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VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

by Thomas Goho, Ph.D.

JULY 2019

A “Goldilocks economy” is the term many economists and media pundits use to describe America’s current economic condition. Like Goldilocks’ porridge, the U.S. economy is neither too hot nor too cold. The thinking is there is neither too much inflation nor too little growth.

The current American economic expansion will set a longevity record of 121 months if, as expected, it continues until the end of July 2019. But will the business cycle continue running neither too hot nor too cold? In this issue of Viewpoint, let’s assess the condition of the American economic porridge.

Economic Growth

U.S. economic growth is showing signs of possible sluggishness in the second half of 2019 after several quarters of solid growth.

In 2018, the U.S. economy grew at a brisk pace with real Gross Domestic Product (real GDP) achieving a growth rate of 3%. Growth did slow in the fourth quarter to a lukewarm 2.6%.

That fourth quarter weakness in growth reversed in the first quarter of 2019 with a solid 3.2% quarterly improvement. (*See Figure 1.*) Some of the improvement is attributable to a significant buildup in business inventories that added .65% to the quarter’s growth rate. Without the inventory buildup, growth would have been a still respectable 2.55%.

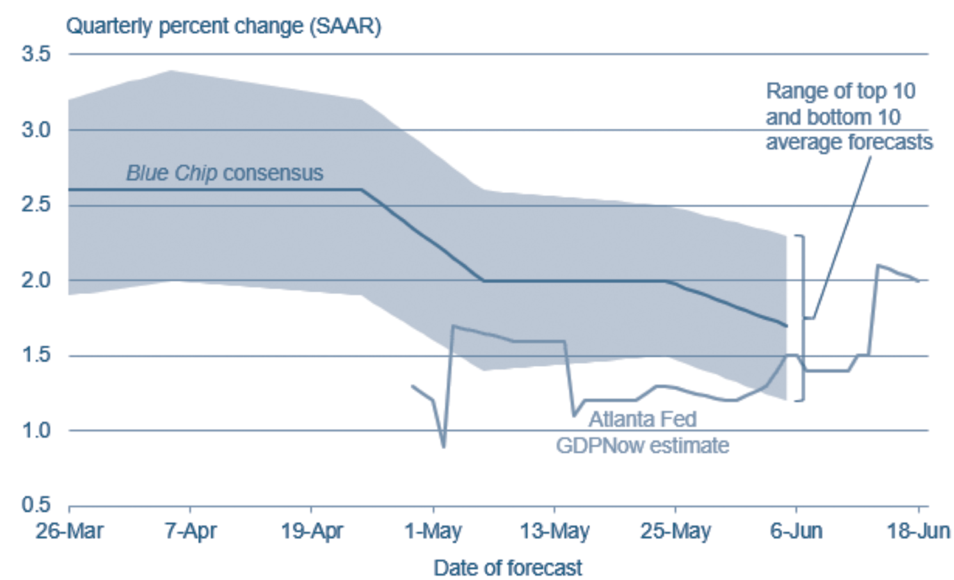
In recent years, a significant inventory build in one quarter is often followed by an inventory drawdown that produces a weakness in growth the next quarter. Primary forecasts of second quarter 2019 growth point to a weakening in underlying American growth.

Figure 1:
Real Gross Domestic Product, 2010 to Present.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database. Extracted from the database on June 3, 2019.

The Federal Reserve Bank of Atlanta's forecasting model suggests second quarter growth of about 2.0%. (*See Figure 2.*) The Atlanta Fed forecast is higher than several other economic growth models such as the Blue Chip consensus, which shows growth of slightly above 1.7%

Figure 2:
Federal Reserve Bank of Atlanta, Q2 2019 Forecast of Real Gross Domestic Product.



Source: Federal Reserve Bank of Atlanta. GDPNow. June 18, 2019.

If the Atlanta Fed's forecast is correct, economic growth in the first half of 2019 will revert to the relatively weak growth of the first eight years of the recovery instead of the robust expansion of the past two years. The New York Fed's model predicts lower second quarter growth of about 1.4%

Major sources of weakness in U. S. economic growth in early 2019 include at least the following conditions:

- Inventory buildup added to real GDP in the first quarter of 2019, as noted above, but is likely to subtract from future growth as businesses reduce possible excess inventories. A reduction in inventory could reduce growth by almost one percentage point.

