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U.S. economic outlook 10/18

Economic outlook

— The beat goes on for the U.S. economy. Growth continues to run above potential, labor markets are tight (and still tightening), and inflation is back near the Federal Reserve's (Fed's) target but not overshooting (in fact, recent inflation readings have been a bit softer). In short, the economy seems still to be in a cyclical sweet spot. And it's likely to stay that way, at least in the near-term, underpinned by sound domestic fundamentals, fiscal stimulus, accommodative financial conditions (albeit a bit less so recently), and a generally inertial inflation process (governed by well-anchored inflation expectations and a more attenuated responsiveness of inflation to changes in slack). Against this backdrop, we expect growth to remain above potential into next year (though slowing from its current robust pace), labor markets to tighten modestly further and help solidify inflation's move back near the Fed's target, but without provoking a material inflation overshoot. All in all, a quite favorable outlook.

— But there are several looming risks. For starters, financial conditions have begun to tighten. So far, the move has been too modest and short-lived to affect our economic forecast, not least because we have long been incorporating some tightening of financial conditions into our expectations. Indeed, it has been central to what we've felt would ultimately be needed—together with continued Fed tightening and a gradual waning of fiscal stimulus—to prevent overheating. Still, this process could become unruly, and bears close watching.

— There are also still worries on the trade front. Although the agreement between the US, Canada, and Mexico removes the risk of what could have been a highly

Economic and financial market projections

	Real GDP	Core PCE Prices	10-year U.S. Treasury Yield	S&P 500 Index
2016				
4Q	1.8%	1.8%	2.49%	2247
2017				
1Q	1.8%	1.8%	2.48%	2367
2Q	3.0%	1.6%	2.19%	2434
3Q	2.8%	1.5%	2.20%	2493
4Q	2.3%	1.6%	2.40%	2664
2018				
1Q	2.2%	1.7%	2.84%	2703
2Q	4.2%	1.9%	2.91%	2754
3Q	3.2%[F]	2.0%[F]	3.00%	2902
4Q(F)	2.4%	2.0%	3.15%	2910
2019				
1Q(F)	2.6%	2.0%	3.15%	2930
2Q(F)	2.5%	2.0%	3.20%	2965
3Q(F)	2.4%	2.1%	3.25%	3000

Source: DWS as of October 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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disruptive abrogation of NAFTA, there are still risks of other trade restrictions, mostly notably on autos, which could provoke retaliation. Moreover, U.S.-China trade frictions show no sign of abating. Indeed, it's looking increasingly likely that nearly all items traded between the U.S. and China will be subject to some tariff or other restriction by next year. Though the direct effects on the US are still apt to be modest—a temporary lift to inflation and drag on growth, each of at most a couple of tenths of a percentage point—risks of more adverse effects, particularly via financial markets and/or business and household confidence, though little evident so far, cannot be dismissed.

— Finally, the U.S. faces a non-negligible risk of a classic, late-cycle slowdown prompted by overheating and Fed tightening—not any time soon, but increasingly over time. The longer growth remains above potential, and the further labor markets tighten beyond full employment, the greater the risk not only that inflation will eventually move materially above the Fed's target, but that the kinds of broader-based financial and economic excesses that have often presaged economic slowdowns will take hold. We don't see this as an imminent or unavoidable threat; the economy still seems largely devoid of these kinds of imbalances, and "soft landings" have happened before. But at some point labor markets are going to have stop tightening (and perhaps even unwind some of their tightness); on our reckoning this is apt to happen by 2020 or so, as the cumulative effects of tightening financial conditions and a waning of fiscal stimulus start to impact. And that may not be a seamless transition.

— But for now, the coast looks pretty clear. Households continue to benefit from sound finances, elevated confidence, and firm labor markets. Though housing has been a bit sluggish of late, likely reflecting the combined effects of modestly higher interest rates and the reduced subsidy to this sector embedded in the tax reform, fundamentals still look at least modestly supportive. For businesses, conditions remain broadly favorable, buttressed by high confidence, tax reform, strong profits, and still-supportive financial conditions, though in some areas increased leverage has begun to stretch finances a bit, and an uncertain trade environment could hamper exports and deter investment. The global backdrop remains supportive overall, if less so than last year, with some emerging economies facing increased challenges and Europe contending with Brexit and the Italian budget situation.

