Four Questions for 2019

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Disclaimer

The views I will express today are my own and do not necessarily reflect the positions of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

Motivation

- The first of the year is often a time to reflect on last year and to look forward to the year to come.

- Although the final script is yet to be written, last year's growth was the strongest since 2005—and with low inflation.

- But as forecasters and policymakers begin to reflect on the economic possibilities for 2019, several questions come to mind. Let's narrow the list to five.

Four Questions for 2019

- Will job growth remain strong?
- Is inflation headed higher?
- Will the FOMC raise rates again in 2019?
- Will there be a recession in 2019?

Points to Ponder

- The U.S. economy is complex and most sectors are highly interdependent.

- Moreover, the economy evolves over time in ways that are unpredictable (e.g., globalization and the role of finance in the economy).

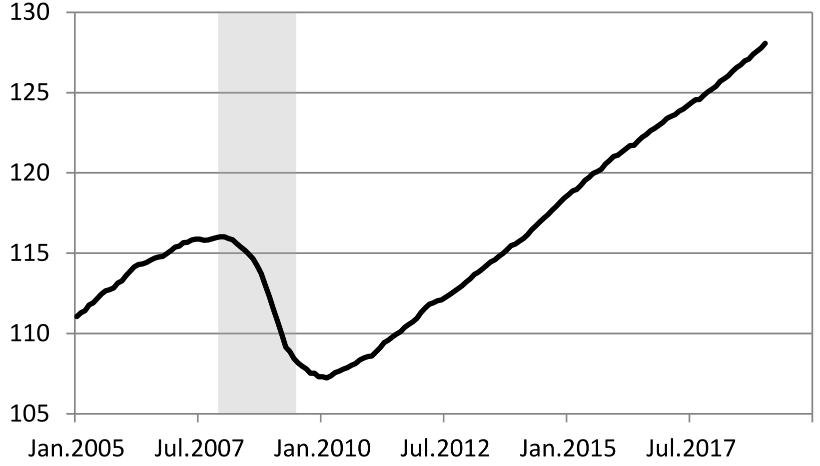
- And economic policy responds to economic outcomes—and can affect economic outcomes in different ways.

#1: Will Job Growth Remain Strong?

- 2.7 million jobs added in 2018. A gangbuster jobs report for January 2019.
- The U.S. unemployment rate is near a 50-year low.
- Many firms—especially in construction—continue to report labor shortages.
- Forecasts suggests solid job growth this year, further stretching tight labor markets.

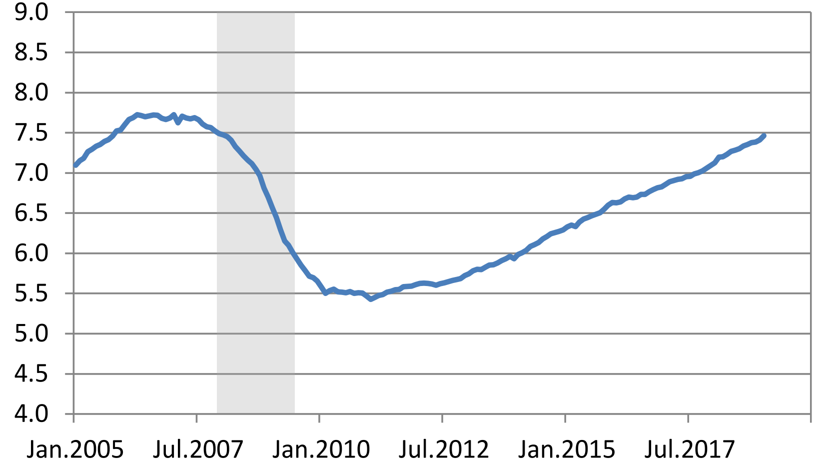
Employment Moving Higher

Private Payroll Employment
Millions of jobs



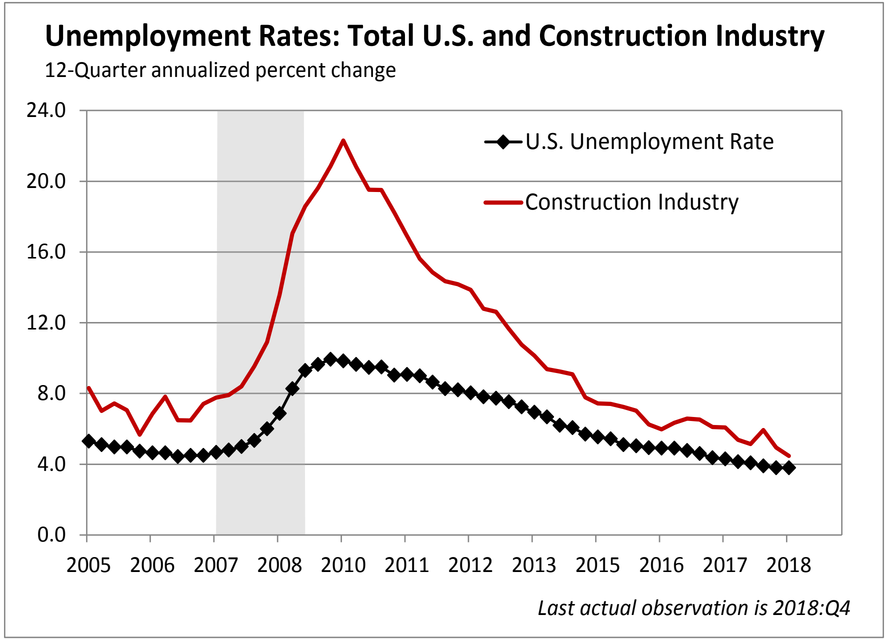
Last actual observation is January 2019

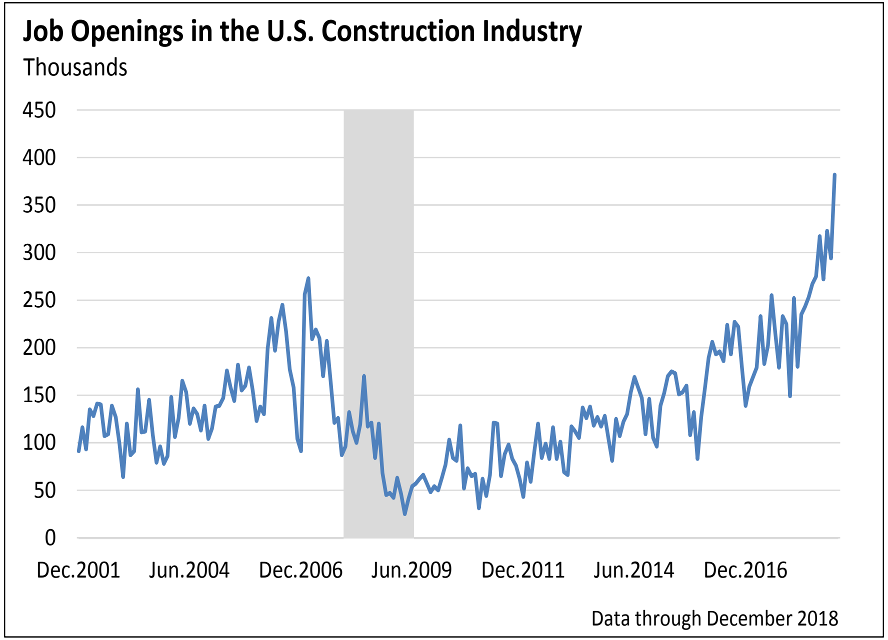
Construction Payroll Employment
Millions of jobs



