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"Weighing the Risks to the Economic Outlook"

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The views expressed today are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee.

Good afternoon. Let me begin by thanking Stonehill College for inviting me to speak. And let me also congratulate the College on the opening of the new Meehan School of Business.

Summer is usually regarded as a time to be more relaxed, take some vacation time, and put your worries aside. In summertime, Gershwin suggested, the livin' is easy.

Unfortunately, this year, the financial markets didn't get the memo. August saw a series of announcements regarding possible additional tariffs; discussions about possible future tax cuts; a significant fall in the 10-year Treasury rate, which now stands at 1.5 percent; and a one-day decline in the Dow Jones Industrial Average of over 800 points, followed by elevated volatility in the Dow over subsequent days.

Indeed, it has not exactly been a low-key, calm summer in the markets. Which begs the question – what are these financial market gyrations telling us about the economic outlook?

Let me point out that despite these headline-grabbing swings in *financial* conditions, domestic *economic* conditions have remained relatively benign:

- The economy grew by 2 percent in the second quarter, and forecasters are expecting growth in the next two quarters to be similar.
- The unemployment rate reached a nearly 50-year low of 3.6 percent in April, and currently stands at 3.7 percent. Forecasters are expecting these near-record lows to continue for at least the next two quarters.
- Inflation, as measured by the PCE price index, is running below the Federal Reserve's 2 percent target, but an alternate measure that removes outsized moves that are likely to

represent one-off changes – known as the Dallas trimmed mean PCE – shows inflation running at 2 percent.[1]

So, with economic conditions relatively strong, why has financial market volatility picked up so markedly this summer?

Financial market participants are certainly concerned that risks related to international trade and geopolitics have intensified. Tariffs are a tax on imported goods and, along with the impact of retaliatory tariffs, they increase the risk that the earnings of firms reliant on foreign trade will be hurt. The reduction in earnings for these firms could affect asset valuations.[2]

In addition, and perhaps more importantly, potential trade disruptions are emerging at a time when many U.S. trading partners are facing mounting economic challenges. For example, China, the world's second-largest economy, faces a number of concerns about the future robustness of its economy. China is heavily reliant on trade, so trade restrictions will take a bite out of the country's economic activity. Moreover, the situation in Hong Kong is raising concerns on many levels, including from an economic standpoint. Other countries are vulnerable to possible U.S. tariffs as well. Japan, South Korea, and many European economies are even more dependent on trade than the United States and face a number of unusual challenges of their own.[3]

Exploring the Yield Curve

In addition to these important global headwinds, we see that yields on the 10-year U.S. Treasury bond have fallen below many short-term yields, resulting in an inverted yield curve. In the past, yield curve inversions have often preceded economic downturns.

However, the current situation is somewhat different, in my assessment. Previously, most of the yield curve inversions were driven by the Federal Reserve raising short-term rates well above the level expected to prevail in the long run, in order to slow the economy down and prevent inflation from accelerating. Today, the short-term interest rate that the Federal Reserve targets, the federal funds rate, is at a level roughly equal to our 2 percent inflation target and still below its expected level in the long run. Rather than policy actions by the Fed that raise the *short*-term rate, what is currently driving the yield curve inversion is the decline in the *longer*-term rate.

The depressed long-term yield, in part, reflects the challenging economic conditions in much of the rest of the world. Currently, U.S. government bond yields (determined, of course, in the marketplace, not set by policymakers) are higher than those in most other developed countries. This provides an incentive for foreign investors to buy U.S government securities, especially if the risk of a dollar depreciation is perceived as low. But such an increase in demand pushes the prices of U.S. government securities up, and yields down.

Weighing the Risks, and Considering Policy

The core question of my remarks today, then, is this: As we all look ahead and evaluate the economy's prospects, how should the relatively good domestic economy and forecasts for the second half of this year be seen against significant risks from trade, a slowdown in some of our trading partners, and the low long-term rates creating an inverted yield curve?

At times like this, it is important to carefully study incoming economic data. If the risks become pronounced and threaten the U.S. outlook, then further monetary easing may be appropriate. However, if the data continue to indicate a U.S. economy growing slightly above the level considered to be the economy's potential growth rate (an estimate of the economy's maximum sustainable output over the long term[4]), with continued gradual increases in wages and prices, then in my view, no immediate policy action would be required.

In fact, the gradual slowing of GDP growth that we are seeing is really not surprising – and is not necessarily a signal of a weakening economy headed for a recession, but instead a natural pattern. As resource constraints (like the availability of workers) become more binding and the effects of the fiscal stimulus wane, and with monetary policy only marginally accommodative, economists would expect actual economic growth to settle in the vicinity of the growth rate associated with the economy's potential.

