The Outlook for the US Economy

Risks of further escalation of trade friction simmer, yet the economy is forecast to remain robust

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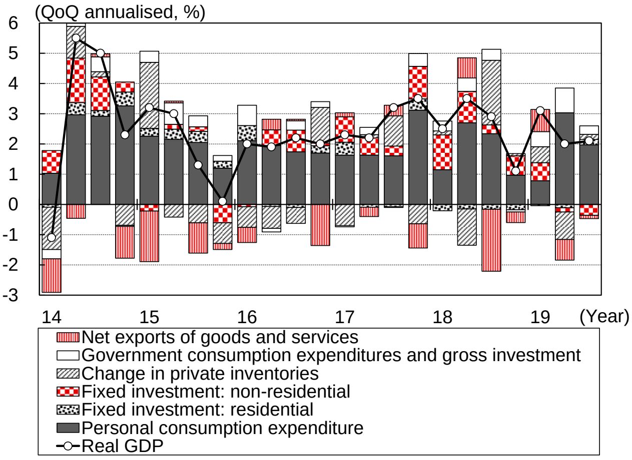
1. Current Conditions

The real GDP growth rate was 2.1% QoQ annualised in the July-September quarter (revised), accelerating slightly from the previous quarter (2.0% QoQ annualised) (Chart 1). Capital expenditure (non-residential fixed investment) slowed further from the previous quarter owing to a significant decrease in investment in mining-related structures and aircraft-related equipment. Meanwhile, although personal consumption expenditure slowed to 2.9% QoQ annualised from the previous quarter (4.6% QoQ annualised), it maintained strong growth that exceeded the average of the current phase of economic expansion (2.4% QoQ annualised). In addition, fixed residential investment entered positive territory for the first time in seven quarters due to the low interest rates of mortgages. In general, the US economy continues to exhibit robust growth. Taking an overview of the last few years, the GDP growth rate rose to a higher level in 2018 thanks to large-scale tax cuts and an increased federal budget, and it continues to outpace the potential growth rate of around just below 2% annualised this year, even though the upward pressure from the aforementioned measures has faded.

Chart 1: Real GDP



Source: Department of Commerce, MUFG Bank Economic Research Office

Table 1: GDP Forecast (Calendar Year)

(YoY, %)

	2018 (Actual)	2019 (Forecast)	2020 (Forecast)
Real GDP	2.9	2.3	1.9
Private Consumption	3.0	2.6	2.5
Residential Investment	-1.5	-2.5	0.4
Nonresidential Investment	6.4	2.9	1.8
Inventory Investment (Contribution)	0.1	0.1	-0.1
Government Expenditures	1.7	2.3	1.4
Net Exports (Contribution)	-0.4	-0.3	-0.2
Exports	3.0	0.0	1.1
Imports	4.4	1.8	1.9
Nominal GDP	5.4	4.2	4.0

Source: Department of Commerce, MUFG Bank Economic Research Office

There is no doubt that the economy is in the process of renewing its record for the longest period of expansion as the labour market and wages maintain their firm upward trend, despite some slowing. However, the amount of exports and imports to and from China fell in

September owing to the effects of tariffs which were imposed against China the same month, and it appears further downward pressure will be unavoidable if the US goes ahead with its tariffs scheduled to come into effect on 15th December. Following the announcement of a “partial deal” for the first stage of US-China trade talks in mid-October, expectations of a completed trade deal between the US and China increased. However, there are reports that negotiations over a “formal” phase one agreement have entered choppy waters. This, along with further deterioration of the situation in Hong Kong, has led to a rise in negative perceptions of China in Congress as well as President Trump’s signing of the Hong Kong Human Rights and Democracy Act. In light of these factors, it is not just trade negotiations between the US and China which have once again become uncertain, but also the relationship between the two countries in general.

Since July, the Federal Reserve Board (FRB) has carried out a series of preventative interest rate cuts at its FOMC meetings, giving economic uncertainty as their main reason for their actions. However, it appears they have stopped lowering interest rates for now following the third rate cut at October’s meeting. The stock market reacted favourably to the FRB’s rate cuts that started in July and prices are currently in the region of an all-time high, despite some fluctuations caused by developments in US-China negotiations. On the other hand, although additional rate cuts were factored in by the market, expectations were adjusted around the start of September and long-term interest rates have continued to rise since then.

