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"Perspectives on the U.S. 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. Thank you for inviting me to New York to address the Forecasters Club. As we close out a year and begin to look to a new one, it is a great time to be talking about forecasts and the economic outlook.

I'll begin with a summary overview, and then walk you through some key data.

The economy continues to perform quite well, as the December employment report from the Labor Department highlighted. We have strong labor markets, with the unemployment rate returning to its 50-year low. And the reported job growth of 266,000 was a nice surprise, particularly for retailers hoping for strong holiday sales. Consistent with the positive news in the employment report, retailers I have talked with have been optimistic about holiday sales. Fortunately for the economy, many consumers seem to be in a buying mood.

Since April, the economy has performed pretty much as many professional forecasters expected – this, despite recent concerns with downside risks, notably those associated with slower global growth and uncertainty about trade policy. While the *composition* of real GDP has been somewhat different than expected by many forecasts from late spring, GDP growth and unemployment have generally been quite close to what was forecast – for example in the Survey of Professional Forecasters, the Federal Reserve Bank of Philadelphia's quarterly survey of roughly 50 forecasters.

Several months ago the financial news seemed to highlight the increasing likelihood of an economic downturn, but more recently those concerns appear to have subsided. In fact, the outlooks of most private forecasters have consistently centered on continued growth in the economy, even while the prognosticators who focus on financial variables such as the slope of yield curve have placed a higher probability on an economic downturn. In other words, financial market practitioners may have priced in slightly more risk to the economy, but economic forecasters saw the most likely outcome as economic expansion.

My own view is that it is unlikely we will have an economic downturn in the coming year, given the generally positive financial conditions and the continued accommodative monetary and fiscal policies. Of course, this outlook assumes that we do not have a significant negative shock from abroad, or experience a negative shock from a sharp ratcheting up of trade disputes with major trading partners.[1]

With the recent positive economic news, and with monetary and fiscal policy already accommodative, I see no need to make the current stance of monetary policy more accommodative in the near term. Given that monetary policy works with lags, and Federal Reserve policymakers have already eased monetary policy three times in 2019, my view is that it is appropriate to take a patient approach to considering any policy changes, unless there is a material change to the outlook.

I would like to turn now to why my perspective on the economy is optimistic. I'll review both the forecasts and economic data, to explain my outlook.

The Economic Outlook

Turning to the data, **Figure 1** shows the Survey of Professional Forecasters' outlook for the unemployment rate, and the actual data for the first three quarters of the year. Since April, the unemployment rate has moved in a tight range. In April, the unemployment rate was 3.6 percent, and in November the unemployment rate was little changed at 3.5 percent. In the intervening period, it fluctuated in a range from 3.5 to 3.7 percent. November's Survey of Professional Forecasters shows that forecasters expect the unemployment rate to remain in this range for the next year. In addition, the shaded region shows the spread between the 25th and 75th percentile forecasts is quite narrow. My own forecast is quite similar, in that I believe the unemployment rate will likely fluctuate narrowly around its current value.

Figure 2 provides actuals for the first three quarters of the year and the Survey of Professional Forecasters expectations for core inflation – which is measured using the Personal Consumption Expenditures, or PCE, price index.[2] In early 2019, core PCE inflation was lower than expected. However, most forecasters continue to believe that shortfall reflected temporary factors – and thus they expect the core PCE, which has subsequently risen, to remain close to the Fed's 2 percent inflation target in 2020.[3] My own forecast is quite similar. I expect that given the strong labor market, PCE inflation should move in a narrow range around the Fed's 2 percent target.

Figure 3 provides actual and forecast real GDP growth. The economy has grown at close to a 2 percent annual rate over the past two quarters, as strength in the household sector has largely offset the weakness in business investment. That pattern is likely to continue, as consumer spending is bolstered by job creation, increases in personal income, and increases in wealth. In addition, the recent monetary policy easing is likely to continue to bolster the housing sector.

Overall the median forecasts from the Survey of Professional Forecasters look quite similar to my own. The U.S. economy is quite solid, and barring an unexpected adverse shock, my view is that the economy is currently well positioned for the coming year. And, depending on one's view about potential GDP growth – because growth above potential implies lower unemployment – it is an economy where labor markets might be expected to strengthen further.

Risks to the Economic Forecast

Of course, the global economy still faces a number of downside risks. Yet, some of the concerns surrounding trade and global growth that were elevated earlier this year appear to have abated somewhat. As you may recall, earlier this fall there was significant discussion about a rising probability of a recession in 2020. These concerns were particularly elevated around the time that trade discussions seemed to falter, and financial market participants became concerned that the temporarily inverted slope of the yield curve was portending an imminent slowdown.[4]

Despite the concerns raised by financial market participants, most economic forecasters assessed a low probability of a recession. The Survey of Professional Forecasters asks participants in the survey to provide their assessment of the probability distribution of outcomes for variables such as real GDP, for the coming year. **Figure 4** provides the average of probabilities based on that survey. The figure shows most of the distribution of forecasts for real GDP fall in the 1 to 3 percent range. Very little of the distribution is associated with probabilities of negative real GDP, which is consistent with a low likelihood of a recession next year.

