SGIA ECONOMY WATCH, MAY 2019

The economy grew at a 3.2% annual rate last quarter, more than double the 1.5% consensus forecast of economists surveyed by The Wall Street Journal. The composition of growth, however, is not as encouraging as the top-line number. Inventory investment, net exports, and state and local government expenditures — three volatile factors that happened to rise concurrently — were the big contributors. In contrast, consumer spending and private fixed investment, the core of the economy, collectively grew just 1.3% (Figure 1).

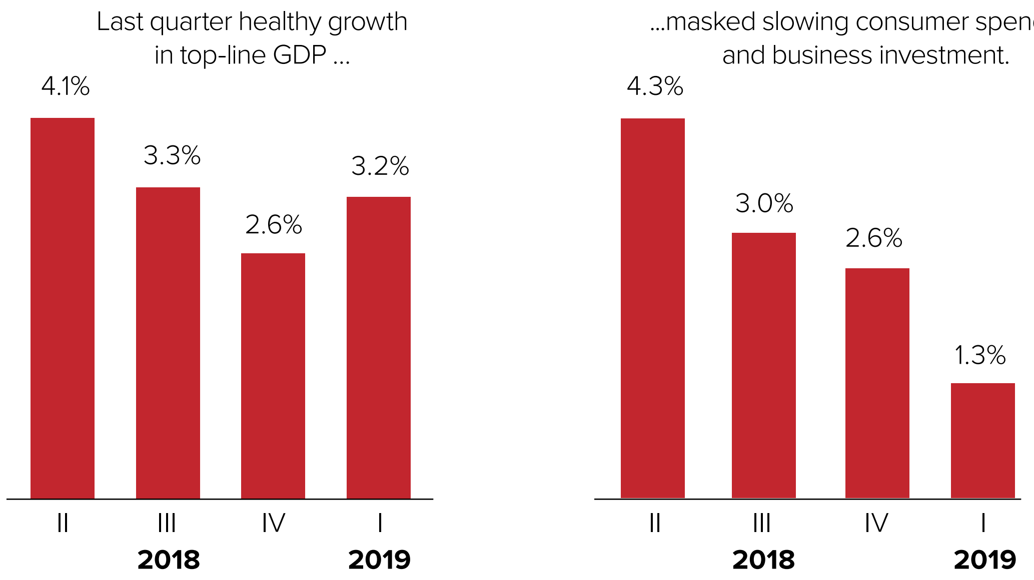
Are we heading into recession? After nearly 10 years of uninterrupted growth, aren't we due for one? Or is a rebound ahead?

Rebound is much more likely than recession for three reasons. First, labor markets are still very healthy. Last quarter, the economy added 541,000 jobs, fewer than the 683,000 added during the same period a year earlier but enough to hold the unemployment rate below 4.0%. Job openings (positions employers could not fill) are at a near-record 7.3 million. And hourly wages of production and nonsupervisory personnel are rising at a 3.4% rate, the fastest in nine years. These indicators were all heading up prior to the Great Recession, so they are no guarantee of continued growth. They are, however, evidence of an economy that will not be easily broken.

Second, capital investment recently boomed. Business spending for equipment and software rose 8.9% during the 15 months ending in June 2018, after declining 0.6% the previous 15 months. Consumer spending gets most of the attention, because it accounts for nearly 70.0% of GDP. And certainly a healthy consumer is essential to a healthy economy. But capital investment, not consumer spending, creates the foundation for sustained economic growth by increasing productivity, which supports non-inflationary income growth, which supports the confidence and spending that drive the economy higher. And because it takes time to capture the full benefits of a capital investment (there's a learning curve, resistance from employees who prefer the old systems, etc.), even though investment has slowed, some benefits of the boom are still ahead of us.

