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U.S. economic outlook 6/18

Economic outlook

— The U.S. economy keeps chugging along. Economic momentum remains strong, with growth continuing to run above potential. Labor markets, already near if not a shade beyond full employment, continue to tighten, and inflation has returned close to the Federal Reserve's (the Fed's) target. What's more, the near-term outlook remains bright. Indeed, the economic expansion, already the second-longest on record, is showing little sign of wear, underpinned by sound domestic fundamentals, fiscal stimulus, and the lagged effects of easier financial conditions. Against this backdrop, we expect growth to remain above potential (if gradually moderating) into next year, enough to tighten labor markets modestly further and help solidify inflation's move back near the Fed's target, though a material inflation overshoot remains unlikely given well-anchored inflation expectations and the attenuated responsiveness of inflation to changes in slack.

— There are, however, several risks to this generally benign outlook. The tightening of financial conditions this year, while modest and not nearly enough to dent our outlook much—especially since we've been anticipating that financial conditions would gradually shift to providing less support as the Fed reduced policy accommodation—bears watching. So too do developments on the trade front. Frictions have been intensifying here, with actual and prospective tit-for-tat trade restrictions between the US and key trading partners [e.g., China, North American Free Trade Agreement (NAFTA) members, and the European Union (EU)] increasing. Though the direct macroeconomic effects still seem likely to be small, risks of more adverse effects—via financial markets and/or business

Economic and financial market projections

	Real GDP	Core PCE Prices	10-year U.S. Treasury Yield	S&P 500 Index
2016				
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	2.9%	1.5%	2.40%	2664
2018				
1Q	2.0r%	1.7%	2.80%	2725
2Q(F)	3.7%	1.9%	2.95%	2750
3Q(F)	2.6%	1.9%	3.05%	2780
4Q(F)	2.6%	1.9%	3.15%	2825
2019				
1Q(F)	2.5%	2.0%	3.25%	2850
2Q(F)	2.5%	2.0%	3.30%	2900

r: expected revision (2.2 was the latest print)

Source: Deutsche Asset Management as of June 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. The 10-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.

Josh Feinman is a managing director and chief global economist of DWS. In this position, he provides portfolio managers and clients around the world with timely analysis of global macroeconomic trends and their implications for financial markets. Feinman is also responsible for authoring and editing a series of publications on global economic and financial market issues for distribution among the bank's offices and clients. A frequent guest lecturer and commentator, Feinman delivers speeches around the world and is a frequent guest on financial television programs and is often quoted in major print and electronic media.

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confidence—cannot be dismissed, and have risen of late.

— Finally, the U.S. faces a non-negligible, medium-term risk of overheating. The longer growth remains above potential, and the further labor markets tighten beyond full employment, the greater the risk not only of inflation pressures, but of the kind of broader-based financial and economic excesses that have often presaged economic slowdowns. We don't see this as an imminent threat, but it is a possibility that looms over the horizon.

— For now, though, the coast looks pretty clear. Households continue to benefit from sound finances, elevated confidence, and firm labor markets. Higher energy prices may dampen purchasing power, but they'll also support the domestic energy sector. For businesses more generally, conditions remain broadly favorable, buttressed by elevated confidence, tax reform, and still-supportive financial conditions, though in some areas increased leverage has begun to stretch finances a bit, and an uncertain international trade environment could hamper exports and deter investment.

— The fiscal stimulus is adding to demand, and should continue to do so at least into next year, if moderately. The boost would likely be bigger but effective tax rates have not come down all that much, 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. And at this point in the cycle, the economy doesn't need demand-side stimulus; in fact, it could be counterproductive, boosting near-term growth but increasing the medium-term risk of overheating and the kinds of excesses that make recession more likely (in part by inducing the Fed to tighten more aggressively).

— To counter this risk, the economy needs help on the supply side—policies to boost potential growth, and thereby 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 estimate and likely to take time to come to fruition. What's more, even under optimistic assumptions about any enduring growth effects from the tax package, the fiscal changes are almost sure to worsen the government's already daunting long-term fiscal challenges, likely necessitating more federal borrowing that could eventually crowd out private, productive investment.

