A partnership between the UCLA Ziman Center for Real Estate and the UCLA Anderson Forecast sponsored by the Ziman Center's UCLA Rosalinde and Arthur Gilbert Program in Real Estate, Finance and Urban Economics

DECEMBER 2019

Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, Senior Economist for the Ziman Center and UCLA Anderson Forecast, cites indicators to state the U.S. economy still poses a significant risk of recession in late 2020, albeit somewhat less than previously thought. This analysis is part of the UCLA Anderson Economic Forecast for 2020 AND 2021, delivered December 2019.

The Two-Track Economy

Consumer spending stays strong while business investment weakens

By David Shulman

We have become a bit more optimistic since our last forecast. Several of our worries have been mitigated. They include:

- After being locked in a 21-month trading range, stock prices have broken out and made decisive new highs.
- The Fed cut its policy rate by 25 basis points and is supplying additional reserves into the banking system to solve a "plumbing" problem. Although the purpose of supplying additional reserves is not a new quantitative easing program, it might have the same effect with respect to the financial markets.
- The yield curve has returned to a positive slope. Although a yield curve reversal usually occurs prior to a recession, the shortness of the inversion period might very well mute its recession signal.
- Housing activity is doing better than previously forecast.
- Better than anticipated employment growth in the October jobs report signals somewhat faster growth going forward.
- There is less pessimism on both an interim U.S./China trade deal and passage of the USMCA trade treaty with Mexico and Canada.

As a result, we are backing away from our long-held forecast of a 3-2-1 economy where real GDP growth on a fourth-quarter to fourth-quarter basis would be 3% in 2018, 2% in 2019 and 1% in 2020. We now anticipate growth in 2020 will be 1.7% compared to 1.25% previously. So call it roughly a 3-2-2 forecast with 1.9% growth in 2021. But make no mistake, there remains a significant risk of recession in late 2020, albeit somewhat less than we previously thought. For those who say that we can't have a recession in a presidential election year, I would note that recessions occurred in 1960, 1980, and 2008 – all presidential election years.

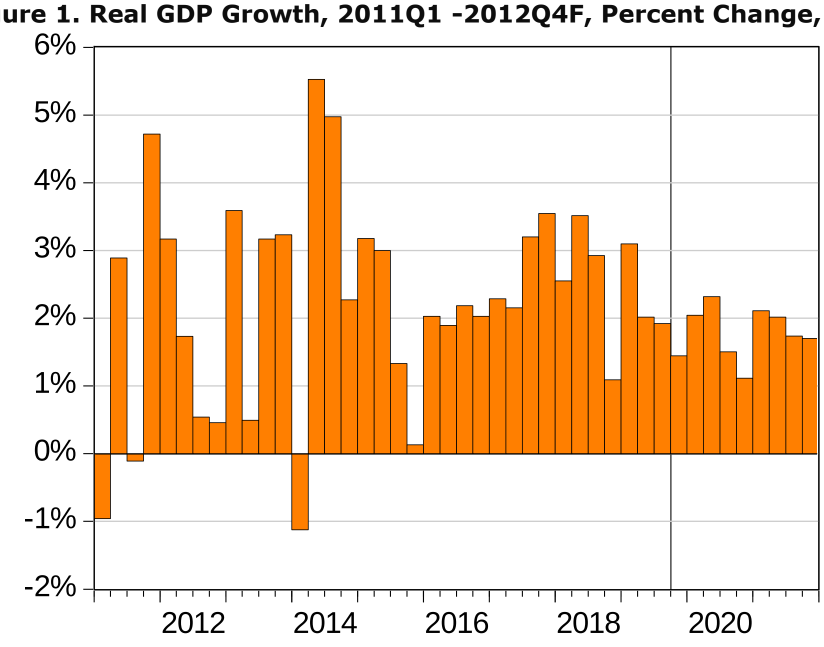
"Housing starts continue to range between 1.25 million and 1.3 million yearly. Although this is more than double the lows during the Great Recession, it remains below the long-term historical average of 1.4-1.5 million units. Our current forecast is tepid, but it is 6% and 4% above what we forecast just three months ago for 2020 and 2021, respectively."

For the past year, economic performance has diverged as strong consumer spending has masked significant weakness in business investment. **You can characterize this as a two-track economy.** This result is somewhat surprising because most observers including us had assumed that the significant reduction in business taxation from the 2017 tax act would spur a capital spending boom. Obviously that has not occurred as growing trade tensions have made it difficult for businesses to plan ahead especially with respect to global supply chains. Indeed, real business fixed investment actually declined in both the second and third quarters of this year. Nevertheless, we think the worst is over and we anticipate a modest recovery over the next two years.

Aside from strong spending on intellectual property, the outlook for overall business fixed investment growth will remain modest with actual declines in structures investment, which is being dampened by weak spending in the oil patch. We would note that the strong increase of 4.1% in the first quarter of 2020 is due to our assumption that Boeing begins to ship its long grounded 737-Max airplane to airline customers that quarter.

We are forecasting a reduction in the growth in real consumer spending that will work to eliminate the recent divergence between it and business spending. Why? There is a real problem emerging in automobile credit. Lending terms have been extended to seven years and many automobile loans are underwater at the initial underwriting. Would you believe a $27,000 Jeep Cherokee with a $45,000 loan? This type of behavior is very reminiscent of home lending during the 2004-2007 bubble years. As a result, with delinquencies rising, we expect there will be an agonizing reappraisal of lending standards in the second half of 2020 that will likely reduce the current run rate of 17 million units a year to below 15 million units in late 2020.