2. Key Points from the Outlook

Variables to take into consideration when forecasting the US economy in 2020 include the outcome of the US-China conflict on the external front and the US presidential election on the domestic front. Regarding the latter, the impeachment proceedings against President Trump over allegations related to Ukraine are now under way. While it is unlikely the process will end with impeachment as the Republican Party holds the majority of seats in the Senate, if the House votes to impeach and a trial starts in the Senate, this is expected to have an impact on the election. In this case, anticipation of a change in administration will spread amongst market participants, resulting in an undeniable risk that financial markets will be shaken by concerns over the continuity of current policies and over Democrat candidates’ manifestos that are tough on big businesses.

At this point in time, however, these risks are considered to be tail risks, and presuming any additional downward pressure from the US-China trade friction as mentioned below will be limited, growth of the US economy will be determined by the trend of personal consumption expenditure, which accounts for about 70% of GDP. Employee compensation, which forms the basis of personal consumption expenditure, is stable, supported by the firm growth of its components: the number of employees and wages. Therefore, there is a high degree of probability that the US economy will maintain a pace of expansion roughly in line with its potential growth rate, led by personal consumption expenditure (Table 1). After the real GDP growth rate hits 2.3% YoY in 2019, growth is forecast to continue to accelerate but at a slower pace compared to the previous year’s average, leading to a GDP growth rate of 1.9% YoY in 2020.

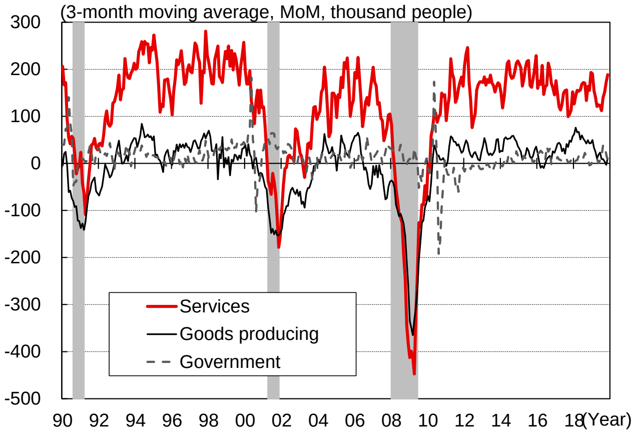
At the press conference following the FOMC meeting in October, Chair Powell said "we see the current stance of monetary policy as likely to remain appropriate as long as incoming information about the economy remains broadly consistent with our outlook", suggesting the FRB will maintain its policy rate for the time being. On the whole, the economy will continue to expand gradually into next year, but given that the presidential election is underway, it seems unlikely the momentum for changes to monetary policy will increase, whether it be a rate hike or cut, so interest rates are expected to remain at their current levels. However, if trade friction between the US and China escalates again – such as a breakdown of negotiations for a formal phase one agreement – and uncertainty about the future of the US economy rises, there is a possibility that the FRB will lower interest rates again as it did when it carried out preventative rate cuts from July.

2.1 Personal consumption will maintain its robust growth on the back of the continued, firm increase in income

Growth of the number of non-farm employees slowed in October: a rise of 128 thousand from the previous quarter. Nevertheless, the results for August and September were revised upwards considerably. In light of this, and the effect of downward pressure (equal to approximately 50,000 people) on October's results from the GM strike, it appears labour will still maintain its firm growth as the US economy marks its longest period of expansion on record.

