Grant Thornton

ECONOMIC CURRENTS

SEPTEMBER 06, 2019

Climbing a Wall of Worry in Jackson Hole

Diane C. Swonk, Chief Economist

"Are you more worried now than before you arrived?"

I asked that question of one of the 40 leaders of foreign central banks attending this year's Jackson Hole meeting. His answer, like many in the room, was "No, I was terrified before I came."

Central bankers the world over are climbing a wall of worry. They worry that low rates for longer will stoke asset price bubbles. They worry about whether rules (e.g., numerical formulas) guiding policy are a safe way to go in a world where the old rules of thumb no longer apply. Central banks represent islands in an ocean in which the tides are constantly shifting in response to the actions of their neighbors. Shifts by the Federal Reserve have significant spillover effects, which are affecting emerging and developed economies alike.

Central bankers worry that they lack "**a rulebook**" for dealing with trade wars, which can escalate in the speed of a single tweet. The policy uncertainty it triggers is undermining decision-making and business investment. Firms are reluctant to place their bets when the rules of the game can change so rapidly.

Banking officials worry that they will not have the tools necessary to offset a recession, with rates already low and in some cases negative. They worry that unconventional policies, such as large scale asset purchases and negative rates, will become conventional. Federal Reserve Chairman Jay Powell already admitted as much in a speech in **June**, when he argued the Fed should "retire the term 'unconventional'".

Uncertainty Dominates the Outlook

Real GDP is forecast to grow at a 1.9% pace in the third quarter, a 0.7% slowdown from the first half of the year. Consumers held strong in July, but business investment continued to weaken. Manufacturing was hit by tariffs and weakness abroad; deliveries by Boeing were delayed beause of problems with the 737 Max; and, bankruptcies in the shale industry are surging. The trade deficit is expected to widen. The silver lining is government spending, which will end the quarter on a high note.

Real GDP growth is expected to slow to a 1.7% pace in the fourth quarter but downside risks are mounting. If trade talks with the Chinese do not go well in October, we could see even more tariffs before year-end. The president is also threatening more tariffs on the European Union (EU), while the fate of the UK and its trade relationship with the EU remains unknown. October could be another rough month for financial markets.

Fed Cuts Reluctantly. The Federal Reserve is expected to cut rates three more times in 2019. This would mark a reversal of the rate hikes in 2018, and faces pushback within the Fed. That forecast is contingent upon a hard Brexit. A move to levy additional tariffs by the president on the EU is possible, which could be another factor prompting the Fed to ease.

“We are experiencing a series of major political shocks. And those political shocks are turning into economic shocks.” - Philip Lowe, Reserve Bank of Australia Governor

They worry about communications and what role they should play in guiding policy. Some central banks have more credibility than their peers in connecting the dots between their decisions and what they mean to the public. The Federal Reserve does not top the list.

At the end of the day, central bankers worry that our elected officials will fail us when we need them most, inspiring chaos instead of calm, failing to invest in new infrastructure and kicking the can down the road on structural reforms - particularly investments in education and training - that would boost productivity growth and pull us out of the low growth rut where we have fallen.

I can’t imagine a better place to express those concerns than at the base of the Grand Teton Mountain at the Jackson Lake Lodge. The rooms are modest, the discussions rich and the views priceless. One has a hard time escaping a sense of humility at the foot of such majesty.

This edition of ***Economic Currents*** provides my takeaways from the Kansas City Fed’s annual meeting in Jackson Hole, Wyoming. Special attention will be placed on how the Fed is likely to incorporate that debate into deliberations on rate cuts. Most of the governors and regional presidents of the Fed attended. That said, the consensus to cut rates gradually as a hedge against future weakness is fragile. Some walked away from the meeting wanting to wait for more evidence of a slowdown before cutting rates again, while others dug in on their belief that a half-point cut in rates is necessary.

10 Takeaways

1. Bubbles. Long expansions coupled with long periods of low rates tend to encourage investors to take greater risks, for which they are not always fully compensated. The housing bubble of the early 2000s marked an extreme example of such behavior. Fed Chairman Powell argued that is not the Fed’s primary job. He said point blank that “we [the Fed] cannot prevent people from finding ways to take excessive financial risks.”

