Capital Risk
Economics

Fourth Quarter 2018

United States

Economic Outlook

Economic Excellence, Political Poverty

While the US consumer leads the way…

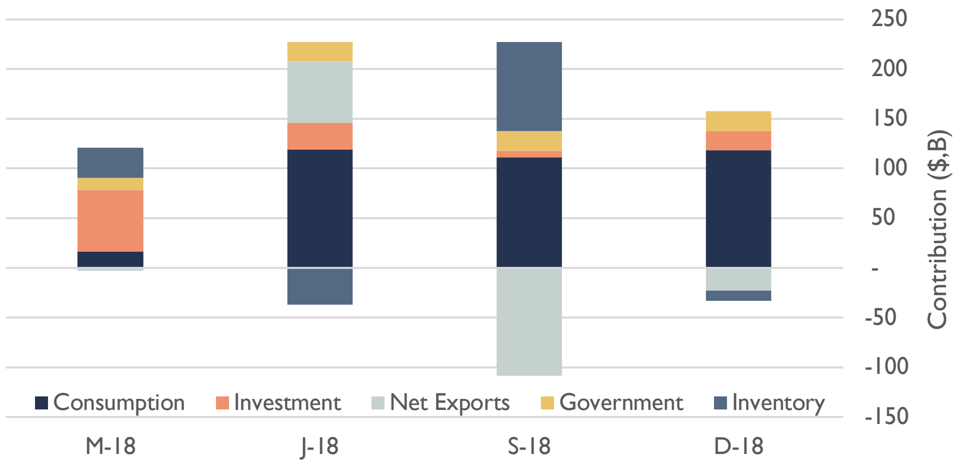
- The forecast real GDP growth for 2019 is a 2.5% rate.
- The expected CPI and Core CPI inflation rates for 2019 are 1.0% and 2.3%.
- Growing imports reflect a healthy consumer; however, exports are challenged as both foreign demand and domestic politics impede growth.
- Investment is surprisingly weak given the level of employment and the tax incentives.

…trade is key, and politics drives the outcome.

The economic environment in the US has a stable consumer and supportive fiscal policy, which should carry the US economy for the year with government expenditures supporting. A strong US dollar continues to augment imports and impair exports. The question is whether investment will rebound or is the decade long expansion ending? Key performance indicators are the growth of investment and residential structures, a higher US dollar supporting imports while constraining exports, and expanding employment to encourage consumption. While political dysfunction will gather headlines, the main risk is the continued Chinese rebalancing of their credit markets, which is in uncharted territory. Politics, however, can trump economics in an instant.

Will investment rebound?

Exhibit 1. GDP Contribution by Component



Source: Federal Reserve Economic Database, CRM Calculations

Growth Summary

The GDP growth rate forecast for 2019 is 2.5%, which is driven by consumption. The lower expected growth of investments and a more substantial drag from net imports differentiate the outlook. A continually strong US dollar from increasing trade tensions and lower foreign demand, particularly China, will lower exports and widen the trade deficit. Capital investment will continue to moderate as the economic cycle slows from its peak. Thus, exports and fixed investment will determine the growth outcome.

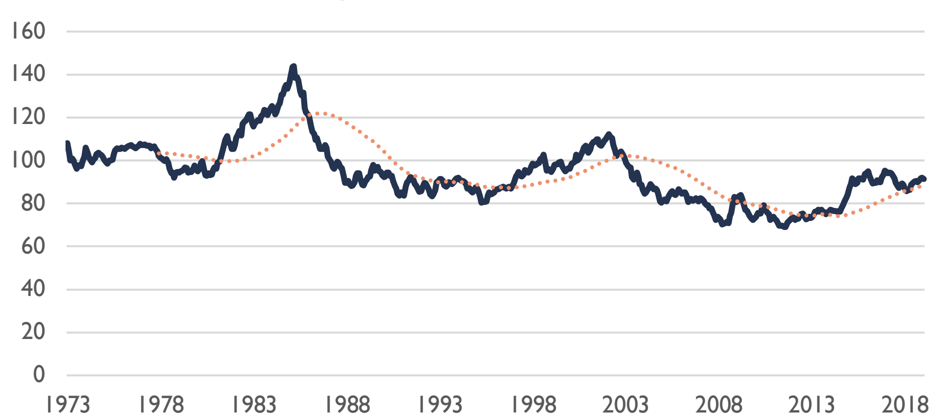
Table 1. GDP and Components

	Real Gross Domestic Product				
2018 December	Total	Consumption	Investment	Government	Net Exports
Current Level ($, B)	18,665	12,953	3,436	3,192	-950
Forecast 1Q (%, Q/Q)	**2.3**	**3.9**	**2.3**	**2.0**	**-966**
Forecast 2019 (%, Y/Y)	**2.5**	**2.6**	**5.3**	**2.0**	**-1016**
			Actual Change		
Prior Quarter (%, Q/Q)	2.7	3.7	-8.8	2.5	10.0
Trailing 12-Months (%)	3.1	2.9	3.5	2.3	8.2

* Changes are annualized rates.

