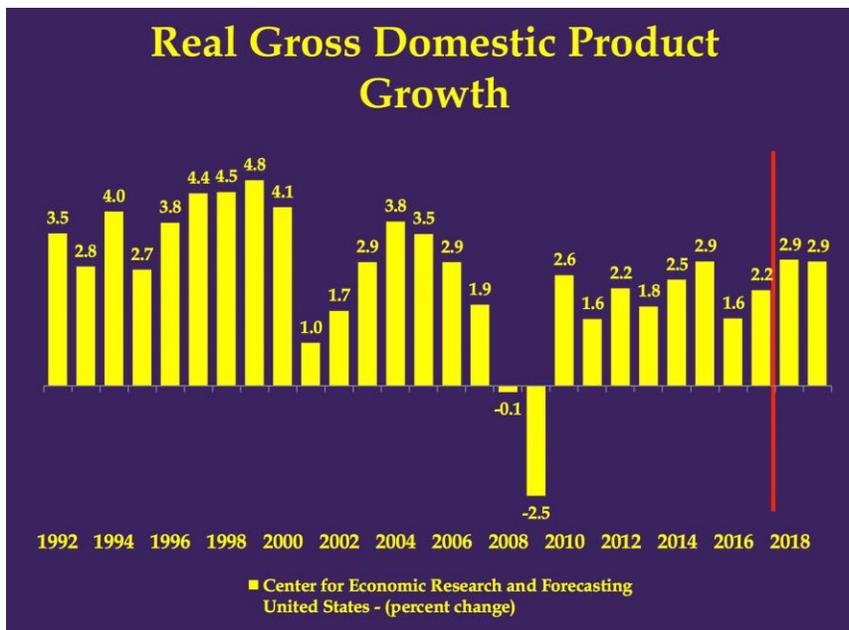


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Monetary Policy and International Trade continue to be a drag on what would otherwise be an improved and generally upbeat economic outlook for the nation.

The U.S. economy has entered a new phase of higher economic growth resulting from changes to the corporate tax system passed at the end of 2017. The new, higher level of growth is a welcome improvement following a disappointing decade of anemic growth since the Recession. We are currently forecasting growth of 2.9 percent for 2018, a full 70 basis points higher than 2017's growth rate and 130 basis points higher than 2016.

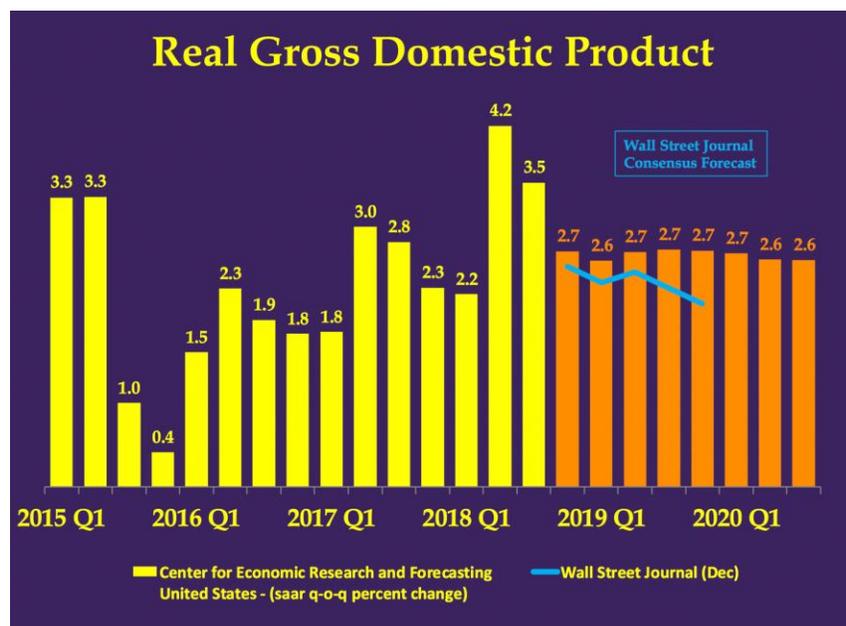


As detailed in the nearby [U.S. Economy essay](#), we believe that extraordinary monetary policies initiated during the financial crisis and the Great Recession are holding the economy back. Growth would be even higher had the Federal Reserve begun to normalize monetary policy earlier in the recovery (we have been crowing since 2012 that the time for normalization has come). Unfortunately, the Federal Reserve does not have a credible plan to achieve normalization before the next economic downturn. This essentially guarantees that the use of untested and poorly understood policy tools and the resulting unintended consequences will continue for at least another business cycle.

