

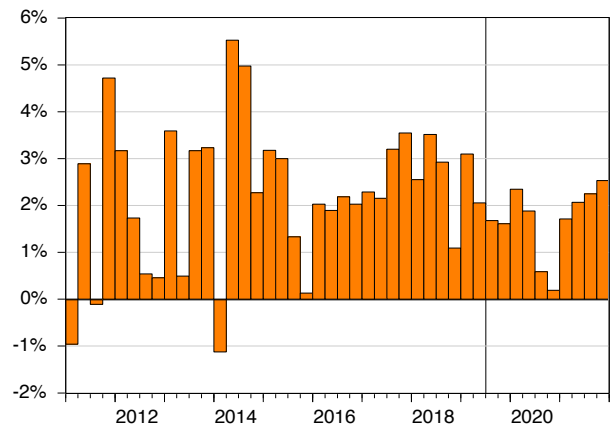
The Year of Living Dangerously¹

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September 2019

With his tweets of August, President Trump escalated our trade war with China and attacked Federal Reserve Chairman Jerome Powell as an “enemy.” All of this occurring against a backdrop of near-recessionary conditions in Europe with the potential for a Brexit disruption, Brazil and Mexico, a slowdown in China, rising geopolitical tensions in the Kashmir, the Middle-East, Hong Kong and the Korean Peninsula and a very real slowing in the U.S. economy. It seems that we are sleepwalking into a recession and perhaps quite a bit more geopolitically.

Although we are not calling for a recession over the forecast horizon, as we have noted for over a year it is very likely that economic growth will stall in the second half of 2020 as the effects of the 2017 tax cuts wane and as trade tensions exact their toll on corporate investment. On a fourth quarter to fourth quarter basis we are forecasting real GDP growth of 2.1% and 1.2% in 2019 and 2020, respectively. **Indeed in the second half of 2020 growth is expected to decline to 0.4% – not quite a recession – but pretty close.** (See Figure 1.) For 2021, we forecast growth to return to 2.1%.

Figure 1 Real GDP Growth, 2011Q1- 2021Q4, Percent Change, SAAR



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

1. With apologies to Peter Weir and MGM (Released in the U.S. in 1983)

What Are We Worried About?

We are worried about the following:

- The escalating trade war with China.
- The weakening of business investment in equipment and structures.
- The negatively sloped yield curve.
- The slowdown in employment growth.
- The inability of housing activity to launch.
- The stagnant stock market.

We will discuss each of these factors in turn.

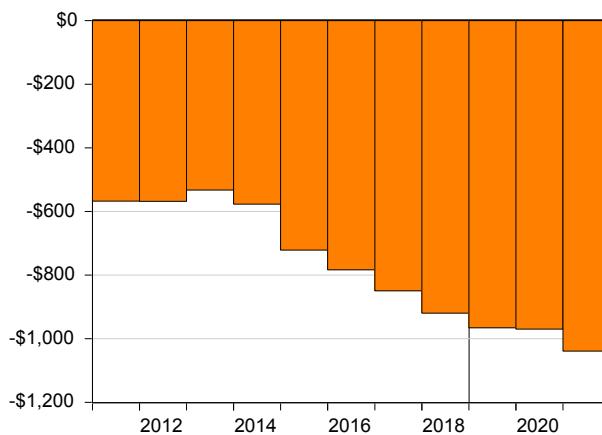
Trade Shock

At the recent Federal Reserve conference in Jackson Hole, Wyoming, Fed Chairman Jerome Powell noted:

“Moreover, while monetary policy is a powerful tool that works to support consumer spending, business investment, and public confidence, it cannot provide a settled rulebook for international trade.” (Emphasis added)

The reason why there is no rulebook is that we haven’t experienced a trade shock since the imposition of the Smoot-Hawley tariffs of 1930. We know how that turned out. Just after Powell made those remarks, President Trump weighed in with a substantial increase in the planned tariffs on Chinese goods (Increased to 10% and 25%, valued at about \$80 billion/year) that are scheduled to go into effect on September 1st and December 15th. As we have argued for two years, tariffs are analogous to putting grains of sands into the gears of commerce which work to reduce output and increase prices. **Indeed a recent Fed study noted that trade uncertainty lowered real GDP growth about 1% in 2019 and projected another equivalent drop in 2020.**² And make no mistake, American businesses and consumers will bear the brunt of the tariffs. And despite all of the Administration’s heightened rhetoric, the real trade deficit will continue to rise as it approaches one trillion dollars this year. (See Figure 2)

