US economy keeps rolling into 2020...

The US economy is on track to close out 2019 with a fourth straight quarter of above-trend GDP growth—a noteworthy accomplishment in a year characterized by rising trade tensions, slowing global growth and recession fears. The Fed’s about-face on monetary policy helped, particularly in the housing sector where lower interest rates have stimulated resale and homebuilding activity. Residential investment added to growth in Q3 for the first time since 2017 and looks set to do so again in Q4. Rate cuts have done less to stimulate business investment (not surprising given the challenges noted above) which declined in each of the last two quarters. That downdraft might be easing with capex shipments and new orders picking up in October and business sentiment showing signs of stabilization—a trend that should be helped by a US-China trade deal. However, it looks like the pullback in oil and gas investment that began in mid-2018 continued toward the end of the year. Reports of financial difficulties among some shale producers hint the sector’s challenges could extend into 2020.

... with a strong labour market supporting consumers

Meanwhile, the US consumer has remained a reliable source of growth. The combination of steady job gains, healthy wage growth, and low inflation has aggregate real incomes increasing at a solid 3% rate. The business sector’s reluctance to invest hasn’t been mirrored in hiring plans, with private sector job gains averaging 200,000 over the last three months. That will be difficult to sustain with the unemployment rate at 3.5% and firms complaining of labour shortages. But even if job creation slows as we expect in 2020, firmer wage growth could provide a buffer for household incomes. A survey of small businesses shows plans to increase compensation are at a cycle high, while an increase in the quit rate suggests job churn (a key driver of wage growth) has picked up. All told, we think there is good reason to expect the household sector will continue to support the US economy in 2020. Nonetheless, with smaller contributions from business investment and government stimulus, we think GDP growth will slow to 1.8% from 2.3% this year.

Fed shifts to neutral after 75 bps of cuts this year

The Fed held monetary policy steady in December after lowering rates at each of its last three meetings (a cumulative 75 basis points of easing). The steady rate decision was entirely expected with policymakers having signaled a shift to the sidelines following October’s cut. Chair Powell reiterated that the current stance of monetary policy is likely to remain appropriate if incoming data are broadly consistent with the Fed’s outlook. The statement dropped an earlier reference to uncertainties about the economic outlook—a change that could be interpreted as slightly hawkish—but still noted that “global developments and muted inflation pressures” will influence the future path of monetary policy. That same language was used to justify rate cuts earlier this year.

The Fed’s updated dot plot was consistent with a neutral bias, showing most committee members expect rates will be held steady throughout 2020. While a small minority think a rate hike might be appropriate next year, Chair Powell threw cold water on the idea that the Fed would follow its 1998 playbook when a mid-cycle adjustment was reversed less than a year later. He said he’d need to see a persistent increase in inflation to move rates higher—an unlikely prospect in the near-term with core PCE running below 2%. At the same time, none of the committee expect to lower rates further in 2020. (It’s worth noting that was also the case last December, and the Fed cut rates three times in 2019.) So what might it take to see additional easing? Our GDP growth forecast for next year (1.7% on a Q4/Q4 basis) is below the Fed’s 2% projection, but we don’t think a modest shortfall—when the economy is already beyond full employment and monetary policy is accommodative—would be enough to trigger further easing. It will likely take a more pronounced slowing in industrial production and business investment or further weakening in global growth for the Fed to move from the sidelines. Those risks can’t be dismissed entirely but seem less acute if a US-China trade deal holds. Our base case remains for the Fed to hold rates steady through 2020.

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