Fuzzy Data, a Slowing Economy and a Trade War

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The Commerce Department delivered a surprise at the end of April by reporting a very strong annualized 3.2% growth rate for real GDP in the first quarter. **However after looking under the hood, the core economy was only growing at a very modest 1.2% rate.** (See Figure 1)[1] The difference is a result of a huge inventory build-up, a substantial decline in imports, surprising strength in exports and a bulge in state and local spending due road repairs associated with this winter's storms.

Similarly the recent employment data does not appear to be as robust as reported. For example as measured by the widely reported payroll series the U.S. economy added 2.62 million jobs over the year ending April 2019, while the household survey reported a far low gain of 1.43 million people employed. This nearly 1.2 million difference between the two series is unusually large. (See Figure 2) Ultimately the gap will close as the data gets revised. Similarly, fuzzy data appeared in the Consumer Price Index where declines of 1.9% and 0.8% in apparel prices in March and April respectively was due to a change in methodology. These price decline are not sustainable, especially with more tariffs on the way.

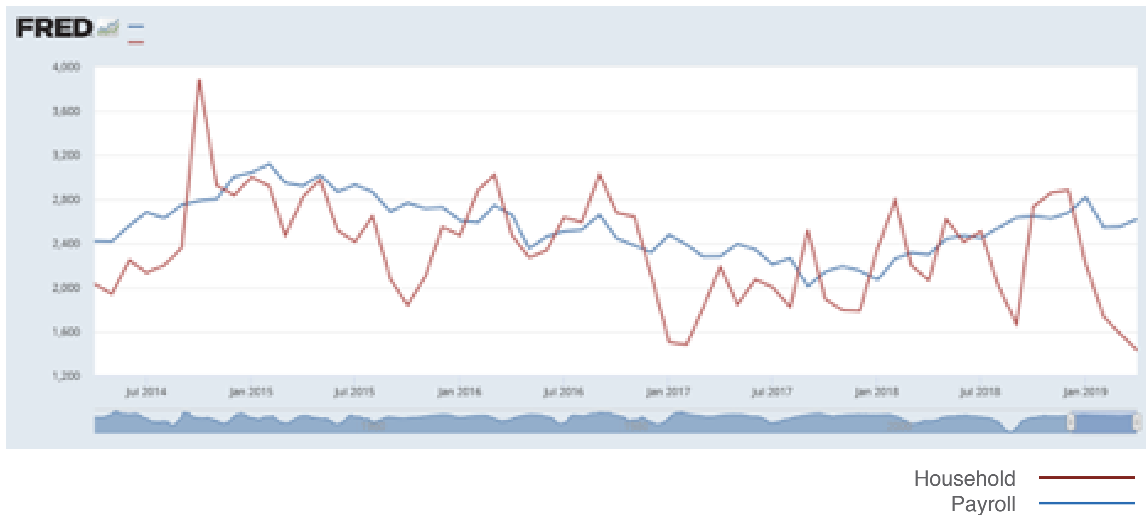
Figure 1 Reported vs. Underlying GDP Growth in 2019Q1

Reported Real GDP Change		3.2%
Less:	Inventory Change	-0.6%
	Export Increase	-0.4%
	Import Decrease	-0.6%
	State & Local Increase	-0.4 %
Equals	Gross Private Domestic Final Demand	1.2%

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

1. *This data is for the April release and does not reflect the May revision which was not available when written.*

Figure 2 Annual Change in Payroll Employement vs. Household Employment, April 2014-April 2019, Monthly Data, in Thousands

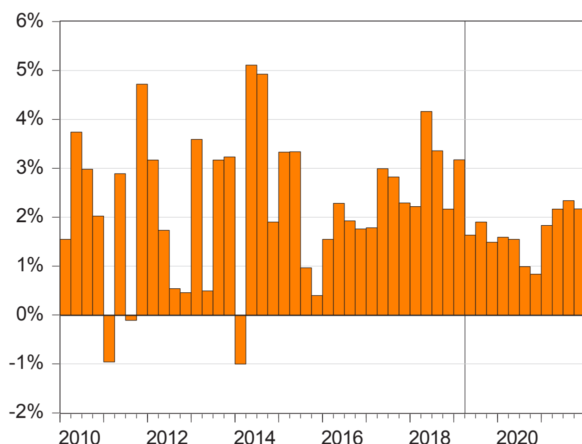


Sources: U.S. Bureau of Labor Statistics; UCLA Anderson Forecast

As a result of the data issues mentioned above we are essentially maintaining our forecast calling for a 3-2-1 economy where growth on a fourth quarter to fourth quarter basis was reported at 3.1% in 2018 and is forecast to be 2.1% and 1.4% in 2019 and 2020, respectively. For 2021 we are forecasting a rebound to 2.1%. (See Figure 3) **It is important to note that when the economy slows to 1% growth the risk of a recession become very real with the second half of 2020 being problematic.**

