

Economic Insights

Commentary by Bob Baur, Robin Anderson, and the Economic Committee



Topic summaries:

- **The US virtuous circle:**

The US economy is on the verge of a positive feedback loop between rising wages, strong investment, great job growth, productivity gains, and consumer spending.

- **Stock and bond markets:**

A stock market upturn into year-end is likely approaching. It could be used to reduce risk ahead of what may be a negative return year for stocks as long-term bond yields make another surge higher.

- **Regional economic updates:**

Less growth divergence is likely in 2019 as US activity moderates modestly and greater Europe and Japan maintain their current growth pace. Chinese momentum will weaken further; countries depending on Chinese imports will face headwinds.



For the month of October 2018

The US virtuous circle

At some stage of an economic expansion, a chain of events may occur that reinforces the economy's forward progress through a positive feedback loop. In other words, one good thing leads to another, leading to a third, which in turn, buttresses the first. That's the virtuous circle, and the United States is on the verge of such a positive loop.

Wage growth is clearly picking up. Average hourly earnings on a three-month smoothed basis are 3.0% above the prior year, the best rate since June 2009. The short-term pace is even faster at 3.6% annualized over the last three months, so the year-over-year average could hit 3.5% by next year's second quarter. Other wage measures are similarly gaining steam.

Rising wage gains coupled with a tightening labor market can have a positive impact on investment. As an extra worker becomes more expensive to hire, companies may spend more on labor-saving equipment and software, making their current or future employees more productive to offset faster wage growth or perhaps make the new employee unnecessary. That productivity gain is already happening, up 2.0% the last two quarters, the second best two-quarter average since 2010.

> The circle begins:

Now, with more output-per-hour from employees, businesses can raise wages without hurting profits. With better earnings growth, good investment can continue. And the gains in output will keep those healthier wages from pushing up inflation. Subdued inflation along with vigorous wage growth is the recipe for higher standards of living. And rising standards of living are the prime source of good feelings and hearty confidence, which generate great consumer spending. Robust business and household purchases bring rising business revenue and profits, which close and reinforce the positive loop. While the pace of US economic growth will weaken in 2019, this virtuous circle of wages, jobs, and productivity should keep growth humming right along at 3.0% or more, at least through the first half of next year. This will be the longest expansion in US history, and the positive feedback loop could keep the cycle going longer than currently thought possible.

Markets were dismal for the Halloween month: all trick and no treat.

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Stock and bond markets

Markets were dismal for the Halloween month: all trick and no treat. Almost all diversified investors saw their portfolios shrink in October. Only short-term, safe-haven bond mutual funds had positive returns. Sugar was up 26.6% for the month; yeah, so what?

Risk aversion is rising; defensive sectors seriously outperformed in October. The worries are about growth: many comments intimate a recession in 2019 or 2020. The long US expansion is nearing the cycle end; the confrontation between China and the United States will weaken growth in both places. An article on *Bloomberg* was titled, “A Synchronized Slowdown Is Looming” and a recent copy of *The Economist* had a recession graphic on the cover.

> A different economy:

Of course, magazine covers are often a contrary indicator. We'd suggest the problem is not growth, but the change in the overall economic and monetary environment. Stocks are being repriced for a different world than existed the last near-decade. That was a morass of super-slow growth, non-stop financial crises, fears of deflation, interest rates near or below zero, and ultra-accommodative central banks. So, stocks became an extension of monetary policy. Exactly as then-Federal Reserve (Fed) Chairman Bernanke said: The Fed would push interest rates so low investors would be forced into risky assets, raising their prices. That world no longer exists.

Thus, there is a contrast, a separation or dichotomy between the real economy and financial markets. Markets are struggling. But, the real economy in the United States is booming and growth in the rest of the world is solid. It is precisely because world growth is robust that stock and bond markets are in turmoil.

> Equities, a year-end rally:

That turmoil will likely continue next year, but we'd guess stocks will push higher into year-end. Why? Several reasons. The Santa Claus rally is traditional, especially after a US election due to fading political uncertainty. Third-quarter earnings are excellent. Yes, a few companies have downgraded profit guidance, but growth is still 20.0% above last year and revenue gains are good. Further, worries about economic growth will diminish: the US economy is decoupled from the rest of the world and 3.0% growth will persist; China is easing policy; Eurozone growth will be revised higher; Japan is rebounding. Inflation is not a problem; central banks don't need to be aggressive in normalizing policy. Any impact of the political turbulence in Europe will stay muted.

