Assembly Committee on Jobs, Economic Development and the Economy
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Economic and Market Overview

John Rothfield, Lead Economist
CalPERS Investment Office

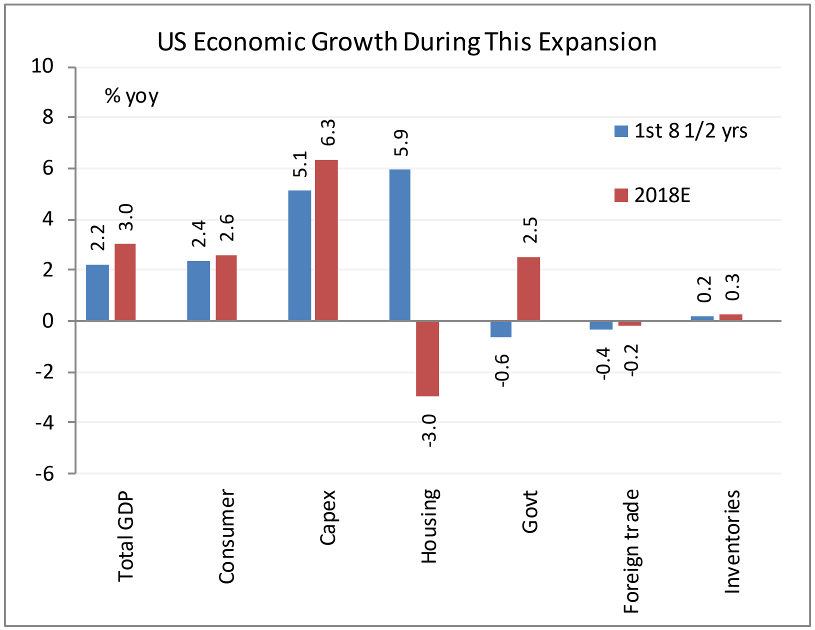
CalPERS

Trending

Positives tend to be more backward looking

Positive	Same Trend	Negative
- US jobs market 18: labor supply kept up with strong demand. Less involuntary part time and more quitting for better jobs. **- US productivity** Productivity this cycle has been volatile but the 2018 trend was improving. **- US GDP growth accelerated** 3.1%E during 2018 vs expansion average of 2.2%. Importantly supply side indicators improved too. **- US consumer: spending, cushion, sentiment** Stable at 5% growth, with only small drop in savings ratio. Lower personal taxes gave one-time support. **- Small businesses remain determined to build** To expand and hire … despite difficulties in finding qualified workers. **- Resilient US corporate earnings and sales** 2018 saw +5% sales, +8% profits S&P500 ex Fin/Energy. Not too far below 8%/12% during 2017. **State and Local on the improve** 7 year high in state revenue growth supported improved S&L construction and hiring.	**- US leverage** US non financial debt is stable at ~250%/GDP, right through the expansion **- External imbalances** Stable US external deficit (2 to 2.5%/GDP) broadly matched by combined surplus of Euro area, Japan and	**- Soft US consumer, housing and credit, no capex uplift** Activity clearly slowed in Winter (GDP growth halves?). Stocks say its an abberation, bonds not so sure. **- Late cycle behavior** US cycle close to record 10 years, Japan at post WW2 record 75 months. U-rates low everywhere. **- World Trade, PMIs etc** World trade was boosted pre tariffs but falling off and correlated with PMIs, trucking activity etc **- US debt trajectory and debt ceiling** Going into a 2020 election year there are fiscal cliff and debt ceiling problems that will be hard to resolve **- QEnd** QE unwind meets still-rising debt, especially in EM and some DM (US corporates, $bloc/Scandi housing). **- Negative sum game trade wars** Significant misunderstanding of trade imbalance drivers ignites policies where everybody loses. **- Disruptive geopolitics** Nationalism and bloc realignments create uncertainty that bleeds into the economic sphere.

2018 was a good year for the US



Consumer – one-time impact from lower personal taxes but possible bleed into 2019.

Capex – acceleration has been underwhelming.

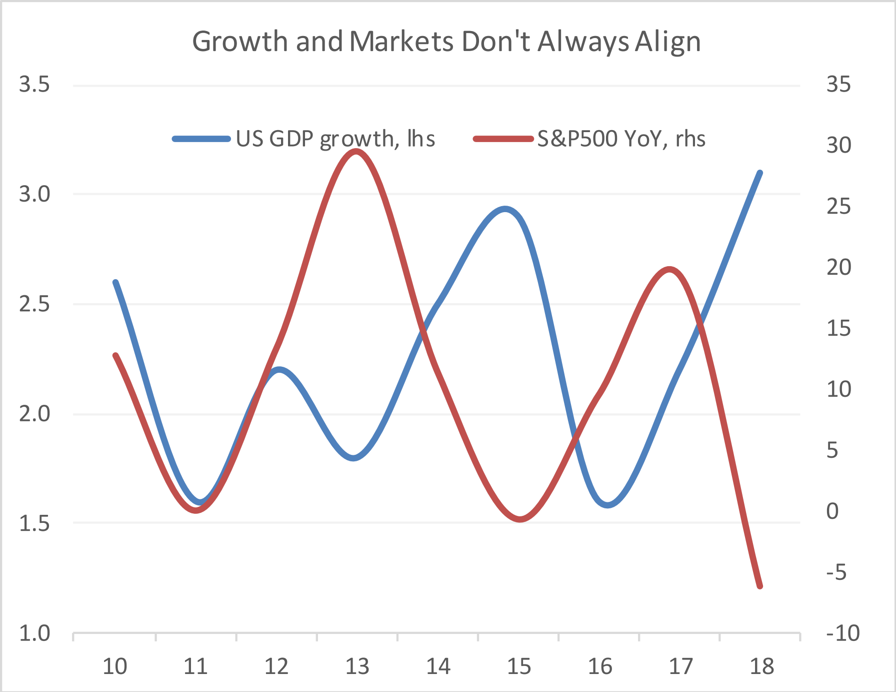
Housing – reasons for its smaller role in this cycle.

Government – S&L/ defense lead the way and has momentum into 2019 (TCJA17 then BBA18).

Foreign trade – a drag due to desynchronized growth and pre-tariff goods flows.

US GDP grew by an estimated 3.1% during 2018, vs the expansion average of 2.2%.
The chart above shows the contributions to what is expected to be a temporary uptick in growth.

