ECONOMIC OUTLOOK

JANUARY 2019

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GDP GROWTH FOR Q3 REVISED DOWN SLIGHTLY TO 3.4% FROM ITS SECOND ESTIMATE AT 3.5%.

Note: This report has four sections – Key Points, This Month's Topics, Conclusion(s) and Our Economic Projections

SECTION 1: KEY POINTS

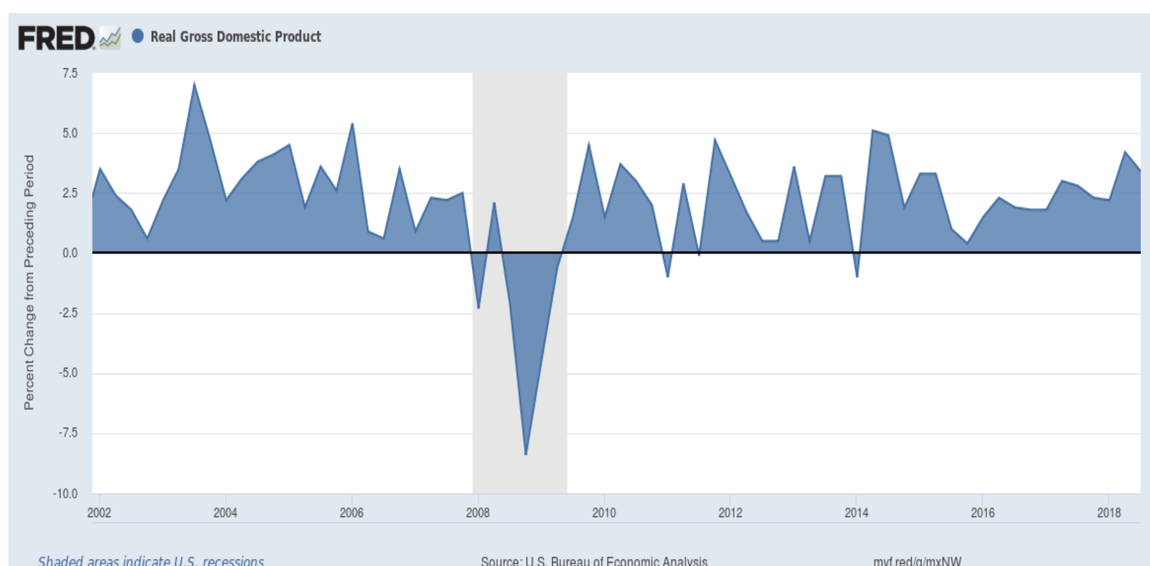
The final Q3 U.S. GDP estimate was slightly lower, but still very robust.

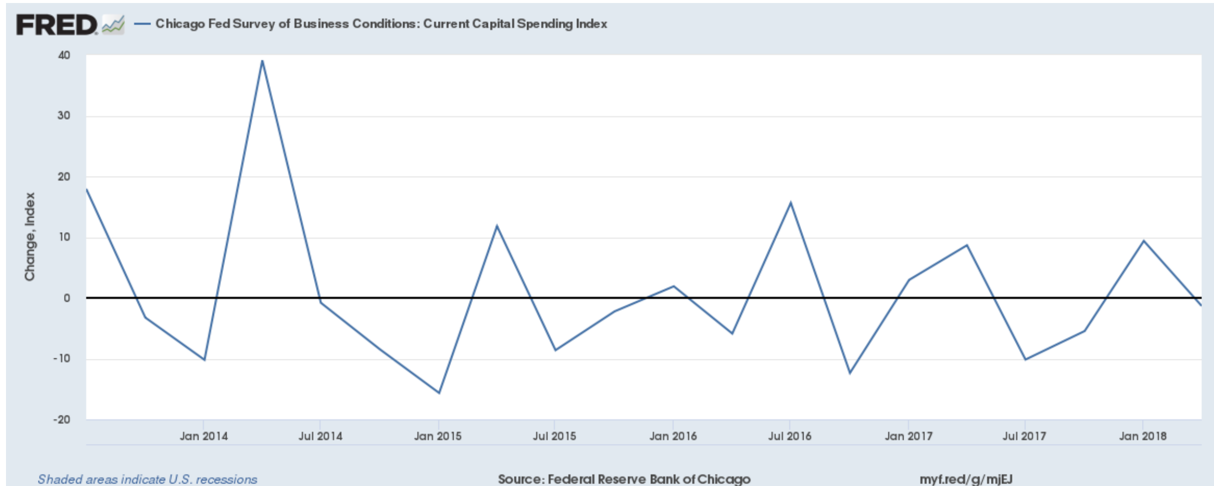
The U.S. Commerce Department revised its estimate of +3.5% for the 3rd quarter GDP down to +3.4%, due to slightly lower consumer spending and weaker exports than previously estimated. That number still supports the impression of a robust quarter, with growth rates above the long-term trend for U.S. GDP growth.

