CIO | VIEW

U.S. Economic Outlook

June 25, 2019

NO MORE PATIENCE?

Christian Scherrmann
U.S. Economist

IN A NUTSHELL

- The U.S. Federal Reserve turned dovish in June's meeting, we now expect a first "insurance" rate cut in July.
- While the economic outlook remains favorable for the time being, the anticipated fallout of trade-related uncertainty calls for some monetary support.
- Inflation is expected to remain weak and labor markets are likely to remain near full employment.

Last month, we argued that it was all going to be about politics from now onwards. And indeed, May and June have not been short of unexpected political developments – and tweets. However, mixed economic data has also raised new questions on how the U.S. economy may evolve. We still expect no immediate recession, nor a sharp downturn, and stick to our view of a moderate cooling of economic activity. This is increasingly reflected in the data. Of course, the ultimate pace of convergence towards a lower growth path and the appropriate monetary policy continues to be dependent on political developments. Geopolitical tensions and the ongoing trade war adds plenty of uncertainty and, if mismanaged, could undermine the economic outlook. Markets appear to be already anticipating this, having priced in several interest-rate cuts in the next twelve months. But is this justified?

Let's have a look at the U.S. Federal Reserve's (Fed's) dual mandate of stable prices and maximum sustainable employment. According to May's employment report[1], non-farm payrolls (NFPs) significantly missed expectations, with only 75,000 jobs created. Average weekly earnings disappointed too, increasing at a moderate pace of just 3.1% year-on-year. But that may say more about excessive expectations than about the actual numbers. The strong job gains of 2017 and 2018, will be tough to repeat with fewer idle workers in the market. And perhaps, observers might be searching for every bit of justification for more monetary stimulus.

A closer look into the report suggests that the weakness of job creation was most likely not entirely a consequence of global political uncertainty. For instance, the main drag was concentrated on the service industry (halved to roughly 82,000 from 170,000), specifically in education and health services. The rest of the shortfall of NFPs in May is mostly explained by weakness in financial as well as business and professional services, sectors less impacted by global trade. Supply constraints might act as natural limits to job growth in those areas, especially in times when overall labor markets are also very tight. However, to be fair, the trade related impact might be felt in an ongoing, albeit minor, soft patch in transportation and warehouses as well as in information services. The weak performance of job growth in the goods producing industry, a natural place to search for an impact from trade-related disturbances, was mainly because of the usually highly volatile construction segment (down to roughly 4,000 from around 30,000).

However, one of our favorite labor-market-health indicators – temporary help services – remained resilient. Meanwhile, job growth in manufacturing continued to cool as it has been since the beginning of the year. Of course this development may be a result of political uncertainty, but we do not observe a sudden drop, let

[1]https://www.bls.gov/news.release/pdf/empsit.pdf

alone an accelerated decline. As a result, it might be wiser to focus on how tight labor markets are rather than whether external shocks are already being felt.

Also, it is always worth recalling that labor-market data is a lagging indicator of economic activity. The unemployment rate remained at its historical low of 3.6% while the broader U6 unemployment measure even declined to 7.1% from 7.3%. U6 unemployment includes underemployed workers, such as those currently working only part time, but seeking a full-time position. Its decline leads us to the conclusion that labor markets are in fact very tight, probably now at full employment. It also seems likely that new full-time jobs are increasingly being created for those already working part-time. The JOLTS[2] (Job Openings and Labor Turnover Survey) contains further hints that full employment has now been reached: in April, the number of vacant positions (roughly 7.5 millions) exceeded the number of unemployed people (roughly 5.8 millions), marking a record high. Additional evidence of labor-market tightness was presented in the most recent issue of the Fed's Beige Book[3], stating that economic activity expanded modestly from April until mid-May with employment increasing on a nationwide level – this, however, was limited by tight labor markets. It also stated that despite the tight labor markets, and some wage-based competition, overall wage pressure remained modest.

And indeed, inflation still lags behind the Fed's objective, casting doubts on whether the Fed will be able to achieve its communicated 2% inflation target at any point in the foreseeable future. Recent economic data is further fueling the discussion. The April release for the Personal Consumption Expenditure Index (PCE) showed headline inflation at only 1.5% year-on-year, while the Fed's preferred measure, the core PCE (excluding prices for food and energy) was just a bit above at 1.6% year-on-year.

