A Wile E. Coyote Economy?

David Shulman
Senior Economist, UCLA Anderson Forecast
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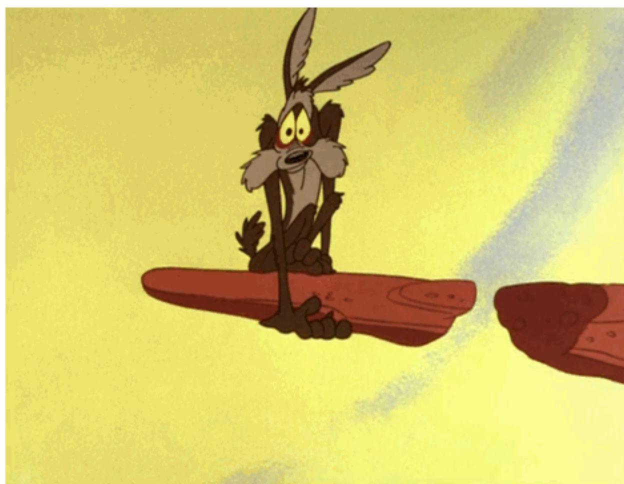
"In 2020, Wile E. Coyote is going to go off the cliff, and he's going to look down, and that (stimulus) will be withdrawn at that point."

Ben Bernanke, Business Insider, June 8, 2018

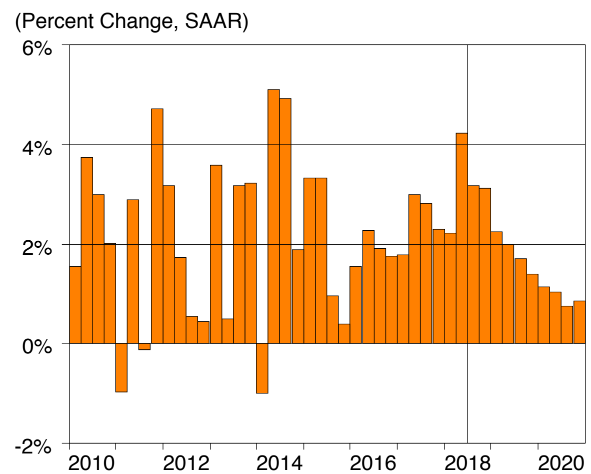
Wile E. Coyote is, of course, a famous Warner Brothers cartoon character who had a way of running well beyond a cliff before looking down and then falling straight down. (See Figure 1) Our view is perhaps not as dramatic, but directionally consistent with Bernanke's remarks, we are looking for a decided slowdown in 2020. **For example, on fourth quarter to fourth quarter basis, our forecast call for real GDP growth to slow from 3.1% this year to 1.9% in 2019 and a near recession 1.0% in 2020.** (See Figure 2)

Figure 1 A Wile E. Coyote Moment



Source: Screen Grab

Figure 2 Real GDP Growth, 2010Q1 -2020Q4F



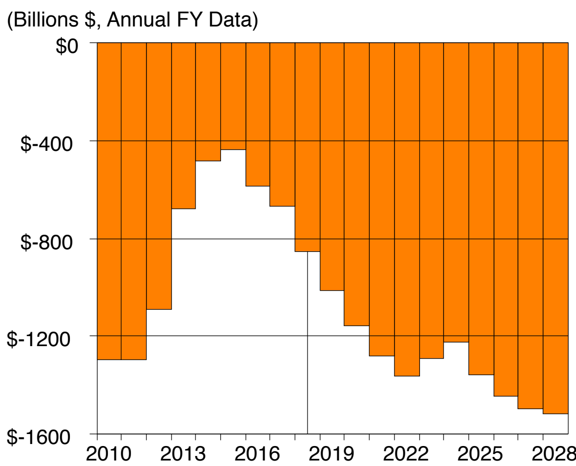
Sources: U.S. Department of Commerce and UCLA Anderson Forecast

The obvious question here is why are we so pessimistic about the outlook for growth beyond 2018, especially after coming off a 4.2% real GDP growth rate in the second quarter? To be sure, there is enough momentum in the economy to generate 3% growth in the second half, but growth will not be sustainable. Simply put, when an economy is already operating at full employment it is very difficult for it grow above trend which we estimate to be somewhat above 2%, which is higher than what the Federal Reserve is now forecasting. Further, the economy is currently benefiting from the massive tax cut and spending increases passed late last

year. As Bernanke noted, the stimulus coming from that will run out in 2020, but the deficits it created will linger on for over a decade. (See Figure 3) **The federal deficit, under current policy, will exceed a trillion dollars a year for as far as the eye can see.**