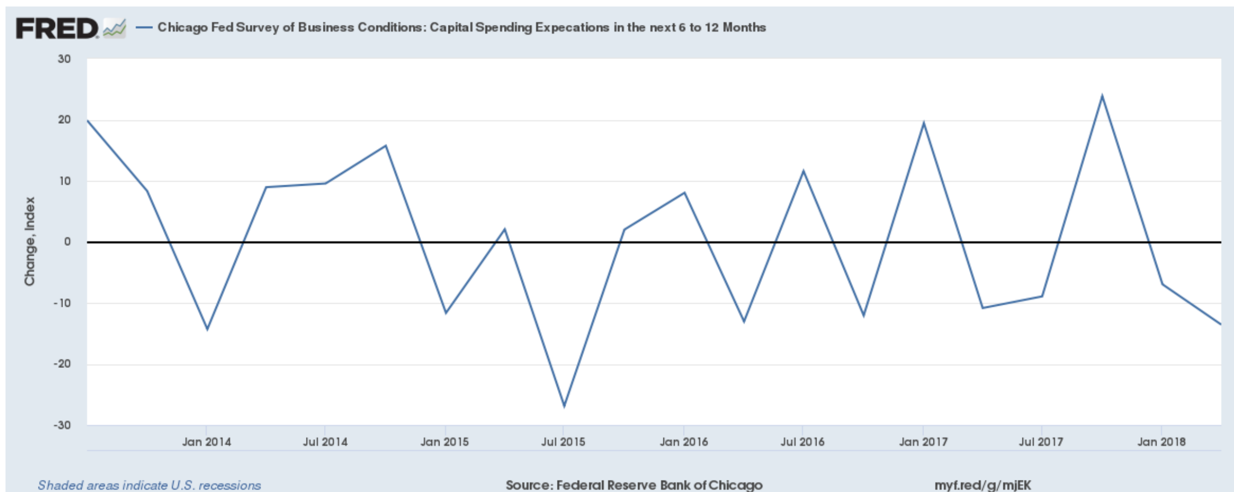
A large driver behind this elevated Q3 growth rate was a buildup in inventories. These can subsequently curtail production down the road, if not met with sufficient future demand. Unfortunately, in our view, sectors tied to trade, manufacturing and housing will create demand headwinds in the quarters ahead. Spending on home building and exports declined in the 3rd quarter.

However, consumer spending grew at a rate of +3.5% in the 3rd quarter. We expect Q4 consumption will continue to strongly support aggregate demand, especially given Holiday retail sales met levels last seen in 2005. This is despite a 2nd successive decrease in consumer confidence in the survey done by the Conference Board; as the overall confidence level remained very close to historical highs. This confirms our overall impression of an optimistic consumer. A robust increase in business investment of +2.5% and a government spending increase of +2.6% accompanied the +3.5% consumer spending growth.

Confirm the direction and strength of **U.S. Real Gross Domestic Product** below.







