CIO | VIEW

U.S. Economic Outlook

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Marketing Material

THE END OF A CUTTING CYCLE AHEAD?

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IN A NUTSHELL

- The Fed looks set to cut rates once again in October, and probably not for the last time in the current cutting cycle.
- We expect the Fed to remain data dependent.
- In our view, there are plenty of risks to the Fed's outlook during the next twelve months. And, most of them are to the downside.

With two 25 basis-points (bps) rate-cut moves already in 2019, the U.S. Federal Reserve (Fed) may face tougher decisions in the meetings ahead. For example, have those cuts sufficiently helped to insulate the economy from existing risks? Is a more neutral stance now appropriate? The markets may be pricing in several more cuts, but financial professionals differ widely in their opinion as to the number or necessity. Even the Fed itself seems unsure. A bias toward lower rates was subject of some dissension in the last Federal-Open-Market-Committee (FOMC) meeting: "Several participants suggested that the Committee's post-meeting statement should provide more clarity about when the recalibration of the level of the policy rate in response to trade uncertainty would likely come to an end" – an open call to implement a stricter forward guidance to show markets the limit of the Fed's willingness to ease.[1]

Forward guidance is one of the most powerful levers in the monetary-policy toolbox. Put simply, it is the clever use of central-bank communication about the future path of interest rates to modify the current behavior of economic agents.[2] Fed researchers themselves distinguish between two general styles: the Odyssean and the Delphic form of forward guidance.[3] The first, named after the ancient Greek hero Odysseus, represents the hard commitment to follow a certain path of monetary policy, a "lashing to the mast." In contrast, Delphic forward guidance, named after the often ambiguous Delphic Oracle, is a more subtle matter.[4] Basically, it is a three step process. First, central bankers publish forecasts about their expectations of the future macroeconomic performance. Second, they name the risks that surround these forecasts. Third, monetary decision-makers preemptively give some indications of how monetary policy might react if the forecasts are missed or the named risks materialize.[5] The latter brings us pretty close to the current style of communication the Fed is practicing. In lengthy, almost ritualistic language, the message is: the Fed will be data-dependent.[6]

With two meetings remaining in 2019 (October and December), let's quickly run through the most important recent data points. Recent labor-market developments indeed suggest some moderation. The current pace of job creation (as measured by the non-farm payrolls (NFP)) remains fairly robust, but below expectations: the three-month average was at 157,000 in September, a significant deceleration from 245,000 at the end of 2018. We did, however see a 50-year low of the unemployment rate at 3.5% as wage growth still remains moderate. One primary reason for the Fed to worry in the near term is the deterioration of industry sentiment. The ISM manufacturing PMI weakened further below the expansionary threshold of 50. The parallel barometer for

[1] https://www.federalreserve.gov/monetarypolicy/fomcminutes20190918.htm
[2] https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/effects-of-forward-guidance-in-three-macro-models-20150226.html
[3] https://www.chicagofed.org/publications/working-papers/2012/wp-03
[4] The authors of the cited study somehow fail to mention that the ancient Delphic oracle often made ambiguous utterances – a strategy still employed by some modern day central bankers.
[5] In general, policy tools to counter e.g. an economic downturn are well telegraphed. In the case of the Fed interest rates are the primary tool.
[6] https://www.federalreserve.gov/newsevents/pressreleases/monetary20190918a.htm

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the service-sector sentiment also declined steadily in the recent months. Of course, the manufacturing sector represents only roughly 11% of the U.S. economy.[7] However manufacturers are also consumers of services and a quick statistical analysis shows that there is indeed a negative spillover into the non-manufacturing sector – at least with some time lag.

Beyond the measures of the real economy, inflation remains modest. This time around, it was not the weak headline or core-inflation figures that caught our attention. Core inflation as measured by the consumer price index (CPI) remains solid above 2% and suggests that the policy-relevant measure core personal consumption expenditure index (PCE) could firm further. What rattled us is the decline of core producer prices for goods (from well above 2% end of 2018 to roughly 1.4% in September). Within both finished goods and certain services, there were clear signs of a loss of pricing power in certain cyclical sectors, such as in the margins received by wholesalers and retailers. That may ultimately suggest lower overall profit growth. While this is currently most acutely felt in the goods-producing sector, producer prices suggest that the pain may already have started to spread to parts of the service sector.

