ECONOMIC OUTLOOK
REGIONS
March 2019

(Crystal) Ball Of Confusion

The backlog of economic data releases delayed by the partial government shutdown has begun to clear but, instead of bringing clarity, the increased flow of data has made it hard to get a read on where the U.S. economy is, let alone to try and predict where it is going. While it may be mere coincidence, the post-shutdown data have exhibited some, well, bizarre swings in the form of monthly changes so large and so abrupt that, rather than informing us about the direction of the economy, the data only muddle the picture. The agencies that were shuttered during the shutdown have issued assurances that the data conform to normal standards of reliability, but in many cases the data have seemed at odds with these pledges, to the point that some of the data have been dismissed out of hand. The initial report on December retail sales is a prime example of data so out of line with every other indicator that they simply are not believable.

To be sure, many of the top-tier economic data series can be volatile from one month to the next, which is why our focus is always squarely on the underlying trends. The problem of late, however, is that the swings in some of the data have been so extreme as to distort these trends which, again, makes it difficult to draw meaningful conclusions as to where the economy is heading. And, while there is never a good time to get bad data, this is a most inopportune time. We, and most others, have long expected that 2018 would prove to be the high water mark for U.S. economic growth during the current expansion and that, while the expansion would endure at least into 2020, the pace of growth would gradually slow. In that sense, data showing slower rates of job growth and consumer spending, for instance, are not overly alarming. The risk, however, is that we become complacent and therefore miss signs that there is something more ominous than the expected deceleration in growth taking place. Swings in certain data series so extreme from one month to the next that they call into question the credibility of the data only enhance this risk.

At the same time, it has been clear for several months that the pace of global economic growth is slowing, but that slowdown has become more pronounced of late, particularly in China and the Euro Zone. What is not clear, however, is the extent to which this slowdown reflects structural issues, of which there is no shortage of in the Euro Zone, and the extent to which it reflects the effects of ongoing trade disputes. These trade disputes have exacted a heavy toll on China's economy and, by extension, the economies of Germany and many emerging market nations in addition to impacting many domestic industries, including agriculture. This is one reason there is such heightened anticipation of an agreement between the U.S. and China to resolve, or at least gloss over, these trade disputes. While it is unlikely that global growth would weaken to the point that the U.S. economy would be dragged into recession, it is simply not plausible to argue that U.S. real GDP growth would emerge unscathed from any such global slowdown.

So, that leaves us to sift through data that we do not always trust and come up with a plausible view of where the U.S. economy is and where it is going. The long-delayed report on Q4 2018 GDP shows real GDP grew at an annualized rate of 2.6 percent in Q4, better than expected but unlikely to survive revision which, when all is said, done, and revised, we expect to be to the downside. At the same time, annualized Q1 real GDP growth is shaping up, based on the limited data available to date, to come in around 1.0 percent, in part reflecting ongoing residual seasonality issues that bias measured Q1 growth in any given year lower.

February job growth didn't surprise to the downside, it shocked to the downside. Total nonfarm employment is reported to have risen by just 20,000 jobs in February, with revisions pegging January's increase at 311,000 jobs. Neither figure, however, reflects the true underlying health of the labor market – an average of the two months would be much closer to the mark. Still, with year-on-year growth of 3.4 percent, wage growth hit a cycle high in February, the jobless rate fell to 3.8 percent, and the broader U6 rate, which also accounts for underemployment, fell from 8.1 percent in January to 7.3 percent in February, the largest monthly decline on record. Consumer spending firmed up a bit in January after having fallen off a cliff in December. Business investment has flattened out. The trade deficit has widened. Residential construction started off 2019 on a strong note. The ISM Manufacturing Index has drifted lower while the ISM Non-Manufacturing Index has pushed higher, but both indicate further economic growth. Like we said, it's all perfectly clear, right?

Happily for the FOMC, muted inflation pressures give them the latitude to sit back and wait for a more clear and coherent picture to emerge from the economic data. Having effectively declared themselves as being firmly on hold, the Committee is clearly in no hurry to push the Fed funds rate higher. What isn't clear is whether this is a sign that the FOMC no longer feels compelled to act preemptively ahead of inflation actually showing signs of accelerating, or whether it reflects significantly downgraded expectations of economic growth and inflation. We suspect it is more the former than the latter, but that will become more clear with this month's FOMC meeting. Any change in the funds rate is out of the question, but the Committee will issue fresh economic projections and an updated dot plot. The main question at this point is whether the new dot plot will imply any Fed funds rate hikes at all this year. We think the March dot plot will imply one funds rate hike but none would not surprise us. After all, the FOMC's crystal ball is no less murky than anyone else's.