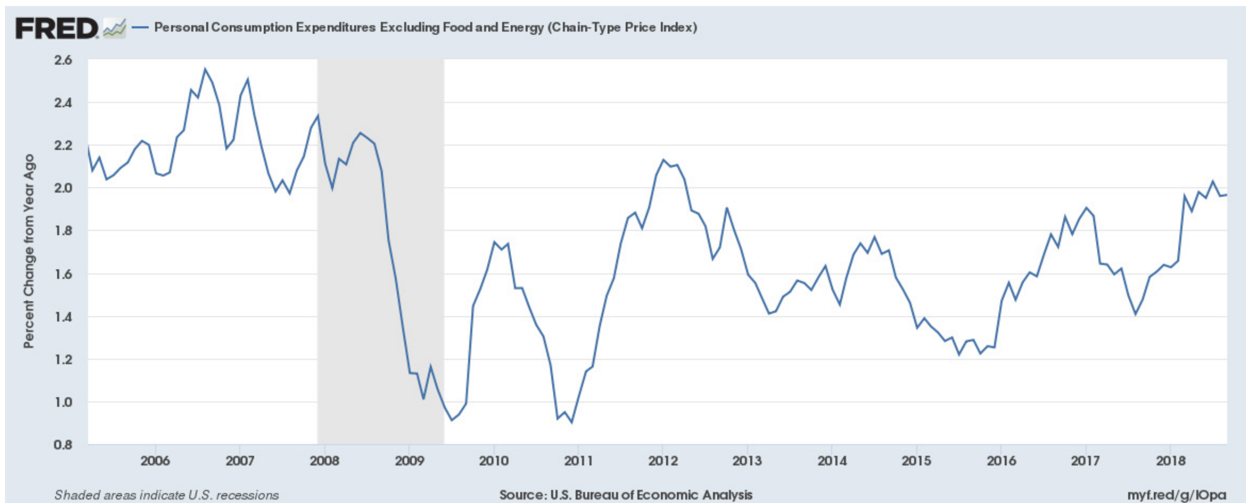
Zacks economists expect a continuation of solid GDP growth in Q4-2018.

What about our annual forecasts for 2019?

#1 Our forecast pegs annualized real GDP growth rate at +3.3% in 2018. Then, we mark a slowdown to +2.6% in 2019.

#2 The projections are in line with the Survey of Professional Forecasters consensus put out by the Federal Reserve Bank of Philadelphia. Consult it at the end of this monthly report.

#3 The FOMC, for another comparable estimate even further out, projects a U.S. growth rate of +2.5% in 2019, +2.0% in 2020 and +1.8% in 2021.



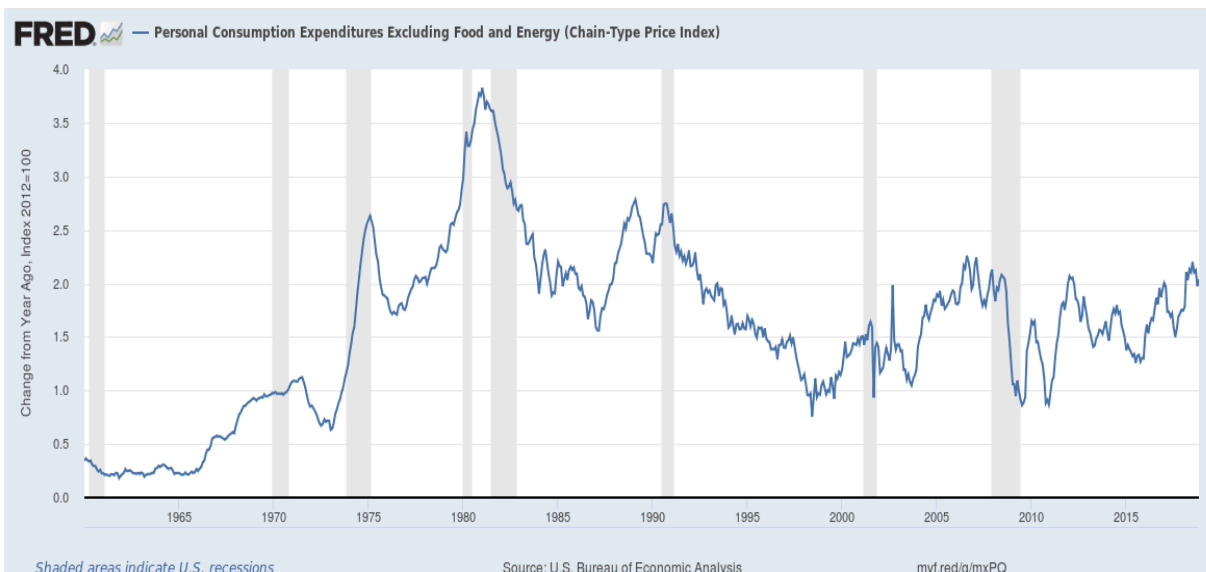
The U.S. labor market remains strong. U.S. consumer inflation is at target.

The U.S. household unemployment rate rose 0.2% to 3.9% in December. Average hourly earnings this month grew by 3.2%. This is a continuing sign that wage growth is building internally.

