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# U.S. economic outlook 5/18

## Economic outlook

— Economic momentum in the U.S. remains strong, with growth continuing to run above potential, and more of the same seems in the cards, at least in the near term. The economic expansion, already the second-longest on record, remains underpinned by sound fundamentals, fiscal stimulus, firm global activity, and the lagged effects of easier financial conditions. Even concerns on the trade front—though hardly allayed—have begun to recede. The recent run-up in energy prices will take a modest bite out of consumer spending, but also provide a lift to the domestic energy sector, mitigating the drag on overall activity. And the tightening of financial conditions seen this year has been too modest to dent our outlook much—especially since we've been anticipating that financial conditions would gradually shift to providing less support as the Federal Reserve (Fed) reduced policy accommodation. Indeed, that's partly why we've been expecting growth to downshift modestly as we head into next year, albeit remaining slightly above potential.

— Against this backdrop, labor markets will likely tighten incrementally further, moving somewhat beyond full employment, helping solidify the recent move of inflation back near the Fed's target. Higher energy prices will provide a temporary additional lift to inflation, though primarily to headline, not core, and the dollar's recent strengthening will be a counter balance. All told, a material inflation overshoot looks unlikely, especially given well-anchored inflation expectations and the generally attenuated responsiveness of inflation to slack.

— Looking further over the horizon, however, there are some looming risks. The more labor markets tighten

### Economic and financial market projections

| | Real GDP | Core PCE Prices | 10-year U.S. Treasury Yield | S&P 500 Index |
|---|---|---|---|---|
| 2016 | | | | |
| 2Q | 2.2% | 1.7% | 1.64% | 2084 |
| 3Q | 2.8% | 1.8% | 1.63% | 2158 |
| 4Q | 1.8% | 1.9% | 2.49% | 2247 |
| 2017 | | | | |
| 1Q | 1.2% | 1.8% | 2.48% | 2367 |
| 2Q | 3.1% | 1.5% | 2.19% | 2434 |
| 3Q | 3.2% | 1.4% | 2.20% | 2493 |
| 4Q | 2.9% | 1.5% | 2.40% | 2664 |
| 2018 | | | | |
| 1Q | 2.3% | 1.7% | 2.80% | 2725 |
| 2Q(F) | 2.9% | 1.9% | 3.00% | 2750 |
| 3Q(F) | 2.7% | 1.9% | 3.05% | 2780 |
| 4Q(F) | 2.6% | 1.9% | 3.15% | 2810 |
| 2019 | | | | |
| 1Q(F) | 2.5% | 2.0% | 3.25% | 2850 |

Source: Deutsche Asset Management as of May 2018. **Performance is historical and does not guarantee future results.** Quarterly GDP change is annualized. The core Personal Consumption Expenditures (PCE) Price Index change is the four-quarter percentage change. The 10-year U.S. Treasury yield and S&P 500 Index level are from the last month of the quarter. F refers to forecast. FR is forecasted revision. The S&P 500 Index tracks the performance of 500 leading U.S. stocks and is widely considered representative of the U.S. equity market. The Personal Consumption Expenditures (PCE) Price Index tracks the average increase in prices for all domestic personal consumption items. The core PCE Price Index is a less volatile report than the PCE Price Index in that it does not include more volatile food and energy prices. It is not possible to invest directly in an index.

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beyond sustainable levels, and the more the Fed hikes in response, the more vulnerable the economy becomes to a setback. Historically, central banks have found it difficult to engineer a soft landing, increasingly so the more labor markets overshoot full employment.

— But for now, the coast looks pretty clear. Households continue to benefit from solid income growth, lagged improvements in net worth, manageable debt and debt service, elevated confidence, and firm labor markets. Higher energy prices may dampen purchasing power, but they'll also support the domestic energy sector. For businesses more generally, conditions remain broadly favorable, buttressed by elevated confidence (despite lingering concerns on the trade front), tax reform, and still-supportive financial conditions.

— The global economy also remains firm, if somewhat less robust than in the second half of last year, sufficient to support a healthy pace of U.S. exports, especially if trade frictions abate.

— The fiscal stimulus should add to the growth momentum too, albeit moderately. Effective tax rates are not coming down all that much, and the economy is near full employment—when fiscal multipliers tend to be smaller because there are few pent-up demands to be vented, and less room to accommodate them without pressing against capacity constraints and pushing up interest rates. At this point in the cycle, demand-side stimulus could actually be counterproductive, boosting near-term growth but increasing the risk of overheating and financial excess—the kinds of imbalances that can make recession more likely (in part by inducing the Fed to tighten more aggressively). Again, we don't see this as much of a risk for the next year or so, but it does loom further over the horizon.

