ABN·AMRO

US Outlook 2020

Group Economics
Financial Markets Research

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Trade truce, but no growth rebound

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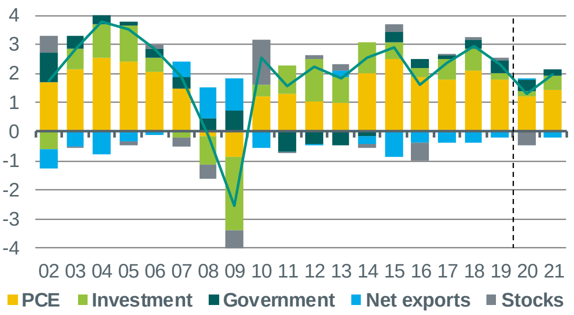
- **The US economy is in slowdown mode**
- **We expect growth to slow further this year, as the weakness in manufacturing weighs on consumption and services**
- **The pause in the trade war will probably hold until the November election, but the risk of a re-escalation after will continue to weigh**
- **The slowdown is in any case not all about the trade war – globally tight financial conditions have also been a factor**
- **Downside risks to inflation bolster the case for another rate cut by the Fed. Policy will in any case remain accommodative**
- **History favours a Trump win in the presidential election, but it is still early days, with the Democrat primaries just beginning**

Introduction

The US economy slowed significantly in 2019, and will continue to slow in 2020. Part of this has been the inevitable snapback to trend, after an exceptionally strong, stimulus-fuelled 2018. However, it is also that the global industrial slowdown of the past two years is finally hitting the manufacturing sector – with a lag. Despite the trade 'truce' with China, we do not expect an imminent and sharp recovery in manufacturing. The key question driving the 2020 outlook will therefore be to what extent the weakness in manufacturing (11% of GDP) spreads to the much bigger services sector (70% of GDP).

Brace for a further slowdown in 2020…

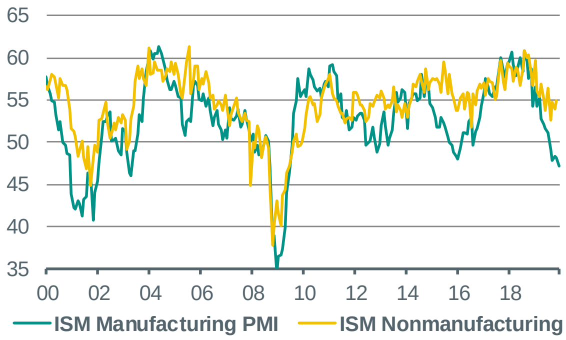
% yoy, annual average, pp contributions



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…as manufacturing weakness spills over to services

Index, >50 = expansion, <50 = contraction



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

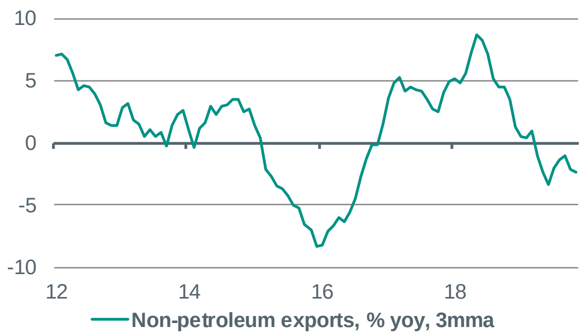
Slowdown is not all about the trade war
From a lofty peak in late 2018, the manufacturing sector slowed dramatically over the course of 2019, and is now in contraction mode. Our preferred barometer for the sector – and the gauge that has the most reliable fit with GDP growth – is the ISM manufacturing PMI; this fell from a peak of 60.8 in August 2018 to a 10 year low of 47.2 as of the latest December reading. While there are some 'special factors' to note, such as the cut in production of the Boeing 737 MAX (which will subtract 0.2-0.3pp from GDP growth in 2020), the weakness has been broadbased across manufacturing sectors. The weakness is also consistent with what has happened to exports, which peaked in May 2018, and have fallen by over 5% since that peak.

What has been behind this weakness? The most obvious culprit is the trade war. Beginning in earnest in 2018, the US has steadily ramped up protectionist measures targeting China in particular, with tariffs of 15-25% now levied on half of Chinese imports. This has led to a collapse in trade between the two countries over the past 18 months, with imports from China down 30% from their peak as of November, and exports to China down 26%. The share of imports coming from China has now fallen to 17% – the lowest since 2012, and a remarkable decoupling of the world's two largest economies.

