TIAA

# Revised 2016 economic forecast: Despite slowdown, a recession is not imminent

## Executive Summary

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- While the stock market fears a worsening slowdown, the Federal Reserve expects wages and inflation to increase this year, leading to a pickup in economic activity.
- This divergence of views on where the economy is headed reflects two different lenses through which to view growth.
- Economists—and the Fed—typically emphasize "real" growth, which represents the true level of underlying demand in the economy. This view is currently more optimistic. In contrast, markets tend to perceive the economy through a "nominal" lens, reacting in the moment to ongoing shifts in data rather than focusing on longer-term trends. This outlook is currently more pessimistic.
- Over the next few months, we will know which view—the market's or the Fed's—is correct, based on the direction of unemployment and inflation, as well as other key indicators.
- While we do not foresee an imminent recession, there is enough evidence to lower our forecast for 2016 average GDP growth from 2.6% to 2.0%.


### Will the economy improve or deteriorate?

Current market volatility is being driven by fears of a worsening slowdown in the economy. Yet the Federal Reserve expects wages and inflation to increase this year, leading to a pickup in economic activity. This divergence of views on where the economy is headed reflects two different lenses through which to view growth.

Economists—and the Fed—typically emphasize the "real" economy, basing their forecasts on underlying *trends* in growth. This view is currently more optimistic. In contrast, markets tend to perceive the economy through a "nominal" lens, reacting in the moment to ongoing shifts in data rather than focusing on longer-term trends. The nominal outlook is currently more pessimistic, even to the point of suggesting a recession is imminent.

At the most basic level, the difference between "nominal" and "real" measures of growth is simply the inflation rate: subtracting inflation from the nominal value results in the real value. For example, if nominal GDP grew by 4% and inflation was 2%, real GDP growth would be 2%.

More important than the simple arithmetic is what nominal and real growth levels tell us about the path of the economy. Think of nominal growth in terms of prices paid and real growth in terms of actual demand. For instance, there may be a difference between what consumers pay for certain goods and services, and how much of those goods and services they really want. While prices could rise for these items, if consumers don't buy more of them, then nominal GDP would increase, but real GDP would not. In short, real GDP represents the true level of demand, which is much more fundamental to understanding how the economy will grow.

Based on the overall evidence, we conclude that the economy is indeed slowing, but this doesn't mean the U.S. is headed for a near-term recession. We are lowering our forecast for average GDP growth in 2016 from 2.6% to 2.0%. In addition, we expect two key interest rates to track at lower levels than in our previous forecast: the 10-year Treasury yield (a bellwether market rate that tends to rise when the economy picks up steam) and the federal funds rate (which the Fed raised in December from near 0% in anticipation of improving economic growth).

## What real growth is telling us

Overall, real growth is holding up. Consumer spending, business investment, and housing all show continued growth, while job creation remains healthy and housing markets have stabilized. That said, there are some risks to growth. Although consumer spending for November and December was respectable overall, spending on goods was weak, and growth in auto sales appears to have peaked. Additionally, recent Fed data suggests that banks are becoming more cautious, and broader loan demand measures have slowed. Lastly, weaker corporate profits growth since last year may lead companies to spend less, which could dampen demand for labor. Despite these risks, the Fed believes that we should begin to see a marked increase in wages and inflation this year, which should coincide with a pickup in real economic activity.

## Nominal growth and its implications

In assessing nominal activity, a key consideration is the growth rate of the monetary base—i.e., the portion of the money supply that is highly liquid and easiest to use, including currency in circulation and reserve balances that banks have on deposit with the Fed. This growth rate is important because it is strongly correlated with the growth rate of nominal GDP. Currently, monetary growth rates suggest that nominal GDP growth will fall below 2% by this summer. And since nominal GDP translates to real GDP by subtracting inflation (which is modestly positive), that means real GDP growth will need to fall to between 1% and 1.5% on an annualized basis.

The implications of this nominal perspective are that inflation will remain weak and that real growth must falter—an outlook that stands in stark contrast to the Fed's view. These two views are not reconcilable; either one or the other is correct, but not both.

### U.S. Economic Forecast

| | Average growth rate | | | 2015 | 2016 | | | |
|---|---|---|---|---|---|---|---|---|
| | 2015 | 2016 | 2017 | Q4 | Q1 | Q2 | Q3 | Q4 |
| Real GDP (%, SAAR*) | 2.4 | 2.0 | 2.4 | 1.0 | 2.2 | 2.5 | 1.7 | 1.8 |
| 10-year Treasury yield (%, quarter-end) | | | | 2.27 | 2.00 | 2.10 | 2.20 | 2.25 |
| Federal funds rate (%, quarter-end) | | | | 0.38 | 0.38 | 0.63 | 0.63 | 0.63 |

* Seasonally adjusted annual rate. Note: light blue highlight represents the beginning of a forecast.

## What to watch for

The way to approach these divergent views of the economy is to become more cautious on growth in the medium term. Over the next few months, we will monitor the path of inflation and the direction of unemployment claims. If inflation picks up substantially, it will most likely be accompanied by an increase in real growth. In that case, the Fed will have been proven right and interest-rate hikes will resume, along with improved corporate profitability and investment. But if inflation stays exceptionally muted, corporate profits remain under pressure, and investment continues to lag, unemployment claims will likely climb, the Fed will be forced to keep any rate increases on hold, and growth will continue to settle.

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