2019 Market Preview: U.S. Economy

THE VIEW FROM THE TOP?

Jeff Hoffmeyer, CFA
Lead Analyst, Asset Allocation

2018 saw another positive year of economic growth, and for some the Great Recession is slowly becoming a distant memory. The current GDP bull market has now lasted an impressive 115 months, making it the second longest since the end of WWII. If this growth continues through 2019 it will surpass the expansion of the 1990s and become the longest in modern history. While economic metrics are very strong, many risks remain, and investors became increasingly concerned over the last few months of 2018.

The most significant issues are geopolitical, particularly the tariff battle with China. Exhibit 1 shows the timeline of the trade war and how it has gradually escalated. In total, the U.S. has implemented new tariffs on $250 billion worth of Chinese goods, while China has enacted $110 billion of new tariffs, which is nearly all of the goods China imports from the U.S. At this point, China has little room to escalate things further, at least through traditional means, while the U.S. was able to threaten a tariff on an additional $257 billion of goods.

Exhibit 1: Timeline of the U.S.–China Trade War

January 22
U.S. introduces tariffs on washing machines and solar cell imports

March 9
U.S. imposes steel and aluminum tariffs on most countries

March 23
China introduces tariffs on $3 billion worth of U.S. imports in response to the steel and aluminum tariffs

April 4
China announces an additional 25% tariff on U.S. imports, including soybeans and automobiles

May 20
U.S. and China issue a joint statement, U.S. agrees to hold off on tariffs while China offers to increase purchases of U.S. goods

June 15
U.S. introduces tariffs on $50 billion of imports from China, China responds with matching $50 billion worth of tariffs

September 24
U.S. announces an additional tariff on $200 billion in Chinese exports at a 10% rate, set to increase to 25% on Jan. 1, 2019. China retaliates with $60 billion worth of tariffs ranging 5%-10%

October 30
U.S. reportedly planning to announce tariffs on all remaining Chinese goods, worth $257 billion

December 2
U.S. and China agree to not increase or impose new tariffs for 90 days, China offers to crack down on intellectual property rights violations

Source: The Wall Street Journal

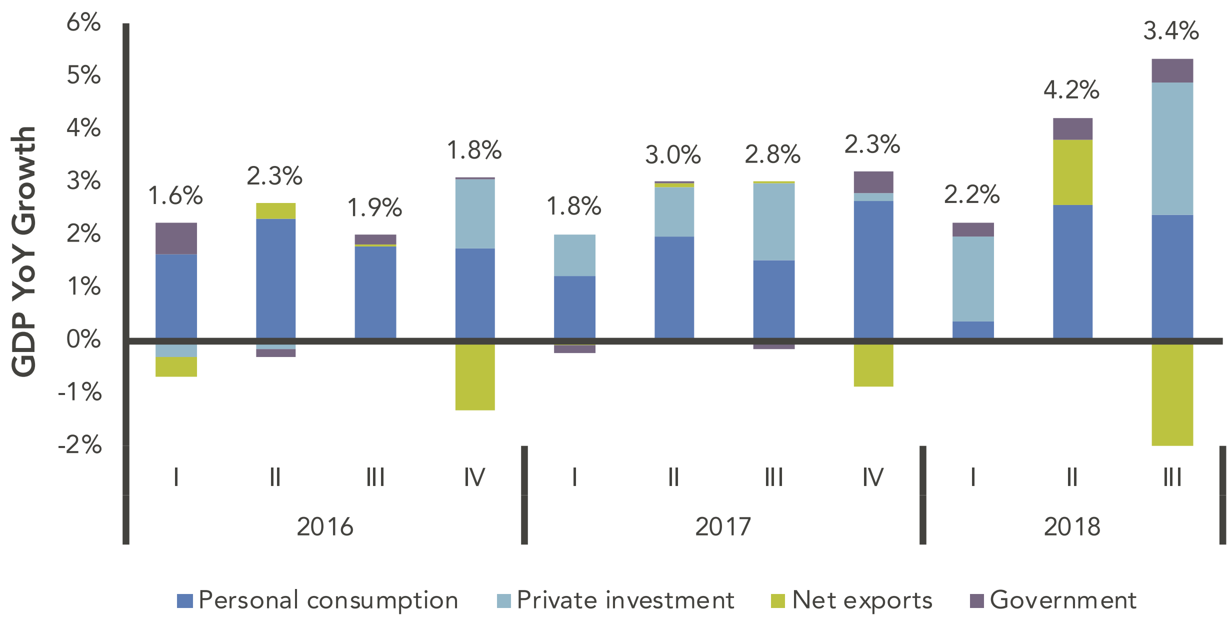
In early December, Presidents Trump and Xi met at the G20 summit in Buenos Aires and agreed to a temporary cease fire, lasting until March 1st of 2019. With this agreement, the U.S. will hold off on new tariffs as well as increasing existing ones, specifically those implemented in September. In exchange, China is offering to purchase more U.S. goods, reduce certain tariffs and increase enforcement on intellectual property rights laws. However, this is not the first agreement between the two countries and there is no guarantee these negotiations won't fall through, leading to further escalation.

