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Deutsche Bank
Research

North America
United States

Economics

US Economic Perspectives

Date
6 September 2019

A trade tipping point

- By many metrics the US economy is on reasonably stable footing. The current US expansion is the longest on record, the unemployment rate is near a fifty-year low, and the economy advanced at a rate about half a percentage point above its potential in the first half of the year. Despite these supportive facts, we have progressively turned more downbeat on the outlook in recent months. We take another step in this more pessimistic direction with this update to our outlook.
- Although we had incorporated a further escalation in trade tensions into our outlook, the trade spat has gone beyond our expectations. The economy is also showing greater sensitivity to this turmoil, with leading indicators for manufacturing sentiment and capex sending dire signals and accumulating evidence of spillovers to the broader labor market and services sector.
- We, therefore, now see a more pronounced and persistent slowdown in growth and a more aggressive easing response from the Fed. In particular, we have nudged our 2019 growth expectations lower by one tenth to 1.9% (Q4/Q4). More worryingly, we now see 2020 growth four-tenths lower at 1.8% with a trough mid-year near 1.3%, driven primarily by weaker capex and consumer spending. A softer growth profile should lead unemployment to peak at 4.3% next year, further dampening inflation, which should remain below the Fed's target until 2021.
- Responding to this softer outlook, we now expect the Fed to cut rates by a further cumulative 100bp through the first quarter of next year. We maintain our call for a 25bp reduction in both September and December, but now see additional 25bp cuts in October and next January. A softer growth profile despite more Fed easing reflects the limited ability of monetary policy to fully offset disruptions from trade shocks.
- Trade developments have neared a tipping point. Our baseline projection expects that the data and risk assets will weaken enough in the coming months for the US Administration to pull back on its ever-escalating global trade war. If instead an off-ramp remains elusive, the US economy could slide into a mild recession, forcing the Fed to join many of its global peers by cutting rates back to zero.

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Introduction

By many metrics the US economy is on reasonably stable footing. The current US expansion is the longest on record, the unemployment rate is near a fifty-year low, companies continue to add jobs at a sturdy rate, and the economy advanced at a rate about half a percentage point above its potential in the first half of the year.

Despite these supportive facts, we have progressively turned more downbeat on the outlook in recent months. Building in a further escalation in trade tensions and recognizing early signs of adverse spillovers from mounting trade disruptions amid a backdrop with persistently below-target inflation, in June we took a more aggressive stance than consensus in expecting the economy to grow only around 1.5% in the second half of the year. This, we believed, would ultimately push the Fed to cut rates by a total of 75bp (see " Preemptive strikes to sustain the expansion ").

The Fed followed through on our expectation for a 25bp rate cut in July, and looks set to ratify our expectation for another reduction in September. But signs are emerging that the triple-cut mid-cycle correction we envisioned for the Fed will be insufficient to forestall a more significant economic slowdown. Indeed, while the recent decline in the ISM manufacturing index is not surprising given the global manufacturing downturn, we have been concerned with evidence of spillovers to areas that have so far been resilient to trade uncertainties. In particular, the deceleration in job gains and aggregate hours worked is consistent with a more fragile labor market (see " Some troubling jobs trends even prior to the latest tariff escalation ") and recent consumer confidence indicators signal rising recession risks (see " Yield curve inversion signals recession...(consumer) surveys say? ").

In light of these more concerning bread crumbs we have adjusted our outlook for the US economy. We now see a more pronounced and persistent slowdown in growth, with the economy growing below its potential rate through the end of next year. This downgrade comes despite a Fed that is expected to cut rates more aggressively over the next several quarters. These facts reflect the limited potency of monetary policy to fully offset disruptions from trade policy.

On this front, our baseline projection expects the data and risk assets to weaken enough in the coming months for the US Administration to pull back on its ever-escalating global trade war. Diminished uncertainty and a somewhat more supportive stance on global trade, helped by a significantly more accommodative Fed, should allow for a modest rebound in the economy by the second half of next year. If the US Administration instead fails to de-escalate its trade war, we would expect the US economy to slide into a mild recession, forcing the Fed to join many of its global peers by cutting rates to zero.

Summary of forecast changes: Weaker growth, more cuts

Incorporating these developments, we have adjusted our forecast in a negative direction through the end of next year. In particular, we now see growth to end 2019 only one-tenth lower at 1.9%, with the downgrade due primarily to softer capex and consumer spending. More significantly, we have lowered our growth forecast for 2020 by 40bp to 1.8%, with the trough in the growth profile occurring around mid-2020 at only 1.3%.

With the economy expected to grow below its potential rate over the next year, the unemployment rate is now expected top out at 4.3%, more than half a percent

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above its current level and slightly higher than estimates of NAIRU. More slack in the labor market leads to slightly lower expectations for core inflation – core PCE is now expected to end 2020 one-tenth lower at 1.8%. Persistently sub-2% inflation will continue to be a troubling result for a Fed that looks set to adopt at least a soft form of average inflation targeting next year. As such, we now see the Fed cutting rates by 75bp more this year – up from our previous expectation of 50bp – and by another 25bp in Q1 2020. These forecast revisions are summarized in the below table and described in greater detail in the subsequent sections.

Figure 1: Summary of key forecast revisions

	2019	2020	2021
Real GDP (%Q4/Q4)	1.9 (-0.1)	1.8 (-0.4)	2.2 (+0.2)
Unemployment rate (%)	4.0 (+0.1)	4.1 (+0.3)	4.0 (+0.1)
Core PCE (%Q4/Q4)	1.8 (unch)	1.8 (-0.1)	2.0 (unch)
Fed funds rate (%)	1.4 (-0.25)	1.1 (-0.5)	1.4 (-0.5)

Note: Figures in parentheses represent the size of the revision. Source : Deutsche Bank

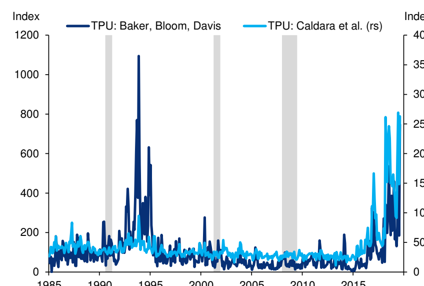
Trade policy: De-escalation necessary to avoid downturn

It is clear that the sharp escalation in trade tensions and tangible uncertainty about the future of trade policy and trading relations has had a meaningful dampening effect on US growth in recent quarters. By one common measure, trade policy uncertainty is at its highest level since the adoption of NAFTA about 25 years ago (Figure 2). More worryingly – and perhaps more intuitively – a recently released trade policy uncertainty (TPU) index constructed by Fed staff has been at a record high level by a wide margin.[1]

Heightened uncertainty intuitively cools business spending plans. The aforementioned Fed research found that the spike in trade policy uncertainty has so far lowered the level of US GDP by about three-quarters of a percent. The recent further escalation in tensions looks set to amplify this impact, with the drag peaking above one percentage point around mid-2020. These effects are large and persistent, consistent with our own estimates that we had already built into our revision. Additional escalation would only further dampen the growth outlook, with potential non-linear responses to the inclusion of key consumer goods risking an even more adverse effect.