The key performance indicator is the US dollar. Political uncertainty, higher domestic interest rates, and in-bound capital flows will continue to drive the US dollar higher. The result is lower commodity prices and higher US imports, and thus a lowering of net exports.

Exhibit 2. US Trade-Weighted Dollar Index



Source: Index is of major currencies. Federal Reserve Economic Database,

Inflation Summary

The core inflation rate expectation is 2.3%, which compares with 2.0% over the last year. At this level, the Fed will continue along the path to interest rate normalization. With unemployment at generational lows and wages growth moderate, the case for employment led inflation is weak; however, declining housing supply and higher interest costs could drive a housing-led increase.

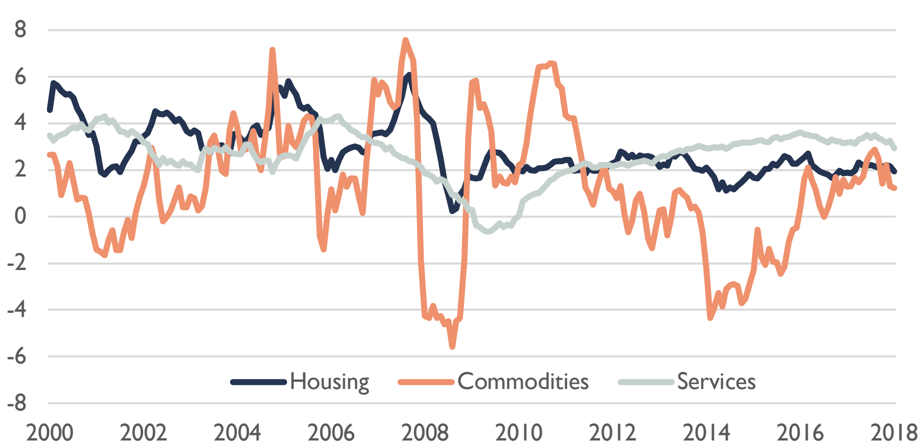
Table 2. Consumer Price Index

	Consumer Price Inflation				
2019 December	Total	Core	Food	Energy	PCE
Index Level	252.9	259.5	254.6	221.7	108.9
2019Q1 Forecast (%, Q/Q)	**1.4**	**1.6**			
2019 Forecast (%, Y/Y)	**1.0**	**2.3**			
			Actual Change		
Quarterly Change (%)	1.4	1.6	0.6	0.7	1.0
Yearly Change (%)	2.0	2.0	1.2	3.4	1.7

* Changes are annualized rates

The primary risk for higher inflation is commodity prices and rest on the continued strength of the US dollar and declining foreign demand (e.g., China). *Unless commodity prices rebound, headline and core inflation will diverge. It is hard to make a case for prolonged inflation above the FED's target.*

Exhibit 2. Inflation Components (y/y, %)



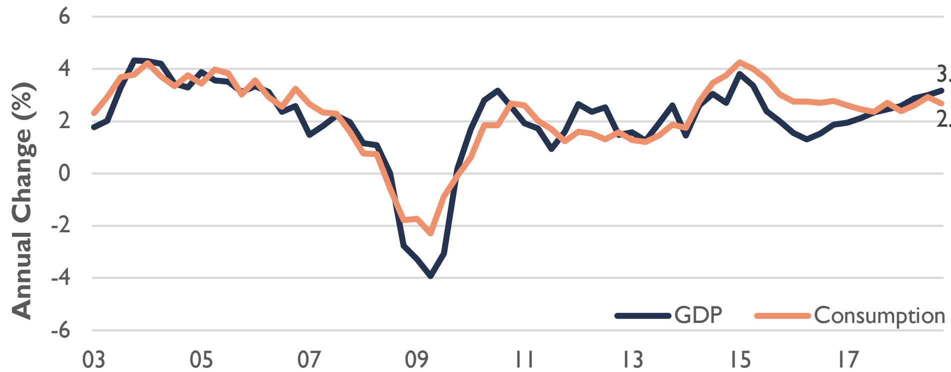
Source: Federal Reserve Economic Database

GDP Components

Gross Domestic Product (GDP) continues at a healthy pace with the US consumer leading the way. The challenge is that further gains in payrolls are difficult given the employment level and wage gains are roughly zero in real terms. The problem is net exports: a strong dollar supports imports and weakens exports. The battle is between which is stronger: the US or foreign consumers.

