With all of the action in the first quarter, it was a tall task for the second quarter to live up to the drama, but it did not disappoint. In many ways, it was far more entertaining. From the Federal Reserve’s adoption of “symmetric inflation target,” to tariffs, to the yield curve flattening, there was a little something for everyone. Without stepping back and looking at the broader picture, it is easy to see only the negative headlines (for example, tariffs). When that step back is taken, however, the U.S. economy remains strong, and there are even nascent signs of a rebound in the economic data of Europe after a disappointing start to the year. There are plenty of reasons to be tentative on the economy, but there are also reasons to be fairly upbeat.

**U.S. Growth**

There is little arguing that the U.S. economy is doing well. The Atlanta Fed's GDPNow tracker puts U.S. growth at nearly 4%. This would be a significant acceleration over the pace of growth in the first quarter. It is likely to moderate somewhat in the second half of 2018, but it shows the amount of momentum the U.S. economy currently has behind it. This pace of growth would translate to more than a 5% nominal pace in the second quarter, easily matching the highs for the recovery, but the GDPNow indicator is somewhat unreliable and highly volatile until a few weeks before the official GDP figure is published.

One way it is useful, however, is to glean a sense of the persistent level of GDP growth. For example, the 90-day moving average has stepped up noticeably from a 2.5% range to +3% range. At the very least, the U.S. is seeing GDP growth that has accelerated.
The signal being sent by the GDPNow report is confirmed by the estimates for GDP in the U.S. continuing to move higher. Despite the implementation of tariffs, the estimates for U.S. growth in 2018 are creeping toward 3%. Granted, there has been a decline in the expectation for 2019, but that should be taken with a grain of salt. If the trade skirmish (there should be some hesitation in calling it an all-out war) escalates from current levels, the prospects for the U.S. economy are fairly bright.

The Institute for Supply Management (ISM) Manufacturing and Services report provides a near real-time update to the state of the U.S. economy, and whether it is accelerating or decelerating. While both series have been choppy in 2018, they have oscillated near post-crisis peaks. The U.S. economy has numerous tailwinds at the moment, and there are few signs the momentum is waning significantly.

**A Less Disappointing Eurozone?**

For all the positive momentum the U.S. has had this year (even if some of the data has missed expectations), the Eurozone has been a giant disappointment. Culpability may be attributed to Italy’s for its populist vote that shook economic confidence, but this only seemed to last a week before it fell from the headlines. Most of the blame should probably be placed on economists getting too optimistic and pushing expectations too high. Now, the opposite is proving to be correct with expectations being washed out to the point of being attainable once again. While Europe is unlikely to post growth figures that compare to 2017, the data is likely to be less disappointing in the second half of the year with growth above 2%.
Federal Reserve

Most of the Federal Reserve's moves in the second quarter were innocuous with expected shifts in the language and a rate hike. But there was one shift in the Fed's policy that was anything but innocuous: "Inflation on a 12-month basis is expected to run near the Committee's symmetric two percent objective over the medium term." This doesn't sound interesting, but it signals a different regime than expected from the Fed going forward. The critical word was “symmetric.”

A "symmetric inflation target" would indicate that the Fed is willing to put up with higher inflation without fighting too hard. It means that, since inflation ran below target for an extended period, the Fed will allow inflation to play catch-up. There have been a number of Fed officials and commentators (including this author) who have advocated for this type of policy, but this is the first time the Federal Open Market Committee (FOMC) has endorsed such a regime, and there were no dissenters to the statement.

In many ways, this is the Fed's "prove it" quarter with inflation readings likely to come in higher than the 2% target. As Fed officials orate to clarify the policy of symmetry, it is worth remembering that symmetry means a "sustained, but contained overshoot of inflation."
This is something the Fed may struggle to explain to an apprehensive market. The market is already pricing in more than the two additional hikes as the Fed has signaled. Meanwhile, symmetry might walk them back toward one quickly.

**The Not So Great**

Of course, there are also reasons to be tentative on the current economic situation. Tariffs are front and center of the concerns along with the potential for the yield curve to invert. The first is fairly straightforward as free trade has been a cornerstone of the global economy for decades and markets loathe change. The yield curve is more esoteric, but it typically indicates that Fed tightening has gone too far.

The most prominent tariffs put in place are on Chinese and European goods. The EU directed its retaliation at Harley-Davidson motorcycles (among other goods) causing Harley to state that it would move production outside the U.S. China, in turn, retaliated against U.S. tariffs largely through its own tariffs on U.S. soybeans and other agricultural exports.

How, when, and with how much blood spilled will the trade dispute be resolved? Those questions are impossible to answer, but they will matter for growth down the road. The question is: How long will it take the tariffs to show up in the U.S. data? And, it might take until 2019 for the data to suffer meaningfully.

The yield curve has been one of the most consistent predictors of a recession in the past, and there is little reason to believe that this has changed. In fact, the Federal Reserve Bank of St. Louis reiterated its usefulness with some caveats: The most predictive curve is the 3-month minus the 10-year and, after inversion, it is an average of ten months to a recession (since 1957). It is worth noting that the “3-10” is indeed flattening, but remains well above the inversion delineation.
Looking Forward

There are numerous crosscurrents with tariffs pushing in one direction, and taxes and the resulting economic momentum shoving in the other. There are reasons to be both optimistic and pessimistic about the economy. Presently, the U.S. economy continues to grow at a clip well above the norm for most of the post-crisis period. With the implementation of tariffs and a flattening yield curve, the momentum of the U.S. economy and the Fed’s current policy trajectory will be continually challenged in coming quarters.

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