Indeed, recent data suggest that trade tensions may already be moving the economy close to a tipping point. The sharp downturn in export orders in the ISM survey has led an impressive deceleration in manufacturing activity and business investment (Figures 3 and 4) and portends further significant declines in these series. It is now our view that at this point, only a meaningful de-escalation or reversal of trade tensions is likely to be enough to short-circuit this downtrend.

Figure 2: Trade policy uncertainty has spiked



Source : PolicyUncertainty.com, Caldara et al. (2019), Haver Analytics, Deutsche Bank

1 See Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo (September 2019), "The economic effects of trade policy uncertainty." Board of Governors of the Federal Reserve System International Finance Discussion Papers, Number 1256.

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Figure 3: Trade tensions pointing to further ISM manufacturing plunge...

Source : ISM, Haver Analytics, Deutsche Bank

Figure 4: ...and dire capex outlook

Source : ISM, Census, Deutsche Bank

Our baseline assumption is therefore that the data and markets will weaken enough in the near-term to force a de-escalation, which could include: (1) more permanently shelving the planned December tariffs on roughly $150bn of imports from China composed of key consumer goods like cell phones and computers; (2) a commitment to hold off on further escalation as trade talks more seriously resume, with credible commitment to the talks from both parties; (3) an announcement to not pursue tariffs on global auto imports; and (4) certainty around the trading relationship with other North American economies, either through passage of the USMCA or a reversion back to NAFTA. With these steps engendering reduced uncertainty, the economy should be able to regain its footing, helped along by a significantly more dovish Fed.

Conversely, failure to de-escalate in the near-term would likely lead to a mild recession next year on the order of the early 2000s episode. This downturn would be led by a further contraction in capex that would more noticeably spill over to more adverse labor market dynamics, ultimately softening consumer spending.

Growth: Set to downshift dangerously close to stall speed

Our updated economic forecasts reflect meaningfully below-trend output growth through the first half of next year led by a substantial pullback in nonresidential fixed investment (capex). We now project real GDP to expand 1.3% annualized in H2 followed by a similarly-sluggish pace of economic activity in the first half of 2020. As we recently noted (See " US Econ Monthly: Warning signs "), leading indicators for growth are sending warning signs (Figure 5). Our DB Momentum Index, which aggregates the signals from the most accurate leading indicators, continues to point to a softer growth impulse near-term, with the trend in private domestic demand growth dipping below 2%. This weakness is now expected to persist through the first half of next year given the persistent drag from record high trade policy uncertainty.

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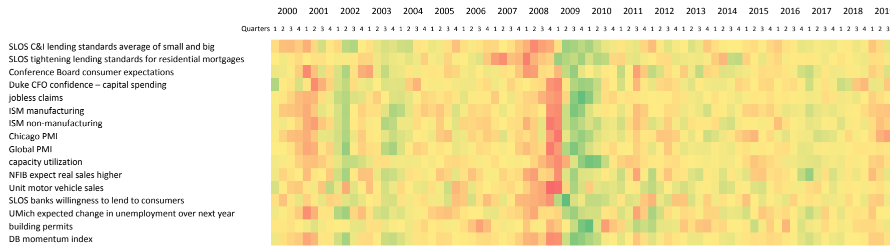
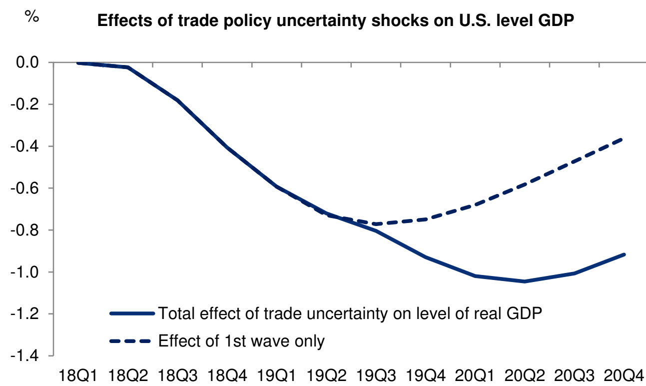
Figure 5: DB growth momentum index flashing some warning signs



Source : Deutsche Bank

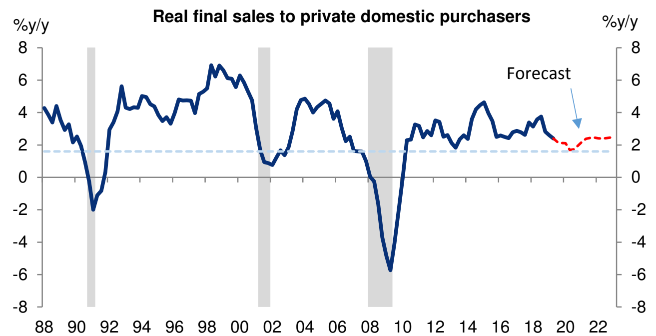
Relative to our prior forecasts, 2019 real GDP growth falls a tenth to 1.9% (Q4/Q4) while 2020 growth declines four-tenths to 1.8%. More accommodative monetary policy, and hopefully some stability in trade policy, begin to boost economic activity back above trend in H2 of next year and into 2021, when we expect growth to return to 2.2%, two-tenths above our prior projection. However, in the near term, with real GDP growth anticipated to fall towards stall speed, the economy could easily slip into a mild recession if trade tensions do not dissipate or the economy is hit by an adverse exogenous shock. Note that compared to our prior forecast for the level of real GDP in Q4 2020, our latest projection is 0.5% lower, which is broadly consistent with findings of recent Fed research on the impact of the latest rise in trade policy uncertainty (Figure 6).[2] Recall that we had already accounted for a few tenths drag on real GDP growth due to this channel (See " Preemptive strikes to sustain the expansion ").