Consult the monthly series for the **Civilian Unemployment Rates in Blue** and the long-term **Natural Rate of Unemployment in Red** below.

This time series goes back to the 1950s. This shows we are well below the Natural Rate.

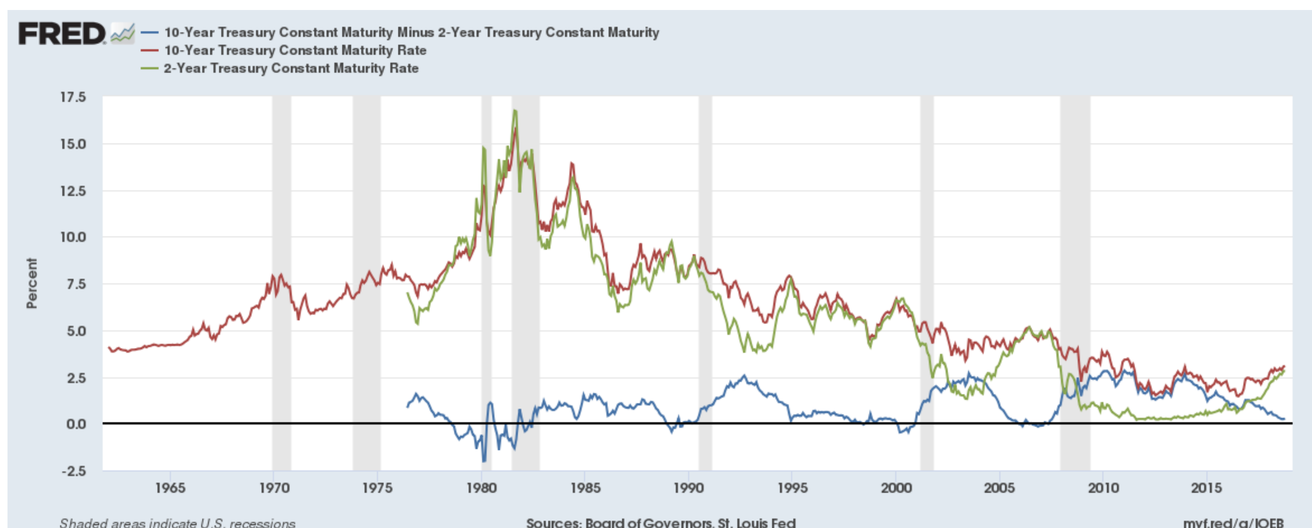
- Core PCE (the Fed's preferred inflation gauge), the data excluding food and energy costs, remained very close to the to the Fed's target of 2.0% at the end of November.
- The graph below depicts **the quarterly change in PCE** from the value a year ago.



- The direction of the current PCE trend demonstrates a subtle upward motion. The FOMC could see this upward PCE motion as data support to raise Fed Funds rates further.

Fixed Income

- The final months of 2018 proved to be a safe haven-driven environment for fixed income markets. Since the beginning of November, yields for the 10-year and 2-year dropped from 3.2% and 2.9% respectively, to 2.7% and 2.5%.
- The gap between the 2-year and 10-year U.S also fell further -- to a near-decade-low of 0.20 percentage points. Zacks economists expect this benchmark U.S. yield spread metric to become narrower still.
- At the long-end, we continue to expect the 10-year U.S. Treasury yield to only slightly rise throughout 2019 and remain below 3.25%.
- At the short-end, we expect the flattening of the yield curve to continue. 2019 likely brings 1 or 2 more hikes in the Fed Funds rate. The FOMC will raise the short end, taking as a given future strong readings on the U.S. economy. Specifically, if core consumer inflation (measured by the PCE) remains on target.
- The 10-year and 2-year U.S. Treasury credit spread is in Blue below.



Zacks Expectations of Fed Policy

- Given robust Q3-18 growth numbers, and consumer price inflation close to the Fed's target for inflation expectations, here's our call. The Fed must inspect both incoming macro data and financial market Tea Leaves very closely in 2019 to achieve its hoped-for soft landing close to a "neutral rate." We see a strong potential for just 1, but possibly 2 more rate hikes in 2019.

SECTION 2: THIS MONTH'S KEY TOPIC

What are key themes to follow closely in 2019?

