

The Risk of Trade Wars

The Trump Administration is resetting U.S. trade policies, much to the consternation of our key trading partners. Some economists fear a return to the “beggar thy neighbor” trade policies adopted during the Great Depression, which are thought to have deepened and extended the Great Depression. A Reuters survey this spring showed that 80% of 104 economists believe that steel and aluminum tariffs would harm the U.S. economy. However, the U.S. economy is currently strong and the drag from trade disruption is still relatively small. We do not expect trade tensions to escalate to the point where the U.S. economy is fundamentally impaired. But any move away from the global status quo will be disruptive, generating costs and benefits. Somebody's ox gets gored somewhere.

It is a very complex analysis to determine how the costs and benefits from the short-term disruptions that are occurring are weighed against medium and longer-term costs and benefits. The costs and benefits are themselves complex. Some can be measured in economic terms on specific industries and companies and may have geographic components. Some can be measured in terms of national welfare. Some are strategic, including those related to national defense, and some are purely political.

Downside effects that are already happening are: higher prices for some imports, reduced demand for some exports, increased uncertainty, businesses reducing leverage, delayed investment, lots of planning for alternative supply chain strategies, inventory management and uncertain pricing strategy. Some businesses may already be delaying hiring. However, overall labor market indicators, including the recent June jobs report from the BLS, remain strong.

In our view, it is beyond the capabilities of economic analysis to develop a conclusive cost-benefit analysis of the current trade policy changes, accounting for both short-term and long-term effects. Simplified assumptions may be fed into macroeconomics models, but the results of simulations will be shaped by the assumptions themselves and by the inherent biases of the models. The Great Recession taught us that much of economics is nonlinear, meaning that relationships between variables and actors change over time. Complex events with nonlinear interactions are inherently unpredictable. However, we should heed the guidance that economics can provide. Economic theory tells us that free and fair trade is efficient and improves the welfare of the trading countries. However, it does not tell us the best route to get to free and fair trade from where we are now.

In the near-term, a significant trade war would result in higher import prices and reduced demand for U.S. exports. This could put the Federal Reserve in a dilemma if the U.S. economy faced higher inflation as uncertainty and business stress increases. It resonates with the stagflation scenario that some economists, including Alan Greenspan, fear. In this scenario, the Federal Reserve could feel the need to raise interest rates to fight inflation when economic growth is cooling, just as the positive effects of the tax reform wind down. A measured, proportionate and agile approach to trade policy could help to mitigate against potential adverse consequences.

We expect to see Q2 real GDP growth in the neighborhood of 4.0 percent. This may be the strongest GDP growth this year. Productivity growth has been historically weak, but it may jump in Q2, to about 3 percent. Stronger productivity growth is essential in order to keep the now 108-month-long expansion going. Stronger productivity growth would also mean that wage growth, due to very low unemployment, would not necessarily be inflationary. This could give the Federal Reserve extra maneuvering room in setting interest rates in 2019.

U.S. Economic Outlook, Summary

	4Q'17a	1Q'18a	2Q'18f	3Q'18f	4Q'18f	1Q'19f	2Q'19f	3Q'19f	2017a	2018f	2019f
Real GDP (Percent Change Annualized)	2.9	2.0	4.0	2.7	2.8	2.6	2.4	2.4	2.3	2.9	2.7
CPI (Percent Change Year-over-Year)	2.1	2.3	2.7	2.9	2.7	2.4	2.5	2.3	2.1	2.6	2.3
Payroll Jobs (Average Monthly Diff., Ths.)	185.4	210.8	206.7	188.3	174.1	164.6	155.6	142.1	181.4	194.9	150.6
Unemployment Rate (Percent)	4.1	4.1	3.9	3.8	3.7	3.6	3.6	3.6	4.3	3.9	3.6
Federal Funds Rate (Effective)	1.20	1.45	1.74	1.95	2.19	2.45	2.69	2.94	1.00	1.83	2.80
10-Yr. Treasury Rate	2.37	2.76	2.92	2.93	3.07	3.26	3.47	3.66	2.33	2.92	3.55

