Stephens

VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

by Thomas Goho, Ph.D.

JANUARY 2020

A new decade is upon us bringing with it a flurry of election year excitement and political analysis. The economic health of the United States could be an important factor in both the presidential and congressional elections. Most analysts believe that a strong economy could provide tailwind for Republicans in key battleground states. Likewise, a sluggish and/or recessionary economy would favor Democratic candidates up and down the ballot.

This issue of *Viewpoint* evaluates current economic conditions and speculates on the course of the economy over the next 12 months.

- Will economic growth be robust in 2020?
- Will workable and sustainable tariff agreements be signed that stabilize fragile international trade relationships?
- Will price inflation remain in check?
- Will the robust labor market maintain its strength?
- Will the Federal Reserve support accommodative monetary policy or will it pull back the reins on money creation?

Let's examine the current economic environment.

American Economic Growth

President Trump came into office in 2017 with a campaign promise to jumpstart the American economy. He asserted that his policies of lower taxes, a firm trade policy and less regulation would provide the boost needed to raise America's languid economic growth rate to a robust 3% to 4%. Third quarter 2019 real Gross Domestic Product (GDP) grew at an anemic 1.9%. (*See Figure 1.*)

The real GDP growth rate in the final 3 years of the Obama administration averaged 2.3%. In contrast, Trump's growth in his first 3 years was slightly better at 2.6% but short of his stated goal. On the one hand his tax cut and policies to deregulate business appear to have helped growth in 2017. But his recent trade policies have massively disrupted business supply chains and corporate capital investment decisions.

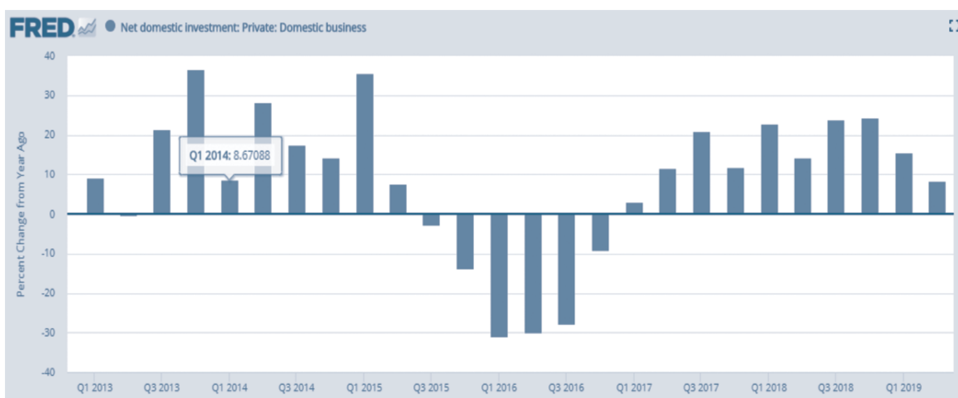
Figure 1:
Real Gross Domestic Product Growth from Q1 2014 to Q3 2019.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

Business Investment

The negative effects of Trump's trade policies appear to have slowed business investment. (*See Figure 2.*) This outcome is unfortunate because strong business investment was sorely needed to bolster growth. In late years of the Obama administration, business investment had tanked. The tax cuts in 2017 reversed that situation and an investment recovery began. But as trade disputes with China, the European Union, South Korea and other countries intensified, business investment flagged. (*See the last two quarters in Figure 2.*)

Figure 2:
Net Domestic Investment, Private Domestic Investment from Q1 2013 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

Industrial Production

Industrial production is almost a carbon copy of the changes in business investment. Production languished at the end of the Obama years, but with the tax cuts in 2017 industrial production rebounded. (*See Figure 3.*) Then as tariff and trade issues with our major trading partners increased, industrial output sank in recent quarters.