Figure 1 — GDP, Consumer Spending, and Investment Growth by Quarter

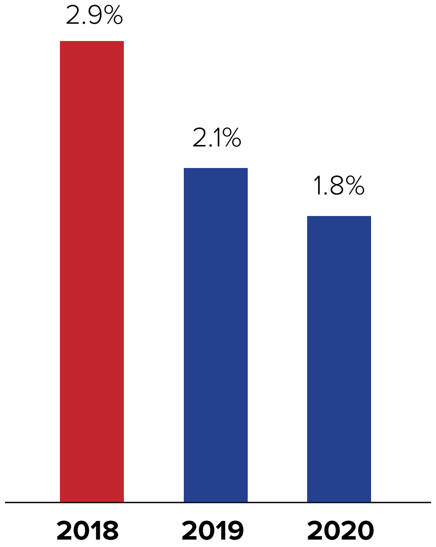
Left-hand chart shows percent change in GDP; right-hand chart shows percent change in the sum of consumer spending and private fixed investment. All change is over the previous quarter at annual rates.



Third, economic expansions do not die of old age — i.e., we are never due for a recession. Expansions die of excesses, such as the real estate bubble prior to the Great Recession of 2008 - 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; or exogenous shocks, such as the OPEC oil embargos of the 1970s.

Figure 2 — The Economic Outlook

Percent change in GDP over previous year. Projections for 2019-20 are consensus of economists surveyed by "The Wall Street Journal."



There is no evidence of excess severe enough to cause recession. The Fed has stopped tightening credit. Economic policy isn't Washington's current priority. And the increasingly diverse, adaptable American economy is not as susceptible to exogenous shocks as it once was.

None of this suggests a quick rebound to last year's 2.9% growth rate. Here's why:

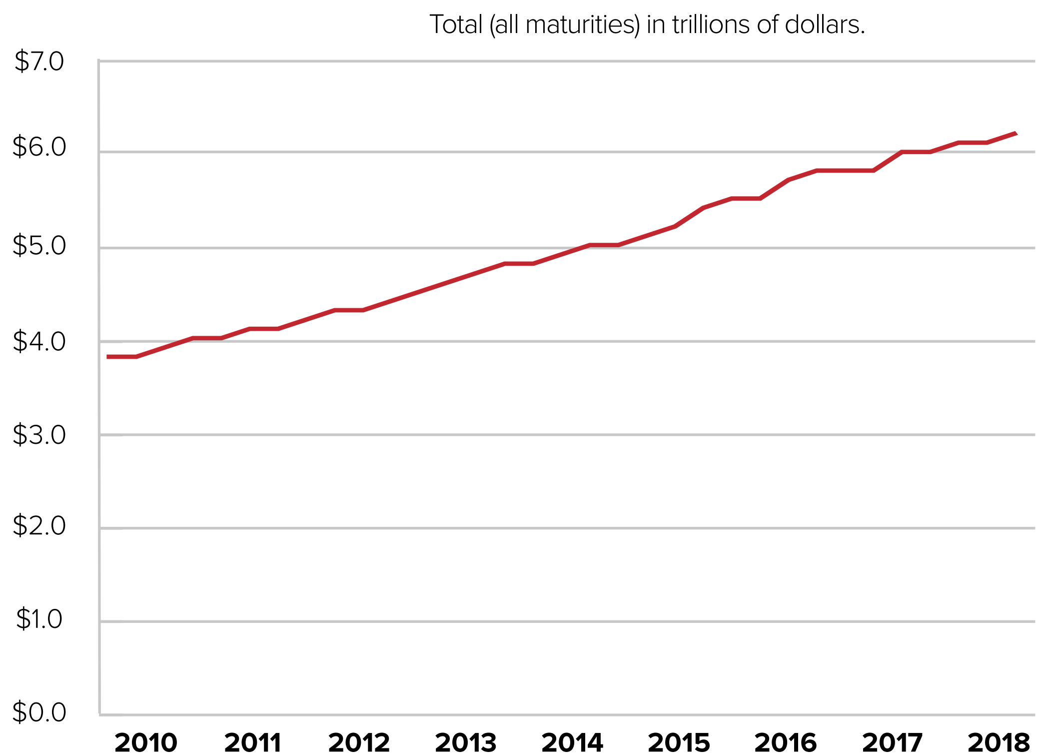
- Tariff disputes continue to disrupt global supply chains and create uncertainty (e.g., "Is one of my products or essential inputs next?") that dampens business confidence and, consequently, expansion plans. The longer the disruption and uncertainty continue, the greater the damage to a struggling world economy.
- The Fed increased the target federal funds rate (the interest rate on overnight loans of bank reserves) eight times between December 2016 and December 2018. No increases are planned for 2019. But because it typically takes nine to 24 months for changes in interest rates to fully work though the economy, there's still considerable restraint in place. The all-important housing market is evidence of that: Housing starts fell 9.4% and existing home sales fell 5.4% last quarter.
- Stimulus from the Tax Cut and Jobs Act of 2017 is fading. No one knows exactly how much the Act boosted consumer spending and business investment, but it clearly did. The good news is that healthy income growth will limit the damage to the consumer. And although after-tax corporate profits will not approach last year's outsized increase (up 19.0%, after growing 5.2% in 2017 and declining 1.7% in 2016), the financials S&P 500 companies have issued in 2019 show margins are holding up.