— Meanwhile, the fiscal stimulus is adding further to domestic demand in the US, and should continue to do so moderately at least into next year. But at this point in the cycle, demand-side stimulus could ultimately prove counterproductive, lifting near-term growth but increasing the medium-term risk of overheating.

— What the economy needs is 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 of uncertain magnitude and timing. 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, necessitating more federal borrowing that could eventually crowd out private, productive investment. Also, protectionism can damage efficiency and erode the gains that trade brings via specialization and comparative advantage.

— All told, we are not expecting a supply-side miracle. Though potential growth may be improving somewhat, as productivity rebounds from unusual weakness, aided in part by a strengthening of business investment, as tight labor markets coax 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. 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. Labor markets seem close to full employment already, if not slightly beyond, and still tightening. Labor costs have been picking up in response, and although the acceleration remains moderate, dampening fears about imminent overheating, wage pressures will likely continue to build incrementally if labor markets keep tightening.

— That should help cement inflation's move back up to the Fed's target. But there's little sign that inflation is about to take off; in fact, the most recent readings have been a bit softer. And we continue to believe that concerns about an inflation surge are overblown given the stickiness of inflation expectations, the strengthening of the dollar, and the generally attenuated responsiveness of inflation to diminished slack.

Monetary-policy outlook

- As long as labor markets continue to tighten, and the outlook for above-trend growth remains intact, Fed policymakers will likely remain inclined to raise the funds rate gradually further, fearful that failing to do so would risk stoking the kinds of excesses and imbalances that might necessitate a more abrupt and potentially destabilizing tightening later on. But they're apt to tread carefully, balancing the risk of doing too little in combating potentially destabilizing excesses against that of moving too quickly and prematurely short-circuiting the expansion.
- In walking this fine line, policymakers will likely be guided from here less by estimates of the neutral rate of interest and the natural rate of unemployment, and more by actual, observable indicators (and how they affect the outlook). When the funds rate was well below estimates of neutral, and the labor market a far cry from full employment, there was value in using these unobservable concepts to inform policy and calibrate forward guidance—to assert, for example, that policy was accommodative and would remain so as long as the labor market remained well shy of full employment and inflation below target. But now, with inflation back near target, and the funds rate and the unemployment rate within the range of uncertainty surrounding estimates of the neutral and natural rates, respectively, these unobservable concepts may do more to cloud than clarify the policy path. From here, the Fed will likely rely more on indicators of labor market performance, inflation, financial conditions, and the economic outlook to guide policy.
- Where that policy is headed, of course, will depend on how the outlook evolves. Our take remains that further modest tightening of labor markets, some additional snugging of financial conditions, and more evidence that inflation has returned to target but is not overshooting, will keep policymakers inclined to tighten policy gradually further. That's apt to include another 25 basis point hike at the December FOMC meeting, followed by additional moves beyond that, taking the funds rate back to 3% to 3-1/4% or so by the second half of next year before the process halts as evidence builds of an economic slowing sufficient at least to prevent labor markets from tightening any further. But we also still see risks to this base case as tilted to the upside—i.e., that the Fed will have to tighten a bit further and longer to achieve the desired result. Also, the Fed's balance sheet will likely continue to run off as planned at least into early 2020, with a cumulative reduction approaching $1 trillion by then.

Financial market outlook

- Financial markets have become a little more volatile and anxious of late, worried perhaps that the US economy is enjoying too much of a good thing—that overheating risks are rising, and that interest rates may increase further than investors had been anticipating. Ongoing trade frictions aren't helping either.
- Although we still see the overall macro backdrop as broadly supportive of risk assets and only a slightly further weight on US Treasury prices, at least in the near term, we've also long warned that markets may come to worry increasingly about the sustainability of the current sweet spot of the economic cycle in the US. The longer growth stays above potential, the tighter labor markets become, and the more the Fed hikes, the greater the risk that financial markets turn persistently more cautious, increasingly aware that the most favorable phase of the economic cycle for financial assets may be behind us.

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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 an agreement signed by Canada, Mexico and the United States to create a trilateral trade bloc in North America. The **U.S. Federal Reserve (Fed)** implements U.S. monetary policy. The **yield curve** is a graphical representation of how yields on bonds of different maturities compare. Typically (and when the yield curve is characterized as _steep," this is especially true), the line rises from left to right as investors who are willing to tie up their money for a longer period are rewarded with higher yields.

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