U.S. Macro Outlook: Beyond That Downer

BY MARK ZANDI — JUNE 6, 2016
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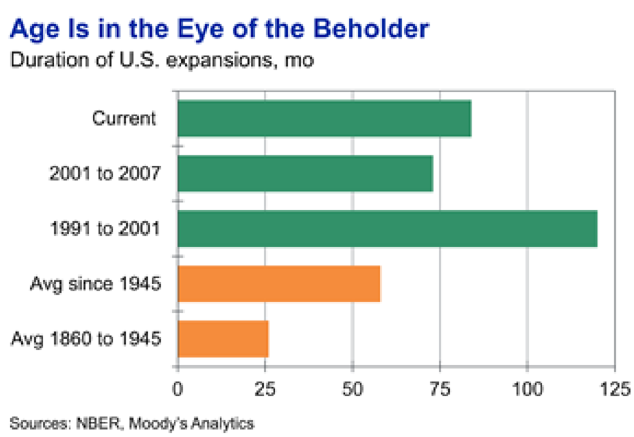
- The May employment report was a downer and dashed expectations for a Fed rate increase in June.
- Still, recession concerns are significantly overdone, and even worries that the economy's growth is significantly throttling back are misplaced.
- A number of pressing geopolitical events could derail things, most notable is the British vote later this month over whether the U.K. should stay in the European Union.
- The most worrisome geopolitical threat to the U.S. economy may be the U.S. presidential election.

May's U.S. employment report was a downer. Job growth was only about 75,000 after accounting for the recently ended Verizon strike, while March and April job gains were revised lower. This is far short of the average of more than 200,000 monthly job gains experienced for the past five years and even less than the just over 100,000 jobs needed to absorb growth in the working-age population.

The soft report dashed any expectations that the Federal Reserve would resume raising rates at the June Federal Open Market Committee meeting, and worries of recession risks were immediately revived. The expansion is celebrating its seventh birthday this month—already long by historical standards.



Longevity isn't a precondition for another recession, but for the statistically inclined, it highlights the risks.

May job miss

Recession concerns are significantly overdone, and even worries that the economy's growth is significantly throttling back are misplaced. The miss in May employment appears due in large part to measurement issues. El Nino-induced warm winter weather likely pulled seasonally adjusted job gains into the first quarter, especially in construction, leisure and hospitality, and retail trade. Employment in these sectors came to a cumulative standstill in the current quarter.

The response rate to the establishment survey was also unusually low. Only 74% of establishments had responded for this initial report, down from more than 82% in May during the previous three years. There will thus likely be a sizable revision to the estimate with next month's report, although there is no way to know if the revision will be up or down.

The tightening job market may also have crimped hiring. With the economy fast approaching full employment—the unemployment rate fell to 4.7% last month—and the number of open job positions near a record high, it stands to reason that businesses are having trouble finding qualified workers to hire.

Consistent with this is the recent pickup in wage growth. Average hourly earnings have risen 2.5% over the past year, and well over 3% on an annualized basis since the start of the year. This compares with no more than 2% through much of the recovery. Wage growth, as measured by tracking the same workers over the past year using ADP payroll records, is even stronger at almost 5%. The wage gains have accelerated across all demographic groups, including employee age, tenure on the job, company size, industry, and region of the country.

Still, it is reasonable to think that businesses may have turned a bit more cautious in their hiring. Given the turmoil in financial markets earlier in the year—at its low in late February, the S&P 500 was down almost 15% from its peak—it was surprising that there had been no apparent fallout on the job market. And the timing of the recent slump in job growth would be consistent with nervous CEOs telling their human resource departments to slow hiring. Even so, this impact on jobs should prove temporary as markets have since recovered.

The U.K. referendum

While there are good reasons to be confident that the U.S. expansion will remain intact and on track, there are a number of pressing geopolitical events that could derail things. Most immediately is the British vote later this month over whether the U.K. should stay in the European Union.

Proponents of a British exit are unhappy with the large number of immigrants coming to the U.K. from the rest of the EU, some of the rules and regulations imposed by the EU, and the fees the U.K. pays to the EU. Exit opponents, including the British government and the Bank of England, argue that the U.K. economy gets substantial benefits from its open trade and borders with the EU. It is unlikely Europe's financial system will remain headquartered in London if there is a "Brexit."

Indeed, leaving the EU would exact a heavy cost on the U.K. economy. Much depends on what kind of relationship the British would negotiate with the EU, but under the most likely scenario, we estimate that U.K. GDP would be cut by approximately 1 percentage point in a year and over 3 percentage points in five years.

British Exit From EU Is a Bad Idea

U.K. real GDP impact, % difference from no-exit scenario

	Per Annum	Year 5		
	Impact %	Worst case	Base case	Best case
Nomura (2016 over 1 yr)	-4.0		-4.0	
Citi (2016, over 3 yrs)	-1.3		-4.0	
HSBC (2016, over 1 yr)	-1.3	-1.5	-1.25	-1.0
Société Genéralé (2016, over 5 yrs)	-1.2	-8.0	-6.0	-4.0
Deutsche Bank (2016, over 3 yrs)	-1.0		-3.0	
Morgan Stanley (2016, over 2 yrs)	-1.0	-2.5	-2.0	-1.5
JP Morgan (2016, over 1 yr)	-1.0		-1.0	
PwC/CBI (2016, over 5 yrs)	-0.9	-5.5	-4.25	-3.0
Credit Suisse (2016, over 2 yrs)	-0.8	-2.0	-1.5	-1.0
OECD (2016, over 4 yrs)	-0.8		-3.3	
Moody's Analytics (2016, over 5 yrs)	**-0.6**		**-2.7**	
Mansfield (2014, over 3-5 yrs)	0.0	-2.6	0.1	1.1
Economists for Brexit (2016, over 4 yrs)	0.4			
Avg	**-1.1**	**-3.7**	**-2.7**	**-1.6**

Source: Moody's Analytics

View a larger version of this table

The fragile euro zone economy would also feel it, as trade, investment and immigration flows would slow. The impact would also likely reverberate across the globe to the U.S. via unsettled financial markets; another reason why the Federal Reserve will wait longer before resuming rate hikes.

