington.

A larger issue is how the president plays his cards. If he reacts by further escalating the trade wars with China and the European Union (EU), then the U.S. economy will likely slip into recession in 2020. If he doesn't and instead comes to some kind of a deal with China, this economic expansion has a much better chance of continuing.

The Federal Reserve has a limited role to play with additional rate cuts. The Fed simply doesn't have many tools, given how low interest rates already are, to shore up confidence and offset the drag created by escalating tariffs and the tit-for-tat of a trade war with China, the world's second largest economy.

This edition of *Economic Currents* examines two scenarios for 2020. The first includes a recession, which has been our baseline for nearly a year. Timing the next recession is a fool's errand, but coming up with ways in which the trade war and the uncertainty it has triggered can snowball are not. The second scenario is more benign, with the economy slowing but not contracting. The latter would require a U-turn by the president who, for the moment, holds unilateral authority on tariffs tied loosely to national security.

A Summer Swoon

Real GDP growth is expected to come in at a 1.5% pace in the third quarter, a full one percent slowdown in growth from the first half of the year. Consumer spending slowed in response to an escalation in trade tensions with China. Business investment fell as companies waited out trade wars. Inventories dropped in the wake of the strike at GM and related plant closings. Exports remained weak. Government spending softened after surging in the second quarter. The only silver lining is residential investment, which looks like it posted the first positive quarter in more than a year and a half.

Prospects for the fourth quarter are about the same. The biggest shift will be the push to recoup losses associated with the GM strike. Tariffs could also play a key role if the administration decides to lift tariffs as scheduled in mid-October and December. It does appear they are granting more waivers than in the past.

The Fed Cuts. The Fed is in a wait-and-see mode. A cut in October will be contingent upon a series of events on the trade front: a hard Brexit in the UK, which could occur as soon as October 31 and a further escalation of tariffs on China. If those do not occur, the Fed will wait until December to cut. Separately, look for the Fed to announce an increase in its balance sheet to alleviate recent problems in the overnight funding market.

Section 232 tariffs, which are part of the Trade Expansion Act of 1962, are an artifact of the Cold War. They have only been used a handful of times since their inception and were largely replaced by the World Trade Organization (WTO), which acts as an arbiter over global trade disputes.

Scenario 1

A Trade-Induced Recession

Chart 1 shows the forecast for the economy if the administration continues along its current path:

- Tariffs are scheduled to nearly triple since the president took office and hit the highest level since the 1970s by year-end. That was before we negotiated trade deals to eliminate those taxes and global supply chains were nearly nonexistent. Only increases in the price of oil could cause such disruptive results back then.
- Tariffs on the EU will be increased this month in response to a ruling against Airbus by the WTO.
- The administratin is weighing larger tariffs on vehicles and parts from the EU, scheduled for mid-November.
- The U.S. is also considering limits on portfolio investments in China and the ability of Chinese firms to list on U.S. exchanges. Retaliation by China will be swift.

The EU is awaiting a ruling from the WTO regarding U.S. subsidies on Boeing, which is due early next year. That is when the EU plans to retaliate on Airbus-linked tariffs. The EU could retailiate sooner if the U.S. levies threatened tariffs on vehciles and parts in mid-November. New EU leaders are slated to take office on November 1 and have warned they will retaliate.

