Green Shoots or Dead Wood?

KPMG Economics

Constance L. Hunter, CBE
Chief Economist
@constancehunter
constancehunter@kpmg.com

Kenneth Kim, CBE
Senior Economic Analyst
kennethkim2@kpmg.com

Henry Rubin
Economic Analyst
henryrubin@kpmg.com

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U.S. Economic Summary – Green Shoots or Dead Wood?

Will the U.S. consumer be the cornerstone of continued growth or will it receive help from the rest of the economy?

- The consumer has been the steadfast cornerstone of the U.S. expansion, but with slowing jobs growth, consumption should drift lower in the coming quarters
- Negative housing investment, slow capital expenditure and investment, a waning fiscal stimulus, and a myriad of trade tensions dim the prospects for growth expanding over the next year and could even pull the economy into recession
- It is due to these dimming factors that the Fed has stepped in with rate cuts designed to insure the expansion continues
- A slow pace of growth, while not inherently undesirable, is more vulnerable to economic shocks from the global economy and/or financial markets

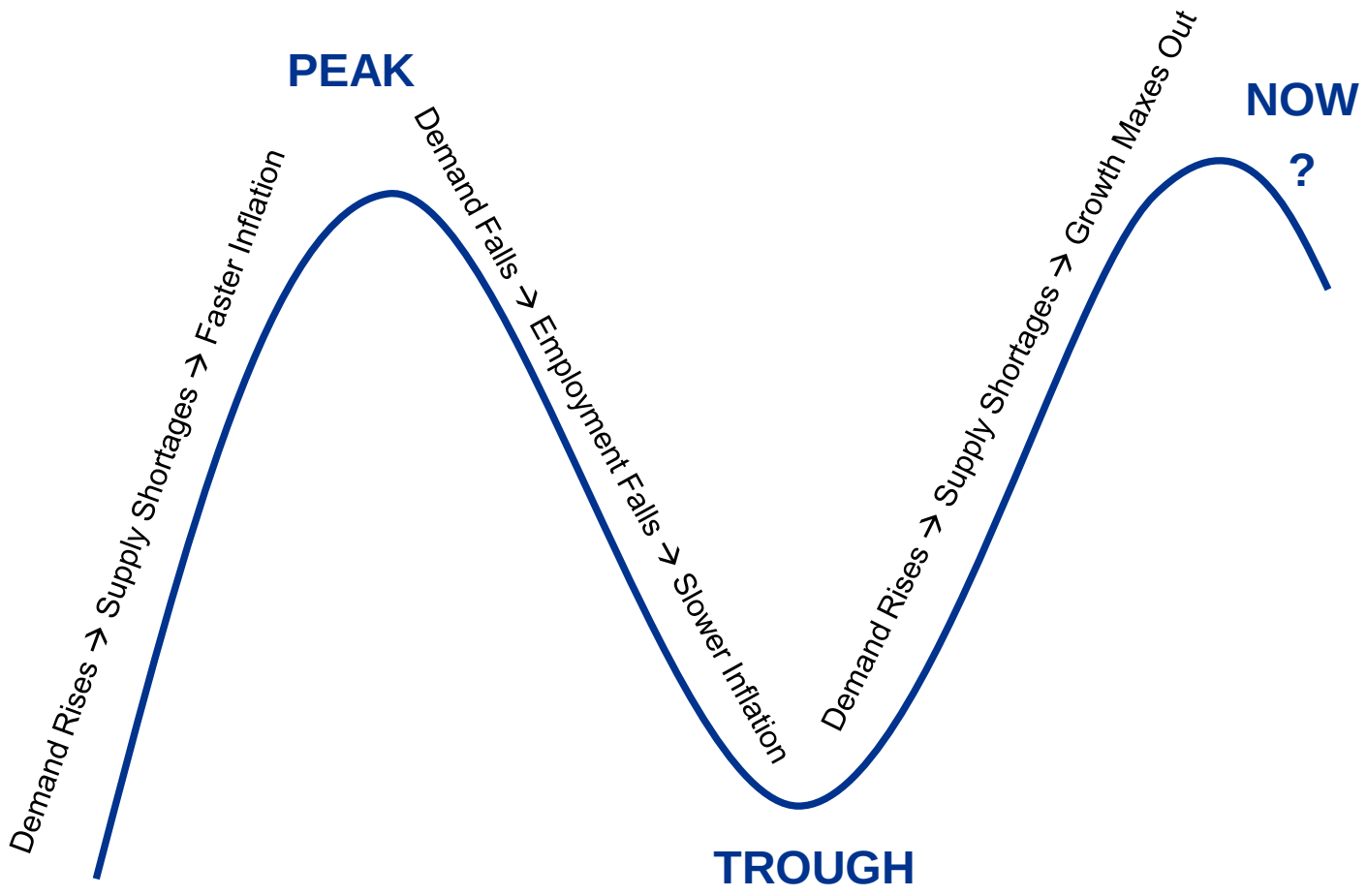
Weakening global growth poses increasing risks to U.S. and global economy

- Concerns of a global economic shock mount as a synchronized global slowdown is underway with a few major economies on the brink of recession
- The global manufacturing economy is in a recession and it is unclear easier monetary policy in the G7 can quickly reverse this trend and prevent spillovers to the broader economy
- Policy levers in China are constrained which poses the greatest risk to global growth in the coming year

Monetary policy is working overtime to help extend the expansion globally

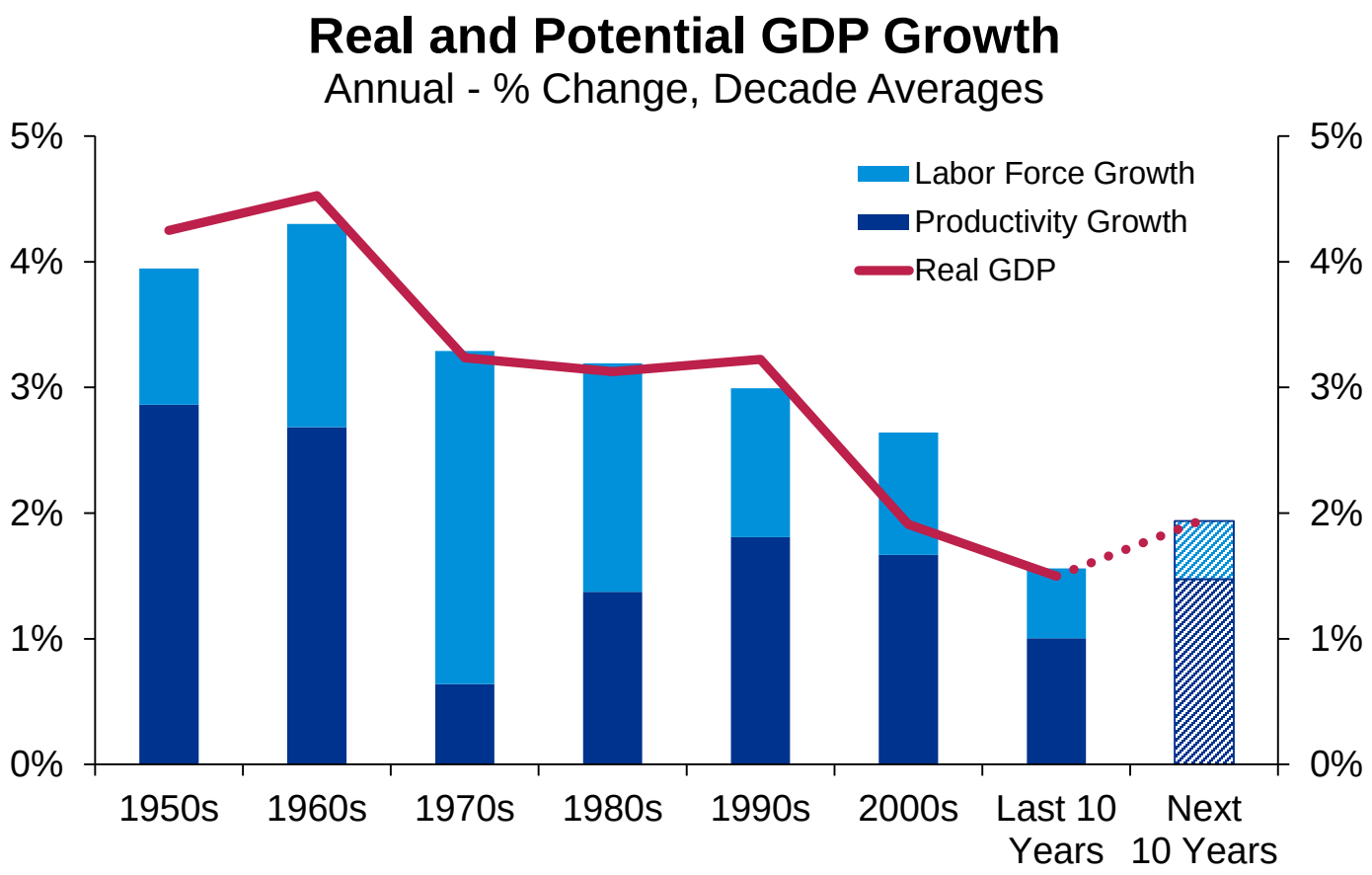
- The Fed along with the ECB, Bank of England, and Bank of Japan are either cutting rates or maintaining bond purchase programs
- Low inflation allows the Fed to take out “insurance” rate cuts and explains market expectations of further cuts

