U.S. economic outlook

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In a nutshell

- We think the United States has a reasonable chance of pulling off a "soft landing."
- This is the key challenge of monetary policy to balance the risk of doing too little in combating potential overheating against that of doing too much.
- Financial markets have become decidedly more volatile and anxious of late, even though the worries might be overdone.

Economic, monetary and financial market outlook

Economic outlook

The U.S. economy continues to perform well overall, though there are hints that momentum may be cresting, and growing concerns about global growth weakening, trade tensions, and tightening financial conditions. Still, the preponderance of evidence suggests that U.S. activity continues to advance briskly, underpinned by solid fundamentals. Labor markets are near full employment (if not slightly beyond), and still tightening, while inflation is back near the U.S. Federal Reserve's (Fed's) target but not overshooting (in fact, recent inflation readings have been a bit softer). In short, the economic news continues to be quite favorable.

But this may be as good as it gets. As we have been stressing, the U.S. economy cannot continue indefinitely on its recent trajectory; the persistence of above-trend growth and ever-tightening labor markets would not only increase the chances of a destabilizing overheating, but might also suggest that the kinds of broader financial and economic excesses that have often spelled trouble in the past could yet develop.

So a moderation in activity is necessary. It's also likely. Indeed, we have long felt that a combination of tighter financial conditions and a gradual waning of fiscal stimulus, coupled with some slowing abroad and at least a mild drag from trade frictions would nudge the U.S. economy onto a more moderate trajectory, downshifting growth in 2019 and increasingly into 2020 to a pace more in line with its longer-term potential (and eventually even somewhat below that pace), helping to prolong the expansion by limiting potentially destabilizing excesses.

Economic and financial market projections

	Real GDP*	Core PCE Prices**	10-year U.S. Treasury Yield***	S&P 500 Index
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	3.5%	2.0%	3.00%	2902
4Q(F)	2.5%	1.9%	2.90%	2700
2019				
1Q(F)	2.6%	2.0%	3.00%	2800
2Q(F)	2.5%	2.0%	3.10%	2875
3Q(F)	2.3%	2.1%	3.20%	2950
4Q(F)	2.2%	2.1%	3.25%	3000

Source: DWS Investment Management Americas Inc. as of 12/2018. Past performance is not a reliable indicator of future returns.

*Quarterly GDP change is annualized.

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**The core Personal Consumption Expenditures (PCE) Price Index change is the four-quarter percentage change. 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

***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.

That still seems a reasonable outlook, though risks have been rising lately. One reason is that financial conditions have recently tightened more sharply than we had anticipated. If this is sustained (and especially if it intensifies), it could raise meaningful downside risks to the outlook – at a minimum curtailing the amount of further Fed tightening likely to be needed to tilt the economy onto a more sustainable path. Also, global growth momentum has been flagging a bit, with particular uncertainties about China, raising the risk that these drags could wash up a bit more powerfully onto U.S. shores. And trade uncertainties remain largely unresolved.

At this point, these developments are not sufficient to move the needle too much on our central forecast, not least because we had already been anticipating many of them (if not perhaps in their full intensity). But they are raising downside risks.

On the domestic political front, the recent election resulting in a divided government is unlikely to alter the fiscal trajectory – no new major initiatives, and no material shift in what is already in train (where we see the boost to demand from fiscal stimulus gradually fading over the next year or two). [CIO Flash - The midterm verdict is in]

Regulatory and trade policy are unlikely to change much either, though the latter remains a wild card. The agreement between the United States, Canada, and Mexico removes the risk of what could have been a highly disruptive abrogation of the North American Free Trade Agreement (NAFTA), but risks of other trade restrictions remain. At least, that the United States and China have resumed negotiations, delaying another round of tariffs, is a positive but hardly definitive step towards a resolution. Though the direct macroeconomic effects on the United States of even another round of tariffs (and retaliation) 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, even if the tariffs persist, risks more adverse effects. Particularly the effects via financial markets and/or business and household confidence cannot be dismissed. And over time protectionism can weigh on the economy's potential growth by limiting the efficiency gains that trade can deliver.

Housing activity has been sluggish lately, but this should not raise undue alarms. The tighter financial conditions that will likely be needed to guide overall economic activity onto a more moderate and sustainable path are bound to have a disproportionate impact on the interest-sensitive housing sector, which is also contending with the reduced subsidy featured in the new tax bill. So whatever

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weakness does ensue in housing – which has not been that pronounced so far, and may not get much worse given some still-favorable fundamentals, such as strong income gains and job markets and the recent dip in mortgage rates – should not be extrapolated to the economy as a whole.

Trade is another area that may contribute to the moderation in aggregate activity. A stronger U.S. dollar (USD) (part of tighter financial conditions), some cooling in global growth, and increasing trade restrictions could all weigh on exports. Business capital expenditures may not remain unscathed either, impacted by tighter financial conditions, worries about global trade, and stretched finances in certain sectors. But conditions remain favorable on the whole, buttressed by high confidence, tax reform, strong profits, and still-supportive financial conditions. Similarly, households continue to benefit from sound finances, elevated confidence, and firm labor markets.

So although we expect growth to downshift over the next year or two, we do not see a recession in the cards. On the contrary, we expect this expansion to persist, becoming the longest ever by next summer, and continuing even beyond that. Most encouragingly, the private sector remains largely devoid of the kinds of large-scale excesses and imbalances that precipitated recessions in the past. Chastened by the crisis, households and businesses, borrowers and lenders, savers and spenders (and regulators) have been much more cautious this time. The private sector is not over its skies.

The economy also seems less vulnerable to the inflationary overheating that brought on recessions in past cycles (in part by provoking aggressive Fed tightening). Yes, labor markets are tight and wage pressures have been building. But only modestly. Moreover, well-anchored inflation expectations, a more attenuated responsiveness of inflation to slack, a stronger U.S. dollar, and some hints of at least modest improvement in the economy's supply potential should all work to prevent a material inflation overshoot, and enable the Fed to tread carefully, avoiding the over-tightening that often doomed past expansions.

This is why we think the United States has a reasonable chance of pulling off a "soft landing[1]" – of moderating onto a more sustainable trajectory, curtailing potentially destabilizing excesses without jeopardizing the expansion. Though rare, soft landings have happened before, and for the reasons outlined above, the United States seems to have better odds of achieving one this time. Still, it is going to a tough needle to thread. [A Closer Look - The U.S. economy: How close to a late cycle?]

Monetary-policy outlook

It is also the key challenge facing Fed policymakers. In essence, they are trying to balance the risk of doing too little in combating potential overheating and broader economic and financial imbalances against that of doing too much and prematurely short-circuiting the expansion. That task has been

[1]A soft landing is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

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complicated by recent developments – especially the turbulence in financial markets (and attendant tightening of financial conditions), increased uncertainties about the global outlook, and unresolved trade tensions – which further cloud the outlook.

Sifting through the fog, though, the case for another 25 basis-point (bp) hike in the federal funds rate at this week's Federal Open Market Committee (FOMC) meeting still seems compelling. With labor markets tight and still tightening, domestic fundamentals sound, inflation near target, and the federal funds rate still slightly below FOMC members' range of estimates of neutral, failing to hike would risk stoking the kinds of excesses and imbalances that might necessitate a more abrupt and potentially destabilizing tightening later on.

But policymakers are apt to adopt a more cautious and explicitly data-dependent attitude about the policy path going forward. For one, inflation continues to show little sign of overshooting. Also, the neutral rate of interest, though admitting of wide bands of uncertainty, is likely to remain lower than in past cycles, suggesting that monetary policy may no longer be that accommodative – especially now that financial conditions have begun to tighten. And that tightening has become sharper of late, raising downside risks to the outlook. Against this backdrop, we expect Fed policymakers to suggest that while additional rate hikes will likely still be appropriate, they are apt to be more gradual and modest than they have been – and that there is no pre-determined path, thus emphasizing the Fed's flexibility to respond to incoming information and how it shapes the outlook.

In other words, reminding people that where rates head from here is conditional on how the outlook evolves. Our take remains that it will evolve in a way that requires further modest increases in the federal funds rate, though the recent tightening of financial conditions, if sustained, might limit those increases to two in 2019 instead of three. But we still see greater risks that the Fed has to tighten a bit further and longer to bring about the desired soft landing. Also, the Fed's balance sheet will likely continue to run off as planned at least into early 2020, with a cumulative reduction of about $1 trillion by then. Crucially, we do not see the economy on some kind of knife's edge, not hinging precariously on slight changes to the path of Fed policy.

Financial market outlook

Financial markets have become decidedly more volatile and anxious of late, worried about slowing global growth, trade tensions, Brexit woes, and how difficult it will be for the United States to sustain its current cyclical sweet spot.

Many of these concerns are well grounded. There's no shortage of things to worry about on the global front, and closer to home we have long worried that markets might come to doubt the sustainability of the good news for the U.S. economic cycle. The longer growth stays above potential, the tighter labor markets become, and the more the Fed hikes, the greater the risk that investors might turn persistently more cautious, increasingly aware

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that the most favorable phase of the economic cycle for financial assets may be behind us.

But the worries may be getting overdone. We still see the overall macro backdrop – no recession on the horizon, no material inflation overshoot and a moderation to a more sustainable pace that enables the Fed to slow down – as broadly supportive of risk assets.

Performance over the past 5 years (12-month periods)

	11/13 - 11/14	11/14 - 11/15	11/15 - 11/16	11/16 - 11/17	11/17 - 11/18
S&P 500	14.5%	0.6%	5.7%	20.4%	4.3%
U.S. Treasuries (10-year)	6.7%	2.0%	0.6%	2.2%	-1.6%

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Glossary

Accommodative

The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Balance sheet

A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

Basis point

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

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

Capital expenditures (capex)

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Federal funds rate

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

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.

Financial crisis

The **financial crisis** refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

Fiscal policy

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Fundamentals

Fundamentals are data giving information about the general well-being of companies, securities or currencies and serving for the subsequent valuation of these as an investment opportunity.

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Inflation

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

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).

North American Free Trade Agreement (NAFTA)

The **North American Free Trade Agreement (NAFTA)** is a trade agreement signed by Canada, Mexico and the United States, creating a trilateral trade bloc in North America, which came into force on January 1st, 1994.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve Board (the Fed)

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

Yield

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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