— To counter this risk, the economy needs help on the supply side—policies to boost potential growth, and thereby afford the expansion extra running room. There are elements of the tax plan that might help on this front, as may recent regulatory changes, but these kinds of supply-side benefits are hard to estimate and likely take time to come to fruition. The earmarked spending increases, by contrast, are apt to provide an immediate lift to demand, but little long-term benefit as they contain few initiatives that might help lift potential output (e.g., infrastructure). What's more, even under optimistic assumptions about the growth effects of the tax package, the fiscal changes are almost sure to worsen the government's already daunting long-term fiscal challenges, likely necessitating more federal borrowing that could eventually crowd out private, productive investment.

— All told, we're reluctant to expect a supply-side miracle. We are anticipating some improvement in potential growth as productivity rebounds from unusual weakness, aided in part by a strengthening of business investment, and as tight labor markets coax some more people into the labor force and prompt firms to search even harder for efficiencies, but these additions are apt to be incremental—sufficient perhaps to mitigate but not fully offset other structural drags, including demographics.

— And the looming specter of protectionism could undermine potential growth. So far, the announced trade restrictions are too small and concentrated to have much adverse macro impact. But if they are the opening salvo of a broader trade war, their deleterious effects would be amplified. That's not our expectation, and recent conciliatory talk from the U.S. and China (and progress on NAFTA) make us more confident that negotiated settlements are likely, though risks of less benign outcomes can't be dismissed.

— Absent a substantial improvement in the economy's potential, it will be hard to sustain recent rates of growth, let alone much acceleration, now that the economy's spare capacity has largely been absorbed. Indeed, labor markets seem close to full employment already. Still, wages continue to accelerate only modestly, allaying concerns about imminent overheating. But if labor markets tighten further, as we expect, wages pressures will likely continue to build, if still gradually.

— That should help cement the move of inflation back to the Fed's target. Recent inflation readings suggest we're almost there already, reinforcing our view that some of the slippage a year ago reflected transitory factors, that inflation would rise back close to target as these temporary restraints faded, as the effects of diminished slack and gradually accelerating labor costs made themselves felt, and as inflation expectations remained generally well anchored. The recent rise in energy prices should provide a temporary lift as well. But fears of an inflation surge seem overblown given the stickiness of inflation expectations, the recent strengthening of the dollar, and the modest responsiveness of inflation to diminished slack.

## Monetary-policy outlook

- With both of their dual-mandate objectives in sight, and the outlook suggesting growth will remain above potential for a while, Fed policymakers are increasingly confident that reducing policy accommodation is the proper course—that failing to do so would risk stoking the kinds of excesses and imbalances that might necessitate a more abrupt and potentially destabilizing policy tightening later on. In other words, easing the foot off the monetary accelerator now—and perhaps before long even gently tapping the brakes—make it less likely the Fed will have to slam on those brakes later.
- However, there are also still reasons for the Fed to tread carefully—to be cautious in removing accommodation. For one, the neutral rate is likely to remain below historical norms (albeit edging up from post-crisis lows), suggesting that it won't take as many rate hikes as in the past to restore a neutral stance (or to move into restrictive territory, if need be). Moreover, though inflation is back near target, it does not seem in danger of sharply overshooting, and given that it has run too low for years, it is important that it return to 2% and stay there (if not a bit above for a while), to ensure that 2% is viewed not as a ceiling but as the symmetric target it truly is, so that expectations remain firmly anchored near the Fed's objective. Finally, financial conditions have begun to tighten a bit, hinting that the Fed may finally be starting to get some traction in tamping down what has been a key tailwind to growth.
- How policymakers balance these competing arguments depends of course on how the economic outlook evolves. Our take remains that further modest tightening of labor markets and financial conditions, coupled with clearer evidence that inflation has returned to target and is staying there (but not materially overshooting), will keep policymakers inclined to remove policy accommodation, though not aggressively by historical standards. That's apt to include not only continued balance sheet reduction, but also further rate hikes, with the next 25 basis points almost certain to come at the June Federal Open Market Committee (FOMC) meeting, followed by a fairly steady pace of moves beyond that, taking the funds rate back to 3% or so by later next year, with a cumulative balance sheet reduction of about $1 trillion—moving policy back to at least a neutral stance, with the possibility of moderate restriction to come.
- The tricky part will be tightening enough to cool activity to a more sustainable pace—or even a bit slower for a while if labor markets materially breach full employment—but not so much as to prompt a downturn. Threading that needle will be no mean feat.

## Financial market outlook

- The economic backdrop of continued solid growth remains broadly favorable for risk assets and a slight weight on Treasury prices. If trade frictions continue to recede, that would reinforce these trends as well.
- But worries about sustainability lurk beneath the surface. The longer the economy grows above potential, the tighter labor markets become, and the more the Fed hikes, the more likely financial markets may fret that the party won't last.

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Definitions

One **basis point (bp)** equals 1/100 of a percentage point. The **Federal Open Market Committee (FOMC)** is a committee that oversees the open-market operations of the U.S. Federal Reserve. **The gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. **The North American Free Trade Agreement (NAFTA)** is an agreement among the United States, Canada and Mexico designed to remove tariff barriers between the three countries. The **U.S. Federal Reserve (Fed)** implements U.S. monetary policy.

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