Are we near the peak of the cycle?



- The peaks and troughs of the business cycle are inevitable aspects of any economy
- Economists watch for supply shortages in labor and capacity that limit the amount of output an economy can produce
- Businesses are currently reporting supply constraints, particularly for skilled labor, leading us to believe that the **peak of the hiring cycle may have already occurred** or be near at hand
- If this is correct, consumption should begin to slow as the pace of new jobs growth slows

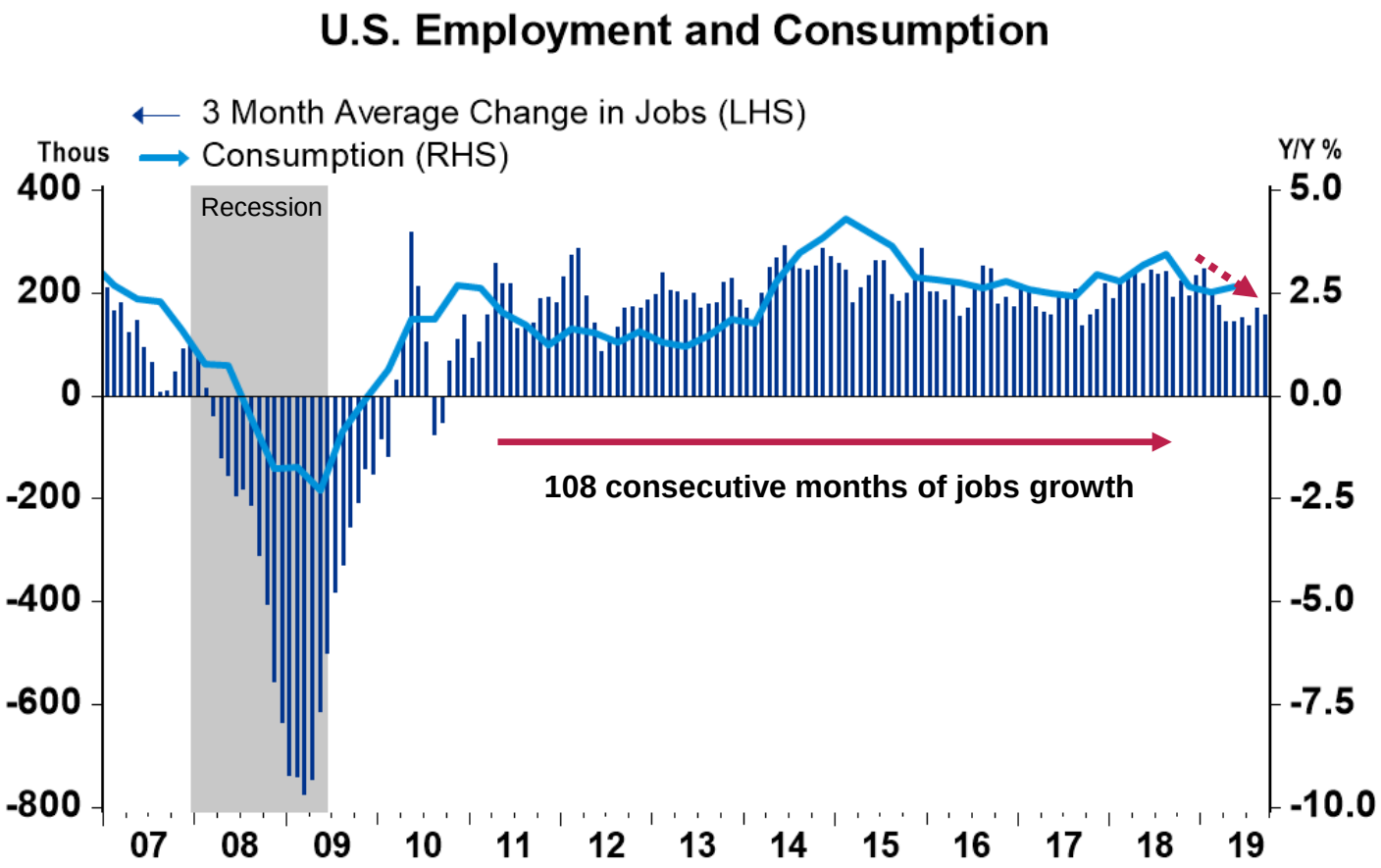
Over the medium term, potential GDP dictates growth rate



Note: CBO forecasts
Source: KPMG Economics, Congressional Budget Office (August 21, 2019), Bureau of Economic Analysis (Q2 2019), Haver Analytics

- Ultimately, economies can only grow at a rate known as their "Potential GDP." This is equal to the sum of the growth in productivity and the growth rate of the labor force
- As birth rates and immigration rates decline, the pace of growth of the working age population slows
- The U.S. currently has a working age population growth of 0.3%, due primarily to immigration
- **Productivity** has averaged 1.0% during the last 10 years and many economists expect it **will improve to 1.5% over the forecast period** of the next 10 years as **artificial intelligence and machine learning become general purpose technologies**