On the domestic side, politics have become increasingly polarized. Midterm elections went largely as predicted, with Republicans maintaining a narrow margin in the Senate, while Democrats took control of the House of Representatives. This likely means there will be more political gridlock, and little major legislature will be passed. Though legislatures from the two parties are unlikely to see eye-to-eye on much, they will have to come to an agreement to approve federal funding, which expired on December 21st. This has resulted in the current partial government shutdown, putting 380,000 government workers on unpaid leave, while another 420,000 essential employees are working without pay. With the ongoing shutdown and the trade deadline looming, politics could play a major role in economic growth for the first half of 2019 and beyond.

Despite these growing political concerns, 2018 saw strong economic growth, with real GDP rising an impressive 4.2% in 2Q and 3.4% in 3Q. This is the highest level of growth the country has seen since 2014. Part of this increased growth is likely due to the tax reforms passed at the end of 2017. While there is much debate about the extent of the impact and who benefits most, economists agree the majority of the growth benefit would come in the short term. With the tax cuts now a year old, it is likely there will be less benefit going forward and therefore less impact on GDP growth.

Also notable is that net exports detracted a significant 2% from growth in 3Q as a result of the new tariffs, without which growth for the quarter likely would have been over 5%. The concern at this point is if the agreement with China falls apart and the tariffs continue, net exports could have further negative impact on growth. At the time of writing, 4Q growth is expected to be 2.8% with net exports detracting 0.5%, according to the Atlanta Fed's GDPNow tool.

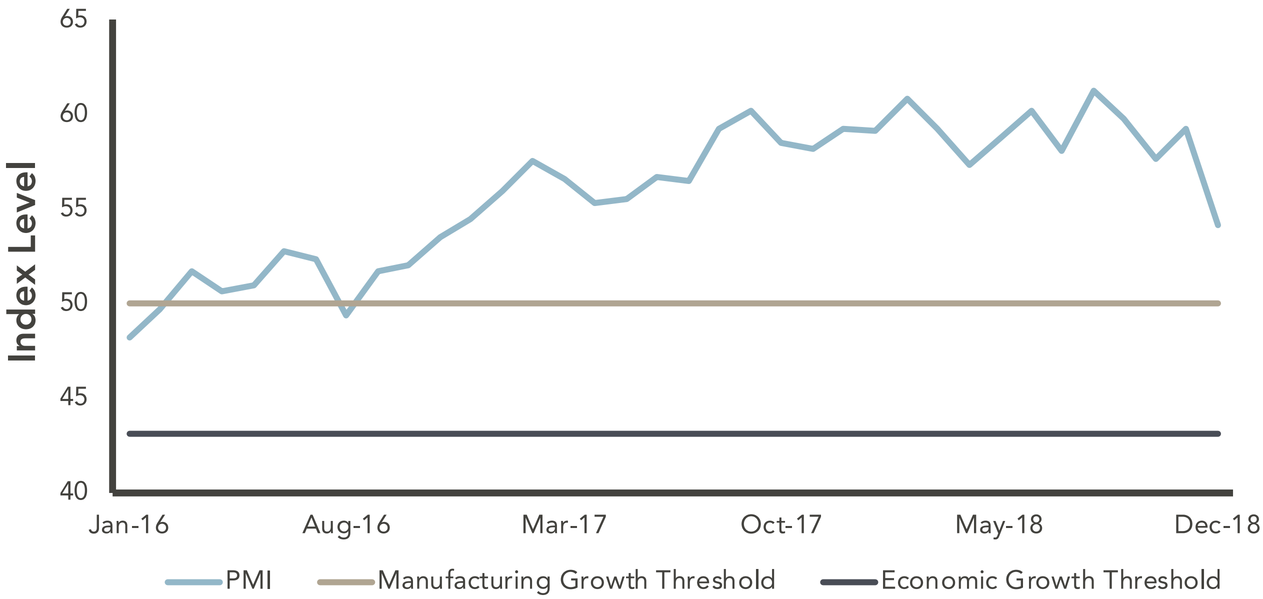
Exhibit 2: Strong Growth Despite Worries