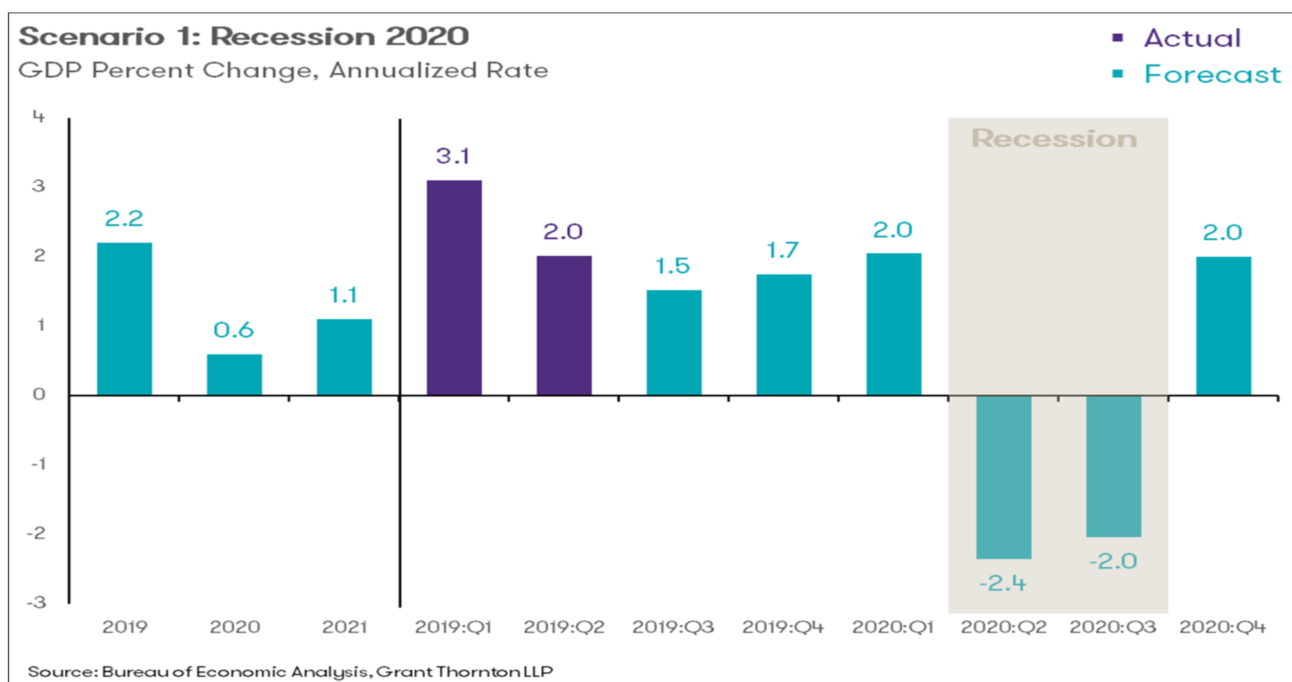
Hopes of passing the U.S.-Mexico-Canada Agreement (USMCA) have dimmed. Ratification could be delayed until 2021, after the 2020 elections.

Separately, the risk is rising that we could see another government shutdown when the continuing resolution expires on November 21. Few want another government shutdown, but skirmishes over funding for a border walll continue. That is what led to the government shutdown in December 2018.

Economic Consequences

Financial market volatility would surge, while credit conditions tighten. To contain the damage, firms could start cutting jobs as well as investment. A global recession cannot be ruled out. Germany, the backbone of Europe, is flirting with recession.

Chart 1



> "Fears of a recession propagated in the press and social media can prompt consumers to pull back before we see actual job losses."

Consumers would then pull back, although the drop in consumer spending is expected to be less than that in business investment. Homeowners rushed to take advantage of the recent drop in interest rates by refinancing, which along with a jump in the savings rate, has shored up their balance sheets.

The wild card is fear. Consumers' expectations about the future have deteriorated, even as their assessment of current economic conditions remains strong. This makes them more vulnerable to negative news shocks. The phenomena we are witnessing were most pronounced in the wake of 9/11. The pullback by businesses and consumers were what tipped the slowdown from the dot.com bust into a full-blown recession.

The shifts we are seeing are what Nobel Laureate Robert Shiller describes as **Narrative Economics** in a new book of the same title. Stories about the economy can go viral, especially given the advent of social media, which amplifies stories (accurate or not) and can create a self-fulfilling prophecy; fears of a recession propagated in the press and social media can prompt consumers to pull back before we see actual job losses.

The Fed Stimulates

The Fed will do all it can to avert a recession. Chairman Jay Powell has already begun the process of easing, despite substantial pushback among the Fed's ranks.

The timing of the next cut in rates is situational. If current fears in financial markets compound and credit markets tighten, then the Federal Open Market Committee (FOMC) will likely ease again at its next meeting on October 29-30. Powell has also mentioned concerns about a hard Brexit, which looks like it could occur on the October 31 deadline if the UK parliament does not find a compromise with the EU.

There were at least four regional Fed presidents who pushed back on rate cuts in both July and September. Three voting members of the FOMC actually dissented at the last meeting, with two opposing the cut and one arguing for a one half-percentage point cut; their ranks have increased since the last meeting. Dissents are rarely made in a vacuum; they usually represent the view of at least one nonvoting member of the FOMC.