Figure 2 Real Net Exports, 2011Q1 -2021Q4, Annual Data, \$Billions



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

Further, the introduction of President Trump’s tariffs has greatly increased the uncertainty about the durability of existing supply chains thereby dampening business investment, more on that below. The Trump uncertainty is having pretty much the same effect as the uncertainties introduced by President Obama earlier in the decade with a multitude of regulatory changes coming from the Environmental Protection Administration, the Department of Labor and the Department of Energy.³

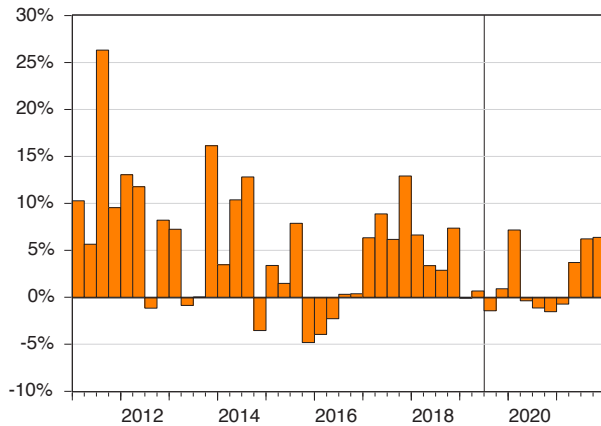
Weaker Business Investment in Equipment and Structures

In response to the rise uncertainty, the growth in business investment in equipment has stalled. After increasing at a solid 6.8% in 2018, real investment in equipment is forecast to grow at somewhat less than 2% from 2019-2021 and there will be several negative quarters along the way. (See Figure 3) The 11% increase in the first quarter of 2020 is based on our assumption that Boeing will resume shipments of the now-grounded 737-MAX in that quarter. Concomitantly real business investment in structures is already in decline at a 3% annual rate and that trend is forecast to continue through 2021. (See Figure 4) Much of the decline is due to weakness in energy-related investment especially related to oil and gas development in response to a 25% decline in oil prices.

2. See Caldera, Dario et.al, “Does Trade Policy Uncertainty Affect Global Economic Activity?” Board of Governors of the Federal Reserve System, Sept 4, 2019.

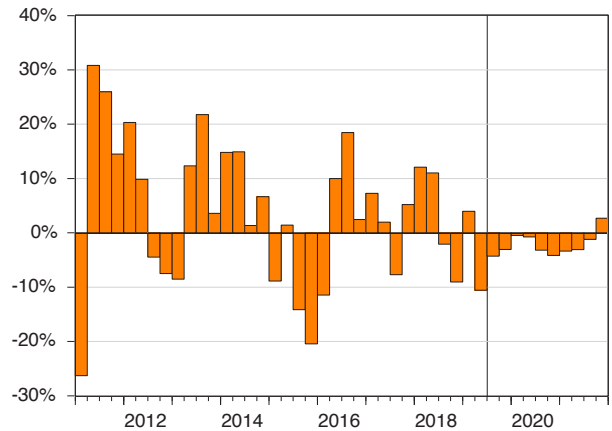
3. See Shulman, David, “The Uncertain Economy,” UCLA Anderson Forecast, September 2010

Figure 3 Real Business Investment in Equipment, 2011Q1-2021Q4F, Quarterly Data, Percent Change, SAAR



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

Figure 4 Real Business Investment in Structures, 2011Q1-2021Q4F, Quarterly Data, Percent Change, SAAR



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

The Negatively Sloped Yield Curve

One of the most widely used and accurate signals of an oncoming recession is a negatively sloped yield curve where the return on short-term money is higher than the return on longer-term money. Not only is a negatively sloped yield curve a signal of an oncoming recession, it is also a cause because it eliminates the maturity transformation arbitrage profits of the financial system thereby reducing the willingness to lend. The indicator that the Fed uses is the difference between the yield on 3-Month U.S. Treasury Bills versus the yield on 10-Year U.S. Treasury Bonds. (See Figure 5)

Yes folks, we have been there since May. (See Figure 5). Aficionados on Wall Street prefer to use the difference between the 2-Year U.S Treasury Note versus the 10-Year U.S. Treasury Bond. That too turned negative in August.

