

MONTHLY REVIEW AND OUTLOOK ON THE U.S. ECONOMY

IN A NUTSHELL

- _ The U.S. economy started 2019 on much stronger footing than forecasters and market participants had anticipated.
- _ Strong labor-market data for April underpins our picture of a well-behaved moderation.
- _ However, risks to this outlook remain. The recent escalation of trade negotiations with China and the lingering dispute with Iran would be the most prominent ones.
- _ The Fed's policy stance was, again, seen as appropriate and the "wait-and-see" approach was reiterated.
- _ All said, we believe there is no reason for euphoria nor for being overly concerned, at least from an economic point of view.

The U.S. economy started 2019 on much stronger footing than forecasters and market participants had anticipated. This can be easily seen if we look back at the sharp deterioration of consensus growth estimates for the first quarter. Between the end of 2018 and the release date of first quarter figures for U.S. gross-domestic-product (GDP) expectations declined from 3.1% to 2.8%. That partly reflected fears concerning the negative effects from the longest government shutdown in history (35 days). Another factor making economic forecasts difficult during this period was the incomplete data as a direct result of the shutdown. And of course, uncertainty over trade negotiations and fears of global growth softening further clouded many economist's crystal ball. In retrospect the reported 3.2% quarter-over-quarter annualized GDP growth rate for the first quarter was more than comforting. When looking at the details of the GDP figures, some mixed feelings remain however. For economists the composition, or the growth mix, is as essential as the headline numbers, if not more.

Private consumption remained a strong driver of economic growth during the first quarter. This is not surprising, given the continuing strength in U.S. labor markets. The not so good news is, private consumption slowed from the last quarter in 2018. Here the government shutdown played a role. Government and especially government contract workers, not sure when they would receive their next paycheck, naturally held back on purchases. In this episode, households spent less than usual on more expensive merchandise (durable goods, like cars, for example). Looking ahead, the soft patch in consumption is likely to be temporary. Indicators of consumer sentiment, such as the one published by the University of Michigan, also suggest somewhat higher consumption going forward. Another surprise: net trade contributed by far the most to growth in the first quarter. That reflected a combination of stagnant imports (due to

lower spending on durable goods) and a surge in U.S. exports. A look into recent trade statistics suggests plenty of stockpiling by European and Asian importers of U.S. goods, perhaps in anticipation of escalating trade tensions. The most interesting item was a jump in U.S. business inventories, the second highest contributor to growth during the first quarter. Our take on this: U.S. domestic businesses prepared for a trade war escalation as well. It probably also reflects producers expectations for higher domestic demand later on in 2019. Recent surveys support this view¹. While e.g. the ISM manufacturing Purchasing Manager Index (PMI) followed a clear downward trend through the first four months, the new order component remained resilient until March. So, looking beyond the headline GDP figure for the first quarter, the underlying trend of growth remains moderate but reasonable. One good way to extract a reasonable indication of the prevailing momentum in the U.S. economy is to take a look at final sales to private domestic purchasers. They are currently quoted at around 2% quarter-on-quarter annualized – a number which is roughly in line with our growth expectations. Looking ahead, inventories must be wound down at some point in time. Moreover, the favorable support from net trade is unlikely to repeat itself in the short term. So we expect at least some negative payback in the following quarters.

There are also some encouraging trends, though. Strong labor-market data for April underpins our picture of a well-behaved moderation. Besides a strong increase of non-farm payrolls and the new cyclical-low unemployment, we were delighted to note an upward trend in labor productivity growth. And labor markets could improve further. As aptly put by one U.S. Federal Reserve (Fed) official, advances in technology may have pushed the natural rate of unemployment lower as job matching may have become more efficient. Also, if sustained, higher productivity may offer some

¹<https://www.oecd.org/economy/outlook/global-growth-weakening-as-some-risks-materialise-OECD-interim-economic-outlook-handout-march-2019.pdf>

All opinions and claims are based upon data on 5/20/19 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Source: DWS Investment Management Americas Inc.

scope for further wage growth. This would support consumption and protect household's balance sheets. Based on this we maintain our scenario of moderating, but above potential, growth through 2019 and 2020. We still expect deceleration not to be excessive nor do we expect a recession in the next twelve months. Furthermore we welcome the fact that such an environment also reduces the long-term risks to the current expansion, such as high inflation and, excessive private leverage.

