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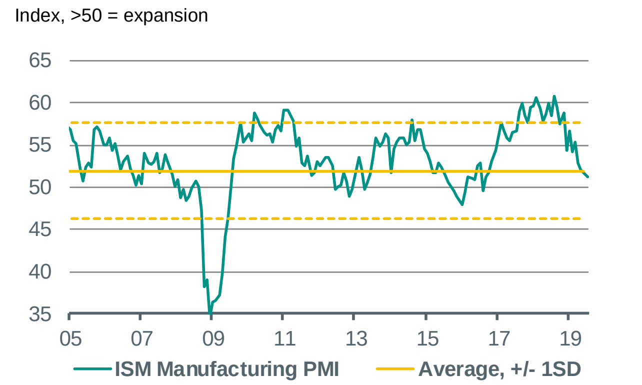
Why the Fed will keep cutting

- **On the face of it, the US economy still looks strong – unemployment is historically low, and growth remains above trend**
- **However, under the hood, things are not so rosy. The manufacturing sector – which tends to drive the business cycle – is weak and is likely to weaken further**
- **This is feeding through to slower jobs growth, dampening consumer confidence. This will ultimately drive a broader slowdown (but not a recession)**
- **Given the looming slowdown and in the absence of inflationary pressure, we now expect the Fed to cut 25bp at all three remaining FOMC meetings this year. Previously, we expected two further cuts by Q1 2020**

1. Trade war is exerting a bigger drag on manufacturing…
Peaking in late 2018, the manufacturing sector has weakened significantly this year. This is evident in both hard and soft activity data; manufacturing output has fallen 1.6% in the year to July, while the ISM manufacturing PMI has fallen nearly ten points, from a peak of 60.8 in August 2018 to 51.2 as of the latest July reading. The forward-looking new orders component has fallen even further, from a peak of 64.5 last August to as low as 50 in June. While it is difficult to parse out the drivers of the weakness, anecdotal commentary in the ISM surveys suggests uncertainty from the trade war is the primary headwind facing manufacturers. With little sign of a resolution in the trade war, and given the global nature of the manufacturing slowdown, we expect the sector to weaken further in the coming months.

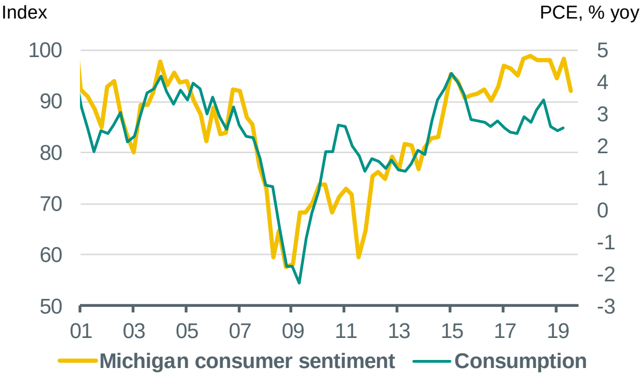
Manufacturing still weakening



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

2. …hitting payrolls, confidence, and consumption – with a lag
The consumer has been mostly insulated from the turbulence in the manufacturing sector, but signs of weakness are appearing. First, payrolls growth has slowed significantly, from a monthly average gain of 223k in 2018, to 165k in the year to July. As might be expected, most of this decline (c.38k) has occurred in manufacturing. Consumption actually picked up after the government shutdown-related distortions at the beginning of the year – evident in the most recent, robust retail sales data. However, consumer confidence looks to have peaked, and the Michigan consumer sentiment survey declined significantly in August, with the current conditions sub-index falling to a near 3-year low.

Consumption solid, but confidence is falling back



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

3. Lower profit margins raises recession risk, but not our base case

A further cause for concern is the significant revisions to corporate profits in the national accounts, which suggests margins have come under greater pressure from higher wage bills than previously thought. In the past, such declines in margins often preceded recessions, as one response to margin pressure is to lay off workers (another is to raise prices; unlikely in the current environment). As discussed in our *US Watch*, the pushing against capacity constraints alone is usually insufficient to trigger a recession – some kind of policy or financial market shock is also necessary. As such, we do not forecast a recession as a base case. However, the revised data suggests an economy much more vulnerable to shocks than was previously apparent. The Fed will be cognisant of this as it recalibrates policy to a more accommodative stance.

Margin pressure raises risks of job layoffs

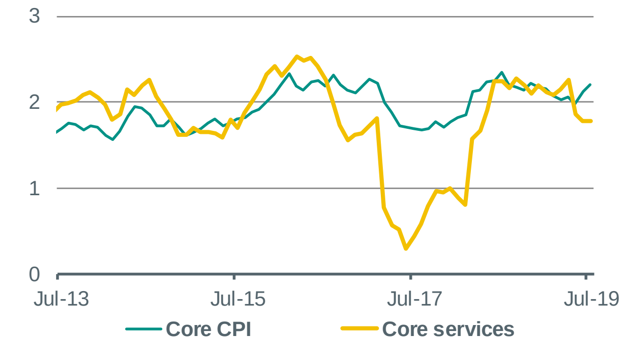
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

4. Subdued inflation an enabler of rate cuts

Having disappointed to the downside for much of 2019 (see here), inflation recovered some lost ground in recent months, with the core CPI measure picking up to 2.2% yoy in July. However, the acceleration in inflation has come from core goods (reversing earlier weakness), and medical sub-indices. Core services inflation – where pass-through from the tight labour market should be more apparent – has actually fallen back in recent months. These dynamics suggest the rise in inflation is unlikely to be sustained. While a tariff-related boost could mean further upward pressure from core goods over the next 12 months, the magnitude would be small (a c.0.2pp increase), and something the Fed would 'look through' provided broader inflationary pressure remains in check. The lack of a sustainable pickup in inflation gives the Fed ample leeway to ease policy to support growth.

Inflation rise is not sustainable

% yoy ('core services' excludes shelter, medical, and transportation)



Source: Thomson Reuters Datastream , ABN AMRO Group Economics