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U.S. ECONOMY

Slowing Global Economy Raises Expectations Fed Will Cut Rates This Year

Soft manufacturing data and falling Treasury yields follow slower-than-expected services growth

Fed Chairman Jerome Powell said this week that "the limited data that we have do show a slowdown" but that central bank has "a positive outlook for this year." **PHOTO:** BRENDAN SMIALOWSKI/AGENCE FRANCE-PRESSE/GETTY IMAGES

By Paul Kiernan

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WASHINGTON—Fresh data suggesting the global slowdown may be intensifying caused a widely watched bond-market indicator to flash its first recession warning since 2007 on Friday, raising expectations the Federal Reserve may cut interest rates by year's end to counter the economic headwinds.

The developments represent a stark turnaround from December, when Fed officials raised rates amid strong growth, tight labor markets and steady inflation. Since then, the picture has been muddied by choppy U.S. economic data, a record-length government shutdown, global trade tensions and the U.K.'s unresolved Brexit plan.

The latest signs of trouble came Friday when a report showed factory output in the eurozone fell in March at the fastest pace in six years, while a measure of U.S. manufacturing activity slid to its lowest level in almost two years. Those data followed a Thursday report showing U.S. services-sector revenues slowed more than previously thought in the fourth quarter, prompting several economists to lower their growth estimates.

The drumbeat of unsettling news Friday drove the yield on 10-year Treasury notes below that of three-month bills for the first time since 2007. That situation, known as an "inverted" yield curve, has preceded every U.S. recession since 1975 and is viewed by many investors as a reliable predictor of downturns.

Traders in futures markets by the end of the day Friday had put a 58% chance of at least one Fed rate cut by the end of this year, up from 11% a month ago, according to CME Group.

"It's very clear that the economy at this point is losing momentum," said Lindsey Piegza, chief economist at Stifel. "I think the risk of turning negative is rapidly rising."

Most economists still think the economy is on solid footing, as does the Fed. On Wednesday, policy makers at the central bank projected U.S. gross domestic product would expand 2.1% this year and 1.9% in 2020, down from 3.1% last year but slightly faster than its long-term potential.

Chairman Jerome Powell said at a press conference Wednesday that the Fed has "a positive outlook for this year, a favorable outlook for this year," underpinned by rising wages, low unemployment and high levels of household confidence.

But Mr. Powell also pointed to a number of risks, such as slowing growth in Europe and China and uncertainty surrounding U.S. trade policy. While fiscal-stimulus measures shielded the U.S. economy last year from such headwinds, the effects of 2017 tax cuts and 2018 spending increases are fading.

Further clouding the outlook, the U.S. government shutdown in December and January delayed the release of most official economic data, making it hard to gauge how much steam the economy has lost.

"The limited data that we have do show a slowdown," Mr. Powell said Wednesday.

But he stressed it wasn't clear which direction the Fed's next interest-rate move should be. "We're going to watch carefully and patiently as we allow events to evolve, and when they do clarify, we will act appropriately."

An additional risk is that the Fed's four interest-rate increases in 2018—the last of which occurred in December—may not yet have been fully felt. It can take many months for such policy changes to work their way through financial markets and the broader economy.

"Even though the Fed has stopped raising interest rates, it's possible we'll have some impact that we'll be feeling for a while in terms of slowing the economy," said Danny Bachman, an economist at Deloitte Services LP.

Given the latest data and signals from the bond market, some said the Fed should look to reduce interest rates to keep the U.S. from following its trading partners into slowdown.

"To prevent recession next year, the Fed should cut rates this year by enough to keep the yield curve" from inverting, Marc Sumerlin of Evenflow Macro, a policy analysis firm, wrote to clients Friday. "Right now, one rate cut is justified, but a growing global downturn would justify more."

After a blockbuster year for U.S. companies, analysts are expecting corporate earnings to moderate in 2019. FedEx Corp. , whose shipping business is often seen as a bellwether for the broader economy, cut its outlook this week for the second consecutive quarter, citing weaker macroeconomic conditions and global trade trends.

A yield-curve inversion is considered a warning sign because it implies bond investors think a weakening economy will require interest rates to be lower in the future than where the Fed currently has set them. While the yield curve has inverted before every recession in recent decades, it has also inverted without a recession following until several years later, and economists think some changes—in particular central bank bond-buying—may have muted its signal.

St. Louis Fed President James Bullard said in an interview Friday that the inversion was "mildly concerning," adding, "I'm hopeful this is just temporary." A sustained inversion, he said, would worry him considerably.

Adam Slater, a lead economist at Oxford Economics, said the indicator isn't foolproof, but isn't something that can be ignored, either.

"Clearly the bond markets are taking the view that not only might we not have any more rate-increases in the States, but we might be thinking about policy easing again in the not-so-distant future," Mr. Slater said.

Fed economists have developed a variant of the yield curve that filters out the effects of central bank bond-buying, thus generating fewer false recession alarms. It compares the three-month Treasury-bill yield today to where the market expects it to be in 18 months. That spread is now negative, according to JPMorgan , corroborating the yield curve's warning sign.

In a survey of economists this month by The Wall Street Journal, the vast majority of respondents predicted the next recession would begin in either 2020 or 2021. The odds of the U.S. falling into recession in the next 12 months were placed at 25%, up from last year but little changed from the prior survey.

Since the last recession ended, the world economy has suffered two defined slowdowns, economists say. The first, in 2011 and 2012, was driven by the European debt crisis and fiscal tightening by congressional Republicans in the U.S. The second, in 2015 and 2016, was characterized by low commodity prices that hit emerging-market economies especially hard.

—Michael S. Derby contributed to this article.

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