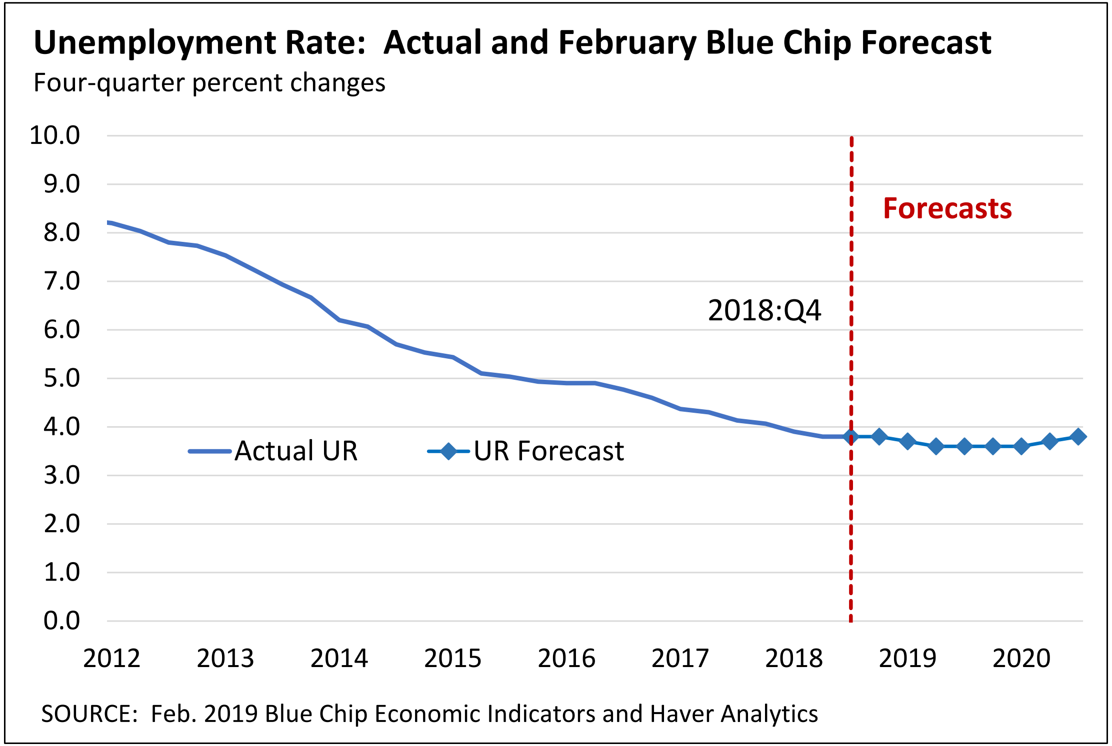
Last actual observation is January 2019

Unemployment ↓, Job Openings ↑





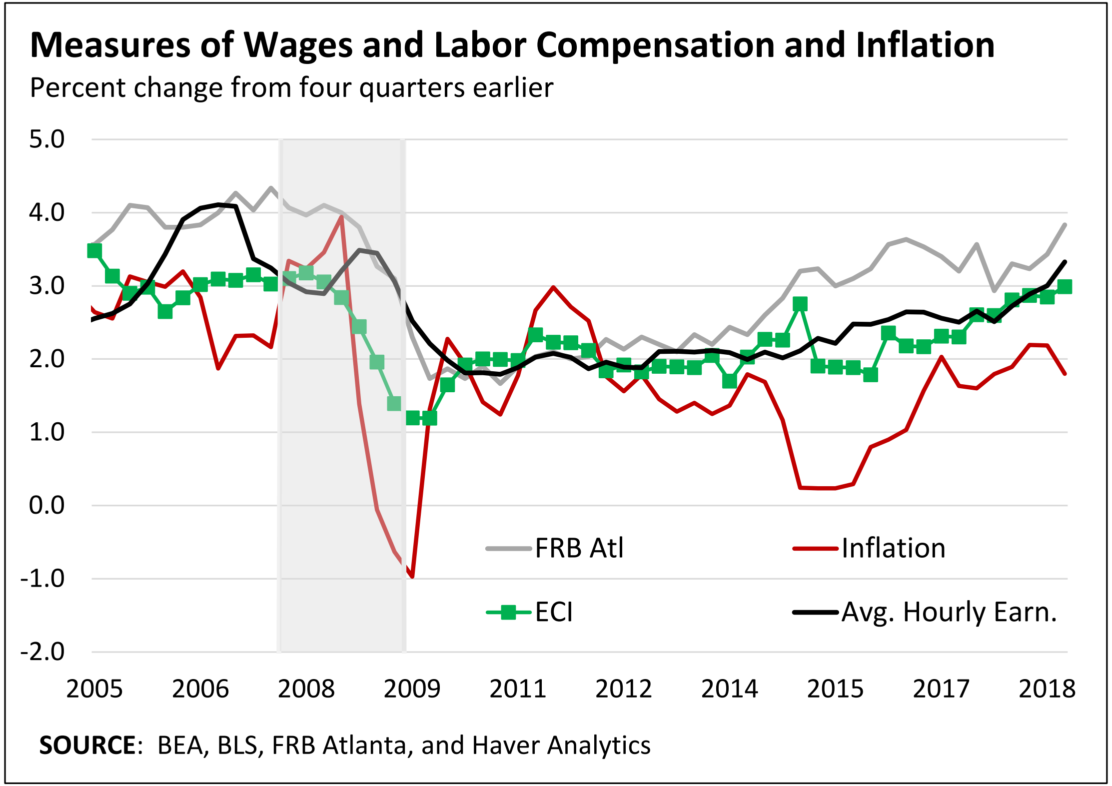
Forecasters Expect the Unemployment Rate to Fall Further



A Wage Puzzle?

- Average hourly earnings rose 3.2% in 2018, the largest increase since 2008.
- But firms, and workers, should focus on total compensation (wages and salaries plus benefits).
- Rising costs of benefits can slow growth of wages.
- Solid economic growth and strong labor demand should continue to put upward pressure on labor compensation.

