FEDERAL RESERVE BANK *of* ST. LOUIS

A Soft Landing in 2020?

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

Introduction

Key themes

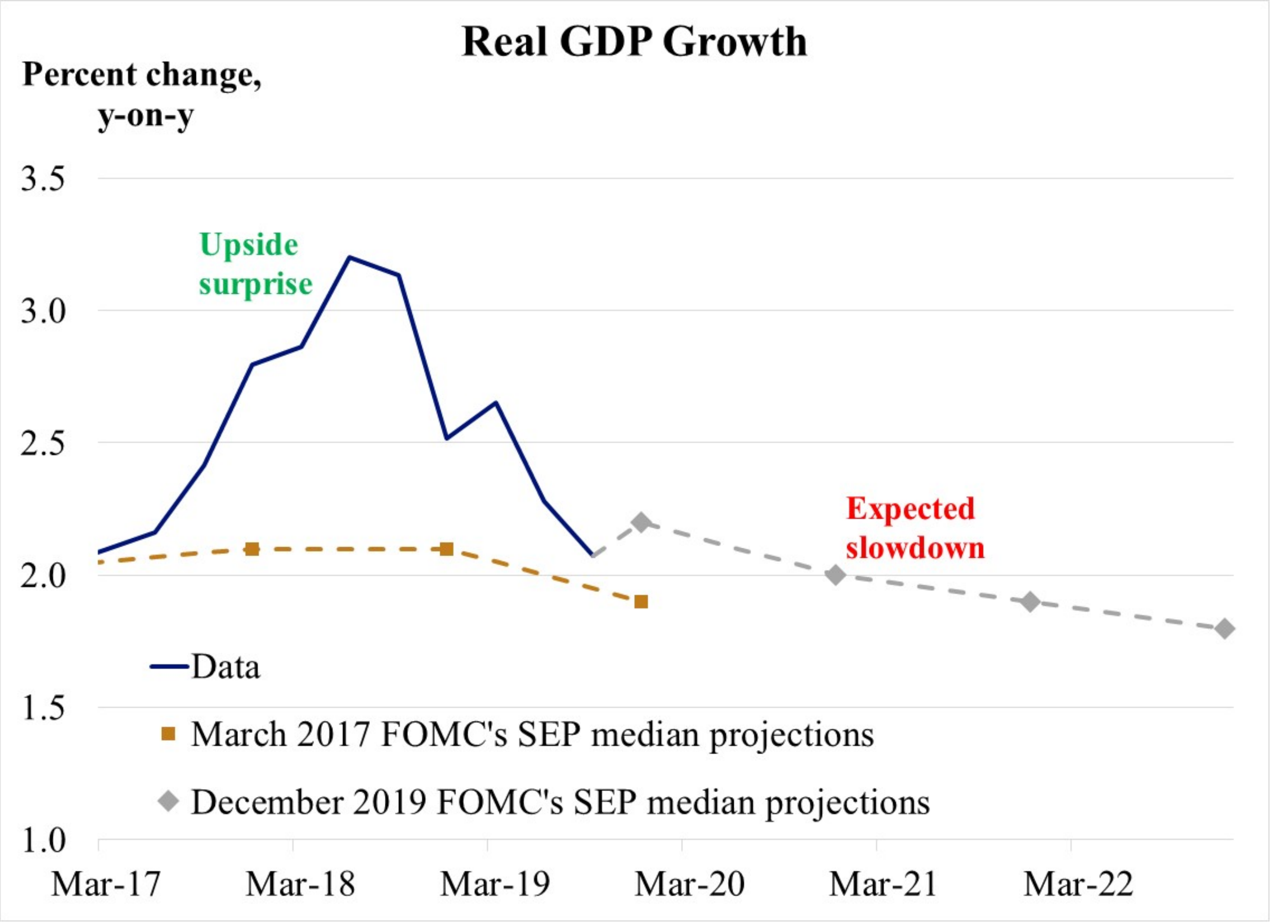
- U.S. economic growth slowed on a year-over-year basis during 2019.
- The Federal Open Market Committee (FOMC) took action to help ensure a soft landing by dramatically altering the path of monetary policy during 2019.
- The current baseline economic outlook for 2020 suggests a reasonable chance that the soft landing will be achieved.
- Trade regime uncertainty will continue, but firms are adjusting business strategies to be profitable even in the face of this uncertainty.
- Geopolitical risk is elevated, but oil shocks may be neutral on net for the U.S., not negative on net as in much of the postwar era.

