ECONOMICS I **RESEARCH**

US Economic Update

March 2019

RBC Capital Markets, LLC

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All values in U.S. dollars unless otherwise noted.
Source for all exhibits is Haver Analytics unless otherwise noted.

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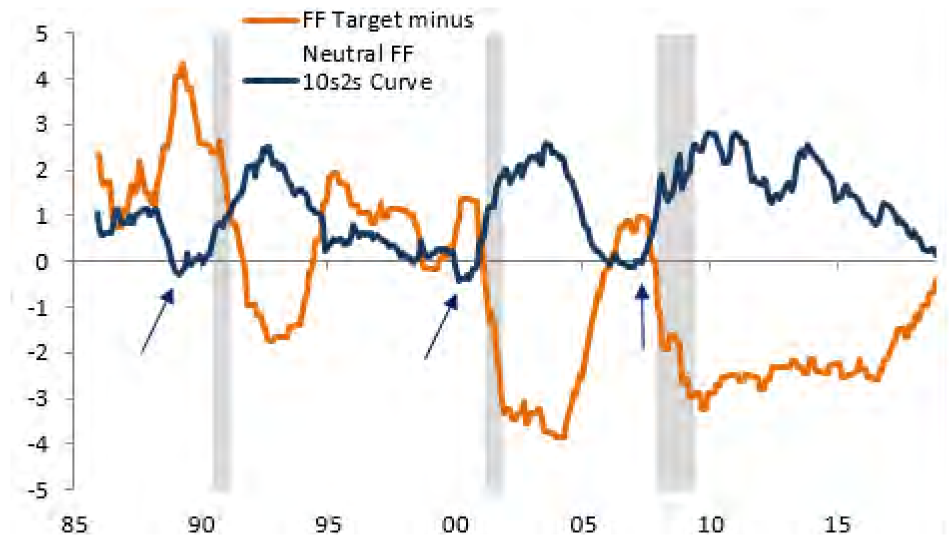
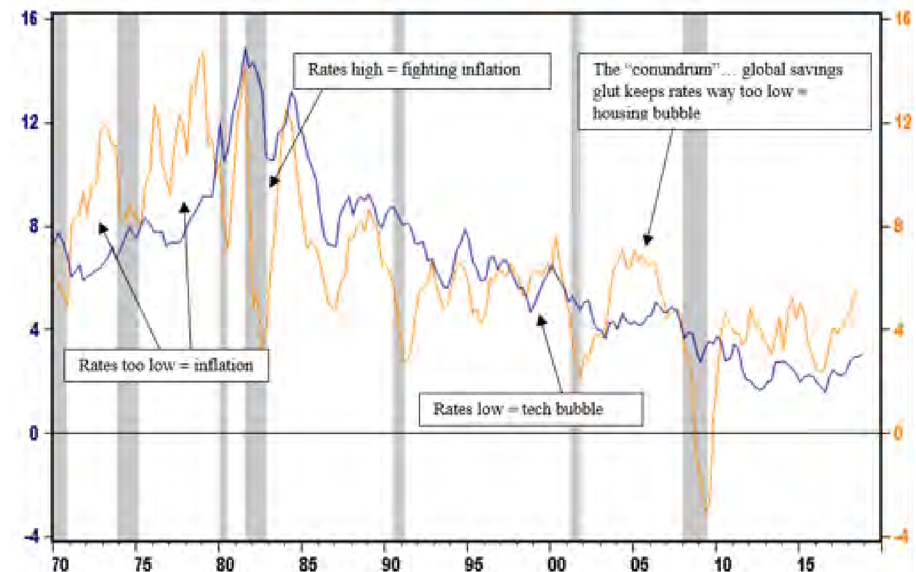
RBC Capital Markets

