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KEY INSIGHTS

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United States: 2019 Mid-Year Macro Update

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Key Insights

- The U.S. economy continued its decade-long expansion in the first quarter of 2019, achieving 3.1% growth.
- The economic expansion is being driven a strong labor market coupled with low borrowing costs for businesses and individuals.
- Amid weakening fundamentals, several headwinds are gaining momentum, including softening housing and manufacturing sectors and waning consumer health, which are compounded by uncertainty from international trade disputes.
- The cumulative effect of growing headwinds is expected to dampen growth to 2.3-2.5% for 2019.

Though currently healthy, the US. economy faces mounting headwinds that will likely slow growth in the year ahead.

Introduction. The U.S. economy is continuing its decade-long expansion midway through 2019. Indeed, U.S. growth achieved 3.1% in Q1, its third quarter above 3.0% in the past year, while the labor market continues solid payroll growth while maintaining historically low unemployment. The strong labor market and low borrowing costs for businesses and individuals are helping to keep the economic expansion alive.

Despite solid foundations, however, signs of weakness are becoming apparent, with looming headwinds raising new concerns. A lackluster housing market, softening manufacturing sector, and rising consumer financial stress will likely drag on economic growth through the rest of 2019. Furthermore, slowing business investment, easing retail sales in the first quarter of 2019, and trade tensions hitting consumers and businesses alike will dampen 2019 growth, which is likely to fall into the 2.3-2.5% range.

International trade disputes in particular are injecting uncertainty into U.S. baseline fundamentals that are already mixed. While trade risks appear to be hitting some sectors harder than others, the effects will undoubtably reverberate throughout the economy. The results of this uncertainty are difficult to properly predict and quantify, though the outcomes of these disputes will ultimately drive U.S. growth prospects.

The economy should continue to benefit from low interest rates and strong wage growth despite persistently low unemployment.

Perhaps it is useful to think about the future direction of the U.S. economy as being shaped by tailwinds and headwinds.

Tailwinds. The Fed has pivoted to more dovish monetary policy, due in part to tepid inflation and despite historically low unemployment, which together have tended to boost real wage gains.

- **Easy Monetary Policy:** International trade disputes, mixed U.S. economic data, and weak global growth has prompted the Federal Reserve to adopt a "wait-and-see" approach to monetary policy through 2019. While remaining committed to his data-dependent approach, Fed Chairman Jerome Powell has signaled willingness to cut rates if economic conditions deteriorate. Furthermore, the Fed indicated that it will unwind its balance sheet by $35 billion each month before ceasing the run-off after September. Indeed, markets are currently expecting a rate cut; 10-year Treasury yields declined to their lowest level since September 2017 and fed funds futures are pricing in a nearly 98% chance of one or more rate cuts by year's end. Dovish monetary policy will spur economic activity through lower borrowing costs as the U.S. transitions into uncertain times. However, if the Fed lowers interest rates below a level dictated by macroeconomic conditions, the Fed may inadvertently foster asset bubbles — including in equity prices and real estate prices — that could magnify an economic downturn.

- **Strong Labor Market:** Even though May's payroll growth disappointed, the U.S. labor market was robust in the first half of 2019. The labor market has added an average of nearly 196,000 jobs per month since June of last year, despite an unemployment rate of 3.6%, the lowest since 1969. With weekly jobless claims remaining near historically low levels, the labor market should remain a bright spot in the economy.

- **Solid Real Wage Growth:** Low inflation has been a global hallmark of the post-Great Recession era. Despite dovish monetary policy, inflation has remained at or below the Fed's target thus far in 2019 with CPI inflation reaching 2.0% in April for the first time in five months. Low inflation amplifies gains in wage growth, which has averaged 3.1% since August 2018. Robust nominal wage growth coupled with low inflation has led to healthy real wage gains, which should buoy consumer spending in the second half of 2019.

Headwinds. While dovish monetary policy and strong job and wage growth may place the U.S. on track for another decent year, the economy faces mounting headwinds for the remainder of 2019. A faltering housing market, softening manufacturing sector, and rising consumer financial stress seem poised to dampen U.S. growth prospects.

Elevated prices and supply headwinds have caused the housing market to soften despite low mortgage rates.