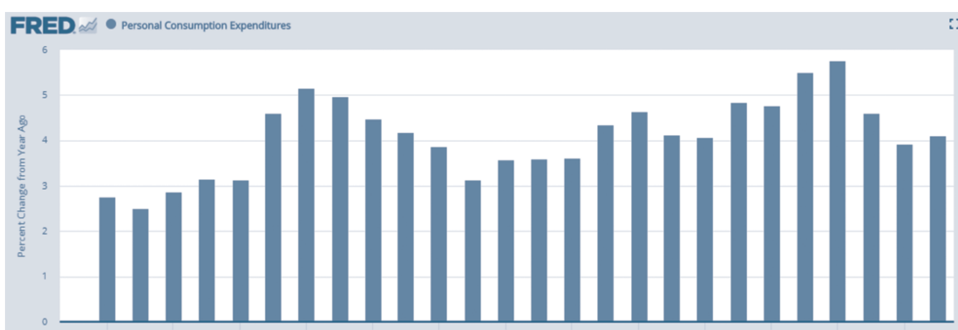
Figure 3:
Monthly Changes in the Index of Industrial Production, Q1 2013 to Present.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

Consumer Spending

Even as the economy struggles with tepid performance in the business sector, one key element of the economy continues apace. Consumer spending, through thick and thin, remains a significant factor in GDP growth. (*See Figure 4.*) Household spending is growing at a rate of about 4% per year in an economy with inflation at a sub 2% level. In other words, real inflation-adjusted spending is strong. Importantly consumer spending constitutes almost 70% of GDP.

Figure 4:
Personal Consumption Expenditures from Q1 2013 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

American households, for the time being, seem to be oblivious to the contentious trade and tariff discussions that are occurring in Washington, Beijing, Brussels, Mexico City, Ottawa and other political centers around the world. Some, but not all, of these trade issues may be resolved in the coming months.

Best Guess About American Economic Growth

The powerful forces of economic disruption caused by erratic trade and tariff decisions emanating from Washington are real and dangerous for economic growth. These negative forces have yet to ripple into household decisions. But those forces are insidious, and they are slowly seeping into households. As households feel these effects economic growth will slow, and the promises of a supercharged American expansion will be unfulfilled. Growth of 3% to 4% will not materialize in 2020. Instead the most likely course is Obama-like growth of 2% or less.

GDP Growth Forecasts for Q4 2019

Federal Reserve of Atlanta GDP Nowcasting	1.3%
Federal Reserve of New York GDP Nowcasting	0.8%
Federal Reserve of Philadelphia (Survey of Economists)	1.7%

GDP Growth Forecasts for 2020

The Conference Board	2.0%
Federal Reserve Bank of Chicago Survey	1.9%
World Bank	1.5%
Bloomberg Economics	2.0%
Organization for Economic Development and Cooperation	2.0%
International Monetary Fund	1.9%
Federal Reserve of Philadelphia (Survey of Economists)	1.8%

Until trade and tariff issues are really resolved, sub-par growth is a reality for the American economy. My growth estimate agrees with several forecasting groups where economists see growth trending in the fourth quarter of 2019 about 1.25%. American growth in 2020 should be about 1.8%.

The trade disputes need real solutions, not tweets and stopgap solutions that paper over fundamental differences in trade relations. The recent first step on a Chinese trade agreement is nothing more than a “baby-step” to address the U.S.-China trade morass. Likewise, the potential trade agreement to replace NAFTA is still subject to final revisions.

Employment and Labor Markets

American workers have yet to feel the effects of a slowing American economy. Almost all indicators of labor market health remain encouraging for job seekers. Republican candidates should be pleased that the unemployment rate remains near a multi-decade low. (*See Figure 5.*) From a high over 10% at the end of the financial crisis, the civilian unemployment rate is now 3.6%.