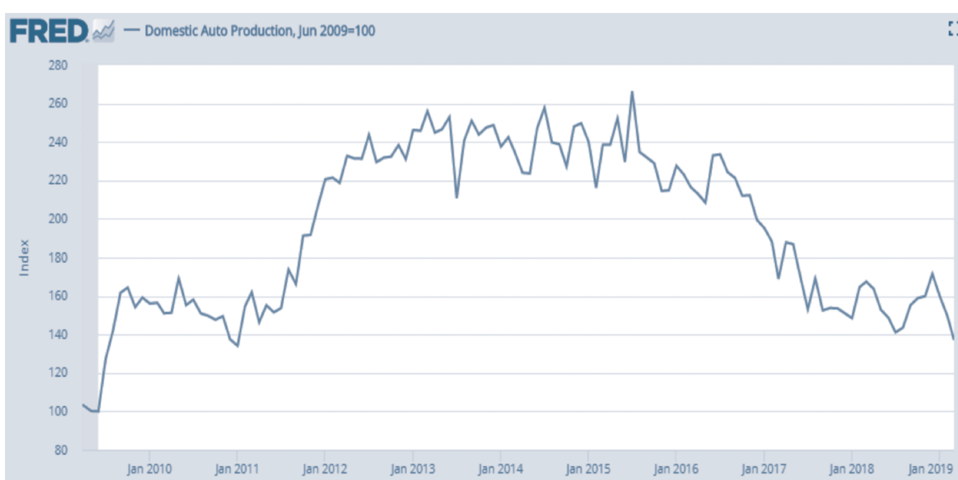
- American industrial production is slowing. (*See Figure 3.*) In the most recent quarter, the index of industrial production turned negative, indicating a reduction in industrial output. It seems companies sped up orders in earlier quarters to avoid the impact of tariffs on Chinese imports. Now businesses are working down those inventories producing a lull in current industrial production growth.

Figure 3:
Quarterly Change in Industrial Production Index, 2009 to Present.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database. Extracted from the database on June 3, 2019.

- Domestic auto and light truck production is a critical component of industrial output. Output, as measured by the index of domestic auto production, has flagged in the past several quarters generating a drag on industrial production. (*See Figure 4.*)

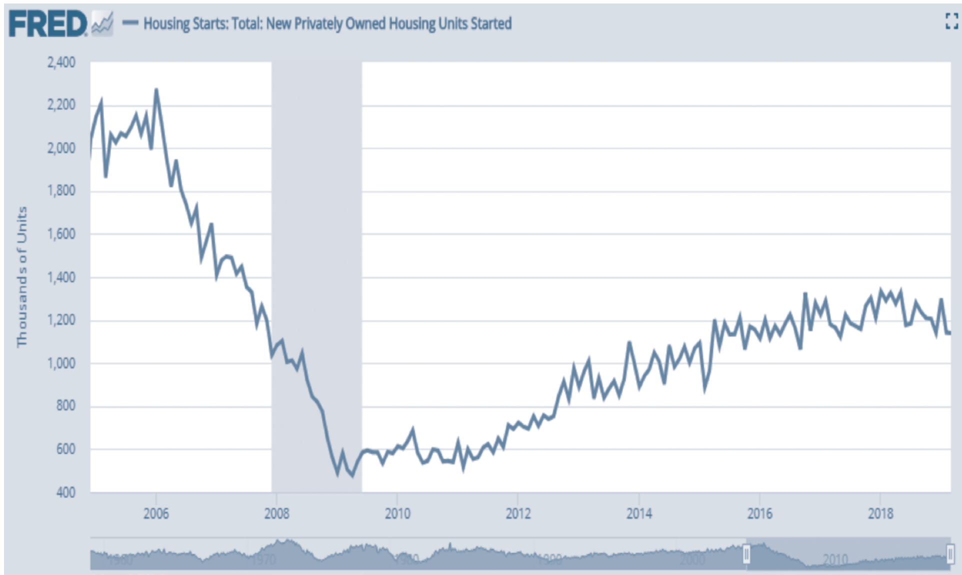
Figure 4:
Index of Domestic Auto Production, 2009 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database. Extracted from the database on June 3, 2019.

