Current Economic Conditions

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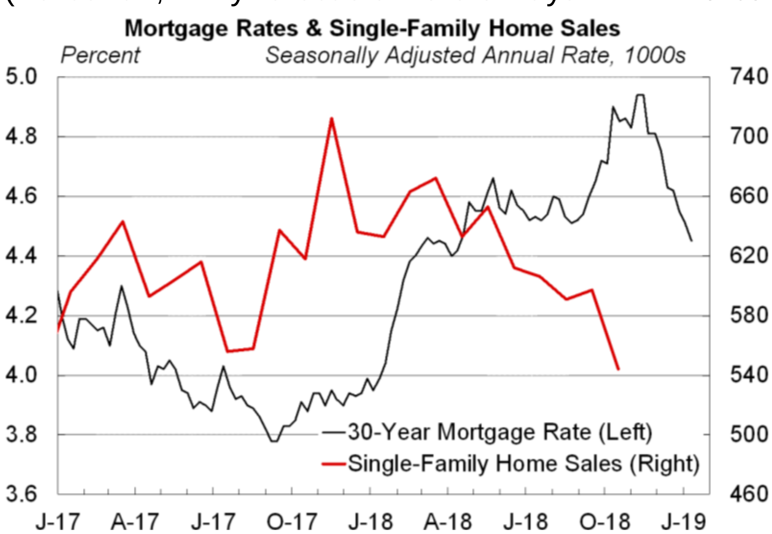
U.S. ECONOMIC GROWTH SLOWING IN 2019

The U.S. economy ended 2018 on a high note, with nonfarm payrolls growing by 313,000 in December. Payroll growth over the prior two months was revised up by 58,000. The strong growth in employment and associated growth in hours worked make it likely that real Gross Domestic Product grew at close to a 3% annual rate in the fourth quarter of 2018. Light vehicle sales surprised on the upside for a fourth consecutive month in December, suggesting that consumer spending on durable goods was especially strong in the fourth quarter. Industrial production in U.S. manufacturing surged 1.1%.

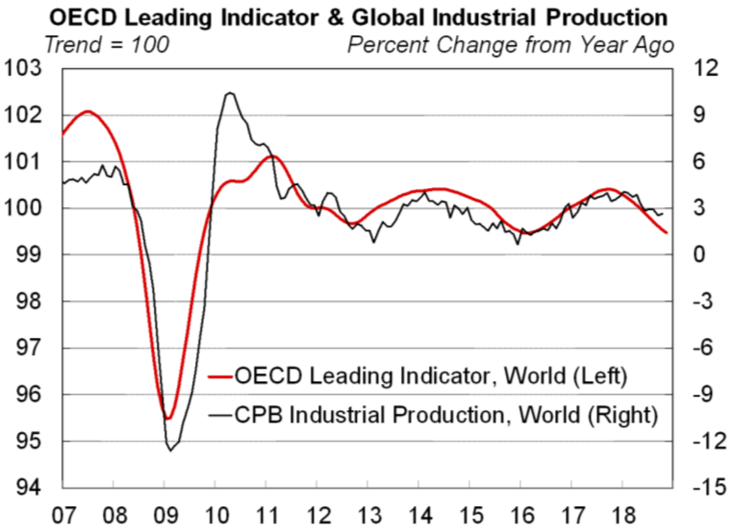
Growth is likely to be much slower in the first half of 2019 than it was in the last three quarters of 2018. This downshift was signaled by a 20% decline in stock prices from September to December, then by a big decline in the Institute of Supply Management's Manufacturing PMI (purchasing managers' index) for December. Particularly concerning was the sharp decline in the PMI's forward-looking new orders index. The National Association of Independent Business's Small Business Optimism Index fell for a fourth straight month in December. Manufacturing indexes from the Federal Reserve Banks of Dallas, New York, and Richmond plunged in January. (But the Federal Reserve Bank of Philadelphia's manufacturing activity index rose, and initial claims for unemployment insurance remain close to 50-year lows.)