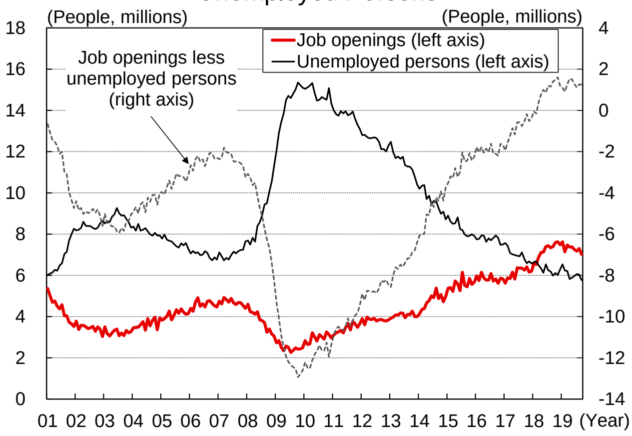
Analysis of the number of non-farm employees by sector reveals that on the one hand, the goods production sector is slowing considerably, while on the other hand, growth of the service sector – which covers 70% of all employees – still remains firm, despite dropping to a slightly lower level. This suggests the service sector has a strong ability to absorb labour supply (Chart 2). In fact, businesses' demand for employees is still historically high, and the number of job openings continues to exceed the number of employed persons in the US (Chart 3).

Chart 2: US Number of Non-Farm Employees



Note: Shaded areas denote periods of economic recession
Source: Department of Labor, MUFG Bank Economic Research Office

Chart 3: Number of Non-Farm Job Openings and Unemployed Persons

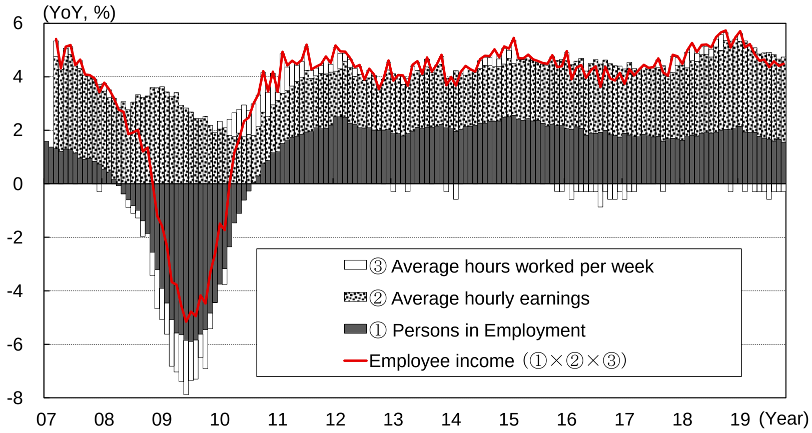


Source: US Department of Labor

Growth of wages is high and has surpassed 3% annualised for more than a year since last August. Based on the report that "moderate wage growth continued across most Districts" in the Beige Book published on 27th November, firm wage growth is expected to continue. As such, it is highly likely that income will continue to grow; multiplying the rise in the number of employees by the growth of wages reveals nominal growth of private income will be around 4% annualised, and real growth will be around 3% annualised (Chart 4).

Due to such robust growth of employee income, it is thought personal consumption expenditure will provide a firm contribution of just below 2% annualised to the real GDP growth rate throughout next year.

Chart 4: Employee Income



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

2.2 US-China trade friction

While it is the friction over trade between the US and China that currently garners most attention, the heart of the conflict between the two countries is the issue of national security and competition for technological supremacy. As a result, it is best to presume that a fundamental solution to the conflict is very unlikely to appear on the horizon for the time being. Following the remark that "we've come to a very substantial phase one deal" by President Trump after US-China ministerial-level talks on 10th and 11th October, there was a temporary rise in expectations that a compromise would be reached with regard to trade issues. However, owing to the current escalation of the situation in Hong Kong, US Congress was almost unanimous in its decision to pass the Hong Kong Human Rights and Democracy Act towards the end of November, which President Trump then signed on 27th November. The Act requires an annual review to assess if Hong Kong's principle of "one country, two systems" is still functioning. The Chinese and Hong Kong governments swiftly responded saying, "this is interference in our internal affairs and is deeply regrettable", and tensions are quickly building. This brings into sharp relief the fact that finalising the phase one agreement is not easy for both sides, and even if they were to achieve a formal agreement for phase one from their shared mutual interests, such as a desire for some kind of political result, it is difficult to foresee a fundamental improvement in their bilateral relations. In the case that a formal agreement is reached, it is unlikely that it will go as far as to "cancel additional tariffs in different phases" (as suggested by Chinese ministry spokesman). It is more likely that the tariffs scheduled for 15th December will be postponed.

