GENERALI INVESTMENTS

Focal Point

US outlook: a soft landing supported by the Fed

28 January 2020

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- Fears of a US recession have abated, but we still expect growth to ease from 2.2% to 1.6% in 2020. The end of the fiscal stimulus and headwinds to capex from existing tariffs and lower profitability will be the main drag.
- Growth will be increasingly reliant on consumption, supported by the labor market and subdued inflation. Interest rate-sensitive components of demand, especially housing, will enjoy the boost from lower interest rates.
- Politics remains the biggest risk factor. The choice of who will oppose Trump in the November election could become another big source of uncertainty from Q2 on. The trade truce with China has reduced tail risks, but a quick and meaningful rollback of existing tariffs appears unlikely.
- The dovish turn taken by the Fed has been instrumental in delivering a soft landing. Our outlook of relatively weak growth in the first part of the year makes another, final, rate cut in Q2 more likely than not. The announced policy changes and especially a likely move towards an average inflation targeting will give a dovish tilt to the stance.

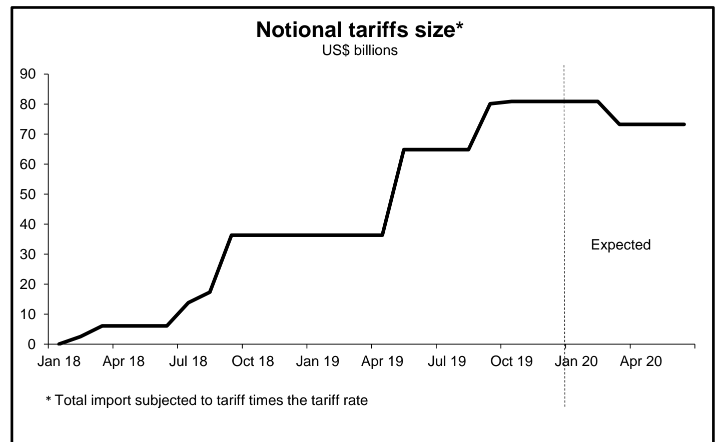
We expect the US economy to cool this year. Growth will likely ease from 2.2% to 1.6% because of the full effect of tariffs becoming effective during the first half of the year. The lagged impact of the 2019 rate cuts and that of the additional reduction we expect for Q2 will engineer a soft landing of the economy, despite still substantial headwinds. The Fed will take big steps to adapt its monetary policy strategy to a low-inflation, low-interest rates world. The broad view of this strategy should be clearer by summer, but the dovish bias it will most likely produce will be welcomed by markets.

Tariffs and Boeing to drag on H1 growth

We expect a rather weak first part of the year, followed by a meaningful acceleration that will bring growth to around 2% qoq ann. by Q4 2020. The weakness will be mostly concentrated in Q1. The halt to the production of the Boeing 737 MAX is likely, according to several estimates, to shave annualized growth by 0.5-0.8pp (which should reverse, when production resumes in H2).

Moreover, the existing tariffs will exert their full impact, continuing to contribute negatively in particular to capex. The signing of a partial trade agreement with China has defused risks of an escalation and led to a partial reduction in tariffs, which should also lower uncertainty. Still, most of the tariffs remain in place. In particular, the increase seen in the second half of 2019, will work though consumption and investment. Predicting the outcome of the ongoing US-China negotiations is hard, but the issue on the table make the attainment of a durable agreement and a substantial cut in tariffs before the November election quite difficult. On top of that, the end of a fiscal stimulus will provide a marginally negative contribution in the first half of the year.

The acceleration we predict for H2 is based to a large extent to the full display of the past rate cuts (plus the one we expect in Q2) to interest rate sensitive components of GDP and a mild rebound in investment.



