U.S. economic outlook

Joshua N. Feinman
U.S. Chief Economist

In a nutshell
- Powerful crosscurrents continue to buffet the outlook for the U.S. economy while domestic fundamentals still look broadly supportive.
- Growth momentum appears to have crested, but the deceleration does not seem excessive and a moderation would actually be welcome.
- Barring an outsized shock, Fed policy is unlikely to change for the next few quarters at least.
- All told, we think this expansion still has legs. Though activity is moderating, we don't anticipate anything close to a recession in the next year or more.

Economic, monetary and financial-market outlook

Economic outlook

Powerful crosscurrents continue to buffet the outlook for the U.S. economy. On the plus side, the domestic fundamentals still look broadly supportive, financial conditions have reversed much of their tightening from late last year, and there are hints of a truce on the trade front. But global activity continues to struggle, trade deals may yet prove elusive (and trade restrictions have already taken some toll), the fiscal stimulus from 2018 is waning, and financial conditions are still a bit tighter on balance (even with the recent easing).

Incoming data are not helping resolve this tug of war. They continue to paint a somewhat mixed and cloudy picture, making it hard to discern underlying trends in the U.S. economy. Adverse weather, residual seasonality in some data series and lingering effects of the government shutdown earlier this quarter add to the confusion and may temporarily weigh on measured activity.

Sifting through the fog, a few outlines can be gleaned, if faintly. Growth momentum appears to have crested, with activity downshifting to a more moderate pace, likely 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 (notwithstanding what will likely be an exaggerated slowing in measured gross-domestic-product (GDP) growth in the first quarter (Q1)), nor is it surprising or undesirable; we've 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 that this one can continue.

But it's hardly a sure thing; "soft landings" – where the economy glides onto a more sustainable path, curtailing potentially destabilizing excesses without jeopardizing the expansion – are never easy to pull off. And there are plenty of risks right now.

Trade tensions are one. The trade restrictions enacted so far, together with those potentially in the pipeline, have likely taken some modest toll on activity already, in part by increasing uncertainty, weighing on investment plans, and contributing to the tightening of financial conditions last year. Much focus has been on the US-China tiff, but restrictions have been enacted on other fronts too, with risks of more to come (on European autos,

[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.

for example). 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, these developments raise risks that global drags could wash up a bit more powerfully onto U.S. shores than we had envisioned.

The good news, though, is that there are hints that at least a partial resolution of the U.S.-China trade conflict may be in the offing – enough to forestall any further tariffs and reverse some of the restrictions already enacted. Though this would by no means resolve all areas of contention between the U.S. and China, an agreement would go a long way to soothing frayed nerves and reducing downside risks of an escalating trade war. Also, a few green shoots have begun to emerge overseas, hints that activity may at least be stabilizing in Europe, China and elsewhere, making us more confident that the worst is past, and some improvement in global momentum may take hold later this year.

Closer to home, the biggest swing factor has been financial conditions. Their sharp tightening late last year was quite worrisome; had it been sustained, it would have cast a meaningful pall on the outlook. That it has now largely reversed certainly makes us breathe more easily, more confident in our judgment that markets got overwrought late last year, more comfortable with our forecast that the economy will weather the storm. But, financial conditions remain vulnerable to reversal (if, say, trade conflicts are not resolved) and even now are still modestly tighter than a year ago, enough to take away some of the impetus from activity, though not nearly sufficient to derail it – especially since many of the 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 only moderately, to rates consistent with, but not threatening to breach the Fed's inflation target. In fact, underlying inflation continues to struggle even to get back fully to target, let alone materially exceed it. Well-anchored inflation expectations, a more attenuated responsiveness of inflation to slack and temporary restraint from the stronger dollar and declines in commodity prices are all helping keep inflation in check, countering any upward pressure that may be emanating from tight labor markets and enabling the Fed to tread carefully, avoiding the over-tightening that often doomed past expansions.

All told, we think this expansion still has legs. Though activity is moderating, we don't anticipate anything close to a recession in the next year or more. On the contrary, this expansion is apt to become the longest ever by this summer and continue even beyond that. In fact, if some of the near-term risks dissipate (trade, global weakness), 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 US seems to have better odds of achieving one this time. Still, it's going to be a tough needle to thread. And risks have risen.