Figure 6: Fed research suggests effect of trade uncertainty on level of GDP persists in 2020



Source : FRB, Deutsche Bank

Figure 7: Annual growth of final private sales expected to dip dangerously close to stall speed



Source : BEA, Haver Analytics, Deutsche Bank

As we have repeatedly highlighted, final sales to private domestic purchasers (final private sales), is the best measure of the fundamental health of the economy as it captures 87% of real GDP. This metric strips out government spending, exports, and inventories, which tend to be the more volatile components of output on a quarterly basis. The year-over-year growth rate of final private sales is expected to bottom out at 1.7% in Q2 of next year. As illustrated in Figure 7, such sluggish growth in final private sales has historically coincided with recession.

2 https://www.federalreserve.gov/econres/feds/files/2019065pap.pdf)

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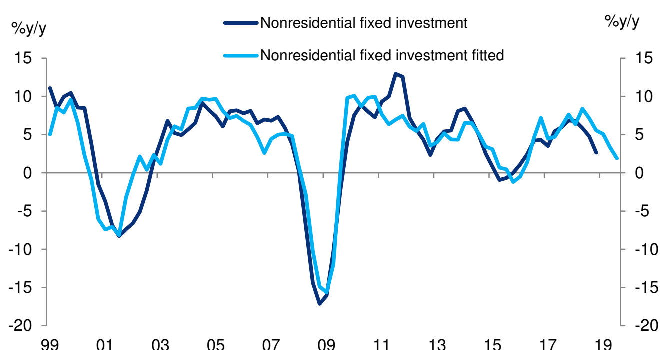
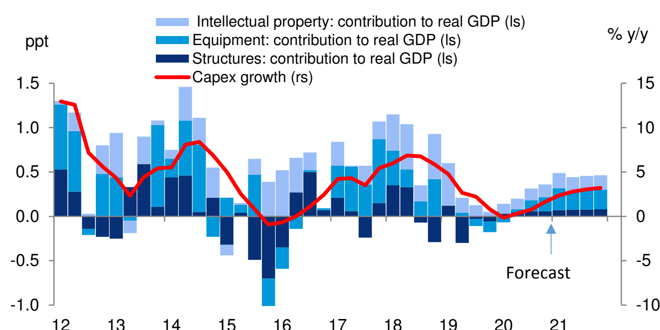
The soft profile for final private sales is largely driven by our diminished outlook for nonresidential fixed investment (capex), which is roughly 16.5% of the series. As we recently outlined (see " The good, the (not so) bad and the ugly – Part I: Capex ") leading indicators of nonresidential business fixed investment have been pointing to significant downside risks to growth over the next several quarters (Figure 8). Our model is a combination of leading manufacturing activity and financial sector indicators that we have found useful over the past two business cycles—specifically, the headline Chicago PMI, the year-over-year change in the Fed's measure of capacity utilization for durable goods manufacturing, the year-over-year change in oil prices and the excess bond premium (EBP). In turn, we now expect nonresidential fixed investment to decline -0.3% over the back half of this year compared to a gain of 1.8%, previously. While we anticipate a modest rebound of 1.6% in 2020 (Q4/Q4), this is roughly half of what we had previously projected.

Figure 8: Our model for capex points to further weakness in H2



Source : BEA, FRB, EIA/CME, MNI, Haver Analytics, Deutsche Bank

Figure 9: Capex is expected to contribute very little to real GDP growth over the next few quarters



Note: Bars represent contributions to the quarter-over-quarter annualized change in real GDP. Source : BEA, Haver Analytics, Deutsche Bank

The risk is that a more pronounced slowdown in business activity spills over into consumer spending, which is essentially driving the vast majority of output growth over the next few quarters. Recall that personal consumption expenditures (PCE) account for nearly 70% of overall real GDP growth and 80% of final private sales. While we continue to expect 2.1% real PCE growth over the back half of this year, we have lowered our 2020 PCE projection a tenth to 2.0% (Q4/Q4). On the surface, consumer spending should continue to be supported by a healthy labor market, still-elevated consumer confidence and relatively sturdy balance sheets. However, there may be some cracks forming in this story.

Our model for consumer spending, which uses consumer confidence, bank lending standards for residential mortgages, the labor force participation rate and growth in nonfarm payrolls implies a meaningful slowdown in consumer spending growth if consumer confidence declines into the low 80s and nonfarm payroll growth slips below 1%, even if banks do not tighten mortgage credit (Figure 10). As we discuss in the next section, there are nascent signs of slowing in the labor market that belie the widely-followed headline nonfarm payroll figures.

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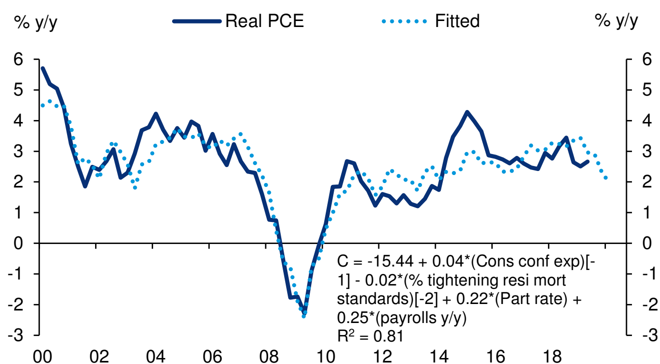
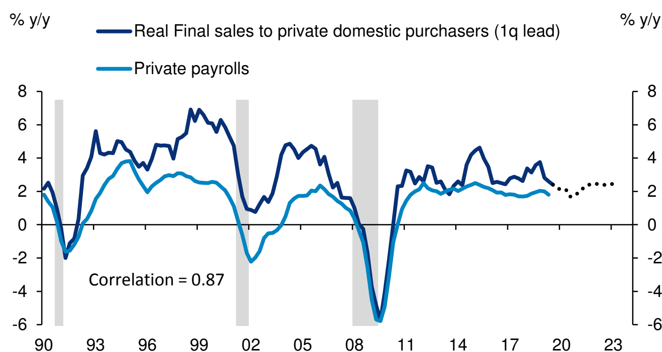
Figure 10: Consumer spending could slow if the drop in business sentiment continues to spill over to the consumer



Source : BEA, Haver Analytics, Deutsche Bank

Figure 11: Labor market should slow further if final private sales growth continues to trend lower



Source : BEA, BLS, Haver Analytics, Deutsche Bank

The outlook for the other components of GDP remains mixed. Although the housing sector should receive a boost from the sharp fall in mortgage rates, residential investment is expected to add only modestly to growth in the coming quarters. Meanwhile, lingering trade uncertainty and several quarters of large inventory builds are likely to lead to a drag from these sectors, albeit in the presence of significant volatility as importers potentially attempt to get ahead of further tariff increases. The government sector should continue to support GDP growth, though we expect the benefits from tax cuts and spending increases to wane into 2020 (see " Budget agreement to remove one crosscurrent facing growth outlook "). Ultimately, in periods like the present when the economy is firing mostly on only one cylinder, there is greater vulnerability to even a modest shock. We discuss the risks of a recession in more detail in the final section.

