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Economics
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GDP Update: Consumer spending to continue to carry the day

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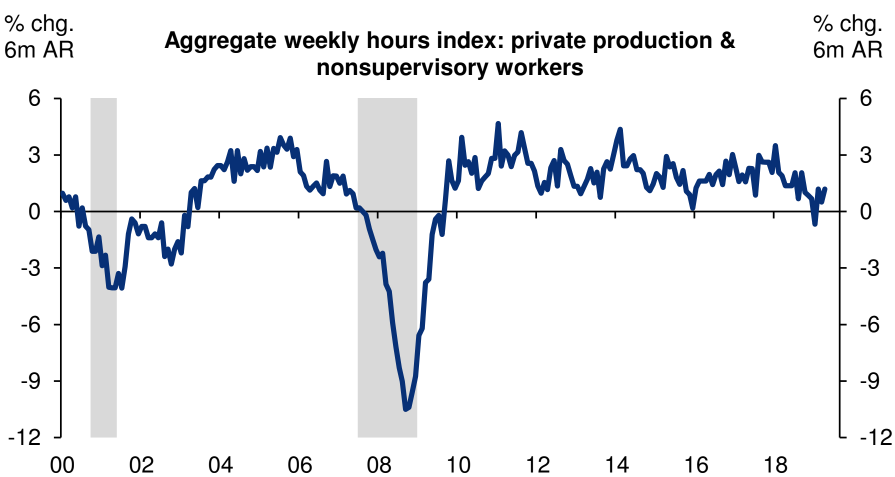
- In light of recent data, we have adjusted our near-term growth profile. We now project Q4 real GDP to grow 1.3% (annualized), up from 1.2%, previously. Though we continue to expect 2020 inflation-adjusted output to rise 1.8% (Q4/Q4), we now see a more balanced growth profile with H1 real GDP rising 1.6% compared to 1.3% in our prior forecast.
- Our updated growth projections reflect a modestly better near-term outlook for consumer spending. Third quarter consumer spending outperformed and the October employment report exceeded our expectations—in particular, the upward revisions to nonfarm payroll gains over the previous two months. In turn, the seeming resilience of the labor market has diminished some of the downside risks to consumer spending.
- To be sure, the economy is not out of the woods as we continue to see weakness in business spending over the next few quarters alongside muted exports growth. This should keep the FOMC leaning in a dovish direction. However, as long as consumer spending can continue to shoulder the burden, we see the Fed on hold for the foreseeable future.

Figure 1: The recent rebound in aggregate hours growth has reduced near-term risks



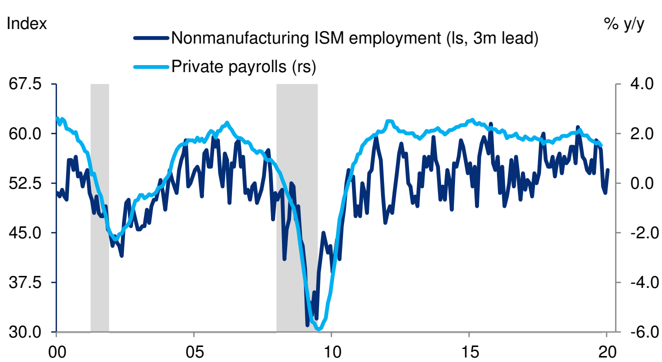
Source : BLS, Haver Analytics, Deutsche Bank

Revisions reveal a more resilient labor market

The October employment report showed a 128k gain in headline nonfarm payrolls. While this is a solid reading on its own for this point of the cycle, underlying details of the report were even stronger. Excluding Census workers, the gain was 148k, and the GM strike depressed payrolls gains by nearly an additional 50k, as auto sector employment fell 42k last month. Most importantly, the sturdy October hiring figures were accompanied by 95k in upward revisions to the prior two months. As shown in Figure 3, the six-month average revision between the first and third employment estimate has begun to stabilize. In addition, the employment component of the nonmanufacturing ISM, which has historically been a leading indicator of job growth, has recently rebounded a bit (Figure 2).