Figure 1. Real GDP Growth, 2011Q1 -2012Q4F, Percent Change, SAAR



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

As was mentioned above, we believe that the economy will remain on a 2% growth path from 2019 – 2021. (See Figure 1) In this environment, payroll employment growth will decelerate from the 170,000/month averaged this year through October to about 80,000/month in 2020 and 50,000/month in 2021. Temporary census hiring will positively affect the data in the second quarter and negatively affect it in the third quarter of next year. In our view, the unemployment rate will bottom at 3.4% in the second quarter of 2020 and then gradually rise to 3.8% by late 2021.

FEDERAL RESERVE POLICY

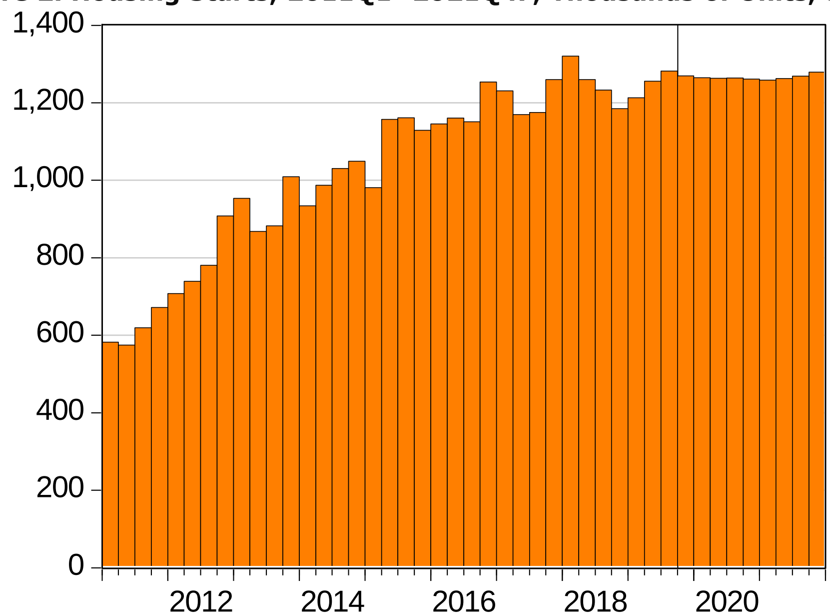
Federal Reserve Board Chairman Jerome Powell made a major policy announcement at his press conference after the September meeting of the Federal Open Market Committee. **In essence he said that there will be a very high bar for the Fed to further lower its benchmark federal funds rate and that there will be an even higher bar to raise the rate.** Thus, the markets should not expect further cuts. We previously forecast that the Fed would cut in December, instead the Fed cut in September. Because we forecast a significant weakening in economy in the second half of 2020, we have penciled in another 25 basis point cut in the fourth quarter of that year.

His higher bar for a rate increase is based on inflation consistently exceeding the Fed's 2% target. We expect that to happen in late 2021, hence we expect a 25 basis point increase late in that year. We do this only to signal that the Fed Funds rate won't remain at 1.38% forever. In this environment, we expect that yields to the 10-Year U.S. Treasury bond will remain in a low 1.5% - 2.25% range.

HOUSING ACTIVITY PLATEAUS

Housing continues to range between 1.25 million and 1.3 million starts. (See Figure 2) Although this is more than double the lows reached during the Great Recession, it still remains below the long-term historical average of 1.4-1.5 million units and well below the two million-plus years associated with booms. Although our current forecast can be characterized as tepid, it is 6% and 4% above what we forecast just three months ago for 2020 and 2021, respectively.

Figure 2. Housing Starts, 2011Q1- 2021Q4F, Thousands of Units, SAAR



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

EXPORT GROWTH STAYS WEAK

The combination of trade tensions (apparently lessening), near recession conditions in Europe, sluggish growth in Latin America and softer growth in China along with a strong dollar make for a hostile environment for U.S exporters. After being essentially flat in 2019, real export growth is forecast to be 3.3% and 1.9% in 2020 and 2021, respectively. The reason for the uptick in the first quarter of 2020 is again our assumption that the 737-Max will ship to customers in the first quarter of 2020 as most of those customers are foreign air carriers.

$TRILLION FEDERAL DEFICITS

Given an existing imbalance between federal revenues and federal expenditures along with an economy plodding along at a 2% growth path, the era of trillion dollar federal deficits is upon us. Remember that there is no recession in the forecast horizon, which means that **should the economy fall into recession the deficit will double**. Moreover, because interest rates are already very low, there can be very little relief coming from a further fall in rates.

CONCLUSION

We modestly upgraded our forecast from last quarter to reflect improved financial conditions, a better housing and employment outlook, some relaxation of trade tensions and a modest improvement in business fixed investment. As a result instead of forecasting 1% real growth for 2020, we expect growth to be on the order of 2% on a fourth-quarter to fourth-quarter basis. After going on a separate track from business investment, we forecast a slowdown in consumer spending largely coming from much weaker automobile sales as credit tightens in that sector. Overall, the interest-rate environment, aside from auto credit, will remain benign. **But make no mistake, although we have lowered the risk of a recession, the second half of 2020 remains problematic for the economy.**

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