However, risks to this outlook remain. The recent escalation of trade negotiations with China and the lingering dispute with Iran would be the most prominent ones. Until recently, we and most observers had hoped for a fairly quick resolution to the trade dispute between the United States and China. The unexpected increase of U.S. tariffs from 10% to 25% on 200 billion U.S. dollars (USD) of imports from China has dashed those hopes. In the usual tit-for-tat manner, China retaliated by introducing various tariffs between 10% – 25% on 60 billion USD of U.S. exports. The latest move, an executive order by President Trump to essentially ban trade with Chinese technology companies, increased the uncertainty even further. Our assessment of this complex situation remains an optimistic one, at least for the time being. We expect some verbal moderation in the course of 2019, most likely followed by a retraction of some of the measures. The recent announcement of delaying the decision on European auto tariffs by the United States and the offer of President Trump to meet with China's Xi Jinping support this view. One key date to watch will be the G20 summit in Japan at end of June which both leaders are planning to attend.

Besides our rather optimistic view on the politics of the trade war, we have to consider at least some economic implications. As we know from the first round of tariffs, the initial fallout will be visible in higher U.S. import prices for the affected goods, which in turn impacts producer prices and eventually consumer prices. Our calculations suggest that the impact on consumer prices in the current situation is moderate and somewhat transitory. This is the good news. Of course this assessment changes if the situation escalates further. Introducing 25% tariffs on the remaining ~300 billion USD of imports would hit the consumer directly. The reason is, that current tariffs mainly target intermediate goods while the next round would hit mainly consumer goods. While it is relatively easy for economists to estimate the direct consequence of higher tariffs, a complete trade ban for a sector is a much tougher assessment. Complex supply chains are not observable from the outside and so it is not straight forward to model the impact of disrupting them. It remains to be seen what net-effects will show up.

Transitory seems to be the word of the hour, not least among Fed officials in recent comments. They mostly used it in the context of weak inflation figures, including the disappointing March ones for the core Personal Consumption Expenditure Price Index (PCE) – the Fed's preferred measure of inflation. Prices increased only very modestly at 1.6% year-on-year in March, relatively far below the Fed's 2% target. So a rather dovish statement following May's Federal

Open Market Committee (FOMC) meeting was widely expected. And, at least from the statement, markets got what they had been looking for. In the press conference however, Chair Powell was more upbeat than expected. His wording was in the neutral camp and he seemed convinced that observed weakness in inflation would be transitory. Further he stated that the Fed remains committed to the symmetric 2% inflation target and that "insurance" rate cuts because of low inflation would not be on the cards. In general, the FOMC also judged labor markets as strong and financial conditions as favorable. In light of their economic assessment, the overall policy stance was, again, seen as appropriate and the "wait-and-see" approach was reiterated. So nothing new here.

What has changed since the last FOMC meeting is, of course, the recent escalation in trade negotiations. Back at the time of the meeting, Powell mentioned reports of progress in trade talks. We now expect the Fed to alter their assessment towards a more cautious tone. And they are already preparing. Summing up recent Fed talk, current tariff measures would only have a minor effect on growth while boosting inflation only a few tenths in the coming months. A prolonged episode or even an escalation could have significant effects, though. Besides this, Fed talk was concentrated on the review of the monetary-policy framework. Here Richard H. Clarida, Vice Chair of the Board of Governors of the Fed, caught our attention, stressing the role of inflation expectations for optimal policy setting. Up until now, the various measures of inflation expectations remain well anchored and imply, if used to derive an estimate of optimal policy, a fairly neutral to slightly accommodative current policy stance.

We expect the Fed, despite the increased political risks and the economic implications of those risks, to maintain a neutral stance in the next quarters. Indeed, weakness in core PCE seems to be transitory. The latest readings of the consumer price index (CPI) and producer prices suggest as much. Furthermore, we believe the effect from tariffs, in the absence of further escalation, should bring back inflation towards target a bit quicker than had previously been anticipated. Also recall the symmetric nature of the Fed inflation target. If you read between the lines on the discussion on the policy framework, the Fed appears most likely to tolerate a modest overshoot of their 2% target – just as they have previously tolerated below target inflation.

All said, we believe there is no reason for euphoria nor for being overly concerned, at least from an economic point of view. The economy remains on a fairly balanced, but moderating, path. Looking ahead, it's all about politics and how markets react on the news flow. So an escalation of the trade war would directly impact financial conditions, followed by a more severe fall-out for the U.S. economy. As of now financial conditions remain favorable, but that can change quickly. Just recall what happened during the last quarter of 2018, when markets tumbled and fears of an immediate recession increased. Based on the current economic data, we do not expect a repeat, for the time being.

All opinions and claims are based upon data on 5/20/19 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Source: DWS Investment Management Americas Inc.

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.

Consensus forecasts

Expresses the average of a range of forecasts from different analysts or brokers on a given data point.

Consumer price index (CPI)

The **consumer price index (CPI)** measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

Dove

Doves are in favor of an expansive monetary policy.

Durable goods

Durable goods are long-lasting and do not have to be purchased frequently.

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.