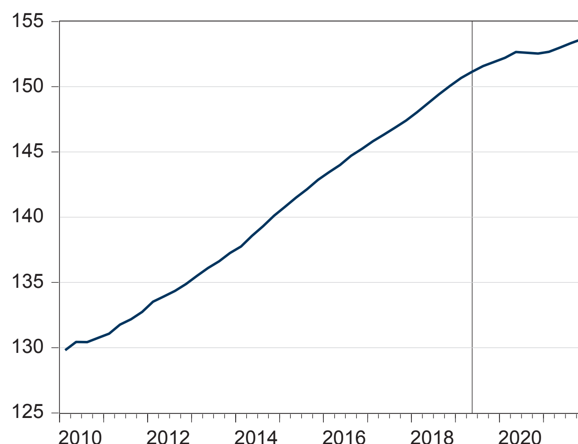
In this slowing environment employment growth will rapidly decelerate from the monthly run rate of 220,000 jobs a month in the year ending in April to about 130,000 a month in the second half and about 50,000 a month in 2020. (See Figure 4) Simply put we tend to believe that the household series mentioned above is telling the right story where over the past 12 months employment growth averaged 120,000 a month. Given our view that the economy is slowing it appears that the unemployment rate will bottom out at April's

Figure 3 Real GDP Growth, 2010Q1 - 2021QF, Duarterly Data, Percent Change, SAAR



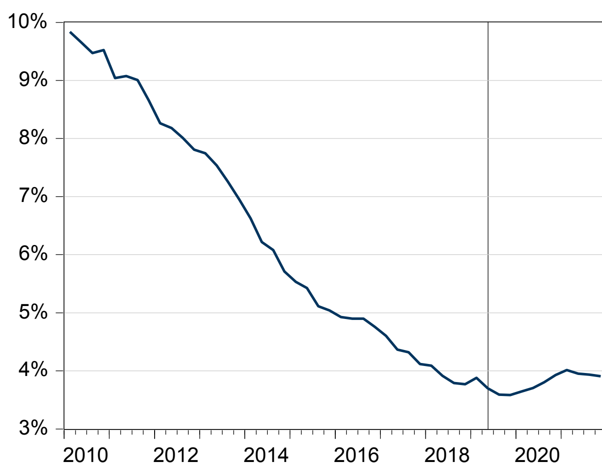
Sources: U.S. Department of Commerce; UCLA Anderson Forecast

Figure 4 Payroll Employment, 2010Q1 -2021Q4, Quarterly Data, In millions, SAAR



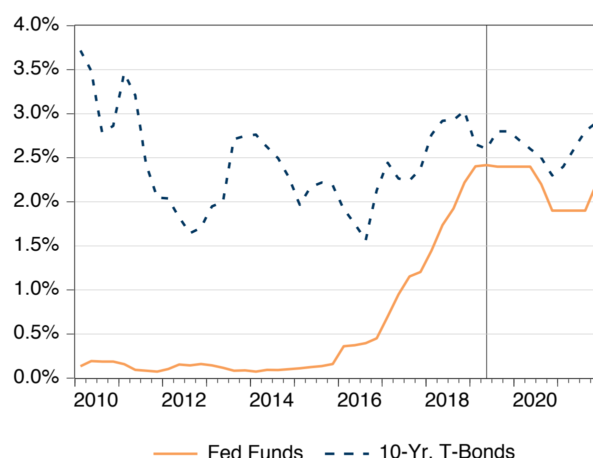
Sources: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 5 Unemployment Rate, 2010Q1-2021Q4, Quarterly Data, Percent, SAAR



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

Figure 6 Federal Funds vs. 10-Year U.S. Treasury Bonds, 2010Q1-2021Q4F, Percent



Sources: Federal Reserve Board and UCLA Anderson Forecast

3.6% level and remain there for about a year before rising to 4% in late 2020 or early 2021. (See Figure 5)