A Soft Landing?

Slower growth

- The U.S. economy grew at a pace exceeding 3% on a year-over-year basis during the second and third quarters of 2018.
- Since then, growth has generally slowed on a year-over-year basis.
- The slowdown was widely expected because the economy tends to return to its potential growth rate, which is sometimes referred to as a soft landing.
- The key risk in 2019 was that this slowing would be sharper than anticipated, i.e., a hard landing.

U.S. real economic growth



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2019-Q3.

U.S. Monetary Policy Changes in 2019

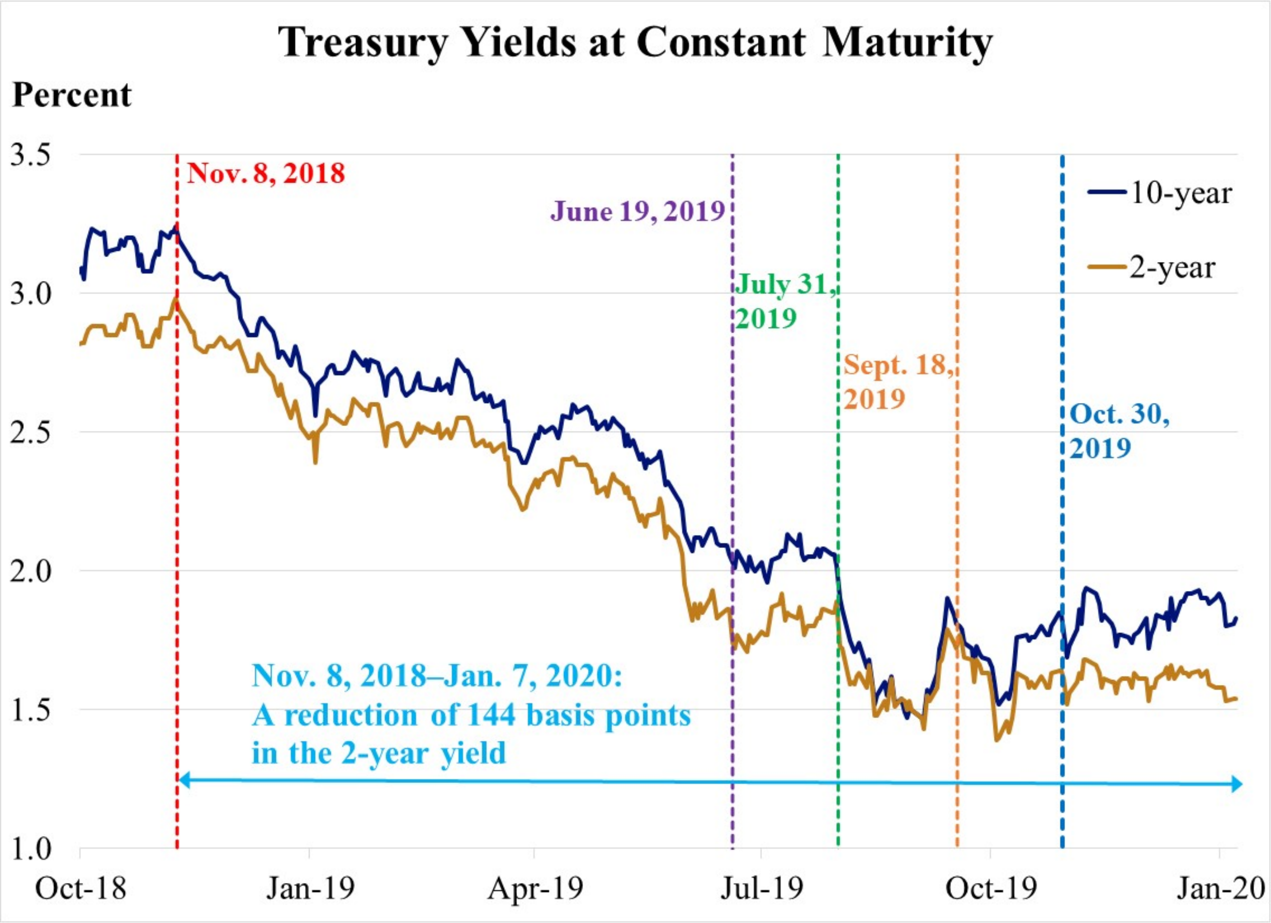
U.S. monetary policy in 2019

- The FOMC was cognizant of the slowing economy during 2019.
- During the first half of the year, the FOMC began to project fewer increases in the policy rate.
- In June, the FOMC indicated that a lower policy rate might be warranted.
- The FOMC then made reductions in the policy rate at three successive meetings, ending the year with a net reduction of 75 basis points in the policy rate.

Interest rates are dramatically lower

- What was the size of this turnaround in U.S. monetary policy?
- The size has been much larger than the three latest rate reductions alone would suggest because the expectation as of late 2018 was that the FOMC would actually *raise rates further*, not lower rates, in 2019.