That said, there is a significant minority of regional Fed presidents who disagree with Powell. They pushed back hard on a quarter-point rate cut in July for fears of stoking financial bubbles. They are worried about everything from commercial real estate to corporate debt and the broader reach for yield.

Low rates for longer also tend to keep less efficient firms from restructuring when they should, which undermines overall productivity growth. In the extreme, zombie firms emerge, which can siphon resources from more productive firms. This happened in Japan in the 1990s.

2. Rules. In theory, central banks that are guided by clear-cut formulas on where inflation and the unemployment rate should be are less susceptible to political pressure. They just adjust interest rates to meet targets. The problem is that those targets move.

Aging demographics, low productivity growth and low inflation have all lowered the bar for what is considered the neutral rate on short-term interest rates. This has opened the door to interpretation. Some within the Fed feel they have reached the neutral rate and that cuts from here on out will be stimulative. Others argue that the Fed overshot on rate hikes and now needs to lower rates to reach neutral. In response, the Fed is forced to guess the neutral level of short-term rates, which opens the door to debate and criticism.

3. Catch-up. One of the few rules the Fed has explicitly agreed upon is a symmetric inflation target. Inflation has fallen persistently below the Fed’s target since its inception in 2012. That means it is willing to allow inflation to rise above its target for a period of time to allow the economy to recoup earlier losses. The shortfall in inflation is one of the three reasons the Fed cited fcr cutting rates a quarter percent in July. Powell underscored that “Low inflation seems to be the problem of this era, not high inflation.”

President John Williams of the New York Fed, who gets to vote at every meeting, repeated that same statement in a speech he gave on the outlook for monetary policy on **September 4.** He clearly supports the chairman with additional rate cuts, given the ongoing shortfall in inflation and weakness we are seeing abroad. Presidents James Bullard and Neel Kashkari of the St. Louis and Minneapolis Feds respectively support more aggressive cuts.

A significant minority believe the slowdown we are seeing in inflation is transitory. One-time factors, such as a shift in how clothing prices are measured, will soon play out. They would like to wait and see whether the rate cut in July will boost inflation.

4. Spillover Effects. What the Fed does affects other economies and is currently returning to the U.S. as weak exports and financial turmoil. The Institute for Supply Management (ISM) Index fell below the 50% threshold in August, signalling a contraction in the U.S. manufacturing sector.

Emerging markets are particularly sensitive to shifts in rates by the Fed. They hold dollar reserves, price contracts in dollars and issue more dollar-denominated debt than developed economies. That works to their advantage when everyone is growing and keeping rates low. Problems arise when the Fed moves out of sync with the rest of the world, which is what occurred in 2018. That is when the tradeoffs between growth and inflation get more difficult. Emerging economies can:

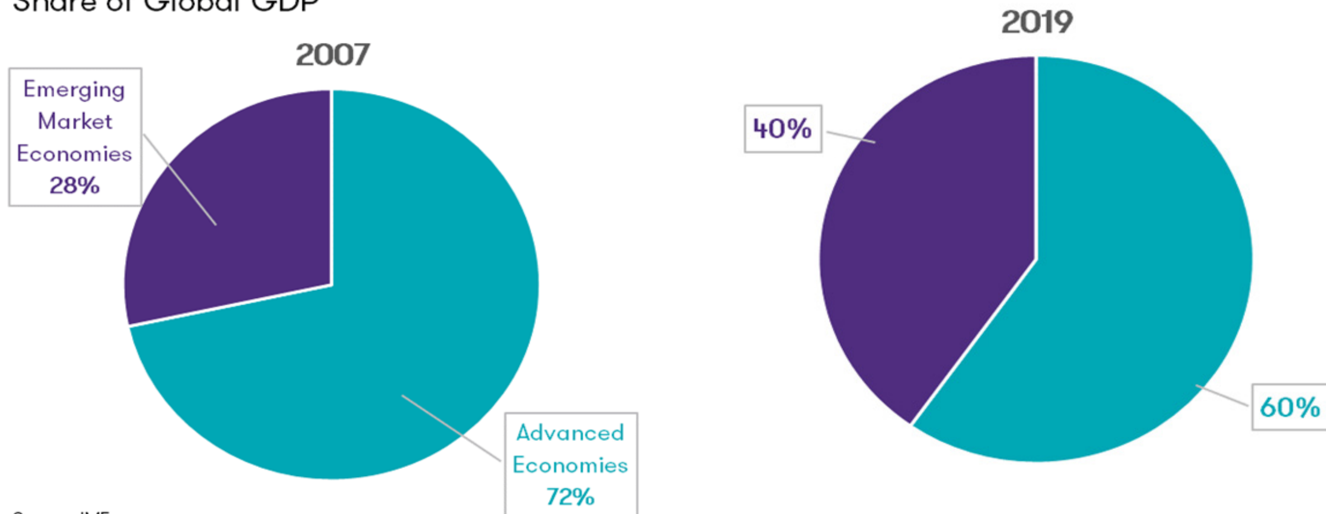
- Raise rates to defend the value of their currencies on foreign exchange markets, which could trigger a worse slowdown or contraction in growth;
- Endure depreciation in their currencies and related surge in inflation, which will significantly increase their costs of servicing their debt.

Most suffer some combination of both. The result can be extreme. Argentina is once again teetering on the brink of bankruptcy in part because of its response to the downward pressure rate hikes in the U.S. exerted on its currency and economy. This is at the same time that the emerging market share of the global economy is rising. That share is rapidly approaching 50%. (See Chart 1.)

Developed economies, which rely heavily on exports to emerging markets, are also suffering. Germany, the backbone of Europe, has already seen one quarter of contraction. Germany is looking to stimulate its economy, but not enough to lift its own fortunes, let alone those of counterparts in Europe. (What Germany considers stimulus is considered stingy to everyone else in the eurozone.)

In response, other central banks have already signalled that they will ease in the weeks and months to come. The European Central Bank (ECB) is up first on September 12. The Fed is also lowering rates, but not as fast as many would like. Other central banks want the Fed to undo its 2018 rate hikes.

Chart 1 Emerging Markets Represent an Increasing Share of Global Economy



Source: IMF

5. Trade Wars. Recent **research** at the Peterson Institute for International Economics reveals that 55 political parties in the Group of 20 (G20) nations have adopted more nationalist and protectionist policies. Brexit and the U.S. trade war with China are merely accelerants to that trend. The goal is to stop the flow of goods and people across borders and subsidize favored industries.