Our take on this and the Consumer-Price-Index (CPI) numbers for May is that inflation remains on a softer trajectory. Service inflation (e.g. for non-tradable goods) might serve as a good gauge on how domestic price pressures evolve. Findings here are striking. The service component of May's CPI (less energy services) increased at a rate of 2.7% year-on-year and at 2.4% year-on-year for April's PCE.

According to the Michigan Consumer Report for May, short-term inflation expectations declined to 2.6% from 2.9%, whereas the longer-term (5-year) expectations dropped by even 0.4% to 2.2% – the lowest levels since the report includes this question. Those weaker expectations are not yet alarming to us. For the time being, various measures of inflation expectations remain above the Fed's 2% target. This must be watched carefully, however. Looking ahead, we expect consumer spending to remain solid as labor markets are still in good shape.

And consumption remains key to the outlook as it is the main component of economic growth. Which brings us back to the latest Michigan Consumer Survey Report[4] for May. It shows that consumer sentiment has already been impacted by the ongoing trade-war discussion. The current sentiment indicator declined somewhat to 97.9 from 100. According to the report, the main focus of respondents, besides the trade dispute with Mexico, has been the U.S.-China trade war and fears about the introduction of another round of tariffs. As a consequence, buying intentions have increased. This probably explains the very sound retail-sales report for May which surprised markets on the upside.

Despite the robust outlook for consumption, industrial data remains on the weaker side. The positive surprise in industrial production in May can be interpreted as a bounce back from a very weak start in 2019. Moreover, investments have been revised down for the first quarter of 2019. The reluctance of U.S. corporations to invest matches the weaker employment numbers in the sector and is also in line with a fairly flat reading of the ISM manufacturing Purchasing Manager Index (PMI) for May. This could partly reflect the tech sector becoming a second battleground in the U.S.-China trade war. A resolution of the tariffs could alleviate the situation somewhat, but the non-tariff measures in the tech sector are likely to further weigh on economic activity.

As we anticipated, the Fed did not cut rates in June's Federal-Open-Market-Committee (FOMC) meeting. However, the statement[5] as well as the economic outlook[6] turned significantly dovish. The Fed now plans to "act as appropriate to sustain the expansion." The reemergence of trade-related crosscurrents increased the Fed's willingness to add a monetary stimulus. The

[2] https://www.bls.gov/news.release/jolts.nr0.htm
[3] https://www.federalreserve.gov/monetarypolicy/beigebook201906.htm
[4] http://www.sca.isr.umich.edu
[5] https://www.federalreserve.gov/monetarypolicy/files/monetary20190619a1.pdf
[6] https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20190619.pdf

growth outlook was revised down only for 2020, implying for 2019 that the surprisingly strong numbers for the first quarter will weigh on subsequent quarters as they have been driven by net trade and a buildup of inventories. This implies lower growth rates for the remainder of the year. Likewise, consumption was judged to be robust while weakness was registered in business income due to uncertainties surrounding the trade negotiations. Inflation now is forecasted, as we have expected, below the 2% target in 2019 and 2020. A striking detail was the major revision to the headline PCE figure, now forecasted at 1.5% from 1.8% in 2019. Core inflation is now expected at 1.8% from 2.0% in 2019 and at 1.9% from 2.0% in 2020. It was also acknowledged that the various measures of inflation expectations have trended lower and are currently at the bottom of their historic ranges. In line with our analysis, they noted that a negative downward spiral could start if expectations deteriorated further – even in an otherwise healthy economy.

Renewed uncertainties around trade negotiations, weaker business activity and an ongoing shortfall of inflation, coupled with some weakening of inflation expectations, led many FOMC participants to conclude that a more accommodating monetary policy would be appropriate. Looking at the dot plot[7], we now see 8 out of 17 participants clearly in favor for a rate cut, 7 of them as much as 50 basis points (bps) over the next two years. In general it was mentioned that the uncertainty surrounding the economic outlook has increased and even those members, currently not predicting a rate cut, expressed that the case for a more accommodative stance was strengthened.