- The following chart captures more of the true magnitude of the change in policy during 2019.

Size of the change in monetary policy



Source: Federal Reserve Board. Last observation: Jan. 7, 2020.

Interpretation

- One straightforward reading of these events is that the outlook for shorter-term interest rates influenced by the FOMC, as embodied in the two-year Treasury yield, dropped by 144 basis points during the last 14 months because of FOMC actions.
- This is a very large change over this time frame.
- Furthermore, these policy actions influenced longer-term U.S. yields, which are more important for investment decisions.
- The bottom line is that U.S. monetary policy is considerably more accommodative today than it was as of late 2018.

Insurance against Downside Risks to Growth

Insuring against downside risks

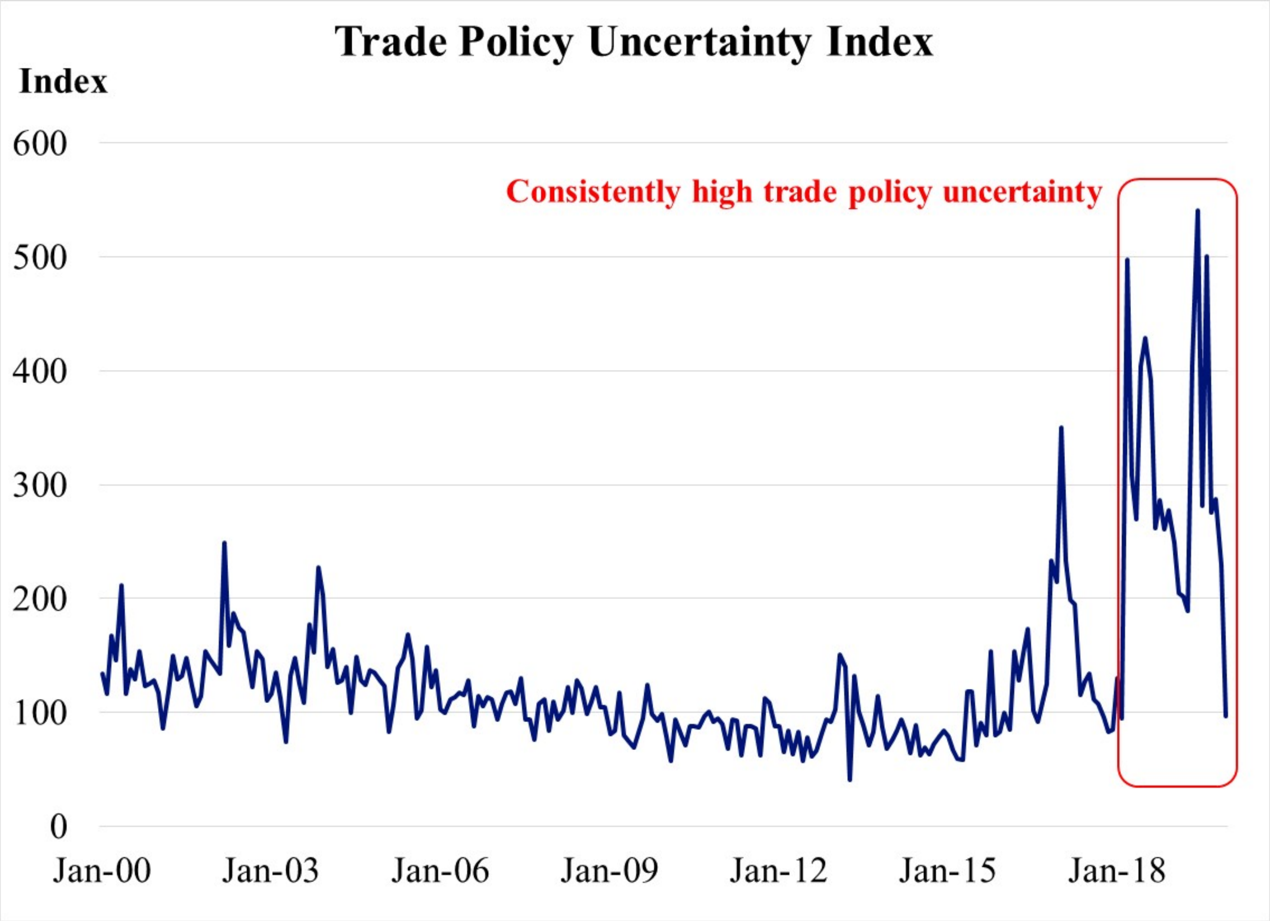
- The FOMC's adjustment toward lower rates in 2019 may help facilitate somewhat faster growth in 2020 than what might have otherwise occurred.
- One could view this as insurance against the possibility that nonmonetary factors could have larger-than-expected negative effects on growth.
- Some factors that have been discussed include global trade policy uncertainty, financial market exuberance and, more recently, resurgent geopolitical risk.

