Global Slowdown

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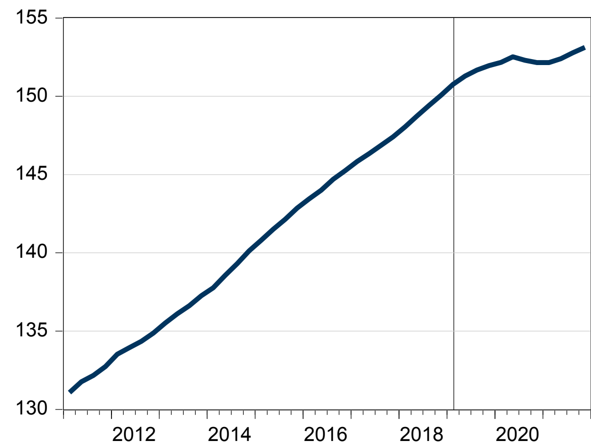
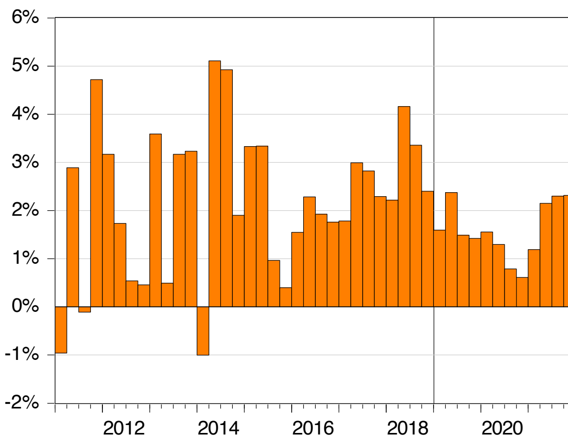
A year ago we were looking forward to a synchronized global expansion; today we are starting a synchronized slowdown. The U.S. economy is part and parcel with the global slowdown, an eventuality we have been forecasting for over a year. After growing at 3.1% clip on a fourth quarter-to-fourth quarter basis in 2018, growth will slow to 1.7% in 2019 and to a **near recession pace of 1.1% in 2020**. However, by mid-2021 growth is once again forecast to be around 2%. (See Figure 1) Similarly, payroll employment growth is forecast to decline from the 220,000 a month recorded in 2018 to about 160,000 a month in 2019 to a negligible 20,000 a month in 2020 with actual declines occurring at the end of that year. (See Figure 2) In this environment the unemployment rate will initially decline from January's 3.9% to 3.6% later in the year and then gradually rise to 4.2% in early 2021. (See Figure 3)

Figure 2 Payroll Employment, 2010Q1–2021Q4F, in Millions, SAAR



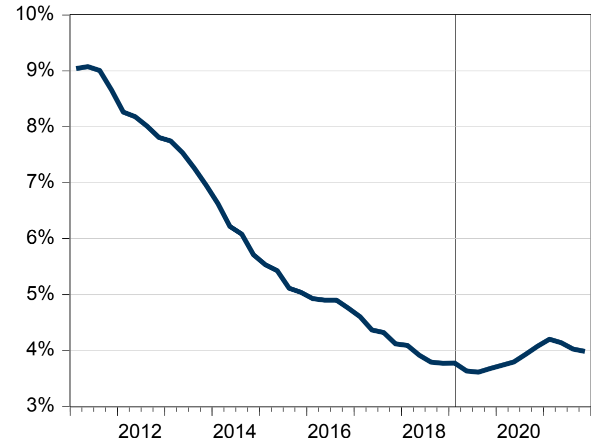
Sources: U.S. Bureau of Labor Statistics; UCLA Anderson Forecast

Figure 1 Real GDP Growth, 2010Q1–2021Q4F, Percent Change SAAR



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

Figure 3 Unemployment Rate, 2010Q1–2021Q4F, Percent, SAAR



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

Why the Slowdown?

