Grant Thornton

DECEMBER 05, 2018

Storm Clouds on the Horizon

Diane C. Swonk, Chief Economist

"Several dry days before the next storm."
-WBUR, November 29, 2018

I read that headline in my Twitter news feed and immediately clicked on it thinking it would offer some insight into the economy. Instead, it was an actual **weather forecast** for the Boston area put out by an NPR station. The joke is on me.

Without sounding too much like the Peter Sellers character, Chance the gardener, in the 1979 film ***Being There***, I also see the weather as a useful metaphor for the outlook. Storm clouds are clearly forming on the horizon. A strong dollar, weaker growth abroad, mounting corporate debt, a slowdown in housing and the ongoing havoc that tariffs are wreaking on global supply chains are each taking a toll. Even the Federal Reserve, which has sounded almost **giddy** about the economy this year, has shifted tone in recent weeks. The minutes of the most recent Federal Open Market Committee (FOMC) meeting were particularly sobering as downside risks now outnumber upside risks to the outlook.

The recent G-20 meeting should have allayed some fears but the more we learn, the less we know about the deal to delay additional tariffs on Chinese imports. Chinese news agencies are reporting a different version of the agreement. White House negotiators also contradict the president's statement. The dissonance, short time frame (90 days) for negotiations and the appointment of one of the administration's most ardent protectionists to close the deal are not encouraging. The results will delay the implementation of additional tariffs to the second quarter of 2019 from the first quarter, instead of eliminating them.

Uncertainty surrounding NAFTA is growing. The signing of the new NAFTA, dubbed the USMCA, at the G-20 by leaders from Canada, Mexico and the U.S. was little more than a photo op. The legislatures of all three countries still need to ratify the treaty to make it binding. That was a heavy lift in Congress prior to the midterm elections; it will be even harder now that Congress is split. The problem is so acute that the president threatened to pull out of the existing NAFTA agreement to try to force a quick resolution by Congress. A move like that would face legal challenges, but the risk is that we could end up with no agreement. That would further undermine our competitiveness and delay investment decisions.

This edition of **ECONOMIC CURRENTS** takes a close look at the outlook for 2019. The economy is poised to slow but not to the point of recession until 2020. We have moved our forecast for the next recession up by six months to the first half of 2020. Election years don't stop recessions from occurring; that said, recessions are notoriously hard to time. No one knows for sure which straw will break the camel's back, only that they are piling up.

2019 Outlook

Growth Slows

Chart 1 shows the forecast for real GDP growth in 2019. We expect growth to moderate to 2.5% in 2019, down from a 2.9% annual average in 2018. A better measure of momentum, the fourth quarter to fourth quarter change in growth, is expected to slow dramatically to 2% in 2019, down from a robust 3.1% this year.

“By the end of next year, we expect the Fed to be forced to reverse course, and start lowering rates.”

- Consumer spending will remain a driver of gains but it will slow from the torrid pace we saw in mid-2018. Vehicle sales are particularly vulnerable. Pent-up demand has been depleted while a jump in lease returns is expected to lower trade-in values. This is at the very moment that higher steel and aluminum tariffs are taking effect and will push new vehicle prices higher.
- Home sales and residential construction will remain subdued. Higher mortgage rates and years of rapid price increases have locked out many first-time buyers from the housing market. The overhang of student debt raises another hurdle. Prospective buyers opting to rent for longer are providing a second wind to the multifamily market. The problem is affordability. Escalating costs have kept many builders from moving downstream where demand for rentals is the greatest.
- Business investment is likely to remain subdued as uncertainty regarding tariffs continues to delay producers’ decisions on where to invest. Hedging against the threat of tariffs has pulled activity forward, which will leave fewer investment decisions.
- Government spending is expected to remain elevated through the third quarter of 2019, which will mark the end of the fiscal year for Congress. After that, we will need another package of fiscal stimulus to keep the government spigots from running dry. There is some desire by incoming Democrats and the president to boost infrastructure spending, but little agreement on how to pay for it. The risk is the government fails to pass another spending bill, which is more the norm than not.
- The trade deficit may improve temporarily as China moves to increase purchases of agricultural products. Any improvement, however, will be short-lived given the dollar’s strength and growing weakness abroad.

Risks. Downside risks now outweigh upside risks, barring a rapid resolution to the preliminary deal cut by the U.S. and China at the G-20 meeting in Argentina. (I am not holding my breath.)