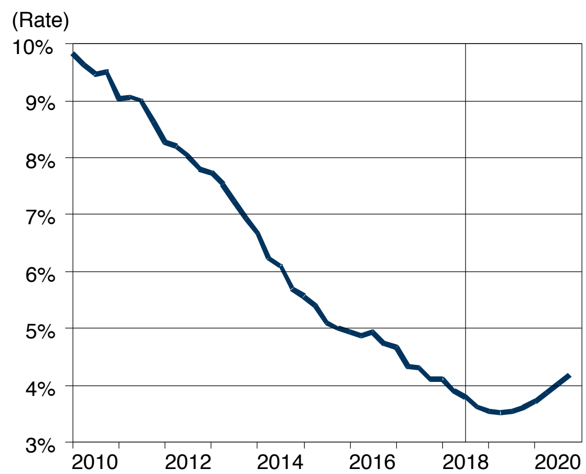
Meantime, employment growth continues to chug along with job gains approximating 200,000 a month this year and then declining to 125,000 a month and a much lower 30,000 a month in 2019 and 2020, respectively. (See Figure 4) In this environment, the unemployment rate will decline to 3.5% in early 2019 and then gradually rise to around 4% in 2020. (See Figure 5) Although we have been consistently wrong as to when wage inflation will ignite, we believe we are now at that moment. Although it is only one data point, average hourly earnings increased by a very strong 0.4% in August over the prior month and are now up 2.9% on a year-over-year basis. We forecast that private sector wage compensation will increase from 2.6% this year to 3.2% and 4.0% in 2019 and 2020, respectively. (See Figure 6)

Figure 3 Federal Deficit, FY 2010 - FY 2028F



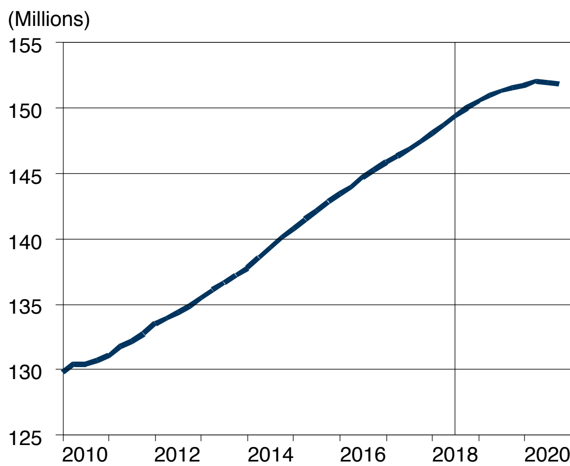
Sources: Congressional Budget Office and UCLA Anderson Forecast

Figure 5 Unemployment Rate, 2010Q1 - 2020Q4F



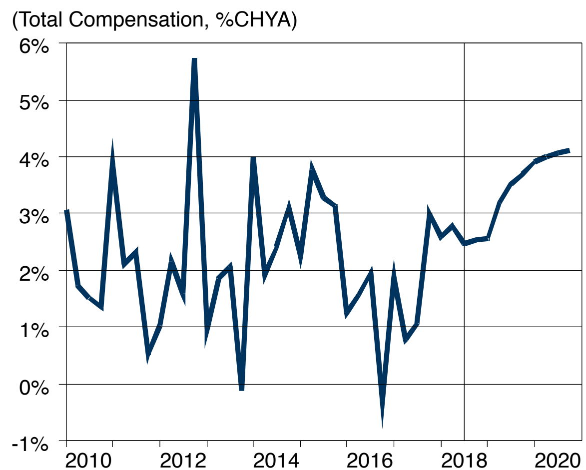
Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 4 Payroll Employment, 2010Q1 - 2020Q4F



Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 6 Employee Compensation, 2010Q1 - 2020Q4F



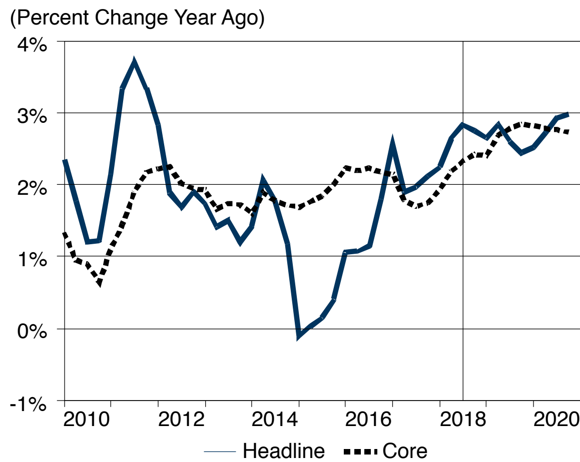
Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Fed Remains on Normalization Path

With most inflation measures running above the Fed's 2% target and with the economy operating at full employment, we believe that the Fed will continue on its path of interest rate normalization. (See Figure 7) Although our view might be a touch on the aggressive side, we forecast that the federal funds rate will top out at 3.25%-3.50% in late 2019 or early 2020. (See Figure 8) Our reasoning is underpinned by our view that the inflation rate will approach 3% in 2020.