All of this points to an economy growing closer to 2.0% than 3.0% over the next 18 months. The consensus of economists surveyed by The Wall Street Journal has GDP up 2.1% this year and 1.8% next year (Figure 2). That's a lot better than collapsing into recession, but it isn't a free pass: Growth of 2.0% reduces GDP by $186.0 billion from what it would have been had growth continued at 3.0%. Considering that last year, textile and apparel manufacturers had sales of $69.6 billion, beverage manufacturers sales of $104.9 billion and TV and radio broadcasters sales of $169.1 billion, the slowdown is the equivalent of losing a major industry.

Of course, a lot can change in 18 months. The answers to these questions will profoundly affect the economy's path:

- Do we get meaningful trade agreements with China and our other major trade partners? If we do, a force pulling down becomes a force pulling up.
- Will inflation stay tame? Whole Foods, Procter & Gamble, Clorox, Mondelez International and Hersey all recently announced price increases, due to rising costs of transportation, ingredients, material, packaging and labor. And oil prices hit a six-month high in late April. Will inflation accelerate later this year, forcing the Fed to tighten credit more aggressively than planned?
- Does record debt increase the economy's sensitivity to rising interest rates? The Fed suppressed interest rates for nearly a decade to aid recover from the Great Recession. Over that period, the total debt of American nonfinancial corporations increased 63.7%, to $6.2 trillion, with substantial increases in B-rated debt (the lowest investment grade) and leveraged debt as investors reached for yield (Figure 3).

Figure 3 — Debt of American Nonfinancial Corporations



- What happens when interest rates begin to rise again, even gradually? How much pressure will rising debt service exert on the profits that support capital investment and hiring? How much will downgrades and defaults increase? Is corporate debt the excess that will eventually cause the next recession?
- Also, between 2010 and 2018, debt issued by the U.S. federal government increased 58.9%, to $21.5 trillion. Net annual interest payments now exceed $370.0 billion, more than Washington spends per year on national defense or discretionary (non-entitlement) programs. The United States is not going to default. But the rising costs of servicing a rapidly rising federal debt will absorb hundreds of billions of dollars that could have been invested in infrastructure, education, energy or any number of programs that would strengthen the economy's productivity and long-term growth potential. (Debt hasn't only exploded in America, as the World Debt Clock, www.usdebtclock.org, shows.)
- Will productivity gains match wage gains? You don't grow an economy by impoverishing people or by imposing regulations that do little more than suppress productivity and innovation. You grow an economy through policies that boost wages, productivity and innovation. How close will we come to those policies?

Even slight changes in the answers to these questions can affect the economy, for better or worse, and the printing industry along with it. We'll report on how it plays out in future issues of SGIA Economy Watch.

 SGIA Market Watch is a periodic supplement to the association's comprehensive studies of printing industry markets and products, financial performance, compensation rates, growth strategies and other critical issues. For information on our research, please contact Olga Dorokhina, Research Coordinator, olga@sgia.org, 703.359.1321, or Andrew D. Paparozzi, Chief Economist, apaparozzi@sgia.org, 347.991.3391.