Our take from the recent developments is that while the Fed remains data-dependent, the door for a rate cut has been opened. We believe this could happen sooner rather than later. In principle, the Fed might show some tolerance towards weaker inflation, given inflation expectations remain well anchored and labor markets remain robust. From now onwards, however, the U.S. central bank might instead follow a strategy of preempting the potential fallout from trade tensions. Such a preemptive approach is not altogether new. In 1995, the Fed lowered rates as a reaction to weak inflation. In 1998, it sought to preempt the spillover effects from the Russian financial crisis and the troubled Long-Term Capital Management fund, albeit at the cost of further inflating the technology bubble in U.S. equity markets. This time around, we expect the first preemptive interest-rate cut maybe as early as July.

GLOSSARY

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

Basis point
One **basis point e**quals 1/100 of a percentage point.

Central bank
A **central bank** manages a state's currency, money supply and interest rates.

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.

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.

Headline inflation
Headline inflation is the raw inflation figure based on the consumer price index (CPI) and not adjusted for seasonality or for the often volatile elements of food and energy prices.

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

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

U6 unemployment rate
The **U6 unemployment rate** is the broadest measure of unemployment including those who have given up looking for work and those who are working part-time but would prefer to work full-time.

[7]Dot plots are projections of FOMC participants, indicating their subjective appropriate level of the federal-funds target, expressed as the midpoint between the lower and upper level, see: https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20190619.pdf

IMPORTANT INFORMATION: EMEA

The following document is intended as marketing communication.
DWS is the brand name under which DWS Group GmbH & Co. KGaA and its subsidiaries operate their business activities. Clients will be provided DWS products or services by one or more legal entities that will be identified to clients pursuant to the contracts, agreements, offering materials or other documentation relevant to such products or services.
The information contained in this document does not constitute investment advice.
All statements of opinion reflect the current assessment of DWS Investment GmbH and are subject to change without notice.
Forecasts are not a reliable indicator of future performance. Forecasts are based on assumptions, estimates, opinions and hypothetical performance analysis, therefore actual results may vary, perhaps materially, from the results contained here.
Past performance, [actual or simulated], is not a reliable indication of future performance.
The information contained in this document does not constitute a financial analysis but qualifies as marketing communication. This marketing communication is neither subject to all legal provisions ensuring the impartiality of financial analysis nor to any prohibition on trading prior to the publication of financial analyses.
This document and the information contained herein may only be distributed and published in jurisdictions in which such distribution and publication is permissible in accordance with applicable law in those jurisdictions. Direct or indirect distribution of this document is prohibited in the USA as well as to or for the account of US persons and persons residing in the USA.

IMPORTANT INFORMATION: UK

Issued in the UK by DWS Investments UK Limited. DWS Investments UK Limited is authorised and regulated by the Financial Conduct Authority (Registration number 429806).
DWS is the brand name of DWS Group GmbH & Co. KGaA. The respective legal entities offering products or services under the DWS brand are specified in the respective contracts, sales materials and other product information documents. DWS, through DWS Group GmbH & Co. KGaA, its affiliated companies and its officers and employees (collectively “DWS”) are communicating this document in good faith and on the following basis.
This document is a financial promotion and is for general information purposes only and consequently may not be complete or accurate for your specific purposes. It is not intended to be an offer or solicitation, advice or recommendation, or the basis for any contract to purchase or sell any security, or other instrument, or for DWS to enter into or arrange any type of transaction as a consequence of any information contained herein. It has been prepared without consideration of the investment needs, objectives or financial circumstances of any investor. 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. 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 DWS, are suitability and appropriate, in light of their particular investment needs, objectives and financial circumstances. We assume no responsibility to advise the recipients of this document with regard to changes in our views.
We have gathered the information contained in this document from sources we believe to be reliable; but we do not guarantee the accuracy, completeness or fairness of such information and it should not be relied on as such. DWS has no obligation to update, modify or amend this document or to otherwise notify the recipient in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.
DWS does not give taxation or legal advice. Prospective investors should seek advice from their own taxation agents and lawyers regarding the tax consequences on the purchase, ownership, disposal, redemption or transfer of the investments and strategies suggested by DWS. The relevant tax laws or regulations of the tax authorities may change at any time. DWS is not responsible for and has no obligation with respect to any tax implications on the investment suggested.
This document 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 document. 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 in this document.
PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