> Caution advised:

If the November-December upturn does materialize, we'd urge investors to use it to dial back risk in their portfolios and preserve capital for whatever market swoons may come next year. We'd guess 2019 will bring negative returns for stock markets, at least for much of the year. Defensive sectors like consumer staples, healthcare, and utilities have outperformed in recent months, especially October. While that may partially reverse in a year-end rally, a defensive tilt to one's portfolio should remain. Growth and tech stocks have led world stock markets higher for years, but that leadership has cracked. History suggests that stock uptrends continue if the leadership persists; when the market leaders crash, the rally is over. The problem is interest rates.

> Yields move higher:

A key but widely overlooked fact was the 51-month high in the yield on 30-year US Treasury bonds, at 3.45% on November 2nd. That's about 0.25% above the yield on 10-year bonds, which suggests the least difficult direction for yields is up. Why are yields rising when inflation is muted? A booming economy, rising potential growth, and policy turning toward normal. Theory also suggests that

over time, yields on long-term US Treasury bonds would approximate the multi-year average pace of US nominal growth. Over the last year, that rate was 5.5%, once again implying the easiest next move for yields is higher.

Ten-year US Treasury bond yields surged higher from late August to early October, but fell back a bit with the recent equity turmoil. However, they jumped along with the frenzied market rally from Tuesday, October 30. If the year-end upturn does emerge, long-term US Treasury yields will ratchet higher right along with stocks. We'd look for yields on 10-year bonds to approach 3.5%. Yields on German government bonds have been volatile in recent months but have moved irregularly higher; 10-year bund yields ended October at 0.38%. Those yields will likely rise toward 0.75% by year-end as the European Central Bank (ECB) ends its bond purchases.

How about short rates? With the US labor market on fire, economic growth surging, wage gains accelerating, and consumer spending near 4.0%, the Fed will surely raise the fed funds rate another notch in December, putting the top of the acceptable range at 2.5%. Yields on two-year US Treasuries should hit 3.0% or more shortly as a result. If the stock market stabilizes well into 2019, the Fed could raise the funds rate again in March. Since we expect more market turmoil next year, we'd presume the Fed will want to pause before or after a March hike. Higher long-term rates and a disorderly stock market will tighten financial conditions without Fed action.

> Summing up:

For years, markets and investors have been swimming in a gigantic ocean of liquidity that was provided by central banks to counter the awful impact of the global financial crisis. That sea of liquidity washed into prices of all types of assets, especially stocks and bonds, pushing them higher and higher. But, that market propellant is fading as robust economic growth forces monetary policy and interest rates back toward normal. This brought financial-market turmoil in 2018, and is perhaps a harbinger of more tumult in 2019.

> Investment implications:

We expect the strong world economy and resilient investor sentiment to push stock prices higher into year-end, maybe back to this year's highs. As long-term yields rise right along with stocks, it may be wise to take advantage of the rally and reduce stock weightings or move to safe-haven investments. We like US Treasury bonds at somewhat higher yields for a six- to twelve-month trade because

another bout of credit stress will likely cause corporate yield spreads to widen. Fixed income investors could hide in high-quality bonds later this year. We like commercial real estate, especially real estate investment trusts once 10-year US Treasury yields hit 3.5%. If that happens, longer bond maturities would be appropriate.

Regional economic updates

> United States:

After a couple of blowout quarters of 4.0% growth, the US economy is likely decelerating. Core capital-goods orders, a key indicator of future investment, have declined the last two months and a key manufacturing survey, while still robust, dropped to its lowest level in six months. Still, with the capital stock at the oldest age in half a century and good incentives embodied in last year's tax reform, investment should grow strongly into next year. Consumer spending accelerated to a scorching near 4.0% rate the last two quarters, but on a small drop in the savings rate. Falling savings does not necessarily portend well for the future pace of spending.

