US: Hope for the best, prepare for the worst

The US economy is experiencing its longest expansion since at least 1854, but the threat of another economically damaging round of tariffs remains high. The Federal Reserve stands ready to embark on a round of precautionary easing

Source: The White House

The US economy is experiencing its longest expansion since at least 1854[1], with the ceasefire in US-China trade tensions suggesting it can continue for at least a few months more. But there are significant hurdles to clear before a formal deal can be signed, so the threat of another economically damaging round of tariffs remains high. As such, the Federal Reserve stands ready to embark on a round of precautionary policy easing.

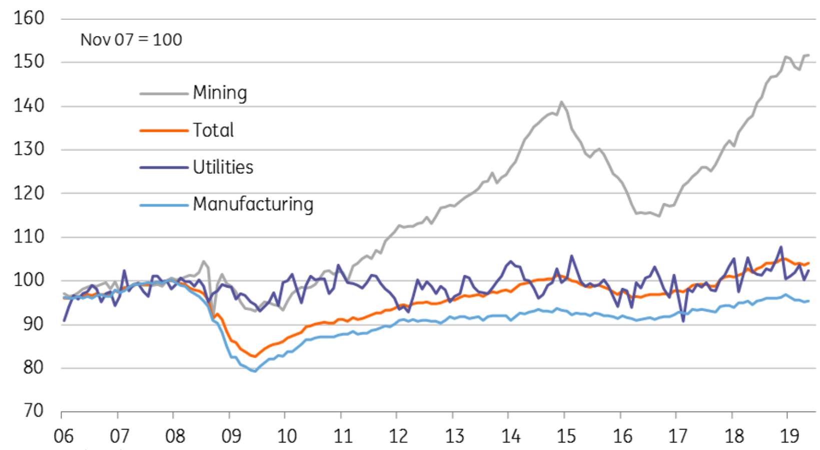
[1] 121st consecutive months based on the National Bureau of Economic Research's database

Uncertainty caused by prolonged trade tensions weighing on US sentiment and activity

Talks between Presidents Trump and Xi on the sidelines of the recent G20 meeting went as well as we could realistically have hoped. Trade negotiations are restarting, there are no additional new tariffs and the Huawei issue has been de-escalated to a certain extent.

The uncertainty caused by these prolonged global trade tensions is weighing on US sentiment and activity, most notably in the manufacturing sector. While industrial production in aggregate is up, this is primarily a mining and utilities story. Manufacturing output has actually fallen 1.5% since last December with the majority of sub-sectors experiencing declines. The latest ISM manufacturing index offered little comfort, with the new orders balance declining to the break-even 50 level. This is the weakest figure since December 2015 and underlines the anxiety within the sector. Moreover, the US's own trade position is deteriorating, with the deficit widening out in 2019 rather than shrinking as Trump had hoped. There are few winners in this trade war so far.

Industrial production component levels



Source: Macrobond, ING

Away from manufacturing, things are holding up better

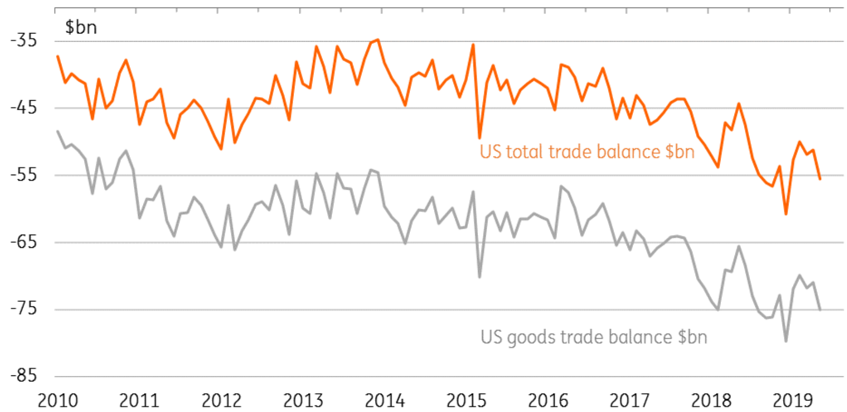
Outside of these areas, the economy is holding up better. The ISM non-manufacturing index is performing reasonably well while consumer spending continues to look healthy. Household confidence has weakened a touch recently, presumably reflecting worries about the economic outlook, but rising incomes and job security continue to offer solid foundations.

