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V I E W P O I N T

THE ECONOMY

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GDP GROWTH RATE PEAKING

The U.S. Department of Commerce announced late last month that its third estimate for the 2Q18 GDP growth rate was 4.2%. This was flat with previous estimate but, as we had anticipated, sharply above the 1Q reading of 2.2%. We had argued that the first quarter was affected by non-fundamental seasonal factors, including winter storms across much of the country.

Growth was broad-based, including capital investments into Intellectual Products (+10.5%), Exports (+9.3%), Equipment (+4.6%) and the all-important Personal Consumer Spending (rebounded to 3.8% from 0.5% in 1Q). The segments that lagged were Housing and State & Local Government spending. The 2Q results benefited from tax cuts (which drove consumer spending) as well as concerns over tariffs (that drove sales for exporters).

A Long Run

Since the current economic expansion began in the fourth quarter of 2009, the economy has grown for 35 quarters in a row. In the post-World War II era, the U.S. has experienced 10 periods of economic growth; these expansions have averaged 20 quarters, or five years. The longest expansion was 39 quarters; the shortest was five. Recently, expansions have been more durable. The six expansions since 1960 have averaged 27 months. Based on the historical record, the current expansion could certainly continue for a few more quarters without breaking longevity records. As we have frequently said, expansions don't die of old age, but rather from problems that emerge as they evolve.

Looking ahead into 2H18-2019, we are forecasting continued growth, as we think the positives in the economy can outweigh the negatives. However, we think the growth rate will slow from the recent high. On an annual basis, we look for growth to increase in 2018 to 3.3% from the 2.5% growth rate recorded in 2017. We look for a modest slowdown in 2019 to 2.3%. This forecast is based on our assumptions for macroeconomic factors such as the employment environment, commodity prices, the dollar and interest rates, as well as assumptions about fiscal policy and even trade policy.

Our estimates are essentially in line with the Federal Reserve's recently published economic projections for 2018-2020. The Fed forecasts that the central tendencies for economic growth by year are:

2018: 3.1%, with a range of 2.9%-3.2%.
2019: 2.5%, with a range of 2.1%-2.8%
2020: 2.0%, with a range of 1.7%-2.4%

The Fed's longer-run GDP forecast for the U.S. economy is 1.8%.

Near-Term Outlook & Core Assumptions

Looking ahead to the second half of 2018, we expect ongoing strength from the Consumer sector, which is benefiting from a robust employment environment. We also look for continued growth in Capital Investment but a bit of a pullback in the Export sector, which surged in 2Q due in part to inventory-building ahead of expected tariffs. For these reasons, we are maintaining our 3Q18 GDP forecast of 3.3%. We continue to look for solid growth in the fourth quarter as well. At our forecast 3.3% pace of growth for the full year, we would anticipate one more Fed rate hike this year.

Below we review our assumptions for the four key drivers of the economy: Personal Consumption Expenditures; Gross Private Domestic Investment; Imports/Exports; and Government Spending.

(continued on next page)

Personal Consumption Expenditures: Personal Consumption Expenditures (PCE) account for approximately two-thirds of the U.S. economy. They have been growing at a 2.6% pace for the past two years, slightly ahead of the rate of the overall economy. The 2Q results were above trend, reflecting a recovery in the all-important Durables segment. Durables had been growing at a 10% average rate for the second half of 2017, before declining at a 2.0% rate in 1Q18 and then recovering to a 9.3% rate in the latest quarter. In our view, these are likely the poles of the range for this metric: our forecasts call for Durable growth in the 3%-6% range over the next few quarters.

We think the key driver for PCE is the trend in employment, which has been positive since 2009: over the past 12 months, the U.S. economy has generated on average 190,000 jobs, according to the U.S. government, and the headline unemployment rate is at a low 3.9%. We see several factors that support an outlook for sustained jobs growth, such as low weekly jobless claims and President Trump's focus on jobs, among others. We look for Nonfarm Payrolls growth to settle in the 150,000-175,000 range over the next several months, given the relatively late stage of the economic cycle. We note that slack remains in the employment rolls: the labor participation rate is a low 62.7%, compared to the 10-year average of 65%. Even so, wage inflation has recently picked up to 2.9%.

