

The United States Economy in 2019: Moderate Growth, Flexible Monetary Stance and Fluctuating Financial Market

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Abstract. The US economy has experienced strong growth in the second half of 2018. The domestic and outside risks are about to be balanced. We have the following views on the US economy in 2019. 1) Supported by solid increase on wage, the private consumption will be the driving force of the real economy. Although the economic growth may slow down, the likelihood of entering recession is minimal, at least in the first half of the year. 2) The monetary policy in 2019 will be more flexible, highly contingent on the performance of the inflation. With the high leverage ratio in nonfinancial cooperates, the current interest rate is quit close to the neutral. 3) The 10-year Treasury yield may climb above 3 percent again and the stock market is likely to fluctuate around the preceding peak.

1. Introduction

The U.S. economy has experienced strong growth since the second half of 2018. Domestically, the labor market is tight, the wage growth is moderate and the production costs rises modestly. The unexpected decline in oil price has alleviated some pressures on inflation. Outside, the United States has reached the new trade agreements with Canada, Mexico, Japan and South Korea.

In 2019, the uncertainty in trade relationships is expected to ease. The U.S. is likely to be well in the negotiations with Europe and China. The global risks may rise in the Italian sovereign debt issue and the Brexit deal. The Fed's interest rate policy and the high leverage ratio of non-financial private sector pose the domestic challenges. Overall, although the U.S. economy growth may slow down, the risk of entering recession is quite low in the first half of the year as the moderate wage growth can give solid support to the future consumption.

2. Real Economy in 2019: Consumption will be the Driving Force of the Economy.

Labor market conditions have continued to be strong so far. The recovery of the labor force participation rate for age 25-54---which is insensitive to population aging --- has been completed. Precisely, the rate of age 25-34 has reached the peak of the last business cycle during 2002-2007, and the rate of age 35-54 has been moved up. While it is still low for age 45-54, the rate of age 35-44 has fully reached the average level of the last business cycle (Figure 1). By gender, the improvement of the labor force participation rate of age 25-44 is largely contributed by the significant increase in the female participation, while the male rate keeps unchanged (Figure 2).

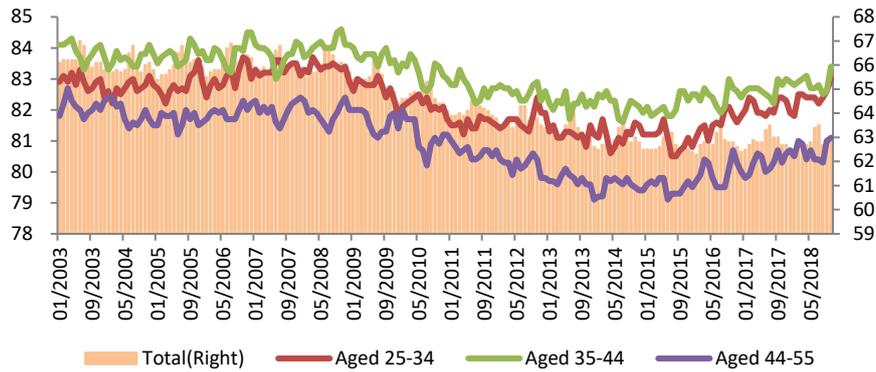


Figure 1: Labor force participation rates, by age (percent)

SOURCE: CEIC.

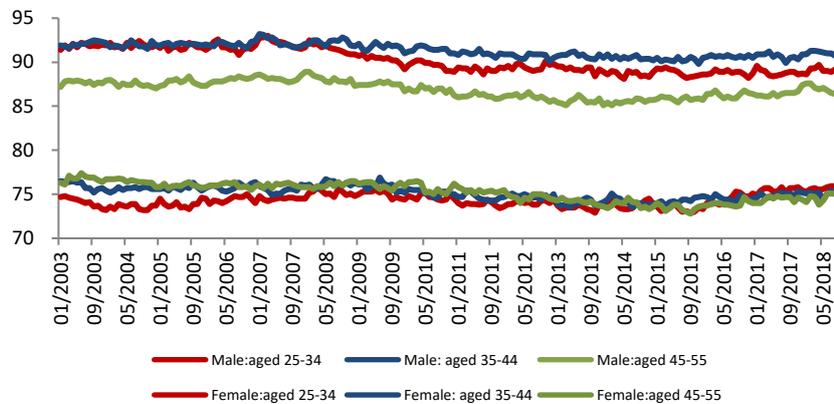


Figure 2: Labor force participation rates, by gender (percent)

SOURCE: CEIC.

