The Outlook for the US Economy

Despite the trade war with China, robust consumer spending will underpin moderate economic growth

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1. Overview of the US economy

The real GDP grew 3.1% annualized quarter-over-quarter (QoQ) in January-March, accelerating from the prior quarter's 2.2% gain. Export growth picked up to 4.8% from 1.8%, while imports declined 2.5% following a 2.0% increase. Net exports contributed positively to GDP for the first time in three quarters, with the contribution rising 1.0 percentage point. Contribution from changes in private inventory also increased. Personal consumption expenditures (PCE), or consumer spending, rose 1.3% QoQ, slowing from a 2.5% gain in the prior quarter. Spending on durable goods including automobiles decreased on the back of the partial government shut-down through late January and the stock selloff around the end of 2018, as well as inclement weather. But solid spending on nondurable goods and services underpinned the overall consumer spending. Meanwhile, fixed non-residential investment, or capital expenditures, rose just 2.3%, slowing from 5.4% growth in the previous quarter as equipment investment fell off. Residential investment remained weak, sliding 3.5% to mark a fifth consecutive quarter of decline.

The economy appears to be expanding in the April-June quarter as well, albeit at a slower pace. While certain indicators such as industrial production and capital goods orders show weakness, retail sales – a key indicator of consumer spending – have picked up. The end of June will mark 10 years of sustained expansion for the US economy since the last trough in June 2009 -- matching the record 120-month streak of growth from the 1990s to 2001. How long the growth will continue is a key question for many. The US-China trade friction, which has drawn much focus lately, took a turn for the worse after US President Donald Trump moved in early May to resume tariff hikes for Chinese goods (Table 1). Until April, hopes had heightened that the two sides may find the middle ground through negotiation. The US-China rivalry for technology dominance over the medium- to long-term underlies the clash. And given the domestic conditions of each country, a fundamental resolution is unlikely in the short run.

Table 1: Latest Developments in US-China Trade Friction

Date	Summary
2019/5/5	President Trump announces tariff hike on $200 bn of Chinese goods
2019/5/10	Additional tariffs on $200 bn of Chinese goods rise to 25% from 10%
2019/5/13	US announces additional tariffs on $300 bn of Chinese goods China announces tariff increase on $60 bn of US goods (effective June 1)
2019/5/15	US announces effective ban on imports from major Chinese telecommunications company

Source: MUFG Bank Economic Research Office

Furthermore, tension over trade has erupted elsewhere. The Trump administration has threatened to impose 5% tariffs on all goods from Mexico, accusing the country of not doing enough to stem illegal immigration to the US. Mexico accounted for 14% of US imports in 2018, second only to China's 21% share.

In view of these developments, how to assess the strength of US economic fundamentals and the downward pressure from policy elements such as the trade war with China will be key to predicting future conditions.

As noted above, personal consumption expenditures -- which account for two thirds of the economy – faltered in some segments in January-March. But as personal income rises on the back of the improving jobs market, PCE is expected to remain resilient for the time being. The trade war is expected to have a limited impact given the relatively small share of trade in the US economy. Still, there is a great deal of unpredictability over: 1) how future negotiations will unfold and how each side will respond; and 2) potential impact on household confidence and business sentiment. As for the tariff threat to Mexico, the move was prompted not by trade matters but illegal immigration. And the Mexican government is open to discussing countermeasures with the US. So the current projection is that even if the tariffs are introduced, they are unlikely to stay long. Meanwhile, as the economic boost from Trump's initial fiscal stimulus package wears off, growth is expected to slow down to the vicinity of potential growth rate, estimated at just below 2% (Chart 1). Also to be watched closely is the national debt ceiling issue, which resurfaced in March. The issue has taken a back seat to the escalating trade war.

