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VIEWPOINT

THE ECONOMY

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ECONOMIC GROWTH EXPECTED TO SLOW

The government shutdown prevented the Bureau of Economic Analysis from delivering its first reading on 4Q GDP. That report is now expected on February 28 at 8:30 a.m. It will take the place of two previously scheduled estimates of fourth-quarter GDP -- the advance estimate originally set for Jan. 30 and the second estimate that normally would be released Feb. 28. We expect the 4Q growth rate – when released – will be will be below the average 3.8% rate of the previous two quarters.

The U.S. Department of Commerce announced late last year that its third estimate for the 3Q18 GDP growth rate was 3.4%. This was down slightly from the previous estimate as well as from the even-more robust growth rate of 4.2% in 2Q18. Consumer and investors should remember those growth rates – and the heady stock-market activity preceding them. Going forward, we think that growth will be more difficult, and market conditions more volatile. We may well start to see evidence of those trends when the 4Q GDP report comes out later this month.

Growth in 3Q was broad-based, driven by capital investments into Intellectual Products (+5.6%) and Equipment (+3.4%), Inventory Building, Federal Government Spending on Defense (+4.9%) and the all-important Personal Consumer Spending category (+3.5%). The segments that lagged were Housing, once again, (-3.6%) and Exports (-4.9%). The 3Q results benefited from the Trump tax cuts, which drove consumer spending, but were hindered by the administration's tariff and trade talks and threats, which cut into exports.

A Long Run

Since the current economic expansion began in the fourth quarter of 2009, the economy has grown for 36 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. And as we have frequently said, expansions don't die of old age, but rather from problems that emerge as they evolve.

Looking into 2019, we are forecasting continued growth, as we think the positives in the economy can outweigh the negatives. However, we think that the growth rate will slow from the recent highs, and we anticipate a below-long-term-trend quarter in the first half of 2019. On an annual basis, we believe growth increased in 2018 to 3.2% from the 2.5% growth rate recorded in 2017. We look for a 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: 3.0%, with a range of 3.0%-3.1%.
2019: 2.3%, with a range of 2.0%-2.7%
2020: 2.0%, with a range of 1.5%-2.2%
2021: 1.8%, with a range of 1.4%-2.1%

The Fed's longer-run GDP forecast for the U.S. economy is 1.9%.

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Near-Term Outlook & Core Assumptions

Looking ahead to 2019, we expect a modest slowdown from the Consumer sector, which is benefiting from a robust employment environment but is beginning to lose confidence in the outlook. We look for a slowdown in growth in Capital Investment, as oil prices have fallen sharply in recent months. We also anticipate a pullback in the Export sector, given the recent trend upward in the dollar as well as the uncertainty in the outlook as trade and tariff talks continue. For these reasons, while we view the overall economy as sound, we expect to see a sharp dip in GDP growth in the first half of 2019, before the economy recovers in the second half. At our forecast 2.3% pace of growth for the full year 2019, we anticipate one Fed rate hike, though there is a possibility for two or even three.

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

Personal Consumption Expenditures. Personal Consumption Expenditures (PCE) account for approximately two-thirds of the U.S. economy. They have been growing at a 2.7% pace for the past two years, slightly ahead of the rate of the overall economy. The 3Q results were above trend, reflecting good growth in the three categories of Durables Goods (+4.3%), Nondurable Goods (+3.7%) and Services (+3.2%).

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 an average of 195,000 jobs, according to the U.S. government, and the headline unemployment rate is at a low 3.7%. However, with the economy near full employment, and given the late stage of the economic cycle, we look for a slowdown in jobs growth in 2019, and for Nonfarm Payrolls growth to settle in the 150,000 range over the next several months.

There are other macro trends that point to a modest slowdown for the Consumer sector. Housing is one example. Homes are typically the largest investments for households. Recently, the bullish case for Housing has started to wane. For example, rising borrowing costs due to the Fed's rate-hike campaign are raising the cost of buying a home, and new home sales are down 9% year over year. Residential investment has declined in seven of the past eight quarters. Household stock-market gains have also vanished in the wake of the broad market sell-off in 4Q18.

