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V I E W P O I N T

THE ECONOMY

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1Q GDP GROWTH RATE EASED TO 2.2%

The Commerce Department lowered its estimate of the 1Q18 GDP growth rate from 2.3% to 2.2%. The results were in line with Street estimates and, as many recent reports have, contained a bit of a warning about 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 1Q, Personal Consumption Expenditures came in at only a 1% rate, lower than overall growth, and contributed 61.4% of core demand (which we define as Personal Consumption Expenditures, Information Technology and Intellectual Property spending, Housing, Exports and Government Expenditures). This is above the 10-year average of 60.8%, as the consumer continues to drive the U.S. economy. We attribute the relative PCE weakness in the quarter to an expected decline in spending on Durable Goods. In the previous two quarters, Durable Goods spending averaged greater than 10%. That's not sustainable — but we do look for a pick-up in this key category as the year moves on.

* 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 8.9% of core demand versus the historical average of 8.4%. We expect oil prices to be above $60 per barrel, low interest rates and technological innovations to support solid Cap-ex spending.

* Housing has finally caught up to its historical level (3.5%) and appears to be heading in the right direction as price increases have been accelerating.

* Exports also grew in 1Q, increasing at a 4.2% 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, and comparisons should be easier for the next 2-3 quarters as the greenback cools. Potential changes in trade policies, tariffs and border taxes could be an offset over the next couple of years.

* 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; however in 1Q18, the share was only 15.3%. We note, though, that the trend in government spending generally has been toward improvement over the past two years, as the government's balance sheet has strengthened.

This GDP report, though weaker than the previous three, likely was impacted by the harsh winter weather — and we look for a pick-up in growth ahead. The report also confirmed inflation is percolating: ex-food and energy prices rose at a 2.3% rate. We think the GDP trends are strong enough to support a Fed rate hike in June, and likely two more in 2018.

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. We think a stable dollar and historically low interest rates are also positive factors.

Risks of Recession

Since the current economic expansion began in the fourth quarter of 2009, the economy has grown for 34 quarters in

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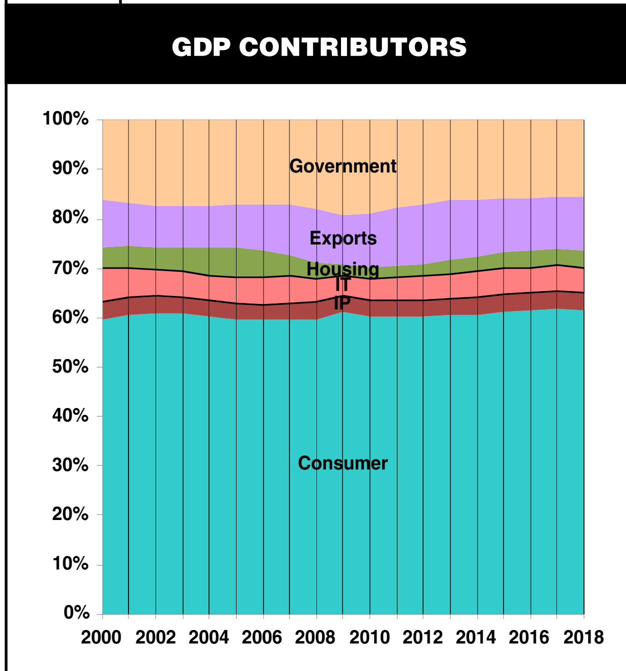
TABLE 1

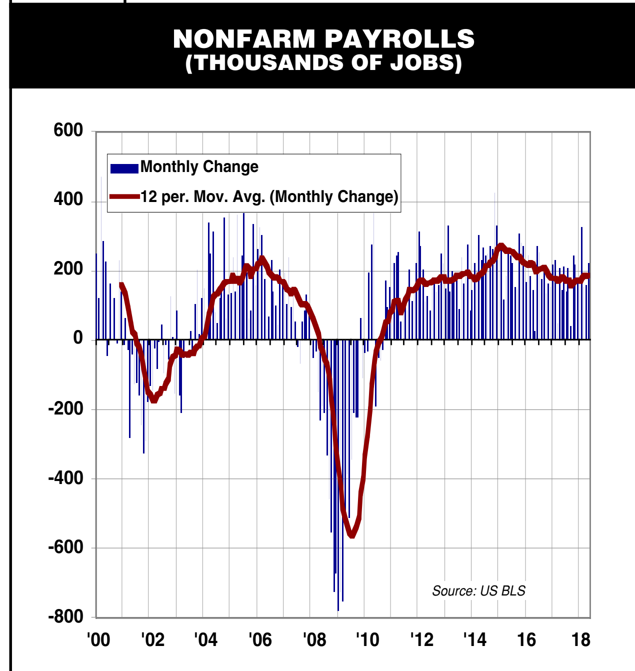
GDP CONTRIBUTORS



The Consumer, Export and Cap-ex sectors continue to drive the U.S. economy.