The Fed, Trump and Interest Rates

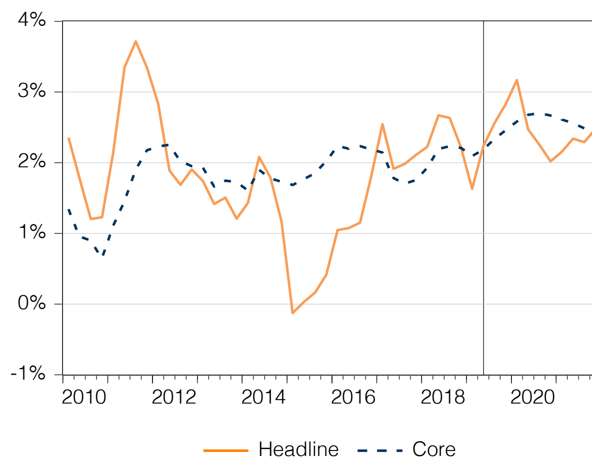
With his call for the Fed to lower interest rates by 100 basis points at a time when the economy is booming, President Trump declared war on the Fed. President Trump escalated by preparing to nominate to unqualified nominees, Stephen Moore and Herman Cain, to the Fed's board of governors. Fortunately those candidacies failed, but for personal, not professional reasons. His next choices likely will not have the personal difficulties of Moore and Cain, but would do his bidding just as well. This is not to say that the Fed board does not deserve a diversity of opinion, but its members should largely be independent of the White House as Trump's earlier appointees of Jerome Powell and Richard Clarida are.

Nonetheless with inflation remaining benign, the Fed is on track to keep interest rates where they are and there seems to be a willingness to let the economy run "hot" for a while. Thus we are forecasting that the Fed Funds rate will remain at its 2.375% midpoint until the middle of 2020 with a total 50 basis points of rate cuts will take place as the central bank responds to a slowing economy. (Figure 6)

In the environment we envision long term interest rates as measured by the 10-Year U.S. Treasury bond will remain range bound between 2.3% - 2.8% through 2020, a far cry from our earlier forecasts.

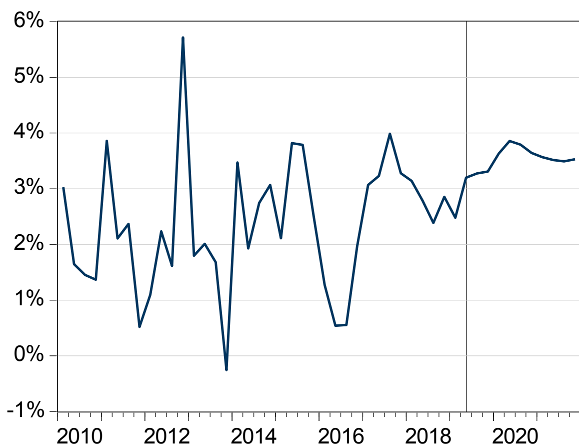
Fed policy will be buttressed by inflation remaining somewhat above two percent as measure by the Consumer Price Index and at their target 2% for the price indices associated with GDP accounting. (Figure 7) Although wage compensa-

Figure 7 Consumer Price Index, Headline vs. Core, 2010Q1 -2021Q4, Percent Change Year Ago



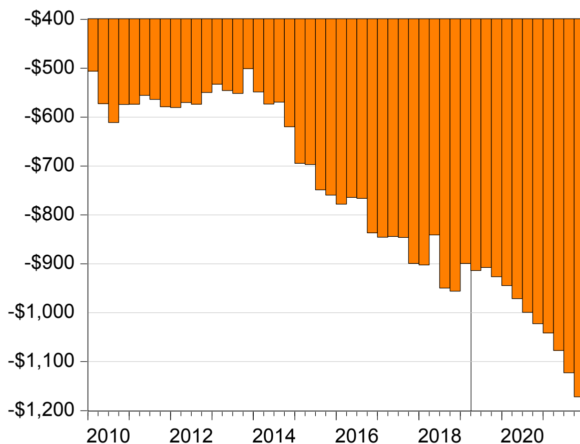
Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 8 Employee Compensation, 2010Q1- 2021Q4, Percent Change Year Ago



Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 9 Real Net Exports, 2010Q1 -2021Q4, Quarterly Data, In $billion, SAAR



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

tion gains will rally from the current 3% to just under 4%, it will not set off inflationary alarms. In fact those gains will be welcomed. (See Figure 8)

