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V I E W P O I N T

THE ECONOMY

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A LOOK OUT TO 2020

The U.S. Department of Commerce announced on March 28, 2019, that its “third” and final estimate for 4Q18 GDP growth was a rate of 2.2%. This was down 40 basis points compared to the “initial” estimate of 2.6% and, as we had anticipated, is a further signal that the economy is cooling off from the impressive-but-unsustainable growth rate of 4.2% in 2Q18.

Since the current economic expansion began in the fourth quarter of 2009, the economy has grown for 37 quarters in a row. In the post-World War II era, the U.S. has experienced 10 periods of economic growth, which have averaged 20 quarters, or five years. The longest expansion was 39 months; the shortest was five.

Recently, expansions have been more durable. The six expansions since 1960 have averaged 27 quarters. But they all have ended at some point, and it is reasonable to believe that the current expansion is closer to an end than it is to the beginning.

With this report, we are publishing our first official estimates for 2020. Based on the historical record, the current expansion could certainly continue for at least a couple more quarters. As we have said in the past, expansions don’t die of old age, but from problems that emerge along the way. Looking ahead to 2020, we are forecasting continued growth, likely setting a record for durability. On an annual basis, we look for growth to moderate in 2020 to 1.9 % from our estimate of 2.1% growth in 2018. But the numbers remain positive. This forecast is based on expectations for continued strength in the consumer sector; a stable-to-declining dollar compared to year-end 2018 levels; energy prices that rise gradually into 2020; and stable interest rates as the Federal Reserve remains on the sideline.

Generally, our estimates are in line with the Federal Reserve’s recently published economic projections for 2015-2018. The Fed forecasts that the central tendencies for economic growth are:

2019: 1.9%-2.2%
2020: 1.8%-2.0%
2021: 1.7%-2.0%

Core Assumptions

Looking deeper into 2019, we expect a slowdown in growth to 2.1% from the 3.0% rate in 2018. We expect a modest slowdown from the consumer sector, which is recovering from the record-setting government shutdown. We look for modest growth in capital investment, as oil prices have steadied after falling sharply in 3Q. We anticipate a pullback in the export sector, given the recent weakness in Europe and the continuing uncertainty over Brexit. And government spending also is likely to stabilize, unless President Trump is able to generate bi-partisan enthusiasm for an infrastructure-spending plan. For these reasons, we view the overall economy as sound but 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 2.1% pace of growth for the full year 2019, we anticipate the Federal Reserve will remain on the sideline, as they have indicated they plan to do.

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.

(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 4Q results were on trend, reflecting good growth in durables goods (+3.6%), and more modest growth in nondurable goods (+2.1%) and services (+2.4%).

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 200,000 jobs, according to the U.S. government, and the headline unemployment rate is at a low 3.8%. 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. Indeed, the most-recent reading was 22,000 new jobs in February, which was undoubtedly affected by the 35-day U.S. government shutdown.

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 last year raised the cost of buying a home, and residential investment has declined in seven of the past eight quarters. Household stock-market gains have also lessened 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 three to five years was the peak in 10-year Treasury bond prices, as yields dropped to historic lows below 1.4% in 2016. However, instead of "bursting," 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% but rates have ranged from -0.5% to 15.2%. Our outlook calls for 1%-4% in CapEx growth through 2020.

The key drivers for CapEx include commodity prices, especially oil, and interest rates. Oil prices have tumbled and recovered modestly in the past six months, as concerns over excess supply and reduced demand have resulted in a 20% reduction in the price per barrel of benchmark West Texas Intermediate Crude since last summer. 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 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 on the soft side. U.S. manufacturers continued to struggle in March, as IHS Markit's preliminary read of its manufacturing purchasing managers' index tumbled to 52.5, its weakest level in nearly 2 years.

- 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 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 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 Trump administration, ultimately is expected to add to the government's coffers through higher tax collections on more working Americans. We shall see.

Risks of Recession

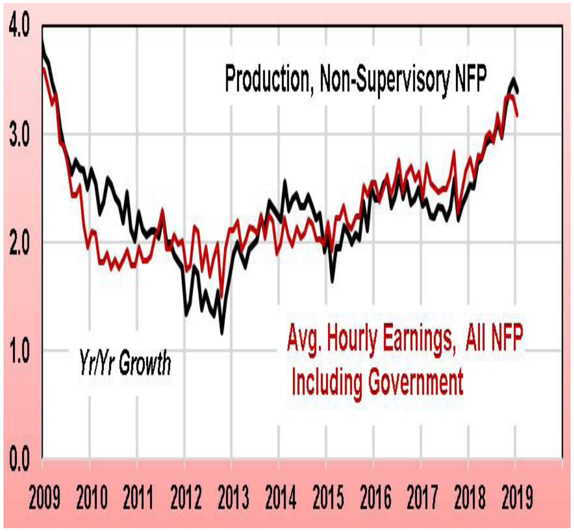
We note that neither our current estimates nor the Fed's forecasts call for a recession in the U.S. through 2021. We believe that key forward-looking indicators (jobless claims, housing starts, the yield curve, and new orders from purchasing managers) are positive enough to keep the economy on a growth 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 up to one more time in this cycle through 2020. We expect longer-term rates to rise modestly as the European economy recovers and Brexit plans become clear. Our preliminary forecast for the 10-year yield in 2019 calls for a range of 2.50%-3.00%.

