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October 10, 2019

United States

MULTIPLE FORKS IN THE ROAD AHEAD

- **US growth is moderating as the damage from erratic and misguided policymaking sets in, but neither secular stagnation nor stagflation is looming on the horizon. Medium-term prospects for the US economy depend critically on the still-buoyant US consumer.**
- **The evolution of trade policy uncertainty and general turmoil in Washington, slowing growth outside of the US, and the inflation path multiply uncertainties around macroeconomic outlook and Fed policy.**

NEITHER SECULAR STAGNATION NOR STAGFLATION

Since late-2017 we have projected that US growth would be boosted by fiscal stimulus in 2018 and slow back toward underlying potential just below 2% in subsequent years. This outlook remains on track: we still do not project a recession in our forecast horizon, but our projections are subject to some major uncertainties. If anything, 2018 saw faster growth than we initially forecast and the ensuing slowdown has been more gradual than our models implied and slightly more resilient to Trump's trade wars than expected.

The Trump Administration's erratic policies have hit supply chains and kept the US dollar strong, pushing forward-looking surveys of business sentiment into territory that is sometimes suggestive of a forthcoming recession. Although US manufacturing and services purchasing managers' indices (PMIs) have softened, these indices have been only partially reliable indicators of looming recessions. The US manufacturing PMI has previously dipped below 50 (i.e., contraction) twice since the global financial crisis (GFC), and has registered five other false recession signals since 1980 (chart 1). It's notable that industrials account for only about 9.4% of the S&P500 and around 11.6% of US economic output. The signal may be better when we look at manufacturing and services together—and at present they don't jointly point toward a recession (chart 1 again).

US financial conditions remain accommodative, surprise indices have trended upward in recent months, and Fed Nowcasts still point to decent growth in Q3 (chart 2) in line with our expectations. Against past history, current US financial conditions are consistent with continued growth; they are likely fuelling some of the recent over-performance against, admittedly, diminished expectations. US corporate profits and core capital goods orders remain at elevated levels (chart 3), but uncertainty could dampen investment decisions going forward. And with inventory-sales ratios near GFC highs, running down these stockpiles could add a further drag on growth.

The US growth outlook depends critically on the still-buoyant US consumer—and there are good reasons to think Americans remain in spending mode. Household balance sheets are in good shape, with the debt-

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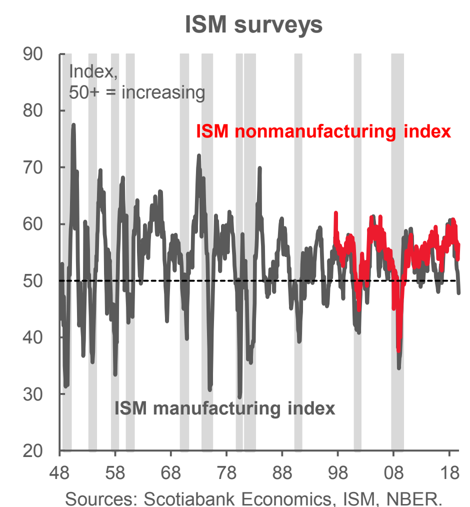
United States	2018	2019f	2020f	2021f
Real GDP (annual % change)	2.9	2.2	1.4	1.8
CPI (y/y %, eop)	2.2	1.9	2.2	2.2
Central bank policy rate (%, eop)	2.50	1.75	1.50	1.50
Canadian dollar (USDCAD, eop)	1.36	1.30	1.25	1.25

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, ISM, NBER.