Source: U.S. Bureau of Economic Analysis

The manufacturing sector is an area expected to be most impacted by the trade war, and there are signs that it is starting to be affected. PMI is a measurement that tracks the relative strength of manufacturing growth in the U.S. and any reading above 50 indicates that the manufacturing sector is growing while a measurement over 43.2 suggests the overall economy is expanding. PMI was exceptionally strong in 2018 through November. However, in December the index fell to 54.1 from 59.3 indicating that while the industry is still expanding, the growth is slowing. Many of the manufacturers surveyed by the index cited the tariffs as the main cause for concern and wondered whether this slowing growth is temporary or the beginning of a longer term trend.

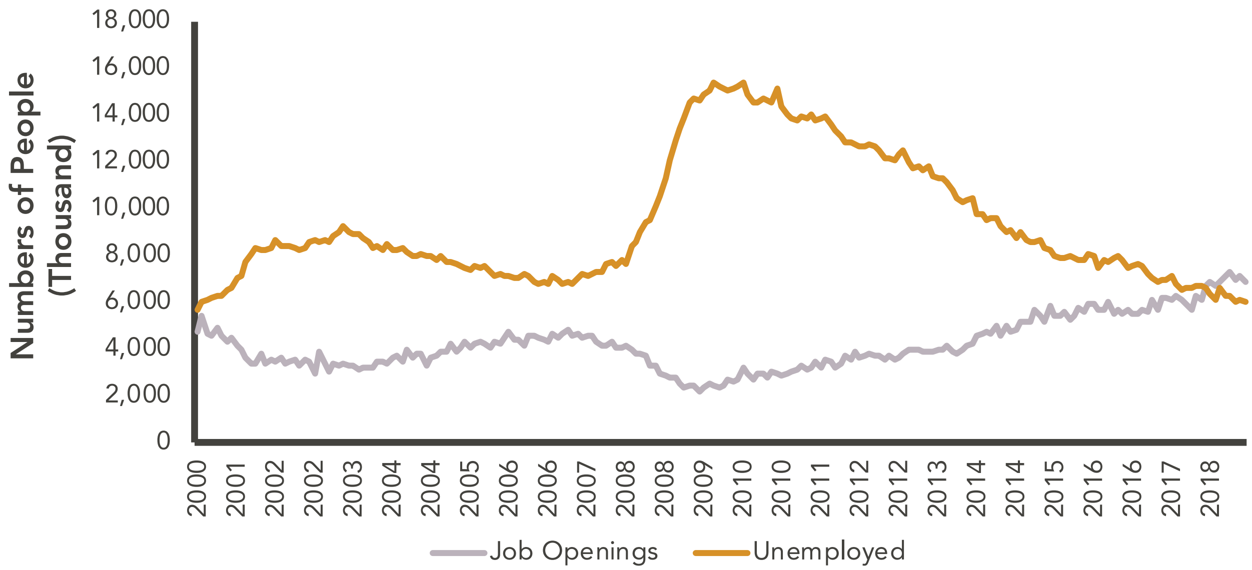
Exhibit 3: U.S. Manufacturing is Alive and Well



Sources: Institute for Supply Management

Manufacturers are also concerned about labor shortages and how it is increasingly difficult to fill positions. While this is frustrating to employers, it speaks to the overall strength of the job market. As of December 31st, there were nearly a million more job openings than unemployed persons in the U.S., meaning there is a job out there for everyone who wants one, albeit not one they are necessarily trained for. The unemployment rate is at 3.9%, which most economists consider to be at or near full employment. The U-6 rate, the broadest measure of unemployment which includes those that are part-time for economic reasons, is at 7.6% and the lowest it's been since 2001. The participation rate is at 63.1%, continuing to be about 2%–3% lower than pre-recession levels. This is mostly due to the baby boomer generation beginning its retirement and may lead to increased labor shortages as more older workers leave the workforce.

