Downshifting to Slower Growth

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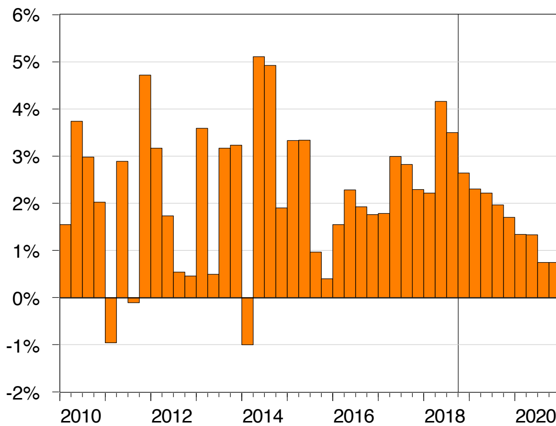
After growing at a 3.1% pace on a fourth-quarter-to-fourth-quarter basis, the growth in real GDP downshifts to 2.1% in 2019 and 1% in 2020 (Figure 1). This is consistent with our prior forecasts that characterize a 3-2-1 growth path for the economy.[1] The downshift in growth is based on our view that above-trend growth is difficult to achieve for an economy operating at full employment, given the sub-1% growth rate in the labor force and productivity gains just above 1%. Unless we witness surprising gains in productivity, the speed limit for the economy is around 2%. Then, you might ask, why are you forecasting a further slowdown to 1% in 2020?

Our position is that the benefits from the huge fiscal stimulus of tax cuts and spending increases will wane by the end of 2019 and the lagged effects of the Federal Reserve's normalization of interest rates, along with the negative effects of the administration's trade policies, will dampen growth further.

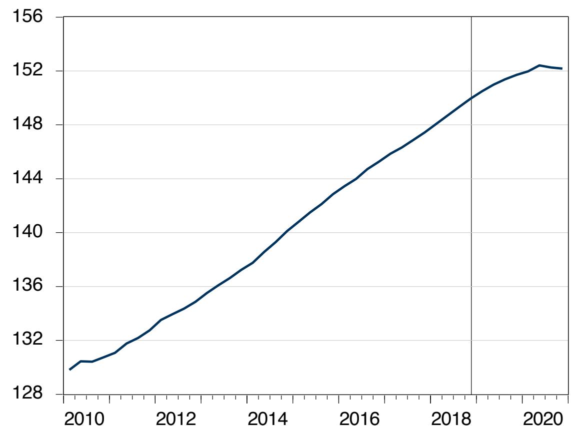
In this environment payrolls will continue to expand, but the 190,000/mo. average gain thus far this year will slow to 160,000/mo. in 2019 and a much weaker 40,000/mo. in 2020 (Figure 2). The unemployment rate will continue to decline from the current 3.7% to about 3.5% for most of 2019 and then gradually increase to 4% by the end of 2020 (Figure 3).

Figure 1 Real GDP Growth, 2010Q1–2020Q4F, Percent Change SAAR



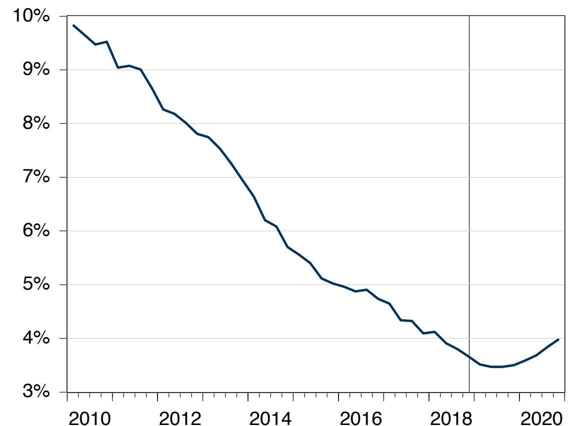
Source: U.S. Department of Commerce; UCLA Anderson Forecast