Figure 5:
Civilian Unemployment Rate from July 2009 to Present.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

This low unemployment rate carries across almost all demographic groups:

- Whites, Blacks, Hispanics and Asians
- Males and females
- Young, prime-working age and the elderly workers
- Full-time and part-time employees
- High school dropouts, high school graduates, those with some college, college graduates, or graduate degrees

Given the low unemployment rate, Democratic candidates struggle to find talking points about labor market conditions. However, they do point to two supposed weaknesses in the economy. First, there are still many workers who are only marginally attached to labor markets. They are either unemployed or working part-time but would like to be employed fulltime. This condition, called the U-6 measure of unemployment, has dropped significantly from its peak of 17.1% at the end of the fiscal crisis Like American narrow measures of unemployment, the U-6 measure is near a multi-decade low, 6.9% in November 2019. (*See Figure 6.*)

Figure 6:
Broad Measure of Unemployment Rate (U-6) from 2000 to Present.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

Real Wages

The second Democratic talking point on labor market conditions is the slow growth in workers' real wages—wages after accounting for inflation. Real wages for American workers stagnated since the start of the recession, and though wages are now growing it's at a sluggish rate. (*See Figure 7.*) From 2002 to the present, real weekly wages for the typical American worker are up in total about 4%. Over a 17-year period this is a pretty dismal performance.

Figure 7:
Median Weekly Real Wages for Full-Time Workers, 2002 to Present.

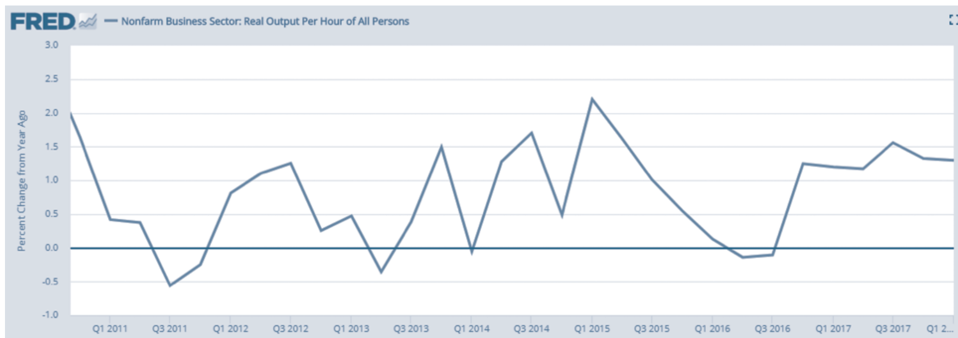
Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

Since President Trump took office real weekly wages have begun to accelerate such that American workers are seeing an increase in their standard of living. Higher real wages undermine the Democratic argument of wage stagnation—at least in the past 3 years.

Labor Productivity

Real wages are inextricably linked to the labor productivity, and the facts suggest lackluster labor productivity in recent years. By almost any metric, growth in American labor productivity has languished since the financial crisis. The result was and is slow growth in workers' real wages. (*See Figure 8.*) Average increases in productivity have averaged less than 1%. Businesses resist wage increases when productivity does not support those increases.

Figure 8:
Private Non-Farm Business Sector Output Per Hour, 2010 to Present.



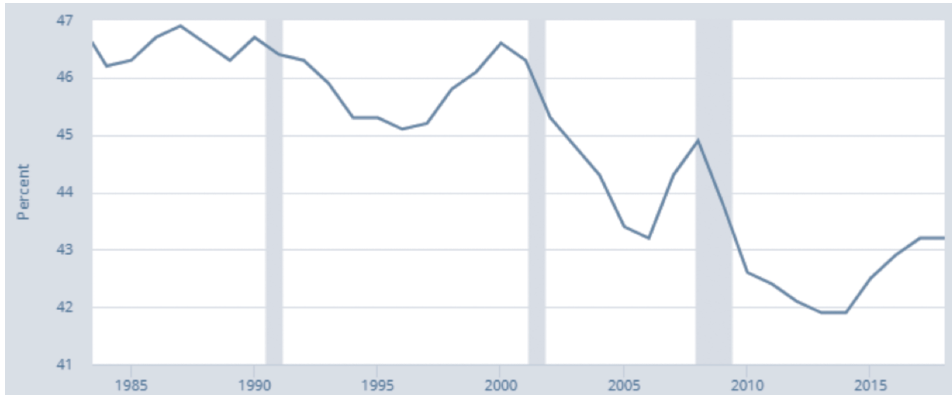
Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

The causes of slow productivity growth induce politicians across the political spectrum to trot out their pet theories to explain the problem, but the fact remains that labor productivity and growth in real wages have suffered in recent decades.