But while the trade war is clearly a significant factor, it is arguably an oversimplification to attribute the global industrial weakness entirely to it. Indeed, as we saw in the eurozone in 2018, the weakness in global manufacturing started before the trade war, and the narrative explaining the weakness at that time was China's deleveraging campaign. This tightness in financial conditions in China, combined with the Fed's own tightening of monetary policy, in our view played a role in the global industrial weakness we have seen. While central banks have since eased policy, this easing has not been of a scale that in the past drove sharp recoveries. This point is crucial, because if our key assumption were that the trade war was the primary source of the slowdown, it would be reasonable to expect a recovery in growth – if not a sharp rebound – following the recent détente between the US and China. The fact that global financial conditions are still not overly accommodative is one of two key reasons we expect growth to remain subdued globally, and – in the US specifically – to slow even further.

Exports are contracting…

% yoy, 3mma



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…while the Chinese import share has plunged

% share of goods from China in total imports

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

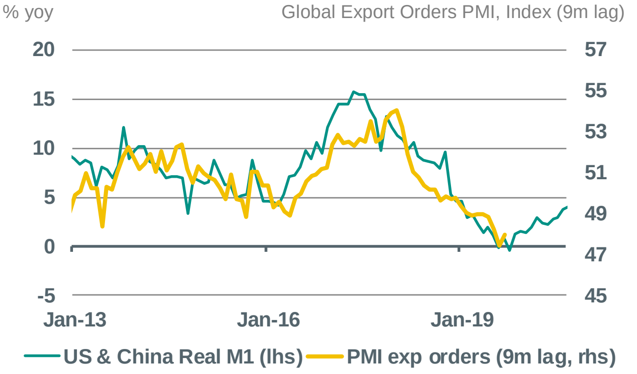
Tariffs will remain a threat
The other key reason we do not expect a sharp rebound is that the trade war itself is actually far from over, in our view. The recent Phase One deal with China will yield no immediate rollback in tariffs, but instead a ceasefire (i.e. no further tariffs for the time being). Any rollback will be limited, and only happen after the US presidential election in November, when the two parties will assess the progress made on the terms of the deal (specifically, whether China has kept to commitments to expand imports from the US – and therefore reduce the bilateral trade deficit). At the same time, new fronts in the US's combative trade policy could also open up, particularly with Europe. The key risk here is whether the US will retaliate against France's digital services tax. While the US and French authorities appear to have struck an interim compromise postponing tariffs to the end of the year, this hinges on the OECD coming up with a framework to tax tech giants in a way that satisfies all parties – a tall order.

Should the US follow through on its tariff threat, it would not be able to specifically target all French goods, since France is part of the EU, but it can target goods that predominantly come from France, such as cheese and wine products. The UK is scheduled to introduce a similar tax in April, and could also become a target of such tariffs – just when it will need to strike a trade deal with the US to partly offset the looming loss of access to European markets. Taken together, while we expect some recovery in investment in the second half of this year, the fragility of the US-China deal – and the potential for new sources of trade policy uncertainty – will likely continue to weigh on business confidence and capex spending.

Investment likely to remain weak

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Tight financial conditions have also been a factor



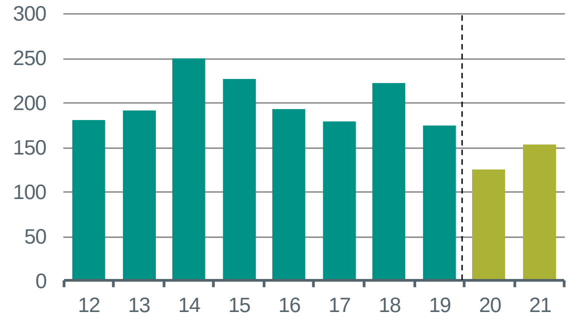
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Weak manufacturing to weigh on services too
The degree to which manufacturing weakness spills over to services is the key uncertainty for 2020. Manufacturing is now a relatively small part of the economy, at just 11% of GDP. This understates how cyclically important the sector is, however. In the absence of shocks, growth in the services sector tends to be more stable, and it is usually the manufacturing sector that drives growth above or below the trend rate. But what is the mechanism by which weakness in manufacturing can cause slower growth in services? There are two main channels: 1) slower manufacturing jobs growth weighs on consumption; 2) weaker growth in services linked to manufactured goods (eg. maintenance contracts for capital goods/machinery).