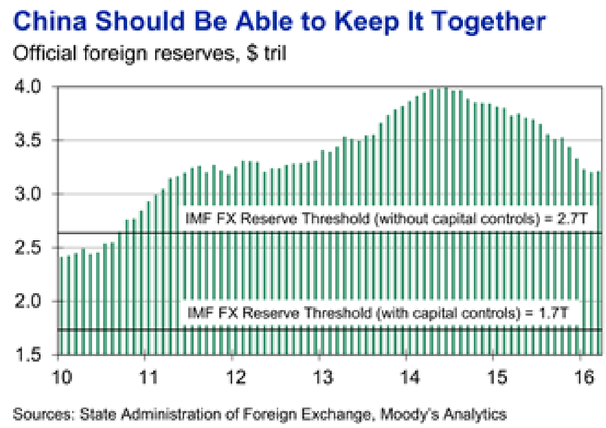
Arguably the most serious threat posed by a U.K. exit would be the potential fallout on similar splinter political movements in the rest of Europe. It could empower euro-skeptic political parties such as the National Front in France, AfD in Germany, Podemos in Spain, and Five Star in Italy. Secessionist movements in Scotland and Catalonia, Spain, may also get a lift. The dissolution of Europe wouldn't be imminent, but Britain's departure from the EU would make it much more likely, to the detriment of the entire global economy.

Fortunately, odds are good that Brexit goes down to defeat. This is key to our sanguine baseline outlook for the U.S. economy. But stay tuned.

Emerging market dysfunction

Geopolitical threats are also emanating from much of the emerging world. Most obvious is the fracturing of much of the Middle East, which has ignited the refugee crisis that is contributing to nativist sentiments in Europe and here. Brazil's political process is imploding, and strongmen are tightening their grips in Russia, Turkey and South Africa.

China also has serious governance problems. Chinese officials are working to balance many seemingly contradictory objectives. They would like a more open financial system and freely floating currency, but these could threaten to ignite large, destabilizing capital outflows.



They would like to rein in the rapid growth in debt, but this could curtail the credit needed to support sufficient growth. They would like to increase the competitive pressures and productivity of state-owned enterprises, but these employ large parts of the population.

Our baseline is that the Chinese will be able to thread those needles, at least sufficiently to roughly hit growth targets. A more stable China and firming global commodity prices should also reduce economic and political pressures throughout the rest of the emerging market. But it would be a bit surprising if this baseline optimism isn't significantly tested in coming months.

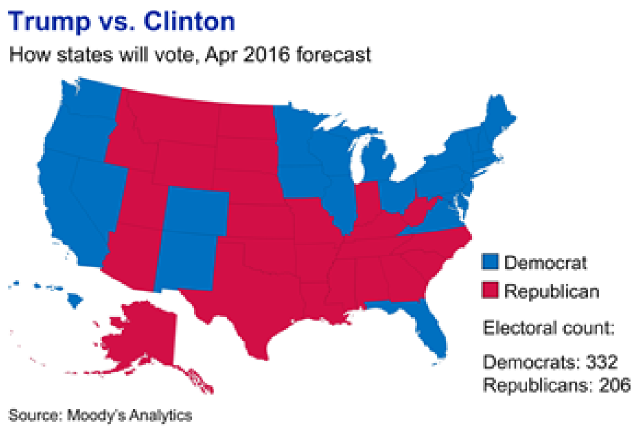
Trump vs. Clinton

The most worrisome geopolitical threat to the U.S. economy may be the U.S. presidential election. Rhetoric of past elections hasn't been pleasant, but elections have rarely if ever significantly impacted the economy. We expect the same this go around, but this election could be very different.

In many respects it already is, given the very incendiary discourse and even violence at some Trump campaign events. The never-ending media coverage of these often discomfiting events could wear down confidence. Adding to the angst may be the high level of uncertainty created by Mr. Trump's unorthodox and opaque economic policy proposals. Talk of deporting over 11 million undocumented immigrants, jacking up tariffs on Chinese and Mexican imports, and confiscating remittances of Mexican workers in the U.S. to pay for building a wall between the U.S. and Mexico may prove too much to bear.

While Mr. Trump is deeply disliked by much of the electorate, Secretary Clinton has her own favorability issues. Her economic policy proposals are much more orthodox and transparent, but persistent questions around her email use while at the State Department make people nervous. Many business leaders are also upset by what they perceive as a significant increase in regulation during the Obama administration, and feel that the Secretary would pursue a similar policy.

The Moody's Analytics election model currently predicts a sizable win by Secretary Clinton.



However, this is based on continued improvement in the job market, low gasoline prices, and solid house price gains. According to the model results, the election is also closer than it appears, as her margin of victory is thin in several key swing states, including Colorado, Florida, Ohio and Virginia. If the economy in these states were to stumble, so too would her presidential bid.

All of these factors make this election and its implications particularly uncertain. Uncertainty is a corrosive on risk-taking, and thus investment, hiring and economic growth. It is hard to discern any measurable impact of uncertainty yet—the stock market remains near record highs—and our baseline is that there won't be any. But this is very much an unfinished script.

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Moody's Analytics added the economic forecasting firm Economy.com to its portfolio in 2005. This unit is based in West Chester PA, a suburb of Philadelphia, with offices in London, Prague and Sydney. More information is available at www.economy.com.

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