- The housing sector is also contributing to recent economic tepidness. Housing starts plateaued at an annual rate of slightly less than 1.3 million units per year since 2017. (*See Figure 5.*) The current annual rate of starts is far better than the .5 million units in the depths of the financial crisis but far lower than the 2.2 million unit rate before the financial crisis.

Figure 5:
Housing Starts, Privately Owned Housing Units Started (Seasonally Adjusted.), 2005 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database. Extracted from the database on June 3, 2019.

In other words, housing investment is a volatile component of real GDP and has not been a positive growth factor in recent quarters. The housing sector is unlikely to boost economic growth in the first half of 2019.

Best Guess About Economic Growth

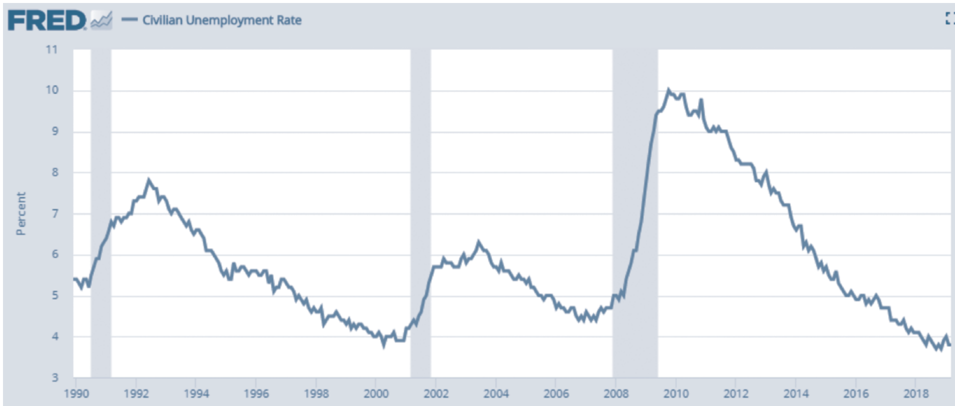
Most government and private economic growth forecasts for the first half of 2019 predict lukewarm "porridge"—growth between 1.4% and 2.0% with the second quarter's GDP likely to be the low point for the year. Growth should accelerate to 2.5% for the final two quarters of the year on strength in consumer spending and ongoing Federal spending.

This yearly growth rate will not match the post-tax cut growth of 3%. But the full-year of 2019 should not mark the end of this expansion. The current expansion will without a doubt set a longevity record in July 2019.

Employment and the Labor Force

Most measures of employment conditions indicate that labor markets remain healthy. The unemployment rate remains at a multi-decade low of 3.6%. (*See Figure 6.*) All sectors of the labor force had increases in employment since the recovery began in July 2009.

Figure 6:
The U.S. Unemployment Rate, 1990 to Present.



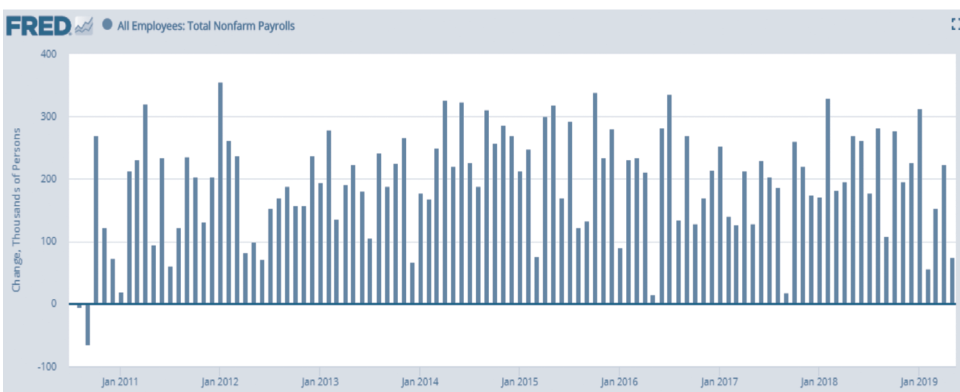
Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database. Extracted from the database on June 3, 2019.