Is The Labor Market Done Too?

If all you had to go on was the headline number atop the February employment report, the increase of only 20,000 jobs might make you conclude that the labor market has joined the housing market, business investment, and consumer spending – segments of the

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economy that have been declared "done" by various observers at various times over the past few months. The temptation to declare the labor market is done might be particularly strong given that it comes amidst a period of wild swings in the high frequency data at a time when economic growth, here and abroad, is slowing. But, as in the case of the housing market, business investment, and consumer spending, we're going to have to go with "no," the labor market is not done. Indeed, we'd say it's far from being done.

Admittedly, we run the risk of being accused of "talking our book," in fact, we've already been accused of exactly that. After all, when the partial government shutdown significantly constricted the flow of economic data, we routinely pointed to the labor market data, which were unaffected by the shutdown, to counter what by late-2018 were growing fears that the U.S. economy was on the verge of slipping into recession. So, our downplaying the February job growth number as not reflective of the underlying health of the labor market could be seen as us attempting to defend an obviously wrong call on the economy. It's a perfectly fair point, though, wow, it could have been made more politely (less crudely) than it was made to us. But, then again, proper etiquette tends to be one of the first casualties in times of crisis, real or perceived.

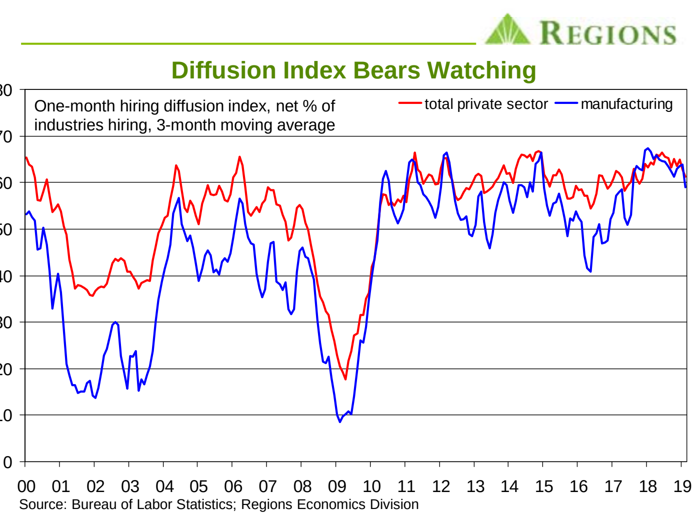
We don't, however, have a book to talk. As always, our approach is to try and read what the data are saying and letting that shape our view of where the economy is going. And, really, having long since lost any capacity for embarrassment, we have no problems admitting to being wrong, having had far more practice doing so than we'd prefer. That said, here's the bottom line – no, we do not think reported February job growth reflects the underlying health of the labor market, but time will tell. Another two or three months of job growth as weak as, or weaker than, that reported for February and we'll have confirmation that we're really lousy at predicting the onset of recession. If job growth bounces back – to trend, not to the inflated rate reported for January – then the February data will take its place in the annals of noisy data that generated considerable hand wringing but told us absolutely nothing of any value about the state of the U.S. economy.

While neither the reported increases of 311,000 jobs in January and 20,000 jobs in February are a true reflection of the trend pace of job growth, they do more or less cancel each other out, leaving average monthly growth of 209,000 jobs over the past twelve months. This is above what we think is a sustainable pace over the course of 2019, but is easily above the pace required to keep downward pressure on the unemployment rate. We do expect the jobless rate to fall further over coming months and thus sustain upward pressure on wage growth.

Even allowing for the fact that the headline job growth number and the unemployment rate are derived from separate surveys, slowing job growth, a falling jobless rate, and faster wage growth might seem like a confusing combination. Particularly if you're worried that we are coming to a turning point for the labor market and the broader economy. Moreover, given that the level of nonfarm employment has historically been a lagging indicator of turns in the business cycle, by time you see outright declines in nonfarm employment, the economy is likely already in recession.