To a large extent, these probabilities likely reflect the strong household sector numbers I mentioned earlier. **Figure 5** shows the growth in real consumer spending, which has been quite strong over the past two quarters. As previously mentioned, plentiful jobs and growth in income have provided improvements in confidence and bode well for holiday sales and beyond.

Trends in the saving rate and household wealth (net worth) shown in **Figure 6** also highlight why the consumer is well positioned to spend. Both the saving rate and household net worth are trending upward simultaneously and have been for some time now, bringing their levels to near highs. As you can see from the portion of the chart before the last recession, the two don't typically move in the same direction.

Figure 7 shows that after a series of quarters in which real residential investment fell, the housing sector appears to be responding to lower interest rates in the marketplace. Of course, the lower mortgage rates are partly spurred by the Federal Open Market Committee's 75 basis point reduction in the federal funds rate, as shown in **Figure 8**.

Figure 9 shows one reason that a measure of the slope of the yield curve may not always predict an economic downturn, as I have discussed in recent talks. The blue line displays one measure of the slope — the 10-year U.S. Treasury rate minus the 3-month Treasury rate. The green line shows the real federal funds rate, minus the estimated real equilibrium rate. Positive values of this series are meant to capture times when the Fed is pursuing restrictive monetary policy, and vice versa for negative values. In the periods preceding the previous two recessions, the Federal Reserve took a more restrictive monetary policy stance in response to rising wages and prices. The more restrictive monetary policy in these episodes raised the short-term interest rates enough to cause an inversion of the yield curve.

In each of the past three recessions, the green line has been in positive territory – simply meaning that monetary policy became more restrictive (the policy rate set by the Fed was higher than the estimate of the equilibrium rate) at the same time that the yield curve flattened or inverted. In the most recent period, the real federal funds rate has remained below the equilibrium interest rate estimate. Of course, the true value of the equilibrium interest rate ("rstar" or r*) is uncertain, and estimates have been declining for some time. Yet if the estimate is accurate, with the recent 75 basis points of reduction the federal funds rate is now much lower than the estimated equilibrium rate.[5] If a negative slope of the yield curve was, in part, predictive because of its association with tightening monetary policy, it may be less predictive in current circumstances – because unlike the other historical episodes, monetary policy continues to be accommodative.

An inverted yield curve isn't the only risk to the economic outlook, however. **Figure 10** highlights another reason why some analysts have been concerned about a possible recession. The purchasing managers' survey from the Institute for Supply Management provides both manufacturing and nonmanufacturing indices, where observations above 50 indicate increases in activity, and observations below 50 indicate declines. A decline in manufacturing is sometimes a leading indicator of a potential recession. And at times, such declines have sometimes predicted recessions that never occurred.

As an alternative, note that the past two recessions were associated with sub-50 readings for both the manufacturing *and* nonmanufacturing surveys. As just noted, when only the manufacturing sector has fallen below 50, it has not been a reliable predictor of a recession. One could argue that the current reading has the potential to be another such false signal, given current events. In particular, since tariffs are particularly focused on traded goods, it is not surprising that manufacturing has been weak. However, the services that account for the nonmanufacturing index movement have held up quite well, since these industries have not been as directly impacted by the trade disputes.

Figure 11 illustrates another indication that financial conditions remain accommodative: the very low 10-year Treasury term premium. In other words, not only is the federal funds rate below the equilibrium rate, but *long* rates also remain quite low by historical standards. The term premium is likely low, at least in part, because many developed countries are still conducting quantitative easing, making U.S. Treasuries look quite attractive by comparison, boosting their demand and depressing the 10-year U.S. Treasury rate.

With both fiscal and monetary policy being accommodative, financial conditions supportive, and recent data positive, I agree with the surveyed professional forecasters that the likelihood of a recession in 2020 is relatively low. However, a low probability does not mean it cannot happen, and certainly a negative shock from abroad or a significant flare up in trade disputes could change the outlook significantly. Hence, as always, it is appropriate to continue to closely monitor incoming data.

Concluding Observations

In summary and conclusion, my view is that the economy is currently in a good place. Labor markets are strong, inflation is moving to target, and growth is likely to be somewhat above potential. Particularly given the recent cuts in the federal funds rate, and the fact that monetary actions take effect with some lag, I would say that this is a good time to patiently assess the economy. In the short run, I do not see a need for additional policy easing unless there is a material change to the forecast.

Thank you, and best wishes for a happy and healthy New Year.

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[1] For additional discussion, see: Rosengren, Eric: "Exploring Economic Conditions and the Implications for Monetary Policy," Oct. 11, 2019.

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[2] For more about core PCE, see: https://www.bea.gov/data/personal-consumption-expenditures-price-index-excluding-food-and-energy#.

[3] The Fed's 2 percent target is for PCE Inflation. Core inflation measures remove volatile food and energy not because they are not important, but because their volatility can distract from broader trends. The core number is often a better gauge of true underlying inflation pressures.

[4] For more discussion, see: Rosengren, Eric: "Assessing Economic Conditions and Risks to Financial Stability," Sept. 20, 2019.

[5] As economists would put it, "r" is now much lower than "r*" it would appear – if the estimate of r* is correct and policymakers' estimates cease declining.