DWS

U.S. economic outlook

Economic, monetary and financial market outlook

Economic outlook

Mixed signals and powerful crosscurrents are clouding the picture, making it hard to discern underlying trends in the U.S. economy. The data have been sending conflicting messages, with some indicators suggesting momentum is unbowed, while others hint at sharp deceleration and most fall somewhere in between. Delays in the data flow resulting from the (now ended) government shutdown further complicate interpretations, while adverse weather, residual seasonality in some data series, and the effects of the shutdown itself may add to the confusion and temporarily weigh on measured activity early in the year. As if that were not enough, financial conditions have swung wildly, tightening sharply in the fourth quarter but reversing course so far this year, while unresolved trade tensions and a weaker, more uncertain backdrop abroad raise still more questions about the U.S. outlook.

In short, the fog is particularly thick right now. Sifting through it, though, a few outlines can be gleaned, if faintly. Momentum has likely crested, and the economy seems to have downshifted to a more moderate pace, reflecting the effects of waning fiscal stimulus, tighter financial conditions, trade restrictions, and a weaker growth profile abroad. But the deceleration does not seem excessive, nor is it surprising or undesirable; we have long felt that these restraining forces would edge the U.S. economy onto a more moderate trajectory, and that such a moderation would actually be welcome, making it less likely that the kinds of excesses and imbalances that have felled past expansions – inflationary overheating[1] and/or private-sector overindulgence – would emerge. That the economy is still largely devoid of these "expansion killers" increases the chances this one can continue.

But it is hardly a sure thing; "soft landings[2]" – where the economy glides onto a more sustainable path, curtailing potentially destabilizing excesses without jeopardizing the expansion – are never easy to pull off. And during the descent phase, passengers can feel a bit queasy, especially if the economy encounters any air pockets or risk factors – of which there are plenty right now.

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

[1] Inflationary overheating is a phenomena when the economy is exhibiting high inflation rates due to prolonged good growth rates and there is excess production capacity.

[2] 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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In a nutshell

- Mixed signals and powerful crosscurrents are clouding the picture, making it hard to discern underlying trends in the U.S. economy.
- Sifting through the fog, though, it seems that momentum has crested, and the economy appears to have downshifted to a more moderate pace, roughly as we expected, reflecting the effects of a waning fiscal stimulus, tighter financial conditions, trade restrictions, and a weaker growth profile abroad.
- A bit more hiking from the Fed may eventually be needed to nudge the economy onto a more sustainable path, but just a little, and nothing until the second half of the year at the earliest.
- We still see the overall macroeconomic backdrop as broadly supportive of risk assets.

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4Q	2.2%(F)	1.9%(F)	2.83%	2567
2019				
1Q(F)	1.8%	1.9%	2.70%	2700
2Q(F)	2.6%	2.0%	2.80%	2750
3Q(F)	2.5%	2.0%	2.90%	2800
4Q(F)	2.3%	2.1%	3.00%	2850

Source: DWS Investment Management Americas Inc. as of 2/2019. Past performance is not a reliable indicator of furture returns.

*Quarterly GDP change is annualized.

**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.

Trade tensions are one. The trade restrictions enacted so far, together with those potentially in the pipeline, have likely taken some toll on activity already, in part by increasing uncertainty, weighing on investment plans, and contributing to a tightening of financial conditions. Much focus has been on the U.S.-China tiff, but restrictions have been enacted on other fronts too, with risks of more to come (on European autos, for example), and even the renegotiated North American Free Trade Agreement (NAFTA) deal is not assured of legislative approval (though it remains likely). Trade conflict is especially inopportune when global activity is already wobbly; momentum in Europe remains sluggish, and uncertainty is rife in China, where trade tensions are exacerbating homegrown strains. All told, global drags could wash up a bit more powerfully onto U.S. shores than we had envisioned. On the plus side, though, partial resolution of U.S.-China trade conflict may be in the offing – enough to forestall any further tariffs and possibly reverse some of the restrictions already enacted. Though it will not likely resolve all areas of contention between the United States and China, an agreement would reduce risks of an escalating trade war.

Closer to home, the end of the government shutdown removes another source of uncertainty. Still, it will take a while for the data backlog to clear, and for the (mild) macroeconomic drag from the shutdown to dissipate. The shutdown however may be symptomatic of a broader political dysfunction that raises questions about how the government will handle issues like raising the debt ceiling[3], which will need to be done later this year.