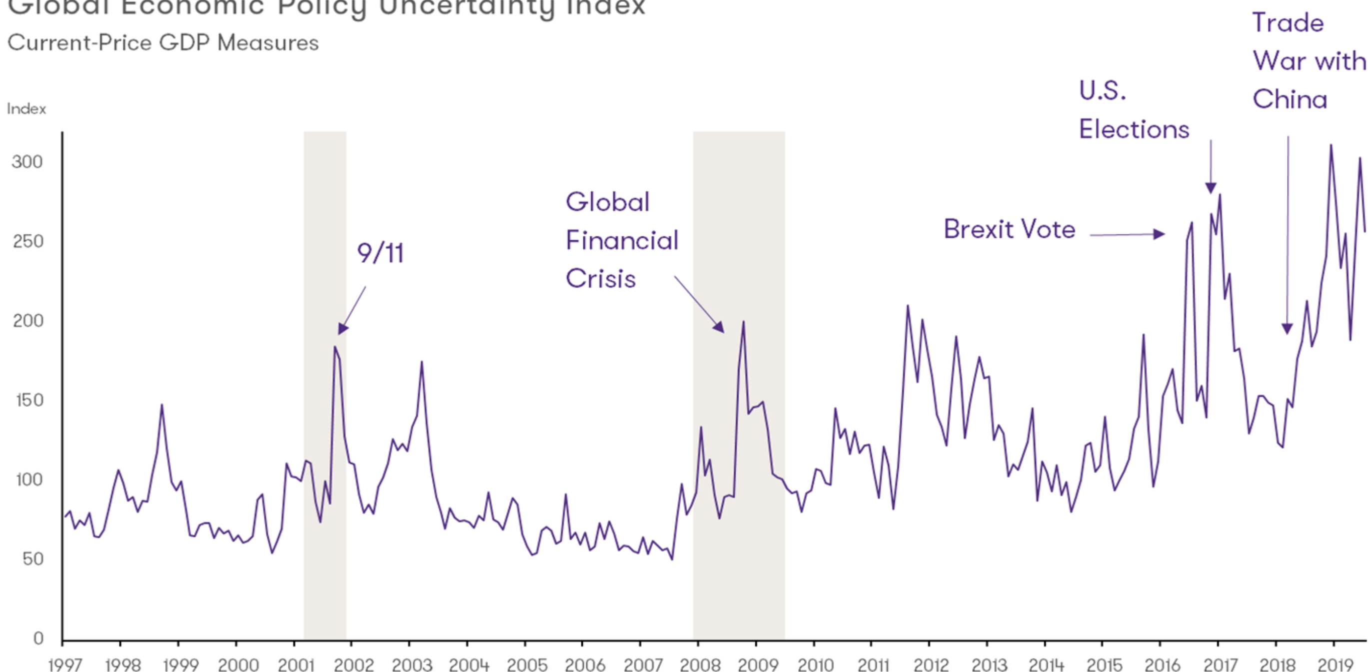
The shifts we are experiencing are not new - they dominated the politics of the 1920s and 1930s and were factors contributing to WWII. What is new is the role that central bankers have been asked to play in offsetting the costs of these policies. There is, as Powell pointed out, no rule book for central bankers to deal with such disruptions to international trade.

Philip Lowe, Governor of the Reserve Bank of Australia summed it best at the conclusion of his panel. "We are experiencing a series of major political shocks, and those political shocks are turning into economic shocks."

6. Policy Uncertainty. Policy uncertainty and the role it plays in affecting the economy has been a focus of the Jackson Hole meetings since 2003. The sharp drop in business and consumer confidence following the terrorist attacks of 9/11 crystallized the need to expand research on the impact uncertainty has on the broader economy. One would be hard-pressed not to find some mention of policy uncertainty in any central banker speech these days. Chart 2 shows global uncertainty exceeding the highs hit during the financial crisis; it is now ubiquitous.

Powell admitted that the Fed is not sure how to stem the uncertainty but underscored that the Fed has to deal with the weakness it triggers. Fed **researchers** recently estimated that policy uncertainty shaved 0.8% from the level of U.S. GDP growth in the first half of 2019. They estimate it could take more than 1% from GDP growth in the first half of 2020. The worst case scenario would be a self-fullfilling prophecy, when a collapse in confidence triggers a pullback in economic activity.

Chart 2 Policy Uncertainty is Approaching a New Peak



December 2018 provided the Fed with a cautionary tale. Consumer and business confidence collapsed on threats of a full-blown trade war with China and fears that the Fed was asleep at the wheel. Retail sales contracted during the height of the holiday season; some retailers said that consumers disappeared for a full week in December. At the same time, factory orders slowed noticeably.

7. Limits. The Fed is worried that its ability to stimulate is limited with rates already so low. A slim majority are willing to make small, quarter-point adjustments today to hedge against the risks of weaker growth down the road. Some oppose that entirely and would prefer to hold their fire until we see the whites of the eyes of an actual recession. Most will accept some combination of both minor cuts today to hedge against downside risks, followed by more aggressive half-point cuts when the economy falters.

8. Unconventional Policies. All within the Fed agree that they will have to engage in large scale asset purchases once the Fed hits the zero bound on interest rates. The jury is still out on whether the Fed goes negative on rates as we have seen abroad. The backlash from the banks would be greatest, but there is more sympathy for such policies than in the past, at least within the Fed. Powell and some regional presidents have expressed support.

