A 2016 redux, or a turning point?

By many measures, the U.S. economy is solid. Payroll employment continued to post strong gains in January, and despite a recent rise, unemployment remains below most estimates of its longer-run normal rate. Although official estimates of GDP for 2018Q4 are not yet available, most projections put 2018(Q4/Q4) real GDP growth at around 3 percent. At the same time, inflation has moderated since mid-year and now appears to have been running slightly below 2 percent.

However, beginning in mid-September a combination of some softer U.S. economic data (particularly in housing), a marked slowdown in foreign economies (notably China), ongoing trade tensions between the U.S. and China as well as other geopolitical instability led to a deterioration of consumer and business sentiment (see Figure 2) and a significant shift in financial markets. From then through the end of the year, credit spreads widened, equity indexes fell and volatility increased (see Figure 3).

With this backdrop, even though the policy actions and communications surrounding the December FOMC meeting were largely anticipated by markets, they were perceived as a sign that policymakers were not sufficiently attuned to the evolving environment. Hence, despite subsequent communications indicating that policy was more flexible than such perceptions, financial markets’ turbulence lingered with sizable declines in risk asset prices by year-end.

At its January meeting, with the reading of the U.S. economy somewhat complicated by a limited data flow due to the partial government shutdown, the FOMC communicated more explicitly that its policy approach would be flexible and data dependent. It also stated that taking into account recent global economic and financial developments and muted inflation pressure, it could be more patient in determining policy adjustments. The communications prior to and at the meeting,

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1 Figure 1 shows the latest NY Fed Staff Nowcast (interactive version [here](https://www.newyorkfed.org/). A summary of recent assessment of economic conditions is in the February NY Fed Staff’s “U.S. Economy in a Snapshot”.

appear to have somewhat calmed markets, but financial conditions remain tighter than they were in September.

The current situation bears similarities to the turbulence of financial markets during the summer of 2015 through early 2016. That turbulence as well appears to have originated at least partly from concerns about the U.S. and global outlooks, and featured widening of credit spreads, fall of long-term yields, decline in risk asset prices and increased volatility (see shaded areas in Figures 2 and 3). Meanwhile business sentiment declined, especially for manufacturers. Even though the median projections of the federal funds rate in the December 2015 SEP were consistent with the funds rate increasing 100bps over 2016, the FOMC would not raise the policy rate again until December 2016.

A number of commentators now assess the economic slowdown of 2015-16 as a ‘manufacturing recession’ that didn’t extend to the whole economy. One interpretation of financial developments during this period was that financial markets were alerting to that. How should we read these signals today?

**Related NY Fed Staff Analyses**

Our internal analyses show that market signals are relevant for both the point projection and the forecast distribution of GDP growth. While none of these analyses is thus far predicting doom, they suggest that the tightening of financial conditions since the fall may shave off 30 to 50 basis points from growth in 2019Q1.

In a DSGE model with financial frictions, a tightening of financial conditions is captured by the widening of corporate credit spreads. The model allows one to interpret the source of widening spreads in terms of structural shocks, primarily: a credit risk shock, that reflects tightening of credit to firms and has a moderate impact on output growth; and a safety/liquidity shock that contracts both consumption and investment resulting in a more detrimental impact on growth (see Figure 4). Comparing the tightening of financial conditions in mid-2015 with that in the fall of 2018 reveals that the shocks behind the widening of spreads in both episodes have similar nature: the shock with the largest impact on the spreads is the one of a relatively benign nature (see Figure 5).

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3 Note that the December SEP shows that FOMC participants had at that time already lowered their expected path for the federal funds rate target.

Other NY Fed staff research\(^5\) has shown that a deterioration of financial conditions indicates increased downside risks to economic growth, as it lowers the left tail of the conditional distribution of GDP growth (see Figure 6).

**Discussion Items**

- Does the recent financial markets turbulence signal a future significant downturn, or represent an “overreaction” to slower growth prospects?

- Do these developments represent ‘crosscurrents’ that could be addressed with a prudent policy that puts further tightening on hold in the near term, as was the case in 2016?

- What data are most important for detecting whether the economy is approaching a turning point? What role is the global slowdown playing, with the associated tightening of policy space abroad?

Figure 1 – New York Fed Staff Nowcast

2018:Q4 GDP Growth

- Percent (annual rate)
- 4.5
- 3.5
- 2.5
- 1.5
- 0.5
- -0.5
- -1.5
- -2.5
- Aug 24, 2018
- Sep 07
- Sep 28
- Oct 05
- Oct 26
- Nov 08
- Nov 20
- Dec 02
- Dec 23
- Dec 31
- Jan 11, 2019
- Jan 25
- Feb 08
- Feb 22
- Nowcast: 2.4
- Latest: February 08

2019:Q1 GDP Growth

- Percent (annual rate)
- 4.5
- 3.5
- 2.5
- 1.5
- 0.5
- -0.5
- -1.5
- -2.5
- Nov 23, 2018
- Dec 07
- Dec 21
- Jan 04, 2019
- Jan 18
- Feb 01
- Feb 15
- Mar 01
- Mar 15
- Mar 29
- Apr 12
- Apr 26
- Nowcast: 2.2
- Latest: February 08

Legend:
- Red: Housing and construction
- Yellow: Manufacturing
- Blue: Surveys
- Green: Retail and consumption
- Light blue: Income
- Pink: Labor
- Greenish-blue: International trade
- Gray: Others

<table>
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<th>Update</th>
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<th>Nowcast GDP Growth</th>
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<th>2019:Q1</th>
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<tr>
<td>Jan 25 8:05 AM Jan 30</td>
<td>ADP nonfarm private payroll employment</td>
<td>Jan</td>
<td>Levelchg. (thousands)</td>
<td>198.4</td>
<td>213.0</td>
<td>0.072*</td>
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<td>New single family houses sold</td>
<td>Nov</td>
<td>MoM % chg.</td>
<td>3.01</td>
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<td>Civilian unemployment rate</td>
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<td>Ppt. chg.</td>
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<td>0.100</td>
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<td>0.069*</td>
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<td>All employees: Total nonfarm</td>
<td>Jan</td>
<td>Levelchg. (thousands)</td>
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<td>56.6</td>
<td>-0.000</td>
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<td>Merchant wholesalers: Inventories: Total</td>
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<td>MoM % chg.</td>
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<td>0.259</td>
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<td>Value of construction put in place</td>
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Feb 01
| 10:00 AM Feb 05 | ISM nonmanufacturing: NMI composite index | Jan | Index | 57.8 | 66.7 | -0.000 | -0.000 | 0.000 | -0.000 | 0.016 | -0.018 |
| 8:30 AM Feb 06 | Exports: Goods and services | Nov | MoM % chg. | 1.04 | -0.619 | 0.039 | -0.065 | 0.043 | -0.071 | 0.031 | -0.120 |
| 8:30 AM Feb 06 | Imports: Goods and services | Nov | MoM % chg. | 1.05 | -2.88 | 0.031 | -0.123 | 0.031 | -0.120 | 0.031 | -0.111 |
| Feb 08 | Data revisions

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- Red: Housing and construction
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- Blue: Surveys
- Green: Retail and consumption
- Light blue: Income
- Pink: Labor
- Greenish-blue: International trade
- Gray: Others
Figure 2 – Consumer and Business Confidence Measures

(a) Consumer Survey Measures

- University of Michigan Consumer Sentiment
- Conference Board Consumer Confidence

Source: University of Michigan, Conference Board

(b) Business Survey Measures

- ISM Manufacturing PMI Composite Index (Left Axis)
- Optimism Index (Right Axis)

Source: Institute of Supply Management, National Federation of Independent Business

(c) Industrial Production Index

Source: Federal Reserve Board

(d) Global Composite PMI

Source: Markit Economics
Figure 3 – Financial Conditions

(a) US Equity Market Index and Volatility

- S&P 500 (Left Axis)
- VIX (Right Axis)

Source: Standard & Poor's via Haver Analytics

(b) Long-Term Treasury Yields

- 10-Year Treasury Bond Yield
- 5-Year Treasury Bond Yield
- Federal Funds Target Rate

Source: Federal Reserve Board

(c) Corporate Spreads

- Moody’s Baa Corporate Spread
- Moody’s Aaa Corporate Spread
- Federal Funds Target Rate

Source: Federal Reserve Board
Note: Spreads are with 20-year Treasury yield.

(d) Exchange Rate

- Trade-Weighted US$ Broad Index (Left Axis)
- Trade-Weighted US$ Major Currencies Index (Left Axis)
- Federal Funds Target Rate (Right Axis)

Source: Federal Reserve Board
Figure 4 – DSGE Model Impulse Responses

(a) Safety/Liquidity Shock

(b) Credit Risk Shock
Figure 5: DSGE Model Forecast Decompositions

BAA - 10yr Treasury Spread; 2019- Q1 Semi v. 2018- Q3

GDP Growth; 2019- Q1 Semi v. 2018- Q3

BAA - 10yr Treasury Spread; 2016- Q1 v. 2015- Q2

GDP Growth; 2016- Q1 v. 2015- Q2
Figure 6 – Vulnerable Growth

(a) Quantile Regression: NFCI

(b) Predicted Distribution of GDP Growth

Sources: FRED, Federal Reserve Bank of St. Louis; authors’ calculations.

Notes: OLS is ordinary least squares; NFCI is the Chicago Fed’s National Financial Conditions Index.

Note: The shaded areas correspond to different confidence intervals around the median; the lightest gray corresponds to [5, 95] percentile interval, the median gray to [10, 90] percentile interval, and the dark gray to the [25, 75] percentile.