US Watch

Group Economics
Financial Markets Research

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Sharper slowdown, softer landing

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- **We expect a sharper 2019 slowdown, but a softer landing in 2020**
- **We downgrade our 2019 GDP growth forecast by 0.4pp to 2.3%, and raise our 2020 growth forecast by 0.2pp to 1.9%**
- **The weaker 2019 forecast comes on the back of a manufacturing downturn, and the government shutdown**
- **The higher 2020 growth forecast is on the back of easier Fed policy and upside risks to government spending**
- **Consumption should remain a key support for growth given stronger wage growth and solid household balance sheets**

Introduction

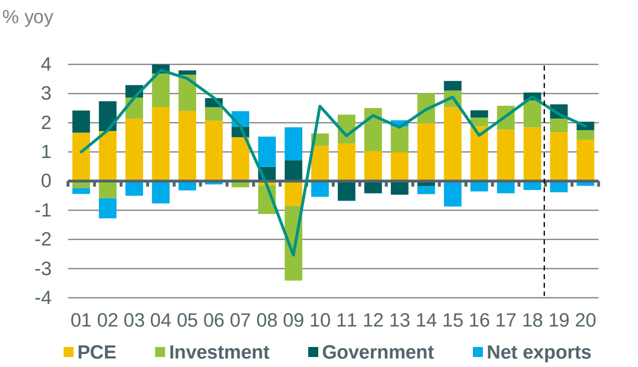
GDP growth slowed by less than many feared in Q4, with growth at 2.6% qoq annualised – well above consensus estimates (2.2%) and trend growth (Fed estimate: 1.8%). The details proved to be even more reassuring, with investment recovering from a weak Q3 (up 6.2% from 2.5%), and consumption continuing to grow at a robust pace (2.8% vs 3.5% in Q3). For the full year, GDP grew 2.9% in 2018, just shy of our 3.0% forecast from early 2018. Despite Q4 being a solid quarter, however, the year to date is looking notably weaker, with the downturn in global manufacturing and the government shutdown weighing on growth. As a result, we are lowering our 2019 GDP forecast by 0.4pp to 2.3%, while raising our 2020 forecast by 0.2pp to 1.9%. In this report we discuss the key drivers of these forecast changes.

A sharper 2019 slowdown, but a softer 2020 landing

Economic outlook (% yoy)	2017	2018	2019e	2020e
GDP (New)	**2.2**	**2.9**	**2.3**	**1.9**
GDP (Old)		***3.0***	***2.7***	***1.7***
- Consumption	2.5	2.6	2.4	2.0
- Investment	4.8	5.3	2.6	1.8
- Net exports (pp cont)	-0.4	-0.3	-0.2	-0.2
Inflation	2.1	2.4	1.6	2.0
- Core inflation	1.8	2.1	2.0	2.1
World trade	4.3	3.3	1.0	3.3

Source: ABN AMRO Group Economics

Weaker investment, stronger government spending



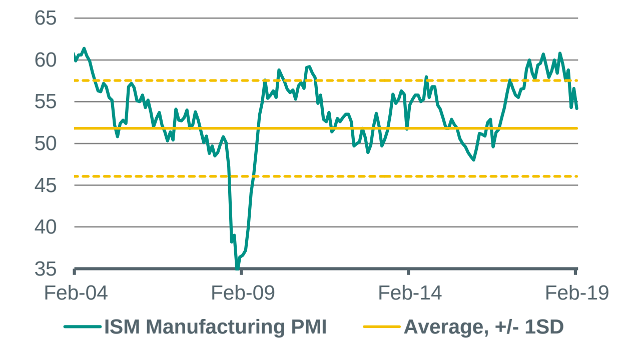
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Two key drivers: Weak manufacturing…

The first reason for our forecast change is the sharper-than-expected slowdown in the manufacturing sector. While we have for some time expected a slowing in the investment cycle (see our *US Outlook 2019*), the unexpectedly protracted weakness in global manufacturing has led to a more rapid loss of momentum, and this looks set to persist for at least the first half of 2019. Indeed, although industrial production continued to grow robustly in Q4, at 4.6% qoq annualised (Q3: 4.9%; Q2: 5.2%), a sharp decline in the forward-looking ISM Manufacturing PMI, from a historically elevated 62.3 in Q3 to 57.0 in Q4, and 54.2 as of February, suggests a significant slowdown in 2019. We see scope for further weakness in manufacturing over the coming quarters, as weaker global demand feeds through to slower export growth. However, while the US is impacted by the global manufacturing downturn, it is nonetheless less export-dependent than, say, the eurozone. As such, we do not expect the downturn to be quite as deep in the US.

Manufacturing down from historically elevated levels

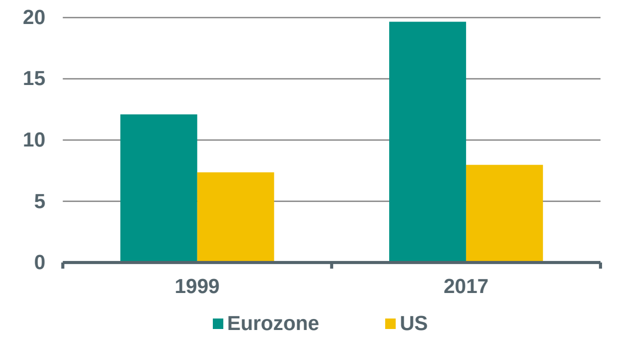
Index, >50 = expansion / <50 = contraction



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

The US is less sensitive to the global cycle

Exports (Eurozone: Extra-EZ), % GDP



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…and the government shutdown

At 35 days, the federal government shutdown of 2018-19 was the longest on record. It affected c.800,000 employees, half of whom were not working, and the other half working without pay. This represented a quarter of federal government employees, or 0.5% of the national workforce. The direct effects of the shutdown, in delayed pay and lost consumption, were likely small – around 0.2pp in annualised growth in Q1. However, the harder-to-quantify indirect effects were probably bigger. These include, but are not limited to: confidence effects (consumer confidence weakened sharply during the shutdown), delays to tax refunds, the impact on contractors and service providers to government from reduced procurement, business activity affected by a slowing in regulatory approvals, and the freeze in government spending increases in the departments *not* affected by the shutdown. All told, we think the negative impact on Q1 GDP growth could be closer to 1.0pp annualised, although some of this will be made up in Q2 and Q3. As a result, we now see growth of 1.0% qoq annualised in Q1, 2.4% in Q2, 2.5% in Q3, as consumption and government spending rebounds, and manufacturing stabilises. We then expect growth to moderate back to trend by Q4 (1.9%). This contrasts with our previous expectation of a strong first half 2019, and a weak second half.

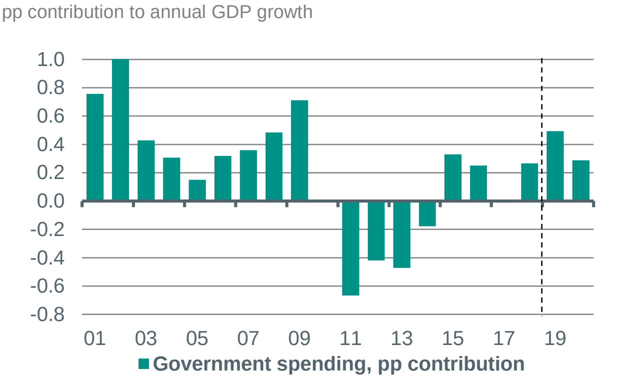
A shallower 2020 slowdown now likely

Alongside the downgrade to our 2019 growth forecast, we have slightly upgraded our 2020 forecast. This is partly technical given the lower 2019 base. However, it also reflects the earlier end to the Fed's rate hike cycle (see here), which has already led to lower mortgage rates and should support residential investment (see here). Government spending should also remain a growth support for 2020. President Trump will present his FY 2020 budget on 11 March, which could well mean an even bigger increase in spending than we currently project; defence spending is already confirmed to be higher. While CEA director Larry Kudlow has suggested *cuts* to non-defence spending, this will not pass in a Democrat-controlled House of Representatives. Fiscal sustainability is scarcely on the political agenda at present, so the path of least resistance will be for more spending, not less. While we do not expect a dramatic increase in spending relative to our baseline, the risk in our view is nonetheless to the upside.

Fed pivot has driven mortgage rates lower

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Government spending to remain a growth support

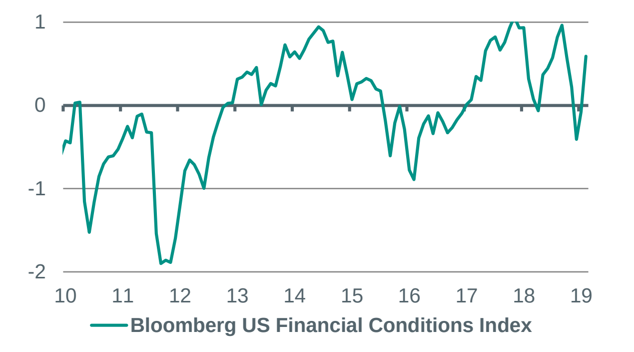


Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Consumption to remain the backbone of the US economy

Against the backdrop of slowing manufacturing and investment, and strong government spending, we expect the US consumer to remain a key pillar of support for growth. Indeed, even as confidence in the manufacturing sector has declined further in 2019, consumer confidence has in contrast bounced back sharply, likely reflecting the end of the government shutdown and the easing in financial conditions – which are now back to levels seen before the late-2018 rout in equity markets began.

A rebound in financial conditions…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

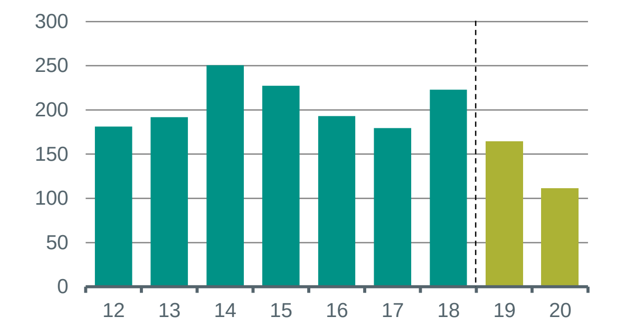
…and consumer confidence

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

The Conference Board's consumer confidence measure rebounded sharply in February to 131.4 after plunging to 120.2 in January, driven by a recovery in both the current conditions and expectations components. We believe the fundamentals underpinning consumption will remain strong in 2019. While payrolls growth is likely to slow on the back of the weakness in manufacturing and investment, and as capacity constraints in the labour market bite, this should be partly offset by accelerating wage growth, which has picked up somewhat more than expected. Meanwhile, the savings rate remains relatively elevated at 6.3% (the pre-crisis low was 2.5%), and household debt and debt servicing ratios historically low. This leaves ample room for consumption to expand more quickly than real wages, should consumer confidence remain elevated, as we expect.

Payrolls growth to slow…

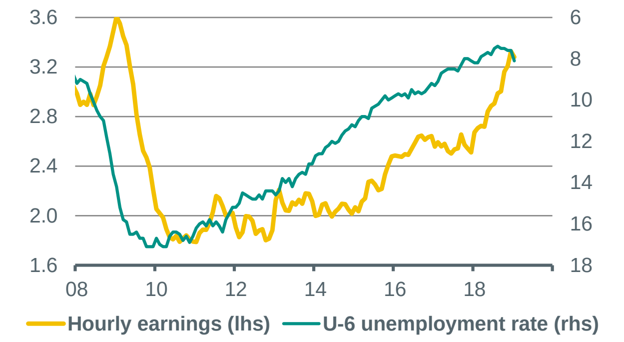
Monthly average nonfarm payrolls



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…but wage gains are accelerating

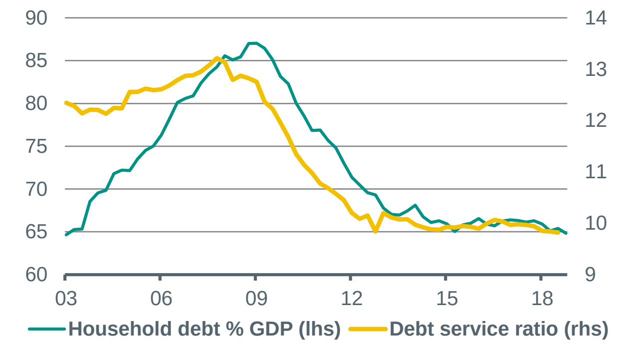
% yoy, 3mma
Rate



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Low household debt and debt service ratios…

% GDP Ratio



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…and a still-elevated savings rate

Rate

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

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