The labor component of the American "economic pie" has shrunk over the past several decades. Labor's share of gross domestic income has fallen significantly since the Reagan presidency. (*See Figure 9.*) During his administration labor's share of domestic income was almost 47% of the economy. Today it is slightly more than 43%.

Although Democratic candidates may not use the term "Share of Gross Domestic Income," their political rhetoric implies that workers are not receiving a "fair share" of America's economic pie. Politicians cannot argue truthfully that current labor markets are weak nor that real wages are not increasing for the first time in several years, but they can and will argue that labor's share of American output is shrinking.

Figure 9:
Wages and Salaries as a Share of Gross Domestic Income from 1983 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

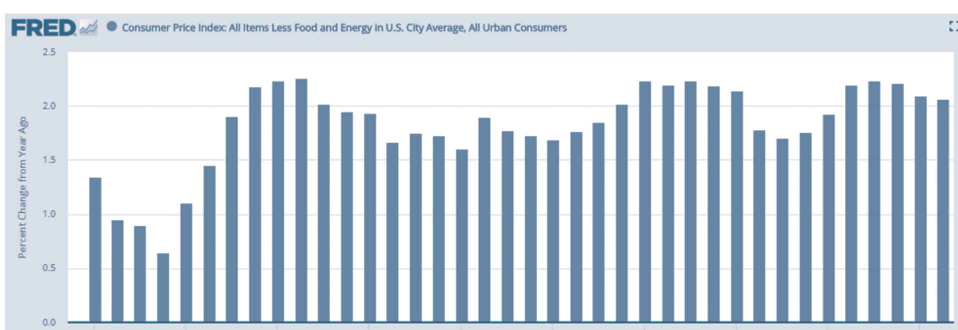
Best Guess About Employment and Labor Market Conditions

Just as economic growth will slow in 2020 so too will employment gains. Job openings should remain plentiful, but not as healthy as 2017 to 2019. The unemployment rate will probably edge up slightly as uncertainties surrounding trade and tariffs persist with major trading partners. Businesses will become increasingly cautious in their hiring decisions. The unemployment rate will likely tick up to 4%, especially if decisions from Washington remain erratic and unpredictable.

Price Level and Inflation

Throughout the trade and tariff turmoil emanating from Washington decision makers, the American consumer remains fortunate that inflationary pressure remain muted. In general, businesses have absorbed higher costs tied to tariffs on Chinese goods rather than passing them on to consumers. Inflation, since the end of the fiscal crisis, hovers around 2%. (*See Figure 10.*) This measure of inflation excludes food and energy prices that are volatile components of the consumer price index (CPI).

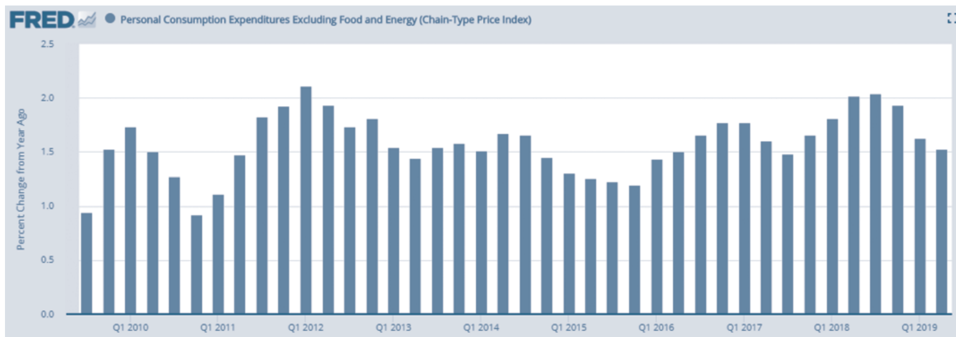
Figure 10:
Consumer Price Index, Excluding Food and Energy, from Q1 2010 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

The Personal Consumption Expenditure Price Index (PCE), excluding food and energy, is also relatively quiescent. (*See Figure 11.*) This price index is the Federal Reserve's preferred measure of inflation. On a quarterly basis the PCE has exceeded its target inflation rate only once in the last 10 years, in the first quarter of 2012. The PCE has averaged 1.6% in the last decade.