Curve inversions in context

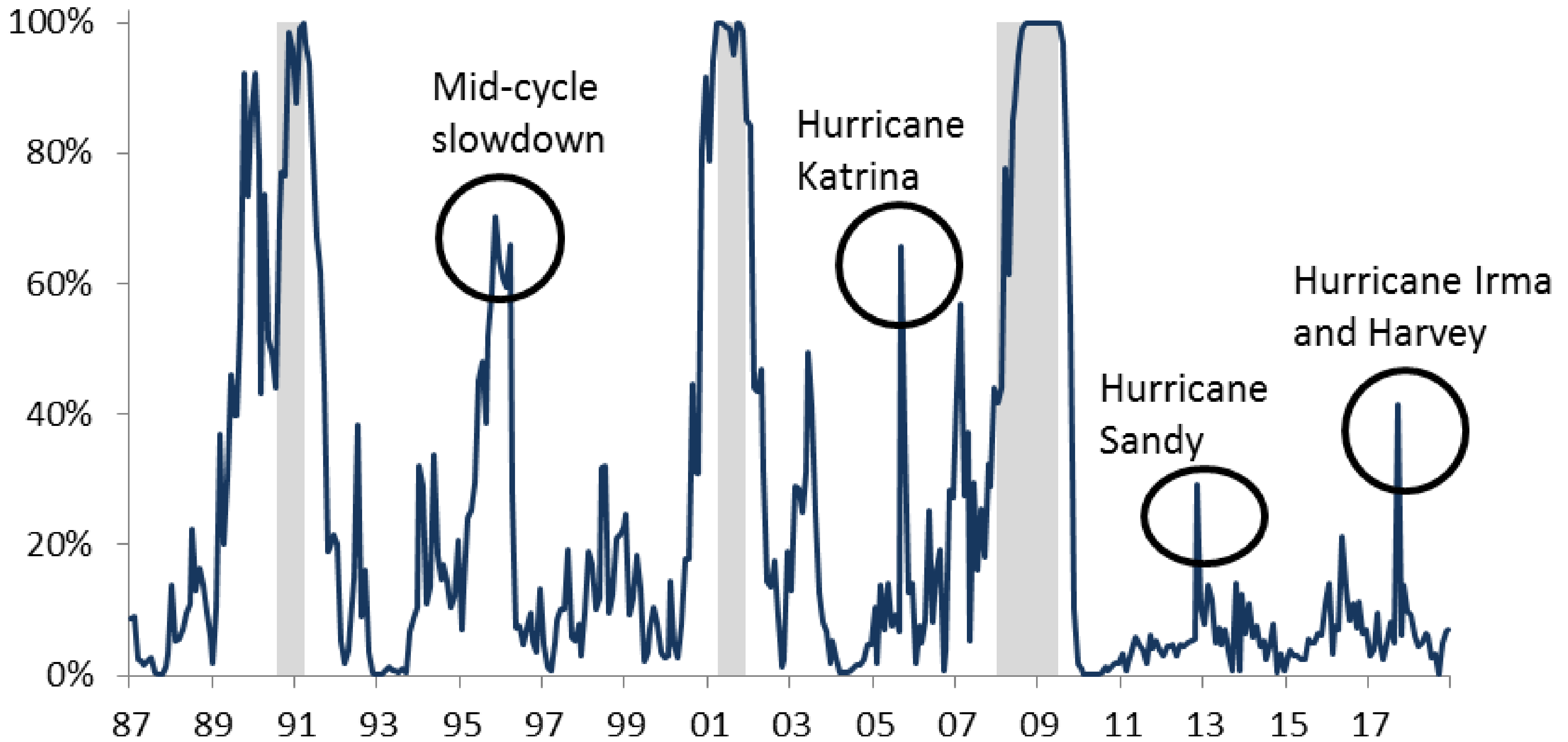
The curve is not some majestic all-knowing creature. It is responsive. And the thing it responds to is Fed action. The curve inverts bc the Fed typically gets aggressive in a hiking cycle. Even the most ardent of pessimists would admit that is not even close to happening at present. In that regard, as the first chart shows, it is critical to remember that a necessary ingredient for a curve inversion signaling a recession is the Fed being through neutral. In fact, we are being generous on that point bc really the Fed needs to be quite a bit through neutral (as the chart shows). As we hope is appreciated, this hiking cycle is now effectively stunted with FF barely at neutral.