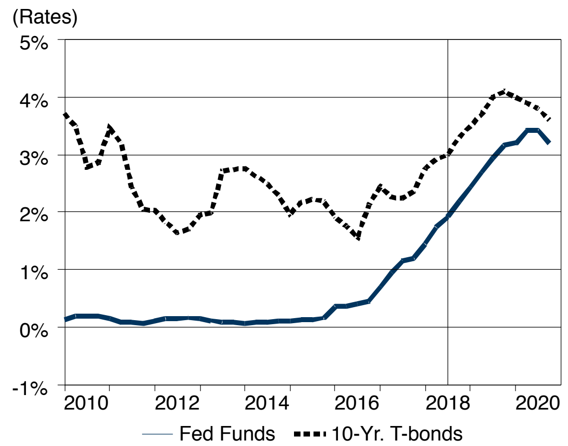
Concomitantly, the Fed will continue on its path of shrinking its bloated balance sheet from the current $4.2 trillion to $3.5-3.8 trillion by the end of 2020. (See Figure 9) Although there are many forecasters concerned that the yield curve will soon invert, we are not of that view because longer dated treasury yields will rise to reflect the heightened inflationary environment. However, we would not rule out an inversion in 2020.

Figure 7 Consumer Price Index vs. Core CPI, 2010Q1 - 2020Q4F



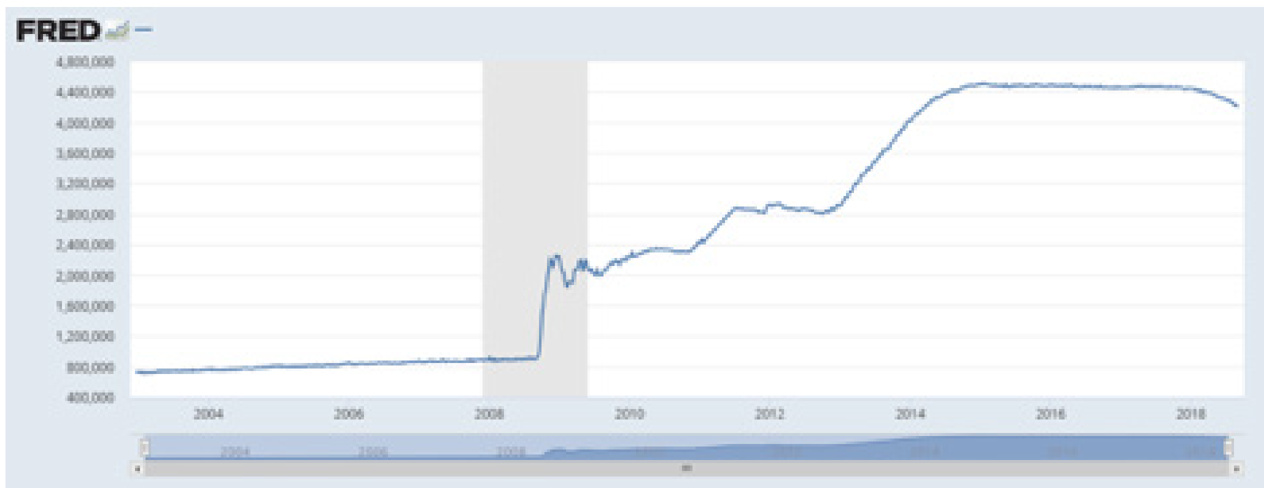
Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 8 Federal Funds vs. 10-Year U.S. Treasury Bonds