“So What” for Markets



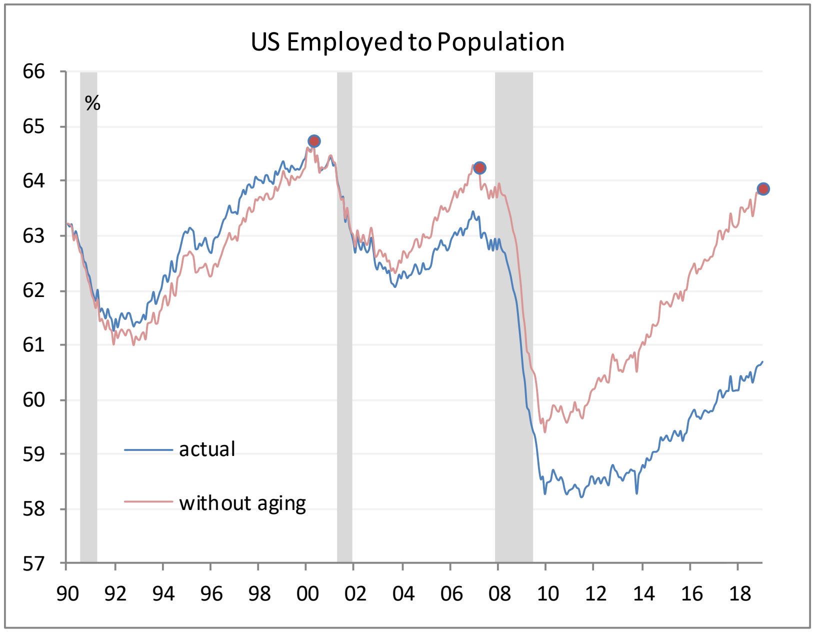
<u>Why?</u>

- ❑ Crowding Out
- ❑ CB takes away the Punchbowl
- ❑ Markets are forward looking
- ❑ Don’t forget Rest of World
- ❑ “High-pressure” growth could compress business cycle

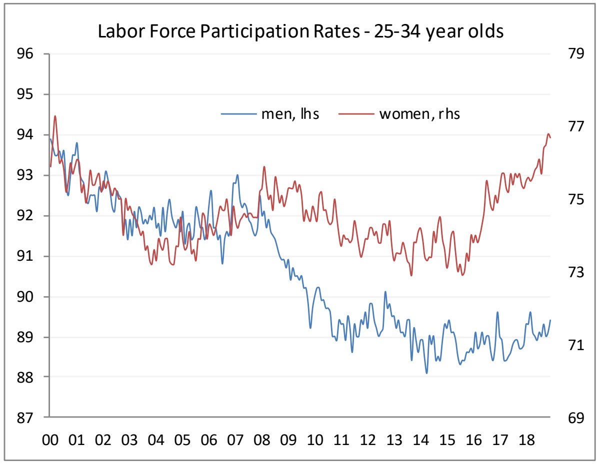
Topic: Have Administration policies compressed or extended the US expansion?

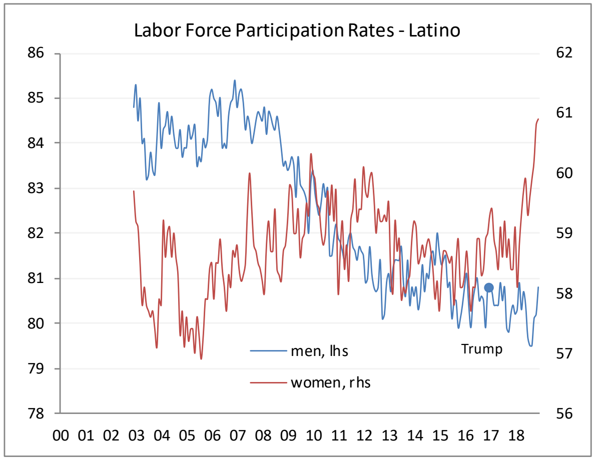
- ❑ Demand vs Supply.
- ❑ ‘Sugar high’ vs ‘Tax Reform’.
- ❑ 2018 was a good year for supply side.
- ❑ Watch …
  1. Labor force participation;
  2. Productivity;
  3. Fed “flexibility”.

(a) Labor force participation



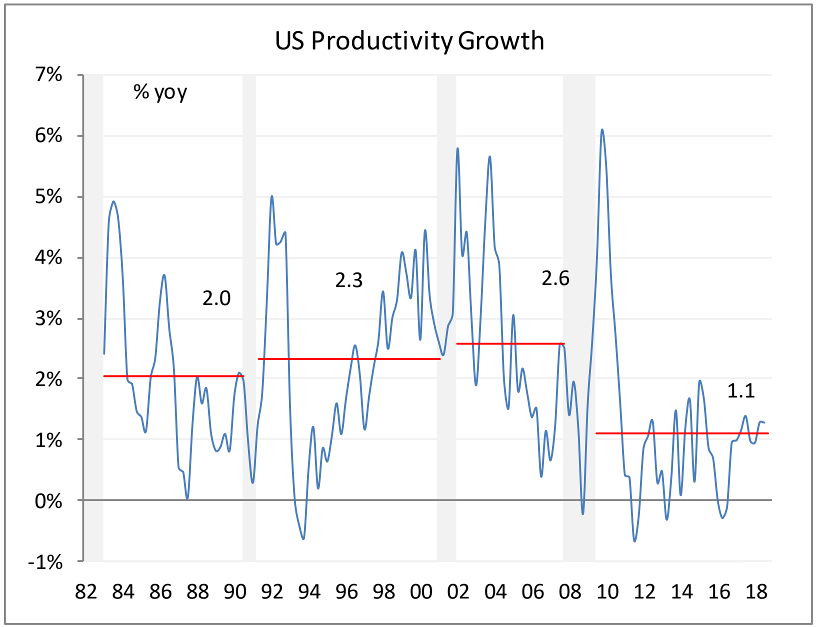
Adjusted for demographics, upside in US labor force may be limited