Consumption continues to carry growth.

Exhibit 1. Real GDP and Consumption (y/y, %)

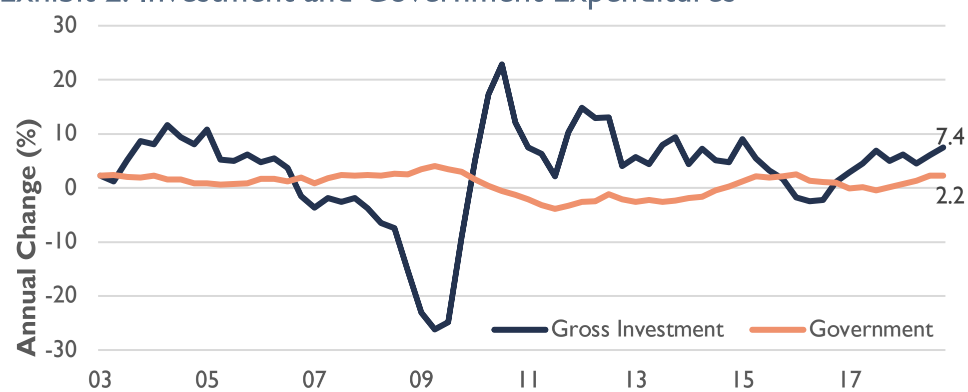


Source: Federal Reserve Economic Database

Gross Investment appears strong; however, there are worrying signs. Residential structures are declining, which is perplexing given the high number of people in the prime household formation cohort. Further, a large inventory build in the third quarter in advance of trade sanctions is not repeatable, which indicates that gross investment will moderate. A robust economy with constrained labor and higher interest rates is usually a time for capital investment, which makes the current outcome perplexing.

Expanding government is offsetting slowing investment.

Exhibit 2. Investment and Government Expenditures



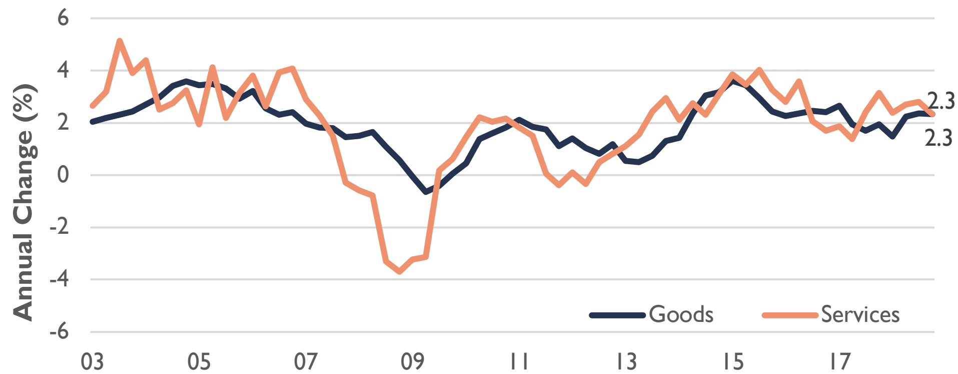
Source: Federal Reserve Economic Database

Consumption

The consumer is evidently in a good position: jobs demand is high, and wages growth is matching inflation. Consumption of goods, however, is slowing to a rate not seen in five years. Services consumption growth, the more substantial proportion that contains the invariant housing component, continues apace. Healthcare and financial services costs are leading consumption higher, while below trend housing, transportation, and food services are moderating the impact of services growth.

Slowing services reflect decelerating housing.

