DWS

U.S. economic outlook

Economic, monetary and financial market outlook

Economic outlook

Powerful crosscurrents are buffeting the economic and financial landscape in the United States, clouding the outlook. On the one side, the preponderance of data suggest the economy continues to perform well and is fundamentally sound. But there are signs of slowing, and several worrisome portents, including weakness abroad, unresolved trade tensions, the lingering government shutdown, and the sharp tightening of financial conditions in the fourth quarter. Although we have only edged down our base-case economic forecast slightly on the back of these developments – in part because we had already built some of them into our view of a moderating economy, and in part because they are apt to prompt the U.S. Federal Reserve (Fed) policymakers to be even more cautious about further tightening – they do highlight the downside risks and heightened uncertainty that attends the outlook.

Growth momentum has likely crested, but that is neither surprising nor undesirable. As we have been stressing, above-trend growth and tightening labor markets could not go on indefinitely, especially now that much if not all of the economy's spare capacity has been absorbed. We have been expecting that a combination of tighter financial conditions, a gradual waning of fiscal stimulus, some slowing abroad, and at least a mild drag from trade frictions would nudge the U.S. economy onto a more moderate, sustainable 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.

Such a moderation would actually be welcome as it makes it less likely that the kinds of excesses and imbalances that have felled past expansions inflationary overheating and/or private-sector overindulgence – will emerge. That the economy is still largely devoid of these "expansion killers" increases the chances that this one can continue. [A closer look – The U.S. economy: how close to a late cycle?]

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	2.5% (F)	1.9% (F)	2.83%	2567
2019				
1Q(F)	2.0%	1.9%	2.70%	2700
2Q(F)	2.6%	2.0%	2.80%	2750
3Q(F)	2.3%	2.0%	2.90%	2800
4Q(F)	2.2%	2.1%	3.00%	2850

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In a nutshell

- A principle of "wait-and-see" seems likely to guide Fed policymakers for a while.
- We still expect the pace of activity to downshift, but do not see a recession in the near-term cards.
- Therefore, we still see the overall macroeconomic 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.

Still, "soft landings[1]" – where the economy glides onto a more sustainable path, curtailing potentially destabilizing excesses without jeopardizing the expansion – are not easy to pull off and risks abound.

Trade tensions are one of those risks. Despite hints of progress in U.S.-China trade negotiations, resolutions on this front – and on auto disputes with Europe and others – remain elusive. Even the renegotiated North-American-Free-Trade-Agreement (NAFTA) deal is not assured of legislative approval, though it remains highly likely. Albeit the direct macroeconomic effects of the trade restrictions enacted so far are apt to be modest, the impacts may be building, in part through indirect channels; more firms, for example, are highlighting trade tensions as a potential weight on their investment plans, and trade worries likely contributed to the tightening of financial conditions in the fourth quarter. The trade conflict is especially inopportune when global activity is already wobbly; economic momentum in Europe remains sluggish, and uncertainty is rife in China, where trade tensions are exacerbating homegrown strains. All told, the risks are rising that these drags could wash up a bit more powerfully onto U.S. shores than we had envisioned.

Closer to home, the United States is also grappling with the partial shutdown of the federal government. Here, the direct macroeconomic effects are also apt to be minor, but will grow and could also engender bigger, indirect disruption effects on private activity the longer the shutdown persists. We believe that this also raises the concern of how the government will handle other issues such as passing the renegotiated NAFTA, and raising the debt ceiling[2], which will need to be done later this year.

The biggest alarm bell by far has however been sounded by financial markets. In fact, if you had tuned out the economic data and the underlying fundamentals, and focused solely on financial markets, you would have concluded late last year that the outlook had darkened materially. Heightened volatility, sharp declines in equity and commodity prices, wider credit spreads, and lower interest rates on government securities suggest that markets had not only downgraded their base-case expectations for economic growth, but increased their assessment of downside risks and the compensation they require for bearing those risks – not just in the United States, but around world. Although sentiment has improved more recently, the reversal has been incomplete, and a sense of unease persists, despite economic indicators that remain solid overall.

Financial markets should obviously not be ignored. They embed much useful information, both as signal of the economic outlook and contributor to shaping that outlook. But financial markets are hardly omniscient or omnipotent. They can swing wildly, much more so than underling economic trends, and not only in ways that augur those trends. After the turmoil late last year, for example, markets have regained some of their footing in recent weeks. And

[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.

[2] It is the legislative limit on the level of national debt that can be incurred by the U.S. Treasury.

financial conditions are just one of many important influences on the economy.

On the whole, those influences remain broadly supportive. Most encouragingly, the private sector is still 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 skis.

