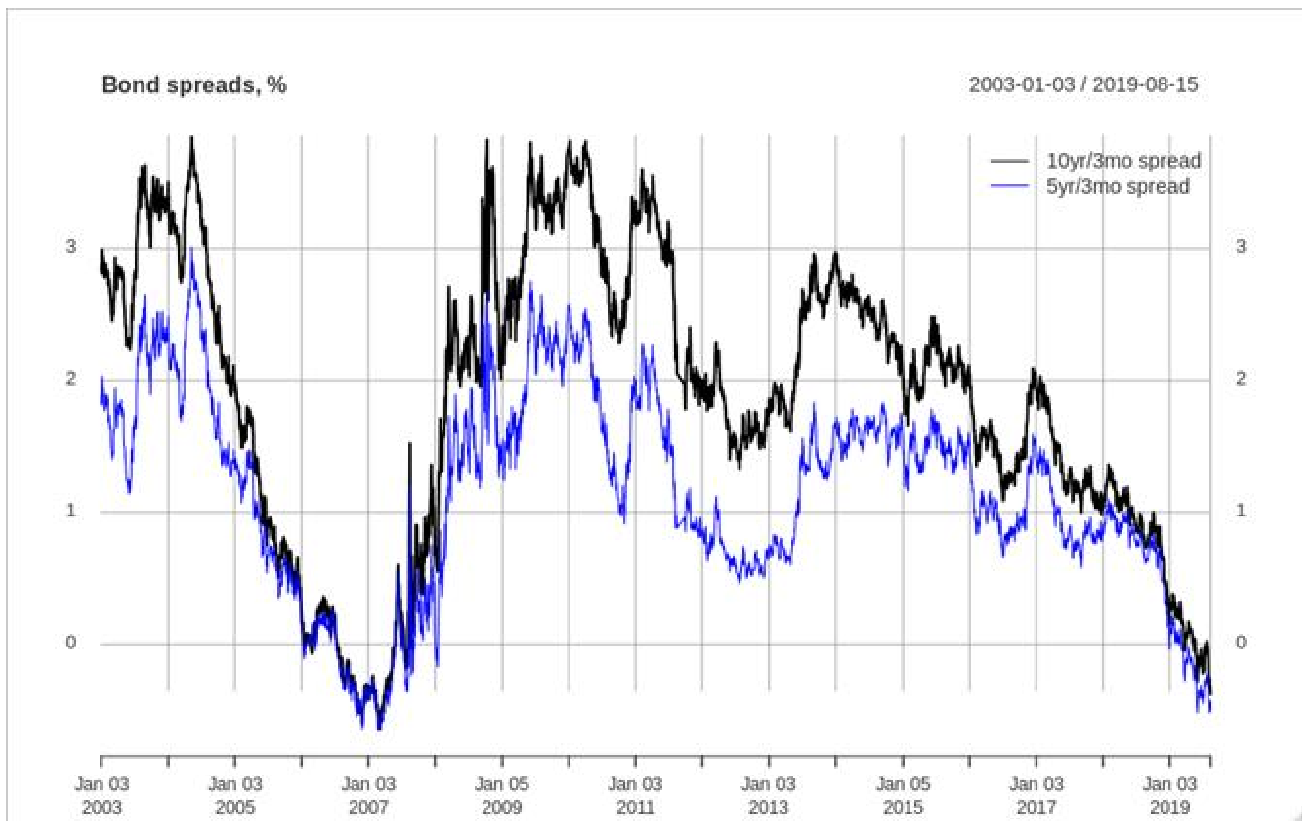
Giving Credit Where It's Due

The US economy is probably going into
recession. Manufacturing production is down from the late-2018 highs, retail
spending growth, wages and payroll gains have slowed. Most importantly, nominal
GDP growth has slowed while markets have taken a bearish turn, sending the NGDP
outlook below 2%. While it is true that the S&P 500 is near an all-time
high, the index has oscillated around the current level for more than a year,
and stocks by themselves are only a noisy indicator of the near-term NGDP
growth.

TIPS, and conventional bond spreads are in
the toilet, with spreads between the long and short ends of the curve going
negative for the first time since 2007. In the past such a curve inversion has
always been followed by recession, though strictly speaking it only means that
short maturity bonds are expected to have the same interest rate as today for
the next five and ten years. It could be that recent geopolitical tension
between the USA and China pushed down the equilibrium short rate (fewer FDI
opportunities for western capital, fewer Chinese funneling money into US real
estate). Maybe the Fed only needs to do a few rate cuts to get back to the
equilibrium rate, and all will be well.



Five-year TIPS spreads are perhaps the most definitive indicator. This series tells us roughly what traders expect from the headline CPI (including oil and food). Inflation expectations peaked over 2% in May 2018, when it seemed Powell would allow the US economy to boom. However, when the rate increases and bearish forward guidance were laid out in summer 2018, expectations began to wane, coming back to 2%. In October, when the Fed signaled it would increase rates again in December, expectations plummeted to around 1.5%. Inflation expectations rose in the first quarter, mirroring the recovery in stocks. Interestingly, after the latest rate cut on August 1st, expectations fell, as bearish forward guidance worsened the outlook. Today, the 5-year TIPS spread is at 1.38%.

The weak inflation outlook suggests the
slowdown and impending recession is primarily a demand-side phenomenon, and not
primarily due to the trade war. This blame-the-Fed explanation is contra to the
story increasingly pushed in the financial media that the slowdown is due to
the trade war. Details on why the trade war would cause a recession are scant. The
reasoning seems to be some vague uncertainty and lack of confidence caused by
tariffs.

Reasonable people can disagree on the
merits of the trade war. Some would justify it on geopolitical or industrial
policy grounds, the other side would point to the inherent efficiencies gained
by freer trade. Whatever position one takes on the issue, it´s simply a fact
that (1) measured inflation has fallen through 2019 and is below the Fed target

and (2) markets are expecting inflation to undershoot the Fed’s target
substantially (the Fed targets the core-PCI index, somewhat different from the
CPI which TIPS are indexed to). Whatever incremental inflation has been
generated by the trade war, it has not been enough to offset the drop in
realized and expected nominal spending.

This fact cannot be repeated enough: ***the trade war is not behind the
slowdown!***The Fed has plenty of room to ease policy, boosting
nominal spending, before inflation becomes an issue. Remember, the Fed “owes”
us for a decade of inflation shortfalls under Bernanke and Yellen, and is
expected to repeat that folly again under Powell.

In an Aggregate Supply/Aggregate Demand
framework, with a monetary policy offset (the Fed boosts domestic spending when
exports fall), the only way for a trade war to cause a recession, is if it
so-crimps Aggregate Supply, that inflation takes off and the central bank opts
to kill the economy to preserve the low-inflation goal. Chinese imports simply do
not have that much influence over the short-run US price level, and they can be
readily substituted with imports from Mexico, Vietnam and other lower-cost
manufacturing economies. Claims of the trade war dampening “confidence” are
readily dismissed. Numerous episodes in recent monetary history confirm that
central banks can *make* the public be confident by hitting any nominal
target they choose. When people opt to stay home from work due to

disillusionment over the uncertain transpacific trade outlook, then we can talk.

The Fed's wrongheaded rate increases in 2018, and failure to correct course in 2019 are the reason we are facing the prospect of recession, not the trade war. Those who disagree need to propose a channel through which tariff policy could explain the data we see: weak inflation, weak markets, and slowing production. The US economy does not stand or fall on soybean exports and tuition payments.