The manufacturing sector has experienced the weakest job growth. Since the recovery began, manufacturing has added about 1.0 million jobs. However, since 2000, manufacturing has lost about 4.5 million jobs in the United States—dropping from 17.3 million workers to 12.8 million.

Most of the job losses are a result of increased automation in manufacturing processes. Globalization of manufacturing has also been detrimental to American workers contributing to American job attrition.

For the entire economy, approximately 20.3 million jobs were added in the 120 months of jobs' expansion—an average gain of 168,000 per month. (*See Figure 7.*) In the most recent month, businesses created 75,000 new jobs across many sectors of the economy except for manufacturing, which was little changed.

Figure 7:
Monthly Changes in Nonfarm Payrolls, 2010 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database. Extracted from the database on June 24, 2019.

While job growth continues its positive trajectory, hourly wage growth continues to be weak. A Bureau of Labor Statistics report showed anemic wage growth in May of .2%. For the year, average wages have increased by 3.1%, a rate in excess of inflation which is under 2%. Workers are gaining ground relative to inflation, but the gain is meager at best.

The recent gains in wages are fairly widely distributed among workers, but surprisingly one group has experienced the largest benefit. According to a study by *The New York Times*, the lowest wage earnings saw the largest wage gains over the past 12 months (through March 2019). Low-wage workers in states with increases in the legal minimum wage appear to have disproportionately benefited from those increases. (*See Figure 8.*) In addition, the highest wages earners, those in the top 25%, saw smaller wage increases than the lowest wage earners.

Figure 8:
Median Annual Wage Growth in the Last 12 Month through March 2019.

Total Wage Gain	3.5%
Lowest 25% in Wages	4.4
Top 25% in Wages	3.0
Full-time Workers	3.6
Part-time Workers	2.5
Low-skill Workers	3.2
Medium-skill Workers	3.4
High-skill Workers	3.6

Source: The New York Times.com. "Why Wages Are Finally Rising, 10 Years After the Recession." (by Ben Casselman.) May 2, 2019

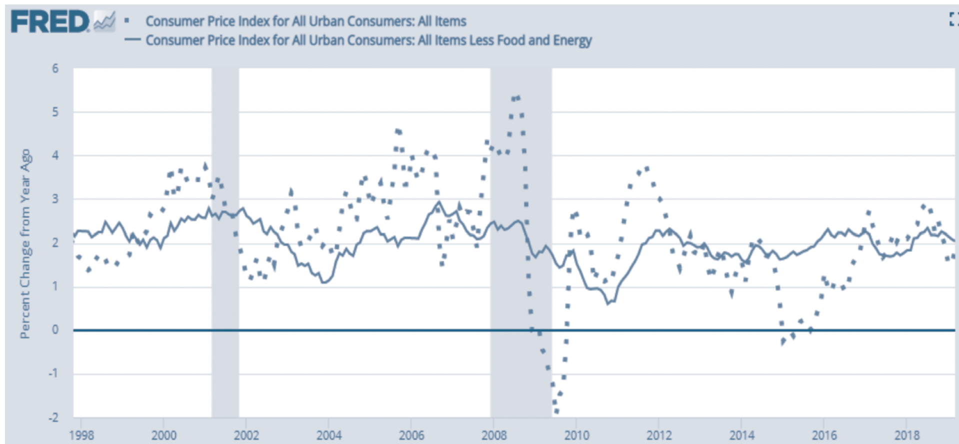
Best Guess About Labor Markets and Employment

Labor markets and employment are generally "hot". The unemployment rate is about as good as it gets, job creation is solid, and real wage growth is helping most American workers. The unemployment rate should stay under 4% for the remainder of the year. Even formerly marginal employable workers are finding work, such as individuals with criminal and/or drug issues. These positive conditions are likely to continue for the rest of the year barring any unexpected decisions from Washington, D.C.