Although we have great respect for the signal coming from the bond market, we believe that the negatively sloped yield curve this time may sending us a false positive signal. Why? In the past when the yield curve was negatively sloped, there was over-building in the housing market. This cycle, if anything, there has been **under**-building. As a result, this time, we might just skate by and avoid a recession.

Figure 5 Slope of the Yield Curve, 10-Year U.S. Treasuries minus Three Month Treasury Bills, Apr 1982 – Aug 2019, Daily Data, Percent



Source: Federal Reserve Board via FRED

Another cause of the negatively slope yield curve is the pressure coming from the global bond market. **As of late-August there were about \$17 trillion of negative yielding sovereign debt concentrated in Europe and Japan.** (See Figure 6) With limited growth prospects, low inflation and aggressive buying from the European Central Bank, European investors have little choice than to pay sovereigns a storage fee for their money. After all, it is hard to store a trillion euros under the mattress. As a result of the gravity coming from Europe the 10- Year U.S. Treasury yield has collapsed to 1.5%, about half of what it was last fall.

Figure 6 Selected Sovereign Yields, 30Aug19, Percent

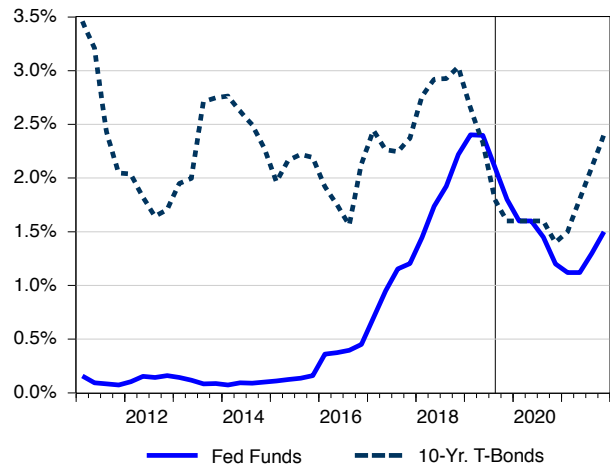
Country	2-Year	10-Year
United States	1.990	1.50
France	- 0.850	- 0.40
Germany	- 0.900	- 0.71
Italy	- 0.170	1.03
Japan	- 0.310	- 0.28
UK	0.400	0.49

Source: CNBC

Because the Fed is very knowledgeable about the yield curve and the contractionary forces coming from the trade war and European weakness, we believe that Fed has entered a significant easing cycle. Where the Fed Funds rate peaked at 2.625% last December, we now believe that the rate will be 1.625% by this December and a very low 1.125% by December 2020. The drop in the Fed Funds rate in 2020 will be the result of the economic weakness we forecast for later that year. (See Figure 7) Of course, by then the yield curve will be positively sloped.

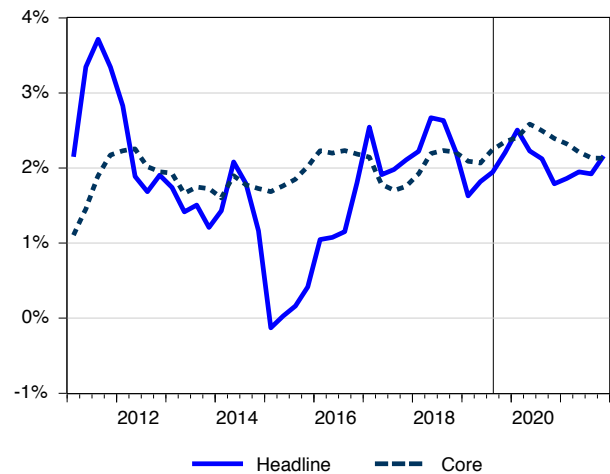
The Fed will be able to be aggressive in lowering rates because, although running somewhat above their target, overall

Figure 7 Federal Funds vs. 10-Year U.S. Treasury Bonds, 2011Q1 - 2021Q4F, Percent



Source: Federal Reserve Board and UCLA Anderson Forecast

Figure 8 Consumer Price Index vs. Core CPI, 2011Q1- 2021Q4F, Percent Change a Year Ago



Source: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

inflation will remain benign. (See Figure 8) However, we would point out that the imposition of tariffs means that there is upside risk to our 2%+ inflation forecast.