Exhibit 4: An Abundance of Jobs

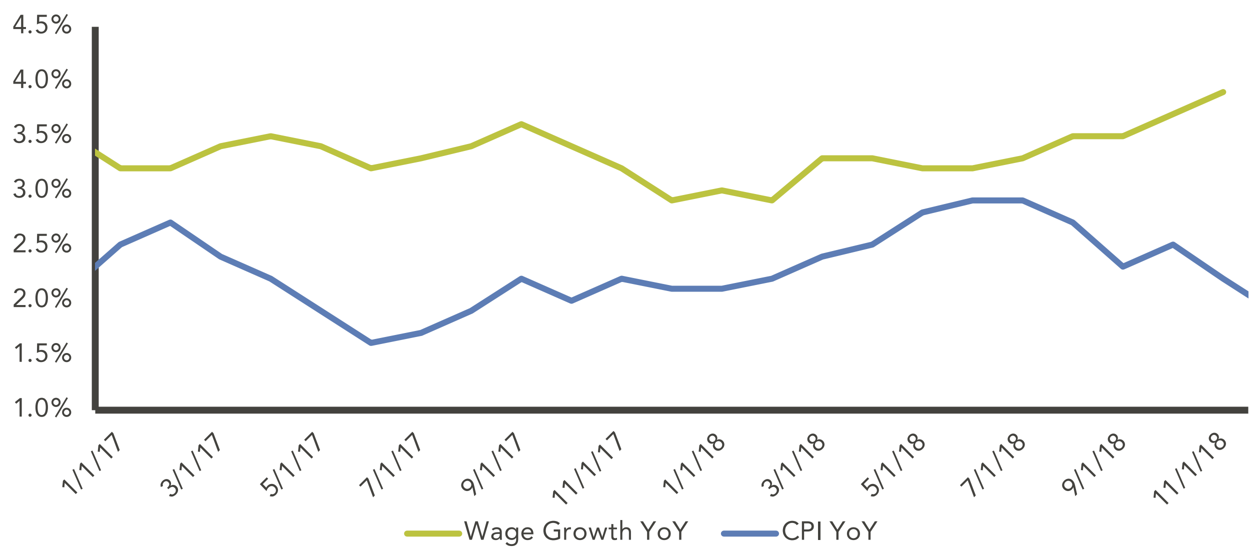


Sources: Federal Reserve Bank of St. Louis

With such strong employment and increasing labor shortages, the expectation has been that wage growth will begin to rise as employers seek to attract and retain talent. And after several flat years wage growth has finally begun to rise in the last few months. In November, hourly wages posted 3.9% growth over the last 12 months, matching the highest rate seen since 2008. Younger workers starting out their careers had the highest growth rates, rising 6.4% for ages 16–24, while older workers over 55 saw their pay increase only 2.2%. With labor shortages and older workers continuing to leave the workforce, it is likely that wages will climb higher in 2019.

Higher wages often lead to higher inflation; people are willing to pay more for goods and employers need to charge more to cover the higher labor costs. So long as wage growth outpaces inflation, consumers' purchasing power will increase. As shown in Exhibit 5, the difference between the two metrics narrowed in the middle part of the year as inflation rose due to higher energy prices. But in the last few months inflation has declined as oil prices fell more than 30% since October 1st.