G20

The **Group of 20** are the largest industrialized and emerging economies in the world.

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.

ISM Purchasing Managers Index

The **ISM Purchasing Manager Index**, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

Leverage

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

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) Index

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

Purchasing Managers Index (PMI)

The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector in a specific country or region.

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.

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.

IMPORTANT INFORMATION

The brand DWS represents DWS Group GmbH & Co. KGaA and any of its subsidiaries, such as DWS Distributors, Inc., which offers investment products, or DWS Investment Management Americas Inc. and RREEF America L.L.C., which offer advisory services. This document has been prepared without consideration of the investment needs, objectives or financial circumstances of any investor. Before making an investment decision, investors need to consider, with or without the assistance of an investment adviser, whether the investments and strategies described or provided by Deutsche Bank, are appropriate, in light of their particular investment needs, objectives and financial circumstances. Furthermore, this document is for information/discussion purposes only and does not and is not intended to constitute an offer, recommendation or solicitation to conclude a transaction or the basis for any contract to purchase or sell any security, or other instrument, or for Deutsche Bank to enter into or arrange any type of transaction as a consequence of any information contained herein and should not be treated as giving investment advice. Deutsche Bank AG, including its subsidiaries and affiliates, does not provide legal, tax or accounting advice. This communication was prepared solely in connection with the promotion or marketing, to the extent permitted by applicable law, of the transaction or matter addressed herein, and was not intended or written to be used, and cannot be relied upon, by any taxpayer for the purposes of avoiding any U.S. federal tax penalties. The recipient of this communication should seek advice from an independent tax advisor regarding any tax matters addressed herein based on its particular circumstances. Investments with Deutsche Bank are not guaranteed, unless specified. Although information in this document has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness or fairness, and it should not be relied upon as such. All opinions and estimates herein, including forecast returns, reflect our judgment on the date of this report, are subject to change without notice and involve a number of assumptions which may not prove valid.

Investments are subject to various risks, including market fluctuations, regulatory change, counterparty risk, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you may not recover the amount originally invested at any point in time. Furthermore, substantial fluctuations of the value of the investment are possible even over short periods of time. Further, investment in international markets can be affected by a host of factors, including political or social conditions, diplomatic relations, limitations or removal of funds or assets or imposition of (or change in) exchange control or tax regulations in such markets. Additionally, investments denominated in an alternative currency will be subject to currency risk, changes in exchange rates which may have an adverse effect on the value, price or income of the investment. This document does not identify all the risks (direct and indirect) or other considerations which might be material to you when entering into a transaction. The terms of an investment may be exclusively subject to the detailed provisions, including risk considerations, contained in the Offering Documents. When making an investment decision, you should rely on the final documentation relating to the investment and not the summary contained in this document.

This publication contains forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. The forward looking statements expressed constitute the author's judgment as of the date of this material. Forward looking statements involve significant elements of subjective judgments and analyses and changes thereto and/or consideration of different or additional factors could have a material impact on the results indicated. Therefore, actual results may vary, perhaps materially, from the results contained herein. No representation or warranty is made by DWS as to the reasonableness or completeness of such forward looking statements or to any other financial information contained herein. We assume no responsibility to advise the recipients of this document with regard to changes in our views.

No assurance can be given that any investment described herein would yield favorable investment results or that the investment objectives will be achieved. Any securities or financial instruments presented herein are not insured by the Federal Deposit Insurance Corporation ("FDIC") unless specifically noted, and are not guaranteed by or obligations of Deutsche Bank AG or its affiliates. We or our affiliates or persons associated with us may act upon or use material in this report prior to publication. DB may engage in transactions in a manner inconsistent with the views discussed herein. Opinions expressed herein may differ from the opinions expressed by departments or other divisions or affiliates of Deutsche Bank. This document may not be reproduced or circulated without our written authority. The manner of circulation and distribution of this document may be restricted by law or regulation in certain countries. This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, including the United States, where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Deutsche Bank to any registration or licensing requirement within such jurisdiction not currently met within such jurisdiction. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions.

Past performance is no guarantee of future results; nothing contained herein shall constitute any representation or warranty as to future performance. Further information is available upon investor's request. All third party data (such as MSCI, S&P & Bloomberg) are copyrighted by and proprietary to the provider.

Deutsche Bank AG is authorised under German Banking Law (competent authority: European Central Bank and the BaFin, Germany's Federal Financial Supervisory Authority) and by the Prudential Regulation Authority and subject to limited regulation by the Financial Conduct Authority and Prudential Regulation Authority. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority, and regulation by the Financial Conduct Authority are available from us on request.

© 2019 DWS Investment GmbH, Mainzer Landstraße 11-17, 60329 Frankfurt am Main, Germany.

All rights reserved.