The Beige Books continue to mention the widespread mismatches between the labor demand and supply across the country. Some states reported that the labor shortages were restraining growth in some sectors. The tight labor markets generally reflect the potential upward pressures on wage costs. The possible acceleration on wage growth will boost consumption as well as the core inflation.

The contribution of household consumption on GDP growth may enlarge. Benefiting from the rise in wage growth, the private consumption has become the highlight of the economic performance in the last two quarters. We expect that consumption growth will be the main driving force of the U.S. economy in 2019. Under current wage pressure, the consumption momentum is sustainable in the short run. The retail sales data for the fourth quarter is expected to be strong.

Although the household debt to GDP is still above the historical average level before the Great Recession, the low interest rate policy and the mortgage refinancing programs have made the burden of household debt repayments reduced greatly. Currently, the mortgage debt service ratio (debt payments to disposable income) is only 4.24 percent, the total debt service ratio is only 9.84 percent, both of which are at the lowest levels since the 1980s (Figure 3). There is potential space for the household debt capacity to support consumption.

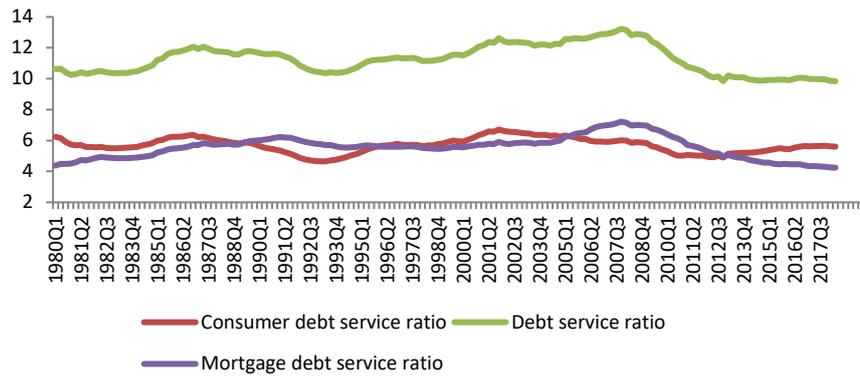


Figure 3: Household debt service ratio (percent)

SOURCE: Board of Governors of the Federal Reserve System.

Investment tends to slow down a little bit but is still sustainable. In the third quarter of 2018, the investment on equipment, construction and residential area has slowed down a little bit, but the investment on intellectual property has kept its own growth path. However, in post-crisis era, the fluctuations of construction and residential investments are not the important indicators for the economic forecasting. In Figure 4, we normalize the fixed investment and its four components by setting all the initial values in 2002 Q1 as 100. Apparently, the post-crisis fixed investment mainly depends on the evolution of equipment and intellectual properties, not on the construction or residential properties. The real investment on construction and residential properties is even lower than that in 1990s. The Beige Books indicate that there is no obvious change in the investment plans of most U.S. companies in 2019. The commercial bank data of industrial loans has just reached a high point.

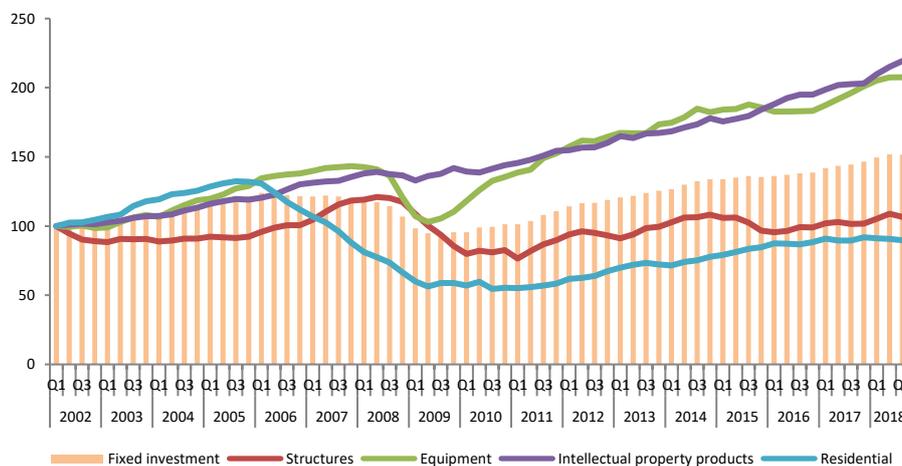


Figure 4: Real fixed investment and its components

NOTE: The values of all series in the initial period, 2002Q1, are all normalized into 100.