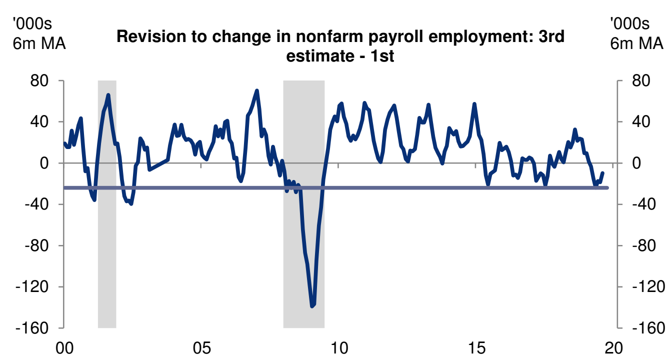
Given an improved labor market outlook, we now anticipate less of a slowdown in consumer spending over the next few quarters and have adjusted our near-term growth forecast accordingly. In particular, we now see current quarter real PCE growth of 2.1% compared to 1.9%, previously. This momentum should carry over into the first half of next year as we now anticipate consumer spending to expand 1.9% annualized in H1 versus 1.7% in our prior forecast. That said, our overall 2020 PCE forecast of 2.0% (Q4/Q4) remains consistent with what we had outlined in our recent deep dive into consumer spending (see "The good, the (not so) bad and the ugly—Part III: The consumer").

Figure 2: The nonmanufacturing ISM employment component bounced in October



Source : ISM, BLS, Haver Analytics, Deutsche Bank

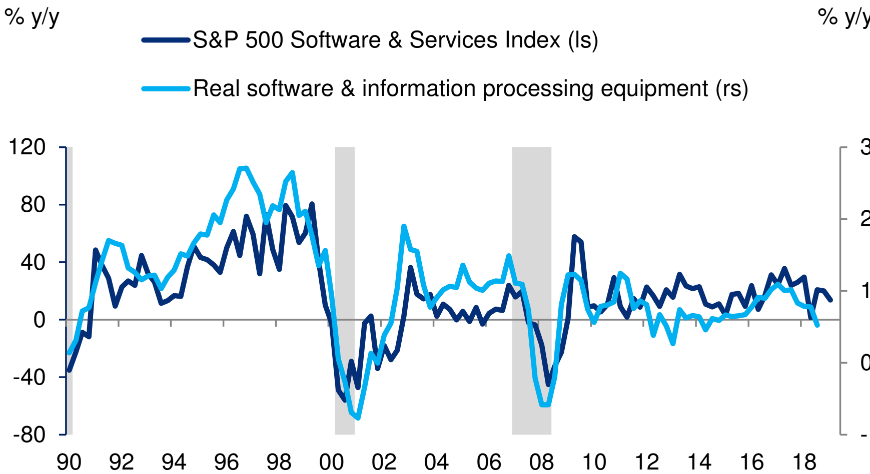
Figure 3: The downtrend in employment revisions may be stabilizing



Source : BLS, Haver Analytics, Deutsche Bank

At the same time, the advance Q3 real GDP release indicated slightly stronger momentum in spending for intellectual property products (IPP), in particular software spending. As we noted in our sector outlook note on capex (see "The good, the (not so) bad and the ugly—Part I: Capex") the trend in technology stock price performance has been a leading indicator for tech spending. As Figure 4 illustrates, technology stock prices have rebounded recently. Thus, we have modestly raised our growth projections for IPP over the next few quarters.

Figure 4: Rebound in tech stocks points to better profile for IPP spending



Source : S&P, BEA, Haver Analytics, Deutsche Bank

The upshot of these tweaks for our near-term forecasts is that Q4 real GDP growth is now expected to expand 1.3% annualized compared to 1.2% previously. This has the effect of raising our 2019 growth estimate a tenth to 2.1%. Additionally, real GDP growth is now anticipated to rise 1.6% over the first half of next year compared to 1.3% previously. To be sure, downside risks remain and we continue to project 1.8% real GDP growth for 2020 (Q4/Q4). However, the upgrade to our growth forecast over the next several quarters implies that the unemployment rate should now top out at 3.9% in Q2 of next year. With growth and hiring picking up in the back half of 2020, unemployment should tick back down to 3.8% by the end of 2020.