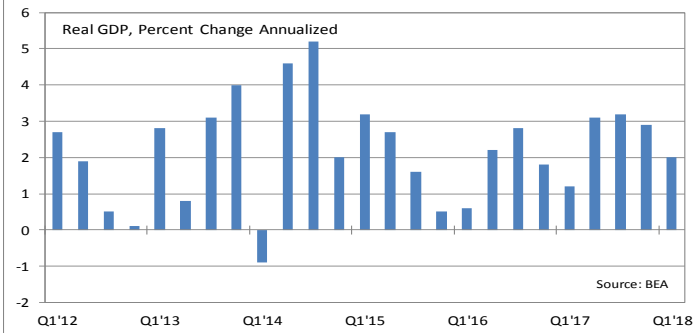
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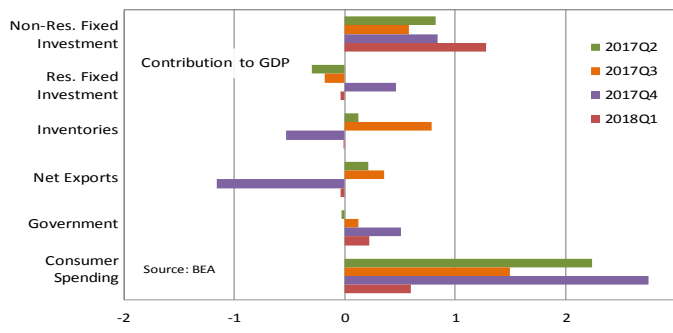
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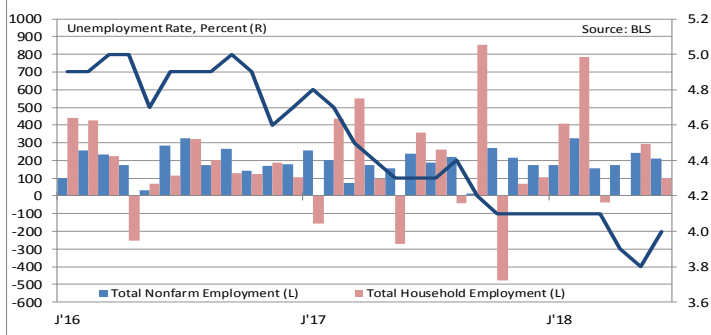
Q1 GDP 3rd Estimate at 2.0%