Global Trade Policy Uncertainty

Ongoing trade negotiations

- Global trade regime uncertainty likely chilled global investment and fed into slower global growth during 2019.
- The direct effects of additional trade restrictions on the U.S. economy are relatively small, but the feedback effects through global financial markets may be larger.

High trade policy uncertainty



Source: www2.bc.edu/matteo-iacoviello/tpu.htm. For details, see D. Caldara, M. Iacoviello, P. Molligo, A. Prestipino and A. Raffo, "The Economic Effects of Trade Policy Uncertainty," revised November 2019, Journal of Monetary Economics, *forthcoming. Last observation: December 2019.*

Coping with global trade policy uncertainty

- Recent developments suggest that near-term uncertainty on global trade policy has abated somewhat.
- Despite these developments, I expect continuing uncertainty to characterize global trade policy over the medium term.
- I also expect that firms in the U.S. and abroad will continue to adjust their business strategies to remain profitable even in an environment with trade policy uncertainty much higher than the postwar norm.
- Business strategy adjustment will make trade policy uncertainty less of an issue in 2020 than it was during 2019.

Financial Markets

Equity valuations during 2019

- Market observers have noted the outsize advances in equity market valuations during 2019, often citing gains of approximately 30% for the year.
- However, those gains are measured from the depths of a selloff in the latter portion of 2018, as it became clear that the economy would slow.
- The level of the S&P 500 index was essentially unchanged between early October 2018 and early October 2019.
- The value of the U.S. corporate sector as measured by the S&P 500 index has been increasing at an annual pace of approximately 9.5% over the past two years.