Given the flatness of the Phillips curve, this implies very marginal changes to our inflation forecasts. In fact the only meaningful change is a one tenth downgrade to 2019 Q4/Q4 core PCE, which reflects some softness in the recent data. To summarize, we see core inflation ticking up to the Fed's target over the next couple quarters. However, much of this rise is due to base effects as the soft prints from early 2018 roll off and inflation should again tick below the Fed's target by the end of 2020.

Fed to remain on hold for the foreseeable future

As we noted last week, we have taken two rate cuts in December and January out of our forecast and now expect monetary policy to remain on hold for the foreseeable future. The reasons for our Fed forecast change were two-fold: One, the FOMC meeting statement and Fed Chair Powell's press conference raised the bar for further cuts more than we had anticipated. The strong October employment report, likely takes easing off of the table in December despite another disappointing manufacturing ISM report. As just outlined, a more resilient labor market should, in turn, support sturdier consumer spending. If consumer spending can continue to hold the line, Fed policymakers appear content to wait and see how trade developments may impact the broader economic outlook.

Two, Fed Chair Powell also indicated that the conclusions from the Fed's policy review would likely be released around the middle of next year. Our January rate cut was in part predicated on the Fed credibly committing to a shift to an inflation make-up strategy at that meeting. With growth expected to stabilize around midyear and inflation close to target, the Fed is more likely to remain on the sidelines at that point and "commit" to any change in inflation strategy by signaling that rates will remain on hold for longer. Indeed, recent research by two former senior Fed researchers called into question the benefits of inflation make-up strategies.[1]

Figure 5: DB US Economic Forecasts

Economic Activity	2019				2020				2021				2019F	2020F	2021F
(% qoq, saar)	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	Q4/Q4	Q4/Q4	Q4/Q4
GDP	3.1	2.0	1.9	1.3	1.5	1.7	2.0	2.2	2.3	2.1	2.3	2.0	2.1	1.8	2.2
Private consumption	1.1	4.6	2.9	2.1	2.0	1.9	2.0	2.1	2.2	2.3	2.4	2.3	2.6	2.0	2.3
Investment	6.2	-6.3	-1.5	-1.1	-0.4	1.6	2.6	4.0	3.6	2.7	3.3	2.9	-0.8	2.0	3.1
Nonresidential	4.4	-1.0	-3.0	0.8	0.8	1.5	2.3	3.0	3.4	3.1	3.2	3.2	0.3	1.9	3.2
Residential	-1.1	-2.9	5.1	3.5	2.9	3.2	3.6	3.7	3.6	3.2	3.0	2.9	1.1	3.3	3.2
Gov't consumption	2.9	4.8	2.0	2.2	1.9	1.8	1.8	1.6	1.8	1.7	1.5	1.4	3.0	1.8	1.6
Exports	4.2	-5.7	0.7	1.6	2.6	2.8	3.0	3.3	3.5	3.5	3.5	3.4	0.1	2.9	3.5
Imports	-1.5	0.0	1.2	3.1	2.7	3.3	3.2	3.5	3.6	3.7	3.8	3.9	0.7	3.2	3.8
Contribution (pp): Inventories	0.5	-0.9	-0.1	-0.4	-0.3	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	-0.1	-0.4	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.4	-0.2	-0.3
Unemployment rate, %	3.9	3.6	3.6	3.7	3.8	3.9	3.8	3.8	3.7	3.7	3.7	3.8	3.7	3.8	3.8
Prices (% yoy)															
CPI	1.6	1.8	1.8	1.9	2.2	1.9	2.0	1.9	1.9	1.9	2.0	2.0	1.9	1.9	2.0
Core CPI	2.1	2.1	2.3	2.3	2.3	2.4	2.2	2.2	2.2	2.3	2.2	2.2	2.3	2.2	2.2
PCE	1.4	1.4	1.4	1.5	1.9	1.6	1.7	1.5	1.5	1.6	1.6	1.7	1.5	1.5	1.7
Core PCE	1.6	1.6	1.7	1.7	2.0	2.0	1.9	1.8	1.8	1.9	1.9	2.0	1.7	1.8	2.0
Fed Funds	2.375	2.375	1.875	1.625	1.625	1.625	1.625	1.625	1.625	1.625	1.625	1.625	1.625	1.625	1.625

Source : Deutsche Bank

1 https://www.piie.com/publications/policy-briefs/average-inflation-targeting-would-be-weak-tool-fed-deal-recession-and

Appendix 1

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