

# Economic Insights: Is the worst over?

## Monthly update: February 2019

Commentary by Bob Baur, Robin Anderson, and the Economic Committee

U.S. recession worries of late last year came to naught. Yes, retail sales and housing starts collapsed in December as the stock market swooned and part of the government shut down. Pundits worried that fourth quarter growth would plunge but it didn't. Growth did moderate from the super-strong summer pace, though it was solid at 2.6% annualized over the prior quarter. Capital spending kept up its terrific pace of 6.2%, where business spending on intellectual property—including software and research development—soared 13.1% for the third double-digit gain in four quarters. Consumer spending growth stayed at a healthy 2.8% pace. Since the holidays, business and consumer sentiment improved with a monster stock market rally.

**More cooling.** Still, U.S. economic growth may fade more in the first quarter as global slowing drags industrial activity lower. Manufacturing output contracted in January, and a key business survey fell to the lowest level in two years. Investment may soften, too, as core capital goods orders, a leading indicator, declined four of the last five months. Survey-based capital spending plans weakened. Inventories surged the last two quarters and may detract from growth this quarter.

**Vigorous growth in 2019.** Still, for this year, growth will likely stay in the 2.5% range. Household fundamentals remain extremely healthy—wage growth is accelerating, and record job openings suggest job gains will stay robust. Consumer spending growth should remain around 3% or more. We look for housing to pick back up after the fade of a one-time hit from the change in state and local tax deductibility in certain states.

## Interest rate outlook: historic policy change?

The Fed may be opening the door to what could be its biggest policy change since Paul Volker moved focus to the money supply from interest rates in 1978. Fed members are considering changing from a simple 2% inflation target to aiming for average inflation of 2% indefinitely. That would be a massive change, as the Fed could allow inflation to run above target for a long time to make up for whatever period it stayed below target. In other words, the Fed might relax while the economy runs hot and wages surge to make up for the last decade or so when inflation stayed well below target. Fed academics suggest this strategy might make sense and their policy review will continue throughout most of this year.

**Tame expectations.** We look for the Fed to keep its funds rate on hold at least through mid-year. Fed Chair Jerome Powell and others emphasize patience in normalizing policy—that's a big reversal from December's hawkishness. Besides, even with U.S. wages accelerating, we expect inflation to be tame this year. The Fed may indeed stay on hold in 2019 as the fed funds rate is likely near neutral, which neither slows nor boosts economic growth. And without further signs of too much exuberance, distress, or inflation, there's little reason for the Fed to stray from neutral.

**Whither long rates?** Before the last few days, the bond market hadn't exhibited the same enthusiasm as investors in the monster stock market rally that kicked in after Christmas. Yields on 10-year U.S. treasury bonds collapsed to 2.55% early this year and stayed weak until pushing up to 2.75% on March 1. Yields on 10-year German bunds and Japanese government bonds (JGB) behaved similarly, moving up the last of February from super-low levels. While this may only be a bounce from severely oversold levels (JGB yields were -0.04% at the recent low), it could be the bond market signaling an end to the global growth scare. If long yields continue to rise faster than short yields (i.e., a steeper yield curve), that would suggest that better growth is on the way.

We'd thought there would be another downdraft in long-term interest rates by mid-second quarter as earnings guidance and reports get downgraded from slower world growth. Recent higher yields may only mean that bond investors are getting caught up in the exuberance of the colossal post-Christmas stock market surge. We'd still position for lower yields until May, after which we think long yields will move higher into year-end.

Downdraft or no, long-term safe-haven yields must surely push higher as central banks continue to bring policy rates toward normal. Nominal U.S. growth is currently in the 4% to 5% range and expected to stay there, absent recession. That should ultimately propel 10-year U.S. treasury bond yields up to that zip code sometime after 2020.

Mortgage rates are down. Household formation is looking up. Job growth for twenty-somethings is strong. Wage gains have been the best in lower wage occupations. Some housing data is perking up, too—pending home sales, homebuilder confidence, building permits, and mortgage applications. Investment may lighten a bit from its fast 7.0% pace of 2018. But decent revenue growth, 100% deductibility of capital spending, and faster wage gains should promote healthy investment growth.

**All systems go.** If this good growth continues through July, it will be the longest economic expansion in U.S. history. After that? Who knows, but signs of trouble from our proprietary Recession Dashboard are limited. Household debt as a portion of U.S. output is far below the highs of the last decade. Profit growth is healthy and inventories aren't a problem. The Federal Reserve (Fed) is no longer aggressive with rate hikes, and inflation is quiescent. We're not seeing gross overvaluation in the stock market. No surge in interest rates. More people are coming back into the labor force from the sidelines. Faster wage growth, along with more hours worked, means total household income is on the rise—near a robust 5.5% pace. The imbalances or forces that typically bring on a recession just aren't there. This economic expansion could last longer than anyone thinks possible.

## Market outlook: Is the monster rally over?

Last month, this analyst suggested the odds favored another market downdraft, something approaching December's lows. Didn't happen; stocks kept roaring higher. The S&P 500 Index soared 6.6% in December, 7.9% in January, and 3.0% in February, for a total 18.4% compound gain since Christmas. That's an amazing run. Of the 46 world equity indices we track, none—not even one—had a negative return since Christmas. Well over half had double-digit returns.

Can it continue? Is this the beginning of another long bull market? Doubtful. Central banks want to unwind the decade of suppressed interest rates and financial repression they oversaw. Stock and bond markets got used to that low-interest subsidy from central banks and the volatility in 2018 was the initial adjustment to that new monetary environment. In addition, world growth slowed in 2018 and the weakness persisted early this year. Markets are likely reflecting too much earnings optimism. Further, it often takes 12 to 18 months for the full impact of central bank tightening to become apparent. So, the 2018 Fed rate hikes and bond sales have not completely worked their way through the financial system.

We'd stay cautious a while longer. If the global slowdown really is over, then long-term yields should push higher and central banks become more aggressive. On the other hand, if growth continues to slow, then the renewed optimism in the stock market is misplaced. Either way, there's likely more downside risk and limited upside in the stock market. For bond investors, we continue to suggest short maturity, high-quality corporate bonds. For stock investors, defensive sectors like utilities, consumer staples, and healthcare would be the safest. With U.S. equities and the U.S. dollar likely over-owned after the dramatic outperformance of the last near-decade, non-U.S. equities and perhaps those in selected emerging markets would perform best.

**Long-term:** We may be close to the start of a radically new investment environment, one where real estate, value stocks, and commodities return to the fore after a decade of underperformance. It depends on wage growth. Notice the similarity of improving labor markets and a pickup in wage growth across major developed economies—U.S., U.K., Eurozone, and Japan. If this trend continues, central bank worries of deflation will evaporate, and inflation edges toward most countries' targets. Long-term interest rates will reflect a little more inflation premium, which is good for financials. Businesses may find some pricing power, which is good for value stocks. Developed-country stock markets may stay bound within a range for some time as interest rates gradually work their way to more normal levels. We'll discuss this more as time goes on.

## Economic update: lowdown on the slowdown

We think it's winding down. Yes, global growth slowed in 2018 and it's still braking a bit. China decelerated sharply but may pick up by mid-year. Idiosyncratic problems ranging from natural disasters and protests, to changing auto emission standards, dragged down activity in Europe and Japan. The U.S. economy resisted the weaknesses elsewhere, but first quarter growth is hiccupping. If official stimulus in China kicks in, world growth could pick up in the second half. Our forecasts for U.S. economic growth are in the tables at the end of the commentary. The 2020 forecasts assume no recession and a kind of steady state equilibrium of 2.25% to 2.5% growth.

**Europe, a trough in the slowdown:** European manufacturing activity remains weak as industrial output declined three of the last four months. Surveys signal contraction. The services side of the Eurozone economy, however, is better. Since the peak of last year, surveys of service sector businesses declined, but not as dramatically as in manufacturing. Consumer confidence fell but remains mostly solid, likely because the labor market is holding up well. The jobless rate keeps dropping, now at 7.8%, down 0.8% from early 2018 and the

lowest in a decade. This good job news is broad-based throughout the Euro area. That's why wage gains are picking up and household consumption is driving growth. Retail sales in Germany rebounded sharply in January.

**Is the weakness ending?** It may be about over, as we expect Europe to rebound modestly the rest of the year. The European Central Bank will stay accommodative, likely changing its guidance to no rate hikes this year and restarting its bank lending program. China's fiscal stimulus may boost global trade in the second half, supporting Eurozone exports and manufacturing. A healthy labor market and better wage growth will boost consumer spending nicely. We look for 1% to 1.5% growth in 2019.

**Japan, the expansion continues:** Activity stays weak as exports plunged and industrial production contracted for a third straight month. Corporate profits declined in the fourth quarter as manufacturing companies feel the Chinese slowdown. Further, Japan is part of the global supply chain that's being disrupted by the trade dispute between the U.S. and China. U.S. auto tariffs loom for Japan and Europe as well. The labor market remains a bright spot with an incredibly low jobless rate of 2.5%. The ratio of job openings to the number of applicants is 1.63, around the highest since 1974, so there are plenty jobs for workers. However, the growth risk is likely on the downside; retail sales are struggling and a drop in profits may impact capital spending. Still, we look for 1% growth in 2019.

**China, a pause in the structural deceleration:** Activity in China may be stabilizing. Our proprietary growth indicator, based on broad range of hard data, improved somewhat. Total social financing accelerated sharply in January, although there may be some noise associated with the Chinese New Year. Exports rose significantly but may be biased by the holiday. Business surveys were mixed; the official manufacturing index fell further while the private Caixin survey rose a bit. Both still show contraction. Surveys of service sector businesses rose handily, suggesting stimulus has started to stabilize growth already. We look for activity to pick up modestly in the second half of 2019.

**India, other emerging markets:** Easier financial conditions, a pickup in Chinese growth, and a weaker U.S. dollar should translate into less risk for emerging markets this year versus 2018. Emerging market currencies did weaken in February after surging the prior month. The Fed will stay on hold at least through mid-year and a pickup in global growth should advance the currencies. Stable to higher commodity prices should help, too. Risks will vary by country. For example, Fitch downgraded Pemex, the state-owned Mexican oil company, at the end of January, and bonds from South Africa may be in peril of a downgrade, too. Growth slowed in India in the fourth quarter to 6.6%. With the manufacturing survey index picking up to a nice 54.3, and the central bank liable to cut rates more, growth should move up above 7% as 2019 progresses.

Baseline Economic Forecasts for 2019-2020

A. Growth in Real GDP - Qtr-Qtr (% Change, Annualized):

	1st Quarter 19 Forecast		2nd Quarter 19 Forecast		3rd Quarter 19 Forecast		4th Quarter 19 Forecast		2017 Actual		2018 Actual	
Real GDP	18,869.8	1.8%	18,987.0	2.5%	19,104.7	2.5%	19,215.7	2.3%	18,050.7	2.2%	18,571.3	2.9%
Personal Consumption Expenditures	13,152.2	3.4%	13,248.9	3.0%	13,336.4	2.7%	13,418.6	2.5%	12,558.7	2.5%	12,890.6	2.6%
Durable Goods	1,718.4	4.0%	1,735.3	4.0%	1,750.3	3.5%	1,763.3	3.0%	1,577.9	6.8%	1,667.4	5.7%
Non-Durables	2,965.1	3.5%	2,994.3	4.0%	3,020.1	3.5%	3,042.5	3.0%	2,822.0	2.1%	2,901.0	2.8%
Services	8,494.7	2.4%	8,545.2	2.4%	8,591.8	2.2%	8,638.7	2.2%	8,184.5	2.0%	8,359.3	2.1%
Gross Private Domestic Invest.	3,458.1	-1.9%	3,475.2	2.0%	3,500.9	3.0%	3,525.0	2.8%	3,196.6	4.8%	3,387.2	6.0%
Bus. Fixed Invest.	2,788.9	3.1%	2,806.5	2.5%	2,827.7	3.1%	2,852.2	3.5%	2,538.1	5.3%	2,714.8	7.0%
Structures	543.8	2.0%	546.5	2.0%	550.5	3.0%	554.6	3.0%	517.5	4.6%	543.2	5.0%
Equipment	1,299.6	1.0%	1,302.9	1.0%	1,309.3	2.0%	1,319.0	3.0%	1,183.7	6.1%	1,271.9	7.5%
Intellectual Property Products	950.1	5.0%	961.8	5.0%	972.4	4.5%	983.2	4.5%	841.1	4.6%	905.6	7.7%
Residential Invest.	606.8	3.0%	611.3	3.0%	615.8	3.0%	620.4	3.0%	611.1	3.3%	609.6	-0.2%
Change in Inventory	40.0	-	35.0	-	35.0	-	30.0	-	22.5	-	45.1	-
Net Exports	-968.6	-	-974.1	-	-978.4	-	-981.9	-	-858.7	-	-914.1	-
Exports	2,570.9	3.0%	2,590.0	3.0%	2,608.6	2.9%	2,624.7	2.5%	2,450.1	3.0%	2,546.6	3.9%
Imports	3,539.6	2.8%	3,564.1	2.8%	3,587.0	2.6%	3,606.6	2.2%	3,308.7	4.6%	3,460.6	4.6%
Gov't Purchases of Goods & Services	3,205.5	1.3%	3,214.4	1.1%	3,223.4	1.1%	3,231.4	1.0%	3,130.4	-0.1%	3,177.8	1.5%
Federal	1,244.1	1.5%	1,248.2	1.3%	1,252.2	1.3%	1,255.3	1.0%	1,196.4	0.7%	1,227.8	2.6%
National Defense	757.4	1.5%	760.2	1.5%	763.1	1.5%	765.0	1.0%	713.8	0.7%	738.2	3.4%
Non-Defense	486.1	1.0%	487.3	1.0%	488.5	1.0%	489.7	1.0%	481.9	0.8%	489.1	1.5%
State & Local	1,959.9	1.0%	1,964.8	1.0%	1,969.6	1.0%	1,974.6	1.0%	1,932.3	-0.5%	1,948.9	0.9%
Final Sales of Dom. Product	18,810.8	2.9%	18,933.0	2.6%	19,050.8	2.5%	19,166.7	2.5%	17,769.1	0.9%	18,507.1	4.2%
Final Sales to Dom. Purchasers	19,752.8	3.2%	19,880.5	2.6%	20,002.6	2.5%	20,122.0	2.4%	18,550.0	0.9%	19,385.4	4.5%
year-over-year	3.0%		2.6%		2.4%		2.3%					
	1st Quarter 20 Forecast		2nd Quarter 20 Forecast		3rd Quarter 20 Forecast		4th Quarter 20 Forecast		2019 Forecast		2020 Forecast	
Real GDP	19,326.2	2.3%	19,437.4	2.3%	19,549.3	2.3%	19,662.0	2.3%	19,044.3	2.5%	19,493.7	2.4%
Personal Consumption Expenditures	13,503.5	2.6%	13,589.0	2.6%	13,675.1	2.6%	13,761.7	2.6%	13,289.0	3.1%	13,632.3	2.6%
Durable Goods	1,778.5	3.5%	1,793.9	3.5%	1,809.4	3.5%	1,825.0	3.5%	1,741.8	4.5%	1,801.7	3.4%
Non-Durables	3,065.1	3.0%	3,087.8	3.0%	3,110.7	3.0%	3,133.8	3.0%	3,005.5	3.6%	3,099.4	3.1%
Services	8,685.8	2.2%	8,733.2	2.2%	8,780.9	2.2%	8,828.8	2.2%	8,567.6	2.5%	8,757.2	2.2%
Gross Private Domestic Invest.	3,556.2	3.6%	3,587.7	3.6%	3,619.6	3.6%	3,651.7	3.6%	3,489.8	3.0%	3,603.8	3.3%
Bus. Fixed Invest.	2,880.4	4.0%	2,908.8	4.0%	2,937.5	4.0%	2,966.5	4.0%	2,818.8	3.8%	2,923.3	3.7%
Structures	560.1	4.0%	565.6	4.0%	571.2	4.0%	576.8	4.0%	548.9	1.0%	568.4	3.6%
Equipment	1,332.0	4.0%	1,345.2	4.0%	1,358.4	4.0%	1,371.8	4.0%	1,307.7	2.8%	1,351.9	3.4%
Intellectual Property Products	992.9	4.0%	1,002.7	4.0%	1,012.5	4.0%	1,022.5	4.0%	966.9	6.8%	1,007.6	4.2%
Residential Invest.	623.4	2.0%	626.5	2.0%	629.7	2.0%	632.8	2.0%	613.6	0.6%	628.1	2.4%
Change in Inventory	30.0	-	30.0	-	30.0	-	30.0	-	35.0	-	30.0	-
Net Exports	-995.6	-	-1,009.4	-	-1,023.4	-	-1,037.6	-	-975.8	-	-1,016.5	-
Exports	2,637.8	2.0%	2,650.8	2.0%	2,664.0	2.0%	2,677.2	2.0%	2,598.6	2.0%	2,657.5	2.3%
Imports	3,633.3	3.0%	3,660.3	3.0%	3,687.4	3.0%	3,714.8	3.0%	3,574.3	3.3%	3,674.0	2.8%
Gov't Purchases of Goods & Services	3,239.5	1.0%	3,247.5	1.0%	3,255.6	1.0%	3,263.7	1.0%	3,218.7	1.3%	3,251.6	1.0%
Federal	1,258.4	1.0%	1,261.6	1.0%	1,264.7	1.0%	1,267.9	1.0%	1,249.9	1.8%	1,263.2	1.1%
National Defense	766.9	1.0%	768.8	1.0%	770.7	1.0%	772.6	1.0%	761.4	3.1%	769.7	1.1%
Non-Defense	491.0	1.0%	492.2	1.0%	493.4	1.0%	494.6	1.0%	487.9	-0.2%	492.8	1.0%
State & Local	1,979.5	1.0%	1,984.4	1.0%	1,989.3	1.0%	1,994.3	1.0%	1,967.2	0.9%	1,986.9	1.0%
Final Sales of Dom. Product	19,277.2	2.3%	19,388.4	2.3%	19,500.4	2.3%	19,613.1	2.3%	18,990.3	2.6%	19,444.8	2.4%
Final Sales to Dom. Purchasers	20,246.2	2.5%	20,371.3	2.5%	20,497.2	2.5%	20,624.0	2.5%	19,939.5	2.9%	20,434.7	2.5%
year-over-year	2.4%		2.4%		2.3%		2.3%					

Source: U.S. Dept. of Commerce, Bureau of Economic Analysis: Principal Global Investors

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