And then there are developments in financial markets. In the fourth quarter of last year, heightened volatility, sharp declines in equity and commodity prices, wider credit spreads, and lower interest rates on government securities suggested 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

[3]The United States debt ceiling or debt limit is a legislative limit on the amount of national debt that can be incurred. This puts a ceiling on the amount of money the federal government may borrow.

the United States, but around the world. This year, a completely different narrative seems to have taken hold, with sentiment reversing sharply (albeit not quite completely).

What to make of these wild swings? On balance, U.S. financial conditions have tightened modestly over the past year, enough to take away some impetus from activity, but hardly enough on its own to derail things – especially since many of other economic drivers remain broadly supportive.

Most encouragingly, the private sector still seems 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 tightening by the U.S. Federal Reserve (Fed). Yes, labor markets are tight and wage pressures have been building. But recent indications suggest that the labor market may have a bit more running room – or at least may not be tightening far beyond full employment, as some had feared. Moreover, labor costs continue to pick up only modestly, to levels consistent with, but not threatening to breach the Fed's inflation target. Well-anchored inflation expectations, a more attenuated responsiveness of inflation to slack, and temporary restraint from the stronger U.S. dollar (USD) and declines in commodity prices should also 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 see activity downshifting, but do not see a recession in the near-term cards. On the contrary, this expansion is apt to persist, becoming the longest ever by this summer, and continuing even beyond that. In fact, if some of the near-term risks dissipate – trade, global weakness, and tightening financial conditions – the economy may even regain some strength, at least temporarily perhaps this spring and summer.

In short, though soft landings are rare, they 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

"Patience" is the operative word for Fed policymakers right now. Against an increasingly cloudy backdrop, with signs of slowing and 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 path of decline – policymakers see the prudent course as "wait-and-see." On hold for now, await greater clarity on how recent developments – financial conditions, trade negotiations, global activity, mixed messages in US data – evolve and shape the outlook.

We still think a bit more hiking from the Fed may eventually be needed to nudge the economy onto a more sustainable path, but just a little (perhaps one or at most two hikes over the next 12 months or so), and nothing until the second half of the year at the earliest. And the hurdle for even that is pretty high, likely requiring clear evidence that the downside risks have diminished, labor markets have resumed tightening, and inflation is at least at target. Of course, where policy actually goes will depend on how the outlook evolves, but the range of plausible outcomes is wider than it has been in recent years, because the outlook is cloudier and policy no longer so clearly accommodative and in need of adjustment.

The federal funds rate will remain the primary lever used to adjust the stance of policy – the balance sheet a more secondary tool. Barring outsized shocks to the outlook, the ultimate size of the balance sheet will be dictated largely by technical considerations – in particular, when reserves are lower than they are now but still "ample" – more than enough to enable the Fed to control short-term interest rates by adjusting administered rates (like interest on reserves). Though there is uncertainty about just what that optimal level of reserves[#] may be, and when it might be reached, we continue to expect it to be sometime between late 2019 and spring 2020, by when the cumulative reduction of Fed security holdings will reach between 800 billion USD and 1 trillion USD (it is 400 billion USD through January 2019). Policymakers may opt to slow the pace of runoff as the end approaches, to get more clarity on just where optimal reserve levels may lie. After the runoff, mortgage-backed security (MBS) holdings will likely continue to dwindle (replaced by Treasuries), and the Fed may shift toward a somewhat shorter duration of Treasury holdings. But barring a renewed shock, the balance sheet will not likely be used as an active tool of policy.

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, many of these fears have receded, and sentiment has recovered, albeit still not quite completely.

It is understandable why people got 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, 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.

[#] Bank reserves are a commercial bank's holdings of deposits in accounts with a central bank plus currency that is physically held in the bank's vault.

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

	01/14 - 01/15	01/15 - 01/16	01/16 - 01/17	01/17 - 01/18	01/18 - 01/19
S&P 500	11.9%	-2.7%	17.5%	23.9%	-4.2%
U.S. Treasuries (10-year)	10.2%	0.6%	-2.0%	0.2%	3.9%

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.

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).

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 (Fed)

The **U.S. Federal Reserve**, 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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