Inflation and Price Levels

The Federal Reserve and investors in recent years have worried about rising inflation given the tightness of labor markets. In past recoveries, an unemployment rate of 3.6% as seen in May 2019 would have set off alarm bells about the future direction of American inflation. These inflationary pressures simply are absent from most price indices. (*See Figure 9.*)

Figure 9:
Headline and Core (excluding food and energy) Consumer Price Indices, 1998 to Present.

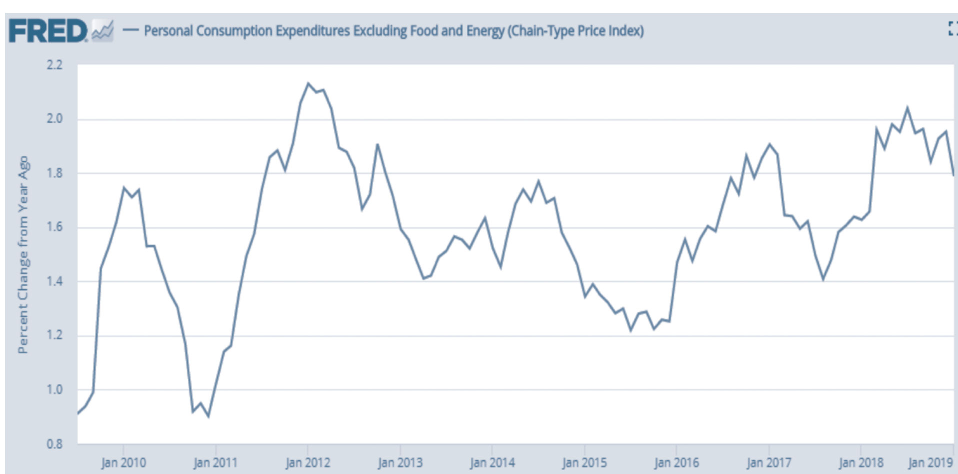


Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database. Extracted from the database on June 24, 2019.

The Consumer Price Index (CPI) is not showing any data that could generate concerns for either the Federal Reserve's Open Market Committee (FOMC) that sets monetary policy or for stock and bond market participants. Inflation is running at a rate of about 2%, which is right at the FOMC's target rate of inflation.

A more dynamic measure of inflation, the Personal Consumption Expenditures Price Index (PCE) that excludes food and energy, is the Federal Reserve's preferred measure of inflation. (*See Figure 10.*) The PCE is running at a rate under 2% and has been under 2% for most of the 10-year economic expansion. Just like the CPI, the core PCE data should encourage the Fed to leave monetary policy largely unchanged at least for the next several quarters.

Figure 10:
Personal Consumption Expenditures Price Index (excluding food and energy), 2009 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database. Extracted from the database on June 24, 2019.

In recent statements, the Federal Open Market Committee has indicated that it might even tolerate inflation at a rate somewhat above its stated goal of 2%. Market participants seemed to have interpreted these statements to mean that the FOMC might even support lowering its target interest rate rather than raising rates as was expected at the end of 2018.

Markets are now pricing in a 64% chance that the FOMC's next move in July will be a single rate cut of .25%. This is a 180 degree turn from late December 2018 when the Fed indicated that two or three rate increases could be possible in 2019.