Figure 2 Payroll Employment, 2010Q1–2020Q4F, in Millions, SAAR



Sources: U.S. Bureau of Labor Statistics; UCLA Anderson Forecast

Figure 3 Unemployment Rate, 2010Q1–2020Q4F, Percent, SAAR



Sources: U.S. Bureau of Labor Statistics; UCLA Anderson Forecast

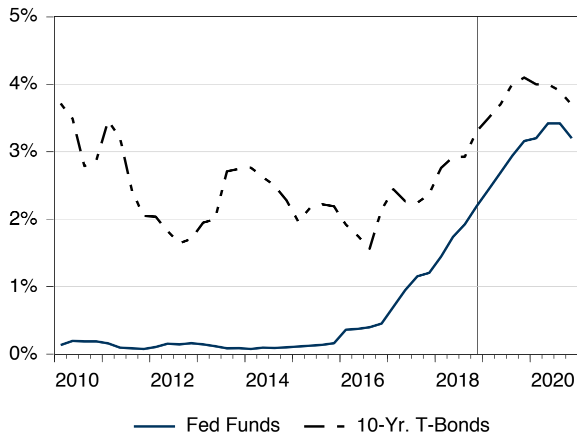
1. *See Shulman, David, "Sunny 2018, Cloudy 2019," UCLA Anderson Forecast, December 2017, and Shulman David, "Regime Change," UCLA Anderson Forecast, March 2018.*

The Fed Normalizes Policy

The recent policy of Federal Reserve has been gradually normalizing interest rates. After years of holding the Federal Funds rate at 0%–0.25%, over the past two years, the rate has increased to its current 2%–2.25%, and we expect another 25-basis-point increase to 2.25%–2.50% later this month. Further we anticipate three or four rate hikes in 2019 that will bring the funds rate up to 3.25%–3.50% by late 2019 or early 2020.

Why so high? We perceive that the normalized funds rate, what the Fed calls R*, to be equivalent to a real rate of 1%. With inflation running somewhat above 2%, that implies a normalized funds rate somewhat above 3%. We would note that prior to the financial crisis R* was perceived to be 4% (2% real), and in the post financial crisis environment it was perceived to be 2% (0% real). We split the difference at 1% real. Given the more than 2% inflation environment we foresee along with the Fed's balance sheet shrinkage and trillion dollar federal deficits (more on all of this below), we forecast that 10-year U.S. Treasury yields will exceed 4% by yearend 2019, up from the current 3.2% (Figure 4).

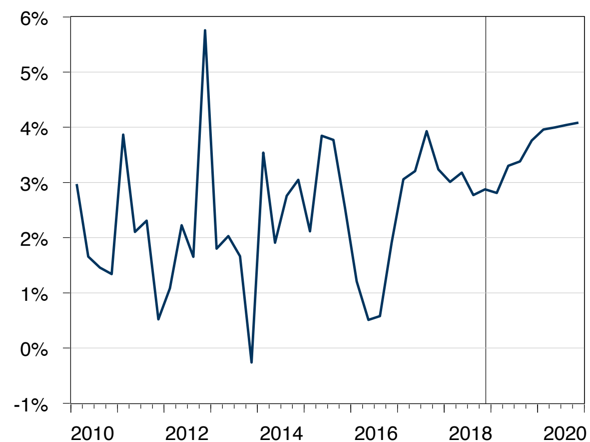
Figure 4 Federal Funds vs. 10-Year U.S. Treasury Bonds, 2010Q1–2020Q4, Percent



Sources: Federal Reserve Board; UCLA Anderson Forecast

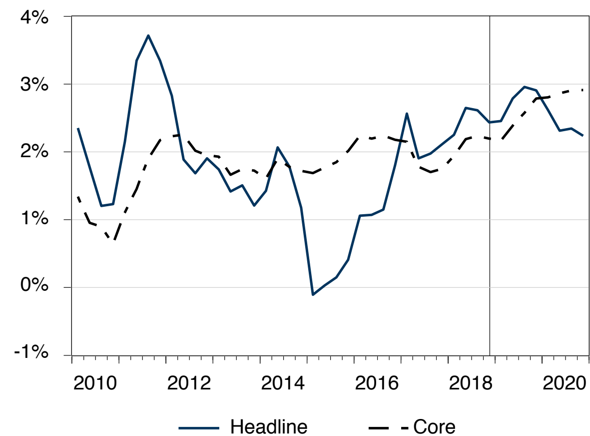
Underpinning the Fed's move to higher interest rates are growing inflationary pressures in the economy. At long last, wage rates are increasing and employee compensation is on track to increase 3.3% in 2019 and 4.0% in 2020 (Figure 5). Simply put, the tight labor market is now showing up in the form of higher wages and benefits. Similarly, inflation as measured by the consumer price indices will approach 3% in both 2019 and 2020, largely driven by higher service sector prices (Figure 6).