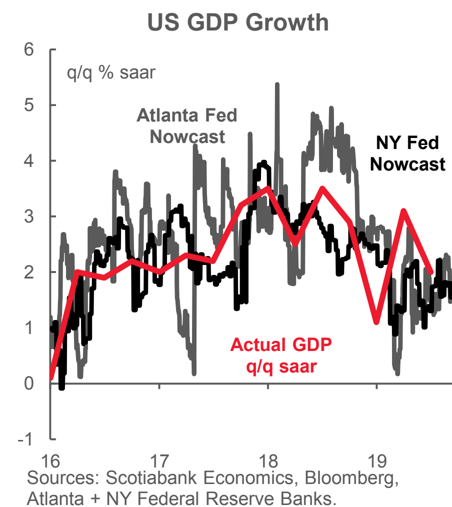
service ratios at their lowest levels in 40 years and the ratio of household net worth to GDP at a record high. New housing starts are just off their post-GFC high, pushed up by lower mortgage rates, which should sustain growth in consumer durables sales (chart 4). Wage growth continues on a sustained upward trend, although it has slowed recently. **Still, consumers and labour markets are often lagging indicators of incipient downturns, and, at the margin, consumer sentiment is now softening, hiring is slowing, and saving rates are rising.**

Nevertheless, even after the recent turmoil in the Middle East, we see little chance that moderate growth is going to be transformed into stagflation. In contrast with the 1970s, underlying US inflation remains soft and higher oil prices aren't likely to strengthen it meaningfully. Headline inflation has been below the Fed's 2% target since late-2018 and is expected to rise back toward the target during 2020. Similarly, as the *Commodities Outlook–Q4 2019 (October 10, 2019)* report lays out, oil prices are expected to remain flat as global growth slows and Saudi capacity comes back online. In any event, the US economy has become steadily less oil intensive over time and oil is now a less important driver of US inflation than in the 1970s (chart 5).

Consequently, we expect PCE inflation to return to the Fed's 2% target only in 2021, on the back of rising labour costs, the lagged impact from fiscally-induced excess demand, and the eventual US dollar depreciation. US dollar depreciation, as well as the pick-up in GDP growth in late-2020 on the back of stronger domestic demand, is driven by our expectation of a decline in trade policy uncertainty following the 2020 US presidential election and by the lagged effect of monetary policy stimulus introduced by the Federal Reserve in 2019.

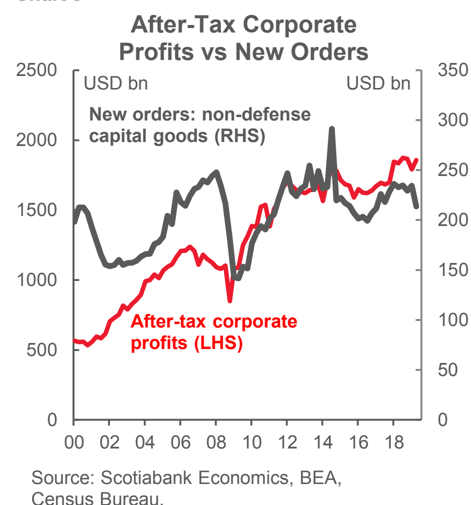
The US outlook has rarely been subject to the degree of uncertainty that currently provides a persistent backdrop to financial markets and policy makers. Three sources of uncertainty dominate the outlook, as summarized by the Federal Reserve's communications over the last few months: escalating trade policy uncertainty, accumulating risks to global growth and unexpected weakness in inflation. Each type of uncertainty can affect the US economy to a greater or lesser extent and shape the stance of monetary policy over 2019–21.

Chart 2



Sources: Scotiabank Economics, Bloomberg, Atlanta + NY Federal Reserve Banks.

Chart 3



Source: Scotiabank Economics, BEA, Census Bureau.

