Economic Insights

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

Topic summaries:

- **U.S. job market is hot:**
  Growth is robust, wage gains are improving, and workers are streaming back into the workforce. With low working-age male participation, some slack is still left. Good job growth will persist; wage gains will exceed 3% this year.
- **Stock and bond markets:**
  Equity market struggles may continue over the summer, but robust world growth, especially in the United States, should promote an equity upturn late year, perhaps into 2019. Use it to reduce risk.
- **Interest rates:**
  Long-term yields may stay range-bound a while longer, but robust global growth means interest rates may soon start another wave higher.
- **Regional economic updates:**
  U.S. growth will stay robust well into 2019; India is similarly a growth outlier. Growth has mildly decelerated in the rest of the world and that will continue into 2019.

For the month of July 2018

U.S. job market is hot

The headline of the U.S. payroll report for July showed weakness. Every news website, business show, and random twitter account had to have an interesting job statistic to quote. The three top stats were solid: 157,000 jobs added; a tick down in the jobless rate to 3.9%; and average hourly earnings kept edging higher, up 2.74% over the prior year on a three-month smoothed basis, the fastest pace of the cycle. But, details of the report show a labor market on fire.

The 157,000 new jobs estimated by the Bureau of Labor Statistics for July was slightly below consensus expectations. But, that fails to note several items: huge upward revisions to May and June jobs of 59,000; the unfortunate loss of an unverified 33,000 Toys R Us jobs because the retail firm closed; a surprising loss of 22,000 jobs in local government, likely a result of difficult seasonal adjustment of education jobs. So, the headline number was much better than it looked.

Still slack:

The closely-watched jobless rate, at 3.9%, is near the lowest in decades. The jobless rate for workers with less than a high school diploma is the lowest on record. The wider measure of underemployment that includes everyone who wants a full-time job was 7.5%, the lowest since May 2001. There are more job openings than unemployed. Businesses are relaxing hiring standards and offering training to enlarge the applicant pool. As a result, workers are streaming back into the labor force faster than Baby Boomers are retiring. The employment to population ratio, at 60.5%, is the high for the expansion. The participation rate prime-working-age males, aged 35 to 54, has been rising, but is still well below past cycles. So, yes, the job market is tightening, but there are still plenty of workers to be enticed back into the workforce.

> The world expansion should continue well into 2019, albeit at a slower pace. Financial markets may not fare as well.
>
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Tariffs:

Trade issues haven't seemed to impact payrolls. Manufacturing employment rose 37,000 in July, even more than the average monthly gain of 27,000 over the last 12 months. That's the best string of new manufacturing jobs since 1995, and, at 2.6% above the prior year, is the biggest jump since 1984. Yes, those companies would rather pay less for hot rolled steel than more from added tariffs. But, so far, tariffs haven't dented expansion plans.

Wages:

Pundits worry about slow wage growth; they just need to be patient. Wages are rising more slowly than in past cycles, but inflation is low and wage gains are definitely climbing. The Employment Cost Index rose 2.8% over the prior year, the best of the cycle. A near-record portion of small businesses forecast higher compensation; consumers have similar expectations. Business confidence is healthy enough to bring those to fruition. So, the wage uptrend should intensify.

Implications:

Looking ahead, the job market should stay strong. Temp jobs exploded in July, up 27,000, and are up a vigorous 3.3% over the last year, a reliable signal of future robust job growth. Besides, profits are excellent; productivity gains are recovering; and businesses need workers. Wage growth should exceed 3% by year-end and keep consumption strong. Robust growth and the super-healthy job market are reasons why the Federal Reserve (Fed) is hiking. The dynamic economy should foster another stock market rally.

Stock and bond markets

Year-to-date returns through July for U.S. stock indices were decent: a total return for the Dow Jones Industrial Index of 4.1% and 6.5% for the S&P 500 Index, the latter propelled by over 12% price gains in the consumer discretionary and tech sectors. The price return of the Nasdaq Composite was a spectacular 11.1%. U.S. small caps rose nicely too, with the Russell 2000 Index up 8.8%. Other world indices did not fare as well. The MSCI World ex United States Index fell 3.2%; and the MSCI Emerging Market Index dropped 6.1%.

U.S. interest rates rose over 0.5% this year, so bond investors had losses, except in high yield or short maturities. The U.S. and Global Bond Aggregate Indices each lost about 1.5% for the first seven months. The Barclay's Long-Term U.S. Treasury Index lost 4.4%. Oil was a big commodity winner, up low double-digits in price. Broad commodity indices were flat, and copper lost 14.2%, aftereffects of decelerating world growth.

Equity outlook:

Stock investors should be cautious for the summer. Profit estimates are soaring, now expecting 25% annual gains through the end of 2018. This may set the stage for disappointment from U.S. dollar strength or rising wage and credit costs. The S&P 500 Index has followed a steep, narrow uptrend since the first of April, but the profit-taking that began near the January highs may continue over the summer. Trade issues with China and the United States seem to be escalating and could be a short-term negative. The U.S. dollar's refusal to weaken could bring another round of turmoil in emerging market assets, which would bleed into developed country stocks. An August dip would favor defensive sectors like utilities, health care, and real estate.

World stock indices will likely recover from an August downdraft to make another run at the January highs and maybe beyond. U.S. growth stocks had significant weakness the last few days of July but may not be enough to inhibit their leadership for a late 2018 rally. That upturn, if it comes, should be used by investors to reduce risk in their portfolios and preserve capital. Two-year U.S. treasury yields above 3%, and ten-year yields above 3.5%, will likely bring trouble and turmoil to world stock markets.

The key to the long stock uptrend since March 2009 was the fall in interest rates and the cost of debt. Robust growth is pushing U.S. long-term yields back to more normal levels, bringing disruption to equity and bond investors. This suggests that stock markets may be in the early stages of a long topping process. As a result, good financial returns over the next few years might be very hard to find; capital preservation will be important.

Interest rates

Range bound:

Developed-country interest rates have fluctuated in a narrow range for a while. Yields on 10-year Japanese government bonds (JGBs) have not been far from 0.0% for two years, given the Bank of Japan's (BOJ) policy target. Yields on 10-year German bunds have varied between 0.3% and 0.5% since mid-May. 10-year yields on U.S. Treasury bonds have consolidated between 2.8% and 3.1% since May. Yields on two-year U.S. Treasury bonds have risen sharply over the last year. U.S. rate history is shown below.

Interest Rates

	12/31/2015	12/31/2016	12/29/2017	05/17/2018 (High)*	09/07/2017 (Low)*	08/03/2018 Current
FFR**	0.5%	0.75%	1.5%			2.00%
2-year	1.05%	1.19%	1.88%	2.56%	1.27%	2.64%
10-year	2.27%	2.44%	2.41%	3.11%	2.04%	2.95%
10-2 spread	1.22%	1.25%	0.53%	0.55%	0.77%	0.31%
30-year	3.02%	3.07%	2.74%	3.25%	2.66%	3.09%

*12-month high and low, based on the 10-year Treasury bond high and low over the prior 12 months
**Upper bound on the range of the fed funds rate
Source: Bloomberg

Over time, theory would suggest that yields on long-term U.S. bonds would trade moderately near the pace of nominal growth on a year-over-year basis. Down-pressure on yields by the extraordinary policy of developed-country central banks kept yields below that natural level since 2010. As the policy effects gradually recede, long-term yields should push higher again. When? Maybe in the fall.

10-year U.S. Treasury bond yields have kept a narrow range for three or six months depending on how one counts. The last consolidation phase from December 2016 to September 2017 took nine months. This suggests any upside breakout for yields is a few months away and might coincide with higher German yields as the European Central Bank (ECB) lessens its accommodation. One might also infer from the weakness in financial stocks and commodity prices, plus large speculative short positions in treasury bond futures, that yields might work lower first, to 2.6%. But, we'd look for a third wave higher to perhaps 3.5% later this year once the uptrend restarts. Those yields would be a headwind for stocks, so yields might not stay high for long.

Short rates:

Unless the stock market weakens significantly, the Fed will raise the fed funds rate (FFR) in September and likely again in December. With inflation low and growth slowing modestly, one more FFR hike in March 2019 should cause the Fed to pause and reconsider its neutral rate view. There could be market turbulence by that time, which might keep the Fed from tightening further. Our forecasts below presume no significant stock market downdraft in 2019, not necessarily a safe assumption.

Interest Rates	Year-end 2018	Year-end 2019
Federal Funds	2.38%	2.88%
2-Year UST Yield	2.5%-2.75%	2.75%-3.25%
10-Year UST Yield	3.0%-3.25%	3.0%-3.25%
2-10 Year Spread	0.25%-0.5%	0.0%-0.5%

Investment implications:

Higher interest rates into 2019 imply that investors with long-maturity bonds would face losses. And if turmoil hits stocks next year, credit stress will return so higher-quality corporate bonds would be best to weather the storm. Good bond returns may be hard to find next year; so, investors might consider whether the meager returns of two-year U.S. Treasury bonds at a 3% yield and ten-year Treasurys at 3.5% would be acceptable, given the safety of one's principal.

Regional economic updates

United States:

The United States may decelerate a bit from its spectacular second-quarter growth pace, but all signs point to 3% or more the rest of the year. Stellar consumer spending, a still lofty household savings rate, robust investment, and a hot labor market are keys to the outlook. Productivity growth, likely 2% or more last quarter, is picking up; that will sustain the trend of increasing wage gains and a faster pace of household purchases. Nominal growth in gross domestic product hit 5.4% over the prior year, the fastest since 2006. This implies that strong revenue and earnings growth will persist, supporting the stock market for a late year upturn from a weak first half. Even with the vigorous pace of activity, inflation pressures remain modest. So, the Fed can stay gradual with rate hikes, likely keeping volatility low for a while.