Sources: Federal Reserve Board and UCLA Anderson Forecast

Figure 9 Federal Reserve Assets, Dec. 02 - Sept. 18, Weekly Data in $Mil

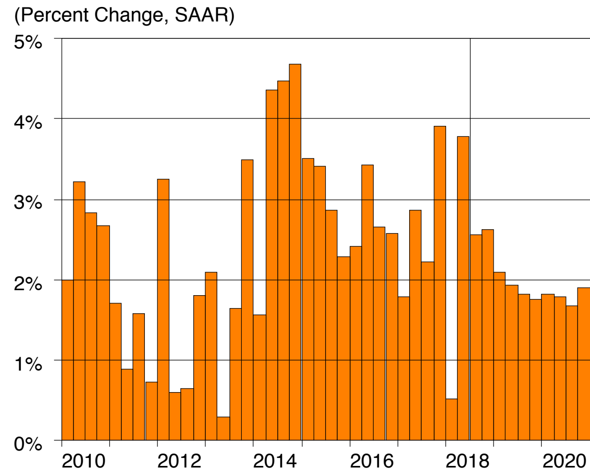


Sources: Federal Reserve Board via FRED

Strength in Consumption, Investment and Defense with Housing Lagging

Over the near-term, the economy is exhibiting broad-based strength. Real consumer spending has rebounded nicely from 0.5% in the first quarter to 3.7% in the second quarter and it is on track to grow at a 2.5% pace in the second half. (See Figure 10) **Of particular note is the surprising strength in the restaurant and bars category, which was up 9.7% in nominal spending in July compared to a year ago.** (See Figure 11) Our cheeky explanation for this is that the Trump people are out celebrating by eating and drinking and the anti-Trump people are acting out their depression by drinking and eating. Nevertheless, regardless of your political point of view the tax cuts are having an impact.

Figure 10 Real Personal Consumption Expenditures



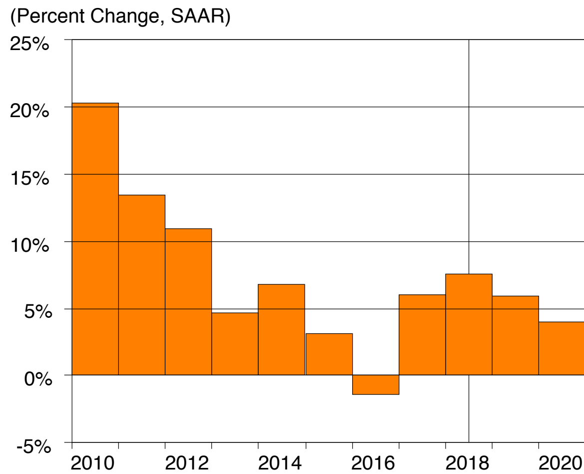
Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 11 Retail Sales at Food Services and Drinking Places, July 2013 - July 2018, Percent Change Year Ago

Sources: U.S. Department of Commerce via FRED

Similarly, business investment, especially equipment spending, remains a source of strength. After declining by 1.5% in 2016, equipment spending increased by 6.1% in 2017 and is on track to increase by 7.5% this year, the best performance since 2013. The rebound in oil and gas activity and the recently enacted corporate tax cuts are helping here.

Figure 12 Real Equipment Spending, 2010 - 2020F, Annual Data



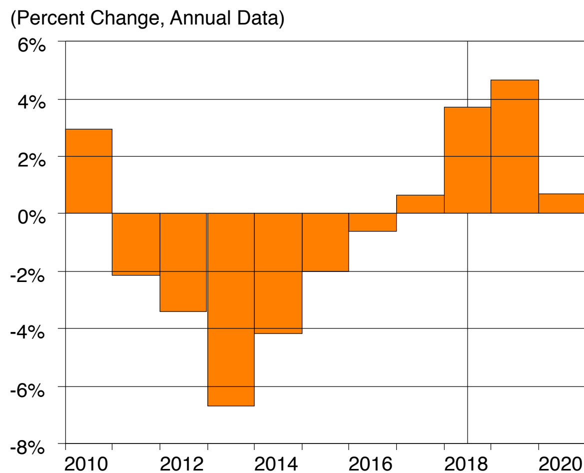
Source: U.S. Department of Commerce and UCLA Anderson Forecast

(See Figure 12) However, as the tax cuts run their course and the oil activity rebound slows, real equipment spending is forecast to increase at a more modest pace of 5.9% and 4.0% in 2019 and 2020, respectively.

Adding to the private sector strength, defense spending is surging. After years of decline, real defense purchases are forecast to increase 3.7% this year and 4.7% in 2019. (See Figure 13) In 2020, the surge will end with only a modest increase of 0.7%. Because most of the increases involve long-lived capital goods, the increase in defense purchases is reinforcing the growth in private sector capital equipment.