Consistent with our view for the past several quarters we believe that the 3% growth in 2018 was a one-off based on the fiscal stimulus coming from the tax cuts and spending increases, especially for defense enacted in late 2017 and the lagged effects of the extraordinarily easy monetary policy pursued by the Federal Reserve. With the effects of the fiscal stimulus now waning combined with the partial normalization of interest rates it seemed inevitable to us that growth would slow. Further the failure of housing activity to provide a propellant for the expansion has been a distinct negative. We will discuss these points in greater detail later. **The slowdown in U.S. economic activity will be exacerbated by concomitant weakness among our global trading partners.**

Global Economy Stalling

Although 2018 started out strong for the global economy, by yearend there seemed to be weakness everywhere. **The weakness is being amplified by the protectionist policies being employed by the Trump Administration and the uncertainties associated with BREXIT.** For example, compared to 2018 German growth is expected to slow from 1.5% to 1.3%, China from 6.6% to 6.2% and Italy is for all practical purposes in recession. **Although these declines in growth appear modest, recent data suggests that there will be substantial downward revisions to the outlook once first quarter data become available.**[1] The global weakness will be transmitted to the U.S. economy by a less than robust export environment and a reduction in corporate profits.

Figure 4 Figure 4. Real GDP Growth for Major Economies, 2018 -2020, Percent

Region/Country	2018	2019	2020
U.S.	**2.9**	**2.5**	**1.8**
Euro Zone	**1.8**	**1.6**	**1.7**
Germany	**1.5**	**1.3**	**1.6**
France	**1.5**	**1.5**	**1.6**
Italy	**1.0**	**0.6**	**0.9**
UK	**1.4**	**1.5**	**1.6**
Japan	**0.9**	**1.1**	**0.5**
Developing Asia			
China	**6.6**	**6.2**	**6.2**
India	**7.3**	**7.5**	**7.7**
Americas			
Canada	**2.1**	**1.9**	**1.7**
Mexico	**2.1**	**2.1**	**2.2**
Brazil	**1.3**	**2.5**	**2.2**

Sources: World Economic Outlook, International Monetary Fund, January 2019

Figure 5 Selected Global Interest Rates, 22Feb19, Percent

Country	2-Year	10-Year
U.S.	**2.50**	**2.65**
Germany	**- 0.60**	**0.09**
France	**- 0.46**	**0.52**
Italy	**0.54**	**2.87**
U.K.	**0.74**	**1.15**
Japan	**- 0.18**	**- 0.05**

Sources: CNBC

This economic weakness has triggered a major contraction in global interest rates making it difficult for the Fed to conduct its normalization policy and has put a lid on long term interest rates. Would you believe 0.09% for the German 10-year Bund and a **negative** 0.60% for the 2-year? (See Figure 5) Where in the recent past we thought yields on 10-year U.S. Treasury would to top out over 4%, we now think that a 3.25% peak is more likely as German interest rates work to suppress U.S. yields. (See Fed discussion below)

A Fundamental Shift in Fed Policy

The combination of the global slowdown, the 20% sell-off in stock prices in the fourth quarter and still quiescent inflation triggered a fundamental shift in Fed policy. Instead of penciling three or four rate hikes next year, it now looks like it will be zero or one. We are in the one rate hike camp for 2019 camp because we believe that inflation will be less than benign. **However, because we are more pessimistic**

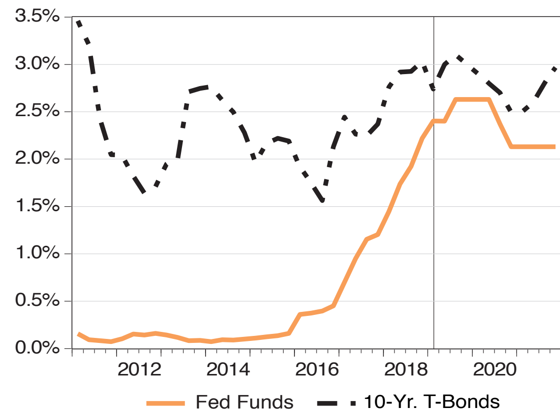
1. See Lafourcade, Pierre and Arend Kapteyn, "Global growth now-cast: a (very) preliminary estimate for Q1," UBS, 18 February 2019.

on the real economy than the Fed, we are forecasting that there will be three rate cuts of 25 basis points each in 2020. (See Figure 6) In this setting of very slow growth and an end to the Fed normalization process coupled with very low interest rates in Europe and Japan it is hard to see long term interest rates going much above 3.25%.

Moreover, it now looks like the Fed is rethinking its balance sheet target. Instead or contracting its balance sheet from the $4.5 trillion peak to $3 trillion or below, it now looks like the shrinkage process will end this year with a balance sheet of around $3.5 trillion. (Figure 7) This change in policy will put less pressure on the long end of the treasury curve.

