US: Manufacturing a recession

The headwinds facing the US economy are building, as trade tensions intensify and evidence of global economic weakness spreads. Given this backdrop, we have cut our 2020 GDP growth forecast to 1.3% and have pencilled in an additional Fed interest rate cut

President Donald Trump, left, meets with Chinese Vice Premier Liu He, front right, at the White House in Washington

Source: Shutterstock

Weaker manufacturing has spurred wider concern about the US outlook

Yield curve inversion has been a precursor to recession nine times over the last 65 years and evidence of another downturn is growing. The US manufacturing sector is an area of particular concern. Output is down 1.6% year-to-date and remains 5% below its November 2007 peak while the latest ISM manufacturing index points to further declines ahead. Excluding the volatile aircraft and defence components, durable goods growth is now negative in year-on-year terms, which suggests falling investment spending in three to six months' time.

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Worries over tariffs and the impact on supply chains at a time of weakening global demand along with dollar strength mean US firms have become more cautious. Profitability is being hit and firms in the sector are increasingly reluctant to put money to work through investment or hiring new workers. Net trade is also likely to remain a drag due to weak external demand and a less competitive exchange rate.

While manufacturing is a less important part of the US economy than it was 30 years ago and weakness here doesn't guarantee a broader recession, there is still the fear that the downturn could spread. Weaker sentiment is one avenue, but there is also the fact that an inverted yield curve, driven by recession fears, could potentially be self-fulfilling. Banks typically borrow short term and lend longer term, so when the yield curve is inverted, bank profitability is hurt. It also tends to lead to reduced risk tolerance, which implies tighter lending standards and reduced credit availability that potentially chokes off economic growth.

Fig 1 More downside risks for manufacturing output

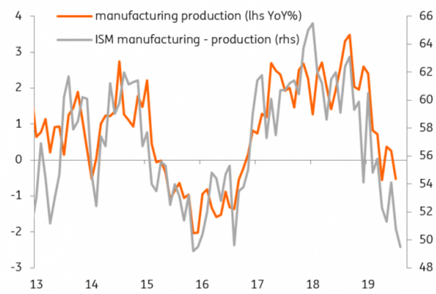
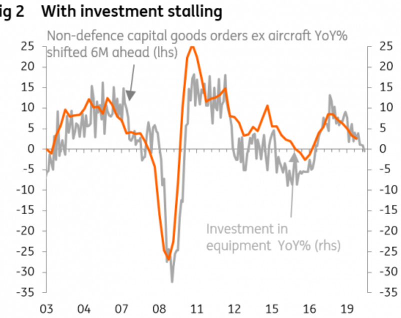


Fig 2 With investment stalling



Source: Bloomberg, ING, Macrobond

Consumer spending continue to support growth

For now, credit conditions remain in decent shape with banks reporting little change in either lending standards or demand for loans. In fact, the plunge in Treasury yields has driven mortgage rates lower and prompted a surge in mortgage activity for both home purchases and refinancings at lower borrowing rates. Home sales have been edging higher too, which has boosted home builder sentiment, but it may not be enough to finally generate a positive GDP contribution from residential investment after six consecutive quarterly declines.

On the positive side of the equation, consumer spending remains the clear growth engine. Despite the volatility in financial markets and the negative headline on trade, consumer confidence remains firm and households are still keen to spend. Employment is at record levels, wages are rising and gasoline prices are falling. So consumers have the cash to spend, with high-frequency data suggesting 3Q started strongly.

Markets are increasingly pessimistic on the outlook

Markets are of the view that this resilience to bad news won't last and they continue to price in rate cuts. More than 100 basis points of cuts to the Fed funds target rate are expected by the end of 2020. So far the Federal Reserve has appeared reluctant to offer such aggressive action, with Esther L. George and Eric S. Rosengren opposing the FOMC decision to cut rates in July and other members arguing for caution.

The Federal Reserve and in particular its Chair, Jerome Powell, have faced a torrent of criticism from President Trump for not doing enough to boost the US economy as he pushes hard to win concessions from China. Powell's response at the recent Jackson Hole symposium was to say that "while monetary policy is a powerful tool that works to support consumer spending, business investment and public confidence, it cannot provide a settled rule book for international trade".

He is essentially saying that lower interest rates can't do much to alleviate the disruptive effect that higher tariffs have on global supply chains. Some officials are also concerned that if they acquiesce to the President's wishes, it will embolden him to push even harder against China, which could create even more near-term downside risks to growth.

Further interest rate cuts are coming

Despite the current reticence, we think the Federal Reserve will cut interest rates further. While 3Q GDP growth should post a respectable 2-2.5% annualised growth rate, we are worried that the attritional nature of market volatility, negative trade headlines, weaker global growth and worries about corporate profitability will result in weaker activity in 4Q. Inflation is also broadly in line with target, and with other central banks queuing up to send dovish signals, the strength of the dollar will be acting to tighten monetary conditions.

Given the latest escalation of trade tensions, this clear headwind to growth is unlikely to abate as quickly as we had hoped. Rather than a deal or a climbdown in 4Q, it could be well into 2020 before an agreement or, more likely, a truce is reached. We continue to believe that President Trump, in a bid for re-election, will recognise the need for a strong economy and rising equity markets and will, therefore, be willing to get a deal done even if it doesn't include all of his initial demands.

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A deal on trade plus Federal Reserve interest rate cuts may well be enough to stimulate a rebound in sentiment and stronger activity and employment numbers in the second half of 2020. Assuming President Trump is re-elected, we suspect he will re-double his efforts to renegotiate trade deals with both China and the EU in a second term.

Based on this potential outcome we have cut our 2020 GDP growth forecast to 1.3% from 1.7% versus the current Bloomberg consensus of 1.8%. We expect consumer spending to slow as hiring moderates, the pick-up in wage growth stalls and asset prices come under pressure. Given this backdrop, we now expect an additional Fed rate cut in 1Q20 after earlier cuts in September and December 2019. However, this may not be quick enough or aggressive enough for President Trump and the financial markets, which are likely to become increasingly impatient with the Federal Reserve. Consequently, we think the 10Y Treasury yield could fall to 1% in the fourth quarter of this year, especially given negative eurozone rates.

There is an argument that being tough on China is a vote winner in itself and the electorate is prepared to accept a weaker economy in the short-term if they believe President Trump's actions will yield real economic returns in the longer term. As such, there is the possibility he keeps pushing hard on China right up to the election in November 2020. This would assume an even more negative growth story, weaker equity markets and even lower bond yields than we have currently priced into our forecasts. We will address this in more detail in our forthcoming *US Politics Watch* note.

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