SOURCE: Bureau of Economic Analysis.

3. Monetary Policy in 2019: More State-Contingent on Inflation.

We believe that the Fed monetary policy tends to be more state-contingent in 2019, and the rhythm of interest rate hikes will mainly depend on the performance of inflation. At present, the Fed seems to be quite worried that the accommodative financial environment will overheat the economy. The Beige Books indicate that firms are facing increasing pressures from costs of labor, transportation,

and partly from the raise in the cost of raw materials due to tariffs. Therefore, the FED expects that inflation pressures will gradually manifest in near future. The policy makers hope to raise the federal fund rate (FFR) to curb the inflation before it exceeds the target range (about 2 percent) too far away. However, due to the Iran oil sanctions, the unexpected drop in oil price may alleviate the pressures on the overall CPI. If the outcome data on inflation does not exceed the target range significantly or even slows down, the pace of interest rate hike in 2019 may be much moderate comparing to the rate raised in 2018, which is a positive factor for the financial markets.

The interest rate is quite close to the neutral. Before the stock market hit the low point recently, the FED insisted that the current FFR was far below the neutral. It is true that the current interest rate is much lower than that before the subprime crisis. The pre-crisis FFR fluctuated between the real and the nominal GDP growth rate in most of the time (Figure 5). After four hikes in 2018, the current FFR (2.25-2.5 percent) is still lower than the real GDP growth rate (3 percent in 2018 Q3) by about 0.5 percent (or 2 hikes). However, the post-crisis financial conditions have been quite different from before since the historically high leverage ratio of nonfinancial corporates is not available in the past either. From the FED's various interest rate formulas to the DSGE model, none of them takes the high leverage ratio of non-financial firms into account in calculating the neutral interest rate. Obviously, if the debt ratio is fully considered, those interest rate formulas, such as the Taylor formula, are not appropriate to measure the "true" neutral interest rate any more.

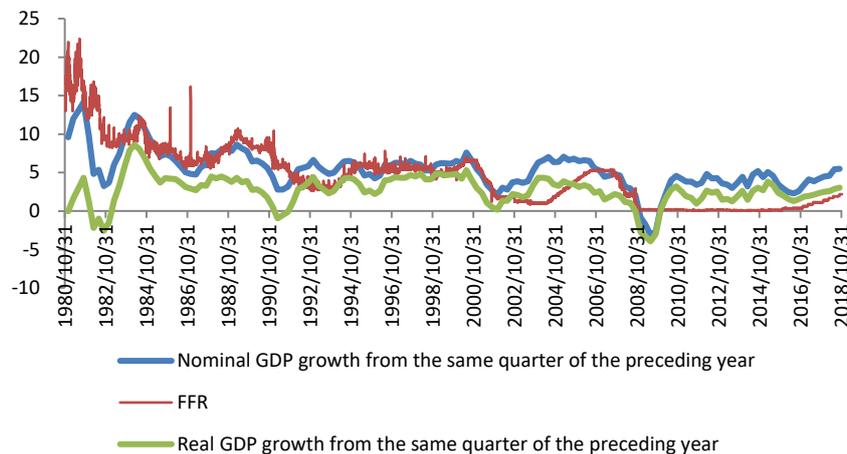


Figure 5: GDP growth and FFR (percent)

SOURCE: Bureau of Economic Analysis, Wind

The current debt burden is not as high as the leverage ratio. We suggest that the leverage ratio is not the direct indicator to measure the debt burden, the ratio of interest expenses to disposable income is. Due to the near-zero interest rate policy in the past decade, even though the federal and non-financial companies have almost doubled their leverage ratio, the actual debt burden is the highest since 1970s. After 2007, the federal public debt to federal income has increased from 196 percent to 442 percent, but the actual net interest payments to federal income has kept at the lowest level, only about 11.5 percent now (Figure 6). The same reason applies to the corporate debt as well (Figure 7).

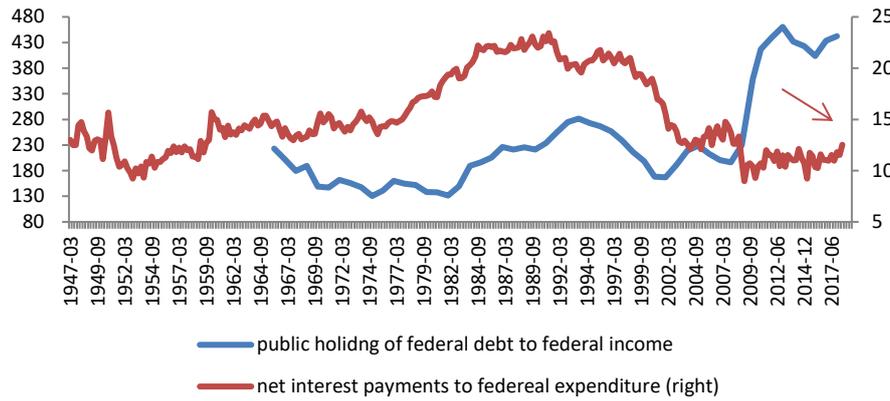


Figure 6: Federal leverage ratio and interest payment burden (percent)

SOURCE: Wind.

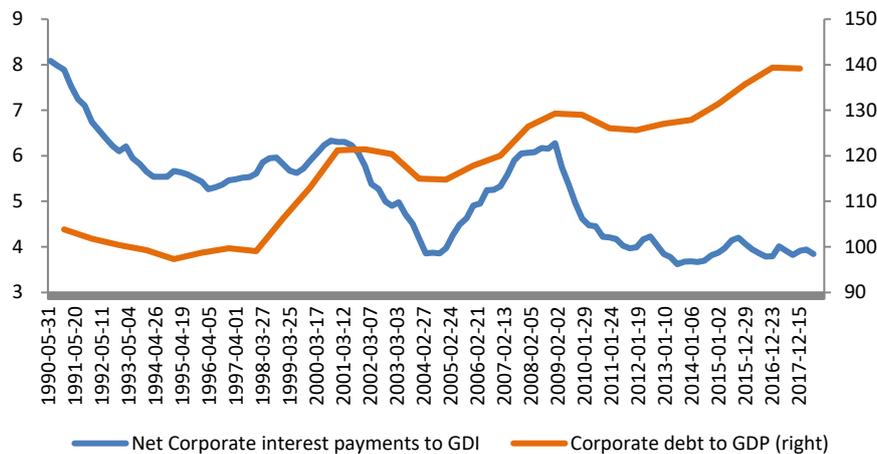


Figure 7: U.S. corporate leverage and actual debt burden (percent)

SOURCE: Wind

In addition, considering that the large fraction of debt contracts in U.S. are under fixed interest rate terms, the interest rate hike in 2018 have little impact on the outstanding debt burden in short run. Higher interest expenses arise from new debt issued at higher rates or from higher rates on existing floating-rate debt. In U.S., about two thirds of nonfinancial corporate debts are from bonds, and the rest is from bank loans. About 98 percent of federal government debts, 98 percent of outstanding corporate bonds and 15 percent of corporate loans have fixed interest rates. Fixed interest rate means that only small fraction of outstanding federal and firm debts need to pay more on interests under the four hikes in 2018. The impact of multiple hikes in 2018 on the economy has not been seen yet.

However, the high leverage ratio will be a problem in 2019. The strong performance of the economy in 2018 does not necessarily imply the same trend would continue in 2019.

The exposed interest rate risks will be unfolded gradually with more and more debt maturing in the following years. The fractions of the outstanding of fixed-rate corporate bonds and loans maturing before the end of 2020 are roughly 25% and 66% respectively. In 2019, the additional interest expense of corporate debt, along with the current interest hikes will be 37billion, twice of 2017 and 2018 combined (Table 1). It is the same to public debt as well. The net public interest expenses to fiscal expenditure has picked up by 1 percent in the mid-2018 (Figure 6). The high leverage ratio is the most important resistance on the road to the ‘neutral’ monetary policy.