Employment Growth Softening

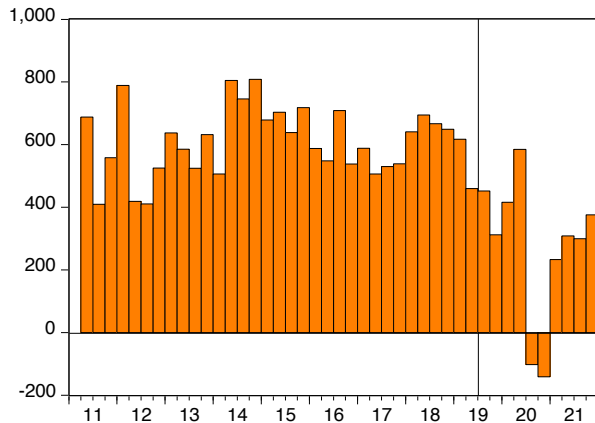
In August, the Bureau of Labor Statistics announced that the estimate for March 2019 payroll employment was overstated by 500,000 jobs. We will not know how this preliminary estimate will translate in actual monthly job growth until we get the January 2020 data, but as a first approximation, recent employment growth has been overstated by about 40,000 jobs a month. Our forecast for job growth is based on current data and therefore it should be viewed as high. Nevertheless, instead the recent normal of job gains of 200,000 a month, we envision job growth in 2020 to be a

tepid 70,000 a month. (See Figure 9) This eventuality will be a shock to those businesses that have relied on the recent history of job growth. We would also note that our forecast includes the temporary government hiring associated with the census, especially in the second quarter of 2020. Given our GDP forecast, the unemployment rate will remain stable at around 3.6% through early 2020 and then rise to about 4% at the end of that year. (See Figure 10)

Housing Activity Remains Sluggish

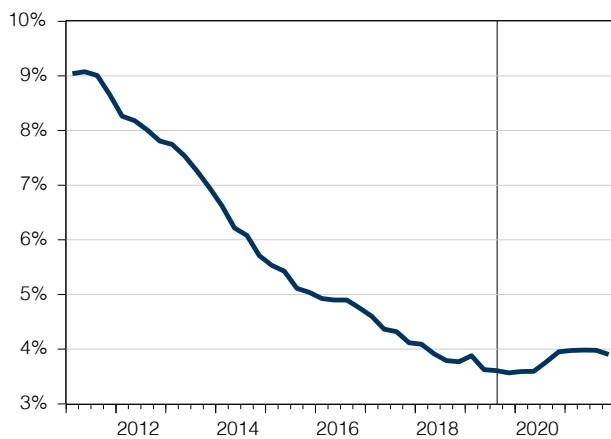
As we have noted ad nauseam, post the Great Recession housing activity has failed to recover to what historically has been a normalized level of housing starts of 1.4 million – 1.5 million units. Activity has stalled out in the 1.2 million – 1.3 million range and we forecast that it will remain sluggish throughout the forecast horizon. Specifically, we are forecasting 1.25 million units for 2019 and for starts to average around 1.2 million units in 2020 and 2021. (See Figure 11) **This sluggishness is especially noteworthy in light of the fact that mortgage interest rates have declined from 5% in late 2018 to around 3.75% today.** What this means is that unlike 2007 housing activity is really not in position to trigger a recession this time around.

Figure 9 Payroll Employment, 2011Q1-2021Q4, Quarter to Quarter Change, In Thousands, SAAR



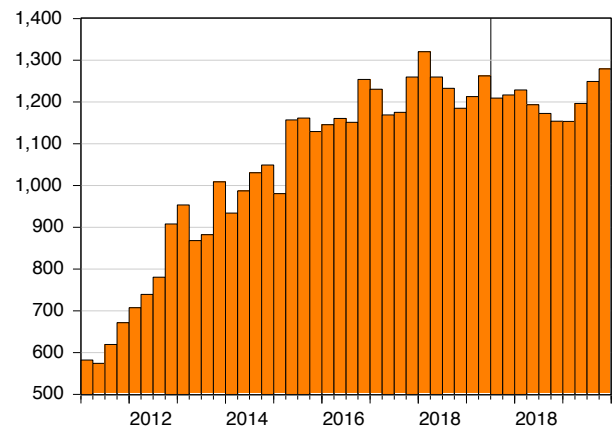
Source: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 10 Unemployment Rate, 2011Q1-2021Q4F, Percent, SAAR



