

# Revised 2016 Economic Forecast: Despite slowdown, a recession is not imminent

## Article Highlights



Timothy Hopper, Ph.D.  
Chief Economist, TIAA

- There are two different lenses through which to view the recent slowdown in the U.S. economy: one emphasizes real growth, while the other highlights nominal growth.
- Economists—and the Fed—typically focus on real growth because it reflects the true level of underlying demand in the economy. From the Fed's perspective, we should begin to see a marked increase in wages and inflation this year, factors supporting a stronger pickup in real economic activity.
- The nominal view, which is how the markets perceive the economy, is currently more pessimistic. Nominal GDP growth could fall below 2% this summer, and subtracting inflation from that level would necessarily result in weaker real growth.
- These two contrasting views cannot be reconciled; either one or the other is correct, but not both. Over the next few months, we will know which one, based on the direction of unemployment and inflation, as well as other key indicators.
- While we do not foresee an imminent recession, there is enough evidence to lower our forecast for 2016 average GDP growth from 2.6% to 2.0%.

## Real or nominal? The growth outlook through two different lenses

Since the beginning of the year, questions about the U.S. economy have mounted. Indeed, there has been a shift in growth since the third quarter of 2015 that is now showing up in the data; however, the changes are nuanced and masked beneath the surface. To understand these changes, we need to draw a distinction between the real economy on the one hand and nominal shifts in economic data—and their implications—on the other.

On the surface, the difference between “nominal” and “real” is simply the inflation rate: subtracting inflation from the nominal variable results in the real variable. A more meaningful way to think about the difference between the two is in terms of prices paid versus actual demand—for example, the difference between what consumers pay for certain goods and services and how much of those goods and services they really want. While prices could rise for these items, if consumers don't buy more of them, then nominal GDP would increase, but real GDP would not. In short, real GDP represents the true level of demand, which is much more fundamental to understanding how the economy will grow. In the aggregate, if inflation is stable, people will make purchase decisions based on how much they want instead of how much an item costs. Production decisions would also be based on how much people demand.

In drawing these distinctions between real and nominal growth, we conclude that yes, the economy is slowing, but that doesn't mean the U.S. is headed for a near-term recession.

### What real growth is telling us

The real economy is holding up—on the surface. Consumer spending, business investment and housing all show continued growth. Demand inside the U.S. appears to be rising at about the same pace today as it has for much of the recovery. Importantly, labor markets continue to tighten, lending strong nominal income growth to the economy. Lastly, housing markets have stabilized and are advancing at a respectable pace in price, sales activity, and construction.

From this perspective, the soft fourth-quarter GDP result (1.0%, according to the government's advance estimate) was driven primarily by a drop in inventory spending and a weaker-than-expected trade balance. In the first quarter of 2016, we expect the economy to rebound from this subpar growth rate, returning to the recovery trend of 2.2%.

But this narrow view masks some of the risks to growth that have materialized recently. For example, while personal consumption expenditures (PCE) for November and December held up overall, spending on goods was weak, and the mix of goods to services slipped. This is typically a sign that PCE will decelerate in coming quarters. Also posing a risk are auto sales, where growth appears to have peaked. We don't expect sales to decline this year, but we also don't expect substantial

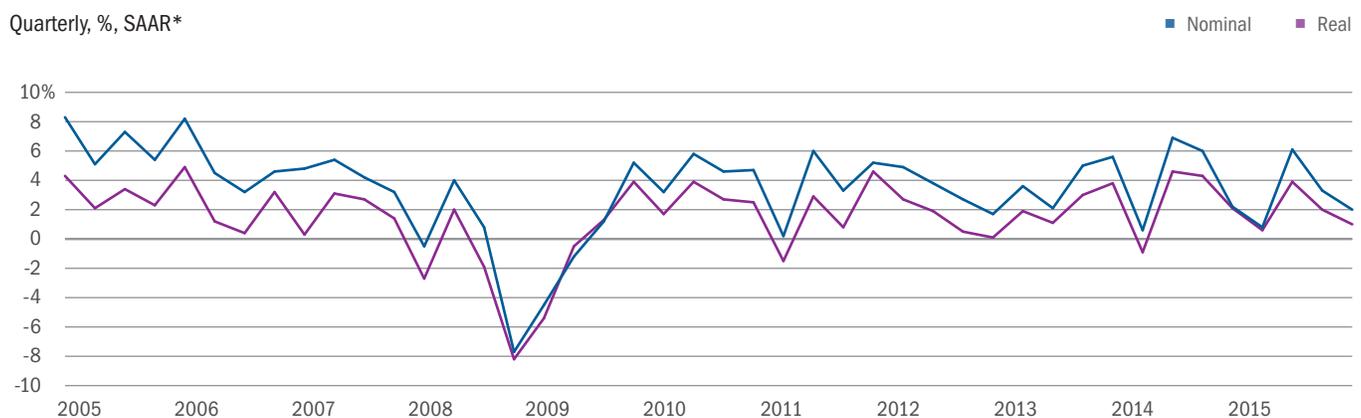
increases. Here, the level of sales is less important than the rate of growth, and auto sales have been a very large component of consumer demand for most of the recovery.

Another risk is found in the Federal Reserve's January Loan Officer's Survey, which suggested banks are becoming more cautious. Automotive loan delinquency rates have ticked up, and broader loan demand measures have slowed. These signals point to a potential slowdown in credit growth, although it has not shown up in the data yet.