Employment growth has slowed, but this isn't down to weaker demand for workers. In fact the ISM manufacturing employment index is back above its 6-month moving average while the National Federation of Independent Businesses continues to report an incredibly strong appetite for finding additional staff. Instead, the problem remains the lack of available workers with the right skill sets.

Indeed, the latest Federal Reserve Beige Book, published just ahead of the June FOMC meeting, suggested that "stronger employment growth continued to be constrained by tight labor markets, with Districts citing shortages of both high- and low-skill workers." Moreover, the NFIB survey indicates 38% of firms could not fill the vacancies they currently have. This is unsurprising when you consider that unemployment is at a 50-year low so the pool to draw workers from is pretty small.

In turn, the competition to attract workers and to retain existing employees is pushing wages higher and leading to improved benefits packages. It may mean that inflation is stickier than many in the bond market expect.

The US trade deficit



Source: Bloomberg

If the trade ceasefire holds, the outlook for the US economy remains decent but unfortunately, we are of the view that there will be a re-escalation of trade tensions in coming months. The US and China are far apart on key issues such as technological transfers, intellectual property rights, state aid and the trade dispute resolution mechanism, with neither side seemingly willing to make the required concessions to get a deal over the line.

China will not want to be seen as have been successfully bullied into agreeing to US demands and is prepared to use additional fiscal stimulus to support its economy. Meanwhile, President Trump believes that the US economy is solid and continues to pressure the Federal Reserve to cut interest rates. He also talks positively of the tax revenue benefits of higher tariffs, although it should be pointed out that these are paid by US businesses and consumers, not by Chinese manufacturers.

A new round of tariff hikes in the second half of the year will contribute to more pronounced economic weakness through disrupting supply chains, putting up costs and hurting profit margins. Such an environment would be negative for equity markets and make US businesses more reluctant to invest and hire new workers. As such, the Federal Reserve is understandably moving in the direction of precautionary policy easing.

We expect a rate cut in July

At the June FOMC meeting the central bank talked of increased “uncertainties” about the economic outlook which they will “closely monitor”. Federal Reserve Chair Jerome Powell subsequently repeated his comment “an ounce of prevention is worth more than a pound of cure”. Given the expectations of renewed trade tensions, we look for the Federal Reserve to implement a July rate cut of 25bp followed by a 25bp move in September.

The most likely timing for a deal to be finalised is late 4Q, even if it doesn't meet all of his initial demands

The chances of a 50bp move in July, which was the prevailing view in mid-June, have certainly diminished given that St Louis Fed President, James Bullard, who was the only Fed official to have voted for a June rate cut, suggested such aggressive action "would be overdone". Nonetheless, the market is pricing in three rate cuts this year with a further 25bp cut in early 2020. We suspect these expectations will be disappointed, leading to potential 2-10Y yield curve inversion with the long end of the curve doing some of the stimulus for the Fed by driving mortgage rates lower.

In terms of where we go from here on trade, there are two possible directions. On the negative extreme, China refuses to do a deal with the US and uses domestic stimulus to offset the pain from trade. President Trump doesn't back down, the US economy slows markedly and aggressive interest rate cuts fail to stimulate the economy and markets enough to get Trump re-elected. China then gets to negotiate with a new Democrat President who may be less confrontational and with whom they can get a "better" deal.

However, we take the position that given the often repeated suggestion that President Trump believes equity markets are a better barometer of his success than opinion polls, he will need to be wary about pushing China too far for too long. Otherwise, he runs the risk of weakening his own 2020 re-election campaign. After all, lower interest rates can only do so much to support the equity market if the core problem – trade – is not dealt with and global growth is deteriorating.

In terms of timing, we need to bear in mind that Super Tuesday – when 15 states will hold their presidential primaries – is on 3 March 2020 and that is when we should have a clear idea of who the Democrat candidate will be to take on President Trump. Therefore we assume that to be in the best shape to take on the challenger, Trump will want to see rising equity markets and strengthening activity data by that point. This suggests to us that the most likely timing for a deal to be finalised is late 4Q, even if it doesn't meet all of his initial demands.

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