Labor Compensation is Rising



The Importance of Productivity

- But faster growth of labor compensation will depend importantly on productivity growth—the growth of output per hour.
- Productivity depends on many things, including investment, worker skills, and new technologies and innovations.
- Productivity growth has been picking up, albeit modestly.

#2: Will Inflation Accelerate in 2019?

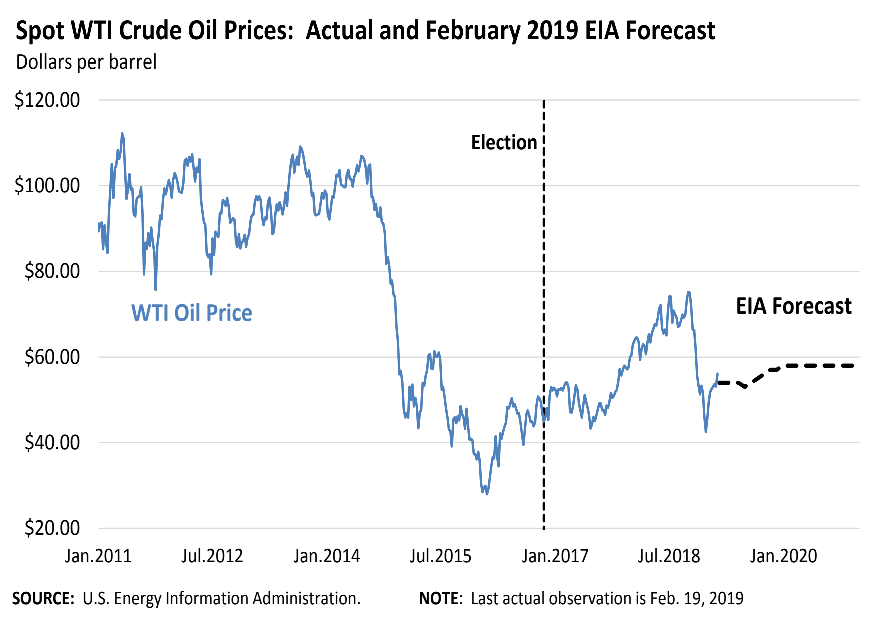
- Inflation in 2018 likely remained below 2% for the seventh straight year. Inflation expectations are tame.
- But many see increased risk of higher inflation because the unemployment rate is near a 50-year low. I don’t.
- Others see trade-related developments (i.e., tariffs) raising inflation. But a stronger dollar and falling oil prices offsets much of these risks.

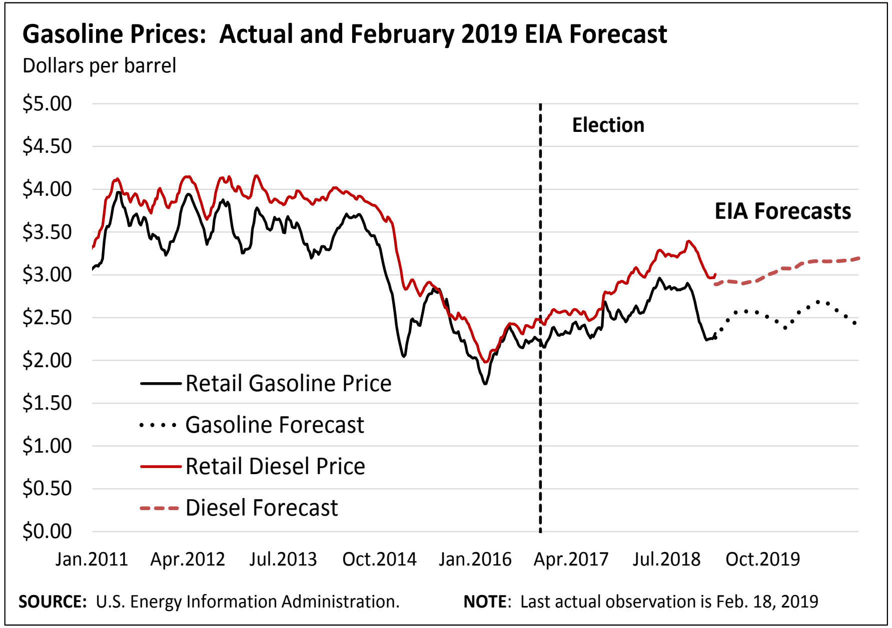
Will A Falling Unemployment Rate Lead to Higher Inflation?

- In a recent speech, St. Louis Fed President Bullard showed that a big decline in the unemployment rate would lead to small increases in inflation.

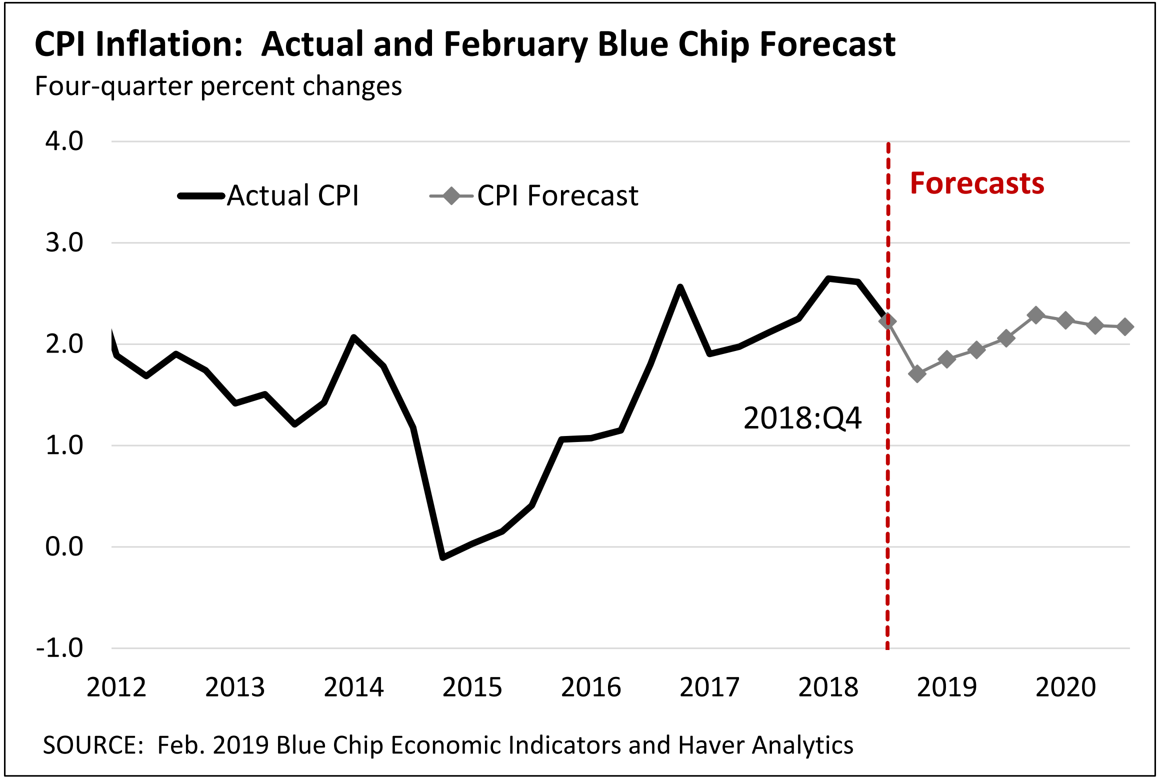
If the unemployment rate was…	The predicted core PCE inflation rate would be…
3.9%	2.0%
3.5%	2.1%
3.0%	2.2%
2.5%	2.3%

