United-States

Landing

The assumption that the US economy is heading for a landing is gaining ground, not just because of the shutdown. The disruption created by the trade war with China, the appreciation of risk on bond and equity markets, the peaking of the energy sector and the deterioration of real estate indices all suggest less buoyant growth. This view is shared by the US Federal Reserve, which has adopted a more cautious tone and suspended the increase in policy rates pending future macroeconomic data.

The wind has turned in the US and, as is often the case in the world's biggest market economy, it was the stock market that proved to be the weathervane. Over the final three months of 2018, equity prices fell by 15%; whilst not a crash, this is a serious correction, which anticipates a likely normalisation of company earnings[1].

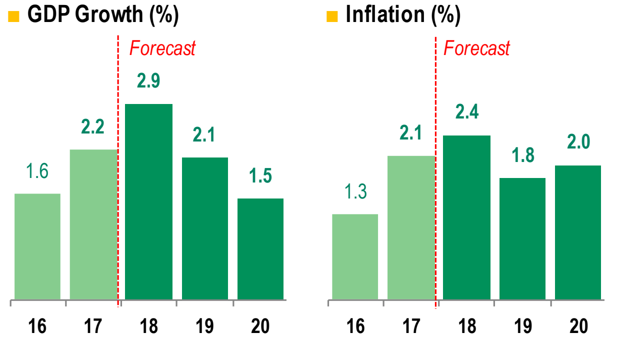
Blowback

There is little here that is surprising. With the effect of tax cuts waning, President Trump's trade war is claiming its first victims among US companies. In December 2018, the index of new industrial orders lost 11 points, registering its biggest fall since that triggered by the collapse of Lehman Brothers a little over ten years ago (Chart 2). In the industrial and exporting region of Philadelphia, the Fed's surveys suggest that expectations are less favourable.

With the price of oil dropping 25%[2], the energy sector is also feeling the pain. Highly leveraged, it is seeing tougher financing conditions (its risk premium is widening) and equity valuations falling. The immediate effects have been brakes on investment and production of oil and gas from fracking, which had set new records in 2018; these will be viewed differently depending on the importance one places on energy transition (see our article on page 24).

As mortgage rates rise, the real estate sector declines. The National Association of Home Builders (NAHB) index has lost ground, auguring over time a fall in housing starts and a correction in prices. Support will not come from the federal government, which, unhelpfully, is under a partial shutdown (see Box). This shutdown is already the longest ever, and will trim between USD5 billion and USD10 billion off economic activity each week[3]; its effects were not particularly visible at the end of 2018 but will be felt in the first quarter of 2019, when growth (at an annualised rate) will be trimmed by nearly one point.

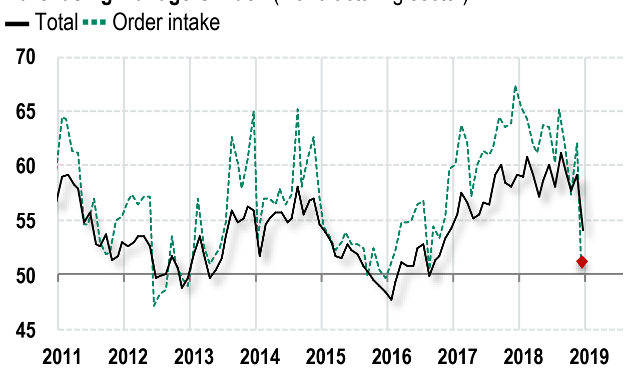
1- Growth and inflation



Source: National accounts, BNP Paribas

2 - A sudden chill

Purchasing Managers Index (manufacturing sector)



Source: Institute for Supply Management

A change in tone from the Fed

Having made nine successive increases in the fed funds rate, taking it to 2.50% (upper limit), the Federal Reserve is now hinting at a pause. Even before the shutdown, members of the Open Markets Committee had tempered their economic diagnosis and their estimates of interest rate increases. Minutes from their last meeting (on 12 December 2018) suggest a cautious and watchful position, faced with feedback from business leaders in the field and

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[1] Between 20 September 2018 (the last peak) and 31 December 2018, the Standard & Poor's 500 index fell 14.5%; over the same period, analysts downgraded their estimates of earnings per share.

[2] On 16 January 2019, a barrel of Brent crude oil cost USD61, 25% below its previous peak at the beginning of October 2018.

[3] Range of estimates based on the cost of the shutdown in the autumn of 2013. See: Committee for A Responsible Federal Budget (2013), *The Economic Cost of the Shutdown*, October.

imponderables such as Brexit, which the Fed has indicated it is following closely[4].

This change of tone has had its effects on the markets; for 2019 the forward yield curves suggest no monetary tightening but rather a status quo, or even a slight relaxation; in the sovereign bond segment, yields have fallen whilst the distribution across maturities has become nearly flat (Chart 3).