But, the jobs market is red hot and shows no hint of losing steam. Payroll growth averaged 200,000 monthly the last 12 months, a superb achievement in the ninth year of expansion. And with more people entering the workforce each month than Baby Boomers retiring, this healthy pace of job growth may be sustainable. Despite the most-watched unemployment rate at the lowest level since 1969, the broadest measure of labor market utilization is still above its 2000 low, so there are more people on the labor force sidelines to reenter. Average hourly earnings in the payroll report and private sector wages and salaries in the Employment Cost Index are growing above 3.0%. The fundamentals of consumer spending, confidence, wage gains, and job growth are very healthy, so consumer spending will keep growing above trend. Healthy investment and vigorous household spending should keep US growth humming along at 3.0% or more most of next year. This should be the longest expansion in US history.

> Europe:

Economic growth in the Eurozone has weakened from its surge in 2017, and the pace will likely be in the 1.5% to 2.0% range in both 2018 and 2019. GDP was up only 0.6% annualized in the third quarter, the weakest since the debt crisis, after a lethargic 1.7% rate in the first half. That deceleration is likely temporary, as transitory German auto production issues brought the weakness. The labor market remains a solid support to growth with the Eurozone jobless rate at 8.1%, a cycle low. Germany's unemployment rate is the lowest since reunification. Wage growth is picking up and should support good consumer spending. A weak currency could boost exports and manufacturing.

With growth okay and inflation slowly moving towards target, the ECB will likely feel confident to move along with policy normalization. ECB bond purchases will surely end in December and the ECB will likely start its rate hikes in the second-half of 2019. If growth weakens further, the ECB may ramp up its bank lending program again rather than restart its bond purchases.

Politics in greater Europe may keep investors queasy but won't likely bring a big growth downturn. Yes, Chancellor Merkel's coalition in Germany has frayed and she has resigned as her party's leader; and the strange alliance in Italy with the far-left and -right is in a budget tussle with the European Union. But, this combination may actually provide a mild tailwind for growth if Merkle's exit lessens the insistence on extreme budget austerity as the solution to debt troubles. A turn toward growth-friendly policies would be a helpful change.

> Japan:

Economic growth in Japan will likely stay in the 1.0% to 1.5% range this year and next. That may seem slow, but it's above trend and great for a country with a declining population. In fact, Japan may be in a sort of mini-boom. The labor market is the best it's been in decades: the job openings-to-applicants ratio is the highest since the 1970s and the jobless rate, at an incredibly low 2.3%, is near the lowest since the early 1990s. According to *Bloomberg*, investment spending has grown for seven consecutive quarters, the longest since the 1980s. Corporate profits keep hitting new records and employment is the highest in history as female participation keeps surging. Wage growth is picking up and the acceleration should support consumer spending. A potential two-point increase in the value-added tax next year could lead to a slowdown, but we'd guess with the strong growth in government revenue underway, there is a chance it gets delayed.

> China:

Chinese economic growth weakened to a 6.0% quarter-over-quarter annualized pace in the third quarter, down from the mid-6.0% range. The government is trying to stimulate, but through incentives to households, not by opening the lending spigots. It's doubtful these efforts will have an outsized impact on growth. Officials want to boost consumption and are choosing tax cuts, including potentially halving auto taxes, and lowering interest rates. Ongoing structural issues will keep growth on a slowing path over several years. The labor force may soon begin to shrink, an aftereffect of the long one-child policy. The government wants to curb pollution and slow the growth of debt, both growth-negative. The property market, which has been booming for 25 years, may be peaking too. Growth in GDP will slow to the mid-5.0% range sometime next year.

➤ Emerging markets:

There are both headwinds and tailwinds for developing countries. Those in East Asia are feeling China's slowdown. Purchasing manager indexes were below 50 in Taiwan, Malaysia, and Thailand. Outside of emerging Asia, a likely weaker US dollar may improve the prospects for 2019. The big downdraft in most commodity prices in 2018 was a big drag on exporters, but if the global growth deceleration is over at least outside of China, commodities may no longer be a burden. On the other hand, higher US interest rates are a big risk for emerging market debt.

➤ A look ahead—less divergence:

The big growth difference between the United States and the rest of the world was the driver of the sharp US outperformance in 2018 since most other markets fell into negative territory. Those growth variances should be less dramatic next year. Europe and Japan should grow about the same pace as this year. China will still grow fast, but at a modestly slower pace; fiscal stimulus will help maintain its brisk rate. The US economy will maintain robust momentum, but activity may mildly decelerate. US stocks are poised for a correction next year, especially if yields on 10-year US Treasury bonds move higher. This would give non-US equities an opportunity to outperform.