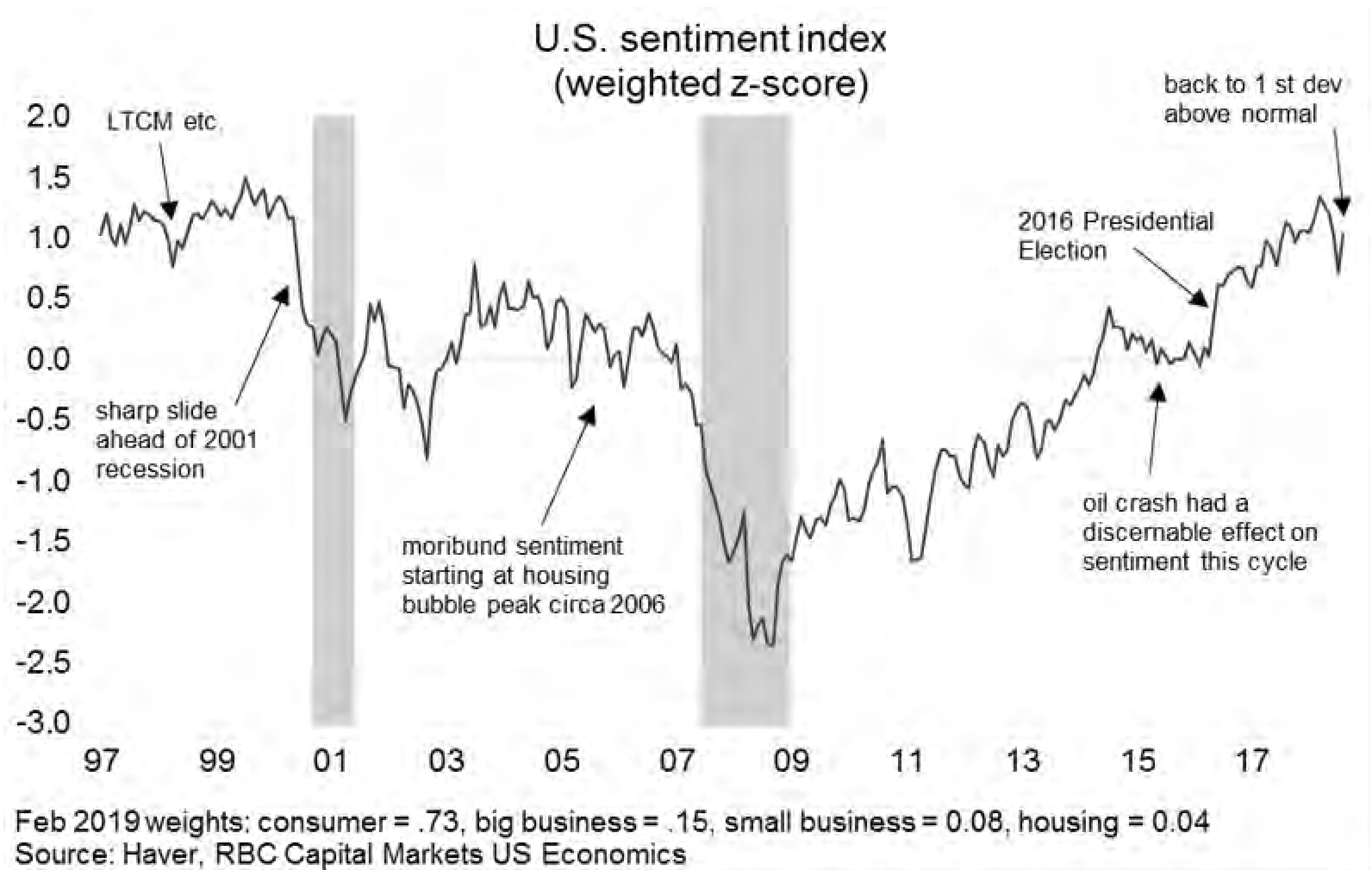
The second thing to remember is 10yr yields are a proxy for nominal GDP. And in that context, it makes sense to pay close attention to 10s and thus the curve. But for a host of reasons (many highlighted by Cloherty in his earlier note) 10s are not acting as a proxy for nominal growth at present! In fact there has been a divergence between the two. In that regard, the fundamental economic guidepost that 10s have provided historically simply is not working now. Hard to take the inversion seriously in that context.