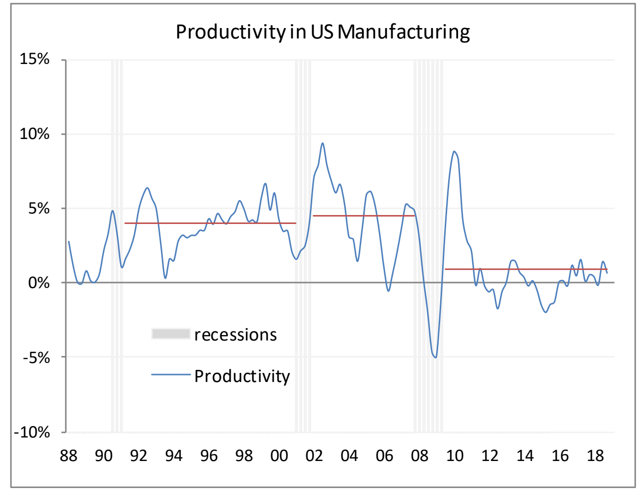


Participation by males continues to lag

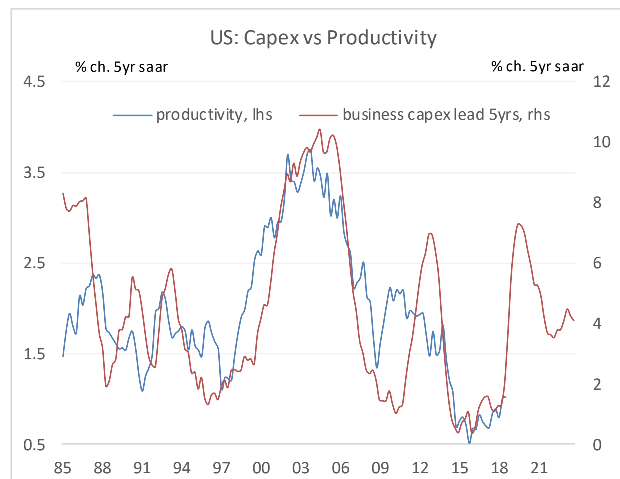
(b) Productivity



The current economic expansion is characterized by low measured productivity growth.

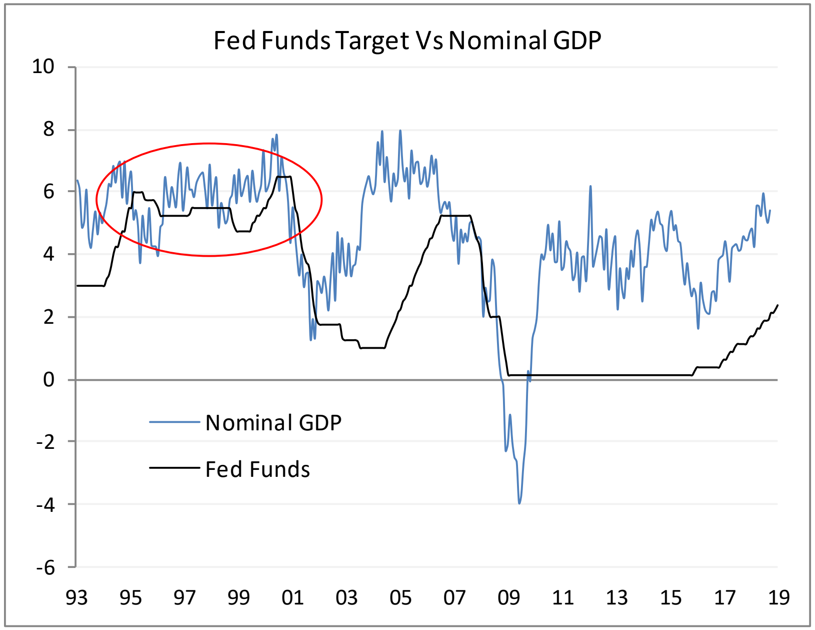


Early stage of manufacturing rebound has been hiring new workers.