In general, the above mentioned developments are not yet alarming signals in terms of a potential recession. We interpret them rather as a sign that the expansion of the U.S. economy is slowing visibly and also of the complexity of economic forecasting at cyclical turning points. The main reason for recent weaknesses seems obvious: trade war tensions. We take little comfort from tentative signs of some sort of trade deal between the United States and China. The current version of the deal does not tackle many of the issues underlying the conflict. In any case, it remains far from clear whether any agreement can actually be reached. Moreover, increasing domestic political tensions surrounding the potential outcome of the impeachment inquiry against President Trump may create further risks to the Fed's economic outlook.

While the above mentioned developments may be enough for the Fed to cut rates once again in October, there is still another component to the story: recent distortions in the money markets [DWS Fixed-Income Perspectives as of 10/4/19]. Repo rates spiked in mid-September, but normalized relatively quickly once the Fed New York flooded reserves into the system. Various reasons have been named for the initial reserve shortage.[8] Whatever the case, the endgame was the decision, concluded in an unscheduled meeting, to renew the purchase of Treasury bills in order to stabilize reserve balances at around 1.45 trillion U.S. dollars (USD) as well as to conduct overnight and term repurchase agreements (repo) operations. The final details arrived via Twitter![9] The New York Fed announced its intention to buy 60 billion USD in Treasury bills per month. While this operation exceeded the volumes of the last round of quantitative easing (QE) in 2012, the Fed insisted that this is certainly no new QE program. We quite agree. Quantitative easing can only be effective if the whole yield curve is involved. And much of its effect, if any, relies on the correct forward guidance being given. However, to prove that the recent policy decision is really purely technically and not a substitution for a rate cut requires a rate cut in October. Beyond that, we expect the Fed not to signal an end of the cutting cycle. Instead, we expect the U.S. central bank to steadfastly remain data dependent. In our view, plenty of risks to the outlook are likely to remain during the next twelve months. And, most of them are to the downside.

OVERVIEW: KEY ECONOMIC INDICATORS

	2018				2019				2020	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP (% qoq, annualized)	2.5	3.5	2.9	1.1	3.1	2.1	1.8	2.0	2.0	2.2
Core inflation (% yoy)*	1.9	1.9	1.9	1.9	1.5	1.6	1.7	1.9	1.9	1.9
Headline inflation (% yoy)*	2.1	2.4	2.0	1.8	1.4	1.4	1.4	1.6	1.7	1.8
Unemployment rate (%)	4.0	4.0	3.8	3.8	3.9	3.7	3.7	3.7	3.7	3.7
Fiscal balance (% of GDP)	-3.5	-3.6	-4.0	-4.1	-4.3	-4.4	-4.4	-4.5	-4.7	-4.6

* PCE Price Index

[7] As measured by value added as percentage of GDP. https://apps.bea.gov/iTable/iTable.cfm?reqid=51&step=51&isuri=1&table_list=5&series=q
[8] Tax payments, treasury settlements, excess reserves by banks, money-market funds holding back liquidity.
[9] https://www.newyorkfed.org/markets/opolicy/operating_policy_191011 and New York Fed on Twitter as of 10/11/19

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GLOSSARY

Basis point
One **basis point** equals 1/100 of a percentage point.

Consumer price index (CPI)
The **consumer price index (CPI)** measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

Core inflation
Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

Cyclical
Cyclical is something that moves with the cycle.

Federal Open Market Committee (FOMC)
The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Inflation
Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

ISM Purchasing Managers Index
The **ISM Purchasing Manager Index**, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

Margin
Margin describes borrowed money that is used to purchase securities.

Monetary policy
Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Personal consumption expenditure (PCE) Index
The **personal consumption expenditure (PCE)** measure is the component statistic for consumption in gross domestic product (GDP) collected by the United States Bureau of Economic Analysis (BEA).

Purchasing Managers Index (PMI)
The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector in a specific country or region.

U.S. Federal Reserve (Fed)
The **U.S. Federal Reserve**, often referred to as **"the Fed"**, is the central bank of the United States.

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