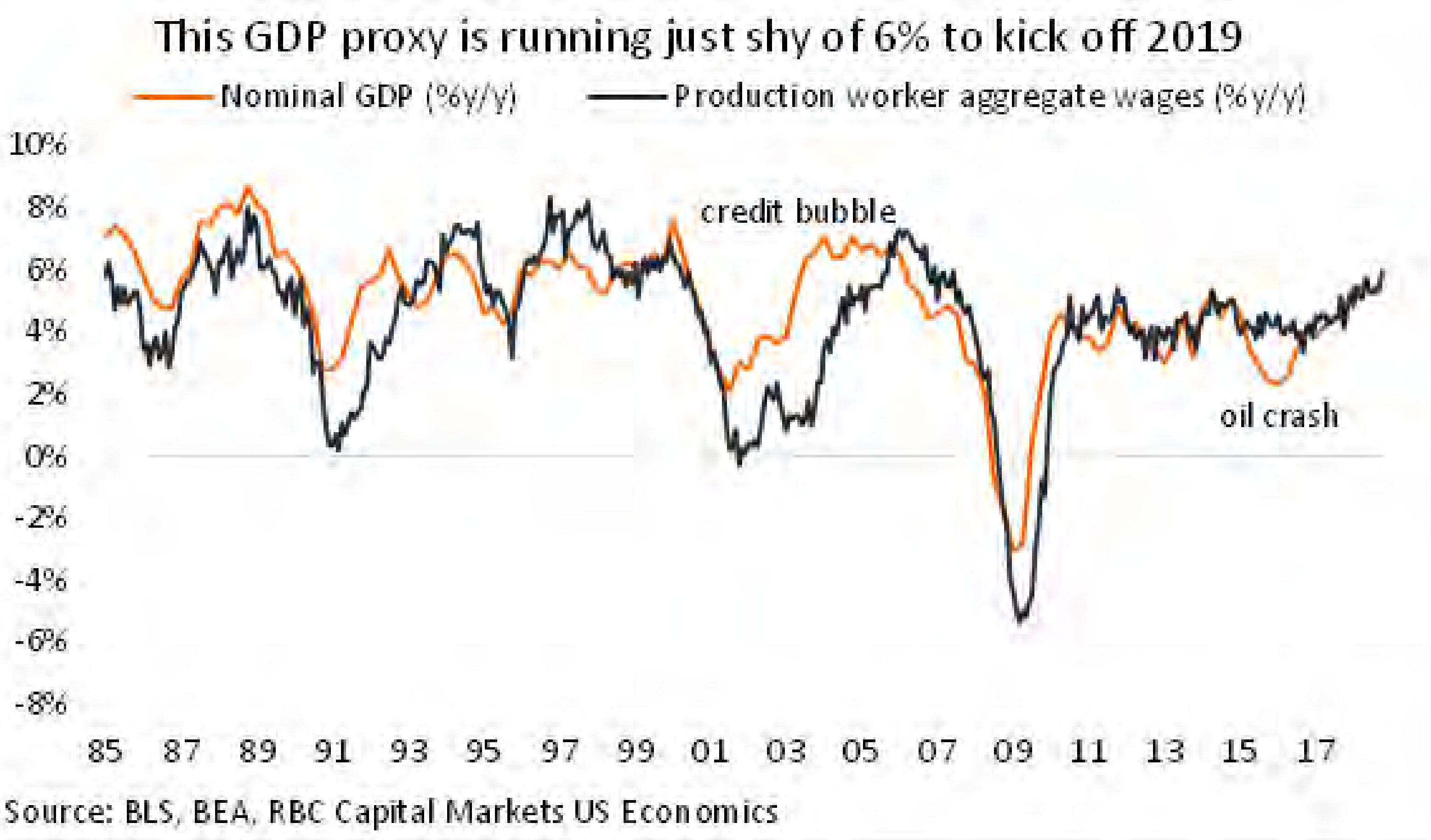
Another look at recession odds in the US



