

NO MORE PATIENCE?



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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 report¹, 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/empisit.pdf>

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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 JOLTS² (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 Book³, 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 Report⁴ 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 statement⁵ as well as the economic outlook⁶ 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/fomcprojtbl20190619.pdf>

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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 plot⁷, 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** equals 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.

⁷Dot 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/fomcprojtab120190619.pdf>

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