Figure 5 Employee Compensation/Hr., 2010Q1–2020Q4, %CHYA



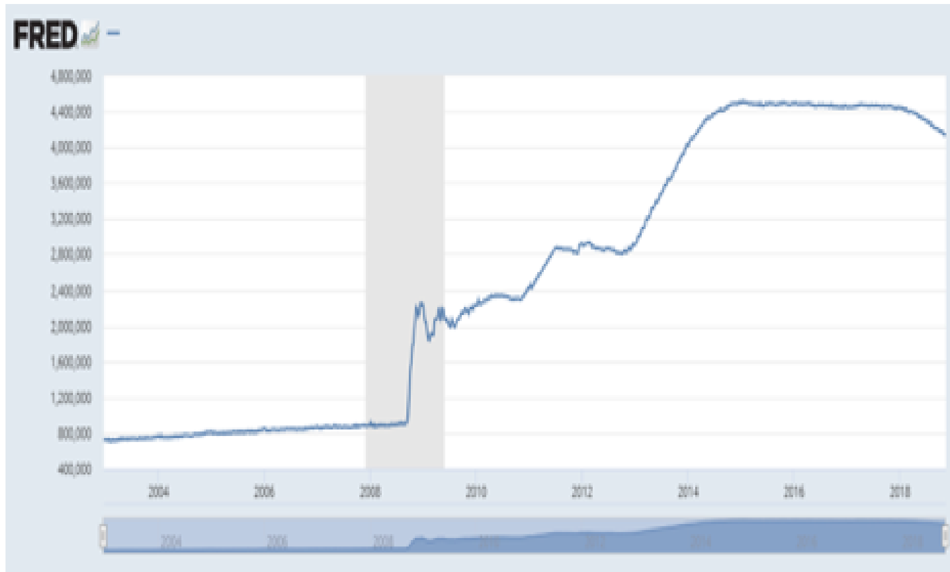
Sources: U.S. Bureau of Labor Statistics; UCLA Anderson Forecast

Figure 6 Consumer Price Index, Headline vs. Core Inflation, 2010Q1–2020Q4F, %CHYA



Sources: U.S. Bureau of Labor Statistics; UCLA Anderson Forecast

Figure 7 Federal Reserve Assets 12/18/2002 to 11/14/2018, in Millions $

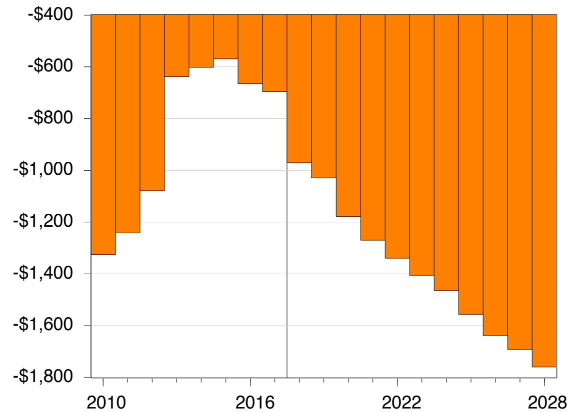


Sources: Federal Reserve Board, via FRED

Moreover, the long end of the Treasury curve will be pressured by the Fed's balance sheet normalization program and trillion-dollar federal deficits as far as the eye can see (Figures 7 and 8). During the financial crisis and its aftermath the Fed increased its balance sheet through three rounds of quantitative easing from $800 billion to $4.5 trillion, an unsustainably high level for it to conduct monetary policy. Now that policy is being reversed with the Fed selling government securities on the order of $40–$50 billion a month. You can call this policy quantitative tightening.