Exhibit 5: Rising Purchasing Power



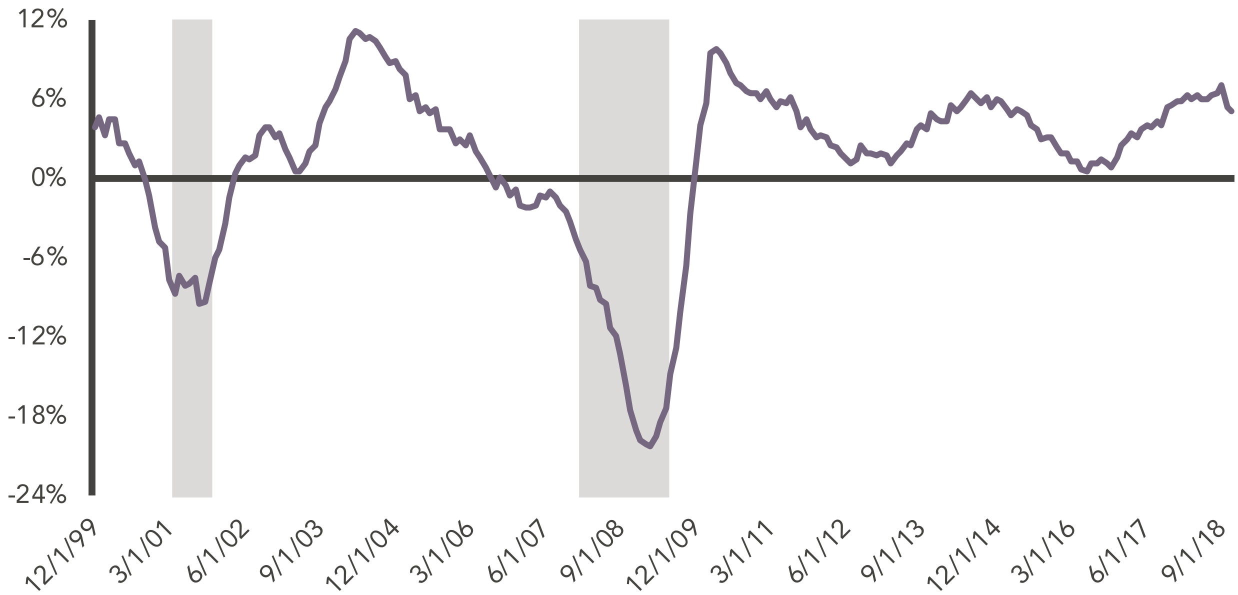
Sources: U.S. Bureau of Labor Statistics

Going forward, it is difficult to predict where inflation will go as there are opposing forces that could affect it. If the trade war continues and more tariffs are implemented, there will be upward pressure on prices as a result of imports from China being taxed. Additionally, if energy prices rebound from their recent rout — possibly from an agreement in OPEC to cut production — we could see inflation spike up.

On the other hand, if the Federal Reserve continues to raise interest rates, inflation should slow. In December, the Fed raised rates for the ninth time in the last three years, bringing the federal funds rate to between 2.25% and 2.5%. This brings the Fed to about one rate hike away from the neutral interest rate, which neither encourages nor slows growth. In 2019, the Fed is expected to pause altogether or at the least, pursue a slower pace after four increases in 2018, which would be a positive for economic growth in 2019.

Overall strong economic signals combined with potentially more interest rate increases makes it reasonable to wonder if we are at an economic peak and that a downturn is forthcoming. In an effort to answer this question Exhibit 6 takes a look at the year over year change to the index of leading indicators. In the last two recessions, the index accurately predicted the economic slowdown, falling negative prior to the crises. During the current extended bull market, the index came close, but never fell negative. Most recent measurements have the indicators up 5.2% over the past year, suggesting that the next recession is still at least a few years away. However, these measurements are unable to take into account less tangible positives and risks that exist in the market, such as new tariffs or a government shutdown.

Exhibit 6: A Positive Sign for Future Growth



Sources: The Conference Board

Ultimately, despite the recent volatility in financial markets, the economic fundamentals are strong. In 2019 geopolitics will likely play a large role, especially in the first quarter. If the trade war and government spending issues get resolved, growth will likely remain positive. Otherwise these problems could drag on for a greater part of the year and growth will likely slow. Overall, we expect GDP to grow between 2% and 2.5% in 2019, unemployment to remain low, and a slight rise in inflation and wage growth.

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO I BALTIMORE I PHILADELPHIA I ST. LOUIS

PHONE 312-527-5500
WEB marquetteassociates.com

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