Labor market: Manufacturing slowdown risks more severe spillover to service sector

As we have been noting over the last several months, the narrative of a tight labor market is not a completely airtight one. To be sure, the average pace of job gains over the first eight months of the year (+160k in total nonfarm payroll gains) have been solid, outpacing the roughly 100k per month clip that would be needed to keep up with labor force growth. However, this in and of itself is a meaningful step down from the payroll gains that have prevailed throughout this expansion, with job gains averaging 211k per month from 2013-2018 and 223k per month seen more recently in 2018.

On top of that, firms also seem to be scaling back on the intensive margin of their labor demand as well. As seen in Figure 12, manufacturing firms have cut back on overtime hours, with production and nonsupervisory workers getting on average half an hour less of overtime each week than they were getting at the peak in early 2018. Given that manufacturing is only around 10% of total private employment, it would be one thing if this slowdown in labor utilization was quarantined to that particular sector as it seemed to be the last time overtime hours fell to this level in the wake of the 2014 oil price collapse. However, this time around, service providing industries seem to be feeling some impact, with the year-over-year growth rate in aggregate hours of production and nonsupervisory workers sliding to 1.21%, just

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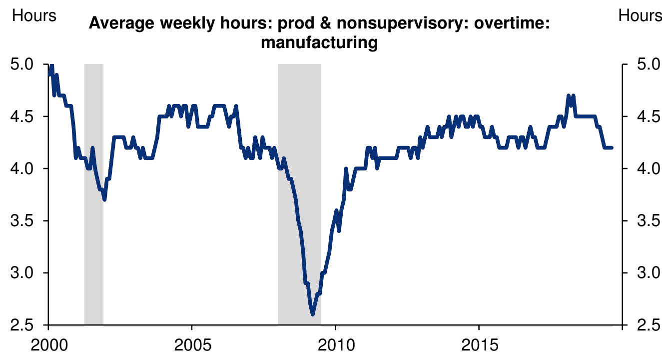
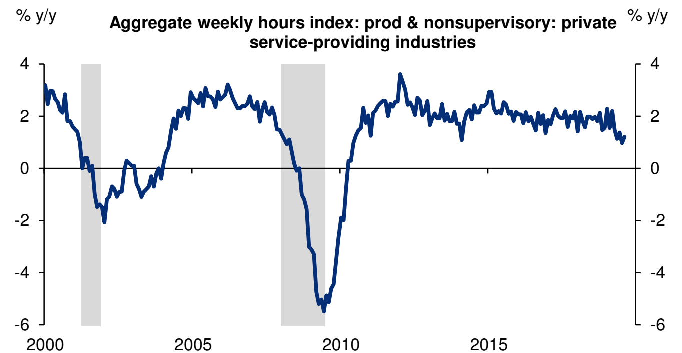
off the slowest pace of growth in this expansion and about half of the 2.3% growth rate seen in 2015.

Figure 12: Drop in overtime hours in the manufacturing sector



Source : BLS, Haver Analytics, Deutsche Bank

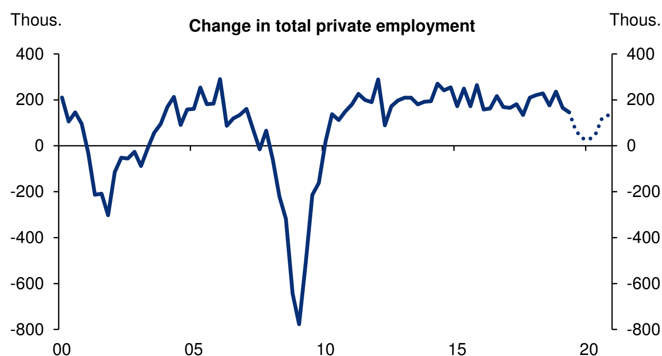
Figure 13: Unlike previous manufacturing slowdown, service sector feeling the effects this time around



Source : BLS, Haver Analytics, Deutsche Bank

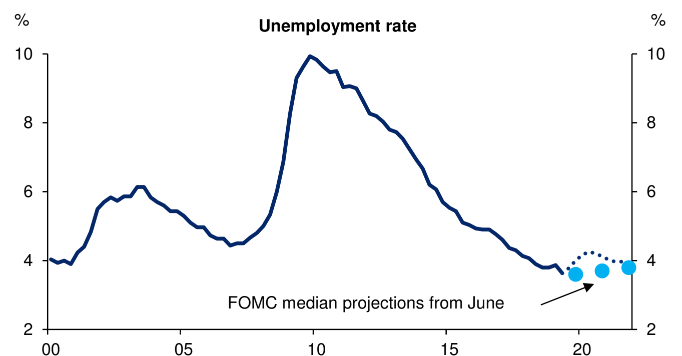
With GDP growth slowing below potential over the remainder of this year and all through next year under our forecast, there should be a marked deterioration in the pace of hiring. Under our assumptions that labor force participation remains roughly steady and there is a slight updrift in productivity growth, our GDP forecast would be consistent with average monthly job gains averaging around 50k through the back half of 2019 before picking up to over 130k by the end of next year (Figure 14). As such, we expect the unemployment rate to rise, reaching 4% by the end of 2019 and peaking at 4.3% by the second quarter of 2020. Then, as growth and hiring begin to pick up, the unemployment rate should begin to subside, getting back down to 4% by the end of 2021 (Figure 15). This forecast is a bit more pessimistic in the near term than the median forecast from the FOMC's June Summary of Economic Projections, which saw unemployment staying at 3.6% until the end of 2019 before ticking up a tenth in both 2020 and 2021.