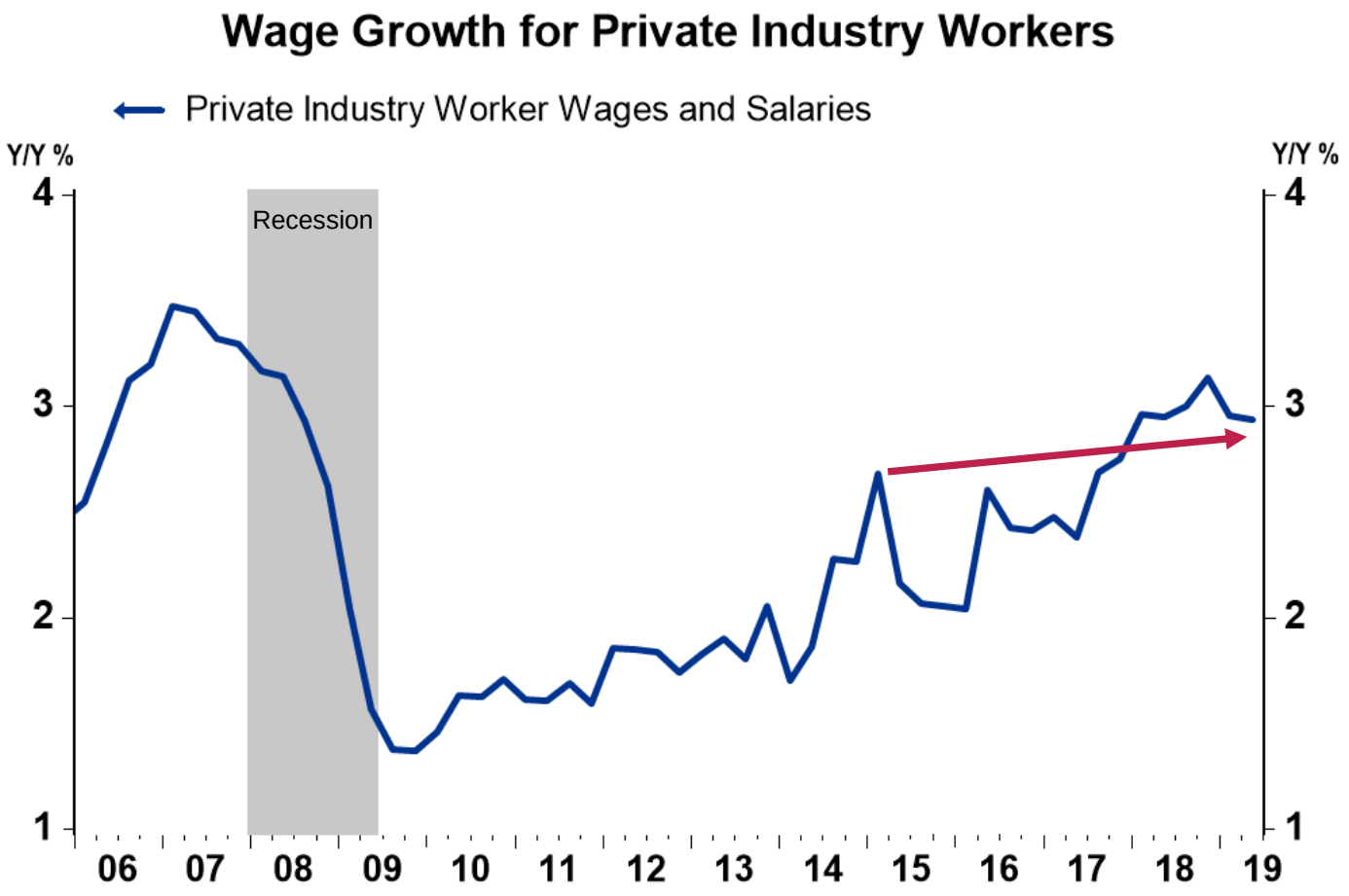
A slower pace of jobs growth likely over next year



Source: KPMG Economics, BEA (Q2 2019), BLS (Sept 2019), Haver Analytics

- Jobs growth has slowed from a 1.8% y/y pace last year to 1.4% presently
- The slower pace of jobs growth is consistent with an aging expansion
- The **slower pace of jobs growth** usually goes **hand-in-hand with a slower pace of consumption**
- The **jobs market is a lagging indicator** and does not foretell a recession is coming

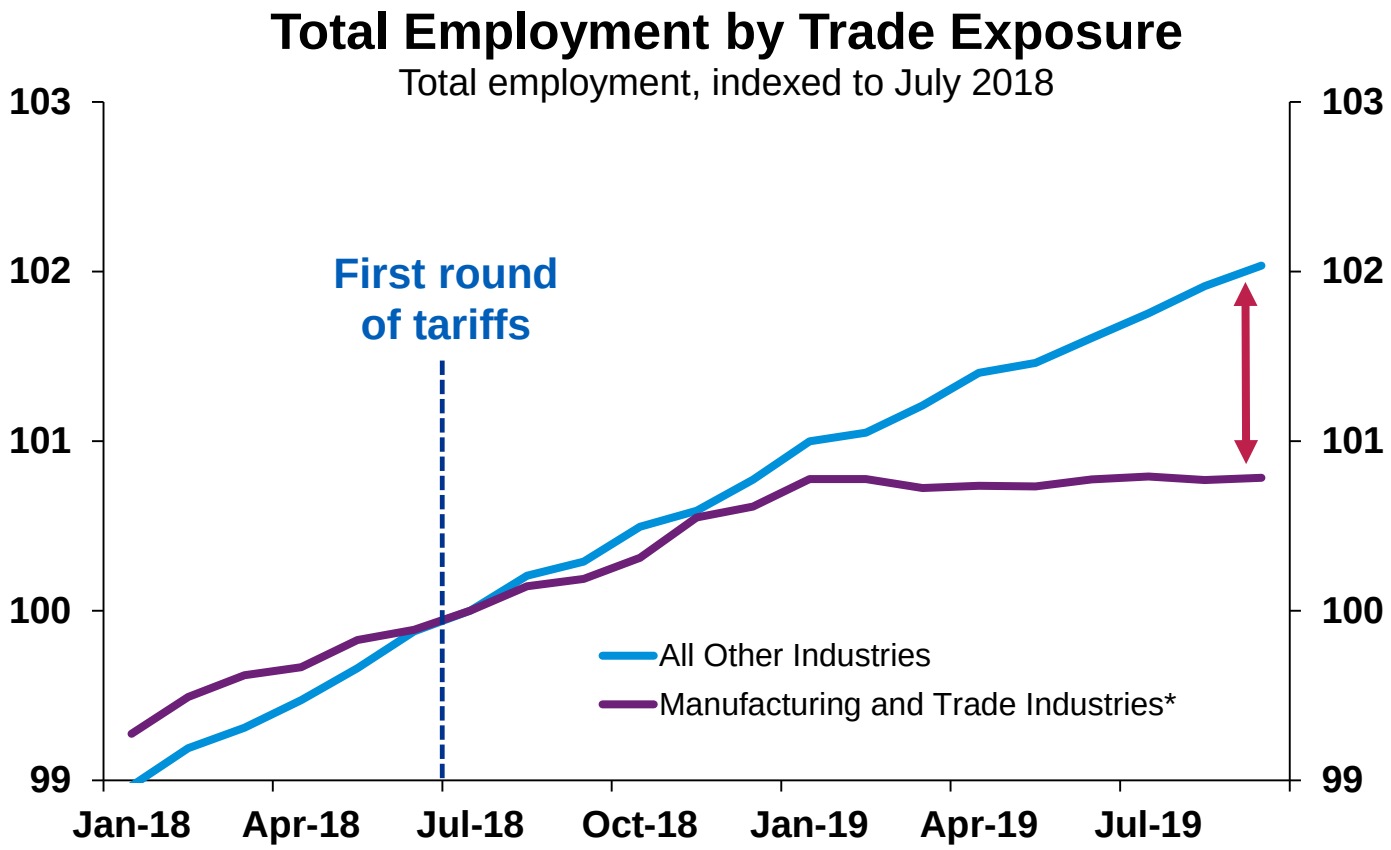
Wage growth flat lined despite 3.5% unemployment rate



