Economic Insights: A tale of two economies

Update for the week of July 22 to July 26, 2019

Robin Anderson, Ph.D., senior global economist

The economy in the United States is solid. That fact can’t be argued. But a quick look beneath the surface shows that it’s an economy split into two.

Consumers are doing great. But producers are struggling. And that’s worth paying attention to because, if business weakness spreads to households (not our base case), the solid standing for the U.S. economy could be derailed.

How’s that?
The U.S. expanded 2.1% in the second quarter. As expected, inventories and net exports detracted from growth after being big contributors to activity at the start of the year. Real final sales to domestic purchases—those that remove inventories and trade—grew 3.5% compared to 1.8% in the first quarter. Government spending grew at the fastest pace since 2009, supporting overall domestic demand.

While inventories declined, they’re still somewhat elevated. Companies are keeping lots of products on hand. That may detract from growth once again in the third quarter as businesses de-stock.

After an early 2019 hiccup, consumer spending sharply rebounded. Durable-goods spending shot up over 8%, the second fastest pace of this expansion. A healthy labor market keeps spending humming along. According to Bloomberg, wages and salaries grew at the best pace since 2007 in the first half of 2019. Annual revisions translated into a faster pace of disposable income growth, especially last year.

The personal savings rate—or income left over after spending—moved up with that better picture of income. Households are building a good cushion for any downside shocks. That indicates that people are better prepared than before the financial crisis to pay for necessities in case that job market chills.

At the same time, companies have stumbled. When companies spend, that means they feel confident. But look at the overall picture:

› Nonresidential investment spending declined in the second quarter. A drop of more than 10% in volatile structures spending—the worst since late 2015—explained that overall weakness. Declines were broad-based across structure type.

› Equipment spending barely expanded.

› Weak investment spending lines up business surveys, which showed meaningful declines in capital expenditures.

› Corporate profits were revised down in prior quarters—down so far they actually dropped to recessionary levels in the first quarter.

› Margins are flashing yellow, too. Those have been declining since early 2018.

Companies are weighed down by the broader global growth slowdown. Tariffs likely exacerbate that weakness.

Week in review

ECB set to cut rates: The European Central Bank laid the groundwork to push rates further into negative territory at their September meeting. Additional quantitative easing is also likely. Mario Draghi emphasized a gloomy outlook, although he didn’t expect the Eurozone to fall into recession. Weakened business surveys for July reinforced this view. We agree with Draghi that the Eurozone is not in recession. The service sector and labor market are holding up despite horrible manufacturing. But weakening business sentiment, especially in Germany, may feed into hiring decisions at some point.

What’s next for the Fed: We think that the U.S. Federal Reserve will cut 25 basis points at its meeting next week. The U.S. economy is in decent shape, suggesting a deeper move isn’t warranted. But if the Fed wants to deliver a dovish surprise, they could slash rates 50 basis points. And, if the Fed did cut by that much, unless the global outlook worsened, the Fed may not cut again.

But like the industrial recession of 2015 and 2016, we expect this turndown to end.

And there are some improvements. Manufacturing production modestly picked up over the last couple of months after bottoming in April. Core capital goods orders, which lead investment spending, turned around in June, but the series is volatile. Some surveys improved in July, but not all. No clear-cut signs of a turnaround.

Housing has yet to definitively improve. Home builder sentiment and mortgage applications have moved up. But, home sales are volatile. Residential investment detracted from overall GDP growth once again in the second quarter.

So what do we think going forward?

We expect the U.S. economy to grow between 2.0% and 2.5% this year. Consumer confidence remains decent, although the Conference Board Consumer Confidence Index declined in June. Jobless claims are ultra-low. Strong wage growth (without a lot of inflation pressures) should keep spending well supported.

The consumer keeps this economy chugging along. If business bounces back, growth could even accelerate in the second half. But if sentiment starts to weigh on hiring, then weakness could spread to consumers.

Investment implications

The GDP report confirmed that fears of a sharp growth slowdown in the U.S. are overdone. If global growth does eventually pick up as we expect, that, combined with lots of central banks easing, should support stocks a while longer. But given that the U.S. economy is doing OK, the market may be overly optimistic about rate cuts. Nominal GDP growing at 4.6% suggests that 10-year treasury rates at around 2% are too low. Over long periods of time, 10-year treasury rates may track nominal GDP growth.

Expressions of opinions and predictions are accurate as of the date of this communication and are subject to change without notice. There is no assurance that such events or prospections will occur and actual condition may be significantly different than that shown here.
Unless otherwise noted, the information in this document has been derived from sources believed to be accurate as of July 2019. Information derived from sources other than Principal Global Investors or its affiliates is believed to be reliable; however, we do not independently verify or guarantee its accuracy or validity. This material contains general information only and does not take account of any investor’s investment objectives or financial situation and should not be construed as specific investment advice, recommendation or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that Principal Global Investors or its affiliates has recommended a specific security for any client account.

Subject to any contrary provisions of applicable law, Principal Global Investors and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in this document or in the information or data provided in this document.

Past performance is no guarantee of future results and should not be relied upon to make an investment decision. All figures shown in this document are in U.S. dollars unless otherwise noted. Investing involves risk, including possible loss of principal.

This material may contain ‘forward looking’ information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Insurance products and plan administrative services provided through Principal Life Insurance Co. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities offered through Principal Securities, Inc., 800-547-7754, Member SIPC and/or independent broker/dealers. Principal Life, Principal Funds Distributor, Inc. and Principal Securities are members of the Principal Financial Group®, Des Moines, IA 50392.

© 2019 Principal Financial Services, Inc. Principal, Principal and the symbol design and Principal Financial Group are trademarks and service marks of Principal Financial Services, Inc., a member of the Principal Financial Group. Principal Global Investors is the asset management arm of the Principal Financial Group.