As for monetary policy, the Federal Reserve has retreated to the sidelines and is reviewing its policy framework internally. With the trade war and the Mexico tariff threat rekindling concerns over a global economic slowdown, market anticipation for a rate cut has driven down the treasury long-term rates considerably. Caution is now widespread in the financial market, which had regained stability. Yet the Fed is unlikely to move interest rates in either direction for the time being, as Federal Open Market Committee (FOMC) members see recent low inflation as "transitory". The Fed is unlikely to resume rate hikes at least until the end of next year because the ongoing review of the Fed's policy framework and the 2020 presidential election could sway policy directions.

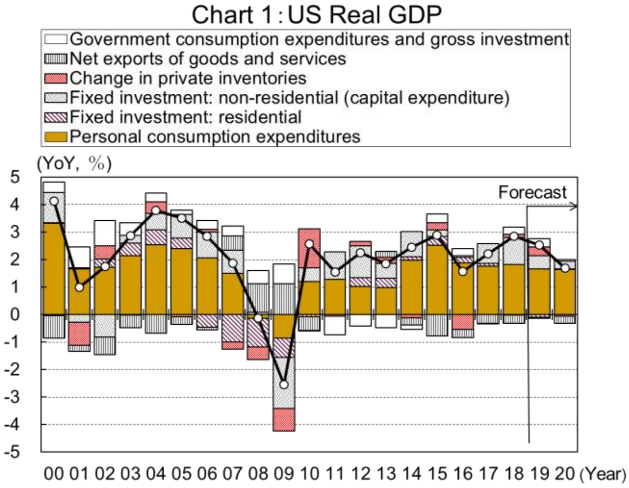
2. Key Points from the Outlook

1. CONSUMER SPENDING WILL REMAIN SOLID ON THE BACK OF GROWING EMPLOYMENT AND INCOME

Changes in retail sales – a key indicator of consumer spending -- and the Consumer Confidence Index suggest that the stock selloff around the end of 2018 and the partial government shut-down chilled consumer sentiment, which in turn dented retail sales. As consumer sentiment improves on rising personal income and the stock market recovery this year, retail sales have increased noticeably (Chart 2). Consumer spending is expected to hold steady as long as personal income remains robust, while consumer sentiment needs to be monitored closely in view of the US-China trade war and the Mexico tariff threat.

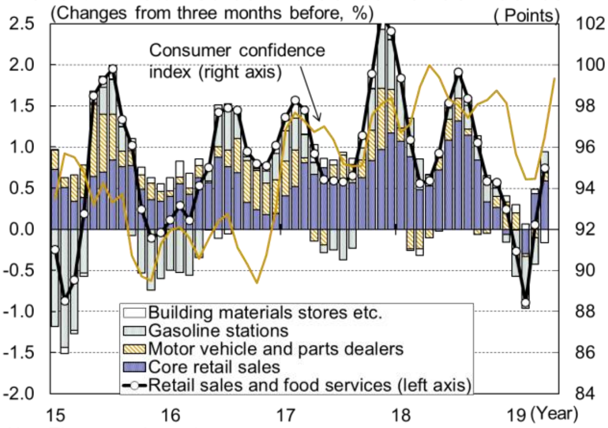
As for the jobs market, non-farm payroll increased sharply in April, rising 263,000 month-over-month (MoM). This year, the increase has averaged at 205,000 as of April, lower than last year's 223,000 average. But the figure is still above the boom-or-bust line of 200,000. Payroll has grown steadily at nearly 2% year-over-year (YoY). As the labor market improves, wages have risen at more than 3% YoY. Moderate growth in wages is expected to continue, according to pay raise plans of small and midsize companies and other sources. Supported by payroll and wage growth, personal income is projected to keep rising at around 5% and underpin consumer spending.