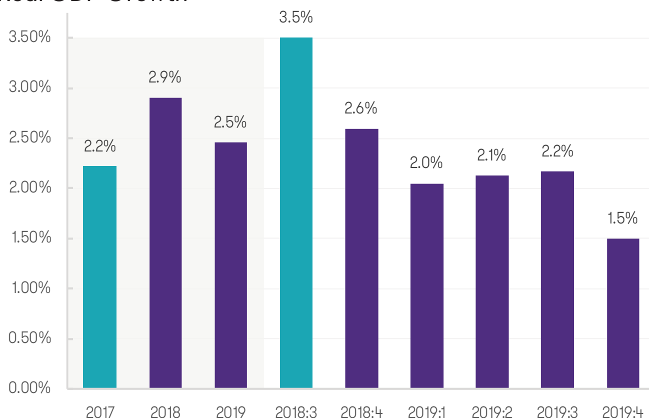
Inflation Nears Target

Chart 2 shows the forecast for growth in the core personal consumption expenditures (PCE) price index, which more accurately tracks inflation than the CPI. The core PCE is expected to hold close to the Fed’s 2% target in 2019.

- A margin squeeze in the equity markets, triggered by higher tariffs and wages, is expected to intensify at the start of the year when the cushion provided by tax cuts plays out.
- Oil prices are expected to rebound as Saudi Arabia cuts back on production. This will further increase transportation and delivery costs.
- The stronger dollar and modest increases in productivity growth should dampen the extent that producers pass those increases onto consumers. The problem for most suppliers is that the pressure to raise prices is gaining momentum.

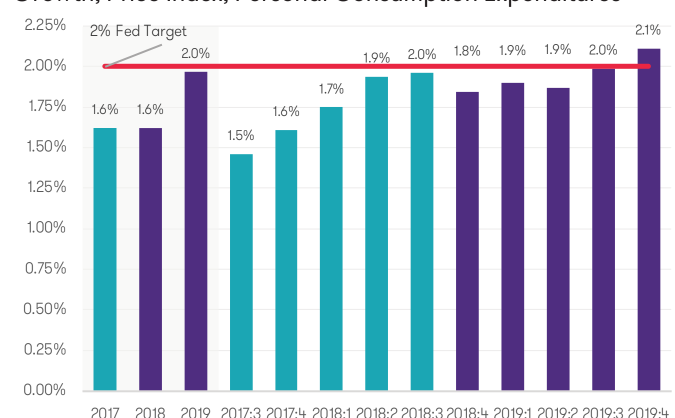
Risks. Tariffs raise the risk that inflation could heat up more than forecast.

Chart 1. Economy Poised to Slow
Real GDP Growth



Annual figures are average annual growth. Quarterly are Q/Q SAAR.
Source: Grant Thornton

Chart 2. Core PCE Hits Fed Target
Growth, Price Index, Personal Consumption Expenditures



Annual figures are average annual growth. Quarterly are 4Q/4Q.
Source: Grant Thornton

“Home sales and residential construction will remain subdued.”

Treading with Caution

Chart 3 compares the forecast for the fed funds rate with the trajectory of the Federal Reserve’s $4.1 trillion balance sheet. After raising rates for a fourth time in December this year, the Fed is expected to slow the pace of rate hikes to two in 2019. By the end of next year, we expect the Fed to be forced to reverse course and start lowering rates.

- Growth in the first half of the year will outperform growth in the second half.
- Inflation will plateau near the Fed’s 2% target.
- We expect to see the unemployment rate fall to a low of 3.4% before edging higher at year-end.

The Federal Reserve is planning to increase the pace at which it sells off Treasury and government agency debt on its bloated balance sheet next year. That will mean smaller increments of rate hikes necessary to fulfill its Congressional mandate of low inflation and low unemployment. The Fed is expected to reevaluate its balance sheet operations at year-end. It could even resume large-scale asset purchases as the economy slips into recession in early 2020.

Risks. The Fed has fewer tools to stimulate the economy than it once did. The fed funds rate, the benchmark for short-term rates, was lowered by an average of 5% during the last two recessions. Next time, we will be lucky to have a 3% cushion before short-term rates veer back towards zero. Fed Chairman Jay Powell has not ruled out taking rates into negative territory during the next recession.

Implications for Financial Markets

Treasury Yields Creep Higher

Chart 4 shows the forecast for long-term rates in 2019. The yield on the 10-year Treasury bond is expected to peak above 3.4% in 2019.