There are other macro trends that are also supportive of a positive outlook for the Consumer sector. Housing is one example. Homes are typically the largest investments for households. Recently, house prices have been rising. The Case-Shiller National Home Price Index has been rising at a 6.0%-6.3% rate for the past six months. Houses are moving: inventories are at a 4.3-month level, within the normal range of 3.5-5.0 months, though the trend has been toward a longer sales cycle. Recent advances in the stock market also provide support. The S&P 500 has more than tripled since the depths of 2009, adding asset value to consumers who own stocks.

We are concerned about bubbles, though. The Conference Board's Consumer Confidence Index is flirting with 16-year highs. We will be on the lookout for declines in this important index. The low levels of the VIX Volatility index in 2017 had also raised warning flags, and indeed, volatility has recently returned to the equity markets. Oil prices also have been on the move. Perhaps the biggest bubble in the past three-to-five years was the peak in 10-year Treasury bond prices, as yields dropped to historic lows below 1.4%. However, instead of a "burst," this bubble has instead slowly let out air over the past few quarters. A plunge in bond prices – and a spike higher in yields – would be a problem for the economy.

Gross Private Domestic Investment: Gross Private Domestic Investment (which we will call CapEx) accounts for approximately 17% of the U.S. economy. This category is more volatile than consumer spending: the average rate of growth over the past eight quarters has been an impressive 4.6%, but rates have ranged from -0.5% to 9.6%. Our outlook calls for 2%-4% in CapEx growth in 2018-2019.

The key drivers for CapEx include commodity prices and interest rates. Commodity prices have stabilized over the past 18 months, as the dollar's upward trajectory in 2014-2016 has reversed course and value vultures have been drawn in by materials prices that are down sharply from cycle highs. The commodities market bottomed in January 2016, when oil prices were below $30 per barrel. Since the lows, oil prices have more than doubled, while copper prices have increased 35%. Yet commodities remain approximately 40% below the highs of 2012-2103, and we forecast higher prices in 2H18-2019. Interest rates also play a role in CapEx. The lower, the better. While the yield on the 10-year bond is now above 3.0%, rates remain low on both a real and historical basis, which should be supportive of corporate investment.

Another important factor in our CapEx model is the trend in New Orders as measured by the Purchasing Managers Index. This survey is conducted monthly, and a reading above 50 points to expansion. Over the years, we have seen readings as high as 80-plus in the early 1950s, and as low as 23 during the depths of the 2007-2009 financial crisis. The latest readings, as of August 2018, were healthy in the 60s for the manufacturing sector.

Exports/Imports: Exports add to economic growth, while Imports detract. Taken together, the impact of Ex/Im has been modestly negative (approximately 200-300 basis points) to U.S. GDP for the past 10 years. But recent trends could well support Export growth, or at least a reduction in Imports, which would reduce the drag on overall U.S. economic growth.

The key drivers for Exports include trends in the dollar and in global economic growth. The U.S. dollar rose from 2011-2016 on a trade-weighted basis (reducing global demand for U.S. products priced in dollars), but in our view has peaked and is likely to remain in a trading range over the next few quarters. The dollar spiked over this five-year period as investors anticipated that the Federal Reserve would be raising interest rates. Still, at the cycle highs, the greenback had risen to levels not seen since 2002. At these high valuations, other global economic factors, including a rebound in the euro, economic growth in China and even the recovery in Latin America, begin to have an impact on reducing the greenback. In short, we think global economic forces will continue to push the U.S. dollar lower from these cyclical highs, supporting Export growth.

In terms of global GDP, growth is looking up. According to the IMF, the global economy expanded at a 3.7% pace last year, up from 3.1% in 2016. The outlook is for continued improvement in 2018 and 2019, with estimates calling for expansion at rates of 3.9% for both years. Emerging markets are expected to drive growth over the next two years; forecasts for this segment of the global economy imply growth of

4.9% both years. Key factors include higher oil production in Nigeria, a rebound of commodity prices in Brazil and continued policy support in China. (As a check on China's growth, we monitor the Aussie yield curve, which remains steep.) We look for strengthening global economic growth to be a driver for Exports. That said, we anticipate a pullback in the growth rate in 3Q from the robust 9.3% growth rate recorded in 2Q. We think 2Q Export demand reflected inventory building ahead of tariffs, which are still being debated.