Table 1

Quarterly US Forecasts	2019		2020				2021			
	Q3e	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	1.8	1.1	1.3	1.3	1.5	1.8	1.9	1.9	2.0	2.0
Real GDP (y/y % change)	2.0	2.0	1.6	1.4	1.3	1.5	1.6	1.7	1.9	1.9
Consumer prices (y/y % change)	1.8	1.9	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
CPI ex. food & energy (y/y % change)	2.1	2.1	2.1	2.2	2.2	2.2	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	1.6	1.8	1.8	1.9	1.9	1.9	1.9	1.9	2.0	2.0
Financial										
Euro (EURUSD)	1.09	1.10	1.12	1.15	1.19	1.20	1.20	1.20	1.22	1.22
U.K. Pound (GBPUSD)	1.23	1.22	1.25	1.30	1.32	1.36	1.38	1.38	1.40	1.40
Japanese Yen (USDJPY)	108	108	107	107	105	105	103	103	102	102
Fed Funds Rate (upper bound, %)	2.00	1.75	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
3-month T-bill (%)	1.85	1.60	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.40
2-year Treasury (%)	1.62	1.40	1.45	1.50	1.50	1.60	1.65	1.70	1.70	1.75
5-year Treasury (%)	1.55	1.35	1.45	1.60	1.70	1.80	1.80	1.85	1.85	1.90
10-year Treasury (%)	1.67	1.50	1.60	1.70	1.85	2.00	2.05	2.10	2.10	2.15
30-year Treasury (%)	2.11	2.05	2.10	2.20	2.35	2.50	2.60	2.70	2.75	2.80

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

THE FED'S THREE DIFFICULT QUESTIONS

The outlook we present is contingent on three key assumptions:

- a reduction in trade policy uncertainty in 2021, following the 2020 US presidential election;
- a gradual slowing of growth outside the US during 2019–20; and
- persistently weak inflation.

Where is the trade war going? (charts 6–8)

Our baseline assumption is that trade uncertainty remains high through 2020, given that US-China trade negotiations are proceeding sporadically: tariff measures are announced and postponed; at times, rumours of an escalation in tensions shake financial markets (e.g., a potential de-listing of China-based companies is one recent case), while at other times exuberant optimism takes hold. Overall uncertainty is expected to wane over the course of 2021 as the impetus for further trade disruptions is likely to be diminished after the US elections, regardless of the winner (chart 6).

Table 2

United States	2000–18	2018	2019f	2020f	2021f
	(annual % change, unless noted)				
Real GDP	2.1	2.9	2.2	1.4	1.8
Consumer spending	2.4	3.0	2.5	2.0	2.0
Residential investment	-0.3	-1.5	-2.6	0.1	1.6
Business investment	3.2	6.4	2.6	1.1	2.3
Government	1.1	1.7	2.3	1.7	1.6
Exports	3.7	3.0	0.0	1.2	2.1
Imports	3.8	4.4	2.0	2.9	2.8
Nominal GDP	4.1	5.4	4.0	3.1	3.7
GDP Deflator	2.0	2.4	1.7	1.6	1.9
Consumer price index (CPI)	2.2	2.4	1.8	2.2	2.2
CPI ex. food & energy	2.0	2.1	2.1	2.2	2.1
Core PCE deflator	1.7	1.9	1.6	1.9	1.9
Pre-tax corporate profits	4.9	3.4	-0.2	2.7	1.8
Employment	0.8	1.7	1.5	1.0	1.0
Unemployment rate (%)	6.0	3.9	3.8	4.0	4.2
Current account balance (USD bn)	-500	-491	-582	-661	-723
Merchandise trade balance (USD bn)	-691	-887	-901	-987	-1064
Federal budget balance (USD bn)	-552	-779	-1,008	-1,034	-1,097
percent of GDP	-3.7	-3.8	-4.7	-4.7	-4.8
Housing starts (mn)	1.26	1.25	1.24	1.26	1.26
Motor vehicle sales (mn)	15.7	17.2	17.0	17.0	17.1
Industrial production	0.9	4.0	1.0	1.5	1.9
WTI oil (USD/bbl)	62	65	57	55	55
Nymex natural gas (USD/mmbtu)	4.74	3.07	2.61	2.64	2.64