A Modest Firming in Energy Prices

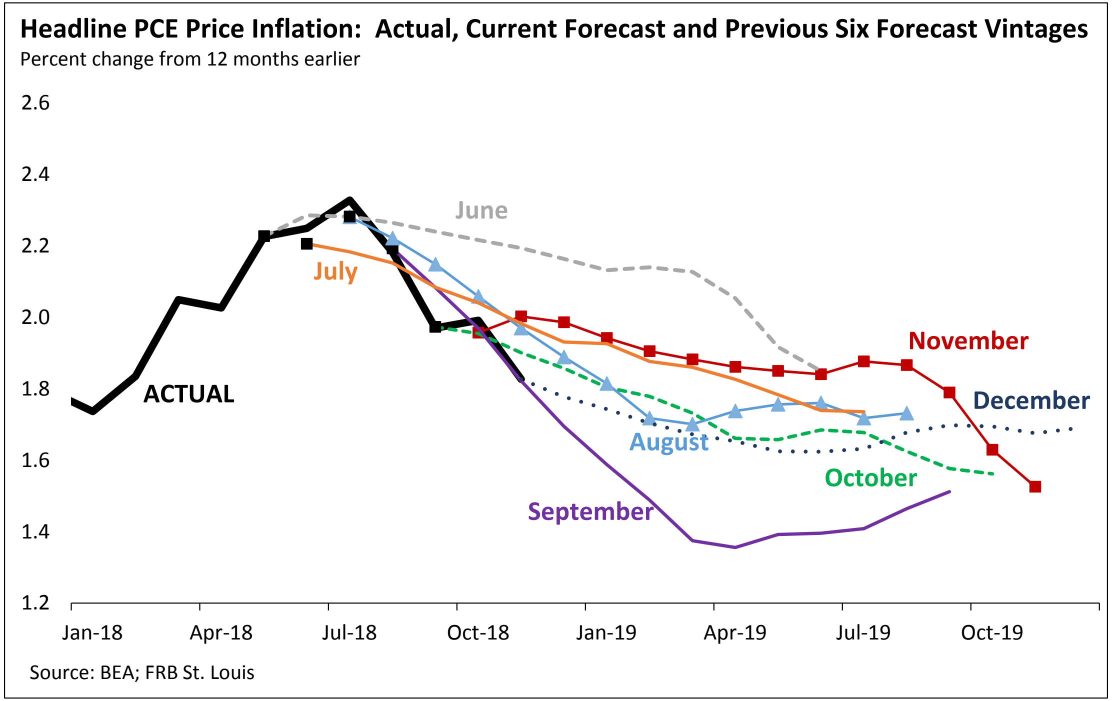




The 2% Inflation Forecast for 2019



Our “Big Data” Model has Signaled Lower Inflation Since Last June



#3: Is the Fed Done Tightening?

- At its December meeting, Fed policymakers raised rates for the fourth time in 2018.
- They signaled that more rate increases were likely in 2019 and in 2020.
- Financial markets did not react well; stocks sold off, and some forecasters raised the specter of a recession this year or next.

Patience, Grasshopper

- In the face of rising financial market turmoil, signs of weaker growth in Europe and China, and slowing inflation, Fed policymakers called an audible.

- In early January, Chairman Powell and other Fed policymakers said that they will be patient in assessing how the economy responds to rate increases.

Enter the Vortex!

"Over the past few months we have seen some crosscurrents and conflicting signals about the outlook. Growth has slowed in some major foreign economies, particularly China and Europe. There is elevated uncertainty around several unresolved government policy issues, including Brexit, ongoing trade negotiations, and the effects from the partial government shutdown in the United States."

Federal Reserve Chairman Jerome Powell, Jan. 30, 2019

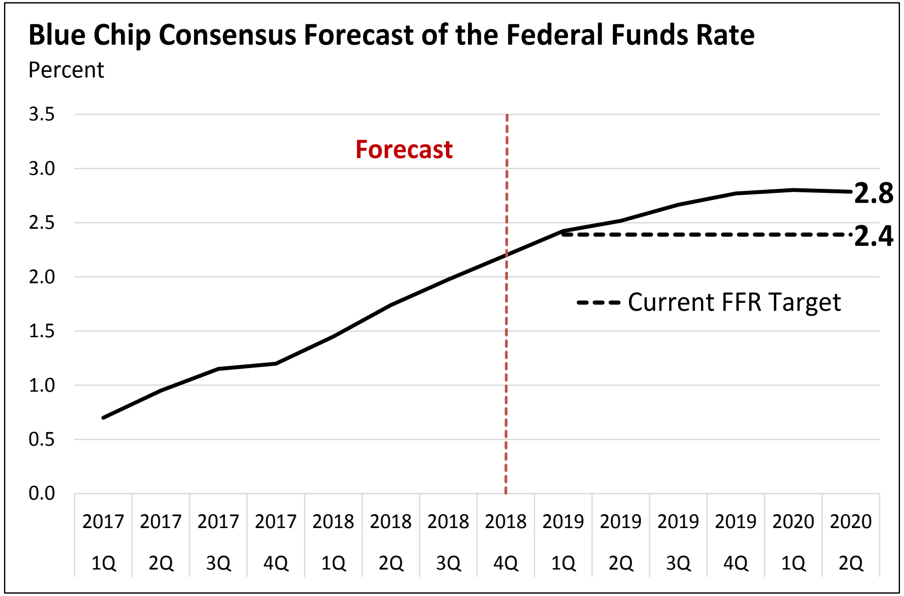
So, More Rate Hikes in 2019?