The effects of the country's Trade War are beginning to show up in economic data. We noted in the [September forecast publication](#) that farm incomes are down more than 20 percent from a year ago and that losses in the Agricultural Industry are being experienced in every region of the country as tariffs slam the door on agricultural exports.

Tariffs have had a profound impact on the timing of economic activity, so far in 2018. An increase in exports contributed more than 1.2 percentage points to the 2<sup>nd</sup> quarter's headline-grabbing economic growth number (4.2 percent!). This increase in exports was driven by U.S. producers who rushed products to market before retaliatory tariffs by China took effect in July. Not surprisingly, a major decline in exports reduced U.S. GDP growth 0.6 percentage points in the 3<sup>rd</sup> quarter. In other words, much of the unexpected bump in growth in the 2<sup>nd</sup> quarter was not a genuine increase in economic activity but rather a change in the timing of activity. Economic activity that would have taken place during the 3<sup>rd</sup> quarter or later instead took place during the 2<sup>nd</sup>. The Administration's international trade negotiations are having a significant negative impact on the U.S. economy.

The current forecast represents a slight downward revision from the September forecast, a difference of about 10 basis points in each of the next two quarters, owing mostly to the impacts of International Trade.



Despite our concerns about monetary policy and international trade, the current CERF forecast is actually optimistic relative to consensus. This is an entirely new and uncomfortable position for the CERF team. Since the Great Recession, the CERF forecast has been more than 50 basis points more pessimistic on average than either the Wall Journal (WSJ) or the National Association of Business Economists (NABE) surveys of forecasters. During that time, it has paid to be pessimistic. Over much of that period, the relatively pessimistic CERF forecast was *too optimistic* relative to actual economic growth. From the Recession until 2016, the economy performed even more poorly than our dour predictions.

Economic growth has exceeded our forecast by an average of 12 basis points since the beginning of 2016. The CERF forecast bias has been negative but small over that time. Once again, our forecasts have been pessimistic relative to consensus but more accurate. Since 2016 Q1, the bias of the CERF forecast is -0.12. The WSJ and NABE surveys have had forecast biases of 0.36 and 0.28, respectively.

<b>Forecast History - United States GDP</b> (Real SAAR Growth)				
Quarter	CERF Forecast	WSJ Forecast	NABE Forecast	Actual (1st Estimate)
<b>2016 Q1</b>	1.5	2.1	2.0	0.5
<b>2016 Q2</b>	1.5	2.4	2.3	1.2
<b>2016 Q3</b>	2.0	2.9	2.8	2.9
<b>2016 Q4</b>	1.8	2.3	2.1	1.9
<b>2017 Q1</b>	1.7	1.9	2.0	0.7
<b>2017 Q2</b>	2.2	2.9	3.1	2.6
<b>2017 Q3</b>	2.2	2.7	2.8	3.0
<b>2017 Q4</b>	2.5	2.8	2.7	2.6
<b>2018 Q1</b>	2.5	2.5	2.5	2.3
<b>2018 Q2</b>	3.0	3.6	3.0	4.1
<b>2018 Q3</b>	3.1	3.2	3.1	3.5
<b>Average</b>	<b>2.18</b>	<b>2.66</b>	<b>2.58</b>	<b>2.30</b>
<b>Average Bias</b>	<b>-0.12</b>	<b>0.36</b>	<b>0.28</b>	<b>-</b>

*Sources: US Bureau of Economic Analysis, Wall Street Journal, NABE, and CERF*

There are a couple of explanations for our newfound optimism. First, it is likely that we assign greater value to corporate tax reform than the consensus. We are admittedly bullish on tax reform and the resulting surge of business investment that was evident during the first half of 2018. Although it is possible that the Trade War will undo the considerable gains flowing from tax reform, we earnestly believe that growth will be higher across the entire forecast horizon relative to the case of no tax reform. Second, some of the forecasters surveyed by WSJ and

NABE are predicting recession within the forecast horizon. A handful of economists predicting economic contraction will naturally pull down the average of forecasts represented by each of those surveys.

Although it is unfamiliar territory, and although we prefer being *accurate* to being either above or below consensus, we'll try to relish being sunny and optimistic while it lasts.

Additional forecast charts are provided on the next page.

### Forecast Charts

