

Economic Insights

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



Topic summaries:

• Stock market outlook:

It's a time for investors to be cautious. Monetary policy is gradually returning to normal, interest rates are moving higher, and the liquidity provided during and after the financial crisis is slowly being withdrawn.

• World economic outlook:

The global upturn varies by region: robust momentum in the United States and India; modest rebound in Japan and the Eurozone; and gradual deceleration in China. The expansion should persist well into 2019.

• Interest rate outlook:

Higher yields are likely over the next six months on both short and long-term bonds. Inflation stays tame with no reason for central banks to turn aggressive.



For the month of September 2018

Stock market outlook

When trying to predict the future, it pays to understand the present and how we got here. There were two responses to the global financial crisis. In developed countries, central banks pushed short-term interest rates to the lowest levels in history, many even negative. Then, trillions of dollars in bond purchases, known as quantitative easing and financed by central bank created funds, pushed long-term interest rates to incredibly low levels. This created mountains of liquidity, which went into risky assets: commercial real estate, houses, private equity, developed country stocks, and bonds as well as those of emerging markets. Just like former Federal Reserve (Fed) Chair Ben Bernanke predicted, stock and bond prices soared.

The second response was in China, and by extension, other emerging countries that exported to China. The global financial crisis hit China hard as growth plunged amid the severe world recession. Officials reacted by opening the lending spigots and directing state-owned banks to fund all manner of infrastructure investment. That huge surge in liquidity created immense demand, and China's economy plus those of its emerging suppliers roared up out of the bottom.

> The tide turns:

But, the super-easy policy needed during the financial crisis is grossly inappropriate for the current US economic surge and world expansion. So, central banks are gradually withdrawing the gusher of liquidity and trying to return policy to normal. Officials in China are working to slow the growth of debt before a local financial crisis erupts. For the Fed, that reversal is underway, but it's just about to get started in Europe and Japan. This suggests the worst credit stress may be yet to come. Losses of liquidity caused emerging market currencies to plunge and bond yields of the most vulnerable developing countries to surge the last few months. As the retreat from extraordinary policy gathers steam, turmoil will likely return.

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In some sense, the long US stock market uptrend since March 2009 was an extension or a derivative of monetary policy. Ultra-low interest rates pushed up the present value of future equity earnings, letting stock prices press higher. As interest rates return to more normal levels, the main propellant of stock prices is fading.

> Maybe not yet:

For now, markets are enjoying a respite. The downdrafts that often hit stock markets in September were avoided this year, as markets around the world ended with gains. Major US indices hit new record highs as stocks followed the uptrend of the first two months of the quarter. Investor concerns about trade tensions, Fed rate hikes, and a flattening yield curve melted away as new heights were reached. Even yields on 10-year US Treasury bonds near the May high of 3.11% failed to produce much anxiety. Optimism returned.

A robust US economy, vigorous profit gains, and solid world growth suggest that the optimism and uptrend could continue through the end of this year, perhaps into early 2019. So, we doubt the long stock market rally is over; we'd stick with a moderate weighting in equities a while longer. We prefer US stocks to emerging markets or other developed countries for now. US growth stocks have been market leaders for several years and the leadership usually doesn't change until the rally is over.

> Prudence advised:

Nevertheless, the end of the investment cycle is likely approaching, pushed by higher interest rates, tighter monetary policy, and the fading rush of liquidity. As noted below, not only will the Fed continue to hike rates, there will likely be another wave higher in long-term US Treasury bond yields. That move up may have already started. This is a time to be cautious.

It may seem contradictory to advise caution on financial markets when the US economy is booming and the world economy is solid. But, it is exactly that robust growth that is disrupting the key driver of financial markets for the last several years: ultra-low interest rates and the liquidity provided in the aftermath of the global financial crisis. The tide is turning.

World economic outlook

The current world economic expansion began in the summer of 2016 and gathered steam throughout last year. Growth peaked early in 2018 and momentum now varies by region. The US economy is red-hot and Indian economic gains are world-beating. Europe and Japan are rebounding modestly from a weak first half. China is mired in a long, gradual structural deceleration. Developing economies, while enjoying a respite from currency depreciation and surging bond yields, face significant headwinds.