Figure 14: Pace of hiring to slow further



Source : BLS, Haver Analytics, Deutsche Bank

Figure 15: Putting upward pressure on the unemployment rate



Source : BLS, Haver Analytics, Deutsche Bank

Inflation: A delayed return to target

Recent inflation data have shown some uncharacteristic strength, at least with

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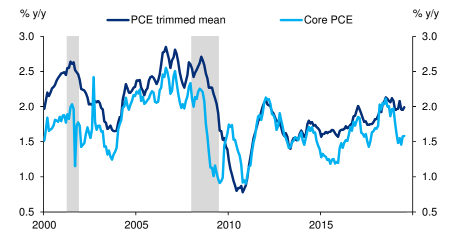
respect to CPI. After a string of four weak core +0.1% CPI prints from February to May, the last two core CPI readings in a row have both posted solid +0.3% readings, boosting the year-over-year rate up to 2.21% in July. This has served to arrest and nearly completely reverse the slide in the year-over-year rate from 2.25% in November 2018 to 2.00% in May 2019.

However, this recent strength in core CPI has not really passed through to core PCE with the year-over-year rate of the latter only getting to 1.58% as of the July data, about 40bps below the Fed's 2% target. This core PCE specific weakness does seem to be largely due to a string of outliers, as the Dallas Fed's trimmed mean PCE measure, which excludes those categories with the largest magnitude moves, has been hovering around 2% for more than a year now (Figure 16).

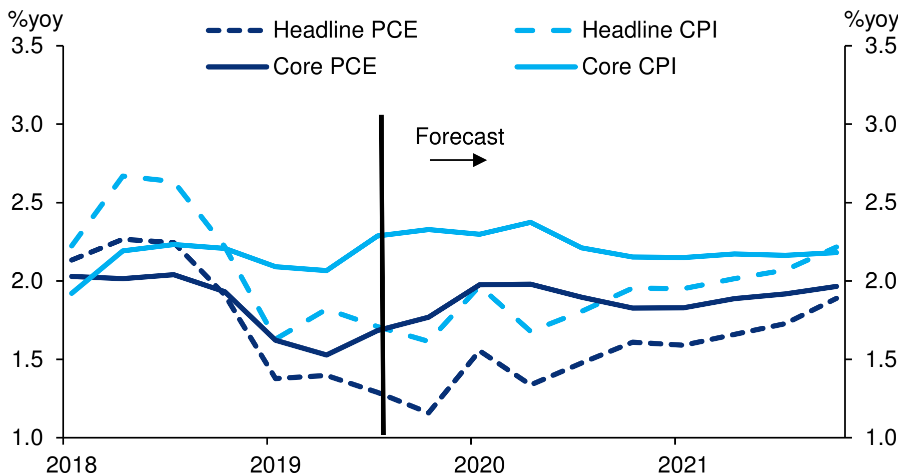
Given that core PCE has often converged back up to trimmed-mean after periods of softness, we expect core inflation to return to the Fed's target. However, the question is about the pace at which it does so. As we pointed out in June, we expect this pace to be relatively moderate, and, given a particularly flat Phillips curve and mounting disinflationary forces from a strengthening dollar, not much has changed on that front. We see year-over-year core inflation continuing to strengthen over the near term, reaching 1.8% and 2.3% for core PCE and CPI respectively by the end of the year before ticking up a bit further to 2.0% and 2.4% by Q2 2020. While these readings would show the Fed hitting its inflation target early next year, they are also somewhat unsustainable as they are in part driven by the favorable base effects from weak prints in early 2019. As those weak comparison prints roll off, inflation should subside slightly to end 2020 at 1.8% before coming back to 2% by the end of 2021.

Figure 16: Previous soft patches have seen core PCE inflation come back to trimmed mean



Source : FRB Dallas, BEA, Haver Analytics, Deutsche Bank

Figure 17: DB inflation forecasts



Source : BEA, BLS, FRB, Haver Analytics, Deutsche Bank

Fed: Moving beyond a mid-cycle adjustment

At the July FOMC meeting Chair Powell described the decision to cut rates as part of a "mid-cycle adjustment" that was intended to act as insurance against the varie-

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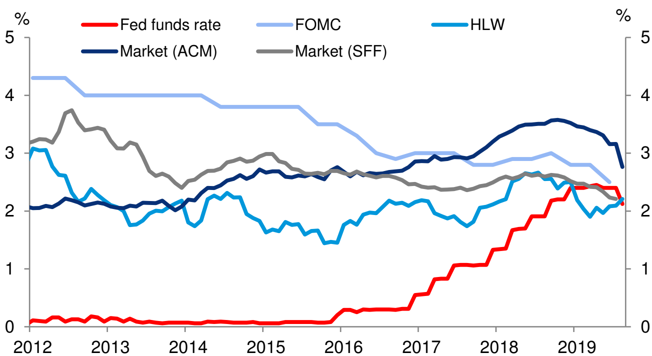
ty of downside risks facing the economy.[3] In the press conference, Powell indicated that this framing did not suggest that the cutting cycle would be one-and-done. Instead, he referenced the 1990s episodes in which the Fed cut rates by 75bp as examples of the type of cycle he and the Committee had in mind at the time. Revisions to our forecast detailed in the preceding sections suggest that this recalibration of policy will be insufficient to successfully insure against a more pronounced slowdown. As such, we now see the Fed pursuing a more aggressive cutting cycle in the coming months.

September: Opting to keep some powder dry

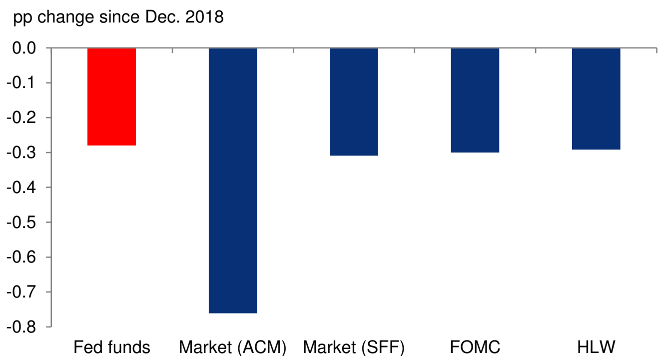
In response to the most recent escalation of trade tensions and downturns in some key data releases, officials across the hawk-dove spectrum have leaned in a more dovish direction. For example, Boston Fed President Rosengren, who dissented from the rate cut in July preferring to instead keep rates unchanged, has sounded more open to rate reductions. Similarly, Dallas Fed President Kaplan, a non-voter who expressed a preference to keep rates steady in July, is now on board with lower rates. The doves have also sounded more dovish, with St. Louis Fed President Bullard now advocating for a 50bp reduction, a stance he did not take two months ago. Coupled with the existing lesson from the academic literature to not "keep your powder dry", as NY Fed President Williams has noted, the fact that the monetary policy stance is little changed because neutral policy has fallen as much as the fed funds rate this year (see Figures 18 and 19 and " Running to stand still "), and a market that is pricing more than 25bp for the September meeting, and the case for a 50bp cut in September is more compelling.

