Watch out, the Fed's not predicting recession

By Eric Reguly
March 10, 2017 – *The Globe and Mail*

If the markets are good predictors of economic downturns, we've got nothing to worry about as Donald Trump dips into his economic stimulus bag of tricks. But what if the markets are wrong? More than a few strategists and economists think the forces are building for a Trumpian recession, and wouldn't that be ironic for a President who vows to "make America great again."

So far, the indicators suggest that the economy is trundling along rather nicely, thank you very much.

The U.S. expansion is intact and will mark its eighth anniversary in June, making it one of the longest on record. The Conference Board's measure of leading economic indicators suggests the uptrend is unwavering and the ratio of cyclical economic spending (spending on business investment, housing and other sectors that tends to dip when the economics jitters set in) shows no sign of a faltering. The yield curve is not flattening out. Historically, a flattening yield curve – that is, when short and long-term bond yields converge – means there is trouble ahead.

No wonder investors are smiling. The S&P 500 has galloped ahead by almost 20 per cent in the last year alone and is up by two-thirds over five years.

Investors are clearly not factoring in an economic downturn, nor are central bankers, even if they, by nature, remain cautious. But as Montreal's BCA Research noted in a report last week, central bankers are notoriously inept at calling recessions.

The forecasters at the U.S. Federal Reserve failed to predict not one of the eight recessions of the last 60 years. For instance, in December, 2007, when the financial system was already cracking – Bear Stearns would blow up only three months later – the Fed forecast a 1.3-per-cent rise in real gross domestic product over the next four quarters. Instead, we were treated to the Great Recession, from which some parts of the planet, notably southern Europe, are still on the mend.

If the economic indicators, and investors, seem in fine form, what could go wrong? BCA, for its part, thinks that Mr. Trump might goose the economy a bit too much. "The problem is that the new administration is intent on stimulating growth when it does not really need a demand boost," said BCA's senior vice-president, Martin Barnes.

There is no doubt stimulus is coming in the form of infrastructure spending and tax reduction – details to come. The question is what sort of inflationary pressures the extra stimulus will place on the U.S. economy, which may not have a lot of slack in it. The unemployment rate, at a mere 4.7 per cent, is close to what many economists consider full employment. Wage growth is accelerating and underlying inflation, as BCA points out, is no longer dropping.

A dose of stimulus, in other words, has the potential to translate into inflation, which in turn, could make the Fed hammer the interest-rate button more often than expected. Last week, William Dudley, president of the New York Fed, said in a TV interview that the case for tightened monetary policy "has become a lot more compelling" since Mr. Trump's election.

While recessions are difficult to predict (or seemingly impossible to predict, if you're the Fed), they are more often than not preceded by tightening credit conditions. The easing era is over in both the United States and in the euro zone, and tightening is coming. Depending on

who makes up the Fed's board of governors – at least three of the seven positions have to be filled by Mr. Trump this year – the Fed could turn more hawkish, in which case the era of low interest rates might come to an end faster than expected.

To be sure, protectionist trade policies could help tilt the odds in favour of a recession some time in the next couple of years. Mr. Trump wants fewer imports and more exports to correct trade imbalances. But if tariffs or a border-adjustment tax are introduced, the countries facing these penalties would surely retaliate, and we all know that trade wars are bad news for economic growth.

Potentially working in favour of continued growth, however, is the potential repatriation of the vast fortunes – estimated at $2.5-trillion (U.S.) – in cash parked overseas by companies such as Apple, Microsoft and General Electric. If Mr. Trump succeeds in dropping corporate tax rates, a torrent of that loot could come back home. Were the cash spent on productivity gains, the economy would be stronger and more competitive. But there is a lot on Mr. Trump's economic agenda and a tax deal aimed at repatriating the foreign cash could be years away.

On Friday, expectations for a Fed interest rate hike next week went from the possible to the probable after the government reported the addition of 235,000 jobs in February, well above the analyst consensus forecast of 190,000. With little apparent slack in the economy, inflationary forces might be gathering momentum. When economies overheat, watch out.