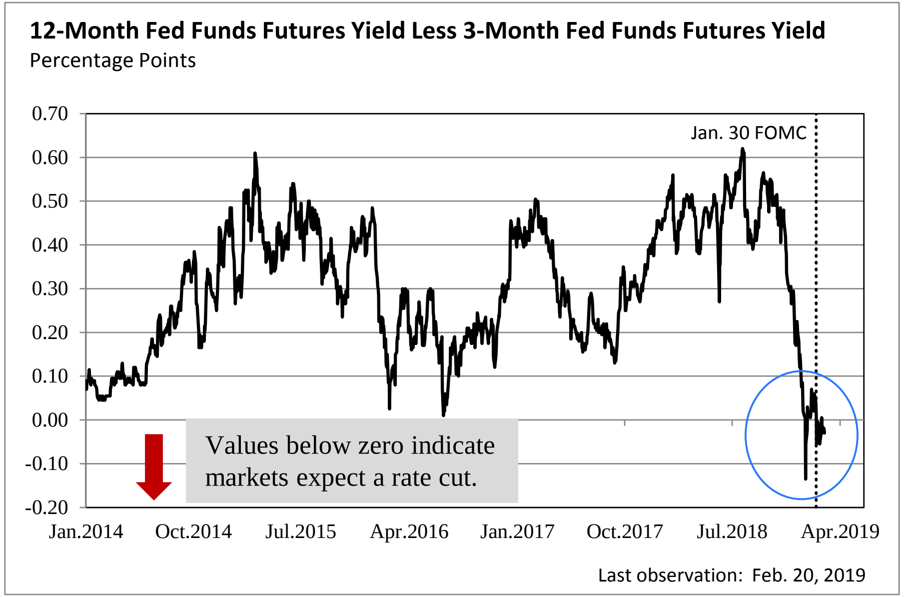
- We're against them—and others are have come around to our view.

- What's the case for more hikes? It mostly boils down to strong labor markets (Phillips curve). Others want policy "space"—raise more to cut more. That's crazy!

- What's the case for staying put? Inflation and inflation expectations have softened. There are some downside risks to the real economy. Financial market volatility?

Forecasters vs. Financial Markets on the Direction of Fed Policy

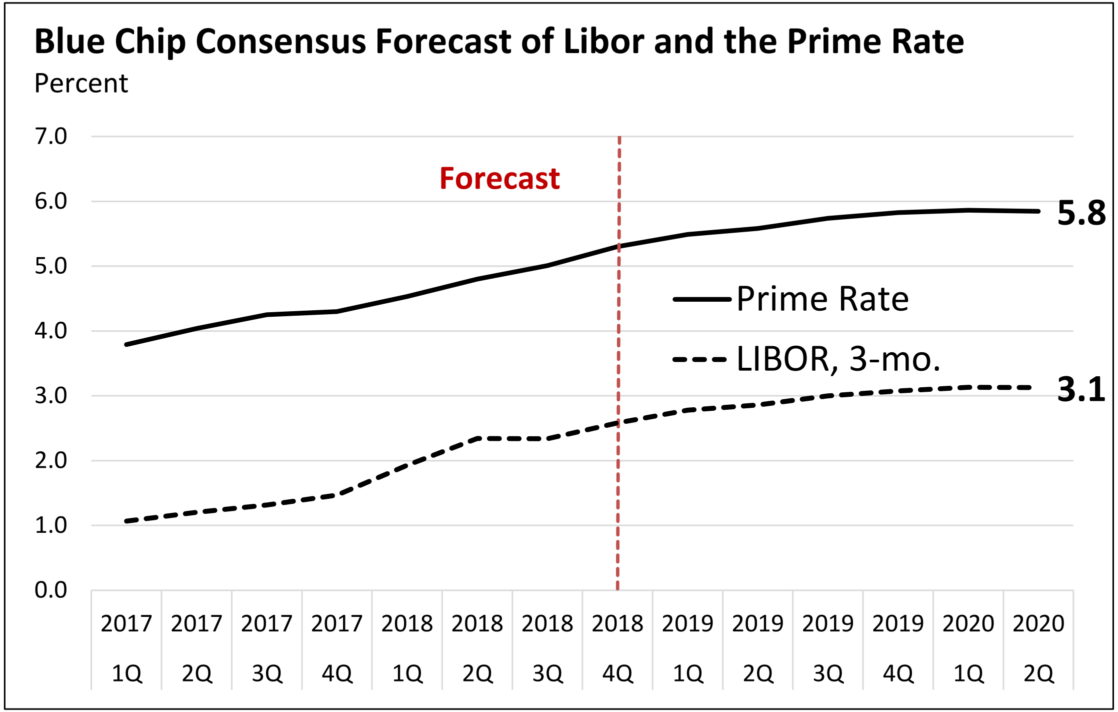




Forecasters

Financial Markets

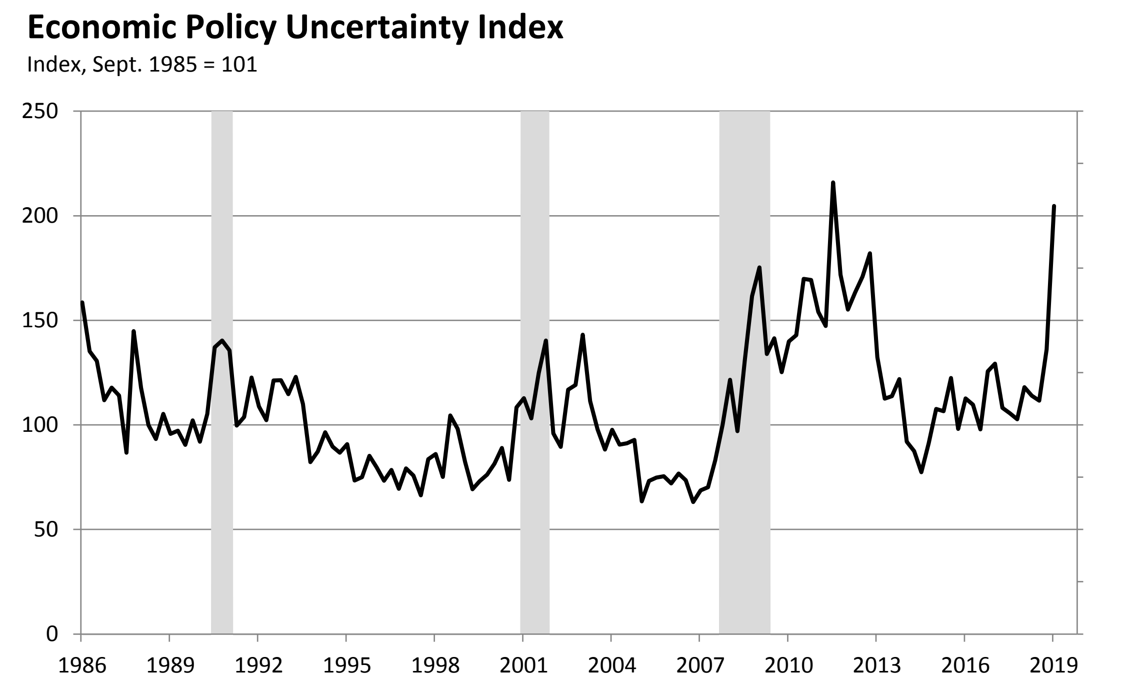
Forecasters: A Modest Upswing in Borrowing Rates



#4: A Recession in 2019?