So far, the divisions have not undermined the impact of rate cuts on the broader economy. They underscore that decisions on monetary policy are made by a committee, not just by one person. That helps to insulate the Fed against the whims of one person or a political party.

The Federal Reserve is expected to increase the size of its balance sheet again by boosting its holdings of short-term Treasuries as soon as October to deal with a technical glitch in the overnight lending market. It is unclear how much additional stimulus will actually be provided by large-scale asset purchases. Much of the drop in long-term rates is expected to be driven by a global flight to safety.

The Fed has honed many of the communications tools it experimented with during the financial crisis. We expect those to be used liberally. The FOMC will commit to keeping rates near zero for an indefinite period of time. Committee members found that putting dates on "forward guidance" limited the impact. The same is true for balance sheet operations.

Powell has said that negative rates are not a goal. That marks a turnaround from one year ago when some on the Fed stated a willingness to explore negative rates. Other countries' experiences with negative rates have not been good. Central banks that have used negative rates have been unable to escape them.

The larger issue is whether the Federal Reserve can avoid a recession entirely. That is doubtful, given how little leeway it has on cutting rates. It is also unclear how much another round of quantitative easing - large-scale asset purchases by the Fed - can accomplish. We will likely get more stimulus from the flight to safety in the U.S. Treasury market. That could lead to negative rates for some Treasury securities, even if the FOMC does not push the fed funds target into negative territory. Former Fed Chairman Alan Greenspan has **warned** of this possibility.

Fiscal Policy Falls Short

Fiscal policy would be better suited to offset emerging weakness. Tax cuts, federal spending increases and the surge in spending tied to entitlements - Social Security, Medicare and Medicaid - could limit funds available for stimulus. This is at the same time that efforts to extend unemployment insurance have been cut and pensions are eating up a larger portion of state and local budgets.

Partisan bickering over how to stimulate - via more tax cuts or increased spending - is another hurdle. Members of Congress can't even agree upon background checks for gun purchases, which Gallup says more than 90% of the public **support**. It is hard to imagine them coming together to stimulate the economy in a timely way.

Increases in Unemployment Rate will be Limited

Our forecast shows the unemployment rate moving up from a low of 3.5% in 2019 to 4.9% by the end of 2020. A rise in the number of retirees will help to slow the increase in unemployment by keeping participation in the labor force low. The number of highly skilled and highly educated workers will remain limited.

Scenario 2
Sustained but Slower Growth

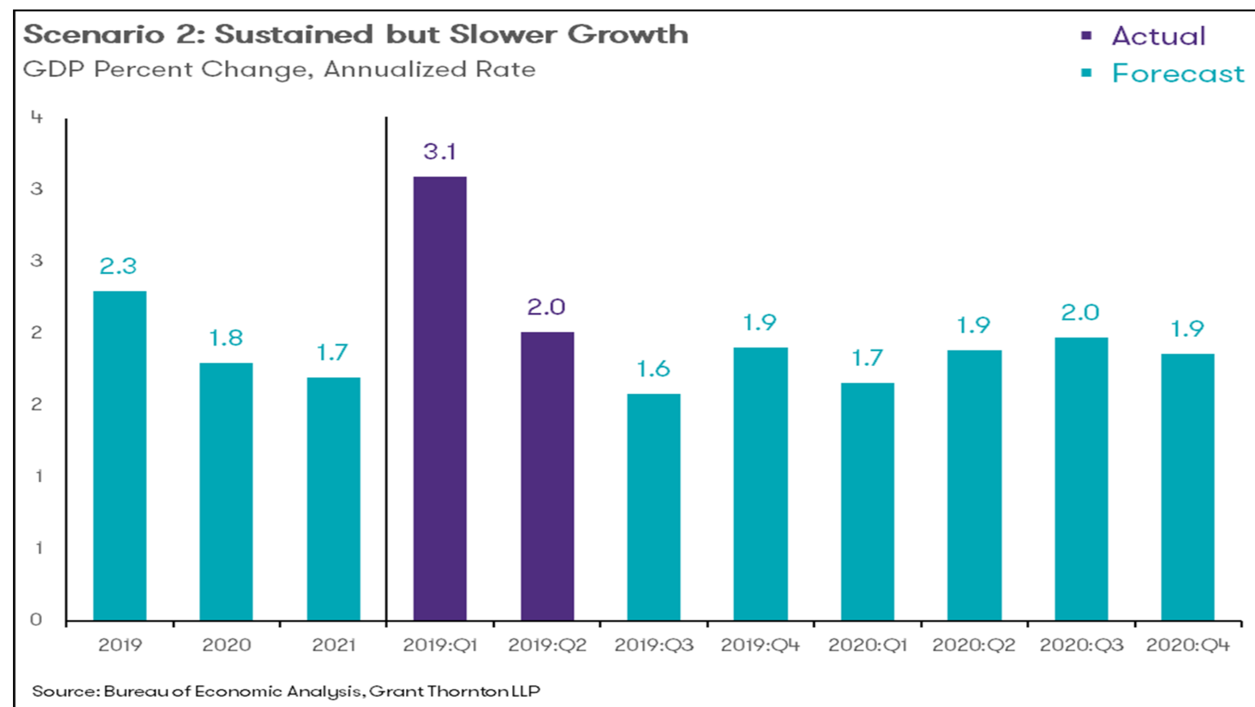
Chart 2 shows a more benign outlook. Growth slows but does not collapse. The assumption is that the president cuts a partial deal with China and rolls back some tariffs.