Source: KPMG Economics, BLS (Q2 2019), Haver Analytics

- Historically a 3.5% unemployment rate would be accompanied by higher wage gains
- The low pace of wage gains is perplexing and there are many possible interacting causes
- Factors including well-anchored inflation expectations, an aging workforce, globalization, reduced union membership and labor bargaining power, and greater numbers of contingent workers are contributors to low wage increases
- The current pace of productivity growth of 1.8% suggests that most further wage gains could be absorbed by corporations without a hit to their margins

Employment in trade-exposed industries has flatlined



*Includes Manufacturing, Retail Trade, Wholesale Trade, and Transportation & Warehousing
Source: KPMG Economics, Bureau of Labor Statistics (September 2019), Haver Analytics

- The trade war with China has adversely impacting hiring in trade-related industries
- Tariffs on all Chinese goods have jumped from an average of 12.4% in 2018 to 21% presently
- We expect trade-related jobs to fall further, expanding to retail and other industries as the full impact of recent tariffs begins to ripple out into the broader economy

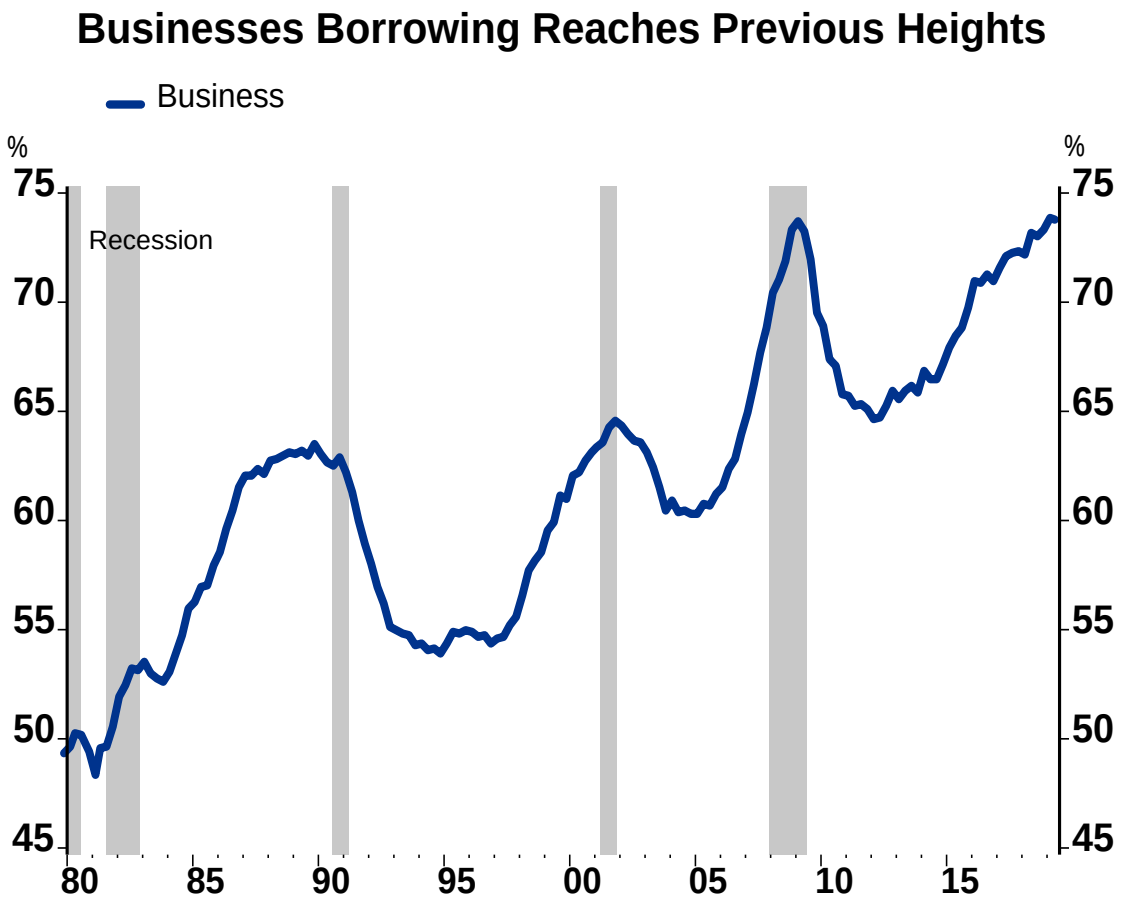
The growth path juxtaposes consumption and investment

Growth Rates %			
	2017	2018	H1-2019
GDP	2.4	2.9	2.6
Consumption	2.6	3.0	2.8
Business Investment	4.4	6.4	1.7
Residential Investment	3.5	-1.5	-2.0
Gov't Spending	0.7	1.7	3.9
Exports	3.5	3.0	-0.9
Imports	4.7	4.4	-0.8

Notes: Annual growth rate y/y %; quarterly SAAR %
Source: KPMG Economics, BEA (Q2-2019), Haver Analytics

- Households and the government are spending
- However, investment from corporations and housing investment by households has waned
- Unless more fiscal stimulus is enacted, government spending will fall in the 4th quarter of 2019 and into 2020
- Continued uncertainty suggests corporate investment is to remain weak and possibly decline
- Lower rates should help household real estate investment but data has yet to provide conclusive proof this is occurring

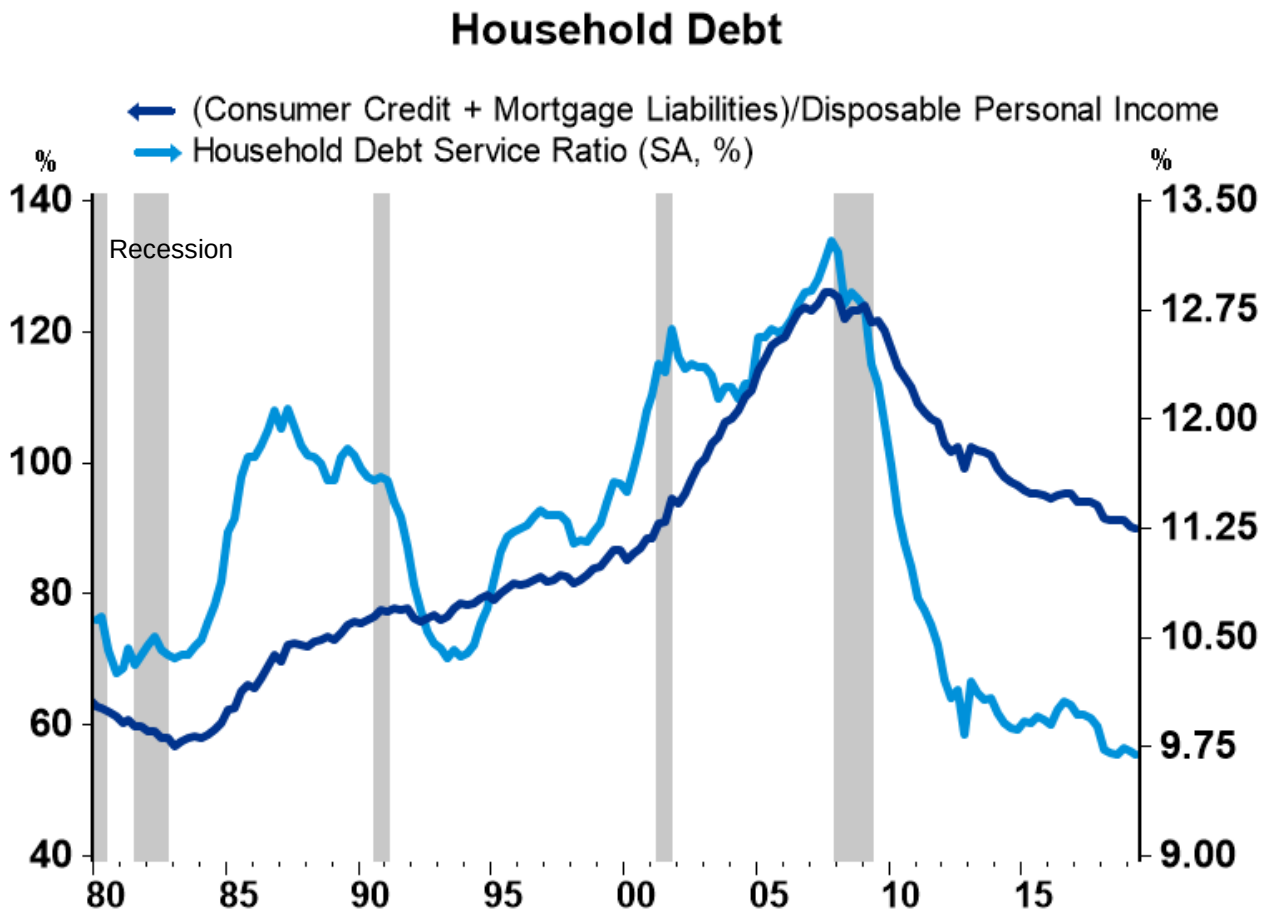
High debt and low investment raises note of caution