Exhibit 3. Consumption: Goods and Services

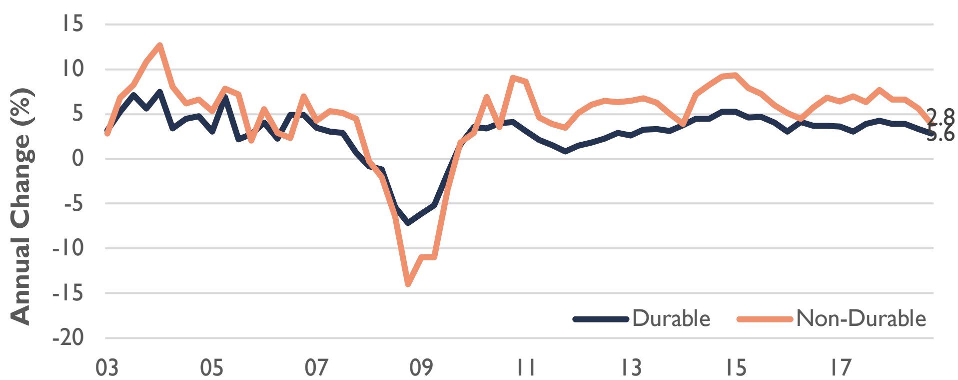


Source: Federal Reserve Economic Database

Durable goods are a hallmark of strong consumption is marked; however, they at a rate not seen since 2009. This outcome is surprising given the combination of a large household formation cohort with the Millennial generation and a tight labor market. The slowing of durable goods and non-durable concurrently are worrisome. Unless wage gains arrive to support consumption, the consumer might show further deterioration.

As evidenced by slowing durable goods.

Exhibit 4. Consumption, Durable and Non-Durable Goods



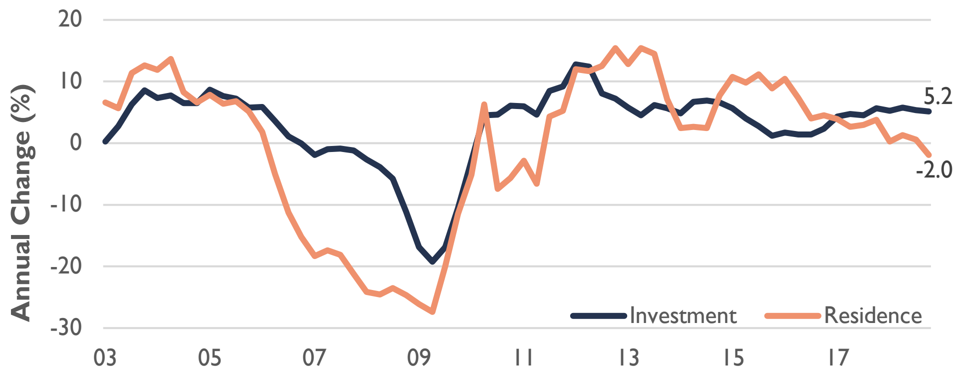
Source: Federal Reserve Economic Database

Investment

Fixed investment in the most variable component of the major GDP components and indicates the expectation of business for the future. While fixed investment continues apace, residential structures are declining. A tight labor market provides an incentive for business to invest in productivity-enhancing capital investments and a supportive fiscal backdrop and still low interest rates are complementary. It appears that higher interest rates and house prices are conspiring to slow demand for housing.

Investment in residential structures is surprisingly weak.

Exhibit 5. Investment, Non-Residential and Residential Structures



Source: Federal Reserve Economic Database

Inventory may provide insight into business expectations. Low levels of inventories are a good sign that demand is robust and future production is required; however, if inventory restocking does not occur, it's an early indication that business does not see future demand. The next few quarters will provide clarity: a restocking will indicate that businesses see future demand. If not, then the slowing durable goods and housing are offering an early warning sign.

While low inventories may signal low business confidence.

Exhibit 6. Inventories

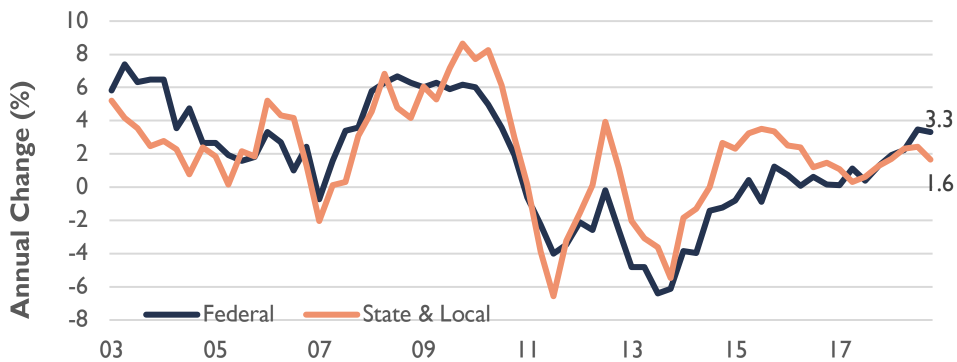
Source: Federal Reserve Economic Database

Government

The government closure will have a modest impact on government expenditures. While the Federal government bickers, the more significant component of government expenditures, the State & Local levels, has returned to expansion after a two-year decline. The main benefit is addition by the removal of subtraction: State & Local levels will no longer act as a drag. Combined, the two will conspire to ensure fiscal policies contribute to GDP growth.