Capex will not rebound much…

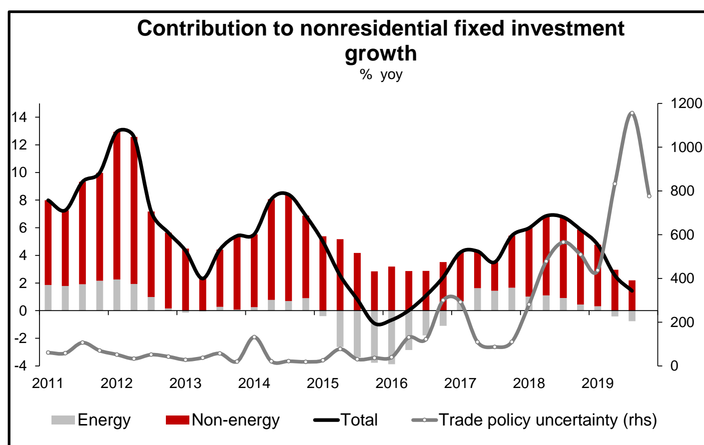
The latest data on sentiment and orders show that the outlook for business nonresidential investment has improved, but not to an extent capable of triggering a rebound. Orders of nondefense capital goods are flat or even slighting contracting on a year-on year basis since July, and both the ISM and NFIB surveys are signaling a weakening of the corporations' intention to step up capital expenditure.

Uncertainty over trade policy (which has been the strongest drag on capex in 2019) has abated since October and is set

to decrease after the recent US-China ceasefire. Lower uncertainty has supported share prices and compressed corporate spreads; this and the Fed loosening brought about a further easing of financial conditions. Given our expectation of positive, but not impressive, stock market gains and stable long-term rates, firms will enjoy easy access to external finance in 2020, even though political uncertainty will remain high.

In addition to that, the protracted fall in profitability, only temporarily stemmed by the 2018 tax cuts, will cap nonresidential capex. Barring an escalation in the US-Iran tension affecting the Gulf region, oil prices should remain broadly stable (at slightly above US$ 60/bbl in our view), with some downside risk due to decelerating demand and possible increase in production by non-OPEC members. This outlook, plus some signs of financial strain by companies operating in the shale sector, will not support but rather restrain capital formation in the energy sector. All this implies that business investment should stop falling on a qoq basis in Q1and then rebound, increasing by around 1% for 2020 as a whole.

The outlook for nonresidential investment is the biggest question mark on the 2020 growth outlook. Risks are broadly balanced: a quick resolution (or long-term fix) of the trade tensions would lift sentiment, allowing capex to benefit in full from the favorable financial conditions. The ensuing lift to US growth would greatly reduce the need for an additional rate cut. On the contrary, further political tensions would quickly depress capex, forcing the Fed into bolder action.

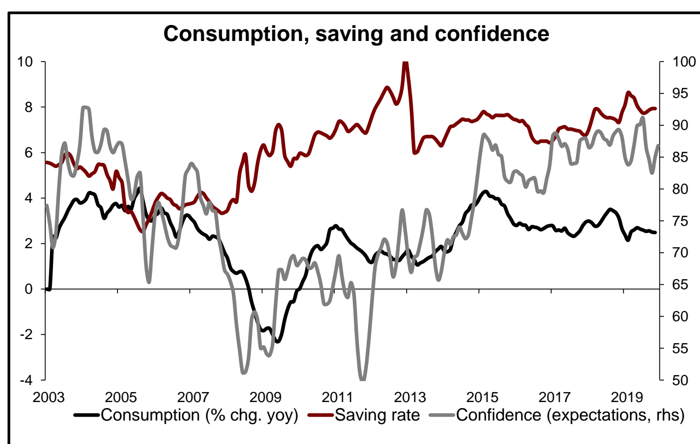


The flip side of easy financial conditions is the buildup of corporate debt. Bank for International Settlement (BIS) statistics show that in Q2 2019, total credit to non-financial corporations had climbed to 75% of GDP, 3 pp above the peak reached before the great financial crisis. Low interest rates are keeping borrowing costs as a ratio over earnings in line with the long-term average. But the deterioration in credit standards amid declining profitability constitutes a potentially big vulnerability, which may affect credit supply in the medium run.

Residential investment has been the main beneficiary from the drop in interest rates. During 2019, the average 30-Year Fixed Rate on mortgages dropped by 100 bps, to 3.7%, the lowest level since 2013, boosting residential investment. Its growth has most likely peaked at 5% ann. in Q3/2019 and will moderate to around 3% in 2020, as the support from lower rates will fade over time.