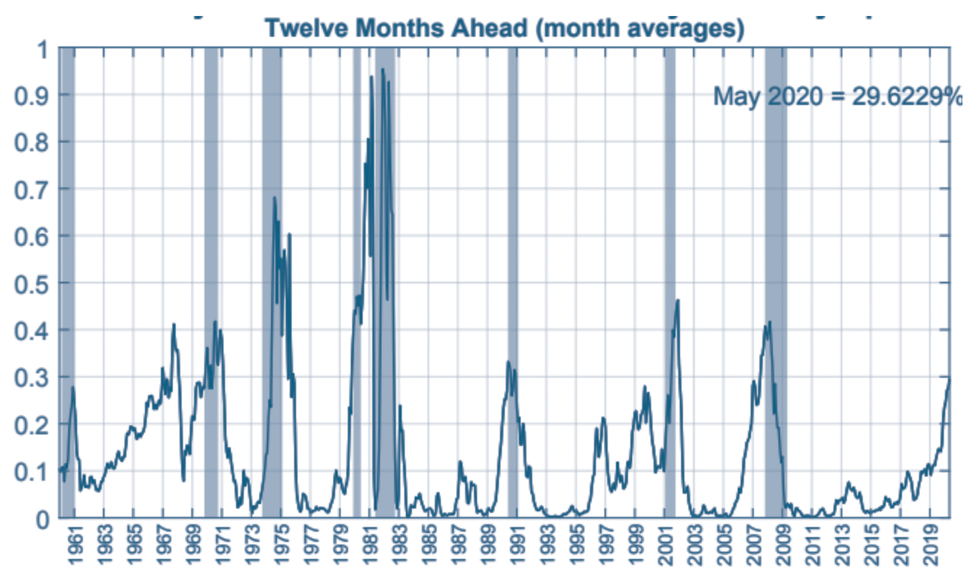
Best Guess about Inflation

The economy is showing scant signs of inflationary pressure. I expect inflation will remain calm for the remainder of 2019 and early 2020. This expectation is based in part by the lack of significant wage inflation. In addition, raw materials costs for a wide range of commodities are actually falling not rising. Overall consumer price increases should be lower than the Federal Reserve's target of 2% per year.

Risks of Recession

The Federal Reserve Bank of New York forecasts the probability of a recession in the next 12 months by examining the relationship between short-term and long-term interest rates. (*See Figure 11.*) Using that metric the Bank estimates the likelihood of a recession in the next 12 months is slightly less than 30%. This measure has a strong record in predicting recessions, but I think in this case the model is too pessimistic.

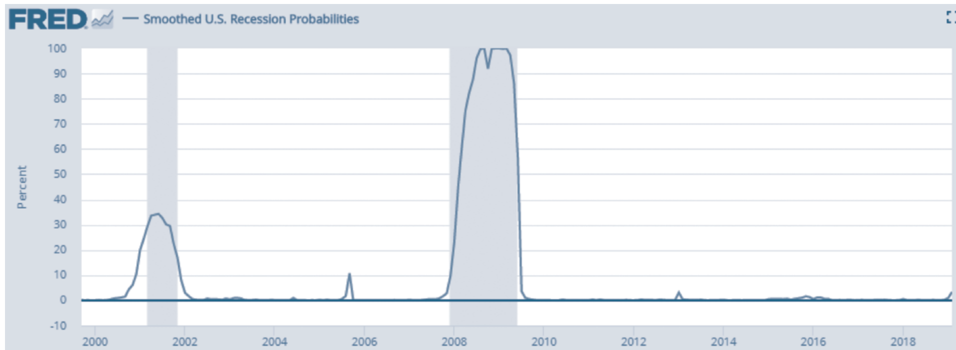
Figure 11:
Probability of Recession in the Next 12 Months.



Source: Federal Reserve Bank of New York. "Probability of Recession and Predicted Real GDP Growth." June 4, 2019.

The St. Louis Fed's recession model is more optimistic. Its recession forecast includes a broad range of economic conditions including employment, industrial production and retail sales. Its model suggests the probability of a recession in the next 12 months is close to zero. (*See Figure 12.*)

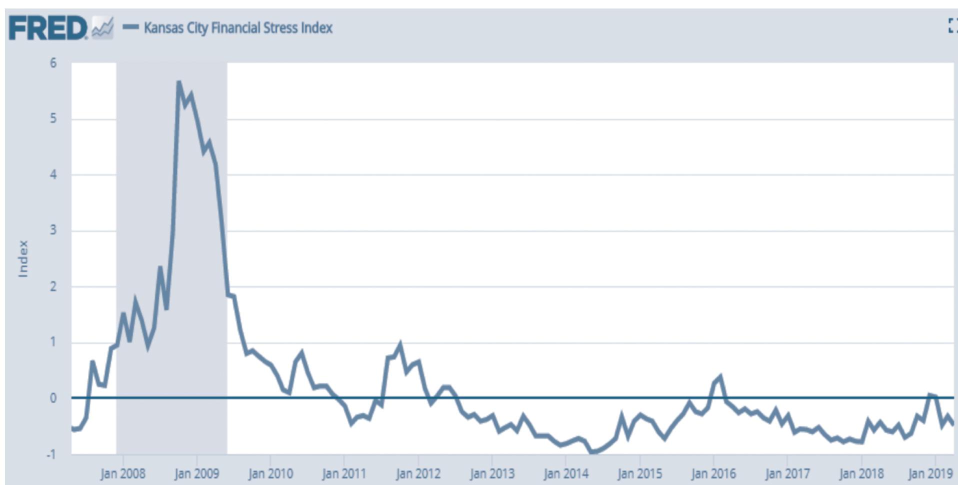
Figure 12:
Probability of Recession in the Next 12 Months.