Figure 11:
Personal Consumption Expenditure Price Index, Excluding Food and Energy, from Q3 2009 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on December 18, 2019.

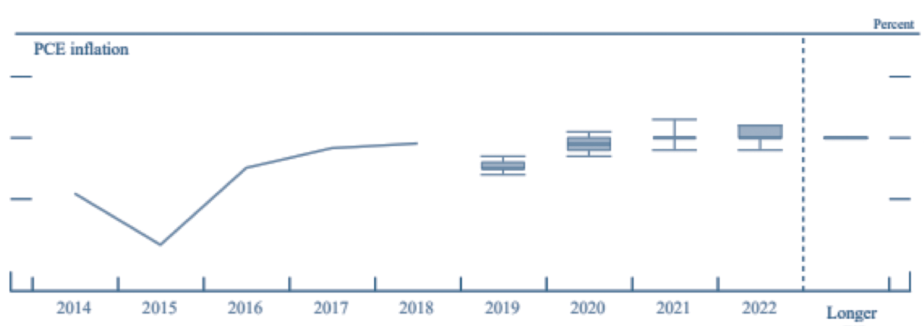
It is not surprising that the Federal Reserve reversed its monetary tightening policy in early 2019, shifting from higher short-term interest rates to lower rates. Inflation is not a problem at the present time even with the uncertainties surrounding tariffs against China and other trading partners.

Best Guess About Inflation

Unless the Trump administration acts at some point to impose large punitive tariffs on almost all Chinese goods, broad measures of inflation such as the core PCE should stay in a range of 1.6% to 2.2%. At the time of this writing, the American and Chinese trade negotiators appear to be making progress toward a modest trade agreement. An agreement would calm my concerns about near-term inflationary pressures.

The FOMC's current guess is that inflation will not be a problem any time in the coming years. (*See Figure 12.*) Its view calls for long-term inflation of close to 2%. Unfortunately, the FOMC has a mediocre track record in its forecasts of inflation---and most other economic outcomes. Still, Fed monetary policy will remain accommodative throughout 2020 with no rate increases expected.

Figure 12:
The Federal Open Market Committee's (FOMC) Forecasts of Core Inflation.

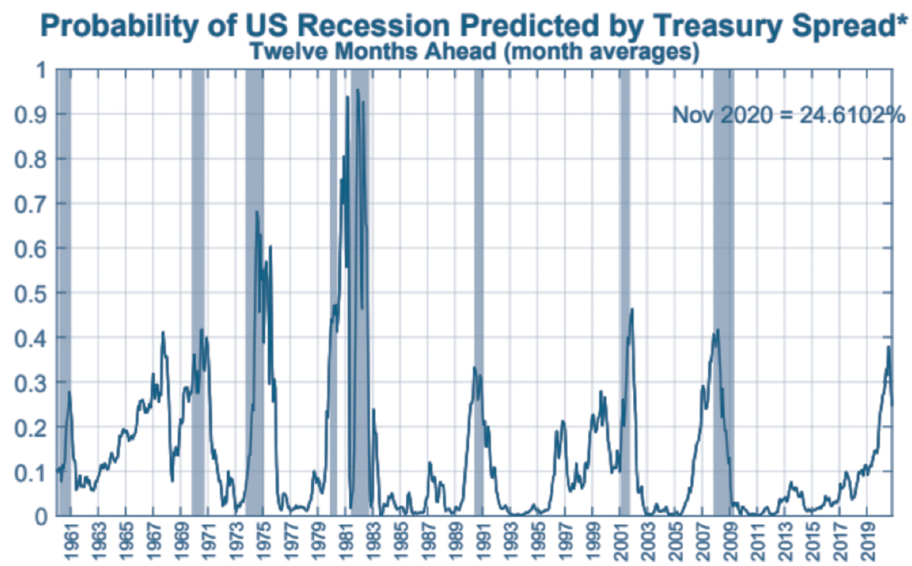


Source: The Federal Reserve Board. Summary of Economic Projections. Released September 18, 2019.