Additionally, the deceleration in corporate profits since last year has two potential impacts on the growth outlook: First, investment capacity may be affected, and we are already seeing signs that broader, non-energy related investment is slowing. Second, a downshift in spending could spill over to labor demand if the corporate sector decides that profits will come under pressure for a longer period of time. Layoffs in the weekly first-time unemployment claims data would tick up in this scenario; if this were to become a larger trend, it would be consistent with a strong drop-off in labor demand, presaging a pickup in the unemployment rate.

An alternative to the "materializing risks to growth" scenario is based on what academics call the Phillips curve, the historically inverse relationship between unemployment rates and inflation. This is what Fed officials are referring to in speeches when they mention "slack in the economy." If we are indeed approaching full employment, then wages will rise, as will inflation. Recent data shows that wage pressures are beginning to mount, while job creation slowed and the unemployment rate dipped in January.

Figure 1. Nominal vs. real GDP growth rate over the past decade



\* Seasonally adjusted annual rate. Last data observation 4Q15 (second estimate).

Source: Haver Analytics.

Opinions on growth and Fed policy will hinge on how one views the data and accepts or rejects the notion that we are finally reducing slack in the economy. Proponents of the risk perspective described earlier would say that none of the risks are currently strong enough to be considered damaging to the business cycle, but they do represent cracks in the recovery, typically consistent with the beginning stages of a slowdown. On the other hand, from the Fed’s perspective, we should begin to see a marked increase in wages and inflation this year, something that should coincide with a stronger pickup in real economic activity.

The obvious question—besides which view is right—is whether any damage to the economy from the risk factors is reversible. The answer is yes, although resilience of this kind usually requires an increase in demand or an easier financial environment (either directly from the Fed or via broader credit conditions). It’s too early to determine whether the economy is on a cycle-ending deceleration path or simply consolidating for a period of time before re-engaging again. But there is enough evidence to lower our forecast for average GDP growth in 2016 from 2.6% to 2.0% (see Figure 2). Against this backdrop of slower growth, we expect both the 10-year Treasury yield and the federal funds rate to track at lower levels than in our previous forecast.

## Nominal growth and its implications

Economic forecasts are based on real activity, because real activity represents the underlying demand in an economy. It’s what we call fundamentals. Yet everyone—particularly Wall Street—lives in a nominal world. Economic forecasts thus differ from “reality” as it’s experienced in the moment, and are best viewed as forecasts of the underlying *trend* in growth. This difference is typically manageable, however, because prices tend to be stable.

As economists, we often ignore the nominal economy, sometimes to a fault. But sometimes the nominal economy sends important signals, and this is one of those times. Thus, we hear pure economists give a sanguine view on current conditions (as previously argued), while Wall Street screams about an impending recession. These divergent perspectives also represent the divide between markets and the Fed.

In assessing nominal activity, a key consideration is the growth rate of the *monetary base*—i.e., the portion of the money supply that is highly liquid and easiest to use, including currency in circulation and reserve balances that banks have on deposit with the Fed. Since 1960, the year-over-year growth rate in the monetary base has turned negative on only four occasions, three of which occurred after the 2008 financial crisis and are associated with the respective ends of the Fed’s three rounds of quantitative easing (QE). The first two negative episodes since 2008 coincided with global growth scares that exacerbated the situation and prompted the Fed to implement additional QE stimulus. Today, we have another global growth scare, driven by a marked slowdown in China, weakness in the emerging markets more broadly, and a steep decline in commodity prices. For these reasons, a vocal segment of the investment community has argued that the Fed will need to launch another round of QE. The Fed, for its part, has communicated its intent to continue *raising* rates, rather than initiate further easing measures.

Why is the growth rate of the monetary base important? Because it is strongly correlated with the growth rate of nominal GDP. Currently, monetary growth rates suggest that nominal GDP growth will fall below 2% by this summer. And since nominal GDP growth translates to real GDP growth by subtracting inflation (which is currently positive), that means real GDP growth will need to fall to between 1% and 1.5% on an annualized basis.

Figure 2. U.S. Economic Forecast

	Average growth rate			2015	2016			
	2015	2016	2017	Q4	Q1	Q2	Q3	Q4
Real GDP (% SAAR*)	2.4	2.0	2.4	1.0	2.2	2.5	1.7	1.8
10-year Treasury yield (% quarter-end)				2.27	2.00	2.10	2.20	2.25
Federal funds rate (% quarter-end)				0.38	0.38	0.63	0.63	0.63

\* Seasonally adjusted annual rate. Note: light blue highlight represents the beginning of a forecast.

The implications of this nominal perspective are that inflation will remain weak, and that real growth must falter. Whether this happens through a strong dollar, low oil prices, soft global demand, or some other factor, isn't really the point; the argument simply says it must happen. This outlook stands in stark contrast to the Fed's view. More importantly, these two views are not reconcilable. On the surface, either one or the other is correct, but not both.

### What to watch for

The way to approach this bifurcated view of the economy is to become more cautious on growth over the medium term. Over the next few months, we will see what path inflation takes, as well as the direction of unemployment claims. If inflation picks up substantially, it will most likely be accompanied by an increase in real growth. In that case, the Fed will have been proven right and rate hikes will resume, along with improved corporate profitability and investment. If, on the other hand, inflation remains exceptionally muted, profits remain under pressure, and investment continues to lag, unemployment claims will likely climb, the Fed will be forced to keep any rate hikes on hold, and growth will continue to settle.



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