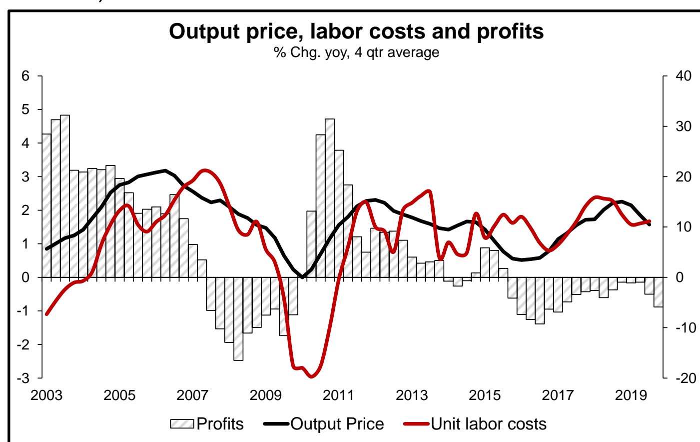
…increasing the role of consumption

The role of household consumption as the backbone of growth will therefore be enhanced. Fundamentals look solid and consistent with a growth rate of just above 2%. Steady job creation and real wage growth sustain income while expectations on future economic conditions fluctuates not too far from the cyclical high. However, the saving rate seems to have moved structurally up since 2017. This will limit the upside to consumption from faster income growth and lower debt servicing expenditures. Moreover, we expect that the weak profitability capping investments will lead to a deceleration in job creation.



Compressed margins will keep inflation tame

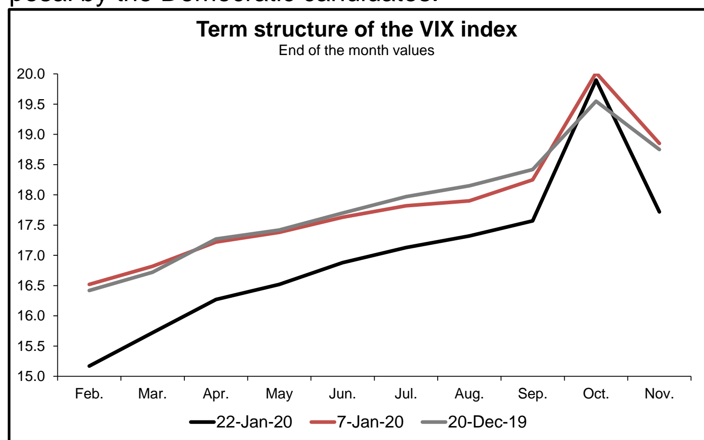
An increasingly tighter labor market has pushed up real wage growth to 2% yoy in Q4, but a surge in productivity has, at least temporarily, slowed down unit labor cost growth to below 2.5% yoy. The increase in labor costs has so far failed to translate into higher inflation. A key culprit is low margins. Profits per unit of output have declined since the 2015 cyclical peak and the extent to which firms are capable to increase margins will be crucial for inflation and investment and employment growth. Going forward, we expect this trend to continue and project core inflation to average 2.3% in 2020 (not to far from the 2.2% posted in December).



An upside risk for inflation is an acceleration in unit labor costs, as productivity is unlikely to improve structurally given the protracted weakness in corporate investment.

Uncertainty on the rise as election approaches

The political environment will remain noisy. Uncertainty will increase as the Election Day (November 3) approaches, especially given Trump's stance and some extreme policy proposal by the Democratic candidates.



Historically, the incumbent president always had an advantage. Currently, Trump's approval rate is below the level seen by most other presidents at this stage of their first term. But the economy and especially the labor market are faring well, which has normally been a plus for the incumbent.