Source: KPMG Economics, Federal Reserve Board (Q2 2019), Haver Analytics

- Business sector debt is higher than the previous peak in relation to GDP
- The share of bonds rated at the lowest investment-grade level (BBB) has reached near-record levels. As of Q1 2019, just over 50% of these bonds outstanding were rated triple-B, amounting to $1.9 trillion
- The three most indebted sectors with the highest leverage (total debt/Ebitda) are consumer cyclicals, consumer non-cyclicals, and energy
- The three least indebted sectors are transportation, basic industry and technology

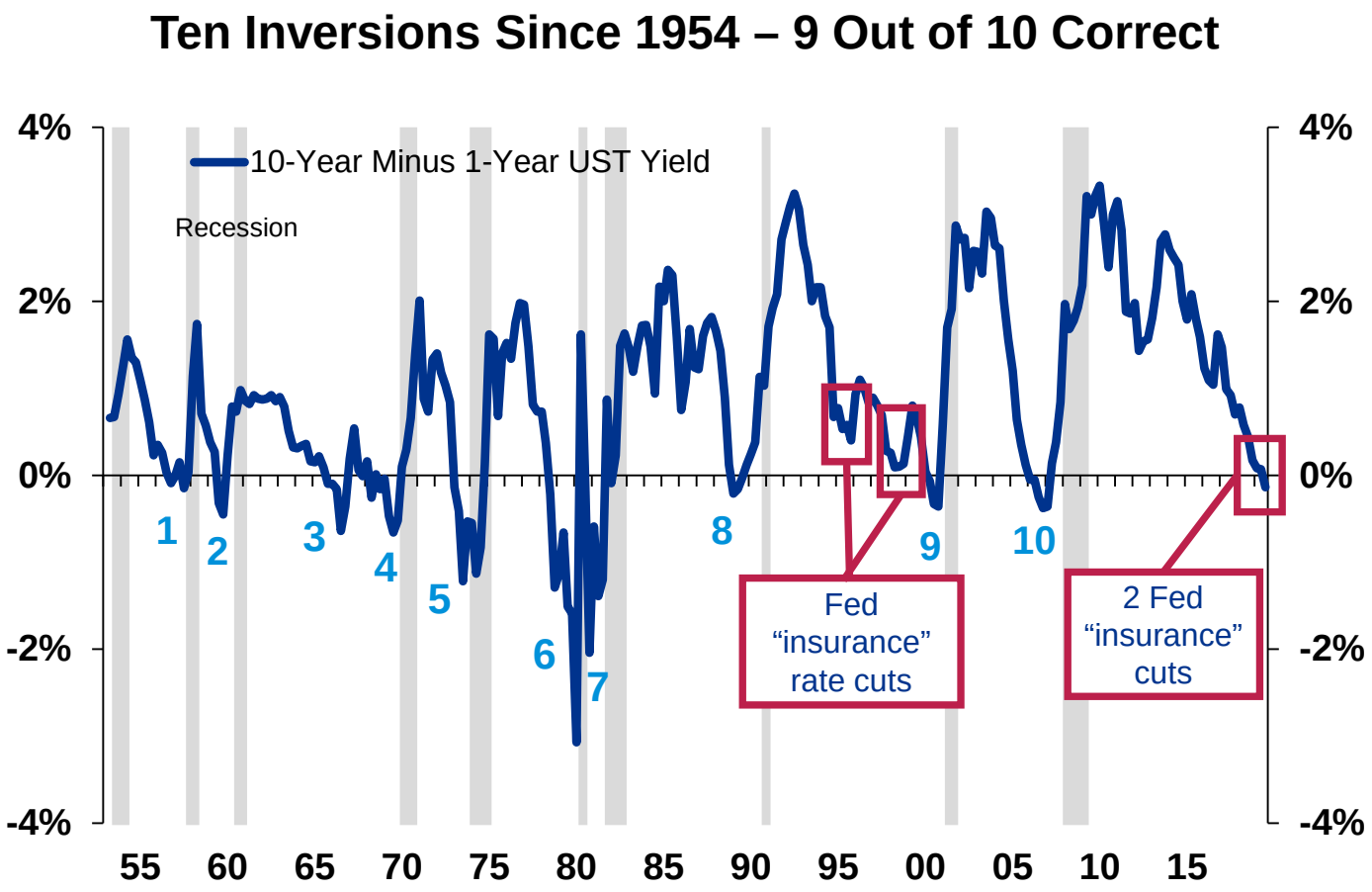
Do households have more capacity to borrow as rates fall?



Source: KPMG Economics, Federal Reserve Board (Q2 2019), Haver Analytics

- Can the U.S. consumer do even more heavy lifting?
- So far a fall in mortgage rates is increasing mortgage applications but it has yet to translate to increased housing investment
- Low interest rates help households manage debt loads and keep payments low. The current household debt service ratio is low by historical measures
- With rates likely to decline even more, there is the scope for increased borrowing by the consumer