Economic and financial-market projections

	Real GDP *	Core PCE Prices**	10-year U.S. Treasury Yield***	S&P 500 Index***
2017				
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	2.6%	1.9%	2.83%	2567
2019				
1Q(F)	1.2%	1.9%	2.60%	2775
2Q(F)	2.8%	1.9%	2.65%	2800
3Q(F)	2.6%	2.0%	2.75%	2815
4Q(F)	2.4%	2.0%	2.85%	2840
2020				
1Q(F)	2.3%	2.0%	3.00%	2850

Source: DWS Investment Management Americas Inc. as of 03/2019. 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.

Monetary-policy outlook

"Patience" is the operative word for Fed policymakers right now, with no rate moves on the horizon. They see the economy in good shape overall (albeit with growth moderating somewhat), and inflation near (though not quite all the way) to target. Against this backdrop, policy in their view remains broadly appropriate, with the federal funds rate near the (admittedly wide range) of neutral.

Looking ahead, with several crosscurrents clouding the outlook (trade tensions, weakness abroad, financial-market turbulence, mixed data), the prudent course in their minds is to pause and take time to assess how things play out. Put simply, policymakers see no compelling need to adjust the stance of policy, or any need to rush to judgment about the likely near-term direction of policy.

All told, barring an outsized shock, Fed policy is unlikely to change for the next few quarters at least. While the hurdle for a rate hike is high, so too is that for a rate cut. Hiking would likely require clear evidence that the economy was on track for above-trend growth, tightening labor markets and inflation at least back up to target. But to cut rates, the economic outlook would have to deteriorate materially, to something far weaker than our base-case forecast (or the Fed's). Indeed, we still think the economy is more likely to evolve in a manner that would be consistent with the next Fed move being up rather than down, though clearly not anytime soon.

Finally, the Fed commented on the balance sheet: according to the statement, the runoff of the Fed's security holdings will begin to be tapered in May, and will end in September. Then, the size of their holdings will be held steady for a while, until growth in non-reserve liabilities (principally, currency) has gradually absorbed reserves somewhat further but still has left them abundant enough so the Fed can continue to control the funds rate by setting administered rates (like the interest rate on reserves), rather than having to do frequent market operations. After that, the Fed will increase their asset holdings as needed to keep pace with growth in their liabilities.

Though this plan implies a slightly shallower runoff (followed by what will likely be a longer period of stasis), no policy implications should be drawn from this. It is a purely technical decision that will give the Fed more time to assess where reserve demand lies and to approach that optimal level (with appropriate buffer) slowly. The balance sheet is not an active tool of monetary policy (though it could become one again if needed). Also, as expected the Fed has emphasized it will continue to run off mortgage-backed securities (MBS) indefinitely, replacing them with Treasuries once the overall balance-sheet runoff ends. No decision was made on the ultimate composition of the Fed's Treasury holdings, though we still expect that the Fed will gradually shift to a slightly shorter weighted-average maturity of holdings.

Financial-market outlook

The mood in financial markets – bordering on the despondent late last year – has improved dramatically in 2019, with risk assets recovering much of their lost ground. Treasury yields remain materially lower, though, suggesting that at least part of the rally in risk assets hinges on a lower expected path of interest rates. In other words, markets may be less worried about the economic outlook in part because they feel that interest rates will be more accommodative than feared a few months ago. Also, concerns about a burgeoning trade war have diminished, replaced by hopes that a truce may be coming, and the government shutdown has come and gone with little lasting damage.

We thought that markets got overwrought late last year, threatening a self-reinforcing spiral of doom and feel much relieved that the mood has brightened. 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 be patient – as broadly supportive of risk assets. But we continue to caution that the U.S. is in a tricky part of the cycle. It will be difficult for the U.S. to sustain the cyclical sweet spot of recent years, and investors might turn more cautious, increasingly aware that the most favorable phase of the economic cycle for financial assets may be behind us.

In particular, risk markets should not hope for rate cuts from the Fed, as those would likely ensue only if the economic outlook deteriorates markedly.

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

	02/14 - 02/15	02/15 - 02/16	02/16 - 02/17	02/17 - 02/18	02/18 - 02/19
S&P 500	13.2%	-8.2%	22.3%	14.8%	2.6%
U.S. Treasuries (10-year)	7.0%	4.7%	-2.9%	-1.3%	4.5%

Glossary

Commercial mortgage-backed securities (CMBS)

Commercial mortgage-backed securities are mortgage-backed security backed by commercial mortgages rather than residential real estate.

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.

Gross domestic product (GDP)

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.

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).

Personal consumption expenditure (PCE)

The **personal consumption expenditure (PCE)** measure is the component statistic for consumption in gross domestic product collected by the United States Bureau of Economic Analysis (BEA).

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. Federal Reserve (Fed)

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