Final Thoughts

Since the end of the financial crisis in July 2009, economists have worried about the next recession. For the first time in 10 years that specter could materialize in 2020, but that is not my expectation. Households, investors and businesses need to hope for the best but prepare for the worst. The Federal Reserve Bank of New York's recession model places the odds of a recession in 2020 at one-in-four chance. (*See Figure 13.*) More sophisticated and dynamic models suggest a similar risk of a recession.

Figure 13:
Probability of U.S. Recession Predicted by Treasury Spread.



Source: Federal Reserve Bank of New York. "Probability of U.S. Recession Predicted by Treasury Spread." Updated December 5, 2019.

In a survey by the National Association for Business Economics, out of the more than 200 economists surveyed, 72% of them thought that the U.S. economy would enter a recession by 2021. They were almost evenly split as to when it would occur, 2020 (38%) or 2021 (34%).

A similar pessimism was reflected in a Zillow.com survey of over 100 economists. Half the economists thought a recession would commence in 2020 and another 35% thought one would start in 2021. There was general agreement that the catalyst will be trade issues rather than a real estate-driven downturn.

Readers need to be cautious of any economic forecasts of recessions. A recent International Monetary Fund study found that forecasts in 63 countries "miss the magnitude of the recession by a wide margin until the [recession] year is almost over." And that conclusion includes forecasts for the American economy as well as all the other 62 countries.

Final Guess for the U.S. Economy

Now that I have thoroughly impugned the skills of economic forecasters in America and around the world, let me venture out on a long limb and make one last guess about the economy in 2020.

Many conditions are suggesting that the world economy is moving in the wrong direction. These include:

- Slow or negative growth in much of the European Union, especially Germany.
- Uncertainty about the results of Brexit and the United Kingdom's ties to almost all its trading partners including the United States.
- Slowing growth in China, the world's second largest economy.
- Uncertainty about enduring American trade relationships with most of its important trading partners.
- Tepid corporate profitability growth in United States and other industrialized economies.
- Lack of solid political leadership in the U.S. given the impeachment process as well as impulsive presidential decision-making.

These factors could coalesce in 2020 potentially marking the near-end of this ten-year economic expansion. I expect that growth by mid-2020 will be dropping toward 1.8%. But I don't expect a recession in 2020. Solid consumer spending, healthy labor markets and some easing in trade tensions will keep the economy safe from a recession.

Investors abhor uncertainty, and 2020 is fraught with major political and policy question marks. The one shocking certainty in early 2020 is that the University of Alabama will not be competing for the national championship in college football.

Best wishes for a happy, healthy and prosperous new year.

Thomas Goho, Ph.D. is formerly the Chief Economic Consultant for Stephens Inc. He also served as the Co-Director of Stephens University at Wake Forest University. Tom enjoys a successful career in both education and business. He served as a professor of finance, Wayne Calloway School of Business and Accountancy, Wake Forest University for 30 years. Before retiring in 2007, Tom was the first to hold the Thomas S. Goho Chair of Finance. Tom also served on the Board of Directors of the Wells Fargo Family of Mutual Funds for 20 years, and also was on the Board of Directors of Lifepath Funds of Barclay's Bank. A former Certified Financial Planner, Tom earned his BS and MBA from Pennsylvania State University and his Ph.D. from the University of North Carolina-Chapel Hill.

Stephens

111 Center Street
Little Rock, AR 72201
501-377-2000
800-643-9691
stephens.com

linkedin.com/company/stephens-inc-
@Stephens_Inc
facebook.com/about.stephens

INVESTMENT BANKING • PRIVATE WEALTH MANAGEMENT • INSURANCE
INSTITUTIONAL EQUITIES & RESEARCH • FIXED INCOME • CAPITAL MANAGEMENT
PUBLIC FINANCE • PRIVATE EQUITY