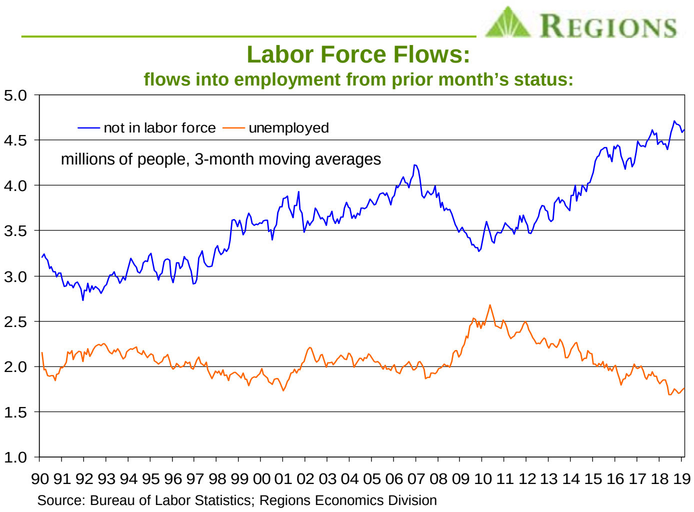
With that in mind, we thought it would be useful to discuss a few beneath the headline metrics we monitor that we think are far more informative as to the state of the labor market than the headline job growth number in any given month. As with any data series, we track the not seasonally adjusted employment data, which, literally, are beneath the (seasonally adjusted) headline job growth number. This was the first thing we turned to when we saw the surprisingly large initial estimate of January job growth. Sure enough, the unadjusted data showed changes in employment in weather sensitive industry groups such as construction, retail trade, and leisure & hospitality services, which were stronger than normal for the month of January thanks to what was atypically mild weather during this January's survey period. This led to inflated estimates of seasonally adjusted January job growth in these industry groups but, as we pointed out in our analysis of the January employment report, also meant that there would be payback in the February data. This is one factor behind the shockingly small estimate of February job growth.

So, if you think about it, over the past two months, perceptions of a $20 trillion economy have been heavily shaped by what was unusually mild weather in the middle of January. More than a little mind boggling, no? Sure, we get it, sifting through not seasonally adjusted data on an industry-by-industry basis isn't everyone's cup of tea – we do it so you don't have to – but it is surprising that many who comment on, and trade on, the data overlook this most basic of steps. To our broader point here, though, the raw data are a good starting point when trying to account for unusually large swings in the headline numbers of any data series.



Perhaps our favorite beneath the headline indicator in the monthly employment reports is the hiring diffusion index, or, a measure of the breadth of hiring across private sector industry groups. The one-month index shows the net percentage of industry groups adding workers compared to the prior month, and the six-month index shows the net percentage of industry groups hiring compared to six months earlier. In the chart above, we show the one-month indexes for the total private sector and for the manufacturing sector. As we have often noted, one of the hallmarks of the current expansion is how broad based hiring has been, in stark contrast to the last cycle when job growth was heavily concentrated amongst housing related industries. We've also noted that a sustained decline in the hiring diffusion index would be a clear warning sign that the expansion was running out of steam; this has been a reliable indicator in past cycles.

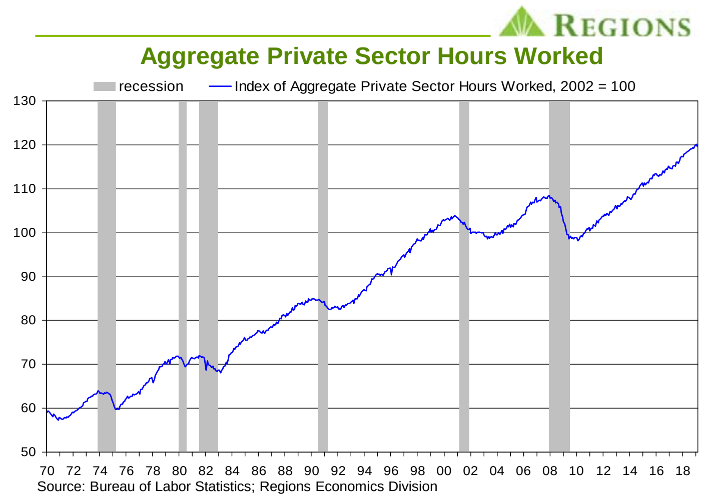
As such, we definitely took notice when the one-month index for the total private sector dipped to 57.2 percent in February from 60.7 percent in January. To be sure, the index can be jumpy from one month to the next, which is why we show the three-month moving average in the above chart, so we're not inclined to make too much of February's decline. That said, we will pay even more attention to this metric over coming months – again, if you see job growth being increasingly concentrated amongst a smaller number of industry groups, that is a clear sign the expansion is running out of steam.