- That's not our forecast, but the probability isn't zero.
- Recession signals are mixed: The yield curve is flat and housing has weakened, but labor markets and consumer spending (mostly!) suggest continued solid growth.
- Headwinds, tailwinds, and whirlwinds: Trade policy; fiscal stimulus; and financial market volatility.
- Headwinds + whirlwinds = rising uncertainty.

Riders on the Storm: Rising Uncertainty



NOTE: Author's calculations. The observation for 2019:Q1 uses the reported value for January 2019.

Rising Uncertainty: Bad Karma

- Firms are reluctant to commit scarce resources to irreversible, long-lived investments with an uncertain payoff.
- The effects can be magnified by an extended period of slow economic growth.
- Waiting until the fog clears. Firms use existing equipment longer rather than replace worn-out equipment.
- Firms tend to work their existing employees longer hours rather than add new workers.

Name Your Poison: Threats to the Economy in 2019

Percent of Responses	Downside Risk
39.6%	Trade policy
20.8	Higher interest rates
12.5	Political or Geopolitical event
10.4	Rising inflation
6.3	Immigration restrictions
4.2	Substantial stock market decline or market volatility
4.2	Other
2.1	Weak wage growth
0.0	Strong dollar
0.0	A widening Federal deficit

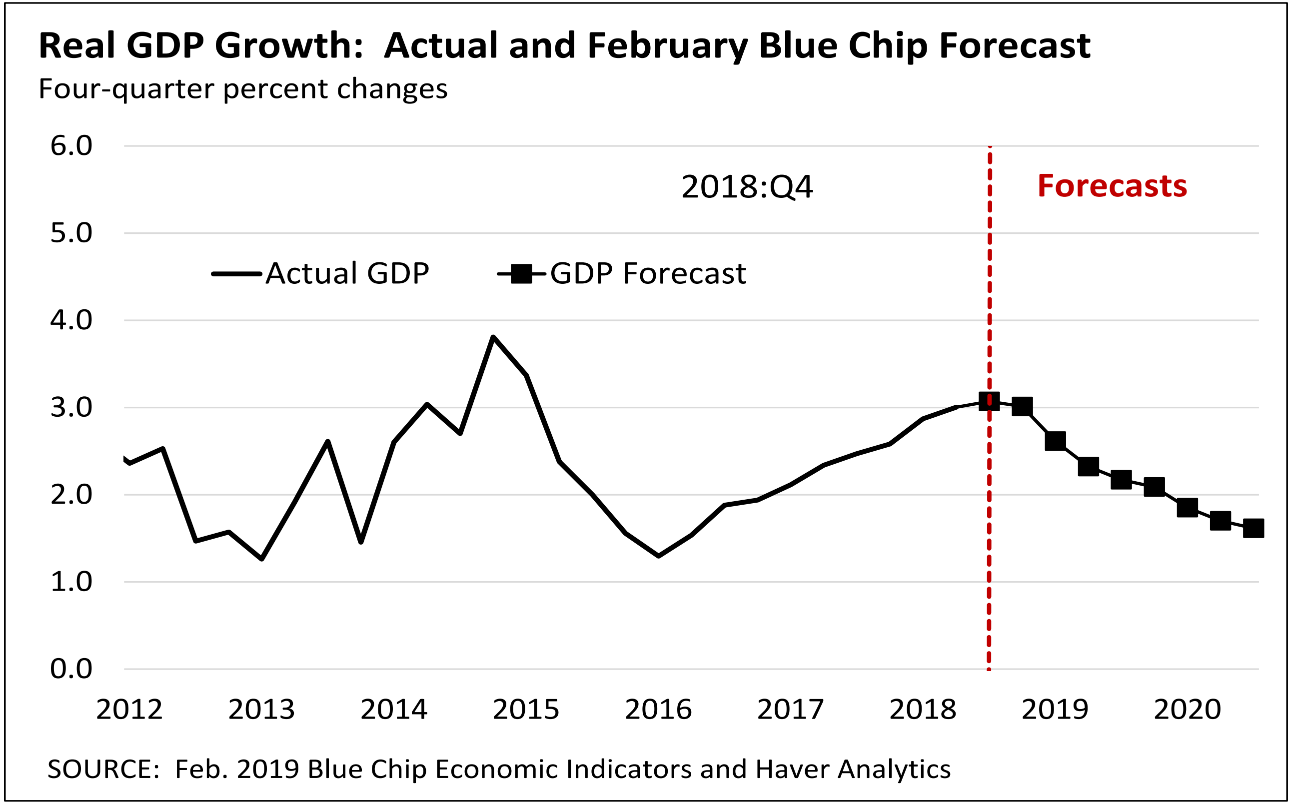
National Association for Business Economics Outlook Survey, December 2018

Don’t Worry Be Happy: Growth Opportunities in 2019

Percent of Responses	Upside Risk
29.8%	Stronger wage growth
23.4	Corporate tax reform
17.0	Infrastructure spending program
8.5	Stronger global growth
6.4	Trade policy
6.4	Other
4.3	Individual income tax cuts
4.3	Stronger equity markets