> United States:

The US growth outlook is more than solid, it's the best in years. Consumer confidence stays near the highest in history. Small business optimism hit a record high, with robust buoyancy about future sales and investment. The labor market is red-hot, keeping consumers optimistic and spending strong. Wage growth is accelerating with smoothed average hourly earnings up 2.8% over the prior year in August, the best since mid-2009. Housing was the only weak spot this year. Home sales have been flat to down and home price gains are the slowest in over a year. Mortgage rates are eating away at housing affordability.

Despite the strong growth pace, inflation remains modest with recent downside surprises. Even though consumer price inflation has accelerated this year, the breadth of price gains has been weak. Take out housing rent and *Société Générale* research shows core consumer-price gains of only a 1.4% average annualized pace so far this year.

Looking ahead, fundamentals suggest US economic growth will stay in a 3.0% to 3.5% range for several quarters, with modest deceleration later in 2019. Household formation is picking up because job and wage growth for first-time homebuyers is strong; so housing activity should revive. Capital spending should remain vigorous, given the old age of the US capital stock and incentives in the 2017 tax reform. Improving wage gains with more hours will support faster consumer spending but should also add to the incentives for vigorous investment. As labor becomes more expensive, companies will have even more reason to invest in productivity-enhancing equipment and software. Capital spending should remain vibrant.

Solid wage growth is the key to prolonging this expansion. If inflation stays mild like we expect, more rapid wage growth implies higher inflation-adjusted income for households. Rising real income is the definition of higher standards of living. That would keep confidence, consumer spending, and investment surging, prolonging what will surely become the longest expansion in US history.

> Europe:

European data have generally been disappointing. Manufacturing slowed because new emission standards weighed on auto production. Eurozone industrial production declined over the prior year in July. The latest manufacturing surveys fell as well, with Germany's down over two points in September. Business confidence measures have been somewhat mixed but stay well off last year's highs. Overall Eurozone economic confidence has dropped throughout the year.

We expect economic growth to range from 1.5% to 2.0% well into 2019. The labor market is a bright spot since labor costs have been rising only slowly even as the jobless rate declines. Prospects for strong wage growth are excellent and should keep household consumption the driver of economic growth. Improving wage gains have boosted the European Central Bank's (ECB) confidence that inflation will move up to target. Germany's headline inflation rate already broke above the ECB's 2.0% target. We expect the ECB will end its bond purchases on schedule January 1, 2019 and begin to neutralize its policy rate sometime the second half of next year.

> Japan:

Japan has strong economic fundamentals. Corporate profits keep hitting record highs. According to the *Nikkei Asian Review*, nearly one in four companies had record profits, a hefty percentage. Record employment and improving wages are bringing more women and older workers back into the labor force. Even so, employers are seeing worker shortages. That's what's driving investment; capital spending rose the most in 11 years last quarter. Good consumer spending buttressed by rising wage gains and an incredibly tight labor market, record profits, and robust capital spending should keep Japanese economic growth above trend and in the 1.0% to 1.5% well into 2019.

> China:

Hard data for China remain mixed to weak. Business surveys for manufacturers are nearing the point of no growth. Gains in fixed-asset investment dropped to another record low in August. Retail sales surprised a bit to the upside while industrial production growth picked up modestly for the first time in four months. Housing stays the one bright spot with home prices still trending higher. According to J.P. Morgan, real estate investment is growing about double the slow pace of overall investment.

Increased bank liquidity, easing lending standards, and sizeable income tax cuts for households may selectively boost growth into year-end. But, we see meager odds of more than a modest pickup in growth. Attempts to reduce severe pollution and too high debt growth, plus a soon-to-be declining workforce, suggest that economic growth will remain in a secular slowdown. We look for official growth in the low 6.0% range into early next year.

> Emerging markets:

After months of currency depreciation and widening credit spreads, emerging economies finally caught a break. The MSCI Emerging Market Currency Index bounced from an early September low. China's yuan stabilization the last two months helped. Markets applauded the Turkish central bank's action to support its plunging currency. Central banks in India, Russia, and Indonesia have also been raising rates. Super-fast growth in India is an outlier in the emerging world where problems exist and growth is slowing.

