BERKSHIRE MONEY MANAGEMENT

The Knowledge and Experience to Build Your Wealth

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From Two to Zero

- The economy has halted, and true to its mantra of being "data dependent" the Federal Reserve has responded by turning dovish from a recent hawkish stance.
- Such a quick turn on policy stance is sure to have investors asking, "What does the Fed know that we don't know?"
- We expect the first half of 2019 will be as close to recessionary level as any other time in recent history, but businesses will keep hiring. (Since 2011 there have been seven quarters of GDP growth under 1%, three of which have been negative.)
- Timing is not imminent but we expect reasonably graceful resolutions to Brexit and the US-China trade war, which would reduce the probability of a 2020 recession.
- The economy will likely expand more robustly in the second half of the year, but will remain fragile and exposed to a recession within the next few years.

In just a few short months, the Federal Reserve went from saying it will raise interest rates twice in 2019 to saying to expect zero rate increases. What caused such a pivot? The short answer is that the economy looks awful.

The economy looks awful because the Fed did its job. Well, maybe "doing their job" is too generous of a summation. The Fed did what it intended to do – slow down the economy. The Fed raised interest rates four times in 2018, raising the federal funds rate a full percentage point. That brought the ten-year Treasury Note rate from a low of 2.034% in late 2017 to a high of 3.248% in late 2018. And that brought up the Prime Rate charged by banks to its best customers from 4.25% to 5.5%.

The slowdown occurred by design, and perhaps it worked too well. It's entirely possible that when we see the Gross Domestic Product (GDP) number for the first quarter of 2019 it will be negative (right now it looks like it might be 0.5%, but as new data is released the math could push that number to below zero).

The Fed engineered the slowdown in response to an economy going gangbusters, in part due to the stimulus from lowered corporate taxes. Companies hired to the point where unemployment was under 4%, well below most estimates of full employment. The hot economy was pushing up prices of risk assets, such as commodities and stocks, but inflation remained modest. This made the Fed feel comfortable in "normalizing" interest rates from very accommodative levels. The President passed legislation to stimulate the economy, and that worked. It worked well enough for the Fed to say, hey, great! This gives us the cover to get interest rates from these absurdly low levels to something more normal.

However, as you might suspect by the Fed making that quick pivot from intending to hike rates two times in 2019 to zero times, the slowdown in growth was more than expected. Part of the greater than expected slowdown was because federal spending was less than what was authorized in the budget deal agreed to years ago. That two-year budget deal significantly increased both defense and nondefense outlays. However, only the defense spending kept up with expectations. The good news for the economy is that some of the remaining spending may occur at the end of this year (and if I wanted to be a political animal, I could also say that's good news for the incumbent Presidential administration as it could serve to juice the economy at a time when citizens are considering how to cast their vote).

Also, the planned slowdown was more than expected because of the partial government shutdown which reduced hours worked by furloughed government employees. Additionally, although most people got back more of their own money last year in the form of smaller tax withholdings in their weekly paychecks, their refunds were smaller than last year. While workers kept more of their money, people spend their tax refunds in different ways than they do their weekly paychecks. Smaller refunds means less "splurge" buying on larger ticket items, like household renovations, or vacation spending, or durable products. I wrote about that in my weekly column, Capital Ideas, for the Berkshire Edge *https://berkshiremm.com/go-refund-me/*

We can also point to the damage done to the global economy from the Brexit issue as well as the US-China trade war as the complexity and uncertainty of finding resolutions to either has halted trade. Both have caused businesses to cease capital expenditures until they have more clarity. I expect resolutions to both, though the timing is difficult to calculate. The President's trade advisors are vocal about holding the course of current tariffs in order to pressure a substantive agreement with China, but the President's campaign team will be sure to put a deal in place soon enough to claim victory and avoid another stock market crash just prior to elections.

Brexit has remained messy, which was to be expected given the complicated politics and gravity of the situation. Updates on the situation are public and frequent and fluid, but it is expected that the British will agree to adopting an exit strategy like Prime Minister Theresa May's proposal. That would keep Britain in the union for trade with the European Union, which would upset hardcore Brexit supporters, but they will win the compromise on their bigger issues. If May's proposal fails, it will be disappointing and a global economic headwind. There isn't much of a silver lining to gaining clarity then, other than that we've been able to see this play out on a world stage so we can measure and understand the impact as a drag, but not the type of process that pushes global trade over a cliff.

The growth of the US economy is largely dependent on continued business hiring. We expect hiring to continue through 2019 and even into early 2020, but not nearly at the pace we've seen. There are more job listings than there are people available for work (7.8 million vs. 6.2 million). Even with some weakness in the first half of 2019, businesses won't cut hiring plans as they've been painfully short of workers for a few years now and don't want to be caught short when the economy rebounds. Also, there is an expense and difficulty to stopping and later restarting current search efforts. The economy only needs to see jobs growth of 100,000 per month, less than half of the growth of last year, to maintain employment levels, which will spur wage growth and revitalize consumer spending. But the jobs growth must continue. Once unemployment begins to increase, even from low levels, it is nearly impossible to stop a recession.

So why did the Fed say it will stop raising rates for 2019? What does the Fed know that we don't know? Truly, nothing. I mean, yes, of course, it's all public data up for interpretation. And the Fed, as promised, is being data dependent. The Fed seems dedicated to keeping us out of a recession, thank you very much. Consequently, given that inflation is modest, I don't see this as a risky approach to monetary policy, so long as they stick with it and don't try to walk back the commitment thus creating uncertainty.

Compared to previous periods, monetary policy is currently extremely stimulative. The nominal fed funds rate is set at a range of 2.25 to 2.5% at a time when inflation is modest. The federal-funds real rate is just 0.25% (when nominal rates are adjusted for inflation it is called the "real" rate.). By comparison, the real rate was 2.75% at the end of the Fed's last tightening cycle in 2006, and 4% at the end of the prior cycle in 2000.

All other things equal, the Fed eliminating its intended rate hikes is good for the prices of risk assets, including equity.

The Bottom Line: The US economy has transitioned from "mid-expansion" to "late-expansion." The next stage is not "in recession," but "at risk." We continue to track the data to determine if we are yet at risk. Or, more accurately, just how at risk we are. In some ways, we're always at risk. There is always the panic of the day that permeates the media and investor conversations. There is always something to worry about, something that puts us at risk. The risks right now are not great enough to overwhelm the expansion. Threaten it, yes, but not overwhelm it. The labor market is strong and shows signs of continuing. While GDP has slowed, it has done so in an orderly fashion due to explainable and temporary factors. And the Fed has decided that it will fight any recession, which reduces the risk I was most concerned about following four rate hikes in 2018, which was a monetary policy mistake. The Fed is now on our side, even if it wasn't last year.

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