However, the Fed is not the biggest seller in the market, the federal government is. The trillion-dollar deficits that we envision mean that the U.S. Treasury will be net new issuance of between $80 and $100 billion per month. Thus, the path for long-term interest rates is steeper. It also implies that interest payments on the debt will double from the current 1.4% to 3.1% of GDP, thereby crowding out other federal spending.

Figure 8 Federal Deficit, FY 2010–FY2028F, in Billions $, Annual Data



Sources: Office of Management and Budget; UCLA Anderson Forecast

Figure 9 S&P 500, 11/17/2017–11/16/2018

Sources: Standard and Poor's, via BigCharts.com

Financial Turbulence Ahead

The recent volatility in stock prices appears to signal that the era of benign financial markets we have been used to for the past several years is coming to an end (Figure 9). Although most market pundits blame the increased volatility of Fed policy and a peak in the growth rate in corporate profits, when you look under the hood you will notice, perhaps, more serious risks facing the financial markets — namely, over-leveraged corporations and escalating trade tensions, especially with China. And don't forget that the energy, social media, banking and pharmaceutical industries will soon find themselves in the crosshairs of the newly elected Democratic House of Representatives.

While the zero and low interest rate policy of the Federal Reserve helped pull the economy out of the Great Recession and later stimulated growth, it also induced corporations to leverage up. For example, AT&T borrowed $190 billion to finance its acquisitions of Time Warner and DIRECTV.[2] And AT&T was far from alone, with such debt-financed acquisitions made by Bayer, Verizon Communications, Abbott Laboratories, Walgreens Boots Alliance, CVS and Broadcom. As a result, Moody's now rates about half of all investment grade corporate bonds Baa, their lowest tier. That means the slightest of economic downturns can force many of these credits into "junk" territory. And this data does not take into account the huge issuance of less than investment grade paper over the past decade that now accounts for about half of the $9 trillion bond market.

Further exacerbating the corporate credit situation has been the "huge deterioration," in Janet Yellen's words, in the $1.3 trillion leveraged loan market.[3] Although not as overextended as the mortgage market was in the mid-2000s, the corporate debt market has the potential to trigger the next

2. Smith, Molly, and Christopher Cannon, "A $1 Trillion Powder Keg Threatens the Corporate Bond Market," Bloomberg, October 11, 2018.
3. Fleming, Sam, "Janet Yellen Sounds Alarm Over Plunging Loan Standards," Financial Times, October 24, 2018.

Figure 10 BofAML U.S. High-Yield Option Adjusted Spread

Sources: Bank of America Merrill Lynch, via Fred

recession. We do note that the credit risks we are discussing have only just begun to materialize in the bond market, with high-yield credit rising from 3.22% in early October to 4.11% in mid-November as the market responded to problems at General Electric, PG&E and oil exploration companies (Figure 10). **It is important to note here that the last three recessions had their origins in the financial markets, with the 2001 recession being caused by the collapse in the high-flying technology/telecom shares and the 1990 recession caused by overzealous lending to the commercial real estate sector.**

With respect to trade it appears that we are in the process of entering an economic cold war with China. President Trump is threatening to impose tariffs on up to 25% on all $537 billion in Chinese imports. At an average rate of 20%, that would amount to a $107 billion tax on the U.S. economy. Although most market participants cling to the hope that a reasonable deal can be made, we would caution them to take careful note of the recent remarks made by Vice President Pence and former Secretary of the Treasury and Goldman Sachs CEO Henry Paulson, a longtime friend of Beijing.

Pence, speaking to Hudson Institute, said the following:

> "America had hoped that economic liberalization would bring China into a greater partnership with us and with the world. Instead, China has chosen economic aggression (emphasis added), which has in in turn emboldened its growing military."