Another of our go-to beneath the headline labor market indicators comes from the monthly data tracking flows of people into and out of the labor force. As seen in the above chart, since mid-2017 more than 4.5 million people per month have transitioned to being employed after not having been in the labor force in the prior month, which is a large number even when scaled to the size of the labor force to allow for comparisons over time. This is one factor we have consistently pointed to as a sign that there is still a good deal of slack left in the labor market, and we've accounted for these inflows in our forecasts of wage growth.

It is not uncommon to hear someone argue that job growth has to come to a halt because firms are "running out of people to hire," pointing to an unemployment rate below 4.0 percent to support their argument. Clearly, this is not the case though, to be sure, in addition to accounting for the flows into the labor force you also must account for flows out of the labor force. On net, however, the inflows continue to more than offset the outflows, as evidenced by continued growth in the labor force. While no one thinks inflows on the order of those shown in the above chart can continue indefinitely, we do think there is further upward room for labor force participation, particularly amongst the 25-to-54 year-old age cohort. It is worth noting that the data on labor force flows are drawn from the household survey (from which the unemployment rate is derived), so while a pronounced and sustained slowing in the pace of flows into the labor force would be a sign that job growth is decelerating, it could take some time for this to show up in the headline job growth number atop the monthly employment report.

Finally, as we noted earlier, the level of nonfarm employment has tended to be a lagging indicator of patterns in the broader economy. One reason for this is that it is costly and inefficient for forms to be continuously making material changes in the number of workers they employ. There is, however, another lever firms can pull that buys them time to assess whether shifts in demand, either to the upside or the downside, are transitory or are more lasting. Firms can easily adjust the number of hours their current work force puts in during a given time period, raising (lowering) hours worked as demand begins to rise (fall), thereby allowing them time to assess whether this shift in demand is transitory or lasting, in which case they will eventually begin to increase (decrease) the number of people they employ.



The above chart shows aggregate private sector hours worked, which has long been one of our favorite indicators of broader economic activity – in most cases it has been a leading indicator of recession and at worst has been a coincident indicator (note, however, it tends to lag the start of expansions for the reason we outlined above, i.e., firms wanting to be sure growth in demand would last). Even if firms were truly "running out of workers" to hire, they still have room to increase total labor input in the form of longer workweeks. Indeed, we have often pointed to what remains a relatively short workweek as an underappreciated form of labor market slack. To our broader point, however, a downturn in aggregate private sector hours worked would be a sign that something is amiss in the U.S. economy well before that would be apparent in the headline monthly job growth number. As this discussion hopefully helps illustrate, there are a number of labor market indicators that fit this bill.

Household Net Worth Takes A Beating In Q4 2018

Along the lines of when it rains it pours, on the same day we got the February employment report, the Federal Reserve released its Q4 2018 *Financial Accounts of the United States* report, or, as it is more commonly referred to, the Flow of Funds report. While the title may not do all that much for you, the report does contain a wealth of information on financial flows through the household, corporate, and government sectors of the U.S. economy.

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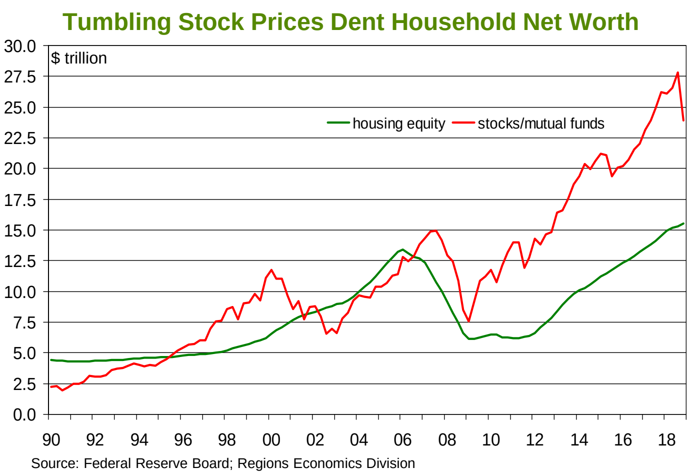
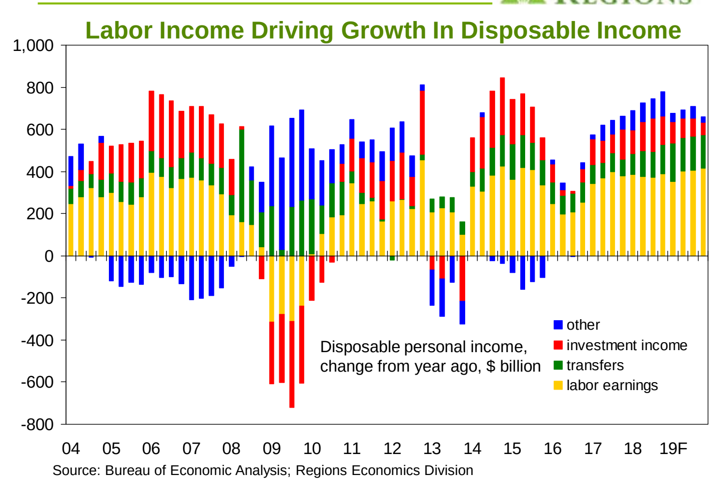
The Flow of Funds report shows that household net worth declined by $3.7 trillion in Q4 2018, which, on a percentage change basis is the largest quarterly decline since Q4 2008. The chief culprit behind the decline in household net worth was the precipitous decline in the aggregate value of stock and mutual fund holdings, which more than offset a modest increase in the value of owners' equity in residential real estate. While it is reasonable to assume the decline in the aggregate value of equity holdings curbed consumer spending in Q4, estimates of the extent to which it did so are pretty much all over the map. It is, however, worth noting that the prolonged run-up in equity prices during a time in which income growth was for the most part middling has likely made equity valuations a more important driver of growth in consumer spending than had been the case in the past, and this effect is not limited to the highest net worth households.



While it is true that thus far in 2019 equity prices have recovered a good portion of the declines seen in Q4 2018, it does not necessarily follow that there will be a corresponding bump in consumer spending. After all, the rout in equity prices in Q4 was a reminder that equity prices are not on a one-way ride higher (well, for some it was a reminder, for others it was an introductory lesson), and if people truly are worried that the end of the cycle is approaching, or even believe there is only limited upside room for share prices from this point on, that could considerably weaken any link between equity prices and consumption spending.

Another detail in the Q4 2018 Flow of Funds report that stood out to us is the slowdown in the rate of growth of housing equity, which can be seen in the above chart. This reflects what was a marked deceleration in the rate of house price appreciation in Q4, and we've seen further deceleration thus far in 2019. So, while aggregate owners' equity as a percentage of the aggregate value of residential real estate rose to 60.05 percent in Q4 2018, the highest since Q2 2002, further increases will be slower in coming during 2019. This is, however, unlikely to have a material effect on consumer spending, if only because homeowners have been much less willing (if not less able) to extract housing equity in order to facilitate current consumption over the course of the current expansion than was the case during the last cycle. Indeed, utilization rates on home equity lines of credit have been steadily falling over the past eight years, and we think it unlikely that there will be a material reversal of this trend any time soon.

If we are correct in our assessment of "wealth effects" on consumer spending, that would imply growth in consumer spending will be even more closely aligned with income growth going forward than has been the case over the current expansion. Given that labor earnings far and away account for the largest share of personal income, accelerating wage growth should provide some cushion against fading wealth effects, thus supporting growth in consumer spending. Aggregate private sector wage and salary earnings (which account for how many people are working, how many hours they work, and what they earn for each hour worked) have been growing at a rate of better than 5.0 percent clip over the past year, and growth will pick up further as wage growth continues to accelerate. To our point from the last segment, if average weekly hours worked increase, that will further bolster growth in aggregate wage and salary earnings, and in turn growth in personal income and consumer spending. The bottom line is that, while growth in consumer spending is likely to slow over coming quarters, healthy growth in labor earnings will mitigate the degree of any such slowdown.



So, once again, we come back to the labor market. If it seems that a lot is riding on the health of the labor market, that's because a lot is riding on the health of the labor market. This helps explain why the February employment report sent shivers through the financial markets. Sure, that wasn't exactly our reaction when we saw the headline job growth number but, then, we can't actually print our reaction here. But, this does illustrate our point as to why it is important to not let the headline job growth number in any given month unduly shape your perception of the labor market, and in turn your perception of the broader economy. We believe, the shockingly low initial estimate of February job growth notwithstanding, that the labor market remains quite healthy. And if we are correct on that point, the current expansion has further to run and will later this year take its place as the longest U.S. economic expansion on record, however bumpy the ride may be.

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Q3 '18 (a)	Q4 '18 (p)	Q1 '19 (f)	Q2 '19 (f)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)	Q2 '20 (f)		2016 (a)	2017 (a)	2018 (p)	2019 (f)	2020 (f)
3.4	2.6	0.8	2.8	2.4	1.9	1.9	1.7	Real GDP[1]	1.6	2.2	2.9	2.3	1.9
3.5	2.8	1.5	3.1	2.6	2.3	2.2	2.2	Real Personal Consumption[1]	2.7	2.5	2.6	2.6	2.2
								Real Business Fixed Investment:					
4.3	9.3	4.9	5.2	4.7	3.8	3.6	3.0	Equipment, Software, & IP[1]	2.1	5.5	7.5	5.7	3.5
-3.4	-4.2	-1.0	2.0	1.3	1.5	1.9	2.5	Structures[1]	-5.0	4.6	5.0	0.0	1.9
-3.6	-3.5	-2.5	-0.6	4.7	2.1	2.0	1.2	Real Residential Fixed Investment[1]	6.5	3.3	-0.2	-1.2	1.8
2.6	0.4	0.8	2.9	0.8	0.0	-0.5	-0.6	Real Government Expenditures[1]	1.4	-0.1	1.5	1.4	-0.1
-949.7	-963.2	-962.0	-966.8	-976.1	-984.7	-989.0	-995.9	Real Net Exports[2]	-786.2	-858.7	-914.1	-972.4	-997.8
877	804	852	873	896	916	927	936	Single Family Housing Starts, ths. of units[3]	785	852	866	884	940
357	347	323	362	359	358	352	347	Multi-Family Housing Starts, ths. of units[3]	393	356	374	350	341
16.9	17.5	16.7	16.7	16.6	16.5	16.5	16.5	Vehicle Sales, millions of units[3]	17.5	17.1	17.2	16.6	16.4
3.8	3.8	3.9	3.7	3.6	3.6	3.5	3.4	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7	3.4
1.7	1.8	1.8	1.6	1.5	1.3	1.2	1.2	Non-Farm Employment[5]	1.8	1.6	1.7	1.5	1.1
2.6	4.2	2.6	1.4	1.8	1.7	1.9	1.4	Real Disposable Personal Income[1]	1.7	2.6	2.9	2.5	1.6
2.4	2.2	2.3	2.1	2.4	2.6	2.7	2.6	GDP Price Index[5]	1.1	1.9	2.3	2.4	2.6
2.2	1.9	1.6	1.7	2.0	2.3	2.6	2.5	PCE Deflator[5]	1.1	1.8	2.0	1.9	2.5
2.6	2.2	1.7	1.8	1.9	2.1	2.3	2.2	Consumer Price Index[5]	1.3	2.1	2.4	1.9	2.2
2.0	1.9	1.9	1.9	2.1	2.2	2.3	2.3	Core PCE Deflator[5]	1.7	1.6	1.9	2.0	2.3
2.2	2.2	2.2	2.2	2.3	2.3	2.3	2.3	Core Consumer Price Index[5]	2.2	1.8	2.1	2.3	2.3
1.89	2.16	2.38	2.38	2.41	2.63	2.63	2.63	Fed Funds Target Rate Range Mid-Point, %[4]	0.39	0.98	1.78	2.45	2.63
2.92	3.04	2.70	2.80	2.85	2.90	2.90	2.90	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.91	2.81	2.88
4.57	4.79	4.46	4.56	4.61	4.69	4.68	4.68	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.55	4.58	4.66
-2.4	-2.4	-2.4	-2.5	-2.7	-2.7	-2.8	-2.8	Current Account, % of GDP	-2.3	-2.3	-2.4	-2.6	-2.9

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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