Inverted yield curve signals enough weakness to cut rates

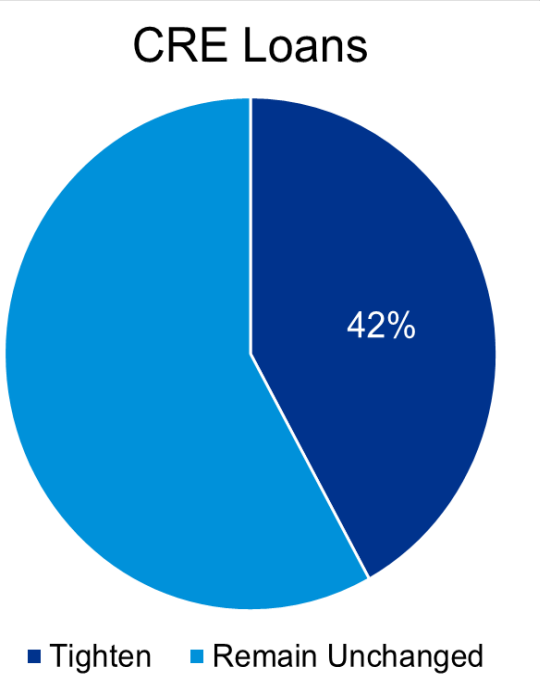


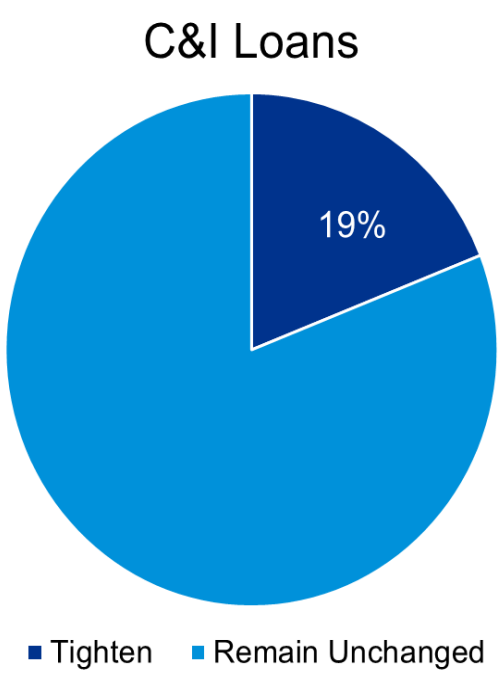
Source: KPMG Economics, Federal Reserve Board, Haver Analytics (Q3 2019)

- A yield curve inversion is usually a reliable signal of an impending economic downturn
- The Fed's so-called "insurance" rate cuts in 1995 and 1998, achieved a soft landing for the economy and even necessitated rate hikes before the cycle ended
- The Fed cut rates in July and September and markets now expect two more cuts in 2019 and at least one in 2020

A flat or inverted curve tightens financial conditions

Were the yield curve to experience a moderate inversion over the next year, my bank's credit standards for:

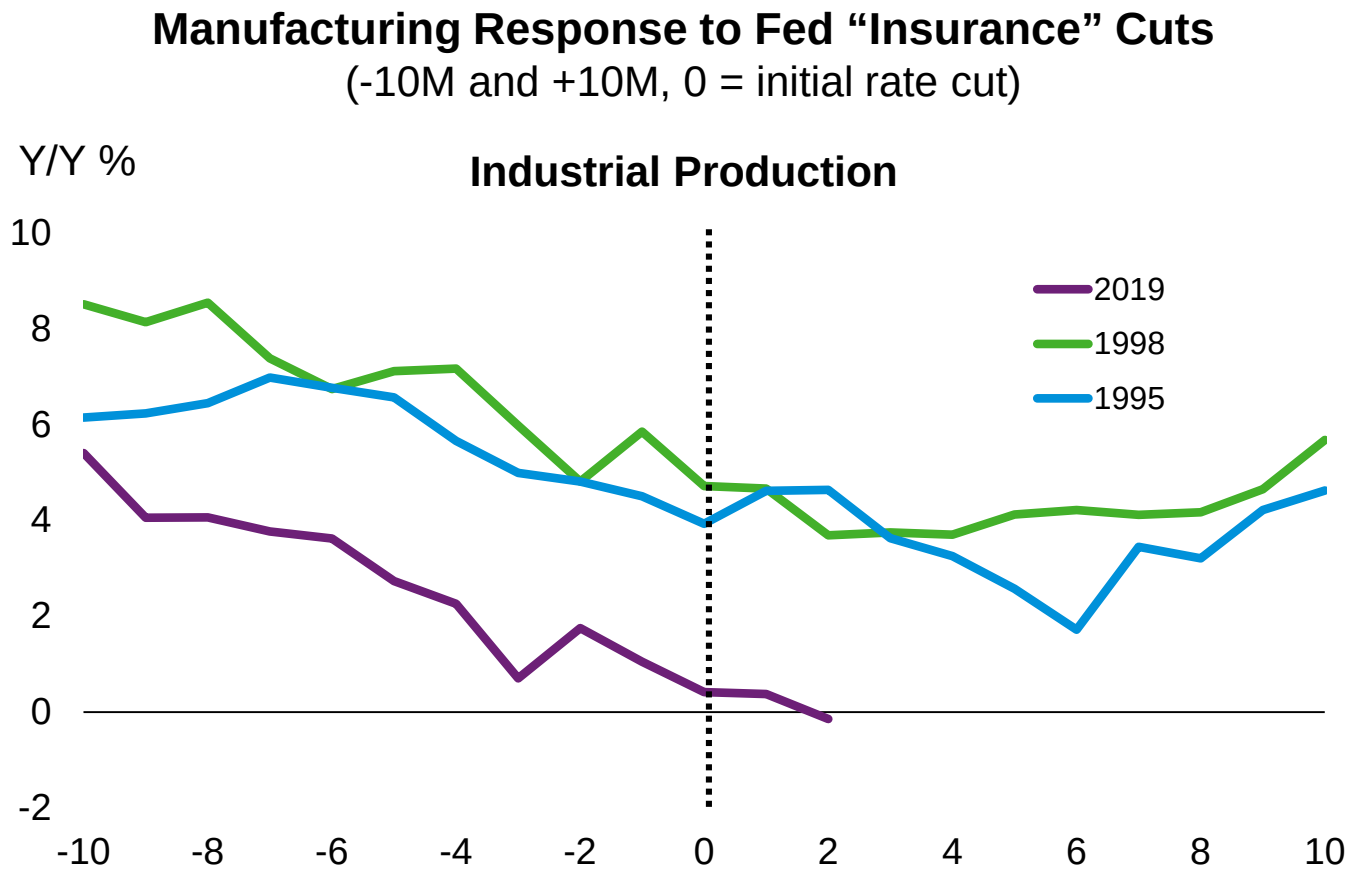




Source: KPMG Economics, Federal Reserve "Senior Loan Officer Opinion Survey" (October 2018)

- A Fed survey from last October showed that banks will tighten credit standards for commercial real estate and commercial and industrial loans as the yield curve inverts
- The inversion of the curve causes tighter liquidity conditions which in turn puts the brakes on the pace of growth by limiting the amount of credit induced expansion taking place

Previous “insurance” rate cuts prolonged growth



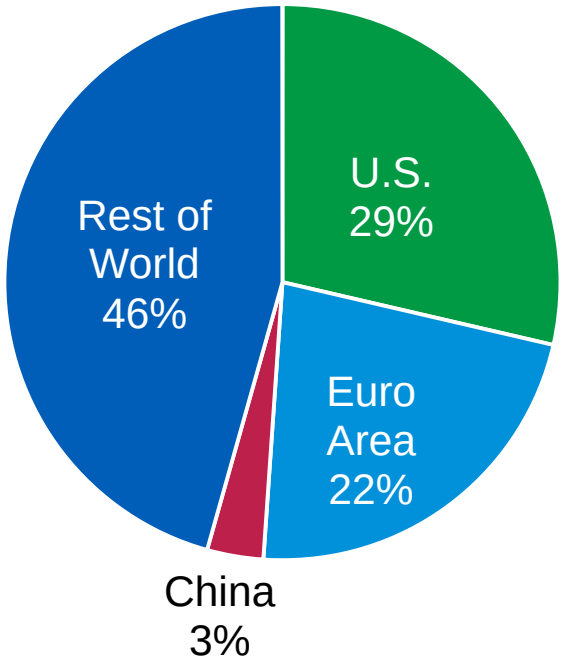
Source: KPMG Economics, Federal Reserve Board (Sep 2019), Haver Analytics

- Taking a deeper look at the response in economic data to the Fed’s insurance rate cuts of 1995 and 1998, we focus on the manufacturing sector which we consider to be a leading cyclical indicator of the economy
- Industrial production improved within six months after the rate cuts in 1995 and 1998, prolonging the expansion for several more years
- The Fed is hoping to achieve the same result this time around