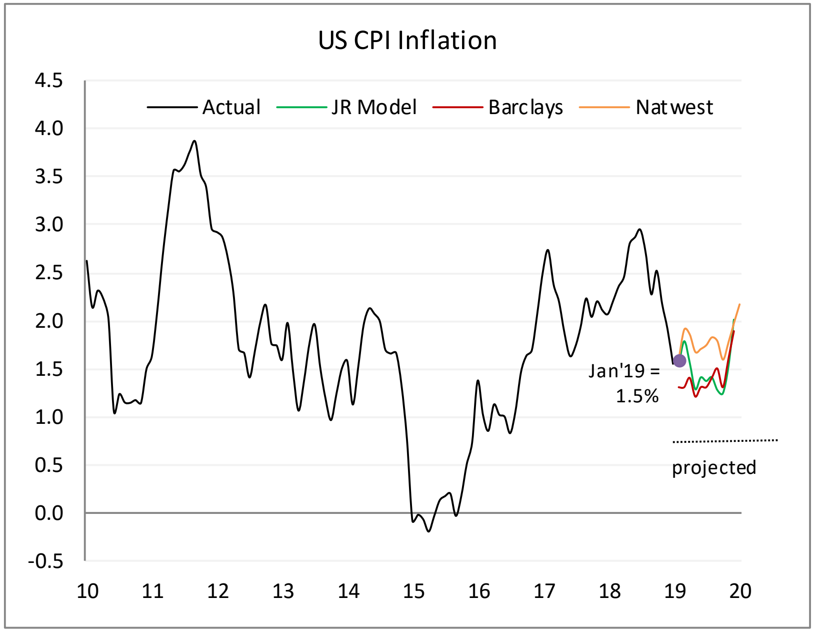


It's *possible* that past capex improvement will deliver a productivity boost

(c) Fed flexibility

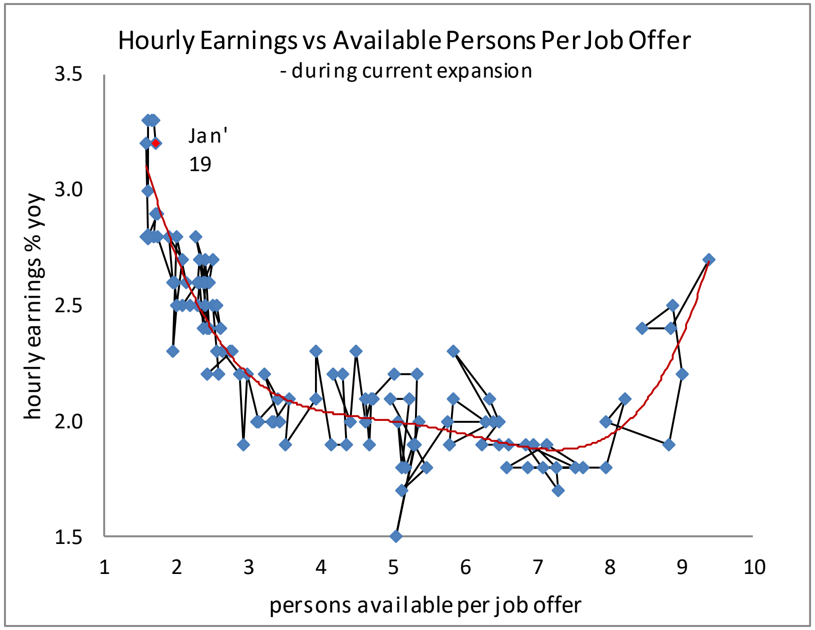


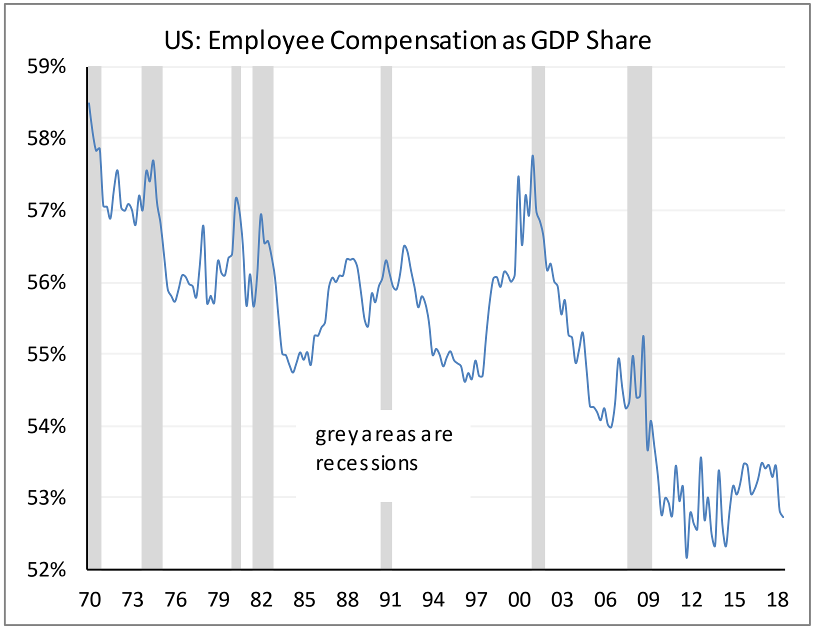
Greenspan's Fed was able to cut rates twice during the 1990s tightening cycle in both '95 and '98



Benign inflation, if realized, would help Fed's flexibility on rates

Wage inflation unlikely to ‘alarm’ Fed





Wages growth in the economy is finally accelerating as the jobs market tightens. That said, employee income as a share of the economy is still very low

Challenging backdrop for economies/ markets

Ageing business cycles

- US expansion is within months of a record 10 years.
- Japan's expansion just reached post-WW2 record 74 months.
- Euro Area's expansion is a relatively short six years to date. But the current slowdown is not in the PIGS, but the Big 3. Europe can no longer rely on US growth as a catalyst for its own growth.
- China growth slowdown appears deeper than the official data show.
- There is less runway for policy calibration

Trade engagement, US debt trajectory and pockets of leverage concern, QEnd policy errors, European populism, pockets of leverage in certain markets.

Challenge: Ageing Business Cycles

US Business Cycle assessment

Labor Market	Early / Late	%
Want A Job per Job Offer		98%
Unemployment Rate		95%
Small Business Hard to Fill		100%
KC Fed Labor Market Conditions		12%
Emp/Pop ex aging		83%
Activity	**Early / Late**	**%**
National Activity Index		34%
Personal Savings Ratio		61%
Consumer confidence		76%
Real Personal Disp. Income		35%
US Yield Curve (2yr vs 10yr)		82%
Quarterly	**Early / Late**	**%**
Profit share of GDP		25%
Current Account/GDP		40%
Leverage less core CPI YoY		31%
Net Worth/DI		100%
Housing affordability		57%

United States		
Mid	Late	Recession
Chicago Fed NAI	Fed tightening	
Real Disp. Income	Employed to Pop	
Personal Savings Ratio	Job Offers vs Pool	
Small Business Plans	Unemployment Rate	
Profit share	SBOI Hard to Fill	
Leverage + External	Consumer Confidence	
Household formation	Net Worth/ DI	
Late-mid	Output gap	
Housing Affordability	Yield Curve	
Labor Market Conditions		
Credit cycle		
Plans to Buy Home		

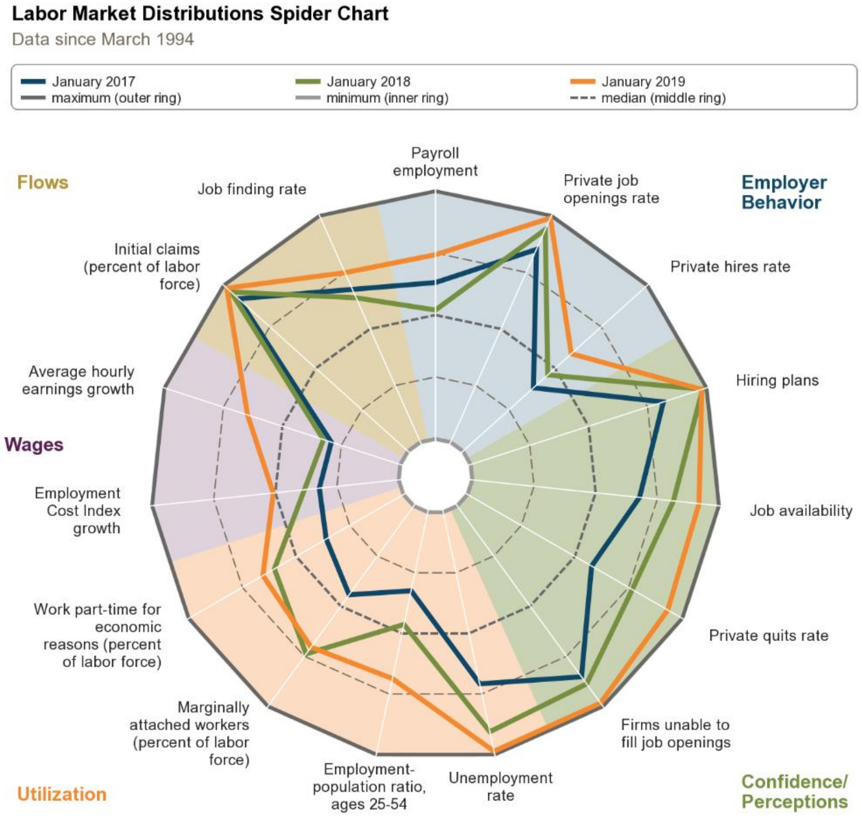
China	Japan	Europe
SOFT/ EASING	LATE	MID+
Elevated	Mid	Mid
Li Keqiang index	Economy Watchers	Credit growth
Steel output	Unemployment rate	Output gap
Cargo, rail, electricity	BoJ Policy	Consumption
Consumer confidence	Late	Employment
CNY TWI, SHIBOR	Output gap	U-rate
Decelerating	Tankan Factor Ut'n	ECB taper (Apr'17)
Fixed Asset Invest.	ESRI Leading Index	Late-mid
Exports, imports/ PMIs		Cap U
Monthly flows		H/H deposit growth
CPI, PPI		Unemployment
M2, TSF growth		Consumer Confidence
Flat to Neg.		Late
Residential		Markit PMIs
Car sales		Bus. Limiting factors
		EU ESI