TABLE 2

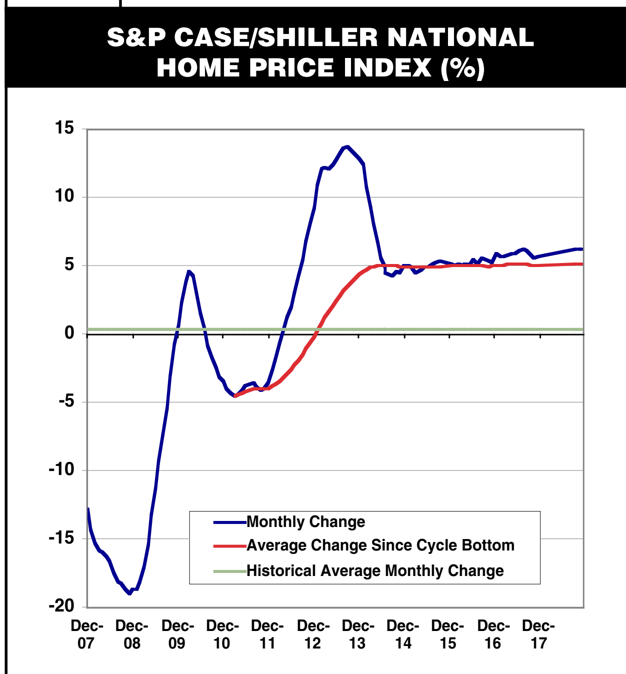
NONFARM PAYROLLS (THOUSANDS OF JOBS)



Companies have been adding workers at a rate of about 200,000 per month for the past six months. The unemployment rate is a low 3.8%. These are solid support factors for consumer spending in the quarters ahead.

TABLE 3

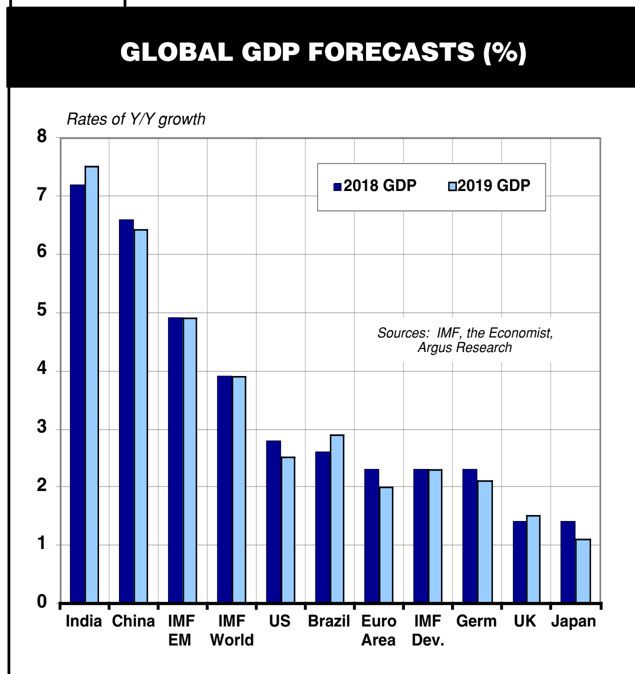
S&P CASE/SHILLER NATIONAL HOME PRICE INDEX (%)



The housing market continues to recover. Prices have been rising at a 6%+ clip in recent months. We still don't see a bubble percolating, though. Supply remains tight.

TABLE 4

GLOBAL GDP FORECASTS (%)



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

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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 since 1960 have averaged 27 quarters. But they all end at some point, and it is reasonable to believe the current expansion is closer to its end than its beginning.

Still, 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, 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.

Our interest-rate forecasts now call for the Fed to keep rates near historical lows at least through 2018. We expect longer-term rates to be capped below 3.5% well into 2018 given global economic uncertainty in large part related to the Brexit vote and Italy's wavering commitment to the euro. While the yield curve is expected to remain upwardly sloped, we do expect a continued flattening over the next several quarters.

Other risks to growth include volatile oil prices; a possible 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 consumer confidence; or inflationary conditions, which are beginning to percolate and should be on the Federal Reserve's radar.

Outlook for Interest Rates

We also note that the Federal Reserve, if it acts too quickly or aggressively, could curtail the expansion. Spreads in the yield curve are tight on an historical basis. This suggests 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 45 basis points, more than 100 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.

The Fed, in its quest to raise rates through 2020, will want to avoid inverting the yield curve, which typically predicts a recession.

As we have indicated, in our view, the economy is strong enough to handle additional rate hikes. Thus, we look for central bank to continue to raise rates in 2018 and into 2019-2020. By that point, the Fed's balance sheet should be smaller as well, this as it continues to unwind its quantitative-easing programs (leaving the central bank in a better position to address any potential crises that may come down the road).

Overall, our forecasts call for modestly higher rates in the quarters ahead, as we anticipate continued strong demand from international investors for longer-term Treasuries to keep yields relatively low on an historical basis.

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, should it occur, is a clear recipe for recession.

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