National Association for Business Economics Outlook Survey, December 2018

The No-Recession Forecast



Recession Probabilities

2019: 26%

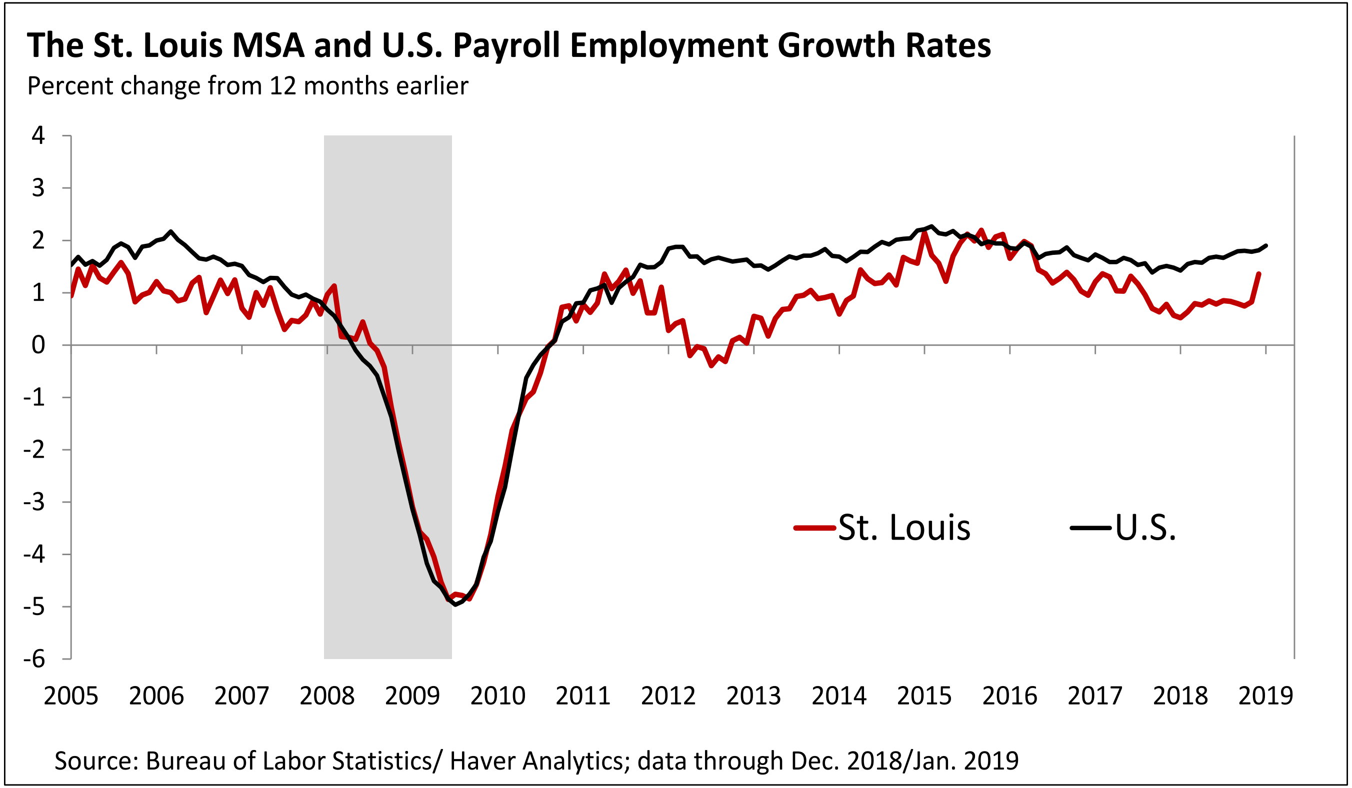
2020: 39%

Main Takeaways.

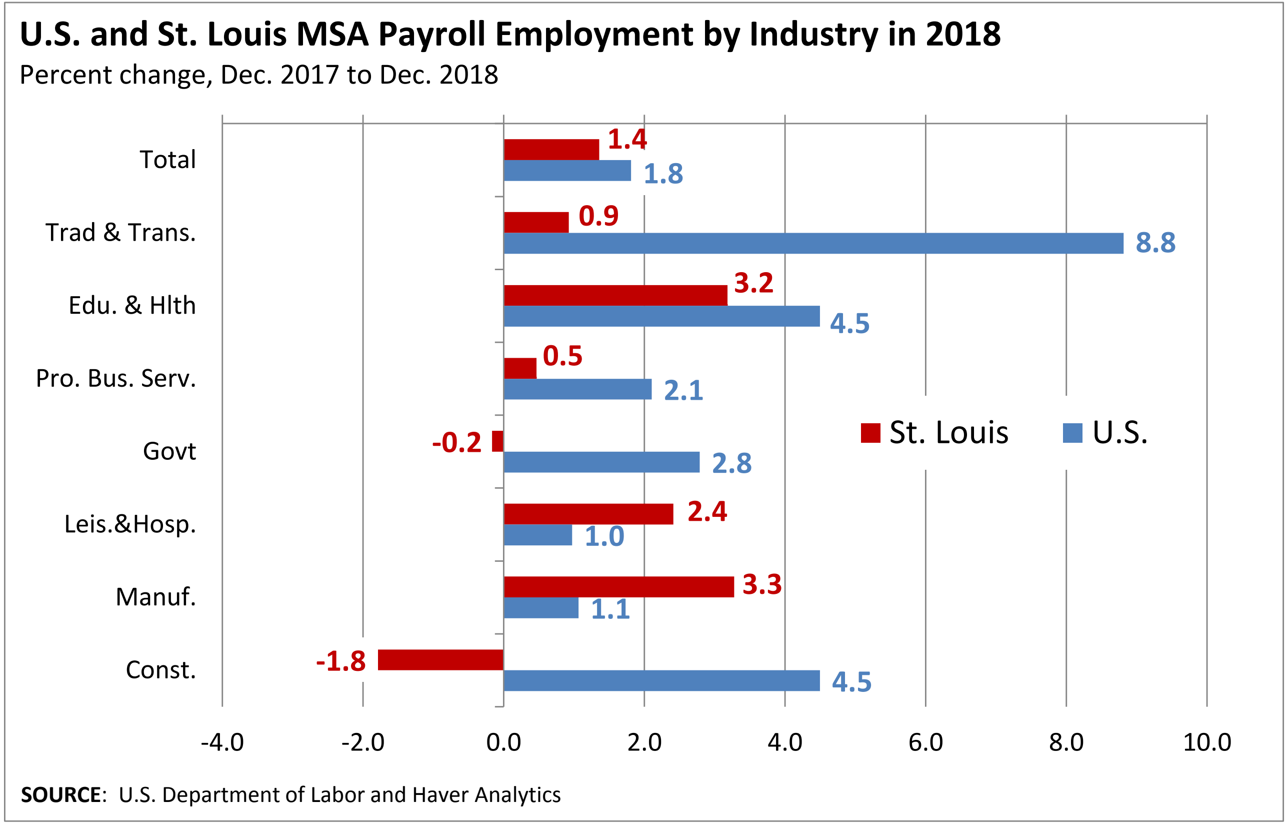
- Although recession risks are modestly elevated, most forecasters expect weaker, though still solid, growth in 2019.
- Inflation has slowed, helped by the plunge in crude oil prices. We see some risk of even lower inflation in 2019.
- Financial markets expect the FOMC keep its powder dry in 2019. By some measures the Fed is too tight now.