Source: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 11 Housing Starts, 2011Q1-2021Q4F, Thousands of Units, SAAR



Source: U.S. Bureau of the Census and UCLA Anderson Forecast

Stock Market Has Gone Nowhere Since January 2018

Although the S&P 500 stock index remains very close to its all-time high, as a practical matter stock prices haven't gone anywhere since January 2018. (See Figure 12) We would note that in January 2018 the Trump Administration got very serious about imposing tariffs and in March 2018 the first round of tariffs on steel and aluminum were put in place. As a result the wealth effect associated with rising stock prices is waning.

What seems to be OK?

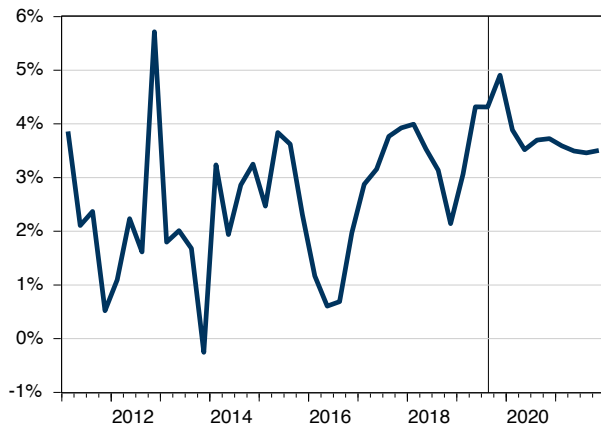
Although there is much to be worried about, consumption, which accounts for about two-thirds of GDP is chugging along, federal spending is advancing smartly in response to the recent budget deal and businesses continue to invest in intellectual property at a heady pace. Spurred on by low unemployment and higher wage income, real consumer spending growth remains solid with gains of 2.5% this year and 2.1% in 2020 and 2021, albeit with 1% growth in the second half of 2020. (See Figures 13 and 14) To be

Figure 12 S&P 500 Stock Index, 1Sep2017 - 30Aug2019



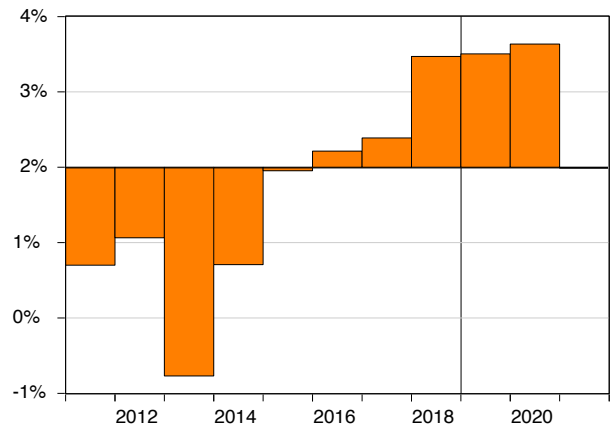
Source: Standard and Poor's via BigCharts.com

Figure 13 Employee Compensation, 2011Q1- 2021Q4F, Percent Change Year Ago



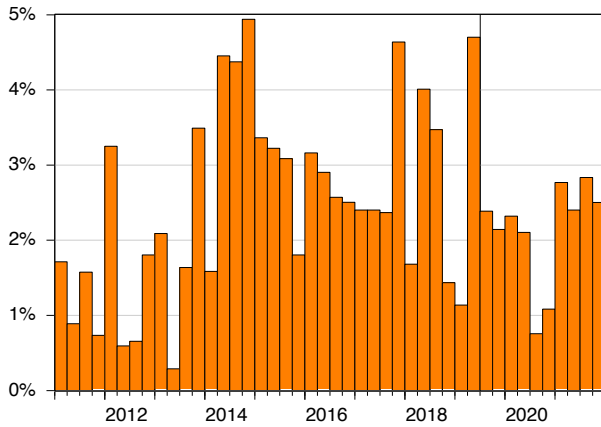
Source: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 15 Real Federal Purchases, 2011 – 2021F, Annual Data, Percent Change



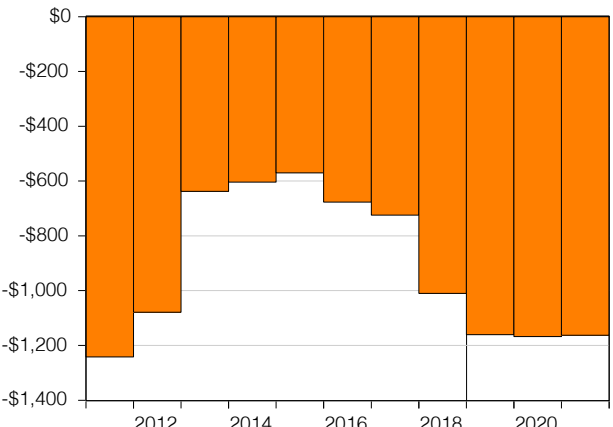
Source: Office of Management and Budget, UCLA Anderson Forecast

Figure 14 Real Personal Consumption Expenditures, 2011Q1- 2021Q4F, Percent Change, SAAR



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

Figure 16 Federal Deficit, FY 2011-FY2021F, Annual Data, In \$Billions



Source: Office of Management and Budget, UCLA Anderson Forecast

sure, the pace is off from the 3% recorded in 2018, but still quite respectable for this stage of the business cycle. As a result, if you are going to tell a story about a recession in 2020 you would have to have consumer spending far weaker than we now have it.

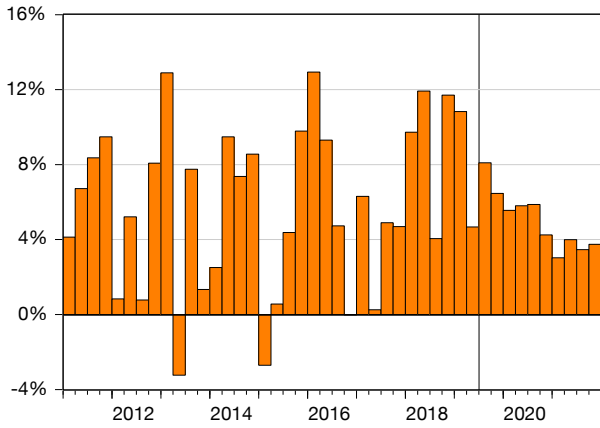
Unlike earlier in the decade federal spending is now increasing at a 3% annual rate. (See Figure 15) As a result of the recently approved budget deal that increases both defense and domestic purchases, the 3% growth rate established in 2018 will continue this year and into 2020 before stalling out in 2021. However, we might be low for 2021 as a new Congress might aggressively respond to the weakness we expect to occur in late 2020.

The flipside of higher government spending will be the prospect of trillion dollar deficits through 2021 and beyond. (See Figure 16) Although both the administration and the Congress do not appear to be interested in the deficit today, the day will come when the deficit is interested in them.

The one bright spot in business investment is the continuing growth in spending on intellectual property. That category includes, among other things, computer software, research and development expenditures and filmed entertainment. Unlike equipment and structures this sector is being driven by technological imperatives that extend well beyond the business cycle. Despite the slowdown, we are forecasting that real intellectual property spending will continue to grow

THE YEAR OF LIVING DANGEROUSLY

Figure 17 Real Spending on Intellectual Property, 2011Q1-2021Q4, Percent Change, SAAR



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

robustly, albeit off the heady 8.4% forecast for this year. Specifically, we are forecasting growth of 5.5% and 4.1% in 2020 and 2021, respectively. (See Figure 17)

Conclusion

Economic growth is dramatically slowing. The near 3% pace of over a year ago is now a memory with fourth quarter to fourth quarter real GDP growth for 2019 and 2020 now forecast to be 2.1% and 1.2%, respectively. Further, job growth will slow to below 70,000 a month, a far cry from the 200,000 plus we have been used to. The real risk is coming from the Administration's high and erratic tariff policies and its potential impact on exports and business investment. As long as consumption remains firm we believe that the U.S. economy will avoid a recession next year, but nevertheless it will be "The Year of Living Dangerously."