With the U.S. economy finishing a strong year of solid GDP growth (despite equity markets being in disagreement) investors wonder what the New Year will bring? While the current volatility in equity and fixed income markets suggest 2019 will be a tumultuous year, Zacks economists have a cautiously optimistic outlook.

We acknowledge valid uncertainties around trade wars and rising interest rates. Yet there are solid economic fundamentals across the board. The latter suggests 2019 should see a continuation of a robust economy with a low probability of recession.

Nonetheless, we expect the following three themes to be the critical catalysts -- in terms of how the U.S. economy and risk markets ultimately perform across 2019:

1) **Trade:** While the trade dispute with China appears to be one big worry on investor's minds, we do not see (yet!) a high risk of a substantial annual macro slowdown. Trade disputes have a long tradition in the global economy.

   Here's some background: In recent history, one of the institutions founded to address this very topic was the World Trade Organization. The U.S. helped to establish the WTO in 1995, as a neutral party that helps settle tariff disputes between member countries. Since its founding in 1995 to today, the U.S. has been involved in roughly 120 trade disputes, both as a complainant and as a respondent. That sums to 240 total (or roughly 1 per month).
   The European Union comes in as a close second with almost 100 as a complainant and 80 as a respondent. The accumulated numbers indicate trade skirmishes are nothing new. They have been part of global trade and will continue to be a part of it.

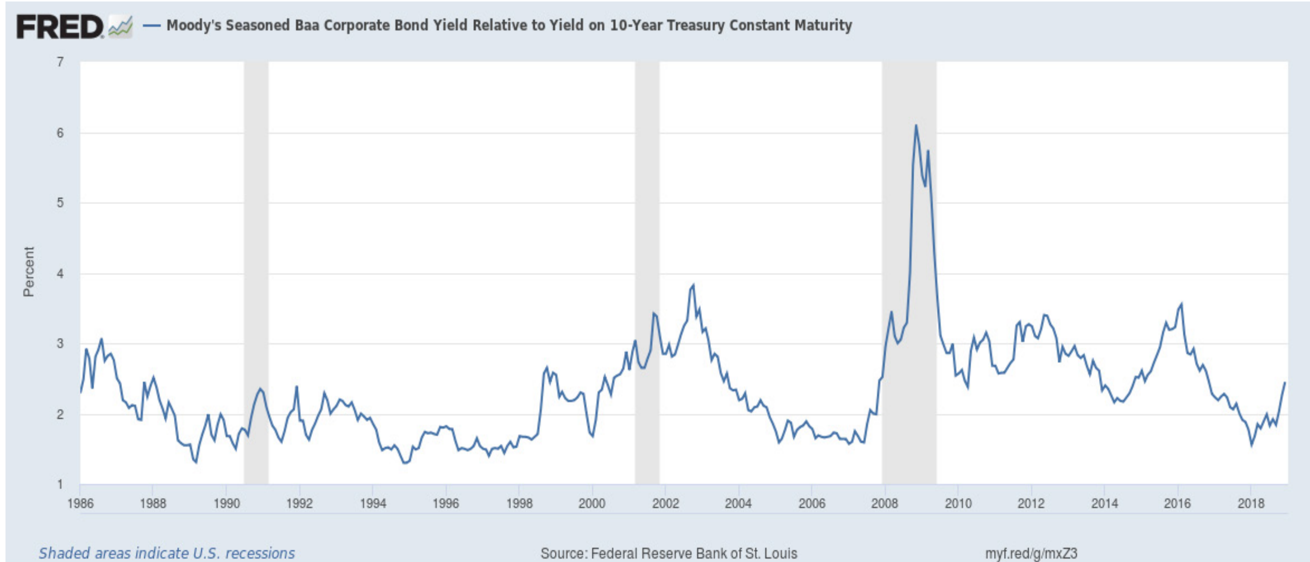
   It is our expectation that delays in negotiations will not be the catalyst to a major annual macro slowdown, but rather a quarterly road bump. However, the risky financial markets are going to sell off, in the face of the uncertainty, regardless.

2) **Debt Levels:** After almost a decade long period of low interest rates, U.S. corporate debt has exceeded levels reached prior to the financial crisis in 2008. In 2018, the International Monetary Fund (IMF) warned us that after the Fed raises interest rates, higher borrowing costs will make it increasingly difficult for highly leveraged sectors. Think about energy, utility, and real estate sectors.