Sentiment data remain sturdy

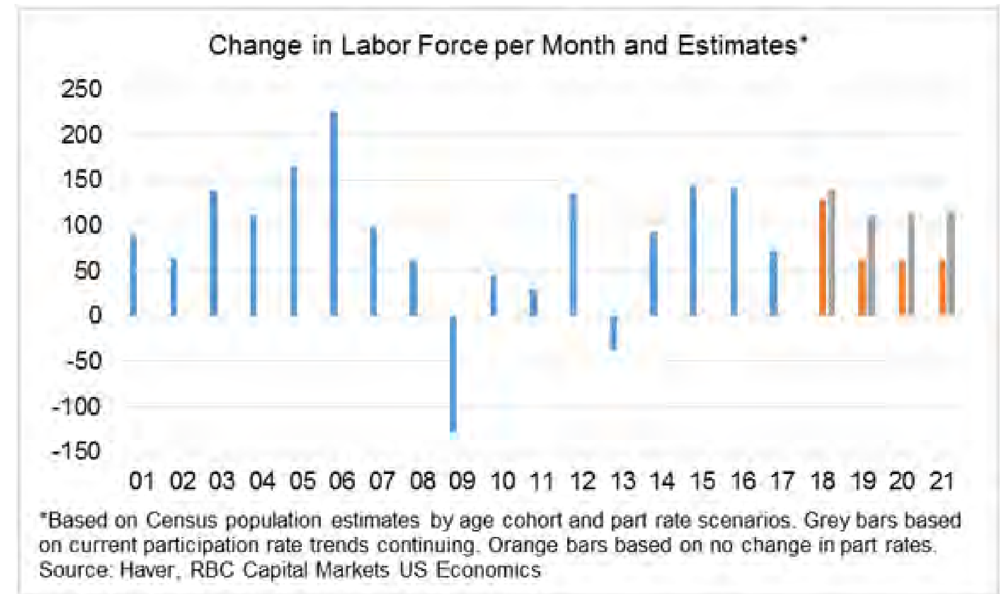


Growth proxy running strong



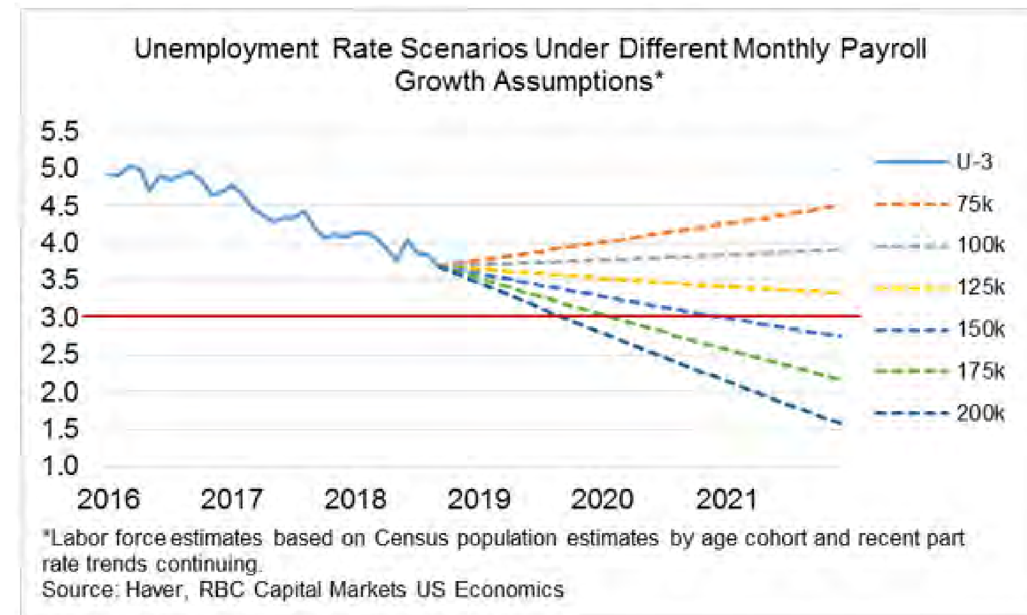
U-rate going lower?

Over the next few years we are looking at an environment where breakeven payroll growth is poised to slow further and thus the downside pressure on the unemployment rate (and upside on wages?) in an environment where topline growth remains well north of potential will become even more significant. Labor force growth obviously looks very different depending on your assumptions about participation. If we maintain current trends in participation (where, for example, the prime worker part rate is in a decided uptrend), the labor force has much more room to grow—we estimate about 115k per month over the next few years. If we hold participation rates steady at current levels and just let population dynamics dictate labor force growth, however, this nearly gets cut in half to around 60k per month. These are essentially the NFP breakeven rates under those two scenarios. In other words, the rate of monthly payroll growth that keeps the unemployment rate stable. You can see how under a scenario where participation rates begin to level off, the downward pressure on unemployment is exacerbated—you need less and less realized payroll growth per month to bring down the unemployment rate…