We remain concerned about bubbles. 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, as the stock market remains volatile, the housing market cools and jobs growth slows. Perhaps the biggest bubble in the past 3-to-5 years was the peak in 10-year Treasury bond prices, as yields dropped to historic lows below 1.4% in 2016. However, instead of a "burst," this bubble has 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 not only the consumer economy but the broader economy as well.

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 6.6% but rates have ranged from -0.5% to 15.2%. Our outlook calls for 1%-3% in CapEx growth in 2019.

The key drivers for CapEx include commodity prices, especially oil, and interest rates. Oil prices have tumbled in the past six months, as concerns over excess supply and reduced demand have resulted in a 33% reduction in the price per barrel of benchmark West Texas Intermediate Crude. Another factor behind the decline in oil prices and commodity prices in general has been a spike in the dollar. These two factors conspired in 2015-2016 to slow down the pace of CapEx. We look for a similar pattern early in 2019.

Interest rates also play a role in CapEx. The lower, the better. As stocks have sold off in late 2018, bond prices have risen. Consequently, rates remain low on both a real and an 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 November 2018, were healthy in the 60s for the manufacturing sector. We shall see whether they remain at these levels over the next few months.

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. Given the recent upward trend in the dollar, as well as concerns over a potential trade war, we think export contribution to GDP will be minimal at best over the next few quarters.

The key macro drivers for exports include trends in the dollar and in global economic growth. Right now, the dollar is on an upswing. The U.S. dollar rose from 2011-2016 on a trade-weighted basis, reducing global demand for U.S. products priced in dollars. After declining in 2017, though, the greenback recovered lost ground in 2018 and is back near all-time highs set back in 2002. The dollar's recovery has been driven in part by concerns over Brexit in Europe as well as the strong GDP reports of 2Q18 and 3Q18. Brexit looks to vex currency investors for the next few months, likely supporting a high level for the greenback.

In terms of global GDP, the growth forecast is positive, but plateauing. According to the IMF, the global economy expanded at a 3.7% pace in 2017, up from 3.1% in 2016. The outlook had been for improvement in 2018 and 2019, but recent revisions have been downward, and the outlook now calls for 3.7% growth in both years. Emerging markets are expected to drive growth; 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.)

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, exports 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 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 will – and have – respond in kind with tariffs of their own. This is one of the reasons we look for export growth – and GDP growth overall – 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 has historically 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 bail-outs 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 spending, post recession, 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 program, according to the administration, is expected to ultimately add to the government's coffers through higher tax collections on more working Americans. We shall see.