External Manager Business Cycle assessment

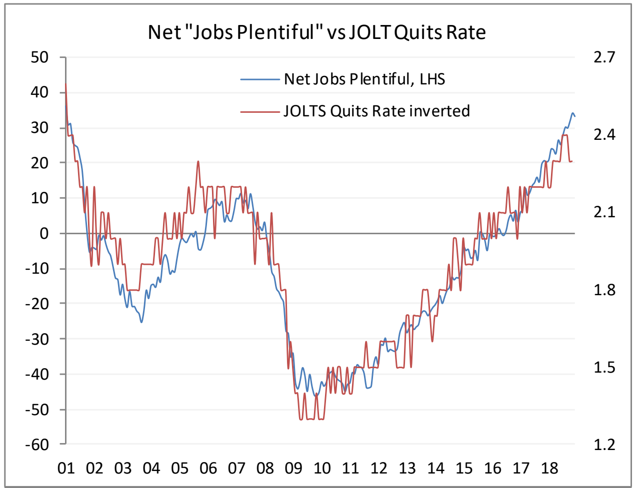
US	EU	UK	JN	China
4	5	6	N/A	N/A
5	4	5	5	4
5	4	4	3	6
4	3	3 (4)	3	5 (4)
4	4	5 (4)	5 (4)	N/A
5 (4)	5	5	5	7
5	3	5	5	5
4	3	4	4	6

Early	1
	2
Mid	3
	4
Late	5
	6
Recession	7

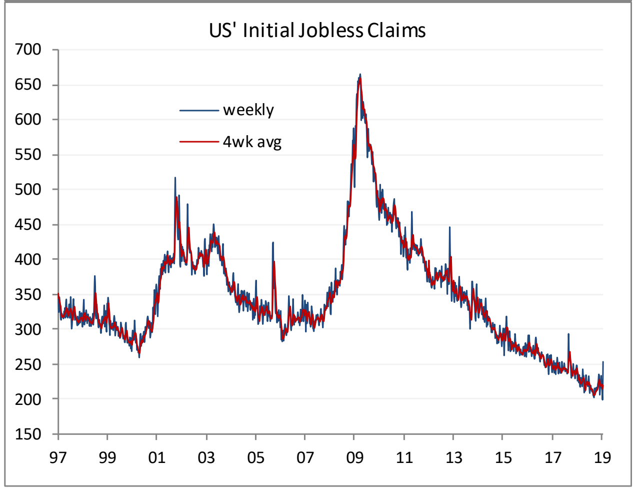
Challenge: US labor market constraints



Some labor market indicators are pushing against post 1994 maximums.

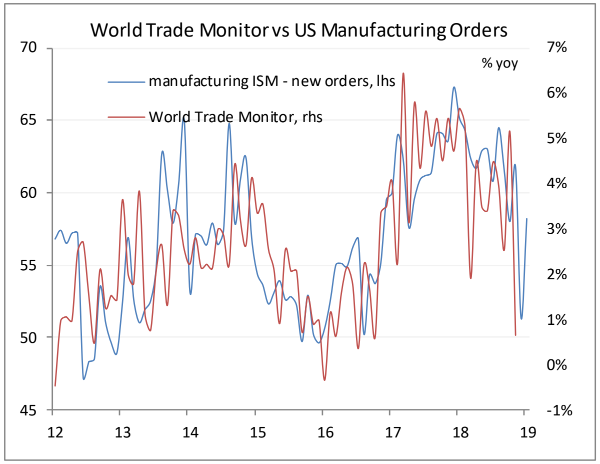


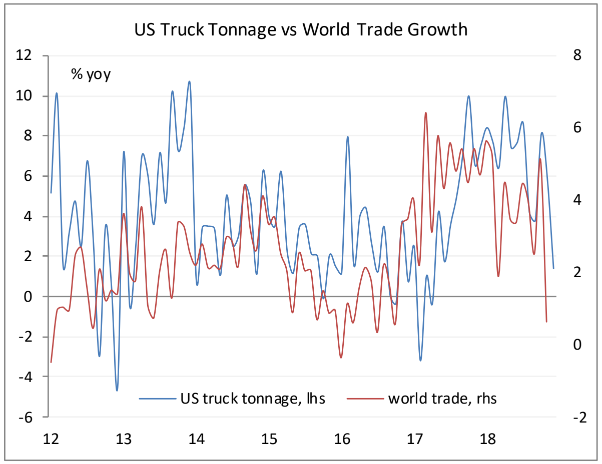
Households see a strong sellers market for their labor.