9. Communications. Communications are another tool but one that is getting harder to leverage, especially when views within the Fed are so fragmented. Powell was visibly shaken in the wake of the July FOMC meeting when he struggled to convey the spectrum of the debate. Four participants wanted to hold the line on rates, two wanted to cut by a more aggressive half-point, while a slim majority supported a quarter-point cut.

We would need to see a much more dramatic deterioration in economic and market conditions before the next FOMC meeting on September 17-18 to bring the Fed together. That is not likely, given the small number of data points we will see between now and then.

Bullying by the White House to cut rates more aggressively further complicates the Fed's messaging because it blurs market perceptions of the Fed's intent. Some market participants believe that the Fed is capitulating to the president by cutting rates.

10. Other Levers. One would hope our political leaders would step in with fiscal stimulus, should our economies falter. Already high levels of public debt are a hurdle. Infrastructure investments would pay off the most in the long-term, especially in light of the low cost of financing such projects. There is less of an appetite for that than for the tax cuts.

Deep political divides are now the norm across most of the developed economies. The current spectacle in the UK is particularly worrisome. One hopes the political brinkmanship will prevent a hard Brexit from occurring, but there is simply no way to know. Our forecast assumes a hard Brexit; hence, we have added an October rate cut.

Bottom Line

Members of the FOMC are increasingly finding themselves stuck between a rock and a hard place. If they cut rates, which they are expected to do, they risk stoking financial bubbles in the U.S. If they don't, they risk pushing the U.S. further out of sync with the rest of the world, which creates a negative feedback loop via weaker growth abroad. Add the flight to safety, which is complicating matters by inverting the yield curve and pushing up the value of the dollar on foreign exchange markets, and the risk of a recession rises even as the Fed cuts.

The only real way out of the current malaise is an immediate cessation of trade tensions, and repeal of tariffs. That could happen, but would require humility in our political leaders. "Humble" is not a word I would use to characterize our political leadership at home or abroad.