Chart 1 : US Real GDP



Source: US Department of Commerce, MUFG Bank Economic Research Office

Chart 2 : Retail Sales and Consumer Confidence



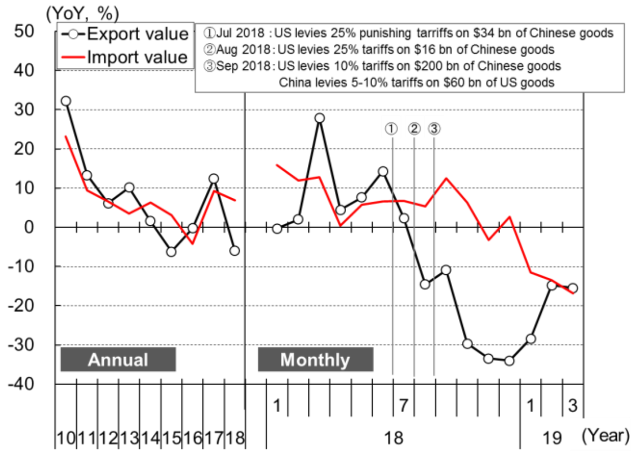
Note:Three-month moving average
Source: US Department of Commerce, University of Michigan, MUFG Bank Economic Research Office

2. IMPACT OF THE US-CHINA TRADE WAR

The fallout of retaliatory tariffs between the two countries is already evident in trade data. US exports to China have declined YoY since August, after China imposed additional tariffs on US goods in July. In December, the exports tumbled by 34% (Chart 3). As for imports from China, growth slowed after September, and March marked a third consecutive month of a decline over 10% YoY. With both countries announcing additional tariffs on May 13, exports and imports are expected to fall even sharper when the higher duties take effect. Underlying the trade spat is the two countries' rivalry for technology dominance over the medium to long term. In light of domestic conditions of each country, a fundamental resolution is unlikely in the short run. The trade war is thus expected to weigh on trade activity for some time, with year-over-year effects of 25% tariffs to be seen for at least a year. And the impact on US domestic prices and supply chain revamps will persist even longer.

Yet estimates show that trade activity pushed down the real GDP by a mere 0.3 percentage point. With domestic demand remaining solid, trade activity appears to have limited impact on the overall US economy (Chart 4). Beyond the trade arena, the dispute could worsen business sentiment and thereby put the brakes on capital investment. But economic reports from Federal Reserve districts suggest that many parts of the country do not anticipate a major hit. And in Congress, hard line stances against China continue to dominate across the political parties. Except in select regions like agriculture-dependent states, voters do not seem to be demanding lawmakers to address trade-war fallouts. Thus, while the matter needs to be monitored carefully, there is not enough evidence that the trade war will slow down the US economy.

Chart 3：US Trade with China



Source: US Department of Commerce, MUFG Bank Economic Research Office

Chart 4：Impact of US-China tariffs on US real GDP

Price elasticity of exports to China	-1.3
Average rate of Chinese retaliatory tariffs against US (%)	18.2
Rate at which companies pass on higher costs to prices (%)	48
Impact on real exports to China (%)	-11.1
China's share in overall US exports (2018, %)	7.2
Impact on real exports (%)	-0.8
Proportion of goods exports in GDP (2018, %)	9.6
US value-added ratio in exports to China (%)	90
Impact of export decline on real GDP growth (% point) ①	-0.1
Impact of tariff-related income drop in the US private sector to real GDP growth (% point) ②	-0.2
Impact of US and China tariffs on real GDP growth (①＋②) (% point)	-0.3

Note: For China's tariffs against the US, estimates assume a 15% average tariff for items currently not subject to the retaliatory tariffs. Exchange rate pass-through in exports are taken into consideration to calculate the cost pass-on rate.
Source: US Department of Commerce, Department of Labor, MUFG Bank Economic Research Office

3. MONETARY POLICY AND LONG-TERM INTEREST RATES

In view of the market swings around the end of 2018 and concern over a global economic slowdown, the Fed has turned dovish this year. In January, it signalled a shift to a wait-and-see policy stance from mild rate increases. The FOMC skipped a rate increase in March, and the central bank plans to stop shrinking its balance sheet by the end of September. Median forecast from FOMC voting members points to zero rate increase this year, down from two hikes projected earlier. As the trade war and the Mexico tariff threat reignite concerns over a global economic slowdown, market anticipation for a rate cut has sent the treasury long-term rates to a 34-month low. Caution is widespread after a period of market stability.