   However, while borrowing costs are indeed rising slowly, we do not expect the rates to rise exceptionally above current levels. Our, expectation of 1 more rate hike by the Fed in 2019, along with a 10-year yield that clocks in below 3.25% by the end of the year, is not a reason for major concern.

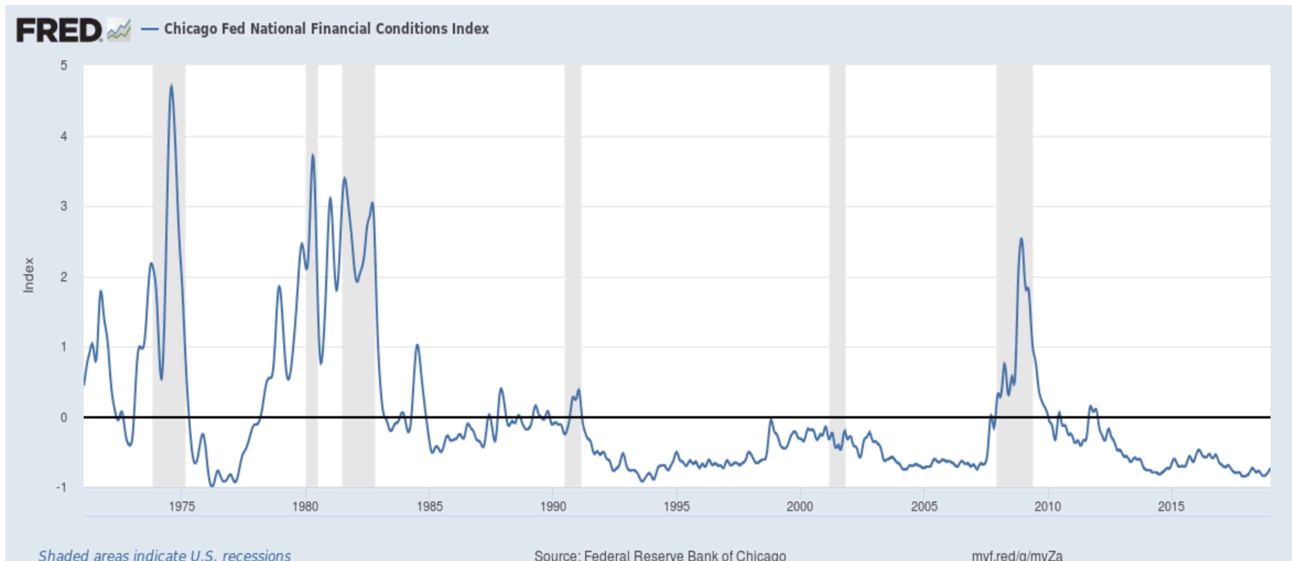
In fact, consult corporate bond yields relative to the 10-year U.S. Treasury yield below. You will note. Even given an increase since the beginning of 2018, this still leaves the spread at historically low levels.

Moody's Seasoned Baa Corporate Bond yield vs. to yield on 10-Year U.S. Treasury--



The Chicago Fed National Financial Conditions Index (NFCI), depicted next, also supports this impression. Financial conditions are still loose compared to long-term averages.