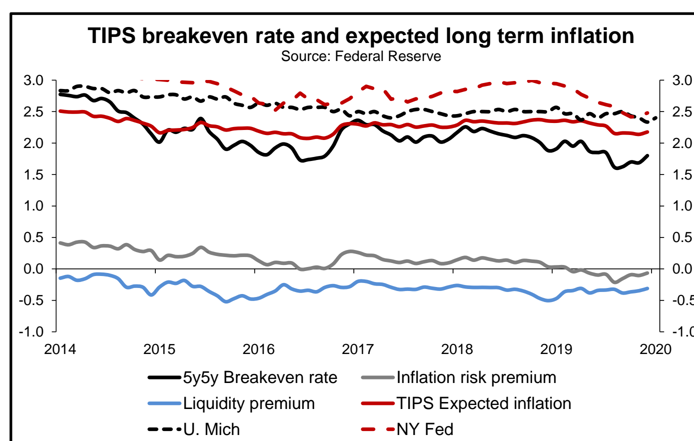
The choice of the contender will be obviously crucial. Markets will be in particular scrutinizing the odds of Ms. Warren and Mr. Sanders, whose policy propositions include free healthcare and education, financed by a sizeable increase in corporate and wealth taxation. Currently centrist Biden has a comfortable lead in nationwide polls. The Iowa caucus on February 3 and, above all, the Super Tuesday on March. 3 (when primaries are held in 14 states), will narrow down the list of candidates, and will give a clearer picture of the Democratic Party's ultimate stance.

The Fed cuts once more and adjusts its strategy

The Fed deserves a lot of credit for the 2020 soft landing of the economy, thanks to its quick U-turn in rate setting. According to the minutes of the latest meetings and the speeches by its members, the FOMC will wait for the full display of the monetary accommodation, without any move on rates. Moreover, by June, the results of the policy review will have large implications for the expected path of short-term rates.

Markets price with an over 50% probability a rate cut only in the final quarter of 2021. We expect it to happen in the second quarter of this year instead, for a series of reasons. First, as explained above, we do not think that the nascent data green shots we will turn into a strong pickup of the economy. In fact, a weaker economy, and possibly a slowdown in job creation will be enough for the "material reassessment" of the outlook, chair Powell set as a precondition for rate moves. Second, the dovish policy turn has so far failed to turn around inflation expectations. Insuring their anchoring would require further action.

Moreover, another cut will also credibly signal the shift to a new policy framework (see below). In a recent study, Fed's economists showed that the Bank of Japan's move from an inflation "goal" of 1% to a 2% target, immediately followed by monetary easing, had a beneficial effect on inflation and the labor market. While the comparison between the Fed and the BoJ is far from perfect, it nevertheless illustrates that decisive action needs to quickly follow words. The upcoming election and the risk of a perceived politicization of the Fed would call for action well before Election Day.



The unveiling of the new monetary policy strategy will be by far the most important event involving the Fed this year. The biggest change to the framework will be the way inflation influences rate setting. In the current strategy past inflation developments do not matter for the setting of current rates. The prolonged undershooting of the 2% inflation target is likely to have contributed to lowering expected inflation. This and the downward trend in the equilibrium real interest rate (R-star) are pushing down the nominal equilibrium rate. This is the level of Fed funds rate above which monetary policy becomes contractionary. Therefore the Fed would have much less flexibility to cut rates in a downturn, as the possibility of having negative Fed funds rates has been repeatedly ruled out by Fed officials.

The new strategy seeks to prevent such an outcome. The most likely approach, average inflation targeting, entails considering a longer term (two to three years) average inflation rate in order to set rates. This means that, following a period of subpar inflation, the Fed will tolerate a period of above target inflation before raising rates, granting a longer lasting monetary easing. Leaving some ambiguity on the time horizon on which inflation is averaged would allow some flexibility in case of sharp cyclical changes.

At the current junction, the move to such a strategy would cement a dovish bias on the Fed action: with the exception of some blips in 2012 and 2018, core PCE inflation has constantly remained below target since 2009. This implies that inflation will have to remain above 2% some time before any monetary tightening takes place.

The softer stance will show up in interest rate: we project the yield on 10-year Treasuries to drift down to 1.6% by the end of the year. This will cushion the negative effect of weaker profits and persistent uncertainty on equity, which should still deliver a modest 2% total return by year-end.

Imprint

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Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

Version completed on January 28th, 2019

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