However, it is important to note that the continuation of the US-China conflict does not necessarily mean new, negative impacts on the economy will appear each year as a result. The conflict will be 'managed' by officials on both sides and, if further escalation can be avoided, the downward pressure on the government will gradually be neutralised, as the whole economy accepts the conflict as the new norm and the impact will be smoothed out year-on-year.

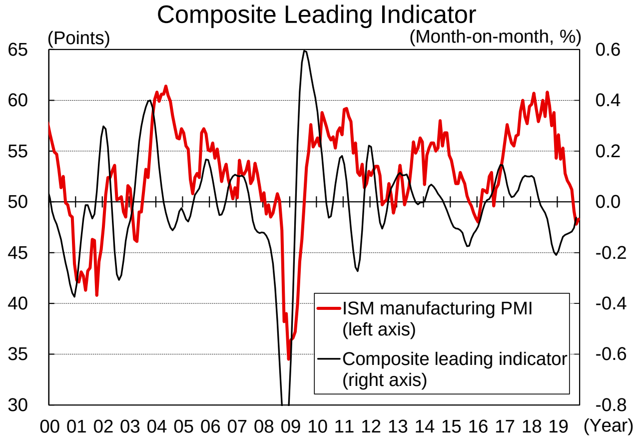
2.3 The future of fixed investment

Fixed investment has been decreasing for the past two quarters owing to a rise in uncertainty about the future caused by US-China trade friction, the deceleration of the global economy and cyclical factors in the manufacturing sector. However, examination of several indicators shows signs that investment is picking up at the moment.

A comparison of ISM Manufacturing PMI and the OECD's Composite Leading Indicator shows the Composite Leading Indicator is leading ISM Manufacturing PMI by around 6 months to a year (Chart 5). It is notable that the growth rate of the US' Composite Leading Indicator bottomed out around the end of last year. In light of the apparent improvement in indicators such as stock prices, housing indicators, new durable goods orders and ISM Manufacturing PMI, it is presumed that ISM Manufacturing PMI will stop falling sooner or later. In addition, growth of core capital goods orders (non-defence capital goods excluding aircraft), which precede fixed investment, has been slowing since around the start of 2017, but it has since stopped falling and was almost flat in the third quarter (Chart 6). The Industrial Production Index also recorded negative growth QoQ for two consecutive quarters in the January-March and the April-June quarters, yet growth returned to positive territory in the July-September quarter: 1.4% QoQ annualised. This recovery is consistent with the aforementioned statement published in November's Beige Books: "in manufacturing, more Districts reported an expansion in the current period than the previous one" (October).

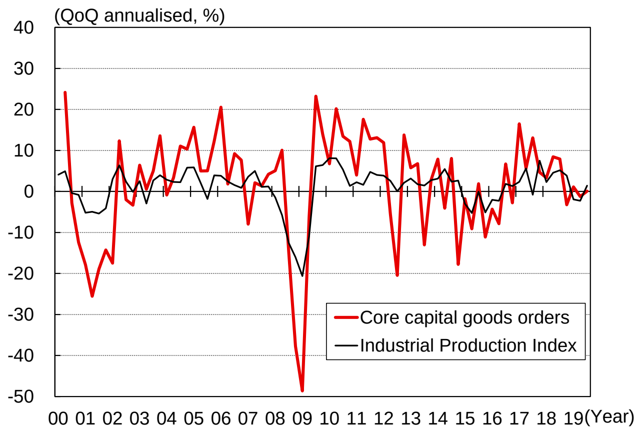
In terms of monetary policy, the FRB carried out its third rate hike at three consecutive meetings starting in July. It is thought this easier monetary policy will support a recovery in fixed investment. Although the situation regarding the trade friction between the US and China still remains unclear, it should be acknowledged that a prolonged conflict between the US and China as mentioned above has already been incorporated into economic outlooks. It is still difficult to forecast to what degree the impact from a change in global supply chains by corporations will have, but the downward pressure from the US-China conflict on fixed investment can be expected to gradually fade away.