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

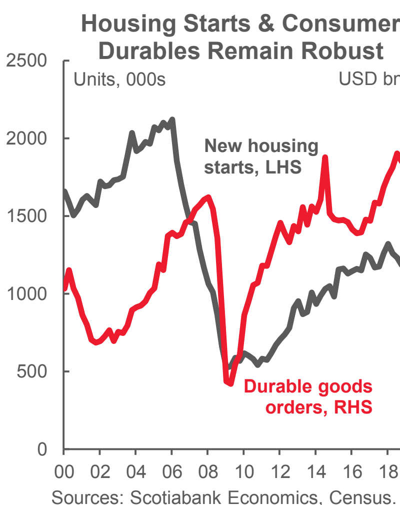
A more optimistic scenario is one in which the lack of certainty about the direction of trade policy declines during 2020, possibly on the heels of the conclusion of a deal between the US and China. Our simulations using the Scotiabank Global Macroeconomic Model (SGMM), which has now been re-estimated to include an explicit measure of trade-policy uncertainty, imply that US GDP growth would rise by 0.2 ppts in 2020 (chart 7) as US-China tensions abate. In the model, lower uncertainty would lead to stronger stock markets and a lower VIX, which supports consumption and investment; a weaker exchange rate owing to a reversal of the flight to the safety of the USD, which would boost exports; and stronger demand through higher investment spending and an acceleration of growth in international trade. All of these effects imply that the Fed would raise the fed funds target rate to 1.75% in Q2-2020 (chart 8) and keep it at that level for the rest of the forecast horizon.

On the other hand, we can also easily envision a scenario where uncertainty remains high through the end-2021. In this case, the results of our simulations show that US GDP growth is 0.2 ppts weaker in 2020 and 0.1 ppts weaker in 2021 than in our base case, leading the Federal Reserve to cut the fed funds target rate by an additional 25bps in Q2-2020. In this scenario, the policy rate is likely to be at 1.25% at the end of 2021.

What if global growth is weaker? (charts 9–10)

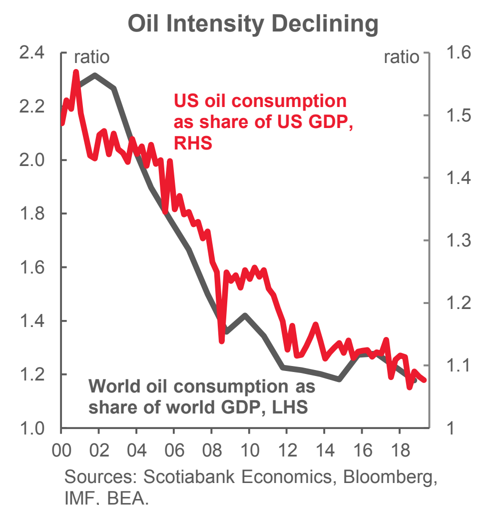
In addition to the effects of trade policy, there is evidence of a global growth slowdown that may or may not be related to it. Even though

Chart 4



Sources: Scotiabank Economics, Census.

Chart 5



Sources: Scotiabank Economics, Bloomberg, IMF, BEA.

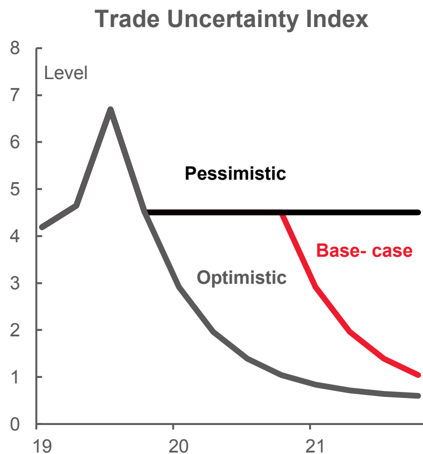
the US is relatively closed to international trade, the global economic cycle matters for the US growth outlook. Not only are US exports dependent on foreign demand, but any slowing in demand for US products is likely to be amplified by resulting weakness in financial markets and tighter borrowing conditions.

As an alternative scenario we assume that global growth is 0.5 ppts weaker over the full projection horizon compared to our baseline, 0.5 ppts being the difference between the median and the 20th percentile forecast for global growth amongst Bloomberg contributors. In this case, US GDP growth is expected to be 0.1 ppts weaker and the Federal Reserve is expected to provide further monetary policy accommodation relative to the base case, with rates falling to 1.25% in 2020 (charts 9 and 10).

