Deutsche
Asset Management

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U.S. economic outlook 3/18

Economic outlook

— The U.S. economy continues to perform well, and the near-term outlook remains bright. Momentum is solid, especially in the labor market, and although spending indicators have slowed of late, suggesting a softer pace of GDP growth in Q1, that softness may reflect the recurring seasonal pattern of weaker gross domestic product (GDP) prints in the first quarter of the year. Growth is likely to looker firmer over the balance of 2018, underpinned by solid domestic fundamentals, strong global activity, fiscal stimulus, and still-generally accommodative financial conditions. Against this backdrop, labor markets will likely tighten modestly further, helping nudge inflation back up to the Federal Reserve's (Fed's) target, though we continue to push back against alarms that inflation will spike sharply higher.

— There are some risks, however, to this generally sanguine outlook. Trade frictions are one; not the isolated tariffs that have been enacted so far, but the possibility of an escalating and broadening trade war that could redound adversely on financial conditions and economic activity. That's not our base case, which envisages only modest further trade restrictions, and only a gradual shift in financial conditions to providing less impetus to growth as the Fed continues to reduce policy accommodation. But risks of more abrupt, severe dislocations cannot be ruled out. Similarly, while we don't see the economy in imminent danger of overheating or financial excess, these risks rise on a medium-term horizon, as the Fed often finds it difficult to tighten financial conditions just enough to bring the economy in for a soft landing.

— For now, though, the coast looks reasonably clear. Households continue to enjoy solid income growth,

Economic and financial market projections

	Real GDP	Core PCE Prices	10-year U.S. Treasury Yield	S&P 500 Index
2016				
2Q	2.2%	1.7%	1.64%	2084
3Q	2.8%	1.8%	1.63%	2158
4Q	1.8%	1.9%	2.49%	2247
2017				
1Q	1.2%	1.8%	2.48%	2367
2Q	3.1%	1.5%	2.19%	2434
3Q	3.2%	1.4%	2.20%	2493
4Q	2.6%	1.5%	2.40%	2664
2018				
1Q(F)	1.9%	1.6%	2.80%	2725
2Q(F)	3.0%	1.8%	2.85%	2760
3Q(F)	2.7%	1.8%	2.90%	2800
4Q(F)	2.6%	1.9%	2.95%	2830
2019				
1Q(F)	2.5%	1.9%	3.00%	2850

Source: Deutsche Asset Management as of March 2018. **Performance is historical and does not guarantee future results.** Quarterly GDP change is annualized. The core Personal Consumption Expenditures (PCE) Price Index change is the four-quarter percentage change. The10-year U.S. Treasury yield and S&P 500 Index level are from the last month of the quarter. F refers to forecast. FR is forecasted revision. The S&P 500 Index tracks the performance of 500 leading U.S. stocks and is widely considered representative of the U.S. equity market. The Personal Consumption Expenditures (PCE) Price Index tracks the average increase in prices for all domestic personal consumption items. The core PCE Price Index is a less volatile report than the PCE Price Index in that it does not include more volatile food and energy prices. It is not possible to invest directly in an index.

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rising in net worth, manageable debt and especially debt service, elevated confidence, and firm labor markets. On the business side, though leverage is up, and the credit cycle seems fairly mature, it does not appear overly stretched. The gap between capital expenditures and internally generated funds has picked up from the lows reached after the recession, but it remains well below levels that preceded past downturns, suggesting there is room for investment to accelerate. And that acceleration seems to have begun, on the back of improved confidence and still-favorable financial conditions.

— The global economy has also picked up steam, bolstering US exports, especially given the lagged effects of the dollar's weakening over the past year.

— And then there's the fiscal stimulus. The tax package and the spending agreement are apt to lift growth by ½%-¾% in 2018 and 2019. The effects would be larger, but effective tax rates are not coming down all that much (given the many offsets and base-broadening provisions), and the economy is near full employment—when fiscal multipliers tend to be smaller because there are few pent-up demands to be vented, and less room to accommodate them without pressing against capacity constraints and pushing up interest rates. Indeed, at this point in the cycle, demand-side stimulus could be counterproductive, boosting near-term growth but increasing the risk of overheating and financial excess— the kinds of imbalances that can eventually make recession more likely (in part by inducing the Fed to tighten more aggressively).

— To counter these risks, the economy needs help on the supply side—policies to boost potential growth, and afford the expansion extra running room. There are elements of the tax plan that might help on this front, as may recent regulatory changes, but these kinds of supply-side benefits are hard to calibrate and likely to take time to come to fruition. The earmarked spending increases, by contrast, are apt to provide an immediate lift to demand, but little long-term benefit as they are short on things like infrastructure that might help lift potential output. What's more, even under optimistic assumptions about the growth effects of the tax package, the fiscal changes are almost sure to worsen the federal government's already daunting long-term fiscal challenges, likely necessitating more federal borrowing that could eventually crowd out private, productive investment.

— All told, while we would welcome a supply-side miracle, we're reluctant to expect one. We are anticipating some improvement in potential growth as productivity rebounds from unusual weakness, aided in part by a strengthening of business investment, and as tight labor markets coax still more people into the labor force and prompt firms to search even harder for efficiencies, but these additions are apt to be incremental—sufficient perhaps to mitigate but not fully offset other structural drags, including demographics. Yes, productivity can sometimes surprise sharply to the upside—few anticipated the surge in the late 1990s, for example—but we'd caution against building that in as a base case.