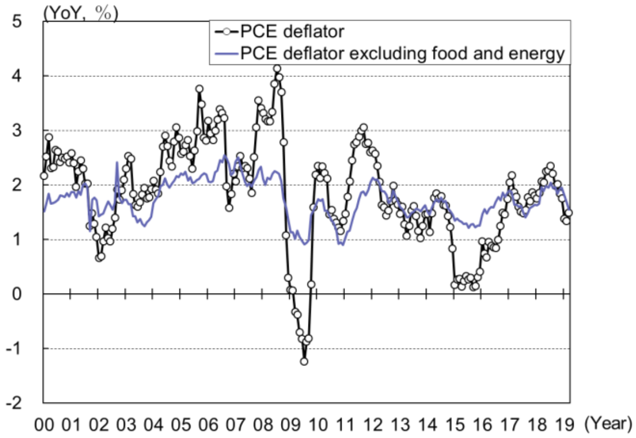
Separately, the Fed is reviewing its monetary policy framework, as part of a broad strategy review announced last November. With the process slated to complete by the end of this year, an expert review is planned for June. It is not yet clear which direction the discussion will take, but evaluation of inflation rate likely will be one focal point. Instead of aiming for 2% inflation over one period, the Fed appears to be considering an average inflation target of 2% over an economic cycle including a downturn phase. PCE deflator growth, a key consideration for the Fed, has often fallen short of 2%. Switching to an average inflation target would make room for an expansionary monetary policy that yields PCE deflator growth of over 2% for some time (Chart 5).

Nevertheless, many FOMC members seem to consider recent low inflation as “transitory” – according to FOMC meeting minutes. The environment is thus not conducive for a rate cut on the basis of inflation readings. Unemployment rate and other jobs indicators traditionally tracked by the Fed are still at historically good levels.

All things considered, the Fed is unlikely to move the policy rate in either direction, so the benchmark interest rate is expected to stay at the current level through the end of this year (Chart 6).

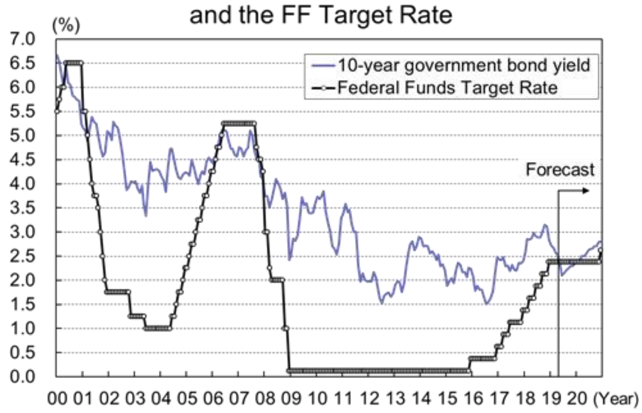
The monetary policy framework review and the 2020 presidential election could sway Fed’s policy directions late this year and next year. And the dynamics of the presidential race are yet to be known because many Democratic candidates are jockeying for party nomination. Toward next year, growth in the US economy is projected to slow and near its potential growth rate -- as should be the case. How the Fed responds to Trump’s public pressure to cut rates, especially with the election on the horizon, will draw much focus. The framework review could be seen as Fed’s effort to lay the groundwork for potential rate cuts. While the review outcome needs to be monitored closely, there is a reasonable chance that the fed will shift gears to rate hikes at the end of next year in order to pursue a neutral interest rate based on a tighter labor market.

Chart 5: Personal Consumption Expenditure Deflator



Source: US Department of Commerce, MUFG Bank Economic Research Office

Chart 6: 10-Year Government Bond Yield and the FF Target Rate



Note: From Dec 2008, the Federal Funds Target Rate is the median of range
Source: Bloomberg, MUFG Bank Economic Research Office