Gains in equity valuations: not so outsized

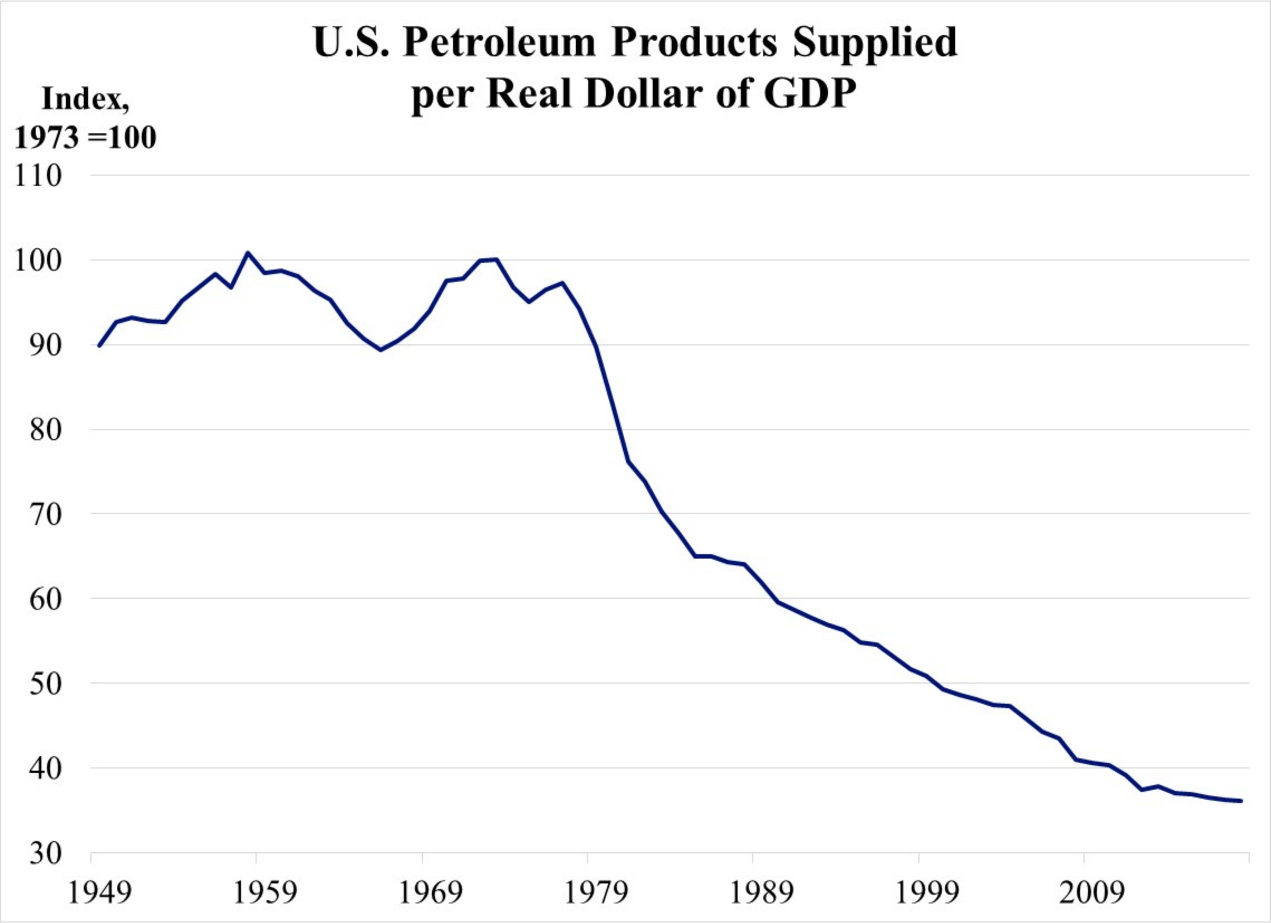
Source: New York Times. Last observation: Jan. 7, 2020.