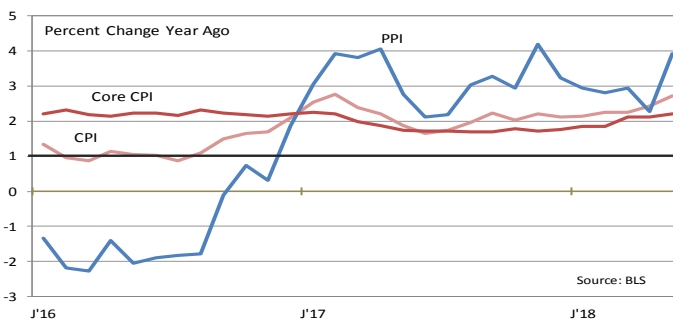
Business Investment Ticked Up in Q1



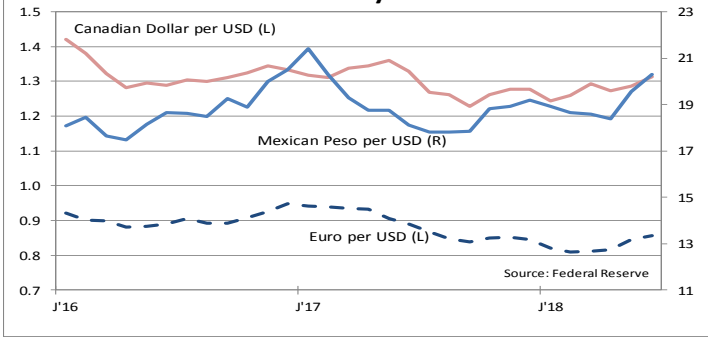
U.S. Adds a Net 213,000 Jobs in June



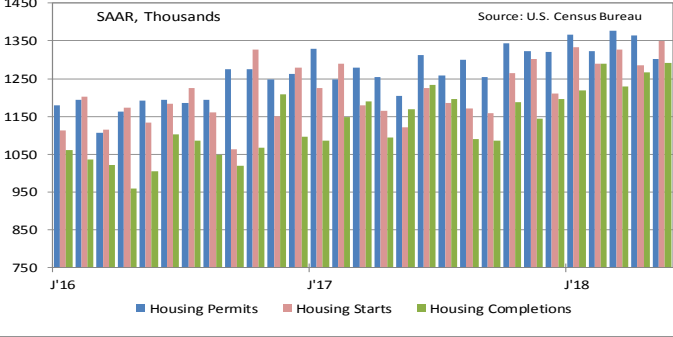
Inflation Metrics Continue to Heat Up



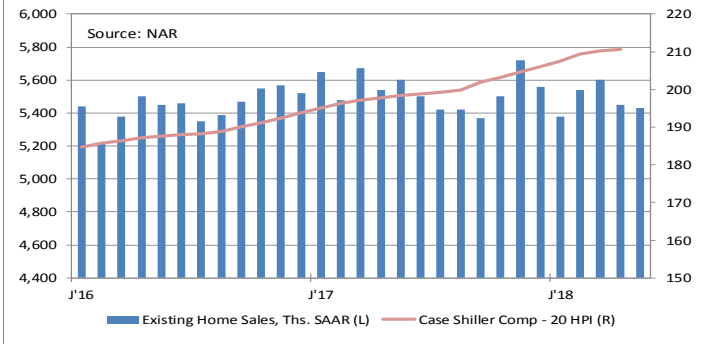
US Dollar Strengthens on Trade Policy Uncertainty in June