Housing activity has softened as fast rising home prices, higher mortgage rates, and lack of adequate supply has curtailed buyer interest. But, household formation is returning to historical levels; jobs for 25- to 34-year-olds are growing faster than the average; there is an outsized number of young adults still living at home. So, there is plenty of pent-up demand to bring more housing activity and perpetuate the uptrend in housing since 2009. Besides, construction jobs are rising at a fast 4.4% pace over the prior year, and homebuilder sentiment stays at a high level.

While trade tensions fill the headlines and are the first question investors ask at meetings, the uncertainty has not shown up meaningfully in household or business confidence, which is still healthy. This expansion will surely last past the end of June 2019 and make it the longest in U.S. history. There are also reasons to think it might even last longer.

Europe:

Real GDP growth in the Eurozone was only 1.4% in the second quarter, broadly the same as the first. That early year weakness might have been from lousy weather, but there were few one-off reasons for persistent softness. For 2018, 2% growth is still possible, but, it's harder to achieve after a limp first half. July business surveys have been mixed with modest deceleration interspersed with stabilization. Retail sales ended the second-quarter 2.3% annual rate above the first-quarter level with a robust rise in June. Wage growth is picking up and the job market is tightening, so consumer spending should propel better growth the rest of 2018.

With a heavy reliance on exports, trade remains a key risk to the region's economy and markets. The recent hiatus in tensions with the United States suggest there are reasons for optimism. The currency has fallen versus the U.S. dollar and will likely push lower to 1.12 dollars per euro to help the Eurozone's exporters. Inflation is edging higher; the jobless rate keeps falling; and business surveys are consistent with growth over 2%. If the expansion lasts another year, which is likely, it will be the longest on record for the Euro area.

China:

Key June data and July surveys of purchasing managers verify that growth in China is slowing. With fears of weak growth and sweeping U.S.-imposed trade tariffs, the yuan has depreciated rapidly since mid-June. To stave off the slowdown and deal with potential trade problems, officials have shifted to easing: tax and fee reductions for businesses and households, lower interest rates, quicker fiscal spending, and entreaties to banks to keep loans flowing. Growth could easily end the year in the lower 6% range. Beijing will likely do whatever it takes to keep growth near its unstated target of 6.5%.

Japan:

Japanese real GDP contracted in the first quarter, but a nice rebound to perhaps a 2.5% rate occurred last quarter. We still expect growth in the 1.0% to 1.5% range for the year. The Nikkei Japan Purchasing Manager Index modestly decelerated in July but remained firmly in expansion territory, a sign the first-quarter setback was a fluke. The labor market remains ultra-tight with 162 job openings per 100 job applicants and an incredibly low jobless rate of 2.4%, a big support for growth. Retail sales did jump last quarter but are still below the fourth-quarter level The BOJ committed to maintain its 0.10 overnight rate and 0.0% target for 10-year JGB yields for an extended period. A wider band for JGB yields to 0.2% should help financial institutions weather the policy. All this suggests the BOJ ultra-extraordinary monetary policy is far from ending.

Emerging markets:

A slowing China, trade war rhetoric, less-easy monetary policy, higher U.S. long-term bond yields, and a relatively strong dollar are hindrances for emerging market stocks, bonds, and economic growth. The pace of emerging market exports has decelerated modestly along with broader global growth. Copper prices and price indices of raw materials have stayed under pressure so far this year, another headwind for emerging markets. A still healthy world expansion, though, can provide somewhat of a cushion.

India:

India is an exception to the weakness in emerging markets. It was the hottest large economy in the first quarter with an outstanding 7.7% real growth in GDP over the prior year. That followed an almost as robust 7.2% surge in last year's fourth quarter. India endured plenty of uncertainty the last couple of years with a bank recapitalization, an overhaul of state sales taxes, and a sudden, drastic change in the physical currency to bring underground transactions into the open. Those changes set the stage for the healthy rebound underway. The stock market has validated the changes with the S&P BSE Sensex Index now well above its January high and a strong 67.6% rally to the peak from its low in February 2016.

Looking forward:

Global growth will likely continue its mild deceleration from last year even as the United States steams ahead. Several factors point to further slowing in 2019 and more volatility. Considerable divergence will remain between market expectations and the Fed's rate hike path; that discrepancy could lead to increased market turbulence. As the fed funds rate gets closer to 2.75% or 3% next year, higher borrowing costs may eat into economic growth as well as company earnings. Wage growth above 3% would weigh on corporate profits, albeit still supporting consumer spending. The ECB will have a new president by the end of next year, another source of uncertainty. At the same time, the ECB may begin to hike rates. Japan is also set to raise its sales tax in late 2019, a potential drag to growth in that country. The world expansion should continue well into 2019, albeit at a slower pace. Financial markets may not fare as well.

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