Renewed Geopolitical Risk

Geopolitical risk and oil shocks

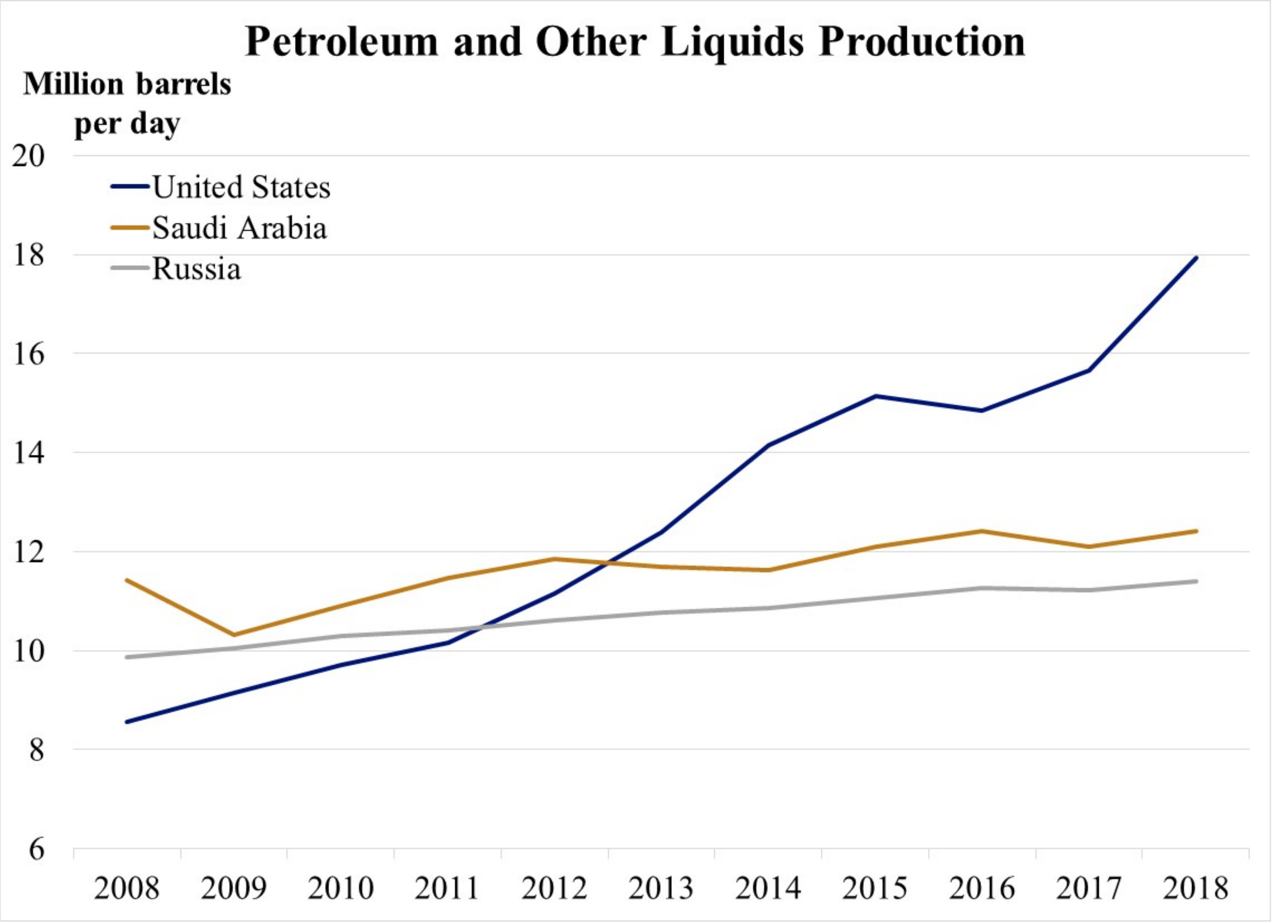
- Renewed tensions in the Middle East have been in the headlines in recent days.
- One important macroeconomic impact could come to the U.S. economy through oil price movements.
- However, oil price shocks probably do not mean what they once may have for the U.S. economy due to:
  - Lower oil intensity compared with levels in previous decades
  - Higher oil production in the U.S.

Lower oil intensity



Sources: Energy Information Administration, Bureau of Economic Analysis and author's calculations. Last observation: 2018.

Higher U.S. oil production



Source: Energy Information Administration. Last observation: 2018.

Conclusion

A soft landing for the U.S. economy?

- The FOMC has a reasonable chance of achieving a soft landing for the U.S. economy in 2020 following a large adjustment to monetary policy during 2019.
- Global trade policy uncertainty is likely to remain high over the medium term, but firms are now adjusting business strategies to remain profitable in the face of this uncertainty.
- Intensification of geopolitical risk may mean higher oil prices, but the ultimate impact of that on the U.S. economy may be approximately neutral given lower oil intensity and higher production in the U.S. than historical levels.

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