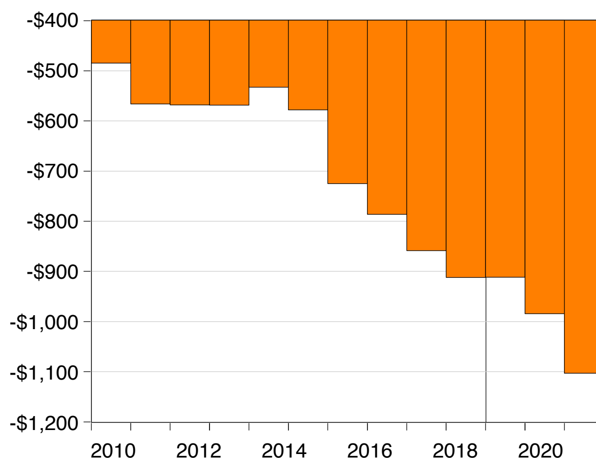
Trade WAR

With trade tensions with China going up and down like a yo-yo it is difficult to forecast what form the final policy will take on. But make no mistake, increasing the tariff from 10% to 25% on $200 billion worth of Chinese imports is not a policy that will enhance economic growth. To be sure there are real trade issues with China, but using artillery instead of a rifle will only make matter worse. **Put simply tariffs act like grains of sand in the gears of commerce.** Output is reduced and prices rise, not a good thing. Remember a tariff is a tax on American consumers and as such is contractionary. And as China retaliates it becomes the stuff that global slumps are made of. Moreover adding insult to injury the successor to NAFTA the U.S.-Canada-Mexico Agreement (USMCA) looks like it is about to implode.

What the Administration doesn't seem to understand that the overall trade deficit is not a matter of the trade balance with individual countries, but rather reflects the imbalance between domestic consumption and domestic production. A nation that consumes more than it produced imports the balance. Hence real net exports will exceed $900 billion this year and approach a trillion dollars in 2020. (See Figure 9)

The flip-side of the trade deficit is the budget deficit. In a sense the U.S. is using the trade deficit to finance the budget deficit because the offset to a trade deficit is a capital inflow of which part of it is used to purchase government debt. After reach $873 billion in fiscal 2018, the budget deficit is forecast to rise to $1.02 trillion, $1.06 trillion and $1.1 trillion in 2019, 2020 and 2021, respectively. (See Figure 10)

Figure 10 Federal Budget Deficit, FY10-FY21F, In $billions, Annual Data

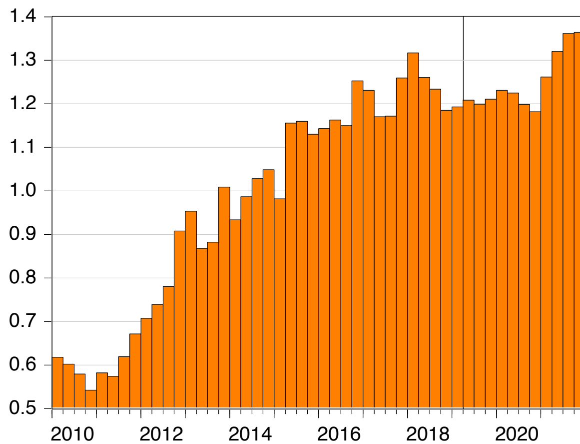


Sources: Office of Management and Budget and UCLA Anderson Forecast

The Housing Conundrum

One of the great conundrums of the long expansion is the failure of housing activity to launch. This is especially troubling because the recent 75 basis point decline in mortgage rates has failed to ignite demand. To be sure housing became way over-built from 2004-2007, but the failure of housing starts after a long expansion to reach the normalized level of between 1.4-1.5 million starts a year remains a mystery. Indeed housing starts have been locked in at level of around 1.2 million starts a year since 2016 and will stay at that level through 2020. (See Figure 11)

Figure 11 Housing Starts, 2010Q1-2021Q4F, Quarterly Data, In millions of Units, SAAR



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

There are a host of explanations for this that involve, lagged effects of the financial crisis, student debt, delayed family formation, restrictive zoning in the job creating metropolitan areas and recently the limitation on state and local tax deductions. With respect to zoning the lack of supply has led to a spike in housing prices and rents which in turn has triggered demands for self-defeating rent control and stricter controls where they already exist.

Conclusion

Don't be misled by the apparent strength in the recent jobs and GDP data. Although growing, the economy is weaker than it looks and has benefitted from several one-off factors involving imports and trade. Thus we are maintaining our 3-2-1 forecast for real GDP growth with a realized 3.1% in 2018, and a forecast of 2.1% and 1.4% in 2019 and 2020, respectively. With job growth slowing to a crawl of about 40,000 a month in 2020 the risk of a recession in the latter part of that year is nontrivial. Inflation is forecast to run somewhat above 2% and the Fed will maintain stable interest rates until the second half of 2020 where we are forecasting two rate cuts. The downside risk to the economy comes from increased trade tensions and the upside risk would come from housing activity rising out of its stupor.