

## Economy Watch

### October 2019: Slowdown, Not Recession



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The American economy has slowed appreciably. What happens next will depend on whether the trade disputes that have created so much uncertainty and disruption are headed toward resolution or escalation.

No one knows which it will be. With brinksmanship, no one ever does. We do know that the effects extend well beyond the products subject to higher tariffs and the industries that depend on them.

For example, capital investment increased through 2017, buttressed by an accelerating economy, streamlined regulation and rising business confidence. But in early 2018, the brinksmanship started. America targeted solar panels, washing machines, steel and aluminum. China targeted American sorghum, aluminum waste, pork, fruits and nuts; the European Union targeted American cranberries, bourbon, Harley-Davidson® motorcycles and jeans; and Canada targeted American steel, aluminum, agricultural products and food products.

Over the next 18 months, goods from luggage to yachts were added to the hit list. Tariff hikes were announced. Some were enforced and some delayed. Exemptions were granted. Some were honored, some rescinded and some were replaced by import quotas. Who knew what was next? As the uncertainty grew, American businesses trimmed expansion plans, slowing the growth rate of capital investment to just 1.5% during the first half of 2019 from 6.6% one year earlier (Figure 1).

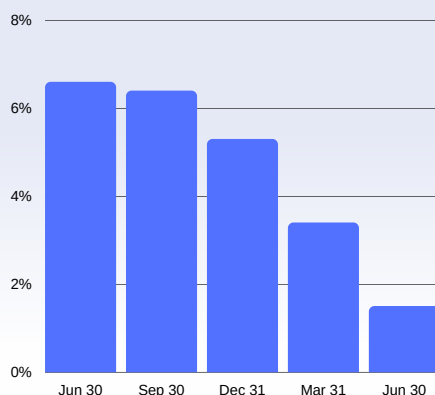
And consider corporate profits. After-tax margins surged following passage of the Tax Cuts and Jobs Act of 2017. But the brinksmanship disrupted the international markets essential to large-capitalization American corporations. (The S&P 500 generate more than 40.0% of their revenues overseas.) Already stressed economies weakened further: Since 2017, GDP growth has slowed from 2.7% to 1.6% in the European Union, from 3.0% to 1.5% in Canada, from 2.1% to 1.6% in Mexico and from 1.9% to 1.0% in Japan, according to the International Monetary Fund. American exports decreased for the first time in three years, while costs continued to rise. By mid-2019, corporate profits were down 0.1%, a dramatic change from the 9.3% increase one year earlier.

The American economy slowed in response to all this, growing 2.5% during the first six months of 2019, down from 3.2%, the fastest rate in four years, during the six months ending September 30, 2018. The slowdown wasn't more pronounced because tight

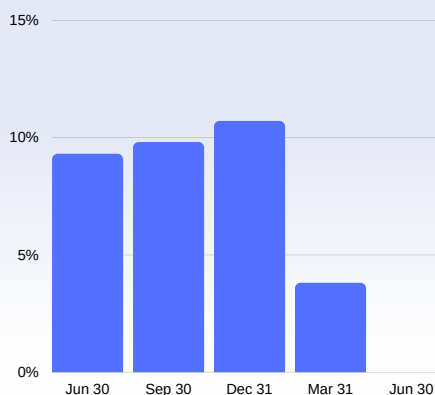
**Figure 1 — Capital Investment, Corporate Profits and GDP**

Percent change in private capital investment (equipment, software and structures), after-tax corporate profits and GDP. All change is during the six months ending on the date indicated, over same period of previous year.