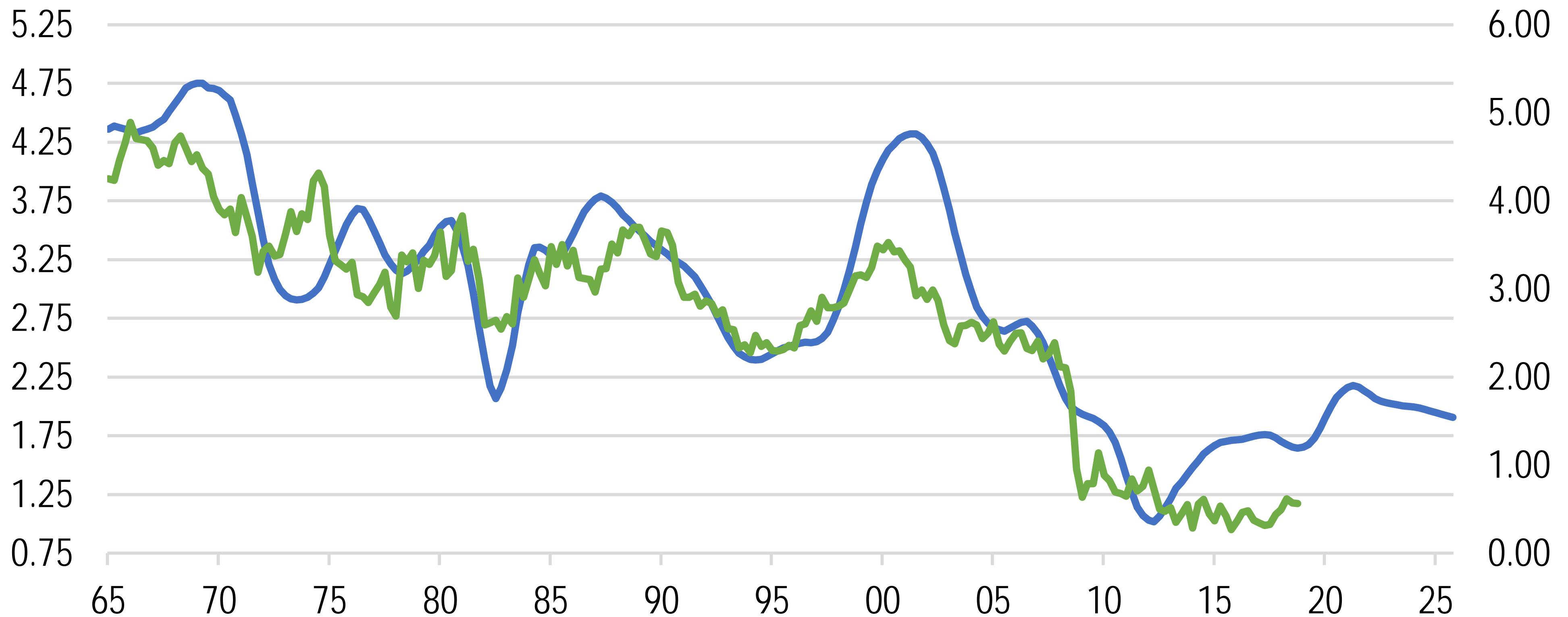


*Based on Census population estimates by age cohort and part rate scenarios. Grey bars based on current participation rate trends continuing. Orange bars based on no change in part rates.
Source: Haver, RBC Capital Markets US Economics

… But even under the scenario where cyclical participation rates keep trending higher, the downward pressure on the unemployment rate is set to continue unless we downshift significantly in terms of monthly payroll growth. Notice that if payroll growth manages to clock in at better than 175k per month over the course of the next 18 months (it has averaged 211k over the last 12 months and 203k over the last six), the unemployment rate would fall below 3%. At a 150k per it would take until early 2021 for it to fall below that threshold. Keep in mind what the Fed's estimate is though. They have built in unemployment rates of 3.5, 3.5, and 3.7 from 2019-2021. It would take a significant deceleration in payroll growth to hit those rates of unemployment—indeed, it would have to fall below the breakeven rate and toward about 100k per month. Implicitly, the Fed is building in a scenario of sub-potential economic activity. With job openings currently sitting at north of 7 million and economic growth likely to clock in near 3% through the middle of next year, a material slowing in payroll growth seems unlikely. We think by mid 2019 we'll be contending with an unemployment rate below 3.5% and an inflation rate at or slightly above the 2% target. This will embolden the committee to hike 4 times in all of 2019.