Figure 18: Neutral estimates fell sharply before the Fed cut rates



Source : FRB, Adrian, Crump and Moench (2013), Christensen, Diebold and Rudebusch (2010), Holston, Laubach and Williams (2017), Haver Analytics, Deutsche Bank

Figure 19: Monetary policy stance little changed as downgrades to neutral rate estimates outpace Fed rate cuts



Note: Dark blue data are various estimates of the nominal neutral fed funds rate. Source : FRB, Adrian, Crump and Moench (2013), Christensen, Diebold and Rudebusch (2010), Holston, Laubach and Williams (2017), Haver Analytics, Deutsche Bank

That said, the solid ISM non-manufacturing index data and a modest rebound in aggregate hours, wages and total income growth in the jobs report, have lessened the urgency of a more aggressive move. Several other developments could argue for a more patient approach from the Fed too, including the apparent agreement to resume trade talks, the resiliency of risk assets, a modest steepening of the curve,

3 Chair Powell was not alone in this view. The minutes to the July FOMC meeting revealed that "Most participants viewed a proposed quarter-point policy easing at this meeting as part of a recalibration of the stance of policy, or mid-cycle adjustment, in response to the evolution of the economic outlook over recent months."

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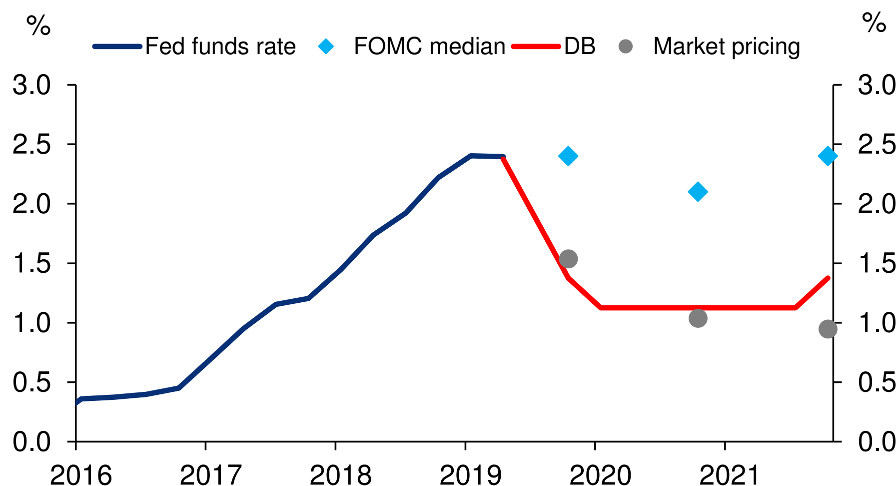
and reduced market pricing for a 50bp cut in September. These developments will make it difficult to achieve a consensus within the Committee on a more aggressive action this month. In a close call, we maintain our existing call for a 25bp rate cut at the September meeting.

Beyond September: Taking out more than insurance

A sharper slowdown in growth, more pronounced rise in unemployment, and modestly softer inflation profile, are consistent with a Fed that needs to undertake more cumulative rate cuts. We now see the fed funds rate falling to just above 1% by the first quarter of 2020 (Figure 20). While this pace of cuts would outperform market pricing over that time horizon – the market is currently pricing a fed funds rate near 1.3% by the March 2020 meeting – we then see the Fed keeping rates steady through the end of 2020 compared to a further decline in market pricing. In 2021, with growth back above potential and inflation at target, we see the Fed nudging rates higher by 25bp in the fourth quarter. This would be a small step towards moving policy back towards estimates of neutral, which continue to be around 2.5% in nominal terms. Given the likelihood that the Fed adopts at least a soft form of average inflation targeting, however, a sharper rise in rates will require a significantly firmer inflation profile than we anticipate.

Figure 20: DB Fed expectations



Note: Latest FOMC median is from the June Summary of Economic Projections. Source : FRB, Bloomberg Finance LP, Haver Analytics, Deutsche Bank

How much lift will this provide to growth? Simulations with the Fed staff's model of the US economy (FRBUS) indicate that 100bp of fed funds rate cuts could boost growth by about 60bp over the following year. As per the Fed analysis highlighted above, this response would not be sufficient to completely offset just those trade disruptions currently planned. Moreover, given that trade uncertainties – not restrictive interest rates – have been a key driver of the slowdown, the sensitivity of the economy to lower rates may well be reduced. For this reason, we see both a more accommodative monetary policy stance and a de-escalation of trade tensions as necessary to bring about a growth rebound later next year.

Balance sheet: Return to growth possible this year

Several non-interest rate issues remain important to the Fed outlook. As we wrote recently, we see increased risk that the Fed's balance sheet begins to grow by year-end (see " Faster reserve drawdown may bring forward timing of balance sheet

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growth "). It is not so much that there is compelling evidence that reserves are scarce – there is only some tentative evidence that we are approaching those levels. Instead, the risk of an earlier start to SOMA growth is driven more by the potential for a sharper rise and greater volatility in several non-reserve liabilities, including currency in circulation, the Treasury general account (TGA) and foreign central bank repos. Faster currency growth into year-end is consistent with seasonal trends, while an increase in the TGA stems from the Treasury needing to rebuild its coffers after the debt limit resolution. Meanwhile, larger foreign central bank repos have been driven by curve inversion.

Our projections now see reserves moving below $1.2tn by year-end, which is a reasonable starting point for thinking about the terminal level of reserves (Figure 21). For example, earlier this year banks reported a lowest comfortable level of reserves, or LCLoR, of $950bn. Adding on a buffer of roughly $200bn to absorb the range of historical shocks to non-reserve liabilities would imply reserves of at least $1.15tn could be needed. The level could in fact be higher, as bank estimates of LCLoR have risen in recent months.