The economy also seems less vulnerable to the inflationary overheating that brought on recessions in past cycles; in part by provoking aggressive Fed tightening. Indeed, labor markets are tight and wage pressures have been building, but only modestly, to levels consistent with, but not threatening to breach the Fed's inflation target. Moreover, well-anchored inflation expectations, are a more attenuated responsiveness of inflation to slack, some hints of at least modest improvement in the economy's supply potential, and temporary restraint from the stronger U.S. dollar and declines in commodity prices should all help prevent a material inflation overshoot, and enable the Fed to tread carefully, avoiding the over-tightening that often doomed past expansions.

All told, we think markets got overwrought late last year about the economic outlook. We still expect the pace of activity to downshift, but do not see a recession in the near-term cards. On the contrary, we expect this expansion to persist, becoming the longest ever by this summer, and continuing even beyond that.

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 and risks have risen.

Monetary-policy outlook

A principle of "wait-and-see" seems likely to guide Fed policymakers for a while. Against an increasingly cloudy backdrop, with signs of slowing and more downside risks, with inflation seemingly in little danger of material overshoot, and with a growing recognition that they have already chopped a lot of wood – raising the federal funds rate a cumulative 225 basis points (bps), and setting the balance sheet on a steady path of decline – policymakers are apt to take a breather here, a cautious pause as they await greater clarity on the outlook.

That is the message emanating from the last Federal Open Market Committee (FOMC) meeting and the recent Fed speeches. That policymakers can afford to be patient. That the prudent course is to await evidence on how recent developments – financial conditions, trade negotiations, the government shutdown, global activity – evolve and shape the U.S. outlook.

We still think a bit more hiking from the Fed will eventually be needed to nudge the economy onto a more sustainable path, but perhaps just two moves over the next year, and nothing until June at the earliest. The actual outcome will of course depend on how

the outlook evolves, as always, though policymakers are apt to be even more cautious and explicitly data-dependent from here, and the range of plausible outcomes is wider than it has been in recent years, because the outlook is cloudier and policy is no longer so clearly accommodative and in need of adjustment.

Finally, the federal funds rate will remain the primary lever used to adjust the stance of policy, whereas the balance sheet is a secondary tool. The economic outlook would have to change markedly to prompt policymakers to alter the adjustment path for the balance sheet that has been in place for over a year. Barring such outsized shocks, the ultimate size of the balance sheet will be dictated largely by technical considerations – in particular, when reserves have declined to levels consistent with banks' demand to hold them, thus solidifying the Fed's ability to control short-term interest rates by adjusting administered rates such as interest on reserves. Though there is considerable uncertainty about just when that might happen, we continue to expect it to be sometime in the first half of 2020, when the cumulative reduction of Fed security holdings (about $375 billion through Q4 2018) will reach almost 1 trillion U.S. dollar. From there, the runoff is apt to stop, and the Fed will return to increasing its security holdings in line with growth in currency and other liabilities, though policymakers may adjust the composition of the Fed's holdings, continuing to run down mortgage-backed securities (MBS), for example, replacing them with U.S. Treasuries, and perhaps shifting toward shorter durations.

Financial market outlook

Financial markets have been on a wild roller coaster in recent months. Late last year anxiety increased sharply as markets worried about slowing global growth, trade tensions, political dysfunction, perceptions of overly aggressive monetary policy, and how difficult it will be for the United States to sustain its recent cyclical sweet spot. More recently, some of these fears have receded and sentiment has recovered, though it remains uneasy.

It is understandable why people have gotten more cautious. There is 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 stayed above potential, the tighter labor markets became, and the more the Fed hiked, the greater the risk that investors might turn persistently more cautious, being increasingly aware that the most favorable phase of the economic cycle for financial assets may be behind us. But we think the worries late last year got overdone. We still see the overall macroeconomic 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)

	12/13 - 12/14	12/14 - 12/15	12/15 - 12/16	12/16 - 12/17	12/17 - 12/18
S&P 500	11.4%	-0.7%	9.5%	19.4%	-6.2%
U.S. Treasuries (10-year)	8.8%	1.7%	0.8%	2.6%	0.9%

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.

Credit market

The **credit market** is the market for corporate bonds

Duration

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

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.

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.

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 tightening cycle

A monetary-policy tightening cycle is a period of time during which a central bank raises interest rates with the aim of slowing GDP growth or inflation.

Mortgage-backed security (MBS)

A **mortgage-backed security (MBS)** is a special type of asset-backed security where the holder receives interest and redemption payments from pooled mortgage debtors, secured by the underlying mortgages.

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.

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

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).

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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.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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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