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V I E W P O I N T

THE ECONOMY

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SECOND-QUARTER GDP GROWTH RATE BOOSTED TO 4.2%

The Commerce Department has raised its estimate of the 2Q18 GDP growth rate from 4.1% to 4.2%. The results indicated an accelerating economy; the growth rate in 1Q was a modest 2.2%. They were also in line with Street estimates and, as so many reports recently have, contained a bit of a warning over inflation.

As we typically do for the second estimate, let's take a closer look at the key contributing sectors to GDP.

* First, the Consumer. During 2Q, Personal Consumption Expenditures grew at a healthy 3.8% pace, just below the rate of overall growth, and contributed 60.6% of core demand (which we define as Personal Consumption Expenditures, Information Technology and Intellectual Property spending, Housing, Exports and Government Expenditures). This is in line with the 10-year average of 60.7%, as the consumer continues to drive the U.S. economy. As we anticipated, the 2Q PCE growth rate was driven by a rebound in Durable Goods, which rose at a 5.4% pace after a rare decline of 0.6% in 1Q.

* Spending on Equipment (generally Cap-Ex, including Information Technology) and Intellectual Property advanced at a faster rate in the quarter (up 8% on average) and accounted for 9.4% of core demand versus the historical average of 8.4%. Looking ahead, we expect oil prices above $60 per barrel, low interest rates and technological innovations to continue to support solid Cap-Ex spending.

* Housing finally has caught up to its historical level (now contributing 3.5%) and appears to be heading in the right direction. The housing market has recovered from the collapse of 2008-2009 (somewhat slowly, at least compared to the auto market) and, in a positive signal looking ahead, price increases have been stable if not higher in recent months.

* Exports also grew in 2Q, increasing at a 9.1% rate and generating 11% of core demand, in line with the historical average. The export sector has cycled through the damaging spike in the dollar during 2014-2015. However, potential changes in trade policies, tariffs and border taxes could be an offset over the next couple of years. In fact, we anticipate a slowdown in export growth in 3Q, as the 2Q totals likely included some inventory building ahead of the tariffs.

* Government Spending remains weak on an historical basis but has strengthened somewhat over recent quarters. Typically, Government Spending accounts for 17.0% of total demand; yet in 1Q18, the share was only 15.3%. We note, though, that the trend generally has been toward improvement over the past two years, as the government's balance sheet has improved.

Looking ahead, our forecasts for GDP growth calls for economic expansion in the 2.0%-3.0% range through 2019. On average, we are modeling 3.0% growth for the next 3-4 quarters, reflecting strength in the consumer sector, housing market and oil patch. A stable dollar and historically low interest rates are also positive factors for economic growth.

The GDP report was full of good news but also confirmed inflation is percolating: ex-food and energy prices rose at a 2.0% rate, in line with the Fed's target. In our view, the GDP trends are strong enough to support a Fed rate hike each quarter for at least the next four quarters.

(continued on next page)

Risks of Recession

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, 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 end at some point, and it is reasonable to believe that the current expansion is closer to an end than it is to the beginning.

That said, we note that neither our current estimates nor the Fed's forecasts call for a recession in the U.S. through 2020. We believe that key forward-looking indicators (jobless claims, housing starts, new orders from Purchasing Managers, the stock market and the slope of the yield curve) are positive enough to keep the economy on a growth track, despite the unpredictable impacts of stock-price swings, global events, weather and other non-economic shocks.

Other risks to growth include volatile oil 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, starts to rise and limits export growth; an unexpected stumble in the housing market or in consumer confidence; or inflationary conditions, which are beginning to percolate and should be on the Federal Reserve's radar.

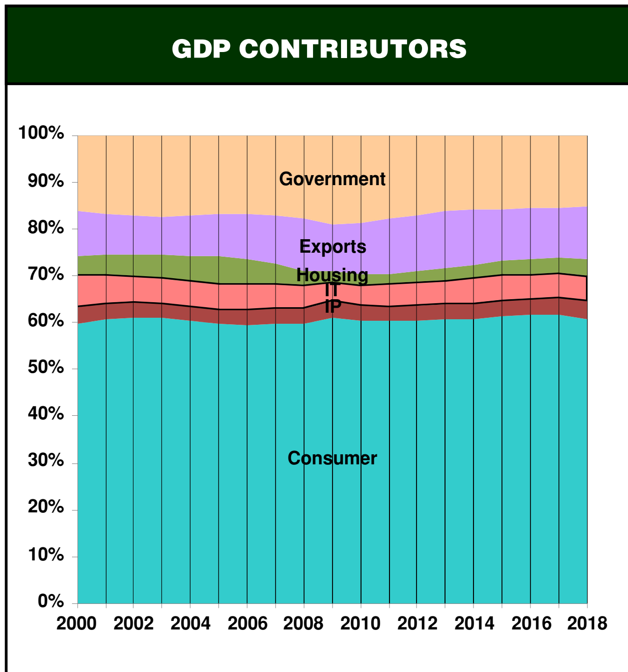
Outlook for Interest Rates

We note that the Federal Reserve, if it acts too quickly or aggressively, poses a threat to the current expansion. Spreads in the yield curve are tight on an historical basis, though not yet inverted. This suggests that economic growth may slow in the quarters ahead.