Translated by Chie Okada-Wighe

Forecast for the U.S. Economy

Forecast →

	2018				2019				2020				2018	2019	2020
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	(Actual)	(Forecast)	(Forecast)
1. Key economic indicators															
Real GDP (QoQ annualized, %)	2.2	4.2	3.4	2.2	3.1	1.9	1.9	1.3	1.8	1.7	1.7	1.6	2.9	2.5	1.7
Personal Consumption Expenditures	0.5	3.8	3.5	2.5	1.3	2.5	2.5	2.5	2.4	2.3	2.2	2.1	2.6	2.4	2.4
Fixed Investment (Residential)	-3.4	-1.3	-3.6	-4.7	-3.5	-2.0	-0.3	0.2	0.9	0.9	0.9	0.9	-0.3	-2.7	0.4
Fixed Investment (Nonresidential)	11.5	8.7	2.5	5.4	2.3	3.0	1.7	1.8	1.9	2.0	2.1	2.1	6.9	3.3	2.0
Changes in Business Inventories (Contribution)	0.3	-1.2	2.3	0.1	0.6	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0	0.1	0.3	-0.1
Government Expenditures	1.5	2.5	2.6	-0.4	2.5	3.2	2.7	-2.0	0.5	0.3	0.3	0.2	1.5	1.8	0.4
Net Exports (Contribution)	0.0	1.2	-2.0	-0.1	1.0	-0.2	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2	-0.3	0.0	-0.3
Exports	3.6	9.3	-4.9	1.8	4.8	2.5	2.5	2.3	2.3	2.3	2.3	2.3	4.0	2.4	2.3
Imports	3.0	-0.6	9.3	2.0	-2.5	3.0	3.4	3.2	3.1	3.1	3.0	2.9	4.5	2.0	3.1
Domestic Private End User Demand	2.1	4.4	3.1	2.7	1.3	2.4	2.3	2.3	2.3	2.2	2.1	2.1	3.2	2.4	2.2
Nominal GDP (QoQ annualized, %)	4.3	7.6	4.9	4.1	3.6	4.2	4.1	3.4	3.8	3.7	3.7	3.6	5.2	4.2	3.7
Industrial Production (QoQ annualized, %)	2.3	4.6	5.2	3.9	-1.9	1.8	1.5	1.7	1.1	1.0	1.1	1.0	3.9	1.8	1.3
Unemployment Rate (%)	4.1	3.9	3.8	3.8	3.9	3.7	3.6	3.6	3.6	3.6	3.6	3.6	3.9	3.7	3.6
Producer Price Index (YoY, %)	2.8	3.0	3.0	2.8	2.0	2.1	2.2	2.2	2.1	2.0	1.9	1.9	2.9	2.1	2.0
Consumer Price Index (YoY, %)	2.2	2.7	2.6	2.2	1.6	2.1	2.0	2.1	2.1	2.1	2.2	2.2	2.4	2.0	2.1
2. Balance of Payments															
Trade Balance (hundred million dollars)	-2,233	-2,055	-2,295	-2,331	-2,175	-2,221	-2,266	-2,312	-2,175	-2,221	-2,266	-2,312	-8,913	-9,013	-9,113
Current Account (hundred million dollars)	-1,239	-1,036	-1,266	-1,344	-1,344	-1,376	-1,409	-1,441	-1,474	-1,506	-1,538	-1,570	-4,885	-4,935	-4,985
3. Financial Indicators															
FF Rate Target (%)	1.50-1.75	1.75-2.00	2.00-2.25	2.25-2.50	2.25-2.50	2.25-2.50	2.25-2.50	2.25-2.50	2.25-2.50	2.25-2.50	2.25-2.50	2.50-2.75	2.25-2.50	2.25-2.50	2.50-2.75
Euro Dollar (3M) (%)	1.9	2.3	2.3	2.6	2.7	2.6	2.6	2.5	2.5	2.5	2.5	2.6	2.3	2.6	2.5
10-year Treasury Note's Yield (%)	2.8	2.9	2.9	3.0	2.7	2.3	2.2	2.3	2.4	2.6	2.7	2.8	2.9	2.4	2.6

Note: FF Rate Targets is end-of-period figures, Euro Dollar (3M) and 10-year Note's Yield are period averages
Source: Compiled by MUFG Bank Economic Research Office from various reports and Bloomberg

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