Growth is being suppressed by a combination of factors. The Fed raised its target federal funds rate by a total of 1.75 percentage points in 2017 and 2018. In retrospect, it raised rates one time too many. (To be fair, if my forecasts were always within 25 basis points of being correct, I'd brag about it.) The average 30-year fixed mortgage rate rose from 3.78% in September 2017 to 4.94% in November 2018. The combination of higher mortgage rates, limits on the State & Local Tax (SALT) deduction, and lower limits on mortgage deductions caused housing starts and home sales to decline through most of 2018. (Despite the impact on housing, I think limiting the SALT deduction and reducing limits on mortgage deductions was good tax policy.) A decline in home sales is ultimately reflected in weaker consumer spending on paint, carpeting, appliances, and furniture. (That explains the earnings warning issued by paint company Sherwin-Williams.) Uncertainty about trade policy has interrupted a nascent surge in investment spending. New orders for nondefense capital goods rose at a 9.1% annual rate from October 2016 to July 2018 but then declined through November (last data available). Weaker growth abroad has hurt U.S. exports. On top of all that, a partial government shutdown is now reducing economic growth.



The negative impact of rising interest rates is likely to ease or even reverse in 2019. The Fed has backed away from its plan to raise rates two or three times in 2019 and is now promising to be "patient" and "data-dependent." Mortgage rates have already declined by almost half a percentage point.

On the other hand, there is no evidence that the slowdown abroad is ending. Industrial production in European Union manufacturing fell 1.3% in November, leaving it down 1.8% from year-earlier levels. Production fell sharply in Germany, France, and Italy. Chinese imports were down 7.6% year-over-year in December. To some extent, this might reflect Chinese retaliatory tariffs on U.S. goods, but it's mostly due to a slowdown in Chinese economic growth that has nothing to do with trade policy. Chinese auto sales fell 3.1% in 2018; that's the first annual decline since 1990. In response to slowing growth, China cut value-added taxes and individual income taxes in 2018 and is considering cuts in its enterprise income tax. It has also reduced reserve requirements for banks. These measures might halt the deceleration in Chinese growth, but given China's enormous government debt and the (related) diminishing results from previous stimulus measures, one should not expect growth to rebound significantly. More broadly, the Organization for Economic Cooperation and Development's global leading index has declined for 14 straight months (through November). While this index is more of a coincident index than a leading one, it shows no evidence that global growth was reaccelerating as 2018 ended. Fortunately for the United States, weakness abroad generally does not trigger recessions in the United States. (U.S. weakness **does** cause recessions abroad.)



With the Fed now patient and data-dependent, the length and severity of the 2019 U.S. economic slowdown will be determined by the length of the government shutdown and by the resolution (or lack thereof) of the trade dispute between the United States and China. According to estimates from the Trump Administration, U.S. GDP growth in the first quarter will decline by 0.1 percentage point for every week the shutdown lasts. Given the slowdown that was already in the pipeline from higher interest rates, slow growth abroad, and trade concerns, the government shutdown is likely to hold U.S. GDP growth below 2%, perhaps well below 2%, as long as it lasts. Ironically, because data aren't being released by branches of the government affected by the government shutdown, we will have no way of knowing how bad the economy is being hit by the government shutdown until after the shutdown ends.

Trade policy remains the 800-pound gorilla. Even with the incentives provided by the Tax Cuts and Jobs Act, it's hard to see U.S. business investment rising significantly until trade policy uncertainty is resolved. A big increase in potential growth, from the Congressional Budget Office's 1.8% estimate to the 2.5% rate I think is possible, won't happen without a big increase in investment that increases productive capacity and boosts productivity growth. (Given the huge slowdown in U.S. population growth since the 1970s, a big increase in legal immigration, which runs counter to current Trump Administration policy, is also necessary to get potential growth up to 2.5% and pay for expected Social Security benefits.)

While U.S. economic growth has slowed, I don't expect a recession this year. The cyclical-sector (housing, business investment, and consumer durables) share of GDP remains well below the peak levels it usually reaches during an expansion. It's hard to have a recession without a big downturn in these sectors, and it's hard to have a big downturn (bust) without first having a boom. To get a recession this year, you probably need three out of four of 25% tariffs, a prolonged government shutdown, interest rate hikes that invert the yield curve, and a big increase in oil prices. But the outlook for 2019 is not as bright as it was six months ago. As long as the government remains shut down **or** the trade dispute with China remains unresolved, expect GDP growth at or below 2%. If the shutdown ends and a trade agreement is reached that eliminates the 10% tariffs on Chinese imports rather than raising them to 25%, expect growth at or above 3% for a few quarters before it settles down to a more sustainable rate. That sustainable rate will depend on immigration policy and business willingness to invest in plants, equipment, and software.