Source: Jeremy Piger and Marcelle Chauvet. "Smoothed U.S. Recession Probabilities." Extracted from the St. Louis Federal Reserve database (FRED). April 9, 2019. Updated June 4, 2019.

A factor that often signals the end of an economic expansion is a build-up of financial stress in a country's economic system. At present, there is scant evidence of severe financial stress that was so instrumental in the financial crisis in 2008 and 2009. The Kansas City Federal Reserve's Financial Stress Index supports that observation. (*See Figure 13.*) Its model that includes 11 economic and financial variables is not indicating financial problems for the economy.

Figure 13:
Kansas City Fed's Financial Stress Index, 2007 to Present.



Source: The Federal Reserve Bank of Kansas City. Financial Stress Index. Extracted from the FRED database June 3, 2019.

Other Federal Reserve Banks' models are signaling modest financial stress indications for the economy which should be reassuring for investors and monetary policy decision-makers. One caveat worth mentioning is a recent statement of Federal Reserve chairman, Jerome Powell. He expressed concern about the level of business debt for a growing number of American companies. So far, that high level of corporate debt is not showing up as a problem in the financial stress indicators.

Best Guess on a Recession

At the beginning of 2019, the probability of a recession was closer to the St Louis Fed's forecast of zero likelihood than the Cleveland Fed's prediction of 33%, but now a recession is clearly possible given the unpredictable nature of decision-making in Washington. It is premature to think that any of America's trade disputes have been settled. Most importantly, the trade issues with China are still in limbo and will remain that way for the foreseeable future.

Trade agreements are complex documents and will not be settled with a photo shoot and a handshake. Many issues with Mexico, Canada, the European Union, Japan and China remain unresolved, and they create the conditions for a slide into a recession.

Final Thoughts

The American economy remains in a Goldilocks environment—not too hot and too cold. Economic conditions are permitting the Federal Reserve to sit tight with monetary policy, neither raising nor lowering interest rates significantly. Numerous conditions in the economy should be encouraging for investors.

- Unemployment is at a multi-decade low.
- Monthly job creation is strong.
- Wage growth exceeds the rate of inflation, raising real household incomes.
- Inflation is well within the norms of monetary policy makers.
- Financial distress is not evident in businesses or households.

The current economic expansion should continue for the remainder of 2019 and possibly beyond. Growth of about 2.5% is quite reasonable for all of 2019. An abrupt end to this healthy economy with solid growth, strong employment and low inflation could certainly be precipitated by misguided decisions in Washington D.C. Still growth is likely for the remainder of the year, but that rate of growth is likely to weaken as trade issues linger.

The imposition of additional tariffs on Chinese imports could be the first step in the wrong direction. Tariffs create uncertainty for American businesses and consumers. In time, the added costs of those higher tariffs on Chinese goods will likely ripple throughout the economy. The Fed's neutral stand on interest rates could be called into question.

Most forecasters think that a full-blown trade war with China would result in a reduction in U.S. real GDP growth ranging from 0.1% to 0.5%. A trade war would slow global growth according to almost all respected organizations, including the International Monetary Fund and the Organization for Cooperation and Development. The effects of slowing global growth would ultimately ripple back into the American economy with unknowable long-term effects.

In the fairy tale, Goldilocks escaped from the bears unscathed. The American economy may not be so lucky if trade and tariff wars persist in late 2019 and into 2020. Most economists are sanguine that these issues will be manageable, meaning that the U.S. can absorb the consequences of trade and tariff warfare over the long run. Some of us are less optimistic that our "fairy tale" will have such a long-term happy ending. Trade wars rarely have a fairy tale ending.

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