Could inflation pick up faster?

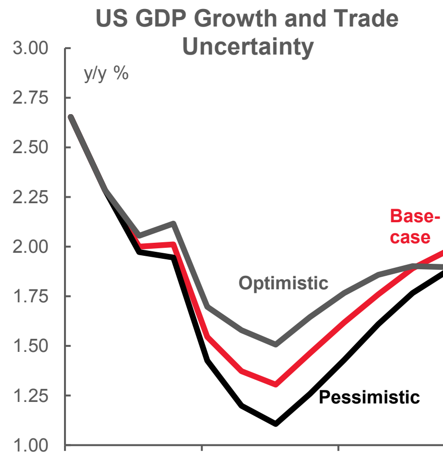
While downside risks to growth are significant, inflation behaviour can complicate the Federal Reserve's calculus. Our outlook assumes that the existing weakness in core inflation remains persistent. If, however, it is more transient, or the recent increases in tariffs produce a larger pass-through than we have assumed, the Fed will have fewer factors to point to when justifying easy monetary policy. For example, if core PCE inflation returns to 2.0% in Q1-2020, compared to 1.8% in the baseline, the rate cut in Q1-2020 may be postponed to later in the year and the case for it might be less robust.

Chart 6



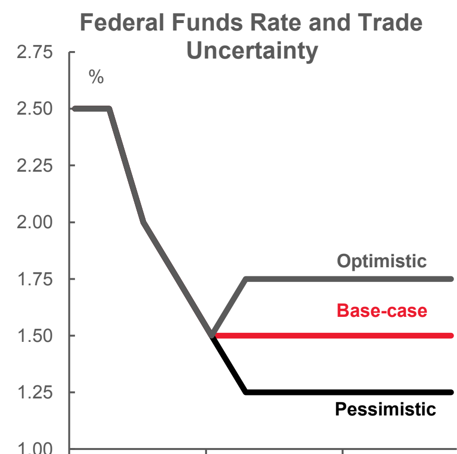
Sources: Scotiabank Economics, Trade Policy Uncertainty, PolicyUncertainty.com.

Chart 7



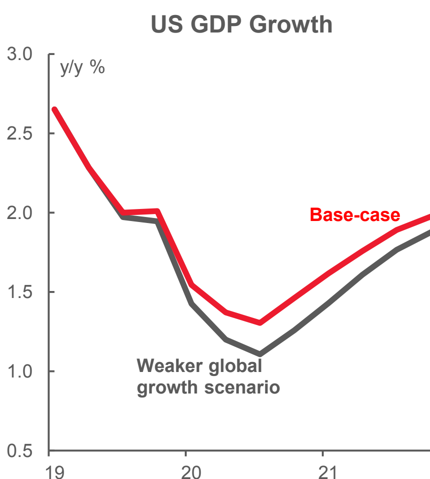
Sources: Scotiabank Economics.

Chart 8



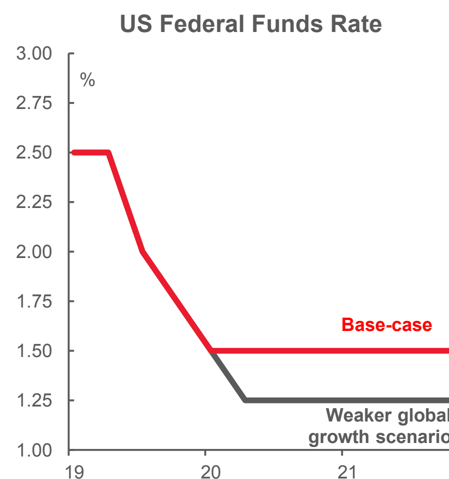
Sources: Scotiabank Economics.

Chart 9



Sources: Scotiabank Economics.

Chart 10



Sources: Scotiabank Economics.

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