— And the looming specter of protectionism could undermine potential growth. So far, the announced tariffs are too small to have much adverse impact, either on financial markets or the macro economy. But if they are the tip of the iceberg—an opening salvo in a broader trade war—that could seriously undermine the open, rules-based global order, weighing heavily on financial markets, economic efficiency, and potential growth, not just in the US, but globally. That's not our expectation, but it is a risk that can't easily be dismissed. With China's trade practices coming under increased scrutiny, and North American Free Trade Agreement (NAFTA) negotiations ongoing, we have not likely heard the last of protectionism. Also, if the tax package succeeds in boosting domestic investment, without lifting domestic saving (government dissaving is actually apt to rise), the extra saving is going to have to come from abroad, which means the current account deficit has to rise—not a problem in and of itself, but something that may further fuel protectionist sentiment.

— Absent a substantial improvement in the economy's potential, it will be hard to sustain recent rates of growth, let alone much acceleration, now that much of the economy's spare capacity has been absorbed.

— Indeed, labor markets already seem close to full employment. Although there may still be some residual pools of slack, they're getting pretty shallow. Still, wages continue to accelerate only modestly and somewhat erratically—enough to reinforce perceptions that labor markets have tightened, but not that they are overheating. But with job growth still running at a pace likely to induce further tightening of labor markets, wages pressures are apt to build, if gradually.

— That should help nudge inflation back up to target. Recent inflation readings have been firmer, reinforcing our view that some of the slippage early last year reflected transitory factors, and that inflation will rise back to target as the temporary restraints fade, the effects of diminished slack and gradually accelerating labor costs make themselves felt, and inflation expectations remain generally well anchored. Still, we think fears about an inflation surge are overblown given the general inertia in the inflation process, the stickiness of inflation expectations, and the attenuated responsiveness of inflation to diminished slack.

Monetary-policy outlook

- Fed policymakers are likely feeling more confident in the outlook, and more convinced that continuing on a gradual path of reducing policy accommodation is the proper course. Another rate hike at the March FOMC meeting seems a fait accompli, accompanied by expectations of still more to come.
- As long as labor markets continue to tighten, and inflation looks likely to return to target, the Fed will remain inclined to scale back accommodation for fear that failing to do so would risk stoking the kinds of excesses and imbalances that might necessitate a more abrupt and potentially destabilizing policy tightening later on. In other words, easing the foot off the monetary accelerator now—and perhaps before long even gently tapping the brakes—make it less likely the Fed will have to slam on those brakes later. Also, it's not as if the steps taken so far have weighed too heavily on the economy or financial markets. In fact, overall financial conditions had continued to ease until early this year, and their recent tightening has been relatively modest. Moreover, the economy has solid momentum, and the fiscal stimulus is apt to add to that. Also, recent readings on inflation have been more upbeat, and given that inflation often lags, and still seems to respond to changes in slack (albeit in a more attenuated way than in past eras), the case for continued removal of monetary policy stimulus remains.
- However, there also reasons for the Fed to tread carefully—to be cautious in removing accommodation. For one, even though interest rates are low by historical standards, the neutral rate seems likely to remain lower too (albeit edging up from post-crisis lows), suggesting that it might not take much more in the way of rate hikes to restore a more neutral stance. Also, there may still be some residual slack in labor markets. Finally, though inflation has looked better of late, it has been running below target for years, so it is important that it return to 2% (if not a bit above for a while), to ensure that expectations remain firmly anchored near the Fed's objective.
- How policymakers balance these competing arguments depends of course on how the economic outlook evolves. Our take remains that further improvement in labor markets and progress on inflation will keep policymakers inclined to remove policy accommodation, though not aggressively by historical standards. That's apt to include not only continued balance sheet reduction, but also further rate hikes, with the next 25 basis points coming at the March Federal Open Market Committee (FOMC) meeting, followed by perhaps three additional moves over the following 12 months (through Q1 2019), and a bit more beyond that, ultimately taking the funds rate back towards 3% or so, with a cumulative balance sheet reduction of about $1 trillion—a notable tightening, but one that by the standards of past cycles would still leave rates low and the Fed's balance sheet elevated.

Financial market outlook

- After a brief period turbulence in February, financial markets have calmed in recent weeks, reassured by ongoing signs of solid global growth and declining fears of overheating and rising interest rates. Still, underlying jitters remain, fueled in part by concerns about trade frictions.
- Our base-case economic outlook remains broadly supportive of risk assets and a slight weight on Treasury prices, but only a slight one, especially at the longer end of the yield curve, which should be supported by still relatively quiescent inflation. However, a lot of good news has been priced in to risk assets, and from here rates of return are unlikely to match what's been seen in recent years (especially if troubles on the trade front intensify).

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Definitions

One **basis point (bp)** equals 1/100 of a percentage point. The **Federal Open Market Committee (FOMC)** is a committee that oversees the open-market operations of the U.S. Federal Reserve. **The gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. The **North American Free Trade Agreement (NAFTA)** is a treaty entered into by the United States, Canada, and Mexico in January 1994, which broadened the free trade arrangement. The **U.S. Federal Reserve (Fed)** implements U.S. monetary policy.

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