From the Import angle, we note that the United States has the largest current account deficit of any country in the world on an absolute basis. The U.S. runs a deficit by importing more goods than it exports. But although the U.S. may have the world's largest deficit, the shortfall has been deeper and it has stabilized in recent years. At the end of the country's fiscal 2017, the U.S. trade deficit was $566 billion, which equaled 3.1% of 2017 GDP. Over the past 25 years, the average U.S. trade balance was a $396 billion deficit, or 2.9% of GDP. When things were going good, the U.S. surplus reached a 25-year high in 2000 at $236 billion or 2.3% of GDP. But then the deficit reached a 25-year low in 2009 at $1.4 trillion, or 9.8% of GDP.

Looking ahead, the Trump administration's policies will no doubt have an impact on the trajectory of the trade deficit and overall GDP. Donald Trump won the U.S. presidency in part by arguing that trade agreements with foreign nations have cost the U.S. jobs. He has scuttled trade agreements and is now imposing tariffs on imported goods. In recent months, these tariff tweets, talks and threats have from time to time led to violent market sell-offs. We think that heavy tariffs, if enacted, would likely be an impediment to jobs growth and exports, as global trade partners respond in kind with tariffs of their own. This is one of the reasons we look for GDP growth to cool into 2019.

Federal and State Government Spending: Government Spending accounts for approximately 17% of the U.S. economy. This category is less volatile than CapEx: the average rate of growth over the past four quarters has been 0.5% but has ranged from -1.7% to 3.0%. Our outlook calls for more modest 0.5%-1% growth into 2019.

Government Spending historically has been a more important driver of U.S. economic growth. For example, under Presidents Bush and Obama, a sharp increase in federal spending was one of a number of factors (lower interest rates, higher deposit insurance, select industry privatization, cash for clunkers, bank bailouts and stress tests, etc.) that helped lift the U.S. economy out of the deep recession of 2007-2009. At the same time, however, the increase in government spending increased the U.S. deficit, and led to Congress' sequestration program, which resulted in cutbacks on spending across the board. This weakness in U.S. Government Post-recession spending has been one of the main reasons the current U.S. GDP recovery has not been as robust as previous recoveries. That said, the recovery certainly has been durable.

Looking ahead, we expect modest growth at best in Federal and State Government Spending, with a growth focus on Defense Spending. The Tax Cuts & Jobs Act, according to the Trump administration, is expected to ultimately add to the government's coffers through higher tax collections on more working Americans. We shall see.

Risks of Recession

We note that neither our current estimates nor the Fed's forecasts call for a recession in the U.S. through 2019. We believe that key forward-looking indicators (jobless claims, housing starts, the yield curve, and new orders from purchasing managers) are positive enough to keep the economy on a growth track over the next few quarters, despite the unpredictable impacts of the stock market, weather events, and other non-economic shocks such as geopolitical threats.

Our interest-rate forecasts now call for the Fed hike interest rates one more time in 2018 and then two times in 2019. We expect longer-term rates to rise modestly as the Federal Reserve reduces its balance sheet, which is bloated from the days of Quantitative Easing. Our preliminary forecast for the 10-year yield in 4Q18 calls for a range of 2.75%-3.75%. The Federal Reserve is in a bit of a tight spot: seeking to raise rates in order to rebuild its recession-fighting tool chest, but not wanting to raise short-term rates so high that the yield curve inverts.

Other risks to growth include volatile oil and commodity prices that could spike higher on geopolitical developments; a weaker-than-expected recovery in China; additional economic trouble in Europe; a dollar that reverses course and once again rises and limits export growth; an unexpected stumble in the housing market; a bear market in stocks; or deflationary conditions, such as Venezuela is currently facing.

We also think it is important to point out that the Federal Reserve currently forecasts its next rate cut in 2021.

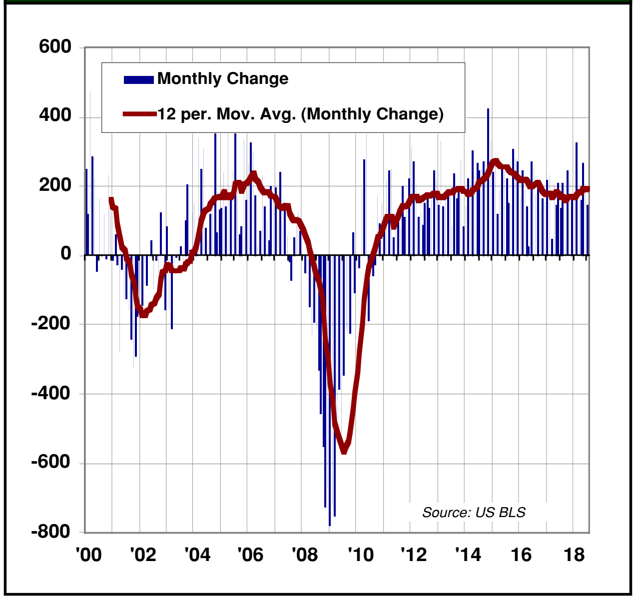
Q: Why does the Fed cut rates?

A: To stimulate an economy in recession.

So as 2020-2021 approach, we may start calling for a conclusion to the current economic expansion.

John Eade, President,
Argus Research

NONFARM PAYROLLS (THOUSANDS OF JOBS)



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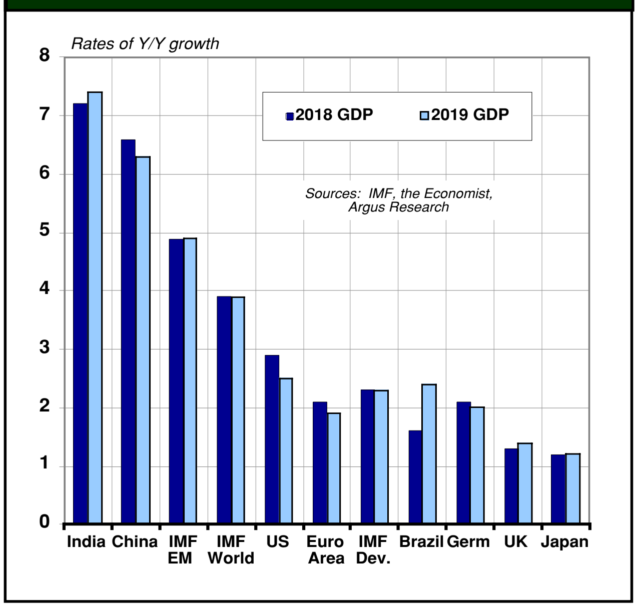
CURRENCY TRENDS

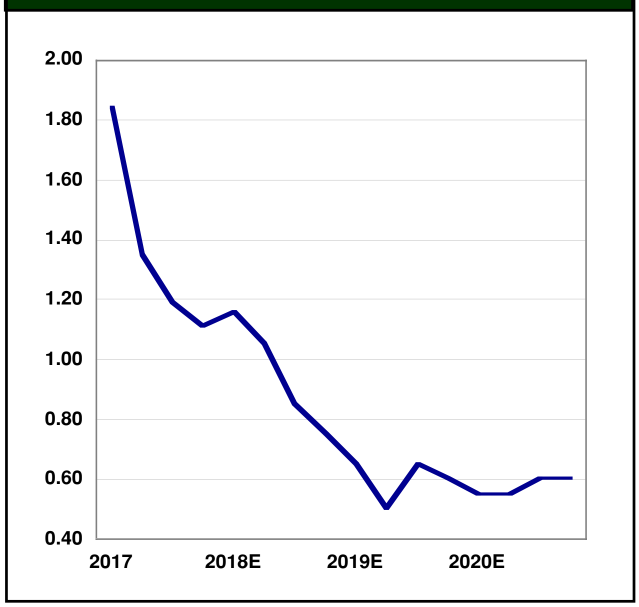
The dollar is up almost 3% year to date. We anticipate a trading range around current levels in 2018, as current currency translation rates against major trading partners are still near-all time highs and other factors – recoveries in China and Brazil, improving trends in the euro – will likely impact valuations.

GLOBAL GDP FORECASTS (%)



According to the IMF, the global economy expanded at a 3.7% pace last year, up from 3.1% in 2016. The outlook is for continued improvement in 2018 and 2019, with estimates calling for expansion at rates of 3.9% for both years.

YIELD GAP (PERCENTAGE POINTS BETWEEN 10-YEAR AND 2-YEAR TREASURY YIELDS)



Despite an upbeat economic outlook on key metrics, the yield curve continues to narrow. A tighter yield curve implies slower economic growth in the future.