Although there has been much discussion of the potential for the treasury curve to become fully inverted (long rates lower than short rates), we do not believe that will be the case. To be sure the curve is currently inverted between

Figure 6 Federal Funds vs. 10-Year U.S. Treasury Bonds, 2011Q1 -2021Q4F



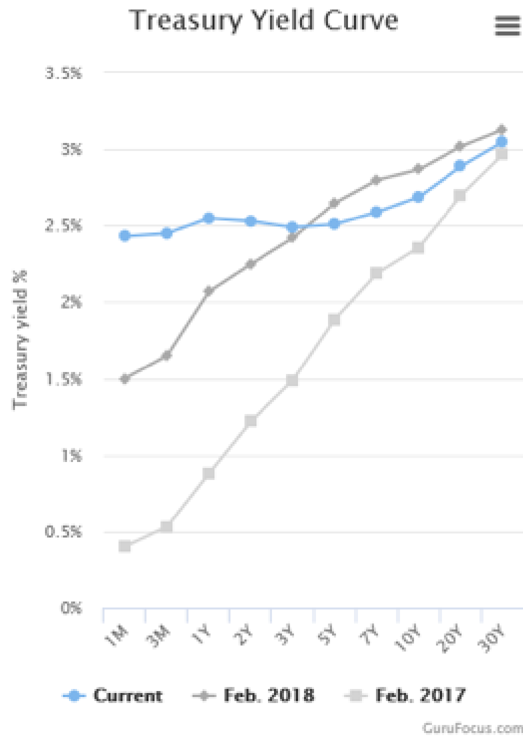
Sources: Federal Reserve Board and UCLA Anderson Forecast

Figure 7 Federal Reserve Assets, 20Feb14 – 20Feb19, In $millions

Sources: Federal Reserve Board, via FRED

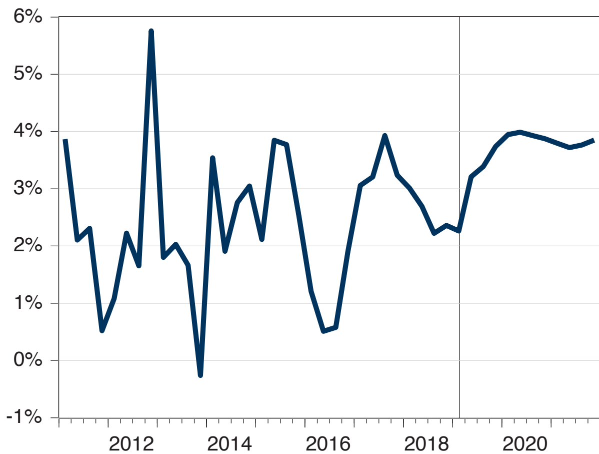
one and five year maturities, but we do not believe that the all-important 90- Day Treasury Bill to the 10-Year Treasury bond will invert.(See Figure 8) Similarly we do not believe the 2-10 year spread will invert on a sustained basis as well.