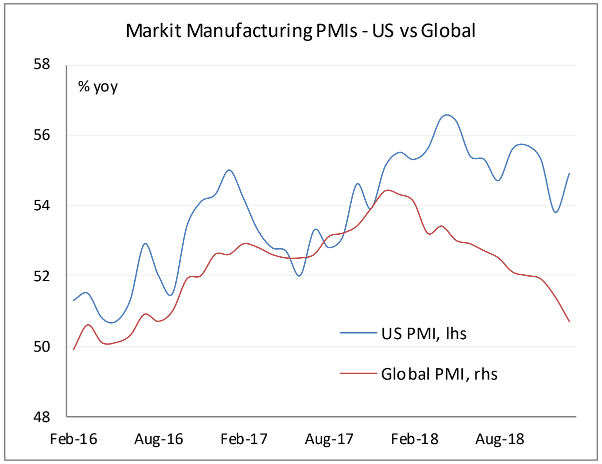
Record low jobless claims

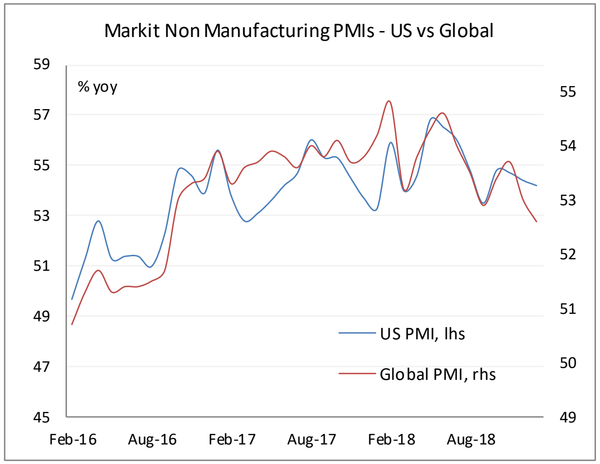
Challenge: Trade wars are a US own-goal





Boost to US from global trade faded into year end

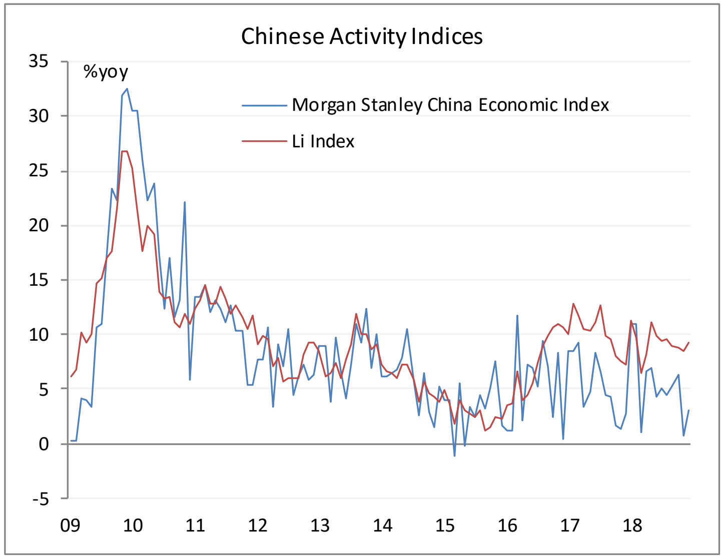




US divergence from rest of world has held up .. In manufacturing

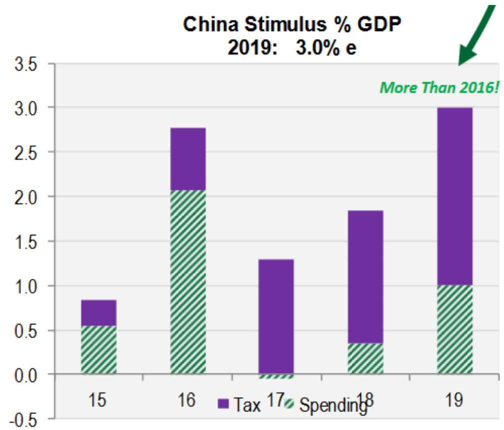
Challenge: China slowdown ….

Broad measures show pronounced slowing

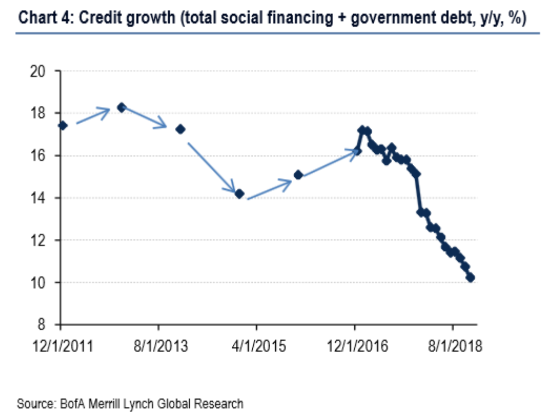


Official data show smooth soft landing to 6.4% but proprietary aggregations show much slower

Policy response has been incremental



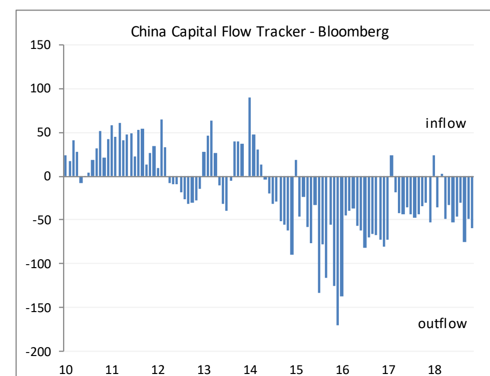
Fiscal expansion accelerates



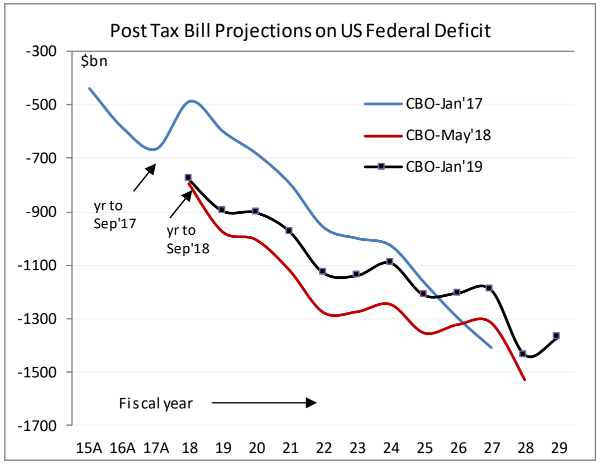
…and more room to accelerate credit

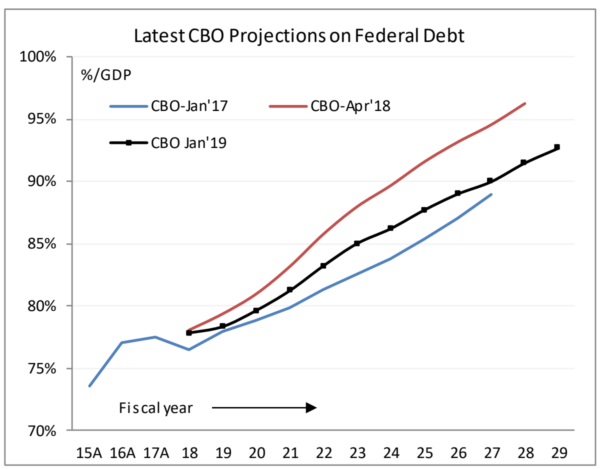
Impossible Trinity:

- Can China control capital outflows as it pulls policy levers?
- '14 reversal took two years



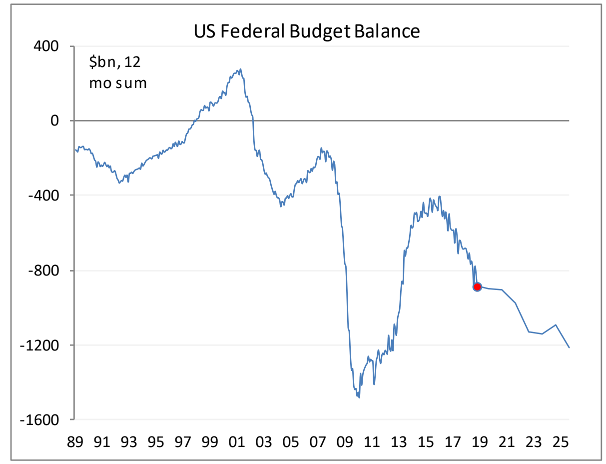
Challenge: US debt trajectory

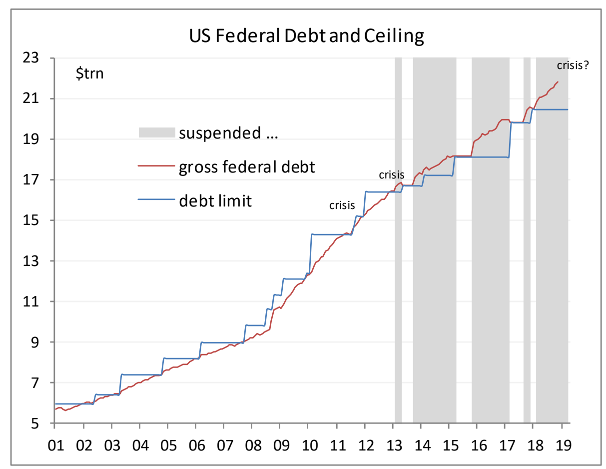




US tax packages (Tax Cuts and Jobs Act 2017 and Bipartisan Budget Act 2018 sharply increased prospective deficits

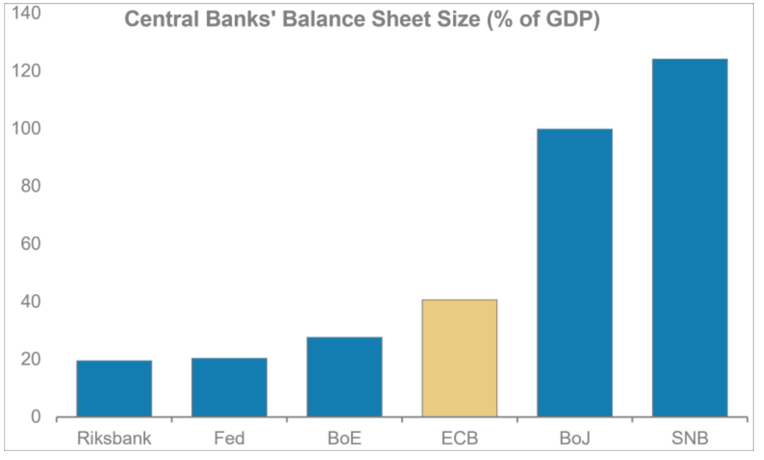
… although the January 2019 CBO update favorably modified future spending on emergencies and debt interest

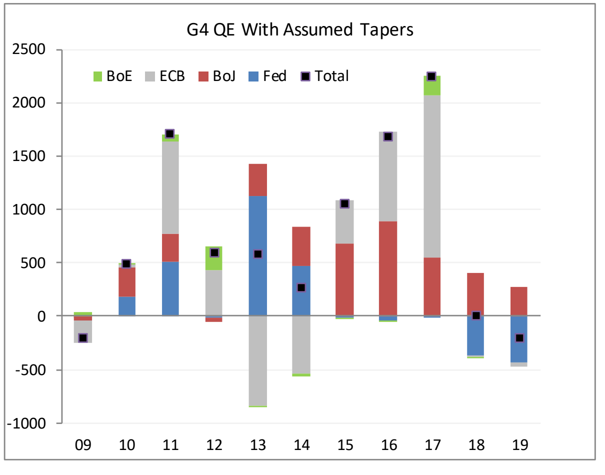




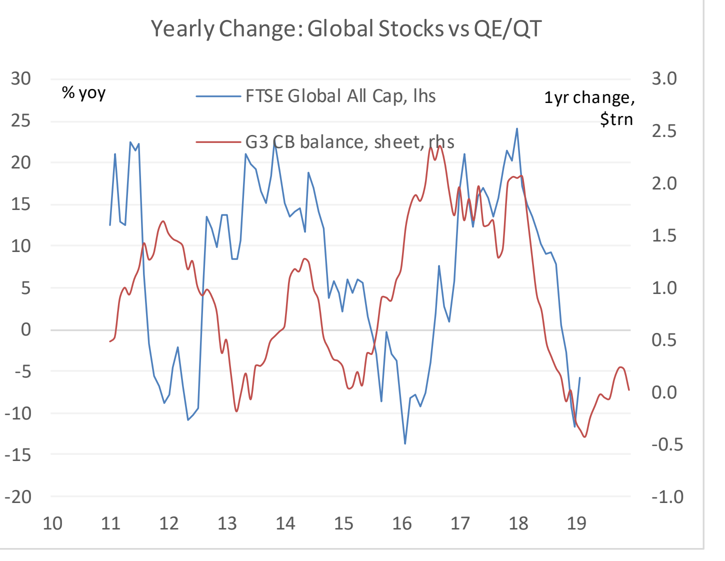
Setting up focus this year on the US debt ceiling

Challenge: Central bank liquidity withdrawal





Central banks have begun to end QE or to start QT

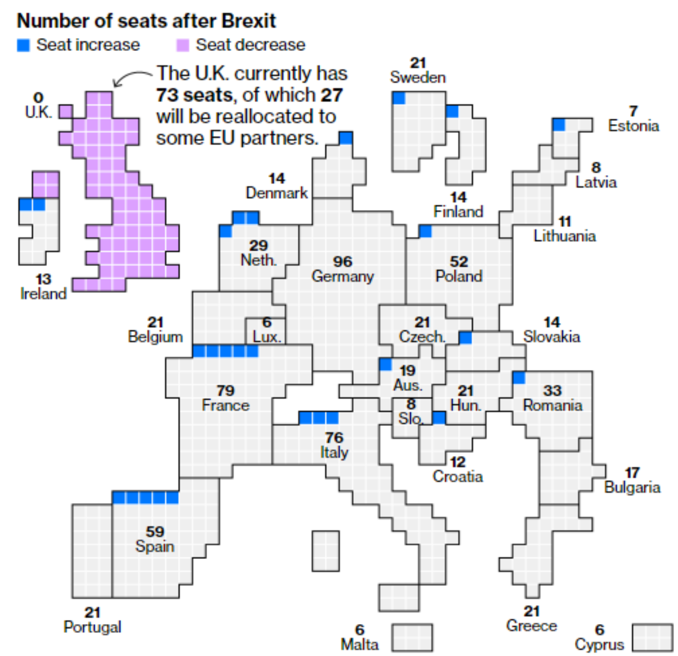


It may already have had some impact on global assets pricing.

Challenge: European populism

May EU Parliament Elections

- The EU Parliament traditionally has split center-left/ center-right and pro/anti-EU.
- The anti-EU faction has had little power and ability to maneuver.
- However, if the UK leaves the EU; France, Spain, and Italy gain seats in the next EU Parliament.
- All three countries have non-mainstream parties that are more skeptical of the EU-project.
- Germany, while does not gain seats, has a more anti-EU balance of power, with AfD now the third largest party in the Bundestag
- Risk for the elections: The elections become a vote around the future to Europe or its priorities.

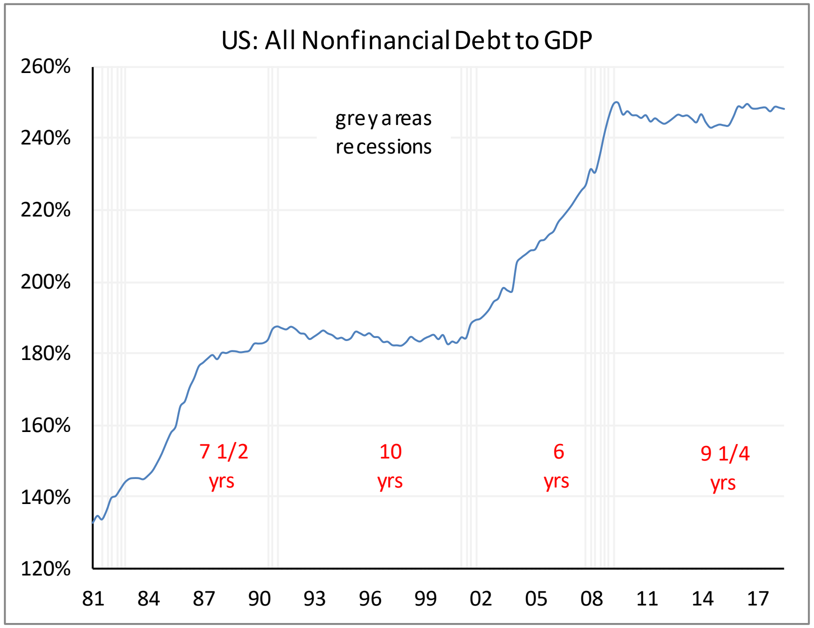


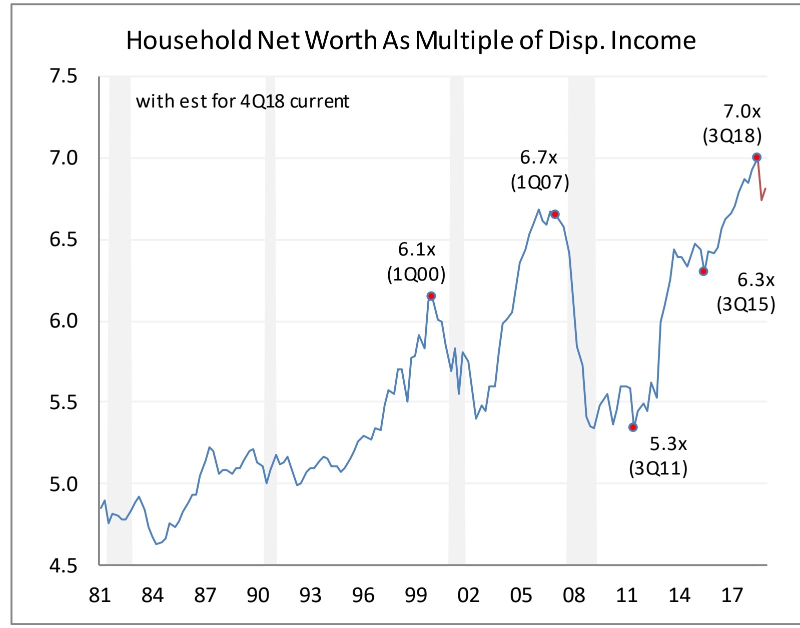
Risks

If anti-populist parties gain traction:

- Parliament becomes fragmented; policies are blocked (e.g. migration and the budget); and forward movement is curtailed.
- League of Leagues may emerge (anti-populist parties form a coalition).

Challenge: Leverage and Valuation





Specialized risk
FOMC (Nov 7-8): "vulnerabilities from leverage in the nonfinancial business sector elevated and … a pickup in the issuance of risky debt and the continued deterioration in underwriting standards on leveraged loans."

Higher risk
FOMC (Nov 7-8): "vulnerabilities associated with asset valuation pressures continued to be elevated"

Scenarios

DOWNSIDE (45%)	CENTRAL (40%)	UPSIDE (15%)
"Valuation and policy risks"	"Shaking off distractions"	"Positive Synchronicity"
US' disruptive engagement threatens global upswing and balance of payments recycling.	Modest rise in US potential growth sustains expansion for now.	Self reinforcing acceleration in US productivity, helping tax reform to partly 'pay for itself'.
'Virtuous' cycle of balance sheet repair and spending unwinds.	Momentum in global economy levels out but does not fall away.	US and China realize mutual interest in backing off confrontation
China's kitchen sink approach to stimulus fails to rally that economy.	China and US corporates can manage the downside from trade disruptions.	
"Free lunch" in early stage of fiscal stimulus gives way to pre-election tactical chaos.	Well signaled (and flexible) removal of stimulus here and abroad.	