Figure 21: Baseline Fed balance sheet projections

	($ Bil.)	Fed Assets: Treasuries	Fed Assets: MBS & Agencies	Fed Assets: Other	Fed Liabilities: Circulated currency	Fed Liabilities: Reserve balances	Fed Liabilities: Reverse repo	Fed Liabilities: Treasury General Account	Fed Liabilities: Other	Total Balance
	Jul-19	**2,081**	**1,514**	**232**	**1,748**	**1,491**	**309**	**177**	**103**	**3,827**
Stable	Sep-19	2,110	1,472	232	1,762	1,293	300	350	108	3,814
	Dec-19	2,164	1,418	233	1,813	1,205	300	390	108	3,815
	Mar-20	2,209	1,373	234	1,839	1,144	325	400	108	3,816
	Jun-20	2,245	1,337	235	1,862	1,122	325	400	108	3,817
Expansion	Sep-20	2,278	1,301	236	1,882	1,100	325	400	108	3,815
	Dec-20	2,416	1,265	237	1,936	1,100	325	450	108	3,918
	Mar-21	2,491	1,243	238	1,964	1,100	350	450	108	3,972
	Jun-21	2,536	1,221	239	1,988	1,100	350	450	108	3,996
	Sep-21	2,578	1,200	240	2,010	1,100	350	450	108	4,018
	Dec-21	2,655	1,179	241	2,067	1,100	350	450	108	4,075

Notes: SOMA Treasuries are reinvested in full beginning August 2019. SOMA MBS are projected to decline by $20bn per month through late 2019, then slows to $12bn per month in 2020. MBS payments are reinvested into Treasuries beginning August 2019. Currency is projected to grow with seasonal pattern at a historical rate of 7% y/y. Treasury General Account balance is expected to increase reflecting higher deficit spending in the coming years.

Source : FRB, Deutsche Bank

A return to Fed balance sheet growth should not be conflated with QE. The former is a passive form of asset purchases, where the Fed is buying Treasury securities to match the growth in non-reserve liabilities. The distribution of these purchases is intended to be consistent with the outstanding stock of Treasury debt, which would imply shorter duration purchases given that the Fed's balance sheet has a longer duration than the market. Conversely, QE was about active asset purchases intended to distort the curve by removing duration and flattening the slope.

Policy review: A soft form of average inflation targeting

By early next year the Fed is also scheduled to complete their comprehensive policy review, with an announcement on their findings and implications in the first half of 2020. As we have written in the past, this review is most likely to lead to a modest re-definition of the Fed's inflation target (see: " Fed's policy review: Refining rather than reinventing the wheel "). This re-orientation should emphasize that the Fed will aim to hit 2% inflation on average, in contrast to their current objective of a symmetric 2% inflation target on a forward-looking basis only.

However, we do not believe that they will commit to make up for a specific past shortfall. While some officials would clearly like to do so, a number of officials would likely not support tying the Fed's hands by committing to make up for past inflation misses. In this sense, while a version of a soft form of average inflation targeting is a likely outcome from this review, a more formal approach is unlikely. As we noted

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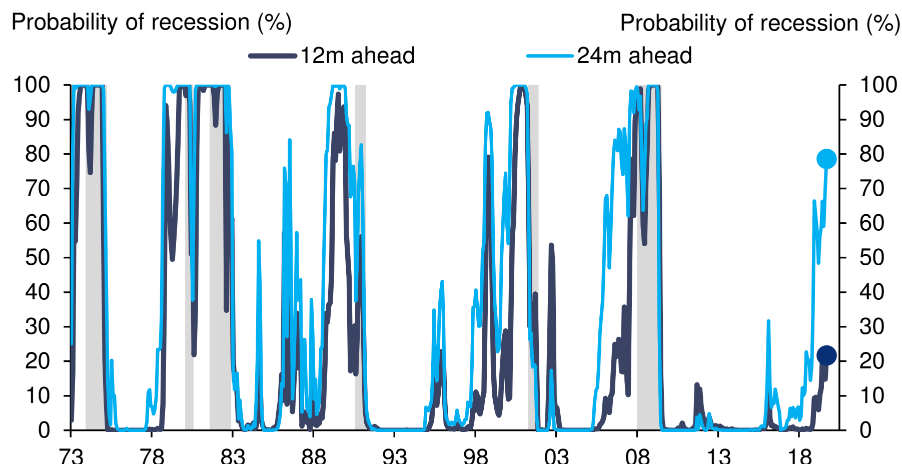
earlier, demonstrating a commitment to this new target would likely require at least one rate cut early next year. This commitment could be more credibly signaled with a rate cut as inflation is near target in Q1 next year.

Recession risk

The title of this outlook update could have been, "US economy headed into recession on current path of trade policy." Our baseline forecast of only a slowdown to moderately below trend growth through next year and no recession for the foreseeable future is predicated on a clear change in the current path of trade policy at some point in the months ahead. As we have noted, business confidence in the US and globally have taken a hit sufficient to do significant damage to investment spending plans. Both trade and indicators of activity in manufacturing have been in significant decline. Downward trends in aggregate hours worked in the overall economy, as well as manufacturing have become worrisome. Consumer spending looks relatively firm for now, but overall financial conditions have moved into negative territory on our in-house metric. Indeed, financial markets have been flashing expectations of recession within the next couple years for some time now. Our own recession probability models based on the yield curve and other financial indicators put the odds of a downturn within the next 12 and 24 months at 20% and 80%, respectively (Figure 22).