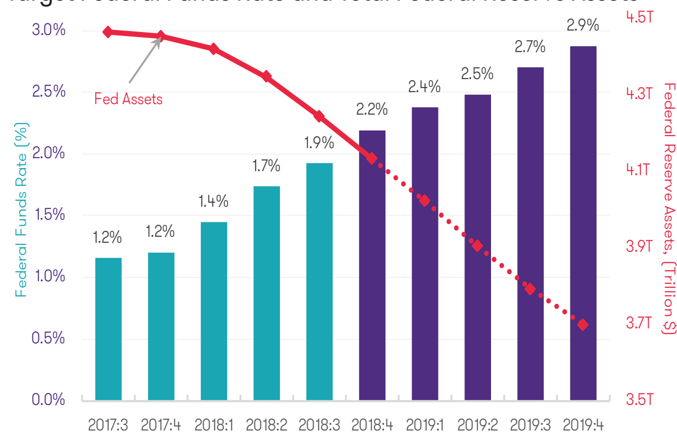
- The Fed is poised to raise rates at least twice in 2019 after hiking rates four times in 2018.
- Foreign demand for U.S. Treasury bonds is waning and could fall short given the sheer volume of debt the Treasury will be forced to issue.
- The ceiling the Federal Reserve once provided on long-term rates with help from its large-scale asset purchases will rise.

Equities Remain Volatile

After-tax corporate profits are expected to slow fairly dramatically next year.

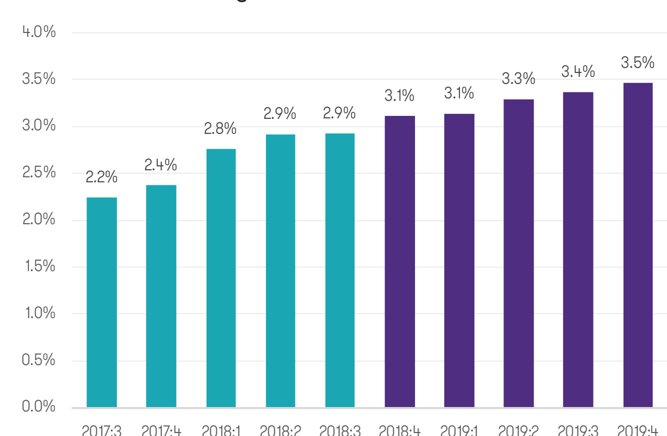
- The boost to year-over-year profits provided by tax cuts in 2018 will disappear in the first quarter of 2019.
- Tariffs, wages, higher rates and expenses from tariffs will combine to squeeze profit margins. Only a portion of the increases is likely to show up in price hikes.
- A strong dollar and weaker growth abroad are likely to reduce exports.

Chart 3. Rates Rise, Balance Sheet Falls
Target Federal Funds Rate and Total Federal Reserve Assets



Source: FRED, Grant Thornton

Chart 4. 10-Year Yields Creep Higher
Yield, 10-Year Treasury



Source: Grant Thornton

“We have moved up our forecast for the next recession by six months to the first half of 2020.”

These shifts, coupled with ongoing uncertainty surrounding trade policy, suggest higher volatility and smaller gains in the broader equity indices than we have become accustomed to in recent years. Our forecast for 2019 is consistent with a 3% rise in the S&P 500.

Risks. The yield curve for five-year and three-year Treasury notes has already inverted, which means that short-term rates are higher than long-term rates; this has raised fears on Wall Street that a recession could occur sooner than expected. The result for financial markets will not be pleasant.

Bottom Line

I grew up in the Midwest, where storms and tornados are a fact of life. I learned at a young age to know where to find shelter before the winds pick up or the hail hits. Even while basking in the sun of an aging economic expansion, I start to check the shadows and look for places to seek shelter for when the storm eventually arrives.