Chicago Fed National Financial Conditions Index--



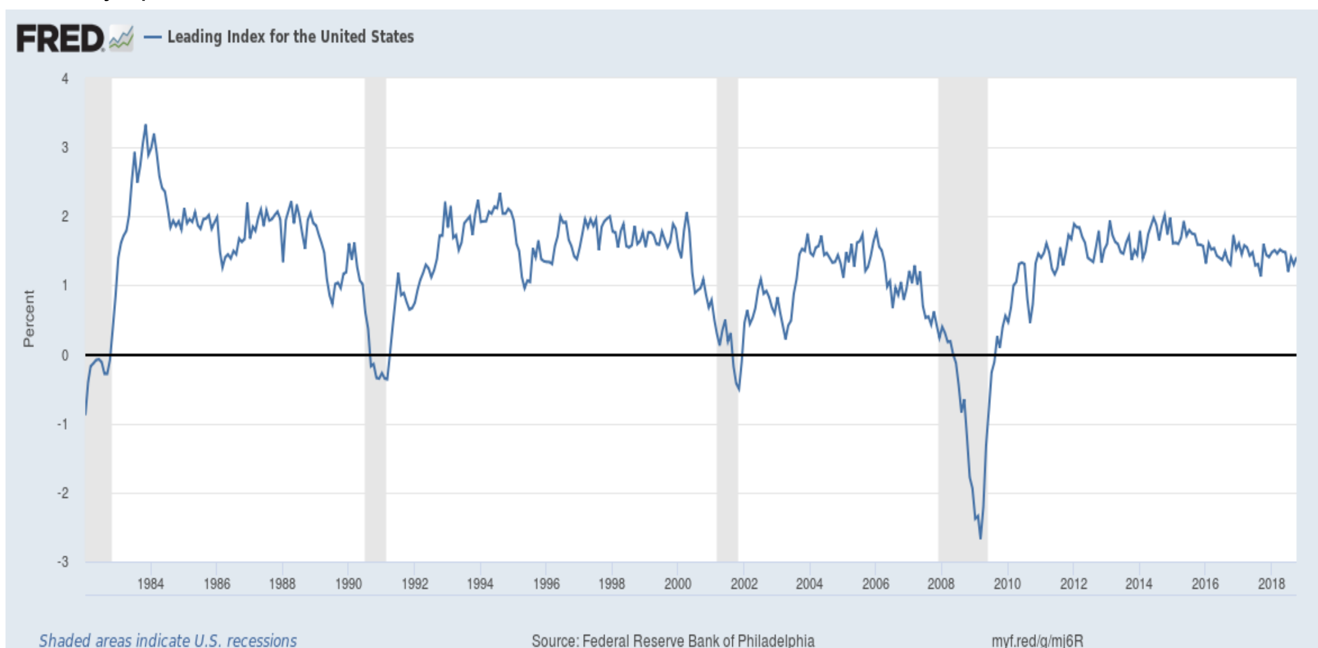
Negative values indicate financial conditions that are looser than average.

In fact, the National Financial Conditions index remains close the levels observed prior to the financial crisis. We thus do not see a current potential for a major downturn in the U.S. economy -- due to corporate debt levels, especially in light of continued solid earnings growth. Zacks and consensus expect high single-digit annual earnings growth across 2019.

3) **Fed Policy**: The big elephant in the room in 2019 is going to be the neutral rate, in our view. *We do question the FOMC's ability to master a slow landing at a normal policy stance.*

The **Leading index of Economic Indicators for the United States --** provided by the Federal Reserve Bank of Philadelphia gathers up an indication of current macro conditions.

This comprises a number of variables with a history of predictive power. They include housing permits, unemployment insurance claims, the ISM manufacturing survey, and the 10-year vs. the 3-month U.S. Treasury spread.



The graph (above) indicates the Leading Index indeed showed light signs of weakness in recent months. But it is nowhere near a below 1.0 level observed in previous recessions. ***It remains to be seen, however, how this Leading Index indicator develops as the Fed continues to tighten monetary policy.***

The Fed manages a dual statutory mandate to maintain both low unemployment and stable consumer inflation. Both targets are close to being met.
Some voting members may want to raise Fed Funds rates multiple times in 2019 in order to have the ability to lower rates, in the event of a future weakening U.S. and global economy.

But if the FOMC raises rates in 2019 beyond an unseen ‘neutral’ rate -- Chair Powell states this is close to, but below, 3.0% -- it might contribute to an early weakening of U.S. growth. Economists consider the ephemeral ‘neutral’ rate as the rate that neither stimulates nor restrains the economy. It merely maintains GDP growth at its trend rate.

There is also a major question about the pace of the ongoing Fed balance sheet reduction. If “QE” did indeed reflate stocks, their monthly pace on the balance sheet reduction may have to slow down, in order to accomplish a smoother landing for risk markets. Draghi exited “QE” too early, in our opinion. And Powell is paying for that mistake.

If the Fed successfully accomplishes a stable U.S. growth landing with a correct ‘neutral’ rate, it will then leave rates at that level. In our view, a stable Fed policy rate will provide a notable tailwind to the U.S. economy, as it will remove Fed policy rate uncertainty from the outlook.

The struggle with all of this is how Fed growth estimates deal with the latest steep drop-off in stocks. This likely throws a monkey wrench into the computation of a ‘neutral’ rate, until the S&P 500 finds a bottom and heads higher.

SECTION 3: CONCLUSIONS

Below: **Zacks January 2019 macro forecasts**, accomplished using an ARIMA (AutoRegressive Integrated Moving Average) econometric system and an Artificial Neural Network.
ARIMA at top, NEURAL NETWORK at bottom.