The currency stabilization and investor optimism brought emerging market currencies, bonds, and stocks a welcome respite. A pause in Fed rate hikes after March next year may provide further support. Still, the gradual removal of excess liquidity, higher yields on long-dated US Treasury bonds, a US dollar that refuses to weaken much, and slower growth in China will remain significant headwinds for all emerging market assets.

Interest rate outlook

> Long-maturity yields:

After staying within a narrow range since March, yields on 10-year US Treasury bonds pushed up to nearly 3.1% in the last few days, coinciding with yields on 10-year German bunds hitting a four-month high above 0.5%. The same week, yields on 10-year Japanese government bonds topped 0.11%, the highest since January 2016. We expect these long-term safe-haven bond yields to work irregularly higher for several reasons. First, over the very long term, long-maturity bond yields should correlate somewhat closely with long-term average economic growth. With US nominal growth now over 5% and that of the Eurozone and Japan between 2% and 3%, current long-bond yields in all three countries seem far too low.

Second, safe-haven bond yields have been and are under significant down-pressure from super-easy monetary policy and large-scale bond purchases by their respective central banks. But, as noted above, the tide of accommodative policy is turning, and Eurozone and Japanese bond yields will have to adjust higher to the new environment. That will take substantial down-pressure off long-maturity US Treasury bond yields. Further, deflation is no longer a concern; inflation is gradually working a bit higher and should push bond yields up to account for future potential inflation.

Last, investors are still enamored with the secular stagnation hypothesis, where inflation, interest rates, and economic growth will stay far lower for far longer. The reason: central banks will be unable to spur inflation because potential economic growth has collapsed. That's the narrative of the "new normal." But, that should be abandoned given the robust world growth and US economic surge of the last 18 months.

We look for another wave higher of long-dated US Treasury bond yields over the next several months, likely to around 3.5%. This would likely raise yields on corporate and emerging market bonds as well as widen yield spreads to safe-haven government bonds. Investors should stick with short to medium-term bonds and higher quality corporate bonds because higher yields will hurt bond prices and push quality spreads wider. The long uptrend in US equities from March 2009 has been an extension of monetary policy and was driven by the ultra-low yields fostered by world central banks. Thus, higher yields, if they do come, will likely bring more turmoil to stock markets. If stock market turbulence does reappear, long-term bond yields would likely retreat, so US Treasury yields of 3.5% may not be around very long. Recent US rate history is shown below.

Interest Rates	12/31/2015	12/31/2016	12/29/2017	05/17/2018 (High)*	09/07/2017 (Low)*	09/28/2018 Current
FFR**	0.5%	0.75%	1.5%			2.25%
2-year	1.05%	1.19%	1.88%	2.56%	1.27%	2.82%
10-year	2.27%	2.44%	2.41%	3.11%	2.04%	3.06%
10-2 spread	1.22%	1.25%	0.53%	0.55%	0.77%	0.24%
30-year	3.02%	3.07%	2.74%	3.25%	2.66%	3.21%

*12-month high and low, based on the 10-year Treasury bond high and low over the prior 12 months

**Upper bound on the range of the fed funds rate

Source: Bloomberg

> The Fed stays gradual:

With the Fed rate hike in September, the upper end of the fed funds rate (FFR) range is now 2.25%. The Fed's estimate calls for another hike in December and at least three more in 2019. That seems excessive for several reasons.

First, we expect inflation to stay modest over the next year; as noted above, outside of US housing, the average of the other components of consumer price inflation remain below 2%. There is no reason for the Fed to become aggressive or push the FFR into restrictive territory. Further, two more FFR hikes, in December and next March, would put the FFR upper range at 2.75%, right in the middle of some estimates of neutral. At that time, inflation will likely remain contained near the Fed's target and wage growth will not yet be surging. So, it's likely the Fed would pause after the March hike and forego the quarterly hike scheduled for June. In addition, by 2019's second quarter, world stock markets could easily be under significant pressure from higher long-term yields and renewed credit stress in emerging markets. So, financial conditions would have already tightened substantially without further Fed action.