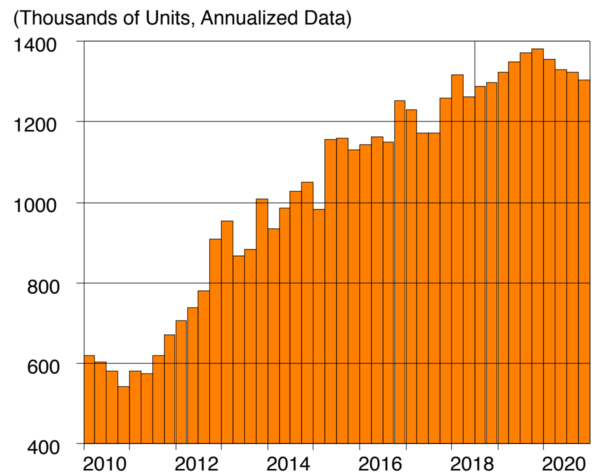
The one disappointing sector of the economy remains housing. To be sure, housing starts are modestly increasing, but because of growing affordability problems and restrictive zoning practices in major employment centers, housing starts remain below the underlying demographic demand. Instead of producing about 1.5 million units a year, housing starts are forecast to **peak** at around 1.35 million units in 2019 (quarterly peaks at 1.38 million units, SAAR) and then rollover as higher mortgage rates exact their toll. (See Figure 14) This is a far cry from the super boom level of in excess of two million units a year over a decade ago. Moreover, multi-family starts will account for about one-third of the overall activity.

Figure 13 Real Defense Purchases, 2010 - 2020F



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

Figure 14 Housing Starts, 2010Q1 - 2020Q4F



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

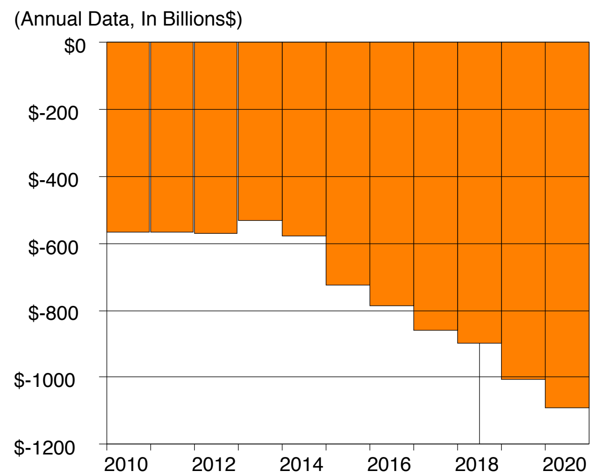
The Trade and Currency Wild Cards

Looming over our forecast is the uncertainty with respect to the trade policies of the Trump Administration and the beginnings of a currency contagion that is enveloping a few of the developing economies (.e.g. Turkish Lira and Argentine Peso). And do not forget the Italian economy remains problematic and could spill over into the Euro at any time. Although progress has been made with respect to renewing NAFTA, it remains to be seen whether or not Canada will join Mexico in making a deal with the U.S. Similarly, with tariffs expected to be extended to an additional $200-467 billion of goods (meaning 100% of imports from China), up from the current $50 billion. With tariffs averaging about 15%, this could amount to about an $80 billion tax on the U.S. economy. And with China retaliating, the U.S. farm economy is in a world of hurt requiring the administration to offer aid to soybean producers.

Further, although a trade war with the European Union has been temporarily avoided, it still remains on the administration's plate, especially with regard to automobiles. Make no mistake that in the short-run, the Trump tariff policies are both inflationary and output restricting. Indeed, the open question remains how uncertainty over trade policy will affect business investment.

However, one thing remains clear. The trade deficit is going to explode. Real net exports, a measure of the goods and services trade balance in 2012 dollars, amounted to -$860 billion in 2017. That will rise to -$900 billion this year and it will exceed **minus one trillion dollars in 2019 and 2020.** (See Figure 14) Simply put, instead of importing stuff from China, the global supply chains will adjust and import from other countries. What the administration doesn't understand is that the trade deficit is largely a result of macroeconomic policies caused by the lack of domestic savings and the ever-growing budget deficit.

Figure 15 Real Net Exports, 2010 - 2020F, Annual Data



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

Conclusion

Over the near-term, the economy remains on a broad-based strong 3% growth track, but that will slow to 2% in 2019 and a near recession 1% in 2020. The slowdown will be caused by the natural constraints of a fully-employed economy with a 3.5% unemployment rate next year and a waning of the administration's stimulus policies. Moreover, with the inflation rate moving closer to 3% than 2%, the Federal Reserve will continue to pursue its interest rate normalization policies that will bring the Fed Funds rate to somewhat above 3%.

The major near-term risk to our forecast remains the administrations trade policies that are both inflationary and output restricting with yet unknown effects on business investment.

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