Government is expanding and removing a drag on growth.

Exhibit 7. Federal and State Government

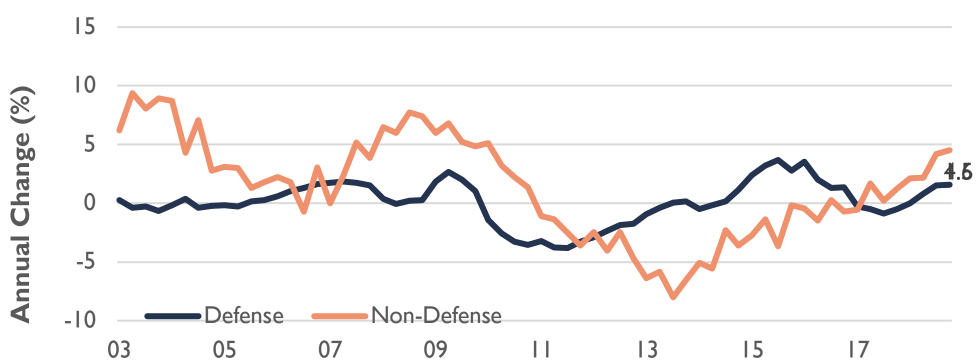


Source: Federal Reserve Economic Database

The Federal government shutdown is an unnecessary drag; however, defense spending is unaffected and continues to lead Federal government growth. The non-defense spending growth rate will slow with the shut-down, it's merely a question of how much. The challenge is that expanding budget deficits make the path untenable in the long run, and with higher interest rates, the bill may arrive sooner than expected.

With both defense spending providing support.

Exhibit 8. Government Spending: Defense & Non-Defense



Source: Federal Reserve Economic Database

Exports & Imports

The US consumer continues to choose between being rich or having higher wages by availing themselves to imported goods. Of course, meager wage growth may be the cause of this decision. The wage suppression reflects the diminishing power of the US worker in the global supply chain. The net export deficit masks strong domestic growth in the US, which is to the benefit of those with jobs and some bargaining power.

Net exports may hit a trillion-dollar deficit!

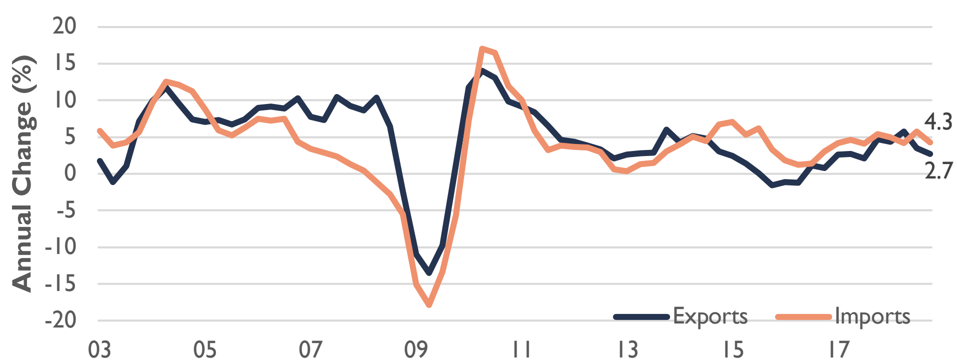
Exhibit 9. Net Exports

Source: Federal Reserve Economic Database

Global demand is picking up as the growth rate of exports exceed imports. While imports are roughly 25% larger than exports, the higher growth rate of exports can deliver a narrowing trade deficit, as it did in the most recent quarter. The direction of the US Dollar will ultimately decide the balance between exports and imports: higher oil prices will lower the US dollar and stimulate exports, or the reverse will support imports. The outcome is largely dependent on trade policy: a dynamic with high uncertainty.

As exports slow faster than imports.

Exhibit 10. Real Exports & Imports



Source: Federal Reserve Economic Database

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