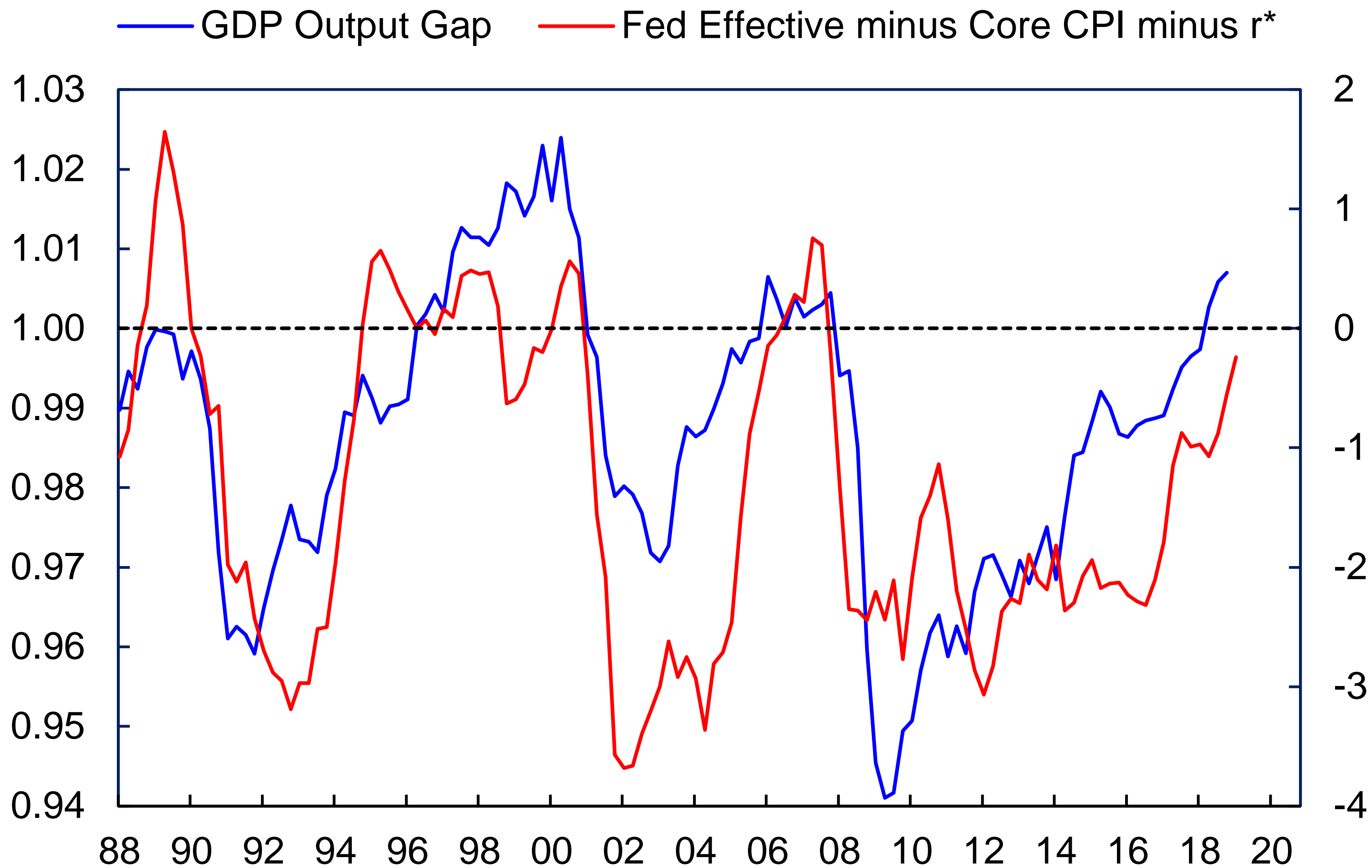


*Labor force estimates based on Census population estimates by age cohort and recent part rate trends continuing.
Source: Haver, RBC Capital Markets US Economics



Source: Haver, RBC Capital Markets US Economics

Monetary policy still looks accommodative relative to the economy



Source: Haver, RBC Capital Market US Economics

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