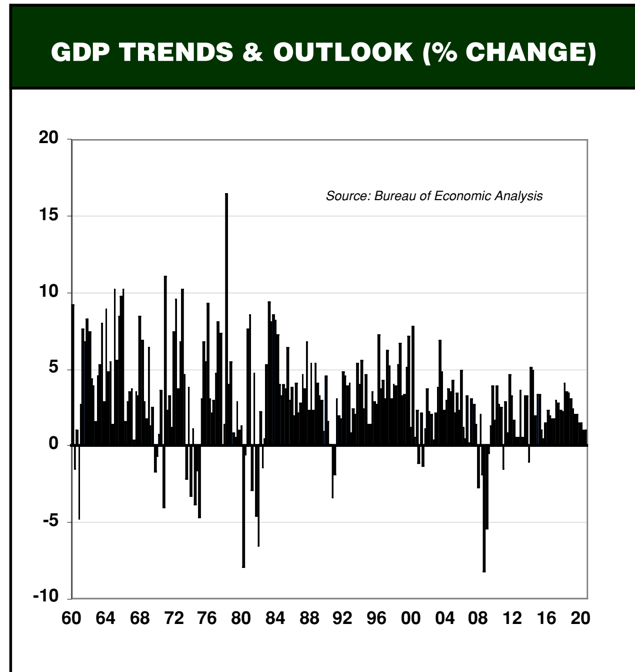
We base our conclusions on analysis of interest-rate activity dating to 2000. The current spread between the 2-year Treasury note and the 10-year Treasury bond is 25 basis points, which is about 150 basis points below the average spread of 172 basis points. At the short end of the yield curve, the current spread between the 2-year Treasury Note and the 5-year Treasury Note is 28 basis points, compared to an historical average of 84 basis points. The story is the same at the long end: the current spread between the 10-year Treasury Bond and the 30-year Treasury Bond is 16 basis points, compared to the historical average of 83 basis points.

As we have indicated, our forecasts conclude that the economy is strong enough to handle additional rate hikes. Thus, we look for central bank raise rates into 2019-2020. By the end of the rate-hike campaign, the Fed's balance sheet should be smaller as well as the unwinding of quantitative-easing programs continues. These two initiatives will leave the central bank in a better position to address any future potential crises.

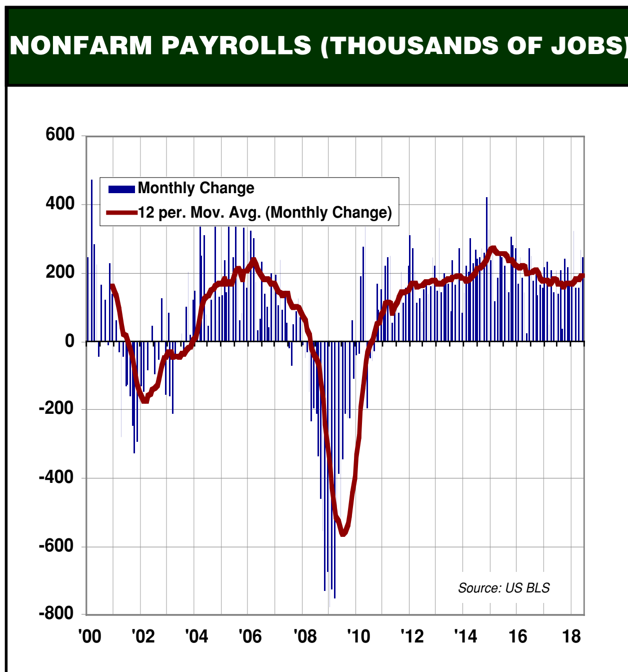
We note the potential for a perfect storm of events, though, that could send rates sharply higher. In this scenario, inflation continues to pick up as unemployment drops and the ballooning U.S. budget deficit causes the Treasury to flood the market with supply — just at the time that global investors lose confidence in the U.S. financial system (too many tariffs?) and bring their money back into their own markets. This scenario is a clear recipe for recession, should it occur. (John Eade, President, Argus Research)



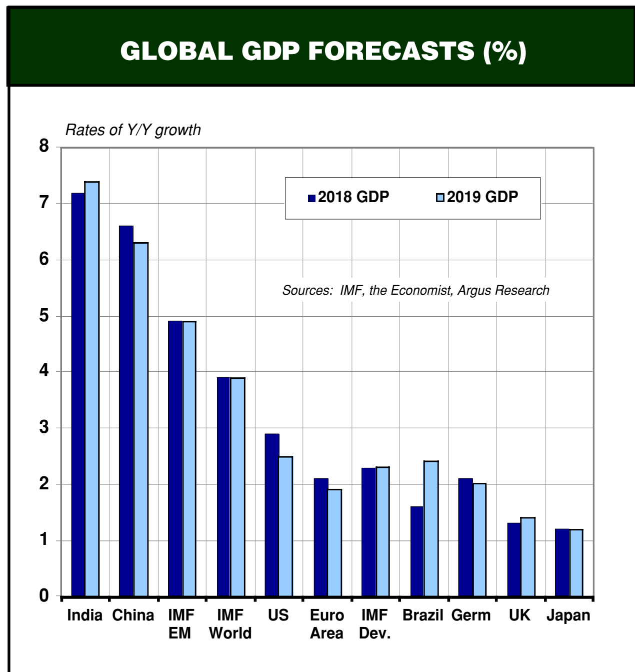
The Consumer, Export and Cap-Ex sectors continue to drive the U.S. economy. Lately, even Government Spending has increased.



Our economic model is forecasting GDP growth through 2020, though the pace is likely to slow as the Federal Reserve lifts interest rates.



Companies have been adding workers at a rate of about 200,000 per month for the past 12 months. The unemployment rate is a low 3.9%. These are solid support factors for consumer spending in the quarters ahead.



Recoveries in European and Latin American economies have lifted expectations for global growth toward 4.0% over the next few quarters.