- **Weak Housing Market:** Despite near-record low mortgage rates and elevated consumer sentiment, the housing market has remained a drag on the U.S. economy for the past three years. Many metrics, including housing starts, building permits, and pending home sales have flatlined or declined since 2016. Though mortgage rates remain in the low 4% range, elevated home prices have caused prospective home buyers to refrain from entering the market. On the other hand, supply side headwinds are dampening prospects in the homebuilding sector. Immigration restrictions and a tight job market are causing shortages in construction labor, while tariffs continue to contribute to elevated input costs. As housing remains a critical component of the U.S. economy — contributing 15-18% to GDP on average — continued lackluster performance will act as a drag on growth in 2019.

- **Soft Manufacturing Sector:** Trade tensions disrupting global supply chains and a strong dollar making U.S. exports more expensive are leading to a domestic manufacturing slowdown. U.S. industrial production has surprised to the downside in Q2 2019, while the ISM Manufacturing PMI is at its lowest level since before the 2016 election. Future manufacturing prospects remain dim as well, as new orders — a leading indicator of manufacturing output — are at their lowest level in 15 months. Of course, the United States is not alone, as EU Industrial Production has sidewinded since 2017 and China's official manufacturing PMI declined in May to its lowest level in 10 years.

Weakening US and global manufacturing activity show little signs of reversal in the near term.

- **Consumer Health and Tightening Credit:** Despite elevated consumer confidence, financial stress is showing signs of rising in the face tightening lending standards. In conjunction with slowing consumer spending, consumer loans are showing foundational weakness. The share of credit card balances past 90 days delinquent is at its highest since Q1 2011, and 90-day delinquent auto loans also hit their highest peak since 2011. Banks are taking note of these headwinds, with 15% of loan officers tightening lending standards for consumer credit cards, according to the Fed's May Senior Loan Officer Survey. Consumer financial stress is inching up, despite easier credit conditions considering expected Fed rate cuts, a sign that the primary contributor to economic growth may be waning.

Factors to Watch. In addition to the trends laid out above, several other factors will affect U.S. economic performance through the remainder of 2019. Trade disputes and geopolitical strife are plaguing the U.S. with uncertainty and could spark a downturn deepened by highly leveraged corporations.

- **Large Corporate Debt and Asset Price Bubbles:** Historically low interest rates have created a low-cost borrowing environment, which in turn has led to highly leveraged corporate balance sheets. Despite reduced tax incentives to take on debt, nonfinancial corporate debt reached $6.4

trillion due in part to loosening standards for corporate lending. The leveraged loan market — credit extended to low-rated, highly-indebted companies — has grown to $1.4 trillion. Furthermore, equity valuations remain at historical highs. The start of 2019 was one of the strongest for equities, which is cause for concern that a bubble may be forming, given ample headwinds to company performance.

Though overleveraged companies are cause for some concern, current debt levels are a fraction of what was seen leading up to the sub-prime mortgage crisis. Additionally, low interest rates provide an environment for companies to remain profitable, a positive for equities valuations. While it remains unclear if overleveraged companies and high asset prices will be the cause of the next downturn, these factors seem likely to at least magnify the effects of a downturn on financial markets.

Trade disputes are the single biggest source of uncertainty in 2019, as tariffs have the potential to drag down both domestic and global growth.

- **Trade Disputes:** President Trump has no qualms about utilizing his most powerful economic tool — tariffs. Outcomes of the various trade disputes are the primary source of uncertainty looming over the U.S. economy and the most critical and complex factor affecting growth prospects in 2019. According to a study from UBS, 25% tariffs on $200 billion of Chinese goods could put $40 billion of sales and 12,000 retail stores at risk. Disruptions from trade disputes will place further stress on the U.S. consumer; a study by economists from the Chinese University of Hong Kong estimates that Chinese imports have decreased consumer prices by 27 percent since 1994. In addition to higher costs for businesses and consumers, a potential China slowdown resulting from tariffs would reverberate throughout the global economy (and ultimately weigh significantly on US growth) given that China accounts for one third of global growth. Although the outcomes and timing of resolutions to these trade disputes remain unknown, both businesses and consumers are likely to suffer.

The Bottom Line. While the U.S. economy had a strong start to 2019, moving forward the outlook is starting to dim. Dovish monetary policy will provide much needed support to the housing and manufacturing industries, while maintaining easy corporate and consumer borrowing costs. However, it remains to be seen if Federal Reserve policy will be enough to counteract the negative effects of fractured global commerce resulting from trade wars.

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