Zacks January 2019 Forecasts

	Real GDP	Unemployment Rate	Payroll (000s/ month)	Core PCE
2018:Q4	3.2	3.7	177.2	2.0
2019:Q1	2.8	3.6	167.3	1.9
2019:Q2	2.5	3.6	150.5	1.9
2019:Q3	2.4	3.6	164.7	1.9
2019:Q4	2.6	3.7	153.0	1.9
2018	3.3	3.9	175.4	1.9
2019	2.6	3.7	196.0	1.9
2020	2.6	3.8	160.4	1.9

Source: Zacks

	Real GDP	Unemployment Rate	Payroll (000s/ month)	Core PCE
2018:Q4	2.6	3.6	149.7	2.3
2019:Q1	2.0	3.6	148.7	2.0
2019:Q2	2.0	3.9	147.1	1.9
2019:Q3	1.9	3.9	148.5	1.6
2019:Q4	1.6	3.8	147.2	1.4
2018	3.0	3.9	165.4	1.8
2019	1.9	3.8	149.3	1.6
2020	1.6	3.9	148.2	1.5

Source: Zacks

What are key differences between Zacks and the Philadelphia Fed forecasts (on the next page)?

- We are higher than consensus on the incoming Q4 data. In Q4-18, Zacks shows a +3.2% real GDP growth forecast. Philly Fed consensus is for +2.8%.
- Zacks for 2019? We come up with lower annual growth than consensus. We estimate +2.6% annual real GDP growth with ARIMA or +1.9% with Neural Net. The Philly Fed Consensus had +2.7% in 2019.

SECTION 4: ECONOMIC PROJECTIONS

Median Forecasts for Selected Variables in the Current and Previous Surveys						
	Real GDP (%)		Unemployment Rate (%)		Payrolls (000s/month)	
	Previous	New	Previous	New	Previous	New
Quarterly data:						
2018:Q3	3.0	3.0	3.9	3.8	175.0	197.1
2018:Q4	2.8	2.8	3.8	3.7	160.4	173.3
2019:Q1	2.4	2.5	3.8	3.7	160.9	161.5
2019:Q2	2.6	2.7	3.7	3.6	151.7	162.0
2019:Q3	N.A.	2.6	N.A.	3.6	N.A.	150.1
Annual data (projections are based on annual-average levels):						
2018	2.8	2.8	3.9	3.9	185.9	194.8
2019	2.7	2.8	3.7	3.6	160.8	167.8
2020	1.9	1.8	3.9	3.7	N.A.	N.A.
2021	2.0	1.5	4.0	4.0	N.A.	N.A.

Median Short-Run and Long-Run Projections for Inflation (Annualized Percentage Points)								
	Headline CPI		Core CPI		Headline PCE		Core PCE	
	Previous	Current	Previous	Current	Previous	Current	Previous	Current
Quarterly								
2018:Q3	2.2	2.3	2.3	2.3	2.0	2.0	2.1	2.0
2018:Q4	2.3	2.3	2.3	2.3	2.0	2.1	2.1	2.0
2019:Q1	2.3	2.4	2.4	2.4	2.1	2.1	2.1	2.1
2019:Q2	2.2	2.1	2.4	2.4	2.0	2.0	2.0	2.1
2019:Q3	N.A.	2.3	N.A.	2.4	N.A.	2.1	N.A.	2.1
Q4/Q4 Annual Averages								
2018	2.5	2.4	2.5	2.3	2.1	2.1	2.2	2.0
2019	2.2	2.3	2.4	2.4	2.1	2.1	2.1	2.1
2020	2.3	2.3	2.4	2.4	2.1	2.1	2.1	2.1
Long-Term Annual Averages								
2018-2022	2.2	2.2	N.A.	N.A.	2.0	2.0	N.A.	N.A.
2018-2027	2.3	2.2	N.A.	N.A.	2.0	2.0	N.A.	N.A.

Risk of a Negative Quarter (%) Survey Means		
Quarterly data:	**Previous**	**New**
2018:Q3	8.6	6.6
2018:Q4	11.1	10.5
2019:Q1	14.4	13.2
2019:Q2	15.6	16.4
2019:Q3	19.6	19.1

Source: Survey of Professional Forecasters
(https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/2018/survq418)