In the past, such a pattern has always presaged a slowdown in the US economy, and it is unlikely that this time will be any different. The flattening of the yield curve increases the carrying cost of debts and contributes to the inversion of the leverage effect, something that the US has made significant use of in recent years[5]. For a number of quarters now, the International Monetary Fund (IMF) has warned of increasing vulnerability of certain sectors of the economy such as energy, infrastructure, healthcare and telecommunications (IMF, 2018)[6]. The IMF indicates that the latest wave of corporate debt issuance not only set new records, but also carries the greatest risk. In 2018, 80% of issues subscribed by institutional investors (mutual or pension funds, insurance companies, etc.) were 'covenant lite', that is to say virtually without any guarantee. Half of leveraged lending was issued at multiples of at least five times annual operating income.

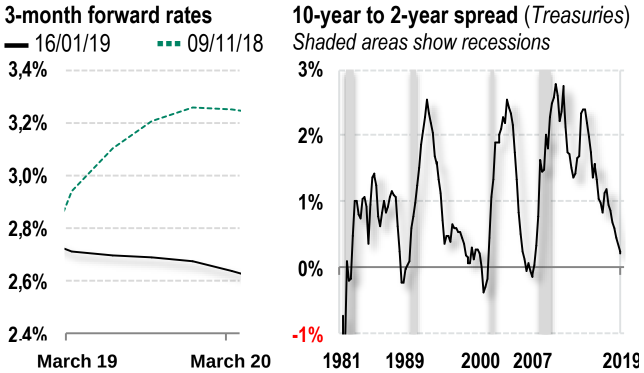
A widening trade deficit

Some USD45 billion in additional import tariffs have been applied since 2018; the US administration could go even further in 2019. On 17 February, the Department of Commerce will deliver its conclusions on the "threat to national security" represented by vehicles manufactured in the European Union, potentially opening the way to additional tariffs. On 1 March, tariffs on Chinese goods could be raised further. To what effect?

The tenuous link between tariffs and the trade balance has already been discussed on these pages[7]. And indeed, the increase in tariffs has, so far, done nothing to reduce the trade deficit. Quite the opposite; the trade deficit excluding oil widened over the final months of 2018. The 12 months cumulated deficit in October was USD800 billion, a record high. Ironically, the biggest increase came in the deficit with China, the country hit the hardest by far by new tariffs. Might this fact dissuade President Trump from going further in his trade war? One might hope so; but hope may not be enough.

Jean-Luc Proutat
jean-luc.proutat@bnpparibas.com

3 - Flattening out



Source: Thomson Reuters, US BEA

4 - The longest shutdown in history

Although it is far from the first of its kind, the current partial shutdown of the US federal government, which began on 22 December 2018, has set a new record for duration: at 27 days and counting on 17 January, it by far exceeds the 21-day shutdown under Bill Clinton at the end of 1995 and early 1996, let alone the average duration of 8 days. And at the time of writing, there is no end in sight, with the question of financing the wall that Mr Trump wants to build on the border with Mexico, the cause of the shutdown, still unresolved. The White House seems ready for the stalemate to continue at least until the State of the Union address, planned for 29 January. And we can not rule out the risk of a second shutdown later this year, at the time of the renegotiation of the debt ceiling, expected in September.

The negative effects on the economy come mainly from the knock-on effects of the immediate income shock for hundreds of thousands of civil servants required to work unpaid, on compulsory unpaid leave from services that are closed altogether, contract workers, subcontractors and those receiving social benefits, the payment of which could be under threat. The shutdown will cost between 0.1 to 0.2 of annualised quarterly growth per week. If it were to last throughout the first quarter, growth would be cut to zero. As a shutdown continues, its negative effects increase in a non-linear fashion. A significant part of the lost growth will, however, be made up in subsequent quarters thanks to employees receiving back pay. Employment data will also see a temporary impact.

The shutdown also interrupts the publication of data from the BEA and the Census Bureau (GDP, retail sales, consumer spending, durable goods orders, housing starts and building permits, new home sales), although not those from the BLS (employment and prices). As a result, the Fed will not have the usual range of statistical information available to it at its meeting at end-January nor, perhaps, that on 19-20 March.

Hélène Baudchon
helene.baudchon@bnpparibas.com

[4] Federal Open Market Committee (2018), Minutes, 18-19 December.

[5] Proutat J.L., (2017), *Is the US economy at a cyclical peak?*, BNP Paribas EcoFlash, June.

[6] Adrian T., Natalucci F., Piontek T. (2018), *Sounding the Alarm on Leveraged Lending,* IMFBlog, November 15.

[7] BNP Paribas EcoPerspectives, 3rd quarter 2018.