CIO | VIEW
U.S. Economic Outlook
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DWS

Marketing Material

U.S. CONSUMER SUPERSTAR

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IN A NUTSHELL

_ The U.S. consumer remains the guardian of U.S. growth.
_ Yield-curve inversion should be taken seriously but not dogmatic.
_ Resilient consumption might give the Fed some degree of freedom.

Every good story needs a hero. In this economic outlook, we take a closer look at the U.S. consumer. The latest release of economic-growth data for the United States sets the stage for a strong comeback of one of the last real heroes of the global economy: the U.S. consumer. Like the Marvel comic star Odin, he is back after two quarters of Odinsleep[1]. In times of political uncertainties, trade wars, weakening global growth and inverted-yield curves[2] one of the main points of concern should be: for how long can the U.S. consumer remain the champion?

In the second quarter of 2019 consumption alone contributed almost three percentage points to a headline gross-domestic-product (GDP) growth of 2.1%.[3] This offsets decreasing exports and unwinding inventories, obviously a direct effect from global trade wars, which contributed negatively toward GDP. Meanwhile, labor markets remain solid and the keen observer could spot a slight pick-up in wage pressures. This is the framing the U.S. Federal Reserve (Fed) used to describe their "favorable" outlook on the economy in the July Federal-Open-Market-Committee (FOMC) meeting. However, inflation overall remains subdued and various uncertainties from the trade war, as well as weaker global growth, called for some monetary support. Consequently, the Fed lowered the federal-funds target range to 2% to 2.25 %. This was labelled as an "insurance cut" or a mid-cycle adjustment, which left markets, and others, seemingly disappointed. The Fed not only pushed back against various calls for more stimulus in July, but also pointed to another round of data dependency. When another 10% tariffs on remaining imports from China were then announced, markets tumbled. Many of the affected Chinese imports are consumer goods – and fears emerged that the last guardian of U.S. growth would disappear. In a quick response to the market reaction, decisions-makers in Washington announced that some of the tariffs on consumer-sensible products will get delayed until mid-December. Disappointing data from China and Germany, however, turned sentiment back into crisis mode as the spread between 2- and 10-year U.S. Treasuries went slightly negative. Historically, this has been a strong sign for an upcoming recession in the following 9 to 18 months. While cause and effect of this metric are heavily debated, the true relationship is not fully understood. One could compare the current situation to 1998[4], when the Fed lowered rates three times to protect the economy just to reenter hawkish territory shortly afterwards. This does not imply that we do not take the signal seriously, but the fact that we do not observe increased imbalances in the real economy corroborates our view that things might not get fundamentally worse, at least for a while.

What remains is a period of volatile markets and the question if and how this could affect the U.S. consumer? U.S. consumers historically allocate retirement savings more toward risky assets when compared to other economies; volatility and lower asset prices should have an enlarged impact on consumption, the reasoning goes. However, Fed research indicates that

[1] If Odin loses his powers before the year is up or has an injury, he is forced to enter the Odinsleep early to heal.
[2] An inverted yield curve is a situation in which longer dated government securities trade at lower yields than short term papers, usually the focus is on the 2-year vs. 10-year maturity.
[3] Growth is usually reported as quarter-over-quarter annualized percentage change. Contribution of all components to growth add up to the headline GDP number. It implies that some components can be negative.
[4] In 1998 the Fed lowered rates from 5.5% to 4.75% to insure the economy against a potential fallout from the struggling Long-Term Capital Management.

this might have changed in past years. A recent Fed model[5] shows that roughly 65 cents of one additional dollar of wages[6] and 3.5 cents of one additional dollar of net wealth are going into consumption, keeping in mind that household's wealth is roughly seven times the level of aggregated income. Surprisingly, this relationship broke down[7] somewhere around 2012 – just as net wealth of households started to recover from the Great Recession. Households seemed less sensitive to changes in their net wealth than the model would have suggested. People also now consume less out of wages as they have been used to. Perhaps consumers still assign a higher probability to a potential job loss than they did before the crisis.[8] Implication for our analysis would be, that household consumption seems to be more resilient toward risky asset volatility and more sensitive to wage developments and expectations about the job-market situation. Certainly the stock-market fragility of 2015 and 2016 curbed consumption while the combination of income losses and spinning markets during the last government shutdown finally depressed spending.

So will the story have a happy ending, in which the U.S. consumer remains the superhero? We think so as long as labor markets remain solid. As of now, the trade war is primarily a threat to the manufacturing sector, not the service sector where most people earn their money. The next test for the wellbeing of the consumer may be in mid-December, when announced tariffs will eventually be enacted. Until then the Fed might put more attention on consumer's expectations about labor markets and the economy, than on market volatility or financial conditions. While consumers seem to remain resilient at the moment, markets obviously remain unsettled – which hopefully is not going to be a self-fulfilling prophecy. We continue to believe in our superhero, the U.S. consumer.

OVERVIEW: KEY ECONOMIC INDICATORS

	2018				2019				2020	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP (% qoq, annualized)	2.5	3.5	2.9	1.1	3.1	2.1	1.8	2.0	2.0	2.2
Core inflation (% yoy)*	1.9	1.9	1.9	1.9	1.5	1.6	1.7	1.9	1.9	1.9
Headline inflation (% yoy)*	2.1	2.4	2.0	1.8	1.4	1.4	1.4	1.6	1.7	1.8
Unemployment rate (%)	4.0	4.0	3.8	3.8	3.9	3.6	3.6	3.6	3.7	3.7
Fiscal balance (% of GDP)	-3.5	-3.6	-4.0	-4.1	-4.3	-4.4	-4.4	-4.5	-4.7	-4.6

GLOSSARY

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.

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.

Great Recession
The **Great Recession** refers to the prolonged economic downturn in much of the world after the financial crisis of 2007-08.

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.

Hawk
Hawks are in favor of a restrictive monetary policy.

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

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.

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.

[5]Source: https://www.federalreserve.gov/econres/notes/feds-notes/what-is-holding-back-household-spending-20180308.htm as of 8/16/19
[6]and proprietor's income
[7]The authors of the study calibrate their model with quarterly data from 1960 to 2007.
[8]As measured by the University of Michigan Consumer Survey – Source: http://www.sca.isr.umich.edu/ as of 8/16/19
* PCE Price Index

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