And:

> "Beijing provides funding to universities, think tanks and scholars, with the understanding that they will avoid ideas that the Communist Party finds dangerous or offensive. China experts know that their visas will be delayed or denied if their research contradicts Beijing's talking points."[4]

4. *Seib Gerald F., "The Significance of Pence's China Broadside," The Wall Street Journal, October 9, 2018.*

Figure 11 Shanghai Composite Index, 11/1/2017–11/16/2018

Sources: MarketWatch.com

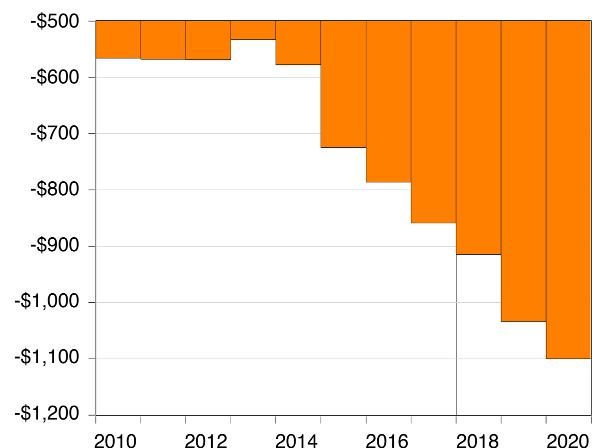
Although the rhetoric coming from the Trump administration might have been expected, Henry Paulson's comments were not. Paulson has long championed engagement with China, but in his Singapore speech he noted that an "economic iron curtain" may soon descend between the two parties — the result of which would be "a long winter in U.S.-China relations" and "systemic risk of monumental proportions."[5]

In other words, both countries are playing with fire. In fact, China is already feeling the pain with slowing economic growth and a nearly 30% stock market decline (Figure 11). There are few winners in a trade war with lots of collateral damage.

China is not the only trade issue the markets face. With the Democrats taking control of the House of Representatives in November it is not clear that the newly signed substitute for NAFTA, the USMCA Treaty, will pass muster. Remember that the Democrats are less free-trade oriented than the Republicans, and it is our guess that, come this spring, the markets will once again be worried about the deal. The risks remain that BREXIT will blow up and Italy will slug it out with the E.U. over its nonconforming budget. **Thus, unless cooler heads prevail, our forecast is that the risks coming from the trade sector are all on the downside.**

The U.S. trade deficit continues to expand as the Trump administration unconsciously uses the trade deficit to finance the budget deficit. As long as the United States is a capital importer, it must, by definition, have a trade deficit. In real terms, the U.S. trade deficit will increase from $914 billion this year to $1.04 trillion and $1.1 trillion in 2019 and 2020, respectively (Figure 12).

Figure 12 Real Net Exports, 2010–2020F, in Billions $, Annual Data



Source: U.S. Department of Commerce and UCLA Anderson Forecast

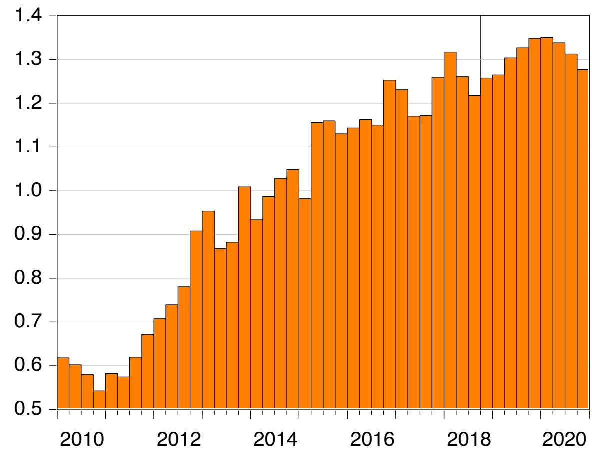
5. *Ip, Greg, "Paulson Forewarns on China," The Wall Street Journal, November 8, 2018.*

Sources of Strength and Weakness

Our main theme is that growth will gradually taper off in all of the major sectors of the economy. It looks like real consumer spending growth peaked at 4% in the second quarter and it will likely taper off to 2% by the fourth quarter of 2019 and 1.5% by the fourth quarter of 2020 (Figure 13). Although consumer spending has been strong of late, we can't say the same for housing activity. Put bluntly, housing activity remains in a rut. Housing starts will advance to 1.26 million units this year, up from 1.21 million units in 2017. We forecast further modest gains to 1.31 million and 1.32 million units in 2019 and 2020, respectively (Figure 14). This level of activity lags below the 1.4–1.5 million units that we believe to be consistent with long-run demand.