On jobs growth in particular, there is already evidence that manufacturing weakness has led to slowing growth. While not falling off a cliff, overall jobs growth slowed considerably in 2019 following a stellar 2018, from a monthly average of +223k to +176k in 2019. Of that 47k decline in jobs growth, by far the bulk of that decline came from falling manufacturing jobs growth (which fell from +53k to +15k), with growth in the services sector declining by much less (from +171k to +161k). Slowing jobs growth combined with stagnant wage growth is now weighing on aggregate income growth. While consumers have plenty of room to dip into savings to make up for slowing income growth – and the extent to which this happens is a key uncertainty – as a base case we do expect slower consumption growth in 2020.

Slowing jobs growth to weigh on consumption

Nonfarm payrolls, monthly average change



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Consumers have some room to dip into savings

Rate

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Housing recovery won't provide much of a boost

One of the bright spots among a mostly slowing economy has been housing investment, which has been stimulated by the Fed's rate cuts. Housing was particularly slow to recover following the Great Recession, given that the crisis was triggered by the bursting of a housing bubble. However, with mortgage rates falling by over a percentage point following the Fed's pivot to easier monetary policy in late 2018, the housing market has been quick to respond, with home sales rising sharply and housebuilding picking up. While housing could once be relied upon as a growth driver, however, its significance to the economy is considerably diminished compared with the pre-crisis period; from a pre-crisis high of 6.7% of GDP in 2005, residential investment now accounts for just 3.7% of GDP as of Q3 2019. Even assuming very strong rates of growth – say, 10% (our forecast is a more conservative 2.5%) – the boost to overall GDP would be limited to just 0.1-0.2pp.

Weaker growth means a weaker labour market…

All told, we expect GDP growth to move another leg lower in 2020, to 1.3% – down from 2.3% in 2019 (itself a significant slowdown from the 2.9% pace of 2018). Such a slowdown also implies a further loss of momentum in the labour market. Here, we expect monthly average payrolls to decline from the +176k pace to +125k, before recovering to +153k in 2021. Our 2020 forecast would be the weakest outturn since 2010, and although a likely stagnation in the participation rate (which has been defying demographic gravity in recent years) should keep unemployment from rising, we do expect the weaker labour market to keep a lid on wage growth.

Indeed, wage growth has already eased over the past year from a peak of 3.4% yoy in February, to 2.9% in December. While we do not expect wage growth to decline further, the fall in jobs growth that we project – and a broadly steady unemployment rate – is likely to keep wage growth from rebounding again.

Unemployment to be stable at low levels

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

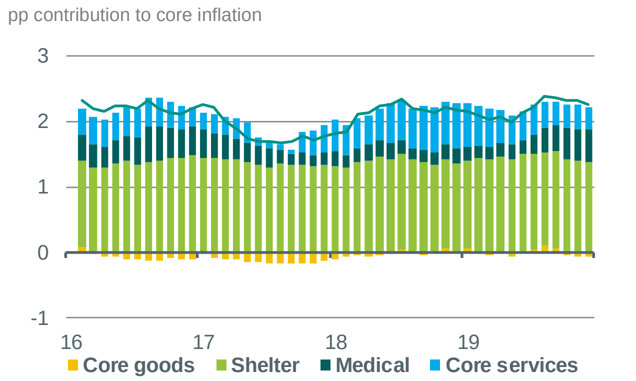
Wage growth is decelerating

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…and downside risks for inflation

Slowing growth and slowing wage growth in particular are creating downside risks to the inflation outlook, just at a time when the more reliable supports for inflation appear to be breaking down. Most notably, momentum in the shelter component (i.e. housing costs) of inflation has declined dramatically over the past year from a peak of 4.2% 3m/3m in May, to just 2.3% in December – the lowest since March 2013. This is significant, because above-trend growth in housing costs had been keeping inflation close to (if still below) target for most of the post-crisis period. This is because shelter has a large weighting in the core CPI (42%) and – to a lesser extent – the core PCE indices (18%). The recent weakness in shelter inflation has yet to make its mark on annual inflation, with core CPI at 2.3% yoy as of December. However, should it persist, we are likely to see core inflation drift lower in the coming months, falling to 1.8% yoy by the end of the year – with risks to the downside.