The table below contains projections for interest rates at year-end 2018 and 2019. The estimates for year-end 2019 assume mild turmoil in world stock markets next year, which brings a long pause in the Fed's rate hike schedule. It's possible that today's super-optimism about US earnings won't be met and the disappointment will create a substantial decline in major stock averages. If that happens, long-term yields at year-end 2019 will be much lower than these forecasts. People say 15 months is a lifetime in politics; it's a lifetime in markets too.

Interest Rates	Year-end 2018	Year-end 2019
Federal Funds	2.38%	2.63%
2-Year UST Yield	3.0-3.25%	3.0%-3.25%
10-Year UST Yield	3.25%-3.50%	3.25%-3.5%
2-10 Year Spread	0.0%-0.5%	0.0%-0.5%

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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 Forecast		4th Quarter 18 Forecast		2016 Actual		2017 Actual	
Real GDP	18,324.0	2.2%	18,511.6	4.2%	18,681.6	3.7%	18,843.5	3.5%	17,659.2	1.6%	18,050.7	2.2%
Personal Consumption Expenditures	12,722.8	0.5%	12,842.0	3.8%	12,948.6	3.4%	13,040.1	2.9%	12,248.2	2.7%	12,558.7	2.5%
Durable Goods	1,628.2	-2.0%	1,662.3	8.6%	1,678.7	4.0%	1,695.2	4.0%	1,476.8	5.5%	1,577.9	6.8%
Non-Durables	2,858.6	0.1%	2,886.7	4.0%	2,911.6	3.5%	2,936.7	3.5%	2,763.9	2.7%	2,822.0	2.1%
Services	8,267.9	1.0%	8,329.8	3.0%	8,379.3	2.4%	8,429.2	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%	3,395.6	9.9%	3,476.8	9.9%	3,050.5	-1.3%	3,196.6	4.8%
Bus. Fixed Invest.	2,654.0	11.5%	2,708.9	8.5%	2,755.4	7.0%	2,802.0	6.9%	2,411.2	0.5%	2,538.1	5.3%
Structures	533.3	13.9%	550.1	13.2%	558.1	6.0%	566.3	6.0%	494.7	-5.0%	517.5	4.6%
Equipment	1,250.9	8.5%	1,264.5	4.4%	1,289.1	8.0%	1,314.2	8.0%	1,116.2	-1.5%	1,183.7	6.1%
Intellectual Property Products	875.7	14.1%	898.9	11.0%	912.1	6.0%	925.5	6.0%	803.9	7.5%	841.1	4.6%
Residential Invest.	615.3	-3.4%	612.8	-1.6%	617.3	3.0%	621.9	3.0%	591.3	6.5%	611.1	3.3%
Change in Inventory	30.3	-	-36.8	-	0.0	-	30.0	-	23.4	-	22.5	-
Net Exports	-902.4	-	-841.0	-	-865.0	-	-886.2	-	-786.2	-	-858.7	-
Exports	2,517.8	3.6%	2,574.2	9.3%	2,583.8	1.5%	2,596.7	2.0%	2,378.1	-0.1%	2,450.1	3.0%
Imports	3,420.1	3.0%	3,415.2	-0.6%	3,448.9	4.0%	3,482.8	4.0%	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%	3,183.6	1.5%	3,193.9	1.3%	3,132.5	1.4%	3,130.4	-0.1%
Federal	1,213.1	2.6%	1,224.0	3.7%	1,228.1	1.3%	1,231.1	1.0%	1,187.8	0.4%	1,196.4	0.7%
National Defense	722.8	3.0%	733.3	6.0%	736.1	1.5%	737.9	1.0%	709.2	-0.6%	713.8	0.7%
Non-Defense	489.5	2.1%	490.1	0.5%	491.3	1.0%	492.6	1.0%	478.0	1.9%	481.9	0.8%