Figure 22: Recession risks have clearly risen according to market measures



Note: Probabilities are based on monthly averages of yield curve data. Dots represent probabilities based on the most recent daily data. Source : Deutsche Bank

Staying on the current path of trade policy would mean (1) the upcoming trade talks with China result in more talk but no action, (2) already announced tariff actions are implemented later this year as planned, (3) the possibility of tariff action on autos more globally remains in place, even if delayed again, and (4) passage of the USMCA continues to languish. Under these circumstances, the current level of uncertainty would likely intensify, with further negative effects on business fixed investment. Stock markets and financial conditions would be hit further. Household balance sheets would not be immune. Consumer confidence, which has already shown signs of wavering with the Michigan sentiment index dropping significantly off its highs, would drop further. A significant downturn in business spending and a slowing in consumer spending could well give us a repeat of the relatively mild recession of 2001. GDP barely fell over a couple quarters during that period, but

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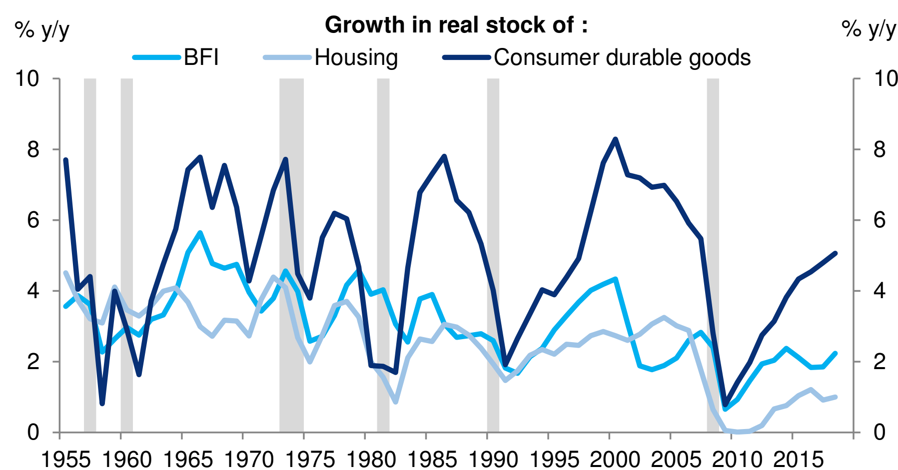
more than two million jobs were lost during that downturn.

One reason to expect that a downturn would be relatively brief and mild if it did come is because there is little evidence of a significant overhang of cyclically-sensitive spending on business capital, housing, or consumer durables. Growth in the stocks of these real assets has been more sluggish than in the past during the current extended expansion period. The rapid growth in corporate credit appears to have gone more into buybacks and dividends than any significant overbuilding of fixed capital. Indeed, the growth of both business capital and consumer durables were substantially higher going into the 2001 downturn than they have been in recent years. In addition, inventory-sales ratios have not looked unusually elevated recently.

Figure 23: Growth in cyclically-sensitive sectors has been subdued, limiting risks of a deep downturn



Source : BEA, Haver Analytics, Deutsche Bank

At the same time, at least a couple factors will tend to increase the downside risk this time around relative to where we were in 2001. The recession following the turn of the millennium was led by the US, indeed specifically by the reversal of an investment overhang touched off by the dot com boom-bust and associated plunge in the stock market. The downturn was then exacerbated by the 9/11 terrorist attack. The current slowdown and potential downturn is more global in nature, with manufacturing and investment activity around the world being affected by the trade-policy-induced hit to confidence.

The scope for a simulative policy response to damp a downturn is also much more limited today than it was in the early 2000s. The Fed cut rates by 550 basis points during the earlier episode, reducing the fed funds target to a low of 1%. Its scope for rate cuts is much more limited now. In addition, the Bush Administration had the luxury of coming to office in 2001 with the federal budget balance in record surplus. As the recession got under way, Congress was able to pass a massive tax cut that added more than 5 percentage points to GDP over several years and clearly diminished the potential downturn. Today's starting point with the budget deficit now approaching 5% of GDP leaves much less scope for fiscal stimulus. In brief, the absence of excessive private spending during this expansion augurs for a mild downturn, but the diminished scope for policy stimulus says there are downside risks.

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Figure 24: DB detailed US economic forecast

Economic Activity	2019				2020				2021				2019F	2020F	2021F
(% qoq, saar)	**Q1F**	**Q2F**	**Q3F**	**Q4F**	**Q1F**	**Q2F**	**Q3F**	**Q4F**	**Q1F**	**Q2F**	**Q3F**	**Q4F**	**Q4/Q4**	**Q4/Q4**	**Q4/Q4**
GDP	3.1	2.0	1.5	1.2	1.1	1.5	2.0	2.4	2.3	2.2	2.1	2.0	1.9	1.8	2.2
Private consumption	1.1	4.7	2.4	1.9	1.7	1.8	2.1	2.3	2.3	2.4	2.2	2.3	2.5	2.0	2.3
Investment	6.2	-6.1	-1.0	0.0	-1.0	1.5	2.5	4.0	3.3	2.7	3.3	2.9	-0.3	1.7	3.0
Nonresidential	4.4	-0.6	0.4	-1.0	0.5	1.4	2.2	2.5	3.4	3.1	3.2	3.2	0.8	1.6	3.2
Residential	-1.1	-2.9	4.1	3.5	2.9	3.2	3.6	3.7	3.6	3.2	3.0	2.9	0.9	3.3	3.2
Gov't consumption	2.9	4.5	2.0	2.2	1.9	1.8	1.8	1.6	1.8	1.7	1.5	1.4	2.9	1.8	1.6
Exports	4.2	-5.8	2.1	2.2	2.2	2.4	3.0	3.3	3.5	3.5	3.5	3.4	0.6	2.7	3.5
Imports	-1.5	0.1	3.5	4.3	2.7	3.3	3.2	3.4	3.6	3.7	3.8	3.9	1.6	3.1	3.8
Contribution (pp): Inventories	0.5	-0.9	-0.4	0.0	-0.4	0.0	0.0	0.2	0.0	-0.1	0.0	0.0	-0.2	0.0	0.0
Net trade	0.7	-0.7	-0.4	-0.5	-0.2	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.5	-0.2	-0.3
Unemployment rate, %	3.9	3.6	3.8	4.0	4.2	4.3	4.2	4.1	4.0	4.0	4.0	4.0	4.0	4.1	4.0
Prices (% yoy)															
CPI	1.6	1.8	1.7	1.6	2.0	1.7	1.8	2.0	2.0	2.0	2.1	2.2	1.6	2.0	2.2
Core CPI	2.1	2.1	2.3	2.3	2.3	2.4	2.2	2.2	2.1	2.2	2.2	2.2	2.3	2.2	2.2
PCE	1.4	1.4	1.3	1.2	1.6	1.3	1.5	1.6	1.6	1.7	1.7	1.9	1.2	1.6	1.9
Core PCE	1.6	1.5	1.7	1.8	2.0	2.0	1.9	1.8	1.8	1.9	1.9	2.0	1.8	1.8	2.0
Fed Funds	2.375	2.375	1.875	1.375	1.125	1.125	1.125	1.125	1.125	1.125	1.125	1.375	1.375	1.125	1.375

Source : Deutsche Bank

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Appendix 1

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