Table 1: Estimated additional interest expense (million)

	FFR change(BP)	Bonds	Bank Loans	Total
2017	24	35	1763	1798
2018	94	898	14440	15338
2019	184	4143	32989	37132

SOURCE: Kumbhat, Ashish, Francisco Palomino, and Ander Perez-Orive (2017). "The Potential Increase in Corporate Debt Interest Rate Payments from Changes in the Federal Funds Rate", FEDS Notes.

Lastly, the liquidity risks caused by interest rate hike and the quantitative tightening are not great. The Fed could further widen the spread between the FFR and the excessive reserves rate to release liquidity if necessary. Under normal scenarios, there is no need to worry much about the market liquidity.

4. Financial Markets in 2019: Moderate Adjustment.

The U.S. Treasury bond yields may still wait for new high. From the perspective of long-term investment, the 10-year Treasury bond has begun to have certain asset allocation value, but the yield may have a new peak before the next recession. The current drop on the yield is mainly due to the declines in the stock market and the oil prices. The deep correction in the stock market has affected the risk attitudes of investors a lot, which raises the concerns about the future economy performance. In addition, the fluctuations of 10-year bond yield are highly correlated with CPI. The unexpected decline in oil prices has largely decreased the market expectation on the future inflation as well (Figure 8). If the coming data does not confirm those concerns, the yield will be more likely to go back to 3% or even higher.

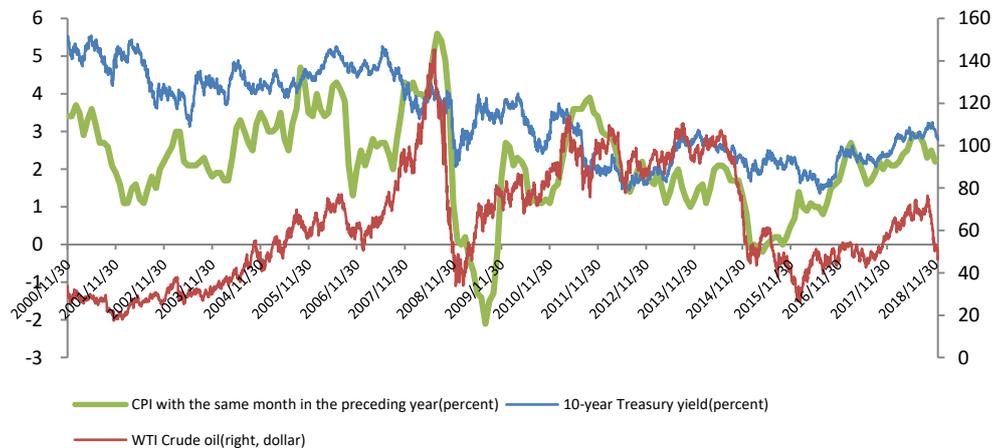


Figure 8: 10-year Treasury yield, CPI and oil price

SOURCE: Wind

The U.S. stock market is likely to fluctuate around the preceding peak. The sharp rise in 10-year Treasury bond yield in late September triggered the stock market correction. We identify the inverse of the Shiller PE (CAPE) of S&P 500 as the long-term rate of return of the stock market. As the S&P 500 achieved 2,900 in late September, the inverse of CAPE decreased to 2.996 percent. At the same time, the 10-year yield climbed up above 3 percent effectively. When the long-run rate of return in the risk-free market exceeds that in the stock market, the asset allocation strategy is optimal to switch from the stock market to the Treasury bond market. Obviously, the investors in equity markets have different expectations about the future economy from the Fed. The financial market needs some time to adjust with the rising risk-free rate.