Shelter has been a key support for core inflation…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…but momentum here is rapidly cooling

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

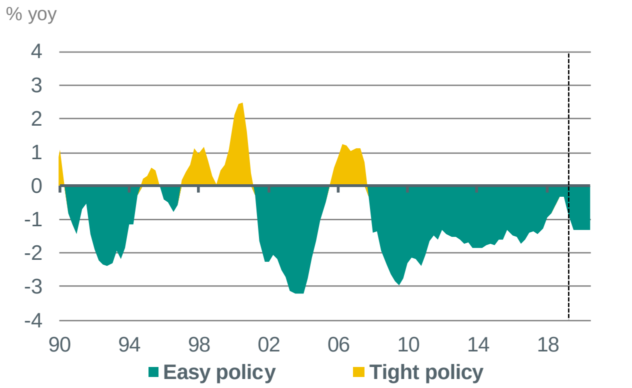
One more Fed cut

While inflation has not been the primary driver of Fed rate cuts, a weaker inflation outlook bolsters the case for more easing. Our base case is that the Fed will make one more ‘insurance’ cut to interest rates, taking the target range for the fed funds rate to 1.25-1.50% by the middle of the year. While Fed officials – even the more dovish FOMC members – currently signal broad comfort with current policy, our growth forecast is considerably lower than the Committee median (at 1.3% vs 2.0%), and we expect slower growth to prompt a change of heart over policy as the incoming data weaken.

Policy framework review: a higher tolerance for above-target inflation?

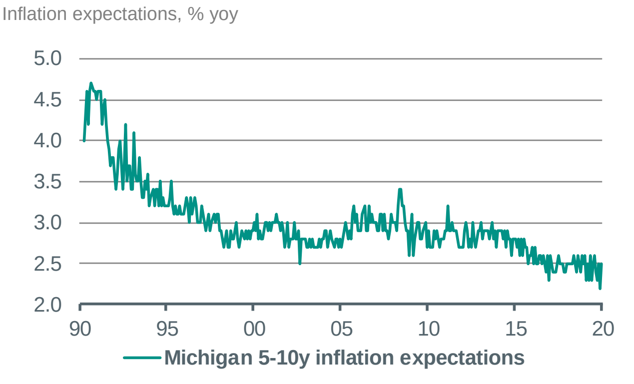
Crucial for longer-term policy will be the Fed’s ongoing framework review. The outcome of the review will be published in the first half of 2020, and could mean changes to the current 2% inflation target. It looks unlikely that the Fed will adopt something as radical as price level targeting, which could be overly prescriptive in requiring the Fed to ‘make up’ for past shortfalls or overshoots in inflation. However, it is possible that the Fed adopts an average inflation target, which – depending on how it is implemented – could be a significant change. Rather less ambitiously, the Fed could adopt an inflation target range. Whatever the Fed chooses to do, the goal would be to make explicit that it is just as tolerant of above-target inflation as it is below-target inflation. While it remains unclear what the Committee will opt for, the minutes suggest that any change would be unlikely to trigger near-term policy actions, but rather would keep the Fed from raising rates should inflation rise temporarily above target. The Fed will hope that such a move will raise flagging inflation expectations, in turn raising the neutral rate and giving it more policy space to deal with future downturns.

Monetary policy should stay accommodative



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Inflation expectations could do with a boost



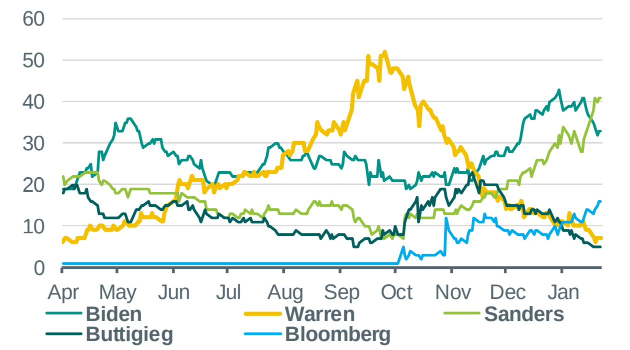
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Election 2020: Joe Biden and Bernie Sanders regain momentum

The presidential election is due to take place a little over 9 months from now, on 3 November. Things will likely become more interesting for financial markets around the middle of the year, when it should be clear who the Democratic nominee will be following the primaries and caucuses set to take place over the coming months. Following a period where the Democratic presidential nomination was looking wide open again, support appears to be coalescing around moderate Joe Biden and the more radical Bernie Sanders in the run up to the primaries, with the Iowa caucus taking place on 3 February. According to the *Predictit.org* betting website, the implied probability of Biden winning the nomination has risen to 33%, up from 20% in November. The probability of Bernie Sanders winning has increased even more, with a 41% probability of winning, up from 12%, following the decline in popularity of left-wing rival Elizabeth Warren. Opinion polling suggests Biden also has the best chance of beating Trump, although the race would likely be just as tight as in the 2016 election. Indeed, despite (perhaps even because of) impeachment proceedings against President Trump, his approval ratings have actually improved a little in recent months, from -12 points in early November to -8 points in the first weeks of 2020, according to *RealClearPolitics*. In any case, it is highly unlikely that Republican senators will vote to remove President Trump when Senate impeachment proceedings start in the coming weeks (Democrat senators do not have the numbers by themselves to do so).

Joe Biden and Bernie Sanders regain momentum

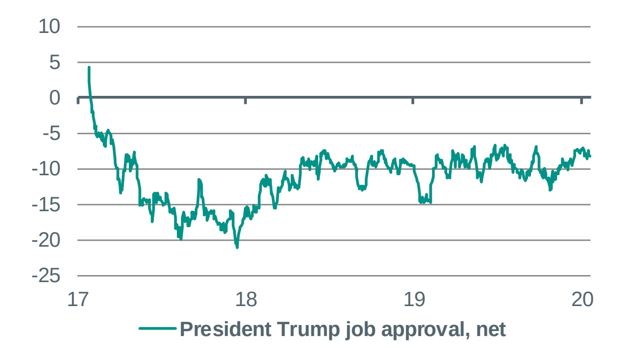
Implied probability of each Democrat winning presidential nomination, %



Source: *PredictIt.org*, Bloomberg, ABN AMRO Group Economics

Trump's approval ratings have improved a little

Net approval rating, %



Source: *RealClearPolitics*, Bloomberg, ABN AMRO Group Economics

Incumbent usually secures a second term

While president Trump's approval ratings are currently somewhat worse than those of Presidents Obama and Bush Jr before their second term elections, it is historically rare for a president not to win a second term. Typically, presidents fail to win re-election when there has been a recession – indeed, the last time this happened was with George Bush Sr. in the 1992 election, when the US was coming out of a recession. Given that as a base case we do not expect a recession in the US this year, it looks marginally more likely at this stage that President Trump wins a second term.

Biggest risk for markets if a left-wing candidate wins the presidency

The election will be significant for the medium- long-term outlook – in particular, its implications for multilateral institutions such as the WTO, and for the future of the Paris Climate Agreement (see the latest *Global Monthly*), but the growth implications of the election are likely to be small on our forecast horizon (to end-2021). The split in Congress (i.e. Democrats controlling the House; Republicans controlling the Senate) makes any pre-election stimulus highly unlikely, while post-election, it will take time for any new policies to have a macroeconomic impact. Beyond 2021, the lack of concern over large deficits on both sides of the political divide means that one way or another, the economy will see some form of extra stimulus (with Trump, a new round of tax cuts; with a Democrat, higher infrastructure spending). With financial markets having grown used to President Trump's unpredictable and combative trade policy, the biggest risk is arguably if a left-wing candidate such as Bernie Sanders or Elizabeth Warren were to win the Democratic nomination, and to then go on to win the presidency. Markets would react negatively to the likelihood of higher taxes and increased regulation under such presidents. This looks a relatively low probability scenario at this stage, but it is still early days.

Key forecasts for the United States

	2017	2018	2019	2020e	2021e
Economic outlook (% yoy)					
GDP	2.4	2.9	2.3	1.3	2.0
- Private consumption	2.6	3.0	2.6	1.8	2.1
- Fixed Investment	4.2	4.6	1.3	0.6	2.7
- Net exports (pp contribution)	-0.4	-0.4	-0.2	0.0	-0.2
Inflation (CPI)	2.1	2.4	1.8	1.9	1.8
- Core inflation (CPI)	1.8	2.1	2.2	2.0	1.9
- Core inflation (PCE)	1.6	1.9	1.6	1.8	1.8
World trade	4.3	4.0	0.0	1.0	2.0
Interest and exchange rates (eop)					
Fed funds rate (upper bound)	1.50	2.50	1.75	1.50	1.50
3m Libor rate	1.7	2.9	1.7	1.6	1.6
10yr yield	2.41	2.68	1.92	1.90	1.90
EUR/USD	1.20	1.15	1.12	1.16	1.20
USD/JPY	113	112	109	112	116
WTI oil (USD/barrel, pa)	60.4	65.8	61.1	55.0	60.0

Source: ABN AMRO Group Economics

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