Economic Consequences

Financial markets will rally while credit conditions ease. Global supply chain disruptions will abate but not disappear. Improving business confidence will keep hiring afloat and spur investment.

Consumers, who have shored up their balance sheets, keep spending but at a slower pace. Employment growth will slow, as retirements pick up and labor markets tighten.

Chart 2



Fed Easing is Limited

The Fed cuts rates just once before the end of 2019. The goal is to sustain the expansion and run what has become known as a "**high-pressure economy**." This is an economy in which everyone who wants a job has a job as well as those who weren't even looking for work. The goal is to engage more of those on the sidelines with higher wages and training that tight labor markets produce.

Concerns within the Fed over financial bubbles will remain high, which will prevent the FOMC from lowering rates as far as some of the Fed's doves would like. The risk that the bursting of a financial bubble triggers the next recession goes up in such a scenario. The Fed is currently most concerned about bubbles in the commercial real estate sector and junk bond market.

Rate hikes are not expected to return before the cycle ends. Inflation has been slow to rise. Part of running a "high-pressure economy" is allowing inflation to run a bit above target for a while as the labor market continues to catch up on losses endured more than a decade ago; the wounds of the financial crisis run deep.

Fiscal Policy Treads Water

The current federal budget (if passed) will not provide the kind of boost to spending and the overall economy we saw in FY2018 and FY2019. This is in addition to the drag we are expecting to see from state and local governments.

Unemployment Stabilizes

The unemployment rate is expected to stabilize between 3.5% and 3.7% in 2020, while wages continue to slowly accelerate. Entry-level and part-time wages are expected to move up the most. Investment in training will also intensify. Firms will need to think more about retaining than retiring older workers and leveraging technology to bridge skills gaps.

Bottom Line

I came of age in the Detroit area, where vandals set the city on fire the night before Halloween. They called it "Devil's Night" for the havoc they wreaked. More than 800 buildings were set on fire by arsonists in 1984, which was the worst year on record. I remember a brief attempt to lower the official tally by counting fires that spread between buildings as one instead of two or more.

I raise that now because October has always left me with a chill. It is also the most volatile month for financial markets. I am not very superstitious, but most traders I know are. Either way, we will need to buckle up as the global trade war unfolds this month. A further escalation of trade tensions from the administration could act as an accelerant to an already combustable situation.