Chart 5: ISM Manufacturing PMI and the Composite Leading Indicator



Source: Institute for Supply Management, OECD, MUFG Bank Economic Research Office

Chart 6: Core Capital Goods Orders and the Industrial Production Index



Source: Department of Commerce, MUFG Bank Economic Research Office

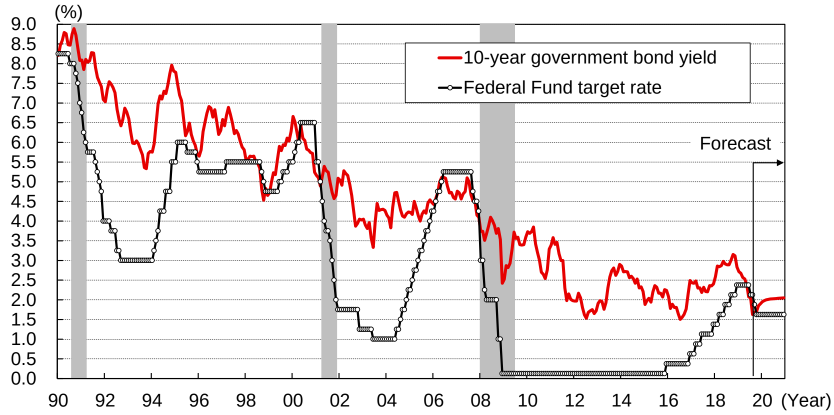
3. Monetary Policy and Long-Term Interest Rates

At the Federal Open Market Committee (FOMC) meeting at the end of July, the Federal Reserve Board (FRB) lowered its target range for the FF rate (from 2.25%~2.50% to 2.00%~2.25%). It then carried out further rate cuts of 0.25% points at its FOMC meetings in September and October. Currently, its target range for the FF rate stands at 1.50%~1.75%.

In its statement after the latest FOMC meeting in October, the policy stance it published in July – "it will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion" – was changed to "the Committee will continue to monitor the implications of incoming information for the economic outlook". At the press conference after October's FOMC meeting, Chair Powell suggested the FRB had ceased its rate cuts for the time being: "as long as incoming information about the economy remains broadly consistent with this outlook, the current stance of monetary policy likely will remain appropriate" and "if developments emerge that cause a material reassessment of our outlook, we would respond accordingly".

Taking a further look back at monetary policy, the FRB carried out a long period of sustained rate hikes from the end of 2015, but then adopted a wait-and-see approach based on fluctuations in financial markets at the end of last year. Since mid-2019, it has carried out preventative rate cuts after taking into consideration issues such as the possibility of an impact on the US economy from the global economic slowdown, the escalation of US-China trade friction and the low inflation rate. As a result, 0.75% points' worth of the previous period of rate cuts has been negated. Therefore, the decision that the current level is "appropriate" suggests the FRB is carrying out a re-evaluation of the neutral interest rate in real terms, and it is unlikely they will decide that interest rates should be raised or lowered for the time being (Chart 7).

Chart 7: 10-Year Government Bond Yield and Federal Fund Target Rate



Note: 1. Shaded areas denote periods of economic recession
2.Since December 2008, the Federal Funds Target Rate is the median of the target range.
Source: Bloomberg, MUFG Bank Economic Research Office

However, the story will change if an event causes a huge shock to the economy. Due to the establishment of the Hong Kong Human Rights and Democracy Act, there is now a possibility that the conflict over human rights issues will also have an impact on US-China trade negotiations in addition to the trade deficit, technological hegemony and national security. There are many downside risks just between the US and China: a breakdown of negotiations for a "formal" phase one agreement, the imposition of tariffs on Chinese goods as scheduled on 15th December and any countermeasures from China, as well as escalation of the situation in Hong Kong and the response from the US and China. Currently, the FRB has adopted a wait-and-see stance, but if any of the above scenarios were to occur, there is an undeniable possibility that the FRB will lower rates further as it did when it carried out preventative rate cuts from July.

Translated by Elizabeth Foster

Forecast for the U.S. Economy

Forecast →

	2018				2019				2020				2018 (Actual)	2019 (Forecast)	2020 (Forecast)
	1～3	4～6	7～9	10～12	1～3	4～6	7～9	10～12	1～3	4～6	7～9	10～12			
1. Main Economic Indicators															
Real GDP (QoQ annualized, %)	2.5	3.5	2.9	1.1	3.1	2.0	2.1	2.0	1.9	1.9	1.9	1.8	2.9	2.3	1.9
Personal Consumption Expenditures	1.7	4.0	3.5	1.4	1.1	4.6	2.9	2.5	2.4	2.2	2.2	2.1	3.0	2.6	2.5
Fixed Investment (Residential)	-5.3	-3.7	-4.0	-4.7	-1.0	-3.0	5.1	1.8	1.0	0.9	0.9	0.9	-1.5	-1.7	1.4
Fixed Investment (Nonresidential)	8.8	7.9	2.1	4.8	4.4	-1.0	-2.7	1.0	1.5	2.0	2.1	2.1	6.4	2.2	0.9
Changes in Business Inventories (Contribution)	0.1	-1.2	2.1	0.1	0.5	-0.9	0.2	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.0
Government Expenditures	1.9	2.6	2.1	-0.4	2.9	4.8	1.6	1.0	1.0	1.0	1.0	1.0	1.7	2.2	1.3
Net Exports (Contribution)	0.0	0.7	-2.1	-0.4	0.7	-0.7	-0.1	0.0	-0.2	-0.1	-0.1	-0.1	-0.4	-0.3	-0.2
Exports	0.8	5.8	-6.2	1.5	4.1	-5.7	0.9	1.6	1.5	1.5	1.5	1.5	3.0	0.0	1.0
Imports	0.6	0.3	8.6	3.5	-1.5	0.0	1.5	1.2	2.0	1.9	1.9	1.8	4.4	1.6	1.6
Domestic Private End User Demand	2.5	4.3	3.0	1.8	1.6	3.3	2.0	2.2	2.2	2.1	2.1	2.1	3.4	2.4	2.2
Nominal GDP (QoQ annualized, %)	5.0	7.1	4.8	2.9	3.9	4.7	3.8	4.0	3.9	3.9	3.9	3.8	5.4	4.1	4.0
Industrial Production (QoQ annualized, %)	2.3	4.6	5.2	3.9	-1.9	-2.3	1.3	1.3	1.4	1.3	1.2	1.1	3.9	1.0	1.1
Unemployment Rate (%)	4.1	3.9	3.8	3.8	3.9	3.6	3.6	3.6	3.5	3.5	3.5	3.5	3.9	3.7	3.5
Producer Price Index (YoY, %)	2.8	3.0	3.0	2.8	1.9	2.0	1.6	1.7	1.8	1.8	1.8	1.8	2.9	1.8	1.8
Consumer Price Index (YoY, %)	2.2	2.7	2.6	2.2	1.6	1.8	1.8	1.9	2.0	2.0	2.0	2.0	2.4	1.8	2.0
2. Balance of Payments															
Trade Balance (hundred million dollars)	-2,207	-2,064	-2,279	-2,323	-2,167	-2,233	-2,214	-2,260	-2,167	-2,233	-2,214	-2,260	-8,873	-8,973	-9,073
Current Account (hundred million dollars)	-1,140	-1,073	-1,257	-1,439	-1,362	-1,282	-1,249	-1,280	-1,310	-1,341	-1,371	-1,401	-4,910	-4,960	-5,010
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	1.75-2.00	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75	2.25-2.50	1.50-1.75	1.50-1.75
Euro Dollar (3M) (%)	1.9	2.3	2.3	2.6	2.7	2.5	2.2	1.7	1.6	1.6	1.6	1.6	2.3	2.3	1.6
10-year Treasury Note's Yield (%)	2.8	2.9	2.9	3.0	2.7	2.3	1.8	1.8	2.0	2.0	2.0	2.0	2.9	2.1	2.0

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

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