Economic Outlook

There have been mixed signals obscuring our view to determine what are the underlying trends in the U.S. economy. The data have been sending conflicting messages, with some indicators suggesting momentum is relentless, while others hint at sharp deceleration, with most falling somewhere in between.

There were delays in the data flow as a result of the government shutdown, further complicating interpretation. Additionally, adverse weather, residual seasonality in some data series and the effects of the shutdown itself may have added to the confusion, temporarily weighing on measured activity early in the year.

As if that weren't enough, financial conditions have swung wildly, tightening sharply in Q4-2018 then reversing course in Q1-2019.

Add in unresolved trade tensions and a weaker, more uncertain backdrop abroad to raise still more questions about the U.S. outlook.

It appears that momentum has likely peaked, and the economy seems to have slowed to a more moderate pace, reflecting the effects of weakening fiscal stimulus, tighter financial conditions, trade restrictions and possibly a weaker growth profile abroad.

The good news is the deceleration does not appear to be excessive, nor was it a surprise.

Economists have long felt that these restraining forces would edge the U.S. economy onto a more moderate trajectory and that such a moderation would be welcome, making it less likely that the kinds of excesses and imbalances, such as inflationary overheating and/or private-sector overindulgence, would emerge and kill any chances this expansion could continue.

Soft landings, where the economy glides onto a more sustainable path, curtailing potentially destabilizing excesses without jeopardizing the expansion, are hardly a sure thing and are never easy to pull off.

And like a flight during the descent phase, you can feel a bit queasy, especially if the economy encounters any air pockets or risk factors, of which there are plenty right now.

High on the list are trade tensions. The trade restrictions enacted so far, together with those potentially in the pipeline, have likely taken some toll on activity, in part by increasing uncertainty, weighing on investment plans and contributing to a tightening of financial conditions.

Most of the focus has been on the U.S.-China tiff, but there have been restrictions enacted on other fronts and potentially more to come. There are risks of more tariffs on European cars and even the renegotiated NAFTA deal isn't assured of legislative approval, although it remains likely.

Trade conflict is especially untimely when global activity is already unsteady. Momentum in Europe remains sluggish and uncertainty is prevalent in China.

All told, global drags could wash up a bit more powerfully onto U.S. shores than we had envisioned.

On the plus side, though, partial resolution of U.S.-China trade conflict may be coming soon, which would be enough to forestall any further tariffs and possibly reverse some of the restrictions already enacted.

Though it won't likely resolve all areas of contention between the U.S. and China, an agreement would reduce risks of an escalating trade war.

Closer to home, the end of the government shutdown removed another source of uncertainty. Still, it will take a while for the data backlog to clear, and for the mild drag from the shutdown to dissipate. Additionally, the shutdown may be indicative of a broader political dysfunction that raises questions about how the government will handle issues like raising the debt ceiling, which will need to be done later this year.

And then there are developments in financial markets. In Q4-2018, a combination of heightened volatility, sharp declines in equity and commodity prices, wider credit spreads and lower interest rates on government securities suggested that markets had not only downgraded their base-case expectations for economic growth, but increased their assessment of downside risks and the compensation they require for bearing those risks, not just in the U.S., but around world.

In 2019, a completely different narrative seems to have taken hold, with sentiment reversing sharply.

The question arises as what to make of these wild swings? Taking everything into account, U.S. financial conditions have tightened over the past year, enough to take away some incentive from activity, but hardly enough on its own to derail things, especially since many of other economic drivers remain broadly supportive.

Most encouragingly, the private sector still seems largely devoid of the kinds of large-scale excesses and imbalances that caused recessions in the past.

Humbled by the Great Recession, households and businesses, borrowers and lenders, savers and spenders and even regulators have been much more cautious this time around.

The economy also seems less vulnerable to the inflationary overheating that brought on recessions in past cycles, in part by provoking aggressive tightening by the Fed.

Labor markets are tight and wage pressures have been building, but recent indications suggest that the labor market may have a bit more running room or at least may not be tightening far beyond full employment, as some had feared.

Moreover, labor costs continue to pick up only modestly, to levels consistent with, but not threatening to surpass the Fed's inflation target.

Well-anchored inflation expectations, a more attenuated responsiveness of inflation to slack and temporary restraint from the stronger dollar and declines in commodity prices should also help prevent a material inflation overshoot and enable the Fed to tread carefully, avoiding the over-tightening that doomed past expansions.
All told, we think markets got strained late last year about the economic outlook. We still see activity slowing, but we don't see a recession in the near-term.

On the contrary, this expansion is apt to persist, becoming the longest ever by this summer and continuing even beyond that. In fact, if some of the near-term risks dissipate, the economy may even regain some strength, at least temporarily this spring and summer.

In short, even though soft landings are rare, they have happened before and for the reasons outlined above, the U.S. seems to have better odds of achieving one this time.

Monetary-Policy Outlook

Fed policymakers are being patience right now, especially with an increasingly uncertain backdrop due to of signs of a possible slowing.

Policymakers are taking a prudent wait-and-see course to put interest rates on hold for now and wait for more clarity on how recent developments evolve and shape the outlook.

Inflation appears not to be in any danger of material overshoot and there is a growing recognition that they have already raised the funds rate a cumulative 225 basis points and have set the balance sheet on a path of decline.

We still believe that the Fed may eventually need to nudge the economy onto a more sustainable path with additional rate hikes, but not in the near future, and nothing until late 2019 or early 2020, at the earliest.

The Fed would likely require clear evidence that the downside risks have diminished, labor markets have resumed tightening and inflation is at least at target.

Where policy goes will depend on how the outlook evolves, but the range of probable outcomes is wider than it has been in recent years, because the outlook is cloudier and policy no longer so clearly accommodative and in need of an adjustment.

The funds rate will be the primary tool used to adjust policy stance and the balance sheet will be more of a secondary tool.

Barring any major shocks to the outlook, the size of the balance sheet will be dictated largely by technical considerations such as when reserves are enough to enable the Fed to control short-term interest rates.

Although there's uncertainty about just what that optimal level of reserve may be and when it might be reached, it is expected to be sometime between late 2019 and Spring 2020, when the cumulative reduction of Fed security holdings will reach their target.

Policymakers may opt to slow the pace of runoff as the end approaches to get more clarity on just where optimal reserve levels may lie.

After the runoff, Mortgage Backed Securities will likely continue to dwindle, replaced by Treasuries and the Fed may shift toward a somewhat shorter duration of Treasury holdings. But barring a renewed shock, the balance sheet will not likely be used as an active tool of policy.

Financial Market Outlook

Financial markets were on quite a wild roller coaster ride in Q4-2018 sparking a steep correction.

This was brought on by sharply increased anxiety as markets worried about slowing global growth, trade tensions, political dysfunction, perceptions of overly aggressive monetary policy and how difficult it will be for the U.S. to sustain its recent run.

More recently, many of these fears have receded and sentiment has recovered, albeit still not quite completely.

It is understandable why people grew more cautious. There was no shortage of things to worry about on the global front and, closer to home, we were concerned that markets might come to doubt the sustainability of the good news for the U.S. economic cycle.

The longer growth stayed above potential, the tighter labor markets became and the more the Fed hiked, the greater the risk that investors might turn persistently more cautious, increasingly aware that the most favorable phase of the economic cycle for financial assets may be behind us.

We believe that the recovery in Q1-2019 proved the worries late last year were totally overdone and we still see the overall macro backdrop with no recession on the horizon, no material inflation overshoot and a moderation to a more sustainable pace that enables the Fed to slow down, as broadly supportive of risk assets.