Economic forecast — October 2019

	2019	2020	2021	2019:2(A)	2019:3	2019:4	2020:1	2020:2	2020:3	2020:4	2021:1	2021:2
National Outlook												
Chain-Weight GDP[1]	2.2	0.6	1.1	2.0	1.5	1.7	2.0	-2.4	-2.0	2.0	2.0	1.5
Personal Consumption	2.6	1.4	1.6	4.6	2.7	2.2	1.9	-0.7	-0.7	1.5	2.5	2.1
Business Fixed Investment	2.4	-2.6	-1.0	-1.0	-1.3	1.0	1.6	-7.6	-10.9	-0.6	1.6	1.6
Residential Investment	-1.8	-0.1	-0.1	-2.9	3.4	4.0	0.5	-3.2	-4.2	-0.6	-0.6	0.5
Inventory Investment	80	-17	23	70	70	64	33	-25	-56	-19	2	21
Net Exports (bil $ '12)	-981	-956	-1016	-981	-998	-1000	-966	-980	-947	-932	-960	-995
Exports	-0.1	1.4	2.2	-5.7	0.3	1.1	8.7	-2.4	-2.0	2.5	3.3	3.6
Imports	1.7	0.3	3.3	0.0	2.2	1.0	2.2	-0.2	-5.1	0.1	5.8	6.7
Government Expenditures	2.0	1.7	0.7	4.8	0.2	0.7	2.3	3.1	0.7	0.5	0.7	0.4
Federal	3.2	3.3	0.1	8.3	1.9	1.1	4.5	6.4	0.3	-0.6	-0.2	-0.5
State and Local	1.3	0.8	1.1	2.7	-0.8	0.5	1.1	1.1	1.0	1.2	1.2	0.9
Final Sales	2.1	1.0	0.9	3.0	1.5	1.9	2.6	-1.3	-1.5	1.3	1.6	1.2
Inflation												
GDP Deflator	2.0	2.6	2.2	2.4	2.4	3.1	2.7	2.3	2.7	2.3	2.0	2.3
CPI	1.9	2.3	1.7	2.9	1.9	3.3	2.7	1.4	2.2	1.1	1.5	2.3
Core CPI	2.3	2.7	2.1	1.9	3.1	3.1	2.7	2.6	2.4	2.1	1.9	2.1
Special Indicators												
Corporate Profits[2]	0.1	-2.1	7.7	1.3	-1.0	0.1	4.0	-4.1	-5.4	-2.1	0.7	7.1
Disposable Personal Income	3.1	1.1	1.5	2.4	2.3	1.5	1.8	-0.4	-1.0	1.3	2.5	1.9
Housing Starts (mil.)	1.26	1.19	1.24	1.26	1.29	1.28	1.25	1.19	1.16	1.17	1.19	1.22
Civilian Unemployment Rate	3.7	4.0	5.0	3.6	3.6	3.7	3.6	3.8	4.2	4.5	4.8	4.9
Total Nonfarm Payrolls (thous.)[3]	1195	-1199	-200	133	515	252	244	-287	-694	-462	-212	-72
Vehicle Sales												
Automobile Sales (mil.)	4.8	3.9	4.5	4.8	4.8	4.6	4.3	3.6	3.4	4.2	4.4	4.4
Domestic	3.5	2.8	3.3	3.5	3.4	3.3	3.1	2.7	2.5	3.0	3.2	3.2
Imports	1.4	1.1	1.2	1.5	1.4	1.3	1.2	0.9	0.9	1.2	1.2	1.2
Lt. Trucks (mil.)	12.1	11.3	12.1	12.2	12.3	12.2	11.9	11.0	10.8	11.3	12.0	12.1
Domestic	9.7	9.2	9.9	9.7	9.9	9.9	9.7	9.0	8.8	9.1	9.7	9.9
Imports	2.4	2.1	2.2	2.4	2.4	2.3	2.2	2.0	2.0	2.2	2.3	2.2
Combined Auto/Lt.Truck	16.9	15.1	16.6	17.0	17.1	16.8	16.2	14.6	14.2	15.5	16.4	16.5
Heavy Truck Sales	0.5	0.4	0.5	0.5	0.5	0.5	0.4	0.3	0.3	0.4	0.4	0.4
Total Vehicles (mil.)	17.4	15.5	17.0	17.5	17.6	17.3	16.6	14.9	14.5	15.9	16.8	16.9
Interest Rate/Yields												
Federal Funds	2.2	0.5	0.1	2.4	2.2	1.7	1.3	0.5	0.1	0.1	0.1	0.1
10-Year Treasury Note	2.1	1.5	1.7	2.3	1.8	1.6	1.6	1.5	1.4	1.5	1.6	1.7
Corporate Bond BAA	4.4	4.1	3.9	4.6	4.0	4.2	4.2	4.3	4.1	3.9	3.9	3.9
Exchange Rates												
Dollar/Euro	1.12	1.13	1.16	1.12	1.12	1.12	1.12	1.13	1.14	1.14	1.15	1.16
Yen/Dollar	108.0	105.1	105.3	109.9	106.5	105.5	105.0	105.1	105.1	105.2	105.2	105.2

1. In 2018, GDP was $1863.8 billion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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