Economic Forecasts and Indicators

In the spirit of the data dependence, let's now turn to the numbers. **Figure 1** shows the growth in real GDP for the first two quarters of 2019 and the Blue Chip consensus forecast through a year from now. The Blue Chip panel comprises roughly 50 professional forecasters who provide their estimates of the future state of a variety of economic variables.

Actual second quarter growth in real GDP was 2 percent. The Blue Chip forecasters expect real GDP to grow at a 2 percent annualized rate for each of the next two quarters. My own forecast is quite similar, anticipating growth in the second half of this year of 2 percent – which is somewhat above my estimate of the potential growth rate in the economy. Growth above that potential rate is what drives unemployment lower, which may further boost wage and price inflation.

Figure 2 illustrates some of the drivers of second quarter growth. Real GDP growth was 2 percent, despite weakness in business fixed investment, residential investment, and exports, as very strong growth in consumer spending offset the weakness in these other components of real GDP. If the consumer continues to spend, and global conditions do not deteriorate further, the economy is likely to continue to grow around 2 percent, in part because the underpinnings of consumption growth — household income growth and household wealth — remain strong, and consumption accounts for about 70 percent of GDP in the U.S.

To that end, **Figure 3** shows that data we have to date on retail sales are consistent with continued relatively strong consumption. In fact, retail sales growth for July was stronger than the growth in any of the previous three months.

However, **Figure 4** shows that the University of Michigan consumer sentiment survey did decline in August, suggesting consumers may have focused their attention on gyrations in the stock market and the possibility of another round of tariffs, although the measure has not yet deviated meaningfully from its range since the beginning of 2017. By contrast, the Conference

Board Consumer Confidence index was little changed in August relative to July. But in sum, as long as employment continues to expand as it has – even recently – the consumer should remain a source of strength for the economy.

However, tariff-related trade disruption and weakness in the global economy remain key risks for the U.S. economy. That said, **Figure 5** shows exports as a percent of GDP for a number of nations. Countries with a large export share of GDP will be highly sensitive to slowing global market conditions and the imposition of tariffs. Among the countries shown, the United States stands out as having a relatively small export share of GDP, at just 12 percent. In contrast, Germany, South Korea, and Italy are much more highly exposed to global trade.[5]

To date, economic forecasts and the underlying data are consistent with a U.S. economy growing slightly above its potential rate. However, the forecasts and recent data highlight that continued strong consumption is key to that outlook. Because of tariffs and slowing global growth, both business fixed investment and exports have been weak. Clearly, there is a downside risk that trade or geopolitical problems could escalate, resulting in a much weaker situation than is currently anticipated in economic forecasts.

Financial Market Indicators

As I mentioned earlier, one source of concern with the economic outlook involves recent movements in financial markets. **Figure 6** shows the 3-month and 10-year Treasury yields, with recession shading. The 10-year Treasury yield rose to 3.24 early last November and is currently about 1.5 percent. This is obviously a very sizable decline, and much more substantial than the decline in short-term rates.

The current rate configuration in the United States, with the yield curve inversion, should be placed in the context of the interest rates prevailing in other developed economies. **Figure 7** shows the monetary authority's policy rate in Europe, Japan, and the United States. While the U.S. central bank has raised the policy rate over the past several years, in Japan and the Euro area the policy rate has not been raised, reflecting the weakness of these economies relative to the United States.

Because the policy rate remains near the effective lower bound in Europe and Japan, the central banks there have been providing monetary stimulus by purchasing long-term securities. **Figure 8** shows rates on 10-year government bonds in the U.S., Germany, and Japan. Particularly striking is the 10-year German rate, which is now more than 200 basis points lower than the comparable U.S. rate, and is more negative than the European central bank's short-term policy rate.

The weakness in Japan and Europe, and the associated easing across the yield curve, causes foreign investors to search for higher yields in the United States. This has encouraged foreign investors to buy 10-year U.S. Treasuries.[6] In addition to the higher yield, U.S. Treasuries provide a "recession hedge" — in an economic downturn here or abroad, the safety and relatively high yields of long-term U.S. government bonds would likely become even more attractive to investors, so their prices would rise and yields decline further. Holding long bonds today thus offers the prospect of capital gains during a downturn, which would partly insulate investors against the losses on other assets in their portfolios that would likely arise in such circumstances.

These alternative explanations for what makes U.S. Treasuries attractive today are challenging to disentangle, making the decline in long-term U.S. Treasury rates somewhat open to interpretation. To the extent that the decline reflects weakness in foreign economies with limited policy space, that foreign weakness is likely already incorporated into economic forecasts. If instead the rate is falling due to perceptions that an economic downturn here is becoming more likely, then one would have to say that the view from bond markets diverges from that of most economic forecasters and constitutes a downside risk to the forecasts.