Economic forecast — September 2019

	2018(A)	2019	2020	2018:4(A)	2019:1 (A)	2019:2(A)	2019:3	2019:4	2020:1	2020:2	2020:3	2020:4
National Outlook												
Chain-Weight GDP[*]	2.9	2.3	0.6	1.1	3.1	2.0	1.9	1.7	1.5	-1.9	-1.3	1.6
Personal Consumption	3.0	2.7	1.3	1.4	1.1	4.7	3.6	2.2	1.7	-1.0	-1.0	1.4
Business Fixed Investment	6.4	2.4	-1.2	4.8	4.4	-0.7	-2.6	3.0	1.9	-5.1	-5.4	-2.2
Residential Investment	-1.5	-2.2	-2.1	-4.6	-1.1	-2.8	1.7	1.1	-1.3	-5.1	-7.3	-2.7
Inventory Investment	48	78	-23	93	116	69	76	51	11	-50	-45	-7
Net Exports	-920	-981	-963	-983	-944	-982	-1001	-997	-981	-968	-959	-942
Exports	3.0	-0.1	1.9	1.5	4.1	-5.8	0.1	2.3	7.0	-0.2	-0.1	3.4
Imports	4.4	1.7	0.9	3.5	-1.5	0.1	2.2	1.2	3.1	-1.6	-1.1	0.6
Government Expenditures	1.7	2.0	1.8	-0.4	2.9	4.5	0.1	0.8	2.6	3.3	0.7	0.5
Federal	2.9	3.1	3.2	1.1	2.2	8.1	1.7	1.3	4.1	6.4	0.3	-0.7
State and Local	1.0	1.2	1.0	-1.2	3.3	2.3	-0.9	0.5	1.6	1.3	1.0	1.2
Final Sales	2.8	2.1	1.1	1.0	2.6	3.0	1.8	2.2	2.2	-0.8	-1.4	0.9
Inflation												
GDP Deflator	2.4	2.0	2.6	1.7	1.0	2.4	2.4	3.1	2.4	2.7	2.7	2.3
CPI	2.4	1.8	2.4	1.6	0.8	2.9	1.9	2.5	2.8	2.2	2.5	1.4
Core CPI	2.1	2.2	2.6	2.2	2.2	1.9	2.9	2.6	2.9	2.7	2.4	2.2
Special Indicators												
Corporate Profits[**]	4.2	2.3	-1.9	4.2	-2.2	2.7	1.4	2.3	6.2	-2.9	-4.6	-1.9
Disposable Personal Income	4.0	3.2	1.1	2.8	4.5	2.5	2.5	2.4	1.2	-0.4	-0.7	1.1
Housing Starts (mil.)	1.25	1.22	1.15	1.2	1.2	1.3	1.2	1.2	1.2	1.1	1.1	1.2
Civilian Unemployment Rate	3.9	3.7	4.1	3.8	3.9	3.6	3.7	3.6	3.6	3.9	4.3	4.6
Total Nonfarm Payrolls (thous.)[***]	2365	1359	-930	674	295	98	691	275	292	-241	-584	-397
Vehicle Sales												
Automobile Sales (mil.)	5.3	4.7	3.9	5.3	5.0	4.8	4.6	4.4	4.3	3.6	3.4	4.2
Domestic	4.1	3.5	2.8	4.1	3.8	3.6	3.4	3.2	3.1	2.7	2.5	3.0
Imports	1.2	1.2	1.1	1.2	1.1	1.2	1.2	1.2	1.2	0.9	0.9	1.2
Lt. Trucks (mil.)	11.9	12.1	11.3	12.1	11.8	12.2	12.3	12.1	11.9	11.0	10.8	11.4
Domestic	9.2	9.5	9.1	9.4	9.2	9.7	9.7	9.6	9.5	9.0	8.8	9.1
Imports	2.8	2.6	2.2	2.8	2.7	2.5	2.6	2.5	2.4	2.0	2.0	2.3
Combined Auto/Lt.Truck	17.2	16.8	15.2	17.4	16.8	17.0	16.9	16.5	16.2	14.6	14.2	15.6
Heavy Truck Sales	0.5	0.5	0.4	0.5	0.5	0.5	0.6	0.5	0.4	0.3	0.3	0.4
Total Vehicles (mil.)	17.7	17.3	15.5	17.9	17.3	17.5	17.5	17.0	16.6	14.9	14.5	16.0
Interest Rate/Yields												
Federal Funds	1.8	2.1	0.6	2.2	2.4	2.4	2.2	1.7	1.3	0.7	0.1	0.1
10-Year Treasury Note	2.9	2.1	1.6	3.0	2.7	2.3	1.7	1.5	1.4	1.5	1.7	1.8
Corporate Bond BAA	4.8	4.4	4.2	5.1	5.0	4.6	4.0	3.9	3.9	4.1	4.3	4.3
Exchange Rates												
Dollar/Euro	1.18	1.12	1.13	1.14	1.14	1.12	1.12	1.12	1.12	1.13	1.14	1.14
Yen/Dollar	110.4	109.3	108.6	112.8	110.2	109.9	108.5	108.5	108.5	108.5	108.6	108.6

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.

Copyright © 2019 Diane Swonk – All rights reserved. The information provided herein is believed to be obtained from sources deemed to be accurate, timely and reliable. However, no assurance is given in that respect. The reader should not rely on this information in making economic, financial, investment or any other decisions. This communication does not constitute an offer or solicitation, or solicitation of any offer to buy or sell any security, investment or other product. Likewise, this communication serves to provide certain opinions on current market conditions, economic policy or trends and is not a recommendation to engage in, or refrain from engaging, in a particular course of action.

"Grant Thornton" refers to Grant Thornton LLP, the U.S. member firm of Grant Thornton International Ltd (GTIL), and/or refers to the brand under which the GTIL member firms provide audit, tax and advisory services to their clients, as the context requires. GTIL and each of its member firms are separate legal entities and are not a worldwide partnership. GTIL does not provide services to clients. Services are delivered by the member firms in their respective countries. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions. In the United States, visit grantthornton.com for details.

© 2019 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd