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Treading Cautiously in 2019

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My husband and I have a home on the shores of Lake Michigan. When the temperatures plummet, the waves freeze along the beach. Families with children traverse the ice to admire them. But heavy snow can make it difficult to tell where the ice thins or ends.

I feel a pit in my stomach every time I see a family walking towards the lake. As far as I am aware, no one has fallen in, but it is the risk of a misstep that I fear.

I feel that same sense of unease about the outlook for 2019. There is no fundamental reason for the economy to slip into a recession this year, but the risk of a misstep or an external shock is clearly rising.

This edition of **Economic Currents** looks at why the economy is expected to slow in 2019. The forecast is even weaker today than it was a month ago, despite a blockbuster December employment report and what was likely a blowout holiday shopping season. Special attention will be placed on the how the Federal Reserve will react to the changing economic landscape. The Fed is now expected to raise rates only once this year before being forced to reverse course and cut rates at year end.

The forecast for a recession in the first half of 2020 holds. Soft landings for the Fed are a bit like unicorns. They require more luck than skill, and are more imaginary than real.

Recession risks could be alleviated by a more predictable path of policy decisions and resolution of differences by our elected officials in Washington. Pigs might also fly.

Bracing for Slowdown

The economy is expected to slow from a 3% pace in 2018 to a 2-¼% pace in 2019. Consumer spending is expected to moderate now that tax cuts and the boost from lower oil prices have played out. Housing is expected to contract, business investment should suffer a temporary blow from the oil price rop we saw last year, and the trade deficit will widen further.

The silver lining is federal government spending, which is slated to pick up once the government reopens. Gains should be fairly strong through the third quarter. Then, all bets are off as a split Congress and the administration will have to agree on a fiscal year 2020 budget.

We could also get a temporary boost to exports as China resumes its purchases of soybeans and lowers its tariffs on vehicle imports. The sticking point is vehicle sales in China, which have peaked after driving global demand for years.

The Fed Lays Low

The Fed has already lowered its forecast for rate hikes in 2019 from three to two. I expect that will fall to one when they redo their forecast for the year at their March meeting. Chairmain Powell and his colleagues are treading cautiously in the face of rising uncertainty regarding the depth slowdown.

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The Case for a Slowdown

1. Policy uncertainty is intensifying at home and abroad.
Trade tensions between the US and China represent one of the greatest sources of unease, given the potential impact on the rest of the world. Both countries would benefit from detente; some sort of deal seems likely. The sticking point is enforcement, which requires verification and time.

To keep the Chinese honest in their commitments, the administration is expected to keep most, if not all, of its existing tariffs on Chinese imports in place, at least for a while. In fact, the administration has maintained every tariff it has levied even after tentative agreements on trade have been reached. This, coupled with the need for major reforms by China, suggests that the relief we derive from any deal could be short lived. It is much easier to say you are going to make fundamental changes to the way you do business than to actually implement them. Many of the infractions that we worry most about with China, such as intellectual property theft, are institutionalized.

The new NAFTA, which was a heavy political lift prior to the midterm elections, has yet to be ratified. It will be even harder to get passed now that Congress is split and the administration’s ire regarding security along the border with Mexico has flared. In the last month alone, the president has threatened to pull out of NAFTA, close the border with Mexico, and declare a state of emergency to fund a border wall.

Negotiations on tariffs with Europe and Japan on vehicles and parts remain an unknown. The EU was able to postpone tariffs while it negotiated in good faith with the US. The emphasis the US now places on bilateral, as opposed to multilateral, trade deficits ups the ante of a misstep. Germany, which has a deficit with the US, has benefitted from a weak euro.

Shifts in the euro reflect economic conditions in the overall eurozone, not Germany alone. Germany can’t do much to level the playing field without the help of the rest of Europe, which is not very happy with German hegemony at the moment.

The United Kingdom (UK) looks like it could be headed for a “hard” or “no deal” Brexit with the European Union (EU.) The UK has until March 29 to accept, alter, or opt out of the EU entirely. Prime Minister Theresa May has already delayed a vote on the agreement she negotiated with the EU because Parliament would have rejected it.

Why do we care? Because uncertainty about economic policy has a price. It has already delayed investment decisions and spurred market volatility; in the extreme, it could ignite fear and panic.

2. Growth abroad is slowing.
Trade tensions, an end to monetary easing and tighter fiscal conditions are all putting a damper on the outlook for growth abroad. The slowdown in China is particularly worrisome as it is the world’s second largest economy, with tentacles extending into nearly every other economy. What happens in China does not stay there. Apple’s recent warning of a sharp slowdown in iPhone sales is an example of how the US is affected by China’s economy.

This marks a sharp reversal of the narrative at the start of 2018, which was one of synchronous global growth. The onus is on the US to carry global growth, which means larger US trade deficits, a flashpoint for the administration.

3. Fiscal stimulus in the US is abating.
The 2018 cut to corporate taxes boosted profits dramatically, but sets the stage for harder year-over-year comparisons in 2019. Gains in productivity growth could have eased the transition, but the capital investments that many expected in response to tax cuts never materialized. Now, companies will likely focus their efforts on reigning in rising costs. Tariffs are expected to hit in full in the first quarter, while wage growth is accelerating. A slowdown in hiring could result.

Some clients have already told me that they have turned down business instead of hiring up. A slowdown in orders for 2019 is another concern.

Separately, the boost to consumer spending associated with the tax cuts is playing out. The bulk of those cuts went to the wealthiest households; luxury items and services will be hit hardest.

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Federal spending is slated to remain strong until the start of the government's 2020 fiscal year on October 1, 2019. Federal spending will contract if additional funding is not approved. Prior to the partial government shutdown, hope had surfaced for bipartisan support for an infrastructure bill to repair and upgrade crumbling roads and bridges. That seems unlikely given the gridlock we are now facing.

The deficit, which has ballooned over the last year, is another sticking point. The Senate seems to have realized that the tax cuts didn't pay for themselves; they are now not as inclined to boost spending as they were in the aftermath of the tax cuts.

4. Surveys suggest that business activity is slowing.

The ISM surveys for manufacturing and non-manufacturing both softened in December. The slowdown in the manufacturing index, which hit its lowest level in 15 months, was the most dramatic. Weakness in orders abroad and concerns about the pinch associated with tariffs were the primary reasons.

The ISM non-manufacturing index held up better, buoyed by tourism and spending during the holiday season. Weakness was in the oil and real estate industries. The contraction in investment associated with the last major drop in oil prices was substantial. This time around, the effects should be more muted, but it will still be negative once the initial boost to consumer spending plays out.

Inventories are also too high in the ISM non-manufacturing index. Stockpiling ahead of a potential increase in tariffs likely added to the problem. A drawdown of those inventories will place a drag on overall growth.

5. Corporate debt is mounting.

Corporate debt has reached a new record. The **Fed** and the **OCC**, which regulate banks, have both raised concerns about easing credit standards in the issuance of corporate debt in recent months.

The greater threat to the economy is the surge in junk bonds. Triple-B rated bonds, which are the riskiest of junk bonds, have grown from $750 billion in 2007 to nearly $2.7 trillion today.

Much of that increased liquidity has come from institutional and retail buyers reaching for yield in a low interest rate environment. So far, they have weathered a jump in credit downgrades and losses fairly well, but no one knows how they will respond as defaults pick up in response to higher interest rates. Many of these companies were only able to survive because of cheap credit. They did little to change their business plans when the economy was expanding and they are ill-prepared to weather a slowdown, let alone a downturn.

Separately, funding for commercial real estate is expected to tighten as we move into the year, eventually putting a damper on commercial construction. Projects in the pipeline will gradually dry up.

6. Home and vehicle sales have peaked.

These tend to be the sectors that we look to as the canary in the coal mine when it comes to predicting recessions. The good news is that both categories of spending can peak a year or more ahead of the overall economy. The bad news is that both appear to have peaked in late 2017.

Housing is the weaker of the two. Years of rapid appreciation coupled with rising mortgage rates have taken a toll on affordability. Ballooning student debt is another hurdle that millennials face. The generation hit hardest by the crisis is also the most indebted before they enter the workforce and can contemplate buying a home.

A recent **survey** by mortgage behemoth Fannie Mae reported a sharp drop in the percent of Americans who believe that now is a good time to buy a home. In December, only 11% of survey respondents believed that to be the case, compared with a high of 37% in March of 2018. Those expecting the housing market to further appreciate also fell during the month. Few want to invest in an asset that could depreciate in value, especially in the wake of the housing bust and the collateral damage it wreaked on household wealth following the financial crisis.

The vehicle industry doubled down on leasing to buoy sales over the last two years, which creates its own set of problems. A surge in the number of vehicles coming off lease in 2019 will suppress trade-in values and hurt new vehicle sales at the same time that the price hikes associated with tariffs are expected to bite.

7. Immigration is expected to slow.

Immigration's role in supporting labor force growth is abating. The result will inhibit labor force growth and exacerbate labor shortages across a broad spectrum of industries. The agriculture, leisure and hospitality, home builders and tech sectors are among the most affected.

Legal immigrants who are here to work are falling as a share of the labor force, while border crossings, a proxy for illegal immigration, are close to a multi-decade low. (See Charts 1 and 2.) Border apprehensions did pick up from a 17-year low in 2018. A push by the administration to apprehend and arrest more people who cross the border contributed to the increase. It is also important to note the increase in border apprehensions of asylum seekers, who are escaping escalating violence in a few key Latin American countries. Border crossings from Mexico specifically have actually slowed dramatically.

Moreover, the situation is expected to get worse. The administration has curbed the ability of spouses of H-1B visa holders to work, making it more difficult for two income households to migrate to the US. This is occurring at the same time that prospects for comprehensive immigration reform look slim. Large differences in what should be done about immigration exist both across and within the two parties.

8. Populism and protectionism will spread.

Elections in Italy, Mexico and Brazil and the backlash to President Macron in France affirmed the spread of populism in 2018. Ray Dalio of Bridgewater has **written** one of the more accessible and easy to understand explanations of populism and what it means to the global economy. He also argues that populism will overshadow monetary and fiscal policy in determining the trajectory of the economy. I agree.

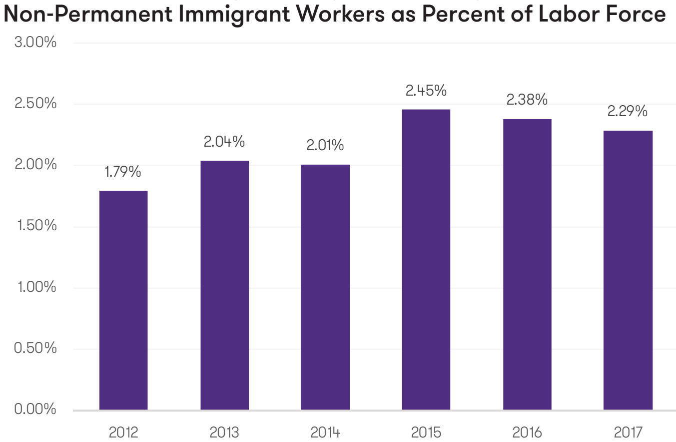
Populists tend to rule by exclusion as opposed to inclusion. They favor nationalist and protectionist policies that foment divisions within and across country borders, causing widespread disruptions to the economies they preside over as well as their trading partners. Initially, populist policies can stimulate growth, but only at the expense of growth down the road. The aim is ultimately to limit cross-border interactions to issues of sovereignty and security instead of commerce.

Populists also seed corruption and cronyism in their administrations as they rely on gatekeepers (with influence) over market forces to guide their economies. The result is even less competition and reductions in efficiencies and growth. The greatest benefit is to those closest to the power.

9. Entropy will intensify.

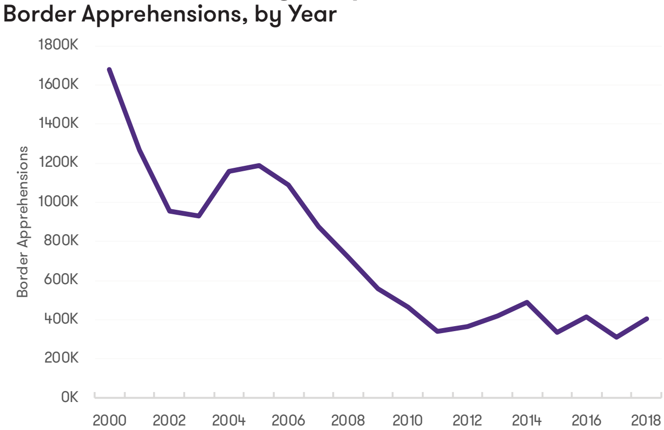
In the year ahead, everything from a split Congress to the Mueller probe is expected to fuel partisanship and deepen the divide within and between the two parties. The failure of our elected officials to keep the government open is just one, of what could be many, costly missteps to come.

Chart 1. Curbs to Legal Immigration Biting
Non-Permanent Immigrant Workers as Percent of Labor Force



Non-permanent immigrant workers estimated as sum of EAD holders and work (e.g. H-1B, L1) visa holders. **Source:** U.S. Department of Homeland Security. **"Yearbook of Immigration Statistics 2017"** (Table 25), **"Number of Approved Employment Authorization Documents, by Classification and Basis for Eligibility"**

Chart 2. Border Crossings Drop to Multi-Decade Lows
Border Apprehensions, by Year



September 2018 data is estimated using southwest border apprehensions data. **Source:** U.S. Border Patrol. **"Nationwide Illegal Alien Apprehensions Fiscal Years 1925 - 2017", "U.S. Border Patrol Southwest Border Apprehensions by Sector FY2018"**

The president has responded by threatening to increase his use of executive authority. In the last month alone, he has threatened to pull out of NAFTA, close the border with Mexico and declare a state of emergency to fund a border wall. Any one of those could come at a large cost to the economy as a whole. At the very least, it will further propel the uncertainty on the policy front, despite improving economic conditions.

The chaos that could emerge from any of these events could also test the limits of the judicial system, and further undermine confidence in our institutions. That includes freedom of the press, which for all its faults, is still society's largest arbiter of separating fact from fiction.

The latter point is too often lost in translation. One needs to follow the rules of the road and know where the potholes are located to move forward with confidence instead of caution.

The Powell Pivot

Fed Chairman Powell effectively shifted the focus of monetary policy from normalizing rates to hedging against downside risks to during his comments at the American Economic Association annual meeting in Atlanta on January 4. He emphasized four key themes:

1 Rate hikes are not on a "preset path," which means the Fed is not locked into the consensus of two rate hikes that emerged from its December meeting.

2 The Fed can be "patient," or pause before raising rates again.

3 The Fred will not hesitate to "shift" its stance on policy and cut rates if necessary.

4 Reductions in the Fed's balance sheet could be halted (or reversed) if they became too disruptive to financial markets.

Miscommunication by Chairman Powell following the December 19 rate hike roiled financial markets. Financial conditions tightened as a result. His clarifications set the record straight and financial markets rallied.

What does the Fed do next? The Fed will hold the line and see where economic indicators move during the first half of 2019. Delays and disruptions to the data created by the government shutdown further underscore the need for caution as the new year gets underway.

We expect a further drop in unemployment and some firming of inflation by mid-year, which could open the door to one rate hike. There will be pushback within the Fed, and at least one dissent, given the composition of voters on the Fed. St. Louis Fed President Bullard is rotating onto the FOMC this year, and he has been opposed to rate hikes for some time.

A weakening of growth in the fourth quarter, exacerbated by a drop in federal spending are expected to prompt the Fed to reverse course and ease at year end. Short-term interest rates could end the year where they started, in a target range of 2-¼ to 2-½%.

The Fed is also expected to put a hold on its balance sheet operations, which should alleviate some of the upward pressure on long-term interest rates. The full effects of those shifts will not show up until 2020.

The risk is that the Fed fails to ease in response to a slowdown in growth, given the inherent lag in the data. By the time they see the weakness, it is usually too late. The Fed had been more effective stabilizing financial markets with rapid cuts in rates, at least until 2008.

Bottom Line

The expansion is poised to slow in 2019, but still meet or beat the length of the 1990s expansion. That would make it the longest of the post-WWII era. The unemployment rate is also expected to fall to its lowest level since 1969.

The parallels to the rest of the postwar era stop there. Scars from the financial crisis run deep, fomenting divisions that were decades in the making. The result has been a predictable, if uncomfortable, rise in populism - leaders intent on dismantling established norms and much of what defined the economic and political alliances of the post WWII era. In the extreme, the ensuing chaos could topple democracies and send economies into a downward spiral. Venezuela is an example.

We are not there yet. The temperatures in Michigan have been tepid so far this winter, so the lake has yet to freeze. The families that come to walk the ice are still safely on the sand. I have lived in the Midwest long enough to know that temperatures will eventually plummet, and the ice will return. For now, I am hoping that this winter remains mild, and we will get a bit of a reprieve from suffering the risk of a more monumental misstep.

Economic forecast — January 2019

	2018(E)	2019	2020	2018:4(E)	2019:1	2019:2	2019:3	2019:4	2020:1	2020:2	2020:3	2020:4
National Outlook												
Chain-Weight GDP*	2.9	2.4	0.3	2.8	1.6	2.0	2.1	1.6	-2.6	-1.0	2.4	2.7
Personal Consumption	2.7	2.6	1.3	3.7	1.5	2.5	2.3	2.3	-0.2	0.3	1.9	2.4
Business Fixed Investment	6.9	3.3	-2.6	5.1	3.4	1.6	1.8	1.2	-7.7	-7.4	0.3	2.6
Residential Investment	-0.3	-1.4	0.7	-4.2	-3.4	2.1	2.4	1.6	0.3	-1.4	1.4	-0.1
Inventory Investment	36.3	61.8	-13.5	74.5	63.5	60.3	68.2	55.1	-11.6	-55.2	-14.9	27.5
Net Exports	-768.4	-863.1	-858.7	-834.4	-841.6	-862.4	-872.4	-876.2	-881.6	-852.0	-843.8	-857.4
Exports	4.0	3.7	3.9	3.2	5.5	4.0	5.1	6.7	2.6	2.6	3.2	4.7
Imports	4.9	5.9	2.8	8.1	4.9	5.6	5.0	5.4	2.6	-1.7	1.4	5.2
Government Expenditures	1.7	2.7	0.8	3.8	3.5	2.6	1.0	0.6	0.7	1.6	-0.5	-0.1
Federal	3.0	4.9	0.5	7.8	6.6	5.6	1.1	-0.2	0.1	2.8	-2.5	-2.0
State and Local	1.0	1.4	1.0	1.4	1.7	0.9	1.0	1.0	1.1	0.8	0.7	1.1
Final Sales	2.8	2.2	0.7	2.8	1.9	2.1	2.0	1.9	-1.2	0.0	1.5	1.7
Inflation												
GDP Deflator	2.2	2.2	2.4	1.9	2.5	2.2	2.1	2.3	2.4	2.6	2.4	2.4
CPI	2.4	1.7	2.6	1.5	0.6	2.8	2.0	2.3	2.4	3.1	3.2	2.0
Core CPI	2.1	2.1	2.3	2.0	2.3	2.0	2.1	2.2	2.3	2.5	2.3	2.3
Special Indicators												
Corporate Profits**	8.2	1.7	1.5	8.2	8.1	5.3	2.0	1.7	-3.7	-4.7	-1.5	1.5
Disposable Personal Income	2.8	2.8	1.0	3.0	3.4	2.6	2.5	2.0	0.0	-0.4	0.9	2.0
Housing Starts (mil.)	1.3	1.3	1.2	1.2	1.2	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Civilian Unemployment Rate	3.9	3.6	4.3	3.8	3.7	3.6	3.6	3.6	3.9	4.2	4.5	4.7
Total Nonfarm Payrolls (thous.)***	2538.4	1416.9	-1256.7	648.4	505.8	306.7	348.7	255.7	-268.5	-390.6	-547.4	-50.3
Vehicle Sales												
Automobile Sales (mil.)	5.5	5.0	4.3	5.5	5.3	5.2	5.0	4.6	3.9	3.8	4.6	4.7
Domestic	4.0	3.7	3.2	4.0	3.9	3.8	3.7	3.4	3.0	2.8	3.5	3.5
Imports	1.5	1.3	1.1	1.4	1.4	1.4	1.3	1.2	0.9	1.0	1.1	1.2
Lt. Trucks (mil.)	11.8	11.7	10.4	12.1	12.0	11.8	11.5	11.3	10.6	9.6	10.3	11.0
Domestic	9.5	9.4	8.6	9.7	9.6	9.5	9.3	9.2	8.7	8.0	8.5	9.0
Imports	2.3	2.3	1.8	2.4	2.4	2.3	2.2	2.1	1.9	1.6	1.8	2.0
Combined Auto/Lt.Truck	17.3	16.7	14.6	17.5	17.3	17.0	16.5	15.9	14.5	13.4	14.9	15.7
Heavy Truck Sales	0.5	0.4	0.4	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.4	0.4
Total Vehicles (mil.)	17.8	17.1	15.0	18.0	17.8	17.5	16.9	16.3	14.8	13.7	15.3	16.1
Interest Rate/Yields												
Federal Funds	1.8	2.5	0.9	2.2	2.4	2.5	2.6	2.5	1.9	1.0	0.6	0.1
10-Year Treasury Note	2.9	2.9	2.3	3.0	2.8	2.9	3.1	2.9	2.7	2.0	2.2	2.1
Corporate Bond BAA	4.8	5.2	4.6	5.2	5.1	5.1	5.4	5.3	5.1	4.4	4.6	4.4
Exchange Rates												
Euro/Dollar	1.2	1.2	1.2	1.1	1.1	1.1	1.2	1.2	1.2	1.2	1.2	1.2
Dollar/Yen	110.4	111.6	107.9	112.8	113.0	111.8	111.2	110.4	109.5	108.4	107.4	106.4

1. In 2016, GDP was $16716.164 billion in chain-weighted 2009 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.