— The looming specter of protectionism could also undermine potential growth. So far, the trade restrictions are too small and concentrated to have much adverse macro impact. But if they are the opening salvo of a broader trade war, their deleterious effects would be amplified. That's not our expectation, but recent news on the trade front has not be encouraging, with the U.S. broadening its trade focus to more countries and industries. Even if the worst case is averted, some trade restrictions are likely to stick, and together with a less open immigration policy are counterproductive for long-term growth.

— Although we are anticipating some improvement in potential growth as productivity rebounds from unusual weakness, aided in part by a strengthening of business investment, as tight labor markets coax some more people into the labor force and prompt firms to search even harder for efficiencies, these additions are apt to be incremental (and at least partly offset by trade and immigration restrictions)—sufficient perhaps to mitigate but not fully offset other structural drags, including demographics. All told, we're not expecting a supply-side miracle.

— Absent a substantial improvement in the economy's potential, it will be hard to sustain recent rates of growth now that the economy's spare capacity has largely been absorbed. Indeed, labor markets seem close to full employment if not even slightly beyond. Still, wages continue to accelerate only modestly, dampening fears about imminent overheating. But if labor markets tighten further, as we expect, wages pressures should continue to build, if still gradually.

— That should help cement the move of inflation back to the Fed's target. Recent inflation readings suggest we're almost there already, though they also ought to defuse overwrought fears of an imminent inflation spike. Yes, inflation has edged back close to target, as some temporary restraints have faded, as the effects of diminished slack and gradually accelerating labor costs are making themselves felt, and as inflation expectations have remained generally well anchored. And the recent rise in energy prices should provide a temporary lift as well (primarily to headline, less so to core). But fears of an inflation surge seem overblown given the stickiness of inflation expectations and the generally attenuated responsiveness of inflation to diminished slack.

Monetary-policy outlook

- Fed policymakers remain on track to reduce and eventually remove policy accommodation. With both of their dual-mandate objectives in sight, and the outlook suggesting growth will remain above potential for a while, policymakers are increasingly confident that this is the proper course—that failing to move policy at least back to neutral, if not a shade beyond, 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.
- However, there are also still reasons for the Fed to tread carefully. For one, the neutral rate is likely to remain below historical norms (albeit edging up from post-crisis lows), suggesting that it won't take as many rate hikes as in the past to restore a neutral stance. Moreover, though inflation is back near target, it does not seem in danger of sharply overshooting, and given that it has run too low for years, it is important that it return to 2% and stay there (if not a bit above for a while), to ensure that 2% is viewed not as a ceiling but as the symmetric target it truly is, so that expectations remain firmly anchored near the Fed's objective. Finally, financial conditions have begun to tighten a bit, hinting that the Fed may be starting to get some traction in tamping down what has been a key tailwind to growth.
- How policymakers balance these competing arguments depends of course on how the economic outlook evolves. Our take remains that further modest tightening of labor markets and financial conditions, coupled with clearer evidence that inflation has returned to target and is staying there (but not materially overshooting), will keep policymakers inclined to remove policy accommodation, though not aggressively. That's apt to include not only continued balance sheet reduction, but also further rate hikes, with the next 25 basis points likely at the September Federal Open Market Committee (FOMC) meeting, followed by a fairly steady pace of moves beyond that, taking the funds rate back to 3% or so by later next year, with a cumulative balance sheet reduction of about $1 trillion—moving policy back to at least a neutral if not modestly restrictive stance. But by the standards of past cycles that would still leave rates low and the Fed's balance sheet elevated.

Financial market outlook

- An economic backdrop of solid growth and close-to-target inflation remains broadly favorable for risk assets and a slight weight on Treasury prices.
- Increasing trade frictions raise some caution flags, however, and worries about sustainability loom over the horizon. The longer growth stays above potential, the tighter labor markets become, and the more the Fed hikes, the greater the risk that financial markets adopt a more cautious, "too much of a good thing" mentality.

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Definitions
One **basis point (bp)** equals 1/100 of a percentage point. **The European Union (EU)** is a political and economic union of 28 member states located primarily in Europe. 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 an agreement among the United States, Canada and Mexico designed to remove tariff barriers between the three countries. The **U.S. Federal Reserve (Fed)** implements U.S. monetary policy.

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