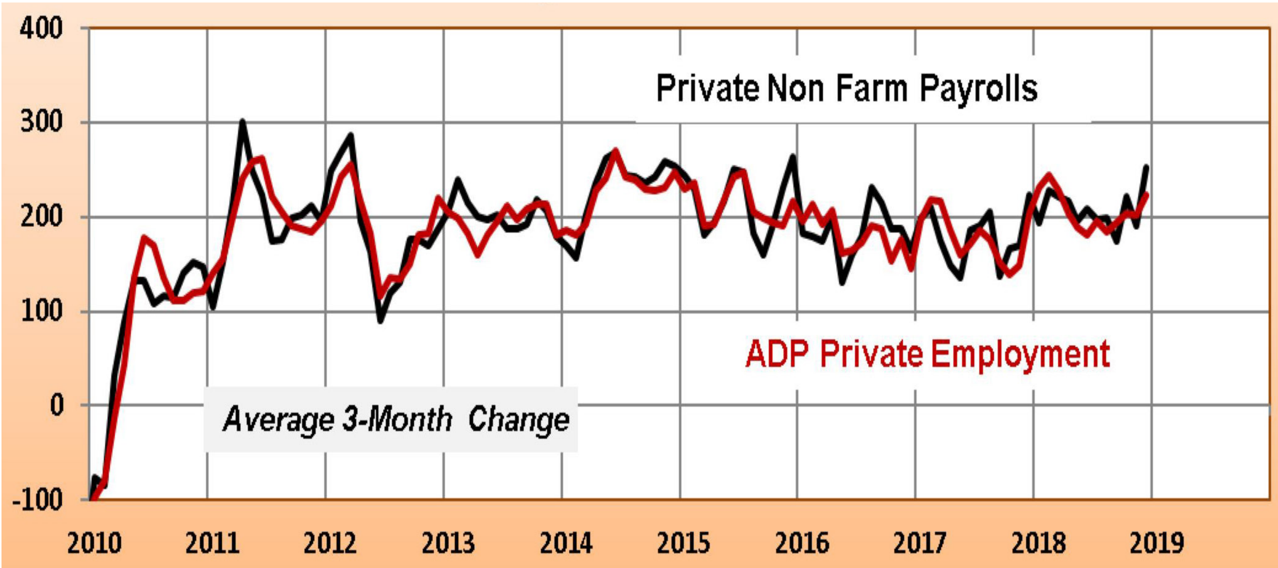
Risks of Recession

We note that neither our current estimates nor the Fed's forecasts call for a recession in the U.S. through 2021. 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 to hike interest rates up to 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 2019 calls for a range of 2.75%-3.75%. The Federal Reserve is in a bit of a tight spot: it is 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.

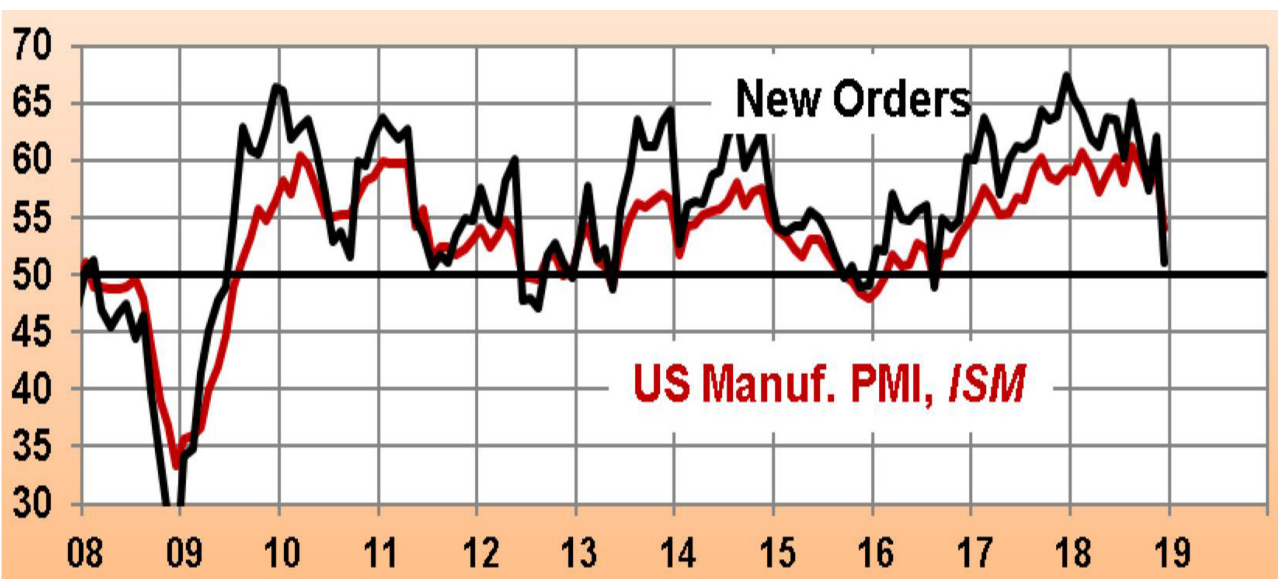
Lastly, our growth forecasts into 2020 call for a further GDP cooling toward the 1%-2% range, versus the current rate of growth in the 3%-4% range. Investors should expect heightened market volatility as the economy continues to slow. (John Eade, President, Argus Research)

JOB GAINS



Employment growth remains strong and should keep the economy out of recession. The nonfarm payrolls total has increased more than 300,000 (before revisions) in each of the past two months.

US MANUFACTURING ORDERS



ISM Manufacturing dropped sharply in December as New Orders tumbled 11%. Employment, Production and Price gains slowed. Supplier Deliveries fell as Inventories fell. This is one of the factors – along with the government shutdown – behind our forecast for below-trend GDP in 1H19.