Figure 8 U.S. Treasury Yield Curve, 22Feb19



Sources: GuruFocus.com

Figure 9 Total Compensation per Hour, Percent Change Year Ago

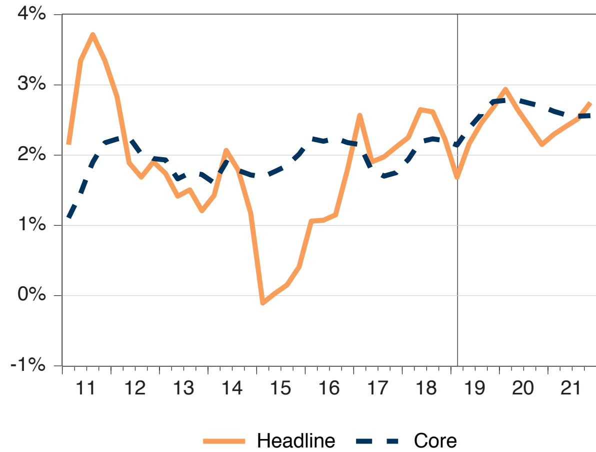


Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Modestly Higher Inflation

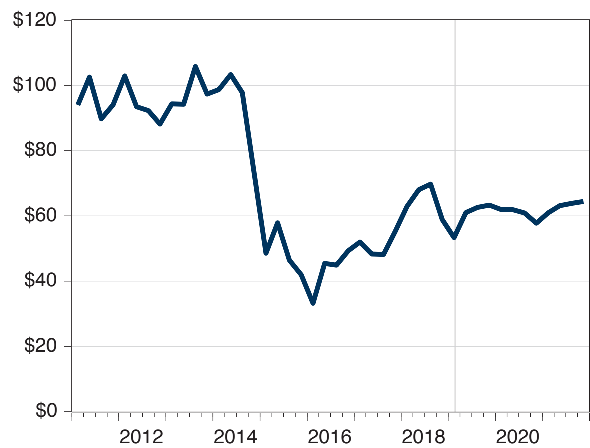
Inflation may not be as quiescent as the Fed thinks. As a result of the very tight labor market wages are increasing at a 3%+ clip and it is likely that the year-over-year gains will soon be running around 4%. (See Figure 9) As a result, wage pressures, especially in the service sector, will keep the core consumer prices increasing at a rate above 2%. (See Figure 10) Moreover it appears that the benefits from the collapse in oil prices is now behind us and that will elevate the rate of change in the headline consumer price index to above 2% as well (See Figure 11)

Figure 10 Headline Consumer Price Index vs. Core CPI, 2011Q1 -2021Q4F, Percent Change a Year Ago



Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 11 Oil Price, 2011Q1 – 2021Q4F, West Texas Intermediate, $/Barrel

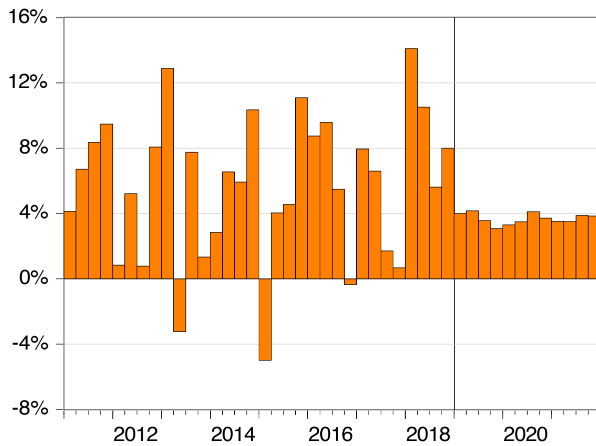


Sources: Commodity Research Bureau and UCLA Anderson Forecast

Investment in Intellectual Property Remains the Bright Spot

The bright spot in the economy remains investment in intellectual property. This sector largely consists of software development, motion picture/TV production and corporate R&D. Although slowing from a torrid 7% pace in 2018, this sector will continue to grow much faster than the economy over the next few years. (See Figure 12) The continued movement of corporate computing to "the cloud" and a host of new entrants into motion picture production (i.e. Amazon, Netflix, and Hulu) are buoying this sector.

Figure 12 Real Investment in Intellectual Property, 2011Q1 -2021Q4F, Percent Change, SAAR

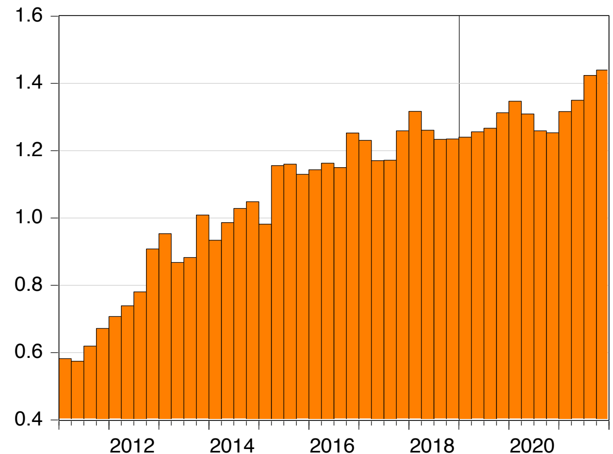


Source: U.S. Department of Commerce and UCLA Anderson Forecast

Housing Starts Remain Below Underlying Demographic Demand

We reckon that the underlying demographic demand for housing starts to be around 1.4 million – 1.5 million units a year. We have yet to achieve that level for over a decade and we forecast that it won't be until late 2021 that housing starts exceed an annual run rate in excess of 1.4 million units. (See Figure 13) There are number of explanation for the housing's failure to launch. They include the after effects of the Great Recession, high levels of student loan debt, the aging in place of baby boomers that is keeping housing units off the market, the concentration of job growth in high cost metropolitan areas and environmental/zoning restrictions that are restricting supply. We believe the main culprit is the last factor.

Figure 13 Housing Starts, 2011Q1 -2021Q4, Thousands of Units, SAAR

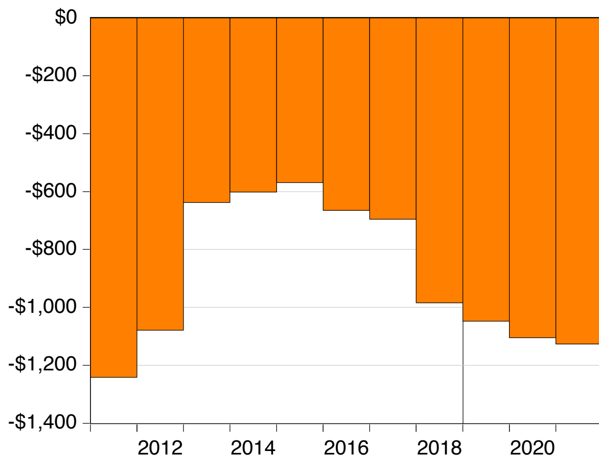


Source: U.S. Bureau of the Census and UCLA Anderson Forecast

The Twin Deficits: Federal and Trade

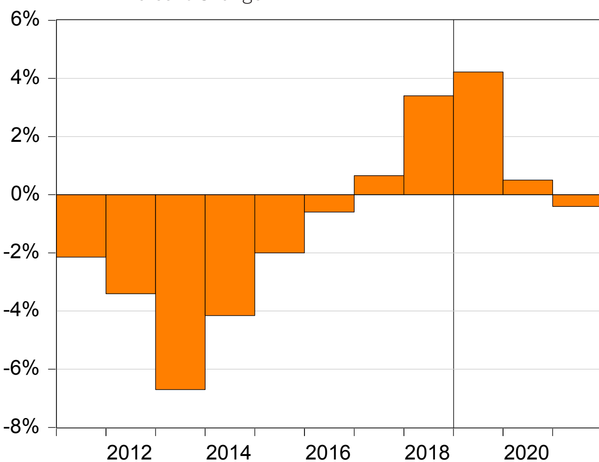
The consequence of the Trump Administration's tax and spending policy is a rising fiscal deficit. After incurring a deficit of $836 billion in FY2018, the deficit will exceed a trillion dollars a year through 2021 and beyond. (See Figure 14) Part of the increase in the deficit is due to the surge in real defense spending, but as we noted above that form of spending will soon level off at a high level. (See Figure 15)

Figure 14 Federal Deficit, FY 2011-FY 2021, In $Billions, Annual Data



Source: Office of Management and Budget, UCLA Anderson Forecast

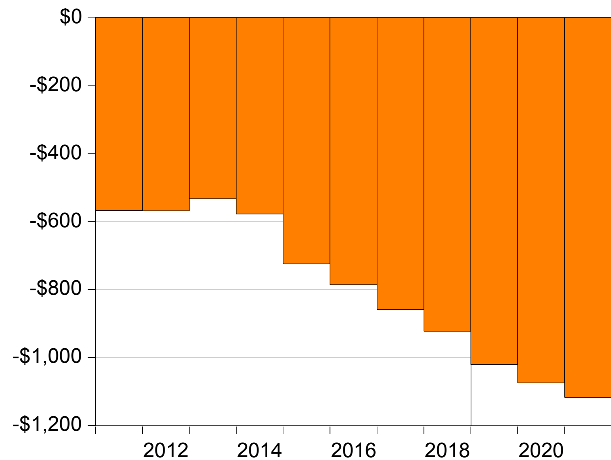
Figure 15 Real Defense Purchases, 2011 -2021, Annual Data, Percent Change



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

The flip side of the budget deficit is the trade deficit. In a sense the U.S. is financing our budget deficit with the trade deficit. How so? A trade deficit implies a capital inflow to finance it. As a result, the real trade deficit will increase from $920 billion in 2018 to over a trillion dollars a year over the forecast period. (See Figure 16) So much for trade protection reducing the trade deficit.

Figure 16 Real Net Exports, 2011-2021, In $Billions, Annual Data



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

Conclusion

Our forecast has been roughly consistent for over a year. We forecast that real GDP growth will slow to below 2% in 2019 and around 1% in 2020 with a modest rebound in 2021. The jolt from the very expansionary fiscal policies of the Trump Administration will soon exhaust itself and there is a very real risk of a recession in late 2020. Meantime the unemployment rate will continue to decline to 3.6%, before gradually returning to 4%. Inflation will remain modestly above 2% and after increasing the Fed Funds rate by 25 basis points mid-year, the Fed will embark on an easing policy in 2020. By 2021 real growth will return to a 2% track.