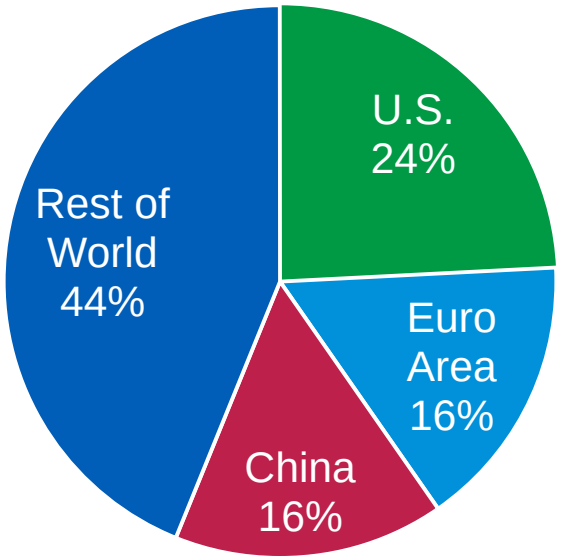
Global economy is different than the 1990s

Share of World GDP

1998



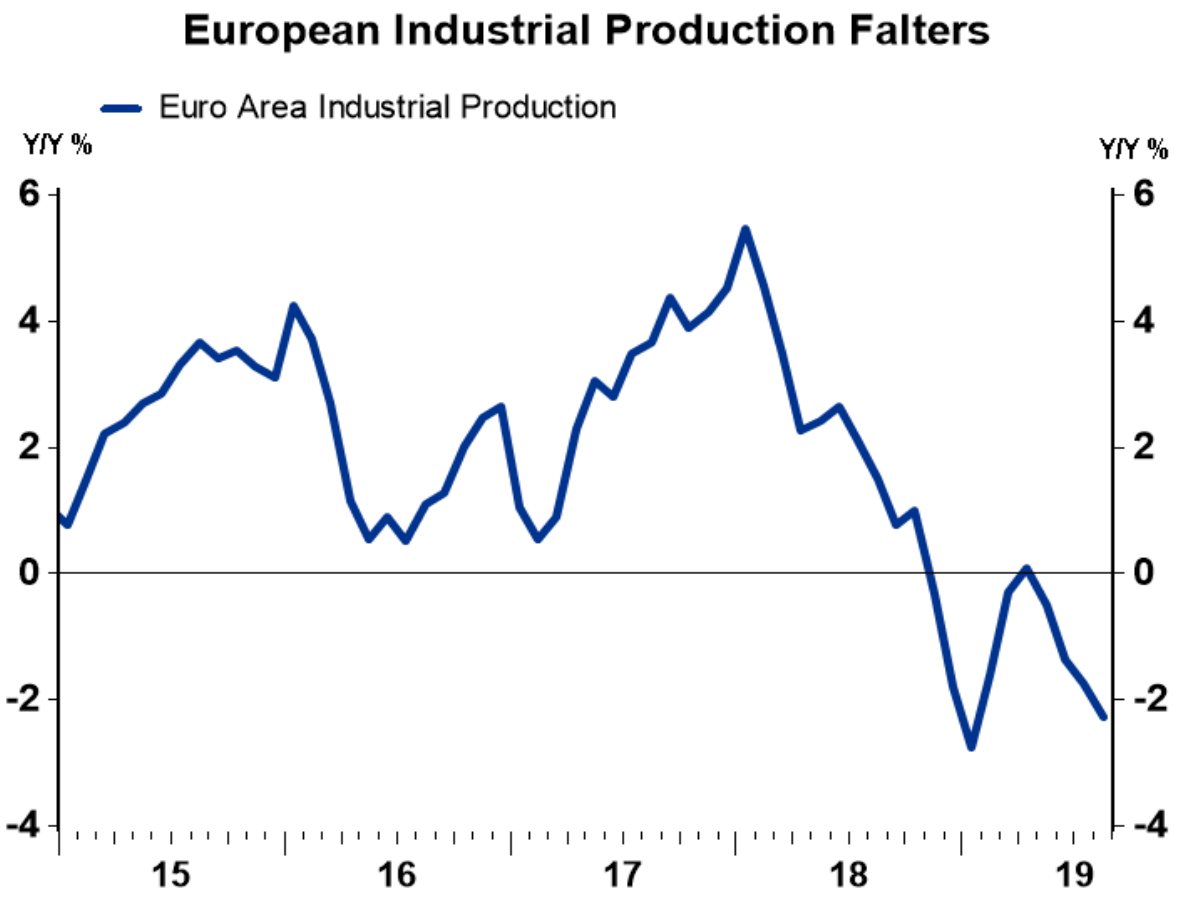
2018



Source: KPMG Economics, IMF (2018), Haver Analytics

- U.S. GDP dominance is not as significant as it was in 1998
- Global integration was not as strong; neither trade volumes nor capital flows were as integrated
- The Euro Area was the only other significant economic bloc
- Now China and the Euro Area make up nearly 35% of global GDP with the possibility to exert significant influence on U.S. domestic economic conditions
- Both European and Chinese growth have suffered a downshift over the past year

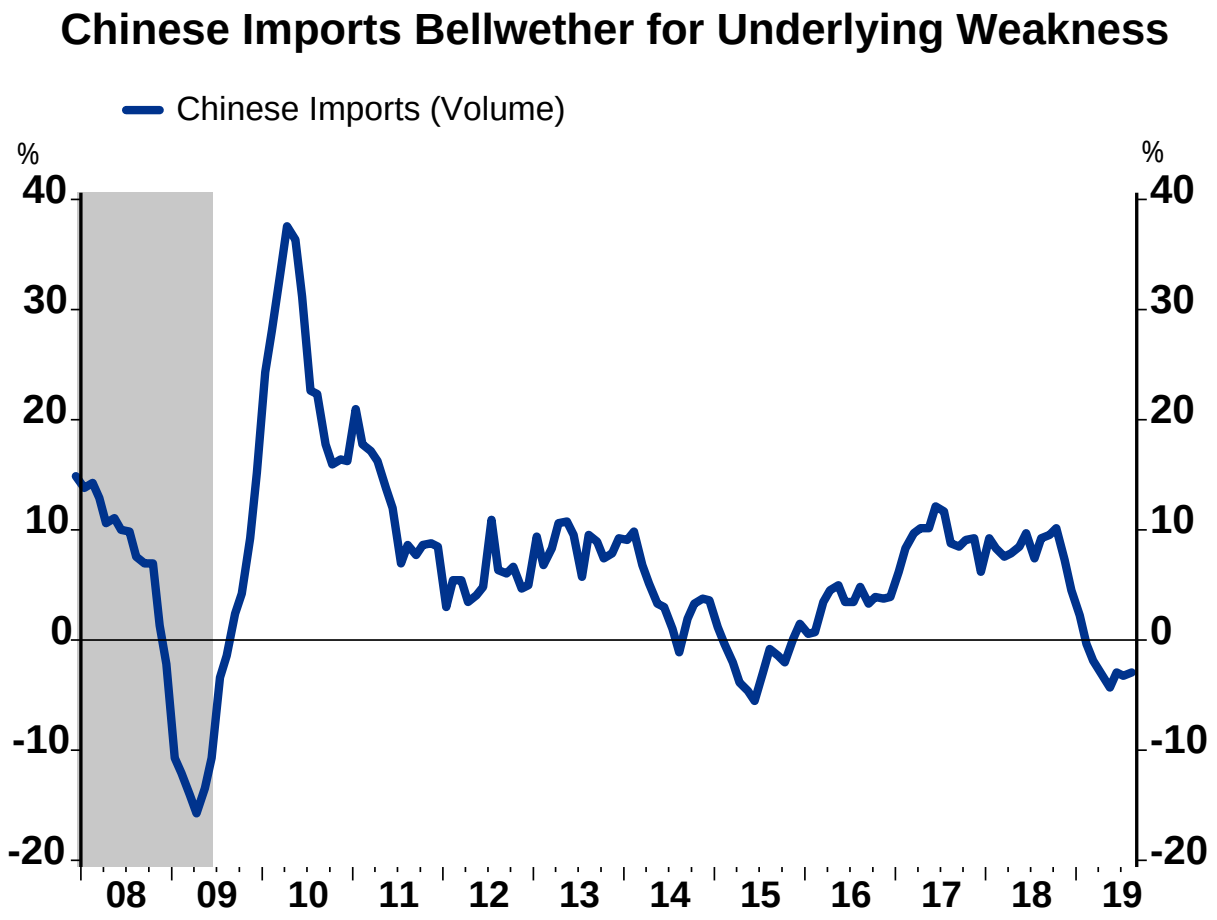
Manufacturing recession in Europe dampens growth outlook