BONUS COVERAGE: THE ST. LOUIS ECONOMY

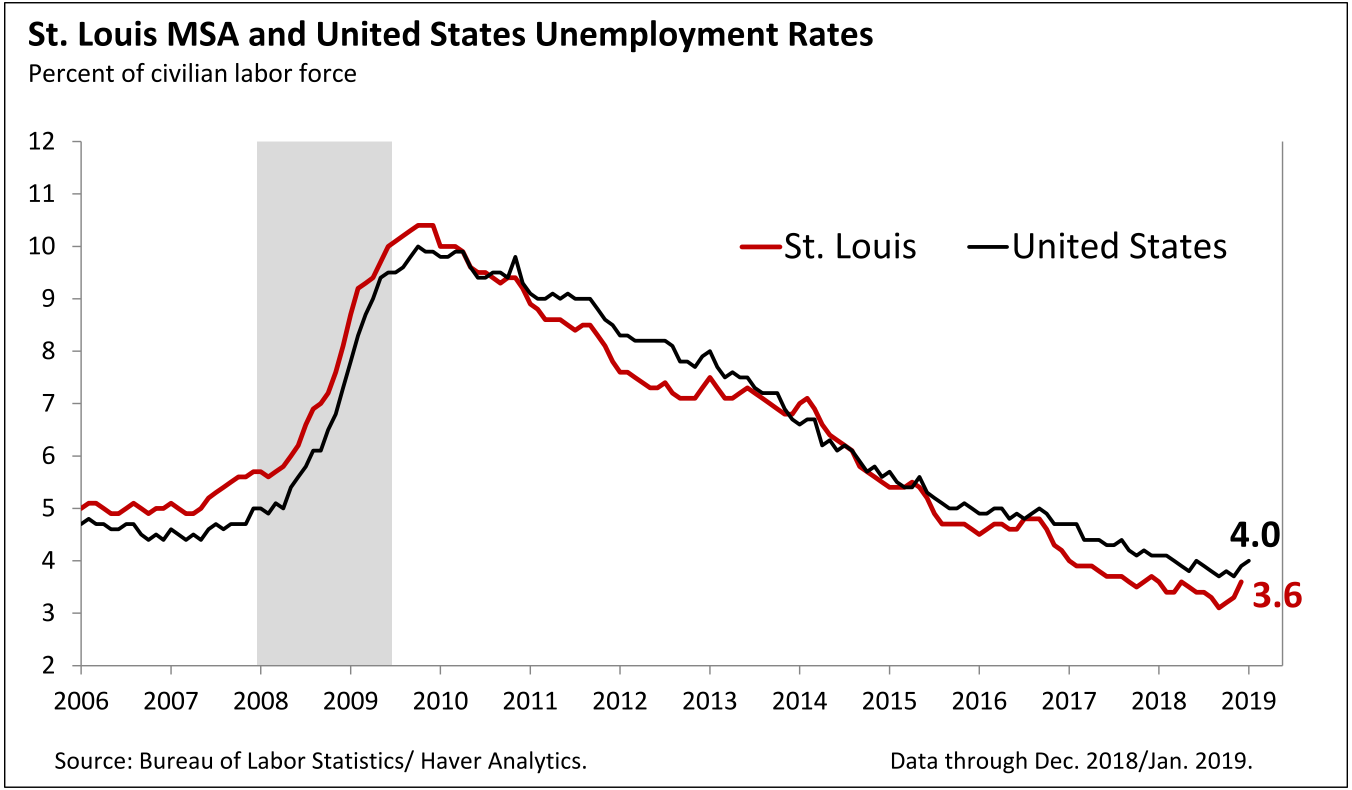
St. Louis Job Growth: Weaker



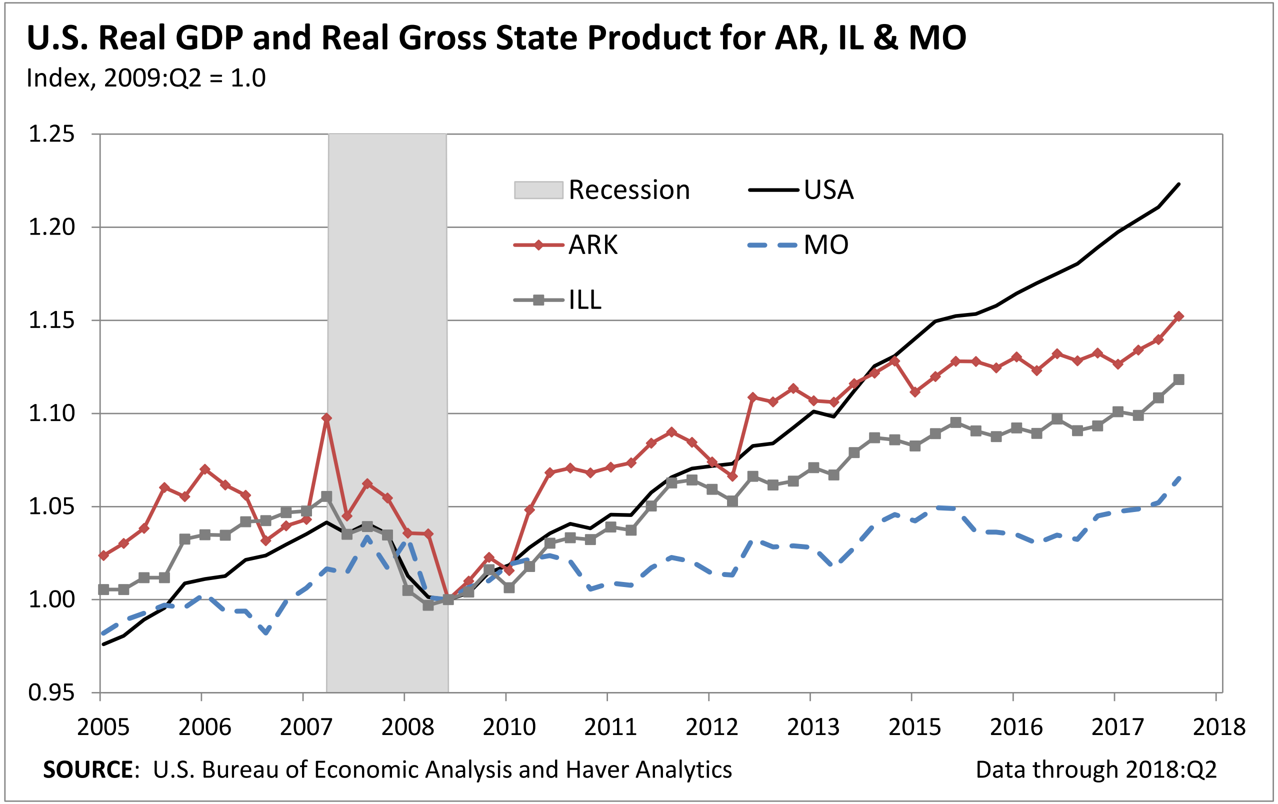
U.S. & St. Louis Job Growth By Industry



St. Louis Unemployment Rate: Lower



Missouri: A Laggard in GDP Growth



QUESTIONS?