Baseline Economic Forecasts for 2018 - 2019

A. Growth in Real GDP - Qtr-Qtr (% Change, Annualized):

	1st Quarter 18 Actual		2nd Quarter 18 Actual		3rd Quarter 18 Actual		4th Quarter 18 Forecast		2016 Actual		2017 Actual	
	Real GDP	18,324.0	2.2%	18,511.6	4.2%	18,671.5	3.5%	18,788.5	2.5%	17,659.2	1.6%	18,050.7
Personal Consumption Expenditures	12,722.8	0.5%	12,842.0	3.8%	12,968.5	4.0%	13,077.8	3.4%	12,248.2	2.7%	12,558.7	2.5%
Durable Goods	1,628.2	-2.0%	1,662.3	8.6%	1,690.1	6.9%	1,706.8	4.0%	1,476.8	5.5%	1,577.9	6.8%
Non-Durables	2,858.6	0.1%	2,886.7	4.0%	2,923.7	5.2%	2,949.0	3.5%	2,763.9	2.7%	2,822.0	2.1%
Services	8,267.9	1.0%	8,329.8	3.0%	8,395.6	3.2%	8,445.6	2.4%	8,022.5	2.3%	8,184.5	2.0%
Gross Private Domestic Invest.	3,321.0	9.6%	3,316.7	-0.5%	3,412.1	12.0%	3,427.0	1.8%	3,050.5	-1.3%	3,196.6	4.8%
Bus. Fixed Invest.	2,654.0	11.5%	2,710.1	8.7%	2,715.7	0.8%	2,757.4	6.3%	2,411.2	0.5%	2,538.1	5.3%
Structures	533.3	13.9%	551.7	14.5%	540.5	-7.9%	548.5	6.0%	494.7	-5.0%	517.5	4.6%
Equipment	1,250.9	8.5%	1,264.9	4.6%	1,266.2	0.4%	1,284.7	6.0%	1,116.2	-1.5%	1,183.7	6.1%
Intellectual Property Products	875.7	14.1%	897.9	10.5%	915.1	7.9%	928.5	6.0%	803.9	7.5%	841.1	4.6%
Residential Invest.	615.3	-3.4%	613.2	-1.3%	607.0	-4.0%	611.5	3.0%	591.3	6.5%	611.1	3.3%
Change in Inventory	30.3	-	-36.8	-	76.3	-	35.0	-	23.4	-	22.5	-
Net Exports	-902.4	-	-841.0	-	-939.0	-	-945.4	-	-786.2	-	-858.7	-
Exports	2,517.8	3.6%	2,574.2	9.3%	2,551.2	-3.5%	2,570.8	3.1%	2,378.1	-0.1%	2,450.1	3.0%
Imports	3,420.1	3.0%	3,415.2	-0.6%	3,490.2	9.1%	3,516.1	3.0%	3,164.4	1.9%	3,308.7	4.6%
Gov't Purchases of Goods & Services	3,152.2	1.5%	3,171.8	2.5%	3,197.5	3.3%	3,208.4	1.4%	3,132.5	1.4%	3,130.4	-0.1%
Federal	1,213.1	2.6%	1,224.0	3.7%	1,234.1	3.3%	1,237.4	1.1%	1,187.8	0.4%	1,196.4	0.7%
National Defense	722.8	3.0%	733.3	6.0%	741.7	4.6%	743.5	1.0%	709.2	-0.6%	713.8	0.7%
Non-Defense	489.5	2.1%	490.1	0.5%	492.0	1.5%	493.2	1.0%	478.0	1.9%	481.9	0.8%
State & Local	1,937.7	0.9%	1,946.6	1.8%	1,962.1	3.2%	1,969.4	1.5%	1,942.8	2.0%	1,932.3	-0.5%
Final Sales of Dom. Product	18,274.4	1.9%	18,515.9	5.4%	18,580.6	1.4%	18,734.7	3.4%	17,617.5	2.1%	17,769.1	0.9%
Final Sales to Dom. Purchasers	19,141.3	1.9%	19,330.8	4.0%	19,480.8	3.1%	19,655.8	3.6%	18,387.2	2.3%	18,550.0	0.9%
year-over-year	2.6%		2.9%		3.0%		3.1%					