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 2%-3% range. Investors likely should expect heightened market volatility as the economy continues to slow down.

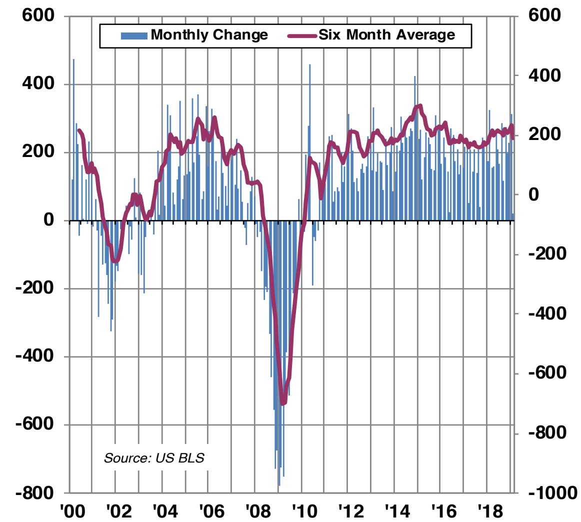
John Eade, President
and Director of Portfolio Strategies, Argus Research

WAGE GROWTH



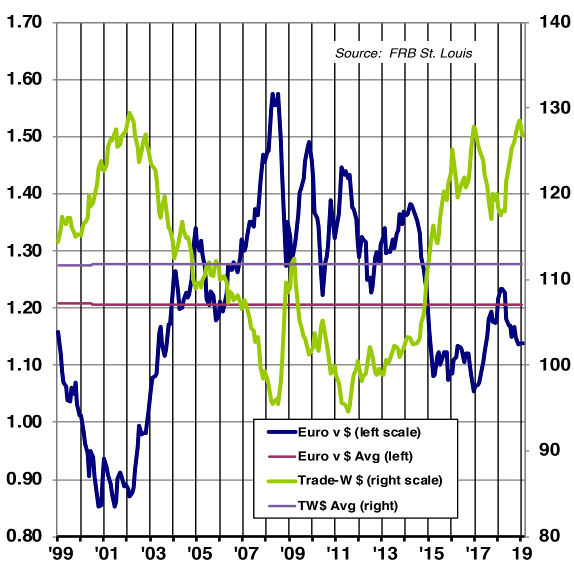
The low level of unemployment is boosting wages, and the rise of wages for all workers has accelerated sharply in the past year.

NONFARM PAYROLLS (THOUSANDS OF JOBS)



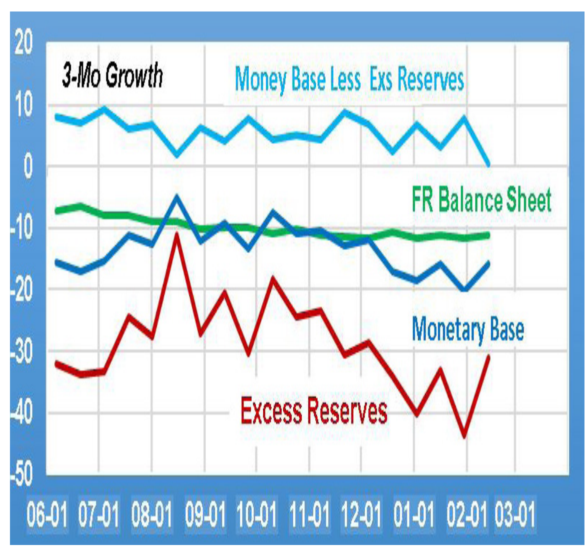
We look for jobs growth to rebound from a weak February reading, and settle in the 150k-175k range in 2019.

CURRENCY TRENDS



Brexit concerns, a slowdown in Europe and solid U.S. economic growth have lifted the dollar to cycle highs. We look for a stable-to-declining greenback in 2019-2020, due to its high valuation.

FED BALANCE SHEET ITEMS



The Fed Balance Sheet (the flat line) has been falling at a 10% rate since the September Fed meeting. This is a tightening move above and beyond the adjustment of the fed funds rate.