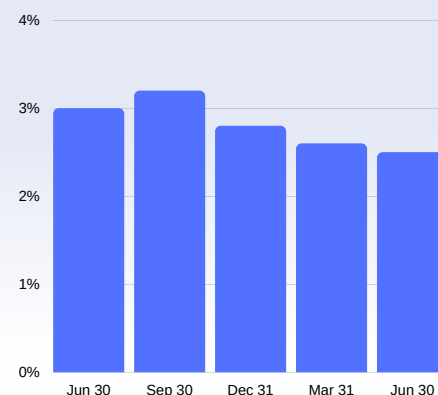
**As capital investment has weakened...**



**...and corporate profits have weakened...**



**the economy has slowed.**



labor markets continued to support healthy compensation gains, which support healthy consumer spending. (Consumer spending accounts for approximately 70.0% of GDP.)

Further slowing is likely over the next 15 months. Even if America and China reach a meaningful trade agreement — the “Phase One” agreement announced October 11 hardly guarantees they will — it will take time to reverse the damage already done. The consensus of economists surveyed by the Federal Reserve Bank of Philadelphia has GDP growing 2.2% this year and 1.8% next year (Figure 2). Last year, the economy grew 2.9%. Growth of 1.8% yields a GDP that is nearly \$210 billion less than growth of 2.9%. That’s the equivalent of losing a major industry.

Recession, however, is not likely this year or next. Recessions are caused primarily by three factors:

- Excesses, such as the real estate bubble prior to the Great Recession of 2007 - 2009, or the dot-com bubble prior to the recession of 2001.
- Policy errors, such as excessively tight monetary policy, poorly designed, timed and executed tax increases and innovation-stifling regulation.
- Exogenous shocks, such as the OPEC oil embargos of the 1970s.

We currently aren’t seeing any of the three. Corporate debt could be the excess that leads to the next recession, but not until interest rates are substantially higher. The Fed has no reason to tighten credit. Washington isn’t doing much of anything on economic policy. And the increasingly diverse, adaptable American economy is not as susceptible to exogenous shocks as it once was.

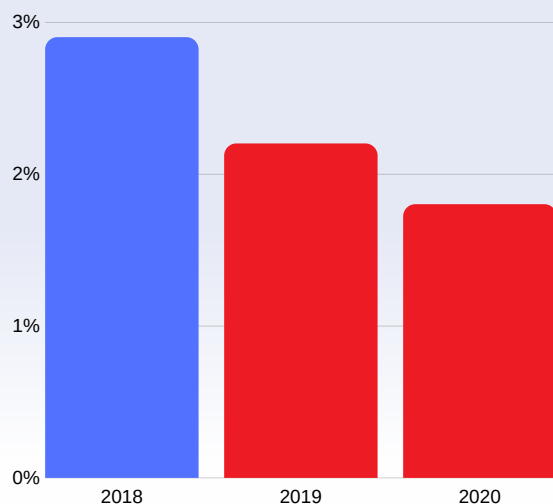
Moreover, housing starts are rising again. Housing starts are one of the most reliable leading indicators of recession, having declined during the 12 months prior to every recession since 1960. No economic indicator is perfect. And no two recessions are identical. But the recent rebound in starts, illustrated in Figure 3, is encouraging. With interest rates falling, continued gains are likely.

Hopefully, the Phase One agreement leads to a more comprehensive Phase Two agreement; the United States-Mexico-Canada Agreement is ratified by Congress; the brinkmanship ends; and the global economy heals rapidly. But again, with brinkmanship, we can never be sure. It’s a slippery slope that leads to a trap door. Slide through the door and the outcome is something, such as global recession, no one intended and from which no one benefits.

We can, however, do more than hope. We can monetize our contributions to the client’s success, sharpen execution through objectives-and-key-results performance management, build our employer brand, uncover what clients really think about us and create a consistently superior customer experience. These and other proven ways to build and maintain margins are covered in the SGIA presentation “Creating Opportunity.” Email [research@sgia.org](mailto:research@sgia.org) for a complimentary copy.

**Figure 2 — The Economic Outlook**

Percent change in GDP over previous year. Projections for 2019-20 are consensus of economists surveyed by the Federal Reserve Bank of Philadelphia



**Figure 3 — Housing Starts**

Thousands of units, six-month moving average.