	1st Quarter 19 Forecast		2nd Quarter 19 Forecast		3rd Quarter 19 Forecast		4th Quarter 19 Forecast		2018 Forecast		2019 Forecast	
Real GDP	18,937.3	3.2%	19,081.0	3.1%	19,216.5	2.9%	19,344.0	2.7%	18,573.9	2.9%	19,144.7	3.1%
Personal Consumption Expenditures	13,170.3	2.9%	13,267.1	3.0%	13,360.5	2.8%	13,450.8	2.7%	12,902.8	2.7%	13,312.2	3.2%
Durable Goods	1,723.6	4.0%	1,740.6	4.0%	1,755.6	3.5%	1,770.8	3.5%	1,671.9	6.0%	1,747.7	4.5%
Non-Durables	2,974.5	3.5%	3,003.8	4.0%	3,033.4	4.0%	3,059.6	3.5%	2,904.5	2.9%	3,017.8	3.9%
Services	8,495.8	2.4%	8,546.3	2.4%	8,595.0	2.3%	8,644.0	2.3%	8,359.7	2.1%	8,570.3	2.5%
Gross Private Domestic Invest.	3,477.8	6.1%	3,518.6	4.8%	3,555.1	4.2%	3,585.7	3.5%	3,369.2	5.4%	3,534.3	4.9%
Bus. Fixed Invest.	2,799.2	6.2%	2,840.4	6.0%	2,872.3	4.6%	2,903.2	4.4%	2,709.3	6.7%	2,853.8	5.3%
Structures	557.8	7.0%	566.0	6.0%	574.3	6.0%	581.4	5.0%	543.5	5.0%	569.9	4.9%
Equipment	1,303.6	6.0%	1,322.7	6.0%	1,335.8	4.0%	1,348.9	4.0%	1,266.7	7.0%	1,327.8	4.8%
Intellectual Property Products	942.2	6.0%	956.0	6.0%	966.6	4.5%	977.3	4.5%	904.3	7.5%	960.5	6.2%
Residential Invest.	620.5	6.0%	625.1	3.0%	629.7	3.0%	634.4	3.0%	611.8	0.1%	627.4	2.6%
Change in Inventory	35.0	-	30.0	-	30.0	-	25.0	-	26.2	-	30.0	-
Net Exports	-950.6	-	-955.3	-	-959.6	-	-961.1	-	-906.9	-	-956.7	-
Exports	2,589.8	3.0%	2,609.7	3.1%	2,628.4	2.9%	2,644.7	2.5%	2,553.5	4.2%	2,618.1	2.5%
Imports	3,540.5	2.8%	3,565.0	2.8%	3,587.9	2.6%	3,605.8	2.0%	3,460.4	4.6%	3,574.8	3.3%
Gov't Purchases of Goods & Services	3,219.2	1.3%	3,230.0	1.3%	3,239.9	1.2%	3,247.9	1.0%	3,182.5	1.7%	3,234.2	1.6%
Federal	1,243.2	1.9%	1,249.1	1.9%	1,254.0	1.6%	1,257.2	1.0%	1,227.1	2.6%	1,250.9	1.9%
National Defense	748.1	2.5%	752.7	2.5%	756.5	2.0%	758.4	1.0%	735.3	3.0%	753.9	2.5%
Non-Defense	494.5	1.0%	495.7	1.0%	496.9	1.0%	498.2	1.0%	491.2	1.9%	496.3	1.0%
State & Local	1,974.4	1.0%	1,979.3	1.0%	1,984.2	1.0%	1,989.1	1.0%	1,954.0	1.1%	1,981.7	1.4%
Final Sales of Dom. Product	18,883.5	3.2%	19,032.1	3.2%	19,167.7	2.9%	19,300.2	2.8%	18,526.4	4.3%	19,095.9	3.1%
Final Sales to Dom. Purchasers	19,809.8	3.2%	19,963.2	3.1%	20,103.0	2.8%	20,237.0	2.7%	19,402.2	4.6%	20,028.2	3.2%
year-over-year	3.3%		3.1%		2.9%		3.0%					

Source: U.S. Dept. of Commerce, Bureau of Economic Analysis; Principal Global Investors

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