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Weakening Economy with Non-Transitory Deflation

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Following a deceptively strong first-quarter GDP growth rate, which was bloated by unsustainable inventory build and a drop in imports, the economy has returned to its downward sloping path. Virtually every economic indicator released for April and May came in below expectations, including the latest employment report that revealed a tepid 75 thousand payroll increase for May, putting the economy on track to advance at less than half the first-quarter's pace in the current quarter. The Atlanta Fed's GDPNow model is forecasting a growth rate of 1.5 percent for the period, while the New York Fed's Nowcast model is tracking a 1.3 percent pace. Importantly, the slowdown is underpinned by weakness in the economy's main growth drivers – consumer spending and business investment.

With the tailwinds from the 2017 Tax Cut and Jobs Act fading and headwinds from escalating trade tensions and a global growth slowdown gaining velocity, the outlook for the rest of this year and beyond is fading. Against this backdrop, the pressure on the Fed to cut interest rates sooner rather than later has intensified, with the futures market pricing in a cut as early as July and two more before the year's end. Fed Chair Powell gave credence to that perception in his June post meeting press conference, opining that the central bank was closely monitoring developments on the trade front and financial markets, and would take appropriate action if they showed signs of adversely impacting the economy. Meanwhile, the Fed continues to debate rate cuts.

Against this economic backdrop and the persistence of well-entrenched deflationary forces, there should be little question that the Fed's next move will be to cut rates, either next month or shortly thereafter. However, the move will do little to jump-start the economy's growth engine or ignite the inflation embers, which have persistently flickered below the central bank's 2 percent target. The inflation conundrum is rooted in structural not cyclical forces, and the economy's trend growth rate has downshifted markedly from earlier decades, thanks to a graying population, reduced productivity and a massive debt buildup that is generating ever-smaller output gains per dollar of leverage even as it burdens future generations with strangling debt-servicing charges. The evolving love affair with modern monetary theory (MMT) in Japan and elsewhere is only exacerbating this dire prospect.

Weakening Near-Term Outlook

The Trump administration took many bows for the above-consensus growth over the past year, claiming that its policies have lifted the economy out of the diminished growth trend it traveled over the past decade. But the accolades will be short-lived, as the tax cuts and increased government spending that juiced growth last year will not have lasting effects. The fiscal thrust, like the massive monetary stimulus that has been pumped into the system since the Great Recession and financial crisis, provided at best a temporary jolt that gives the false impression of enduring strength.

Like the monetary stimulus, which temporarily breathed more life into zombie firms and industries that would otherwise have withered on the vine, the fiscal boost temporarily put more money in the pockets of households and in the coffers of corporations. As expected, the windfall boosted activity for a while, as consumers, emboldened by a strengthening job market, increased spending on cars and other durable goods, against which they also took out more loans. The average size of a new car loan now stands at an all-time high of $31 thousand. Likewise, the additional cash flow provided by the tax cuts generated a temporary boost to business investment spending; nonresidential outlays surged by an annual rate of 11.5 percent in the first quarter of 2018, the strongest since the third quarter of 2011. That was followed by another respectable increase of 8.7 percent in the second quarter of last year.

However, the impetus from the tax cuts has been fading since the middle of last year. While the bottom line of corporations has continued to benefit from a reduced tax burden, the increased cash flow has been redirected away from investments and into share repurchases, M&A activity and dividend payouts, none of which enhances the longer- term growth prospects of the U.S. economy. Meanwhile, the low interest rate environment continued to stoke business borrowing, resulting in a record-high level of corporate debt to GDP.

Despite this ample supply of borrowed and internal funds, corporations have pulled back investment spending, seeing little profit opportunity in a low-growth global environment that continues to be threatened by escalating trade tensions. In the first quarter, equipment spending fell by 1.0 percent, the first decline in three years, and the declining trend in orders for nondefense capital goods points to further weakness over the foreseeable future.

The Fed Takes a Dovish U-Turn

The artificially induced acceleration in GDP and the transitory increase in inflation that briefly touched the Fed's 2 percent target emboldened the central bank to raise interest rates four times in 2018. But following the last hike in December the Fed quickly got the message that the economy was in no position to withstand continued rate increases, which the FOMC had planned for 2019. Buffeted by president Trump's criticism on one side and the onset of market turbulence and escalating trade tensions on the other, the beleaguered Fed's attitude was de-hawked in January and turned outright dovish in June while still promising to patiently follow the data and allow unfolding events to dictate the future direction of policy.

Both the data and events in the financial markets have clearly pushed the Fed further towards a dovish stance. Not only is economic growth slowing dramatically, the brief flirtation with 2 percent inflation last year, like the growth spurt, has become a distant memory. The latest reading of the Fed's preferred inflation gauge, the core personal consumption deflator, puts the rate of price increases further behind the 2 percent target, resting at 1.6 percent again in May. The Fed admits that the 2 percent target will not be hit anytime this year, although it still believes that it will move up towards that threshold beyond the medium term.

We disagree. Like the growth spurt last year, the brief inflation pickup in 2018 was a head-fake that is now unwinding and succumbing to the powerful deflationary forces that are firmly entrenched in the global landscape. The deceptive acceleration in growth last year – driven primarily by fiscal stimulus – imparted a temporary boost to productivity that allowed corporations to give bigger pay raises to workers and pass some of the higher labor costs on to consumers by boosting prices. This dynamic underpinned the pickup in wages, inflation and prices during the course of the year. But that dynamic is now running in reverse.

Restraints on Corporate Pricing Power

As the economy slows, so too is productivity growth, depriving both labor and businesses of their bargaining strength. Despite the lowest jobless rate in a half-century, workers are seeing the best of their wage gains in the rear view mirror.

After hitting a cycle high of 3.4 percent in February, growth in average hourly earnings has steadily slowed, slipping to 3.1 percent in May. That slowdown reflects growing corporate resistance to labor demands as productivity-driven profits growth last year has come to an end. Following five consecutive quarters of growth, after-tax profits of nonfinancial corporations fell in the first quarter, erasing the entire gain over the second half of last year and then some. Nor was it just the fading of tax benefits that took a bite out of earnings. Profits before taxes fared even worse, falling for two consecutive quarters. Simply put, corporations are facing headwinds that are buffeting both the top and bottom lines. With fiscal stimulus waning, so too is domestic demand for corporate output even as the pronounced global slowdown is slicing into revenues from overseas sales. The strong dollar is also hurting exports, undercutting the pricing competitiveness of American-made products.

But the constraints on business pricing power go beyond currency fluctuations. The global inflation environment today is much different than it was in the decades prior to 2008, when central banks worried more about high than low inflation. For one, populations throughout advanced economies are aging and living longer. As people get older, they spend less and save more. Not only are populations aging, falling birth rates are sharply curtailing population growth. Hence, changing demographics are generating fewer workers and consumers, a time-honored recipe for slower growth and low inflation.

Making matters worse, the slowdown in population growth is being accompanied by slower productivity growth, not only in the U.S. but also throughout advanced nations. In OECD economies, labor productivity growth has averaged just over 1 percent a year since 2005, less than half the pace over the previous decade. The decline in productivity growth is consistent with trends in the labor market. According to the National Federation of Independent Businesses (NFIB), the number one problem facing firms is finding qualified workers. It is hard to sustain productivity growth if there is a scarcity of qualified workers unless automation is an option. The advances in technology seen in recent years, particularly in the field of robotics and artificial intelligence, may yet boost productivity, but so far the results are not showing up in the data – or in corporate earnings reports.

We also look at the NFIB surveys as a proxy for corporate pricing power. The net percentage of firm's retail selling prices peaked last May, at 19 percent. In May of this year, the percentage had fallen to 10 percent. Likewise, the percentage of firms planning to raise selling prices fell by 9 percentage points in May compared to last November.

Importantly, there are compelling reasons to believe that the stubbornly low inflation is more structural than transitory. Keep in mind that except for last year, inflation has mostly remained below the Fed's elusive 2 percent target for more than two decades, dating back to the 1990s. This suggests that some enduring forces are keeping inflation at bay, overwhelming such time-honored inflationary catalysts as a tightening labor market and sustained economic growth, both of which have been amply present over this period.

While economists have debated this issue for some time, most agree that certain trends have become more prominent since the 1990s that, to varying degrees, explain why inflation has not responded to cyclical forces as in past cycles. These include globalization, which expands competition with lower-cost producers overseas, new technology, such as the Internet, which equips consumers with a greater ability to shop online for lower prices, and the decline in union membership, which reduces the bargaining power of workers and, hence, restrains the increase in labor costs associated with an expanding economy.

Pushing on a String

Although the growth slowdown and the escalation of trade and now currency tensions have prodded the Fed into a dovish position during the spring, the persistence of low inflation is the key reason it is moving ever-closer to cutting rates. Even if it does, however, it is highly unlikely that inflation would respond. The main purpose of a rate reduction is to stoke the economy's growth engine, which generates the typical late-cycle burst in activity that ignites inflation. But this is not your father's expansion, as prices that have historically responded to faster growth have not done so in the current cycle. Although GDP growth has picked up from 1.3 percent in mid-2016 to 3.1 percent in the first quarter of this year, cyclically sensitive prices have hardly budged. In fact, despite a labor market that until recently steadily churned out over 200 thousand jobs a month and wage growth that has firmed to over 3.0 percent from 1.5 percent a few years ago, cyclically sensitive prices are actually rising more slowly than the 2004-2007 average of 3.0 percent.

Instead, given the dampened cyclical movement in inflation, easing monetary policy would lead to more asset price inflation than consumer price inflation. If so, this would set the stage for another asset bubble that in time-honored fashion would ultimately come crashing down and bring the economy with it. As it is, equity price valuations are elevated and corporate bond spreads, including high-yield bonds, are narrow. Indeed, the only thing propping up stock prices is the prospect that the Fed will cut rates sooner rather than later. That prospect, in turn, is stoking investor appetite for riskier assets, facilitating the under-the-radar rapid growth in shadow banking, wherein non-bank investors are eagerly extending loans to credit-challenged borrowers. According to Inside Mortgage Finance, a trade publication, the shadow banking system now accounts for more than 50 percent of mortgage lending, up from 9 percent a decade ago when regulators imposed tougher lending restrictions on traditional bank lenders following the financial crisis.

Simply put, a misguided Federal Reserve policy can do little to reverse powerfully entrenched global deflationary forces that are being reinforced by slower growth, escalating trade tensions and heightened geopolitical risks, punctuated by the current upsurge in unrest in Hong Kong, Brexit, an Italian debt crisis and ongoing uncertainty related to Korea, Iran and Syria among other trouble spots. In this environment, the appetite for safe havens will remain strong amid a shrinking pool of quality assets.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	6/30/2018	3/31/2019	6/30/2019	Last Quarter	Last Year
6-Mo. Bill	2.08	2.44	2.05	0.73	2.50
2-Yr. Note	2.53	2.29	1.74	1.37	3.82
5-Yr. Note	2.73	2.23	1.76	2.80	7.35
10-Yr. Note	2.85	2.41	2.00	4.22	10.38
30-Yr. Note	2.98	2.82	2.53	6.76	12.87

Municipal Bonds	Yields (%)			Total Return (%)	
	6/30/2018	3/31/2019	6/30/2019	Last Quarter	Last Year
Barclays GO Bond Index	2.56	2.19	1.87	2.06	6.65
Barclays State GO Bond Index	2.50	2.13	1.79	6.00	2.00
Barclays Local GO Bond Index	2.62	2.25	1.97	2.12	6.91
Barclays Revenue Bond Index	2.81	2.43	2.13	2.25	6.98

Equities	Levels			US $ Terms (%)	
	6/30/2018	3/31/2019	6/30/2019	Last Quarter	Last Year
S&P 500	2718.37	2834.4	2941.76	4.30	10.41
DJIA	24271.41	25928.68	26599.96	3.21	12.20
NIKKEI (Tokyo)	22304.51	21205.81	21275.92	0.46	-2.54

Commodities	US $			Percent Change (%)	
	6/30/2018	3/31/2019	6/30/2019	Last Quarter	Last Year
COMEX Gold Active Monthly	1254.5	1293	1413	9.28	12.63
CRB Future Com. Pr. Index*	200.3852	183.7511	181.0378	-1.48	-9.66
West Texas Intermediate Crude ($ per bbl.)	74.15	60.14	58.47	-2.78	-21.15

Currencies	Levels			Percent Change (%)	
	6/30/2018	3/31/2019	6/30/2019	Last Quarter	Last Year
Yen	110.76	110.86	107.85	2.72	2.63
Sterling	1.3207	1.3035	1.2696	-2.60	-3.87
Euro	1.1684	1.1218	1.1373	1.38	-2.66

Global Bond Markets**	Levels			US Dollar Terms (%)	
	6/30/2018	3/31/2019	6/30/2019	Last Quarter	Last Year
German 10-Yr.Bond	0.16	-0.21	-0.44	1.88	5.70
Japanese 10-Yr.+ Bond	-0.02	-0.16	-0.22	0.49	1.96
UK 10-Yr.+ Bond	1.24	0.91	0.76	1.40	5.67
Emerging Market (USD)	5.75	5.32	4.88	3.75	10.95

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices

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