Publisher: DWS Investment GmbH, Mainzer Landstraße 11-17, 60329 Frankfurt am Main, Germany

HONG KONG

The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the investments contained herein. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. This document has not been approved by the Securities and Futures Commission in Hong Kong nor has a copy of this document been registered by the Registrar of Companies in Hong Kong and, accordingly, (a) the investments (except for investments which are a “structured product” as defined in the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong) (the “SFO”)) may not be offered or sold in Hong Kong by means of this document or any other document other than to “professional investors” within the meaning of the SFO and any rules made thereunder, or in other circumstances which do not result in the document being a “prospectus” as defined in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the Laws of Hong Kong) (“CO”) or which do not constitute an offer to the public within the meaning of the CO and (b) no person shall issue or possess for the purposes of issue, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the investments which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the investments which are or are intended to be disposed of only to persons outside Hong Kong or only to “professional investors” within the meaning of the SFO and any rules made thereunder.

SINGAPORE

Singapore Interests in the funds mentioned herein are not allowed to be made to the public or any members of the public in Singapore other than (i) to an institutional investor under Section 274 or 304 of the Securities and Futures Act (Cap 289) (“SFA“), as the case may be, (ii) to a relevant person (which includes an Accredited Investor) pursuant to Section 275 or 305 and in accordance with other conditions specified in Section 275 or 305 respectively of the SFA, as the case may be, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

IMPORTANT INFORMATION: APAC

DWS is the brand name of DWS Group GmbH & Co. KGaA. The respective legal entities offering products or services under the DWS brand are specified in the respective contracts, sales materials and other product information documents. DWS Group GmbH & Co. KGaA, its affiliated companies and its officers and employees (collectively “DWS Group”) are communicating this document in good faith and on the following basis.

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 DWS Group, 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 constitute an offer, recommendation or solicitation to conclude a transaction and should not be treated as giving investment advice.

DWS Group does not give tax or legal advice. Investors should seek advice from their own tax experts and lawyers, in considering investments and strategies suggested by DWS Group. Investments with DWS Group are not guaranteed, unless specified.

Investments are subject to various risks, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back 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. The terms of any investment will 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 transaction and not the summary contained herein. Past performance is no guarantee of current or future performance. Nothing contained herein shall constitute any representation or warranty as to future performance.

Although the information herein has been obtained from sources believed to be reliable, DWS Group does not guarantee its accuracy, completeness or fairness. No liability for any error or omission is accepted by DWS Group. Opinions and estimates may be changed without notice and involve a number of assumptions which may not prove valid. All third party data (such as MSCI, S&P, Dow Jones, FTSE, Bank of America Merrill Lynch, Factset & Bloomberg) are copyrighted by and proprietary to the provider. DWS Group or persons associated with it (“Associated Persons”) may (i) maintain a long or short position in securities referred to herein, or in related futures or options, and (ii) purchase or sell, make a market in, or engage in any other transaction involving such securities, and earn brokerage or other compensation.

The document was not produced, reviewed or edited by any research department within Deutsche Bank and is not investment research. Therefore, laws and regulations relating to investment research do not apply to it. Any opinions expressed herein may differ from the opinions expressed by other Deutsche Bank departments including research departments. This document may contain 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 Deutsche Bank as to the reasonableness or completeness of such forward looking statements or to any other financial information contained herein.

This document may not be reproduced or circulated without DWS Group’s written authority. The manner of circulation and distribution of this document may be restricted by law or regulation in certain countries, including the United States.

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 DWS Group 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.

Unless notified to the contrary in a particular case, investment instruments are not insured by the Federal Deposit Insurance Corporation (”FDIC“) or any other governmental entity, and are not guaranteed by or obligations of DWS Group.

Publisher: DWS Investment GmbH, Mainzer Landstraße 11-17, 60329 Frankfurt am Main, Germany