Economic forecast — December 2018

	2018	2019	2020	2018:1(A)	2018:2(A)	2018:3(A)	2018:4	2019:1	2019:2	2019:3	2019:4	2020:1
National Outlook												
Chain-Weight GDP[1]	2.9	2.5	-0.2	2.2	4.2	3.5	2.6	2.1	2.1	2.2	1.5	-2.0
Personal Consumption	2.7	2.6	0.4	0.5	3.8	3.6	2.8	1.8	2.6	2.3	1.8	-1.4
Business Fixed Investment	6.9	3.8	-1.0	11.5	8.7	2.5	4.8	4.1	3.2	2.7	1.9	-3.6
Residential Investment	-0.3	-1.7	-4.6	-3.4	-1.3	-2.6	-5.7	-2.1	0.4	2.1	-0.1	-5.8
Inventory Investment	36.1	56.5	17.1	25.8	-31.3	73.7	76.2	63.5	50.3	54.7	57.6	48.0
Net Exports	-762.4	-829.6	-845.2	-751.0	-696.0	-788.7	-813.8	-812.0	-826.5	-835.8	-844.0	-858.4
Exports	4.1	3.8	1.4	3.6	9.3	-4.4	2.6	7.6	3.7	4.4	3.0	-0.3
Imports	4.8	5.1	1.5	3.0	-0.6	9.2	5.3	5.4	4.7	4.5	3.2	1.6
Government Expenditures	1.8	2.7	0.9	1.5	2.5	2.6	4.2	3.1	2.8	1.1	0.5	0.7
Federal	3.0	4.9	0.5	2.6	3.7	3.5	7.9	6.6	5.6	1.1	-0.1	0.1
State and Local	1.0	1.4	1.1	0.9	1.8	2.1	2.0	0.9	1.2	1.1	0.8	1.1
Final Sales	2.8	2.4	0.1	2.0	5.4	1.2	2.6	2.4	2.4	2.1	1.4	-1.8
Inflation												
GDP Deflator	2.2	2.3	2.4	2.0	3.1	1.7	1.8	2.7	2.1	2.2	2.5	2.6
CPI	2.4	2.2	2.3	3.5	1.7	2.0	1.9	2.5	2.2	2.0	3.2	2.4
Core CPI	2.1	2.2	2.4	3.0	1.8	2.0	2.1	2.6	2.2	2.2	2.3	2.6
Special Indicators												
Corporate Profits[2]	8.0	2.9	-3.1	5.9	7.3	10.3	8.0	8.0	5.6	2.9	2.9	-1.8
Disposable Personal Income	2.8	2.4	1.0	4.5	1.8	2.4	3.1	2.2	2.6	2.3	1.7	0.6
Housing Starts (mil.)	1.3	1.2	1.1	1.3	1.3	1.2	1.2	1.2	1.3	1.3	1.2	1.1
Civilian Unemployment Rate	3.9	3.5	4.4	4.1	3.9	3.8	3.7	3.5	3.5	3.5	3.5	3.7
Total Nonfarm Payrolls (thous.)[3]	2504.6	1621.5	-1960.1	632.3	634.3	623.0	614.9	525.1	453.5	353.2	289.7	-202.4
Vehicle Sales												
Automobile Sales (mil.)	5.5	5.0	4.3	5.7	5.5	5.4	5.4	5.3	5.2	4.9	4.7	4.0
Domestic	4.0	3.7	3.2	4.1	3.9	3.9	4.0	3.9	3.8	3.6	3.5	3.0
Imports	1.5	1.3	1.1	1.6	1.5	1.5	1.4	1.4	1.4	1.3	1.2	1.0
Lt. Trucks (mil.)	11.8	11.5	10.3	11.5	11.8	11.7	12.0	11.9	11.7	11.2	11.1	10.4
Domestic	9.4	9.3	8.5	9.3	9.5	9.4	9.6	9.5	9.4	9.2	9.1	8.6
Imports	2.3	2.2	1.8	2.2	2.3	2.3	2.4	2.4	2.3	2.0	2.0	1.8
Combined Auto/Lt.Truck	17.2	16.5	14.6	17.2	17.3	17.0	17.4	17.2	16.9	16.1	15.8	14.4
Heavy Truck Sales	0.5	0.5	0.4	0.5	0.5	0.5	0.6	0.6	0.5	0.4	0.4	0.3
Total Vehicles (mil.)	17.7	17.0	15.0	17.6	17.8	17.6	18.0	17.8	17.4	16.5	16.2	14.7
Interest Rate/Yields												
Federal Funds	1.8	2.6	1.2	1.5	1.7	1.9	2.2	2.4	2.5	2.7	2.9	2.2
10-Year Treasury Note	2.9	3.3	3.2	2.8	2.9	2.9	3.1	3.1	3.3	3.4	3.5	3.4
Corporate Bond BAA	4.8	5.3	5.3	4.5	4.8	4.8	5.2	5.2	5.3	5.3	5.4	5.4
Exchange Rates												
Euro/Dollar	1.2	1.2	1.2	1.2	1.2	1.2	1.1	1.1	1.2	1.2	1.2	1.2
Dollar/Yen	110.5	110.5	107.0	108.3	109.1	111.5	112.9	111.9	110.8	110.1	109.3	108.3

1. In 2016, GDP was $16716.164 billion in chain-weighted 2009 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

Copyright © 2018 Diane Swonk – All rights reserved. The information provided herein is believed to be obtained from sources deemed to be accurate, timely and reliable. However, no assurance is given in that respect. The reader should not rely on this information in making economic, financial, investment or any other decisions. This communication does not constitute an offer or solicitation, or solicitation of any offer to buy or sell any security, investment or other product. Likewise, this communication serves to provide certain opinions on current market conditions, economic policy or trends and is not a recommendation to engage in, or refrain from engaging, in a particular course of action.

"Grant Thornton" refers to Grant Thornton LLP, the U.S. member firm of Grant Thornton International Ltd (GTIL), and/or refers to the brand under which the GTIL member firms provide audit, tax and advisory services to their clients, as the context requires. GTIL and each of its member firms are separate legal entities and are not a worldwide partnership. GTIL does not provide services to clients. Services are delivered by the member firms in their respective countries. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions. In the United States, visit grantthornton.com for details.

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd