Stonebridge Economic Outlook

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Still on Track--Unfortunately… ***Full Article on Page 2***

Although U.S. real gross domestic product (GDP) growth in the first quarter was considerably less than anticipated in the previous forecast, the shortfall should be offset by a somewhat stronger than previously expected second quarter. As a result, average real GDP growth for the first half of 2017 most likely will differ very little from the earlier forecast of a bit over 2.0 percent at an annual rate. Given that the first half will be roughly in line with earlier expectations, there is very little need to change the real GDP growth forecast for the second half of 2017 or all of 2018. In particular, real GDP growth still is expected to slow to an average of less than 1.0 percent for the second half before stalling out entirely by year-end. At the moment, we think the stall will be severe enough for the National Bureau of Economic Research to eventually declare it a recession. That said, due to more recent observations, a few other aspects of the forecast, including consumer price inflation and the unemployment rate, need to be revised a bit. With the recent drop in crude oil prices, overall consumer price inflation has slowed considerably. This slowdown not only requires a downward revision to the near-term inflation forecast but it also may question whether inflation could accelerate by year-end to a level that would be as problematic for consumers as anticipated in the forecast. Every shock needs a setup and the second-quarter slowdown in inflation could be that setup. After all, something is more likely to shock when everyone is convinced it cannot happen. In addition, the civilian unemployment rate already has fallen to the level anticipated later this year causing a slight downward revision for the remainder of the year. But rather than question the forecast, the revision to unemployment tends to reinforce it. After all, the excesses that help derail economic expansions cannot occur without the exuberance that typically comes from very tight labor markets.

Assessing the Impact of the Presidency on the Economy... ***Full Article on Page 6***

The general impression is that presidents have a great deal of impact on the economy. But in reality, the president's ability to influence the economy's performance during their term of office is very limited. Although presidents generally try to help the economy, they often overstate their contribution. To paraphrase, "the road to recession is paved with good intentions." In particular, contrary to the general impression that Republican administrations are good for business, nearly all of the economic recessions since 1960 have occurred with a Republican in the White House. However, this statistic may be more a matter of chance than policy acumen. In this regard, President Trump obviously wants to avoid a recession but if he cannot, he wants it to occur early enough in his first term to blame it on the previous administration and take the credit for the economic recovery that most likely would follow. Based on history, he has a very daunting task. Indeed, it seems that the economy has more impact on the general perception of a president than the president might have on the economy.

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Still on track--Unfortunately

Although U.S. real gross domestic product (GDP) growth was considerably slower in the first quarter than anticipated in the previous forecast, any shortfall should be offset by a somewhat stronger second quarter (see Table 1). Hence, average real GDP growth for the first half of 2017 most likely will differ very little from the earlier forecast of a bit over 2.0 percent at an annual rate. As such, there is very little reason to make any substantial changes to the forecast for real output growth for the second half of 2017 as well as for all of 2018. In particular, the pace of real GDP growth still is expected to slow to an average of less than 1.0 percent for the second half before stalling early next year. At the moment,

Table 1
Forecast Summary

	2016	2017f				2018f
		Q1	Q2	Q3	Q4	
Real Gross Domestic Product	2.0	**1.4**	**3.0**	1.2	0.5	0.6
Consumer Price Index, All	1.8	3.1	**0.2**	**3.0**	**3.9**	2.0
Consumer Price Index, Core	2.2	2.5	**1.3**	**3.0**	**3.5**	2.0
GDP Chain-Type Price Index	1.6	**1.9**	**1.9**	2.5	2.8	1.7
Civilian Unemployment Rate	4.7	4.7	**4.3**	**4.2**	**4.3**	6.0
Price of WTI crude oil ($/bbl)	49.1	51.8	48.8	51.2	58.5	51.5
Trade-Weighted Dollar Index	94.4	94.4	93.0	90.1	87.5	79.0
S&P 500 Operating Earnings	106.3	29.0	30.2	31.9	30.1	98.0
Percent vs. Year Ago	5.8	21.0	17.5	11.2	7.9	-19.1
91-Day Treasury Bill Rate	0.4	0.6	0.9	1.7	2.7	1.7
10-Year Treasury Note Yield	2.1	2.4	2.3	2.5	2.7	2.5
30-Year Mortgage Rate	3.8	4.2	4.1	4.5	4.8	4.6
Bank Prime Rate	3.6	3.8	4.0	4.7	5.7	4.7

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.
Note: Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. Quarterly changes are percent changes from the previous quarter at annual rates.
The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates are averages for the last quarter of the year indicated. Quarterly estimates are averages for the quarter indicated. S&P earnings are per share for the period indicated.
f-forecast; bold type reflects a major change from the previous forecast

we think the stall early next year will be severe enough for the National Bureau of Economic Research to eventually declare it a recession. The key to stronger real GDP growth in the second quarter is consumer spending, which should improve considerably from its disappointing first-quarter performance of only 1.1 percent growth at an annual rate, following three consecutive quarters with gains of 3.0 percent or more. Although the first-quarter slowdown in real consumer spending was widespread across all categories, it was spending on services that seemed to lead the way.

But apparently this slowdown in service spending will prove temporary. Recall that unusually mild weather in January and February caused real spending on services to decline, owing in large part to dramatic declines in spending on housing and utilities. The implication is that even a return to normal weather would facilitate a substantial rebound in service spending. But in fact, many parts of the country have had record high temperatures in the second quarter, suggesting an even greater jump in utility spending than would occur otherwise. In May (the most recent data available), real PCE was at a level that was already 2.9 percent at an annual rate above the first-quarter average, suggesting that a rebound in consumer spending is on track. More importantly, real disposable personal income in May was up an even stronger 4.5 percent at an annual rate from the first quarter, suggesting that consumers continued to acquire the wherewithal to spend.

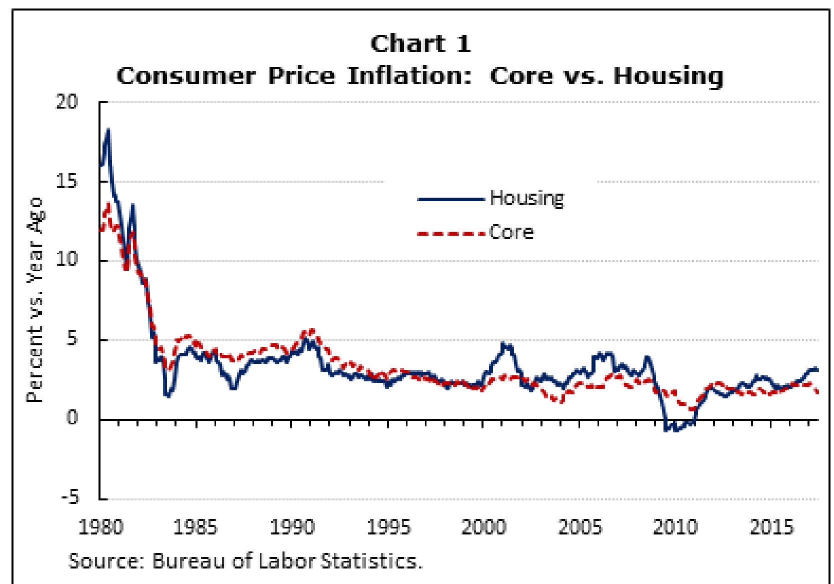
Another positive factor for second-quarter real GDP growth is likely to be the change in business inventories. In this case, it is not that the change in inventories will contribute markedly to growth in the second quarter but rather that it is unlikely to be the drag it was in the first quarter. This is supported in large part by the uptick in factory output in recent months as reported by the Federal Reserve Board. The point is that once goods are produced, they are either sold or added to inventory. In the second quarter, I expect that most of the goods produced were sold, causing inventories to change very little. Recall that the change in business inventories went from a gain of nearly $50 billion in the fourth quarter of 2016 to essentially no change in the first quarter of 2017, detracting slightly more than 1.0 percentage point from first-quarter real GDP growth. If the change in inventories is essentially unchanged again in the second quarter, as now expected, then the impact on real GDP growth will be near zero as well.

Unfortunately, this is the extent of the good news for real GDP growth in the second quarter, which is why a rebound in consumer spending is so important to the headline statistic. Fixed investment was surprisingly solid in the first quarter—contributing nearly 2.0 percentage points to real GDP growth. However, this performance is unlikely to be repeated in the second quarter, as both residential and nonresidential fixed investment have slowed according to more recent data. Housing starts, which serves as a reasonable proxy for residential investment, fell to 1.09 million units in May and are down substantially from the 2017 high of 1.29 million units in February. Moreover, shipments of nondefense capital goods excluding aircraft, imports of capital equipment, and private nonresidential construction, which when combined provide a proxy for nonresidential fixed investment, have been stagnant at best according to their latest readings. Government spending may show some increase in the second quarter but it is likely to be offset by the drag coming from a mildly wider international trade deficit. On balance, the expectation is that real GDP growth will jump to 3.0 percent at an annual rate, thanks to a sharp rebound in consumer spending.

Nevertheless, any upside surprise to real GDP growth in the second quarter is expected to be short-lived. The problem is that real disposable personal income growth and solid consumer balance sheets both may be at risk late this year or early 2018. As unlikely as it seems at the moment, the culprit still is expected to be inflation as it accelerates to a level that would cause a substantial drop in purchasing power to consumers, leading to a sharp decline in real consumer spending. Of course, consumers could try to maintain their spending plans by borrowing, but even that option eventually would be thwarted by higher interest rates. After all, the Federal Reserve's response to higher inflation would be further hikes in short-term interest rates, adding to the cost of consumer debt financing.

At the moment, this warning seems offbeat at best. After all, the latest readings on consumer price inflation and the unemployment rate are far from problematic. In fact, in both cases, my forecasts for the second quarter, as well as for the third quarter, have been revised downward from the previous forecast.

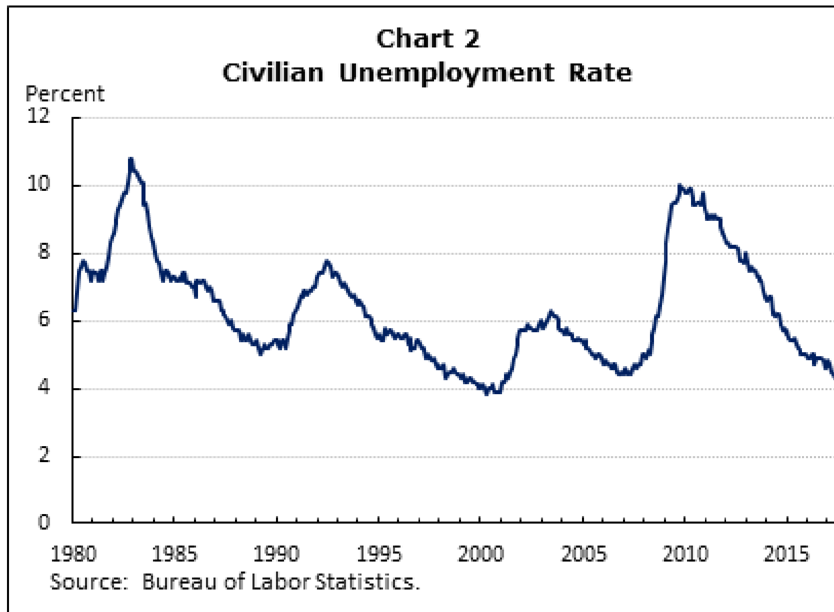
First, the plunge in crude oil prices has contributed markedly to the anticipated sharp slowdown in overall consumer price inflation in the second quarter, questioning whether inflation will accelerate as much as shown in the forecast. The interesting aspect of this is that an acceleration in inflation likely would be more shocking now than earlier this year, which makes it an even more likely candidate to end the current expansion.



As shown in Chart 1, the housing component of the consumer price index (CPI) tends to move in unison with core CPI inflation (overall CPI excluding food and energy), with the former being more volatile than the latter. Over the last few months, the percent change from a year ago in the housing price component has shown some acceleration, while the percent change from a year ago in the core component has slowed. Based on the past, this divergent tends to be short-lived. And when the housing index is increasing faster than core, it is the former index that tends to lead the latter. Under such circumstances, core CPI inflation most likely will accelerate again over the next six months or so. Clearly, such an acceleration in core inflation accompanied by a rebound in food and energy prices would provide the basis for a shockingly high inflation rate. The truth be told that inflation need not be as high in the current environment as in the past in order for it to be shocking. We expect CPI inflation to accelerate to near 4.0 percent late this year, which is far higher than the consensus forecast.

In addition, the civilian unemployment rate in May is already at the level I thought would not happen until later this year. As shown in Chart 2, the civilian unemployment rate in May fell to 4.3 percent, a rate that was last reached 16 years ago (May 2001). Given the lower labor participation rate now versus then, it should be no surprise that the unemployment rate could get this low—maybe even lower. In May 2001, the civilian labor force participation rate was 66.7 percent, while in May 2017 it was 62.7 percent; that is, in 2001 a larger share of the working-age population was looking for a job versus now which means that fewer new jobs are needed to lower the unemployment rate. In this regard, I have argued for years that retiring "boomers" are the biggest contributing factor to this decline. After all, the boomers are still alive (and still counted as part of the working age population), but increasingly retired (and therefore no longer employed or looking for employment).

By definition, boomers have dropped out of the labor force, causing the participation rate to fall. Some may contend that for this reason, 4.3 percent unemployment today does not have the same meaning as 4.3 percent 16 years ago. I disagree. Unless boomers suddenly stop retiring or come out of retirement, neither of which I expect to happen, a 4.3 percent civilian unemployment rate represents a very tight labor market.



But rather than question the forecast, the downward revision to the unemployment rate tends to reinforce it. After all, the excesses that typically derail economic expansions cannot occur without the exuberance that typically comes from very tight labor markets. Recall that in the past, when the unemployment rate falls as low as it was in May, it typically coincides with an economic reversal either immediately or soon after.

Investment implications

Since the forecast is little changed, the investment implications are little changed from the previous report as well. That is, if a recession is less than a year away, then care should be taken buying risk for two reasons. First, prices of risky assets are very high, suggesting that the upside may be much smaller than the downside at this point in the market cycle. Second, if my forecast of a recession is correct, the likelihood of the downside is substantially higher now than at any time over the last eight years.

Assessing the Impact of the Presidency on the Economy

The general impression is that presidents have a great deal of impact on the economy. But in reality, the president's ability to influence the economy's performance during their term of office is very limited. Although presidents generally want to help the economy, their policies often come with a host of unintended consequences. To paraphrase, "the road to *recession* is paved with good intentions." Clearly, George W. Bush was unable to prevent the mortgage and housing crisis that led to the very severe 2007-09 recession. At the time, most market participants, as well as policymakers, considered it a good thing that people who normally could not qualify for a traditional mortgage to buy a house were able to do so with a subprime mortgage, little knowing that the mortgage was secured by an overpriced house and mispriced mortgage insurance. The best George W. Bush could do was to help facilitate cleaning up the mess and propose rule changes to help avoid another such debacle in the future.

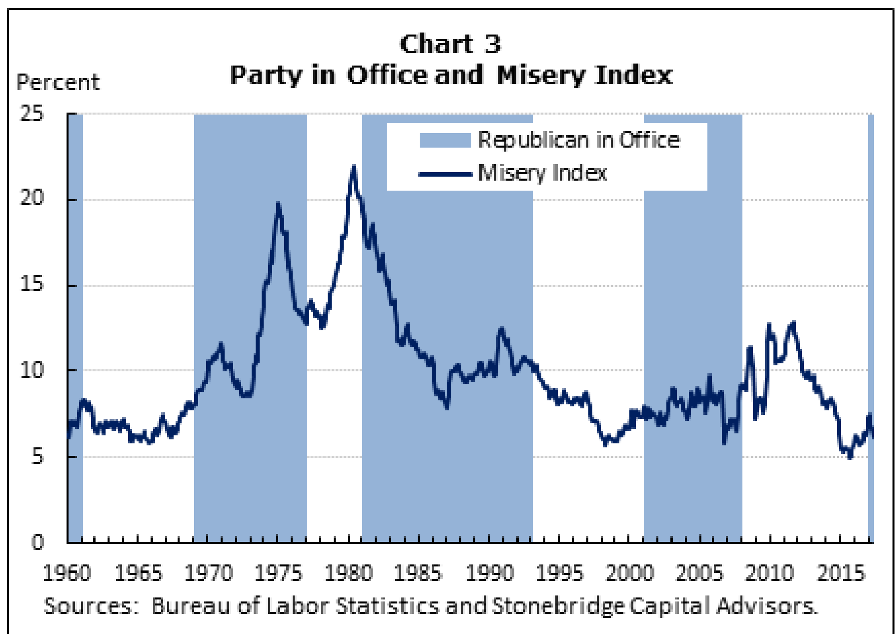
Needless to say, George W. Bush was not the only president to deal with a recession, and certainly not the only Republican president. Indeed, more recessions have occurred with a Republican in the White House than with a Democrat. Since 1960, the U.S. economy has experienced eight recessions according to the National Bureau of Economic Research, ranging in duration from six to eighteen months. Seven of the eight occurred while a Republican was president—and the one recession with a Democrat in office (Carter) was the shortest on record (six months). Nevertheless, it was the timing and not the duration of the Carter recession that mattered. Because the recession, albeit very short, occurred during the final year of his first term, he failed to be elected to a second term.

On the other hand, three of the recessions under Republican presidents started immediately or shortly after they took office, well before any of their economic policies were implemented. The timing of these recessions often allowed the new president to blame the recession on the policies of the previous administration, as well as take credit for the recovery that followed, which in turn helped them get elected to a second term (Nixon, Reagan and George W. Bush). Indeed, adjusting for the timing of these three recessions, one might argue that the number of recessions under a Republican administration is no different than under a Democrat Administration—four recessions each. The bottom line is that in terms of a president avoiding recessions, it could be more a matter of luck than policy acumen.

This may be best demonstrated with the help of Arthur Okun's "misery index," which is the sum of the rate of unemployment and the percent change in consumer prices for a given period (see Chart 3). In economic terms, a high reading reflects the misery associated with the loss of purchasing power by consumers; that is, either being unemployed or facing the loss of real income due to higher prices.

During his presidential campaign in 1980, Ronald Reagan used the misery index very effectively to assess how voters felt about the economy at the time—in short, they were miserable. When Reagan took office in January 1981 the index was at a very high 19.3 percent, but was already on a downward trajectory. Although this was too late to help Jimmy Carter get reelected, it was setup perfectly for Ronald Reagan's reelection. By the start of Reagan's second term, the index had fallen to 10.8 percent, which was still high by historical standard but much improved from where it was when he entered office.

When George H. W. Bush took office in January 1989, the misery index was an even lower 9.9 percent and the expansion was still nearly two years from its peak. And despite the tremendous popularity he gained due to his leadership in directing an overwhelmingly successful military response to the Iraqi invasion of Kuwait, the bad luck of the index edging back up to 10.8 during the summer of his last year had a great deal to do with George H. W. Bush being a one-term president. When Bill Clinton succeeded him in January 1993, the misery index was 10.6 percent but the economic cycle was already well into its recovery phase.



A downward trend in the misery index continued throughout Bill Clinton's presidency, bottoming out at 5.9 percent in March 1999. By January 2001, when George W. Bush took office, the misery index had edged back up to 7.9 percent. During his first term, the index bounced around a bit, but on average was little changed. The data available at the time of his attempt at reelection (September 2004) put the misery index at 7.9, unchanged from where it was when he started. However, W. Bush was not so lucky in his second term, with the index climbing to 11.0 percent in September 2008, which was the data available at the time of the November 2008 election. The Democrats regained the White House.

This is where it gets more interesting and more difficult to predict presidential election outcomes based on the misery index. Barack Obama took office in January 2009 with the index at 7.7 percent, considerably lower than the 11.4 percent reading in August of that year. Although the index rebounded somewhat in the spring of that year, it dipped to 7.5 percent in July 2009, which coincided with the end of the recession according to the National Bureau of Economic Research. It then proceeded to spike again through the end of that year. Apparently, this occurred early enough in Obama's first term that he was still able to blame it on the nasty recession at the end of George W. Bush's second term. Although the index generally remained high for most of Obama's first term, it did show a steady improvement during the last year of his first term, which may help explain why he was elected to a second term.

By Barack Obama's second inauguration, the index had slipped to 9.6 and was heading lower. In September 2015, the index had fallen to its record low of 5.0 percent. When Trump took office earlier this year, the index was at 7.3 percent. Indeed, the reading available at the time of the election was a much lower 6.4 percent (September 2016), hardly high enough to be a threat to the incumbent political party.

The latest reading—May 2017—was 6.2 percent, certainly a level that if it was sustained would favor President Trump's election to a second term. At the moment, the consensus economic forecast would suggest a pretty benign reading of the misery index over the next two years. And as promising as the consensus forecast is for the Trump administration, the risk is that either the consensus forecast is wrong or that the bad news comes later in his first term. Obviously, the Trump administration hopes to avoid a recession over the next four years but if he cannot, he most likely would want it to occur early enough in his term to blame it on the previous administration and take the credit for the economic recovery that most likely would follow. Based on history, he has a very daunting task. Indeed, President Trump should be careful not to take credit for any good economic news now because then it would be more difficult for him to blame any bad news on the Obama administration. After all, there was no nasty recession at the end of Obama's second term, like that at the end of George W. Bush's second term, to provide an excuse for any increase in the misery index.

It seems that taking office at the trough of the business cycle versus the peak can explain much of how we perceive a president. The reality is that presidents are unable to avoid recessions. After all, if presidents could control the business cycle, then why do we still have recessions? On the other hand, presidents could propose policies that may influence the precise timing of business cycles, especially the onset of recessions, through federal tax and spend policies, as well as through their appointments to the Federal Reserve Board. But such policies and appointments at best would only delay the business cycle, which may allow excesses to build to the point where the recession, when it does come, is more severe than it would have been otherwise.

Nevertheless, as our leader, the president could affect how we feel about events by delivering a clear message. In fact, it may be simply how the message is delivered that matters. John F. Kennedy petitioned citizens to ask less of government and do more for themselves; "ask not what your country can do for you, but what you can do for your country." Ronald Reagan had a similar message but it was different in tone; "government does not solve problems, it subsidizes them." He wanted less government but he did not want to make it optional. Both were perceived by many as very effective leaders.

There is considerable debate among economists about just how much of an impact presidents have on the economy. I contend that they probably do have a meaningful impact, but it tends to manifest itself long after they leave office. I am referring to how policies change incentives to encourage or discourage certain behavior. The areas where this probably has the greatest economic impact is with regard to productivity and labor force participation. It seems that the policies of the last several decades have worked to discourage both, but then this may be a topic of another essay.

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