But the financial markets are sending mixed signals about economic risks. If one thought that the economy was going into an economic downturn, one would expect such concerns to be reflected in *equity* prices, as corporate earnings tend to decline significantly in a recession. **Figure 9** shows the S&P 500 and Dow Jones averages. While both indices are down a little more than 3 percent from their July highs, overall stock prices remain robust. Recession concerns do not seem to be reflected in the current pricing of stocks.

Another market indicator that can reflect recession concerns is the spread between yields on BAA-rated corporate bonds (bonds with the lowest of the "investment grade" ratings) and 10-year Treasury yields, as shown in **Figure 10**. This spread, which would grow if perceived risks about private sector investments were heightened, is not unusually elevated, as we would expect if bond investors were concerned about a near-term recession.

In sum, one widespread interpretation of the inversion in the Treasury yield curve is that it portends a likely economic downturn in the United States. I would say, however, that such a view does not seem to be strongly echoed in equity markets, bond spreads, or economic forecasts. A plausible alternative explanation would be weakness among U.S. trading partners has depressed long rates in their countries, which has, in turn, depressed long-term Treasury rates in the United States by shifting demand to long-term Treasuries, inverting the yield curve. We are wise not to place too much confidence in either interpretation, but instead watch closely for signs of risks materializing in the economic data.

Inflation Considerations

Another potential concern is that inflation has remained consistently below the 2 percent goal that the Fed has announced and intends to deliver. **Figure 11** shows core PCE inflation and the Dallas trimmed mean PCE. Both measures try to remove "noise" from the measured inflation rate. The Dallas trimmed mean, as previously stated, removes any unusual outliers in the inflation series and is currently at 2 percent. Core PCE, which removes the often-volatile food and energy prices, is at 1.6 percent. During previous periods when the series have diverged, core PCE has tended to move toward the Dallas trimmed mean. This would be consistent with a situation where the recent low readings in core PCE reflect transitory changes in prices (other than food and energy) that are removed by the Dallas trimmed mean measure.

Figure 12 shows that wages and salaries, using either average hourly earnings or the Employment Cost Index, have been slowly increasing. As wages rise, unless productivity rises as well to offset the increase in production costs, firms will need to decide whether to reduce margins or raise prices. The gradual increase in wages and salaries is consistent with a tight labor market. With the unemployment rate at 3.7 percent, this tightness in labor markets should also gradually cause inflation to return to the Federal Reserve's 2 percent target.

Concluding Observations

Concerns over tariffs and geopolitical uncertainties have increased discussion around a possible economic downturn. It is clearly reasonable to make the assessment that risks are elevated. Should those risks become a reality, the appropriate monetary policy would be to ease aggressively. However, to date, these elevated risks have not become reality, at least for the U.S. economy. Economic forecasts – and, as I've demonstrated, many financial market indicators – remain benign, consistent with a forecast of growth slightly above potential.

In my view, one should not be overconfident that the economy will be just fine *or* that an economic downturn is inevitable. As a result, this is a particularly good time to carefully watch incoming data – to determine whether any additional policy adjustments are necessary to achieve the Fed's Congressionally mandated goals of maximum employment and stable prices. Returning to where I started my remarks, I'll just say that is how I plan to spend the last few days of summer, and beyond.

Thank you.

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[1] For more discussion, see the Dallas Fed's *Two Measures of Core Inflation: A Comparison*, by Jim Dolmas and Evan F. Koenig: https://www.dallasfed.org/-/media/documents/research/papers/2019/wp1903.pdf.

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[2] Furthermore, to the extent that U.S. consumers lack domestic alternatives, at least in the short run, to the more expensive imported goods, the loss in consumers' purchasing power could also reduce the earnings, and hence the valuations, of firms not directly exposed to international trade.

[3] As a result, these countries could be affected by global trade disruptions more than the U.S. at a time when in several of these countries the scope for additional monetary policy easing is very limited. But these countries also face a number of domestic challenges of their own, from trade disruptions between Japan and South Korea and between the U.S. and China to an unsteady recovery in the Euro area combined with a variety of political challenges in European countries and the U.K.

[4] For context on the estimate of the economy's potential growth rate, see the Congressional Budget Office, for example https://www.cbo.gov/publication/53558.

[5] There are other ways that international conditions affect U.S. firms. For example, multinational firms, many of which produce goods and services in foreign countries, will also be affected by foreign economic activity and may face reduced earnings.

[6] With the implicit bet that the interest rate differential will not be offset by a future dollar depreciation.