State & Local	1,937.7	0.9%	1,946.6	1.8%	1,953.8	1.5%	1,961.1	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%	18,663.6	3.2%	18,795.5	2.9%	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%	19,506.3	3.7%	19,659.4	3.2%	18,387.2	2.3%	18,550.0	0.9%
year-over-year	2.6%		2.9%		3.1%		3.4%					
	1st Quarter 19 Forecast		2nd Quarter 19 Forecast		3rd Quarter 19 Forecast		4th Quarter 19 Forecast		2018 Forecast		2019 Forecast	
Real GDP	18,999.4	3.4%	19,148.9	3.2%	19,285.2	2.9%	19,413.3	2.7%	18,590.2	3.0%	19,211.7	3.3%
Personal Consumption Expenditures	13,132.3	2.9%	13,228.8	3.0%	13,321.8	2.8%	13,411.8	2.7%	12,888.4	2.6%	13,273.7	3.0%
Durable Goods	1,711.9	4.0%	1,728.8	4.0%	1,743.7	3.5%	1,758.8	3.5%	1,666.1	5.6%	1,735.8	4.2%
Non-Durables	2,962.1	3.5%	2,991.3	4.0%	3,020.8	4.0%	3,046.9	3.5%	2,898.4	2.7%	3,005.3	3.7%
Services	8,479.3	2.4%	8,529.7	2.4%	8,578.3	2.3%	8,627.2	2.3%	8,351.5	2.0%	8,553.6	2.4%
Gross Private Domestic Invest.	3,534.7	6.8%	3,581.2	5.4%	3,618.5	4.2%	3,649.7	3.5%	3,377.5	5.7%	3,596.0	6.5%
Bus. Fixed Invest.	2,850.7	7.1%	2,892.6	6.0%	2,925.2	4.6%	2,956.6	4.4%	2,730.1	7.6%	2,906.3	6.5%
Structures	576.0	7.0%	584.4	6.0%	593.0	6.0%	600.3	5.0%	552.0	6.6%	588.4	6.6%
Equipment	1,339.7	8.0%	1,359.3	6.0%	1,372.7	4.0%	1,386.3	4.0%	1,279.7	8.1%	1,364.5	6.6%
Intellectual Property Products	939.1	6.0%	952.9	6.0%	963.4	4.5%	974.1	4.5%	903.1	7.4%	957.4	6.0%
Residential Invest.	631.0	6.0%	635.7	3.0%	640.4	3.0%	645.2	3.0%	616.8	0.9%	638.1	3.4%
Change in Inventory	30.0	-	30.0	-	30.0	-	25.0	-	5.9	-	28.8	-
Net Exports	-891.0	-	-895.3	-	-899.1	-	-900.3	-	-873.6	-	-896.4	-
Exports	2,615.9	3.0%	2,636.0	3.1%	2,654.9	2.9%	2,671.3	2.5%	2,568.1	4.8%	2,644.5	3.0%
Imports	3,507.0	2.8%	3,531.3	2.8%	3,554.0	2.6%	3,571.6	2.0%	3,441.8	4.0%	3,541.0	2.9%
Gov't Purchases of Goods & Services	3,204.6	1.3%	3,215.3	1.3%	3,225.2	1.2%	3,233.2	1.0%	3,175.4	1.4%	3,219.6	1.4%
Federal	1,236.9	1.9%	1,242.7	1.9%	1,247.7	1.6%	1,250.8	1.0%	1,224.1	2.3%	1,244.5	1.7%
National Defense	742.5	2.5%	747.1	2.5%	750.8	2.0%	752.7	1.0%	732.5	2.6%	748.3	2.1%
Non-Defense	493.8	1.0%	495.0	1.0%	496.2	1.0%	497.5	1.0%	490.9	1.9%	495.6	1.0%
State & Local	1,966.0	1.0%	1,970.9	1.0%	1,975.8	1.0%	1,980.7	1.0%	1,949.8	0.9%	1,973.4	1.2%
Final Sales of Dom. Product	18,951.4	3.4%	19,101.0	3.2%	19,237.2	2.9%	19,370.3	2.8%	18,562.4	4.5%	19,165.0	3.2%
Final Sales to Dom. Purchasers	19,820.2	3.3%	19,974.0	3.1%	20,114.1	2.8%	20,248.4	2.7%	19,409.5	4.6%	20,039.1	3.2%
year-over-year	3.7%		3.4%		3.2%		3.0%					

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