Source: KPMG Economics, EuroStat (August 2019), Haver Analytics

- European industrial activity has been declining for more than a year, led by weakness in the German auto sector
- The weakness in the German industrial sector stems from weak export demand from China
- The latest Euro Area industrial production data suggests that the weakness in autos may have broadened into other areas of manufacturing

Slowing Chinese growth is impacting global economy



Source: KPMG Economics, China Customs (August 2019), Haver Analytics

- Because Chinese GDP statistics are subject to biases, most economists look for proxy statistics to interpret conditions in the Chinese economy
- Proxy indicators for Chinese GDP such as import volume suggest weakness

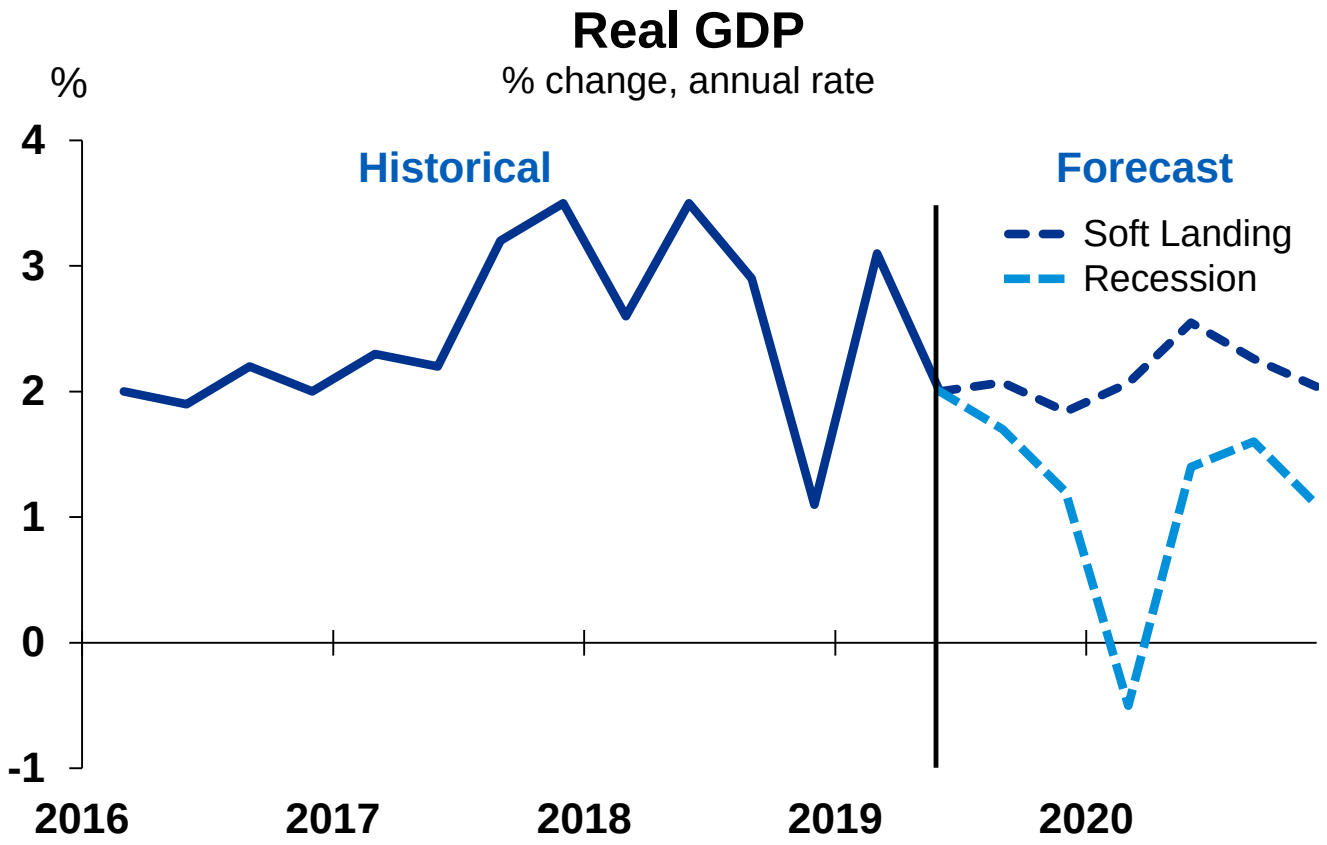
The world's largest economies exhibit slower growth

Real GDP Growth Rates %				
Top 10 Countries by GDP		2017	2018	2019 Q2
1	U.S.	2.4	2.9	2.0
2	China	6.8	6.6	5.5
3	Japan	1.9	0.8	1.8
4	Germany	2.8	1.5	-0.3
5	U.K.	1.8	1.4	-0.8
6	France	2.4	1.7	1.3
7	India	6.9	7.4	2.9
8	Italy	1.8	0.7	0.1
9	Brazil	1.1	1.1	1.8
10	Canada	3.0	1.9	3.7

Notes: Annual growth rate y/y%, quarterly SAAR%
Source: KPMG Economics, Respective Countries' National Statistics Office (Q2 2019), Haver Analytics

- The top 10 countries account for roughly 2/3 of world GDP
- 7 of the 10 have registered weaker growth rates in 2019 versus 2018
- Germany and the U.K. fell into negative territory in Q2 2019, raising concerns that the global economy is at risk
- U.S. growth has also cooled markedly this year
- China's economy has slowed to 5.5%. Hurt by excessive debt financing over the past several years and the slowdown from the U.S.-China Trade War, China's policy options are limited. Furthermore, its potential GDP is falling due to demographics

Near term growth outlook – a tale of two scenarios



Source: KPMG Economics, Macroeconomic Advisers by IHS (September 2019)
Note: Real GDP is GDP adjusted for inflation; Real GDP reported at a seasonally adjusted annualized rate

- Beyond the return to potential GDP the big question is if the Fed can achieve a soft landing
- If global growth stabilizes or rebounds, the Fed can engineer a soft landing in 2019 and possibly 2020. If a soft landing is achieved, it will likely mean a continuation of wage increases and inflationary pressures, which means the Fed could resume raising rates in 2020, tightening liquidity conditions. In other words, a soft landing delays the arrival of a recession but does not prevent one
- Adrian and Estrella (2009) say that a monetary cycle ends when the funds rate peaks, which in turn is a good predictor of an impending recession
- Should global events cause a financial shock, a recession could arise due to tightening liquidity conditions and financial contagion

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