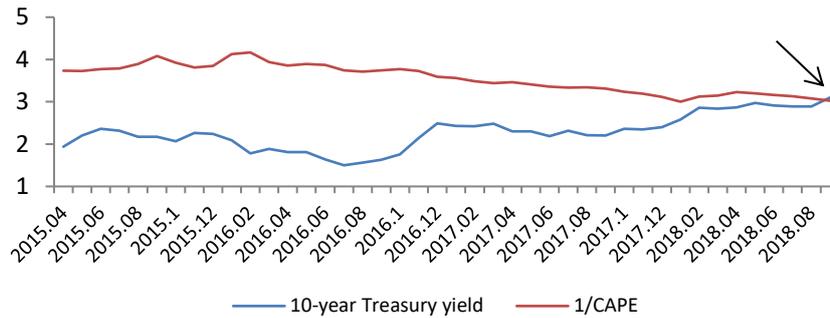


Figure 9: Long rate of return in risk-free and equity market (percentage)

NOTE: The data is from 2015.4-2018.9, monthly

SOURCE: Robert J. Shiller’s website, <http://www.econ.yale.edu/~shiller/data.htm>

The 10-2 year Treasury yield spread has weak explanatory power in indicating the coming of recession. The financial market usually view the yield spread as one of the leading indicators to forecast the coming of the bear market. However, the spread is not able to predict the precise timing of recession. The date when the spread converges to zero for the first time is generally 1-2 years ahead of the stock market peak. Instead, the implied 3-month forward risk-free rate is much better. The 3-month and 6-month Treasury bill rates are selected to calculate the forward 3-month interest rate¹. We find that if the forward rate jumps up a lot suddenly, the stock market will peak in the next 1-3 months. The jump in the forward interest rate occurs when 3-month bill rate declines while the 6-month rate keeps unchanged. The divergence between them may be related to the rising expectation on the Fed interest rate reductions but the 6-month rate has no much time to adjust to it. As Figure 10 shows, the implied 3-month forward rate has good guidance for the 2000, 2007 and 2015 peaks. Currently, the jump has not been observed.

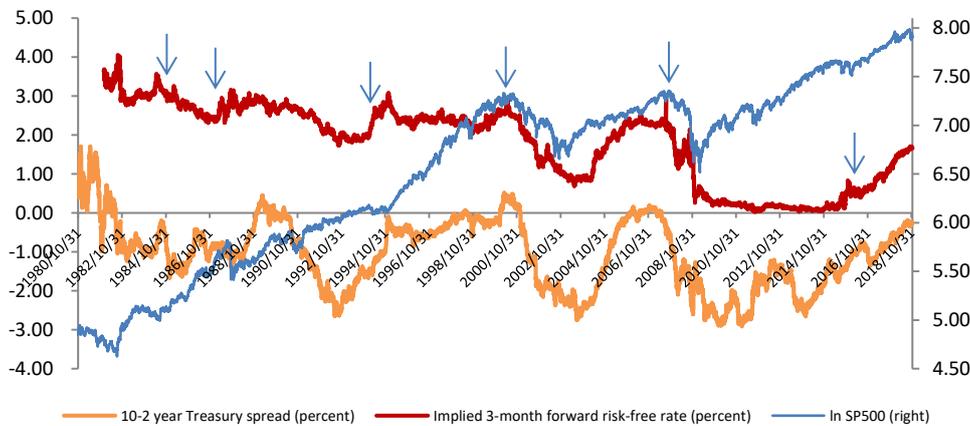


Figure 10: Leading indicators of the stock market

SOURCE: Wind

The dollar is weakening and the gold has a chance in 2019. In 2018, the U.S. dollar index fluctuated above 95, which is contributed by the lack of timely tightening of the European monetary policy and the divergence in economy performance between the U.S. and other developed economies. The recent uncertainty in the Brexit led to the breakthrough of 97. However, we expect that the dollar will finally fall after the end of Brexit as the Fed interest rate hike will slow down in 2019 and the E.U. has ended the Q.E. at the end of 2018. After the U.S. dollar weakens, there will be upward trend for gold price.

¹The implied 3-month forward risk-free rate is calculated as: $[(1+6\text{-month T-bill rate}/2)/(1+3\text{-month T-bill rate}/4)-1]/4$.

5. Conclusion

Based on the solid economic data, we believe the U.S. economy will continue to function well in 2019 with wage and consumption as the driving forces. The monetary policy is to be more state-contingent on the performance of inflation. As the true neutral interest rate is much lower than the pre-crisis level under current high leverage ratio in nonfinancial corporate sector, the interest rate hikes will be about twice. Obviously, the correction in the financial market implies that the investors hold different views on future economy from the Fed. It takes some time for the market to adjust to the new interest rate level. With the convergence of monetary policy among developed countries, the dollar is about to slide down and therefore the gold price will move up.

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