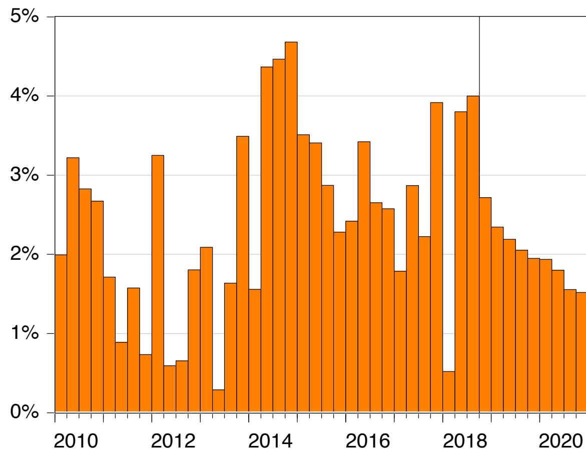
A real bright spot in the economy has been investment in intellectual property, forecast to increase a white-hot annual rate of 9% this quarter. This broad category consists of computer software, research and development and filmed entertainment. To be sure, growth in this sector will taper off, though it will still be consistently growing faster than the economy as a whole (Figure 15).

Figure 14 Housing Starts, 2010Q1–2020Q4, in Millions of Units, SAAR



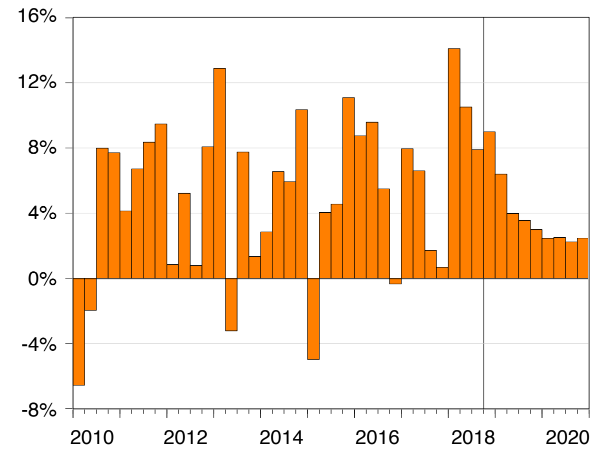
Source: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 13 Real Consumption Expenditures, 2010Q1–2020Q4F, Percent Change, SAAR



Source: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 15 Real Investment in Intellectual Property, 2010Q1–2020Q4, Percent Change, SAAR



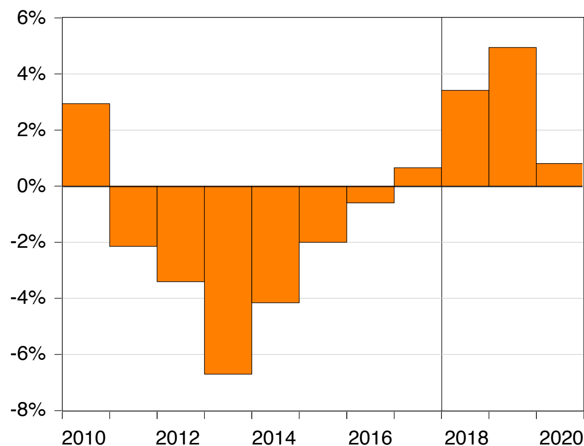
Source: U.S. Department of Commerce and UCLA Anderson Forecast

Another bright spot for next year will be the continued strength in real defense spending. After increasing 3.4% this year, real defense spending is forecast to rise by 4.9% in 2019 and level off with a 0.8% gain in 2020 (Figure 16). The Trump defense buildup is for real.

Conclusion

The economy is in the process of downshifting from the 3% growth in real GDP this year to 2% in 2019 and 1% in 2020. At full employment, 3% growth is not sustainable. With the Fed tightening, trade tensions rising, the impact of the fiscal stimulus coming from tax cuts and spending increase waning, financial markets will likely experience increased turbulence. Over-leverage in the corporate sector represents the major financial risk to the economy. Nevertheless, Main Street will likely experience higher real wages coming from a very tight labor market, as evidenced by a 3.5% unemployment rate. **Thus, a good year for Main Street and choppy year for Wall Street.**

Figure 16 Real Defense Purchases, 2010–2020F, Percent Change, Annual Data



Source: U.S. Department of Commerce and UCLA Anderson Forecast