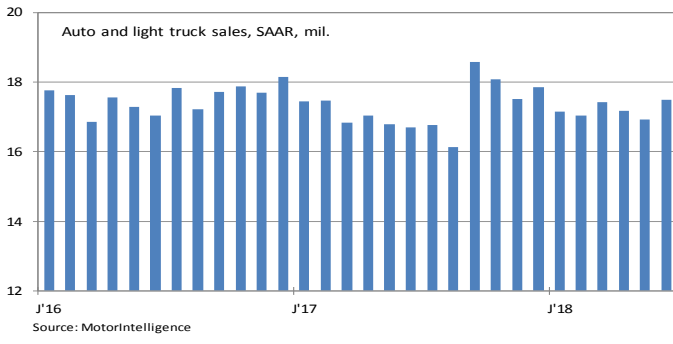
Housing Starts Rebounded in May



Existing Home Sales Trending Down



Auto Sales Improved in June



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	4Q'17a	1Q'18a	2Q'18f	3Q'18f	4Q'18f	1Q'19f	2Q'19f	3Q'19f	2017a	2018f	2019f
Output											
Nominal GDP (Billions \$)	19754	19960	20250	20484	20725	20962	21198	21433	19391	20355	21313
Percent Change Annualized	5.3	4.2	5.9	4.7	4.8	4.6	4.6	4.5	4.1	5.0	4.7
Real GDP (Chained 2009 Billions \$)	17286	17372	17542	17659	17782	17896	18004	18113	17096	17589	18057
Percent Change Annualized	2.9	2.0	4.0	2.7	2.8	2.6	2.4	2.4	2.3	2.9	2.7
Pers. Consumption Expenditures	12035	12061	12143	12198	12260	12319	12382	12442	11891	12166	12410
Percent Change Annualized	4.0	0.9	2.7	1.8	2.0	1.9	2.0	2.0	2.8	2.3	2.0
Nonresidential Fixed Investment	2366	2425	2476	2515	2550	2581	2609	2637	2314	2492	2623
Percent Change Annualized	6.8	10.4	8.6	6.5	5.7	4.9	4.4	4.4	4.7	7.7	5.3
Residential Investment	605	603	610	617	625	632	637	642	598	614	639
Percent Change Annualized	12.8	-1.1	4.9	4.4	5.2	4.4	3.6	3.1	1.8	2.7	4.2
Change in Private Inventories	16	14	22	30	43	51	51	50	15	27	51
Net Exports	-654	-657	-640	-637	-643	-647	-647	-644	-622	-644	-645
Government Expenditures	2922	2931	2937	2941	2951	2964	2976	2990	2903	2940	2984
Percent Change Annualized	3.0	1.3	0.8	0.6	1.5	1.7	1.7	1.9	0.1	1.3	1.5
Industrial Prod. Index (2007=100)	105.3	105.9	107.3	107.5	107.9	108.2	108.5	108.7	103.7	107.1	108.5
Percent Change Annualized	7.7	2.4	5.3	0.7	1.4	1.2	1.0	0.8	1.6	3.3	1.3
Capacity Utilization (Percent)	77.0	77.2	78.0	77.9	78.0	78.1	78.2	78.3	76.1	77.8	78.3
Prices											
CPI (1982-84=100)	247.3	249.4	250.6	252.3	254.1	255.5	256.8	258.2	245.1	251.6	257.5
Percent Change Annualized	3.3	3.5	1.9	2.8	2.9	2.3	2.1	2.1	2.1	2.6	2.3
PCE Price Index (2009=100)	113.5	114.2	114.8	115.5	116.3	117.0	117.6	118.1	112.7	115.2	117.8
Percent Change Annualized	2.7	2.5	2.4	2.4	2.7	2.3	2.1	2.0	1.7	2.3	2.3
GDP Price Index (2009=100)	114.3	114.9	115.5	116.0	116.6	117.2	117.8	118.4	113.4	115.8	118.1
Percent Change Annualized	2.3	2.2	2.0	2.0	2.0	2.1	2.1	2.1	1.8	2.1	2.0
Producer Price Index, Finished Goods	200.6	202.3	204.3	205.6	206.8	207.9	209.0	210.0	198.0	204.8	209.5
Percent Change Annualized	5.7	3.4	4.0	2.6	2.3	2.1	2.1	2.0	3.2	3.4	2.3
Crude Oil, WTI (\$/barrel)	55.4	62.9	67.9	72.0	75.0	75.0	75.0	75.0	50.8	69.4	75.0
Labor Markets											
Payroll Jobs (Average Monthly Diff., Ths.)	185.4	210.8	206.7	188.3	174.1	164.6	155.6	142.1	181.4	194.9	150.6
Unemployment Rate (Percent)	4.1	4.1	3.9	3.8	3.7	3.6	3.6	3.6	4.3	3.9	3.6
Average Weekly Hours, Prod. Works.	33.7	33.7	33.8	33.8	33.8	33.8	33.7	33.7	33.7	33.8	33.7
Population (Millions)	327.0	327.7	328.3	329.0	329.7	330.3	331.0	331.6	326.0	328.7	331.3
Percent Change Annualized	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.7	0.8	0.8
Personal Income											
Average Hourly Earnings (\$)	22.24	22.40	22.57	22.76	22.93	23.11	23.29	23.47	22.05	22.66	23.38
Percent Change Annualized	2.1	2.8	3.2	3.3	3.2	3.2	3.1	3.2	2.3	2.8	3.2
Real Disp. Income (2009 Billions \$)	12827	12940	13021	13098	13169	13253	13339	13425	12765	13057	13381
Percent Change Annualized	1.2	3.6	2.5	2.4	2.2	2.6	2.6	2.6	1.2	2.3	2.5
Personal Saving Rate (Percent)	2.6	3.3	3.1	3.1	3.1	3.1	3.1	3.1	3.4	3.1	3.1
Housing											
Housing Starts (Ths., Ann. Rate)	1259	1317	1329	1342	1351	1358	1364	1370	1208	1335	1367
Ext. SF Home Sales (Ths., Ann Rate)	4960	4903	4817	4864	4903	4933	4962	4990	4910	4872	4975
New SF Home Sales (Ths., Ann Rate)	655	656	665	673	680	683	686	688	616	668	687
Case/Shiller HPI (Jan. 2000=100)	196.3	199.8	202.1	204.4	206.8	209.4	212.1	214.8	191.6	203.3	213.5
Year/Year Percent Change	6.1	6.4	6.4	6.2	5.3	4.8	5.0	5.1	5.8	6.1	5.0
Consumer											
Household Economic Stress Index	0.1	0.0	0.2	0.5	1.1	1.3	1.1	0.8	0.6	0.4	0.9
Auto Sales (Millions)	17.8	17.2	17.2	17.1	16.9	16.6	16.2	16.1	17.3	17.1	16.2
Interest Rates (percent per year)											
Federal Funds Rate (Effective)	1.20	1.45	1.74	1.95	2.19	2.45	2.69	2.94	1.00	1.83	2.80
Prime Rate	4.30	4.53	4.80	5.05	5.29	5.55	5.79	6.04	4.10	4.92	5.90
1-Month LIBOR	1.34	1.65	1.97	2.15	2.36	2.62	2.86	3.11	1.11	2.03	2.97
3-Month LIBOR	1.47	1.93	2.34	2.38	2.54	2.76	2.97	3.20	1.26	2.30	3.08
1-Yr. Treasury Rate	1.55	1.94	2.25	2.37	2.51	2.70	2.90	3.12	1.20	2.27	3.00
5-Yr. Treasury Rate	2.07	2.54	2.77	2.81	2.94	3.13	3.34	3.57	1.91	2.76	3.45
10-Yr. Treasury Rate	2.37	2.76	2.92	2.93	3.07	3.26	3.47	3.66	2.33	2.92	3.55
30-Year Fixed Rate Mortgage	3.92	4.27	4.54	4.60	4.75	4.94	5.14	5.32	3.99	4.54	5.21

a = actual f = forecast

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