Stonebridge Economic Outlook

Forecast Update

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Overview

The U.S. economic forecast for all of 2019 is little changed from February, despite the latest shift by the Trump administration to escalate the trade war with China and the surprisingly strong gain in real output growth in the first quarter. In particular, the economy is expected to continue to expand at about its trend rate of growth through the end of this year as the surge in the first quarter is offset by a less robust second quarter. The April unemployment rate of 3.6 percent is unlikely to go much lower in this business cycle. Overall consumer price inflation is expected to rebound sharply in the second quarter from its energy-induced swoon in the first quarter but should still be only moderately higher on average this year. The Federal Reserve may face the dilemma of higher inflation and slower growth owing to an expanding trade war, which most likely will keep the Fed on the sidelines longer.

According to the latest report from the Bureau of Economic Analysis, U.S. real gross domestic product grew a full percentage point faster in the first quarter of 2019 (3.2 percent) than anticipated in the February forecast (2.2 percent). The expectation was that a sluggish consumer sector would restrain growth in the first quarter in the absence of any upward surprises from the other sectors of the U.S. economy. Although the consumer sector delivered roughly as expected, there were several upward surprises from other sectors, including a surprisingly solid gain in net exports. The question is whether the gains in these other sectors can be sustained over the remainder of the year. Although further gains certainly are possible, they are unlikely to be as robust, especially again in the second quarter.

Since the economic fundamentals for all of 2019 and 2020 are expected to be little changed from the previous forecast, the investment implications therefore are little changed as well. Risk still may be okay to own but far less attractive to buy at this point of the business cycle. In this same regard, for those who are more risk averse, it continues to be a good time to reduce risk exposure. Needless to say, the level of confidence around the forecast is much higher this time than it was in February, despite the recent escalation in the trade war.

Forecast Update

The U.S. economic forecast for all of 2019 is little changed from February, despite the latest shift by the Trump administration to escalate the trade war with China and the surprisingly strong gain in real gross domestic product (GDP) in the first quarter. In particular, the expansion is expected to continue at about its trend rate of growth on average through the end of this year. The 3.6 percent unemployment rate registered in April probably is unlikely to go much lower. Overall consumer price inflation is expected to rebound sharply in the second quarter from its energy-induced dip in the first quarter but still should be only moderately higher on average this year. The Federal Reserve may face the dilemma of higher inflation and slower growth owing to an expanding trade war, which most likely will encourage the Fed to maintain a wait and see stance on monetary policy.

The economy's stellar performance in the first quarter at first blush seems to suggest a much better economy in 2019 than currently forecasted. Unfortunately, much of the surprisingly good economic news in the first quarter was likely temporary and is expected to be offset in large part in the current quarter. In addition, with the Trump administration's recent move to raise existing tariffs on $200 billion of goods imported from China from 10 percent to 25 percent and initiating the process of imposing a 25 percent tariff on an additional $300 billion or so of products from China, the outlook will depend in part on how long these tariffs will be in place and how China retaliates. Since the value of goods the U.S. sells to China is far less than the value of goods China sells to the U.S., there may be some incentive for China to broaden the trade war to include other barriers to trade. This could be more detrimental to U.S. consumers and companies than tariffs alone. But it would also be detrimental to China's economy, given the importance of the U.S. as both a consumer and a supplier of Chinese products.

The assumption underlying the Stonebridge Capital Advisor's forecast is that any unusual distortions to the U.S. economy from the trade war will be short-lived. After all, if the trade war starts to have an adverse effect on the economy, the Trump administration will be pressured to back down given the importance of the economy's performance in determining whether an incumbent president gets reelected. Generally, if the economy does well in the year prior to the election, the incumbent is more likely to be reelected. The Trump administration is undoubtedly aware of this correlation as demonstrated by their criticism of the Federal Reserve for raising short-term interest rates last year. The problem for the Trump administration is that the Chinese leadership does not face the same political constraints and are less likely to feel pressured to accept a trade agreement simply for the sake of making a deal. China's leadership can always deflect criticism by blaming Trump. President Trump can try to do the same but will be far less effective if the U.S. economy shows signs of faltering.

Economists and business owners expect the tariff increases to hit consumers in two ways. Businesses that were already passing on the cost of the 10 percent tariffs will now pass on a higher cost. And businesses large and small that previously tried to shield customers from the smaller tariffs will now find it almost impossible to avoid passing some or all of that tax on to consumers. A more substantial concern, however, is that the tariffs, which are essentially a one-time hike in prices, will allow businesses the opportunity to test their pricing power on all goods and services. If businesses encounter little resistance to higher prices, then they will attempt to do more. After all, the market pressures keeping consumer prices in check in the past came from less expensive imported alternatives, many of which came from China. If that alternative is no longer available, inflation expectations could start to rise as well. Higher inflation without a corresponding increase in income will result in a loss of purchasing power by consumers, depressing their ability to spend. Since consumers account for nearly 70 percent of all final goods and services produced in the U.S., it should be no surprise that when the consumer retrenches, the overall economy retrenches.

Table 1
U.S. Economic Forecast

	2018	2019f				2019f	2020f
		Q1	Q2	Q3	Q4		
Real Gross Domestic Product	3.1	**3.2**	**1.1**	2.3	2.0	2.1	0.7
Consumer Price Index, All	2.2	**0.9**	**4.0**	**2.9**	2.6	2.6	2.0
Consumer Price Index, Core	2.2	2.3	2.5	2.7	2.6	2.5	2.0
GDP Chain-Type Price Index	2.0	**0.9**	**2.9**	2.2	2.4	2.0	1.5
Civilian Unemployment Rate	3.8	3.8	3.7	3.6	3.6	3.6	7.0
Price of WTI crude oil ($/bbl)	59.1	54.8	66.0	66.5	68.0	68.0	55.0
Trade-Weighted Dollar Index	91.5	91.5	92.0	90.2	88.0	88.0	79.0
S&P 500 Operating Earnings	155.6	39.1	41.5	42.8	41.0	164.4	120.4
Percent vs. Year Ago	25.0	7.0	7.4	3.4	5.1	5.7	-26.5
91-Day Treasury Bill Rate	2.4	2.5	2.4	2.5	2.5	2.5	1.0
10-Year Treasury Note Yield	3.0	2.7	2.5	2.7	2.5	2.5	2.5
30-Year Mortgage Rate	4.8	4.4	4.2	4.3	4.4	4.4	4.0
Bank Prime Rate	5.4	5.5	5.5	5.5	5.5	5.5	4.0

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

Quarterly changes in real GDP and all measures of inflation are percent changes from the previous quarter at annual rates. For the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates, quarterly estimates are averages for the quarter indicated. S&P earnings are per share for the period indicated.

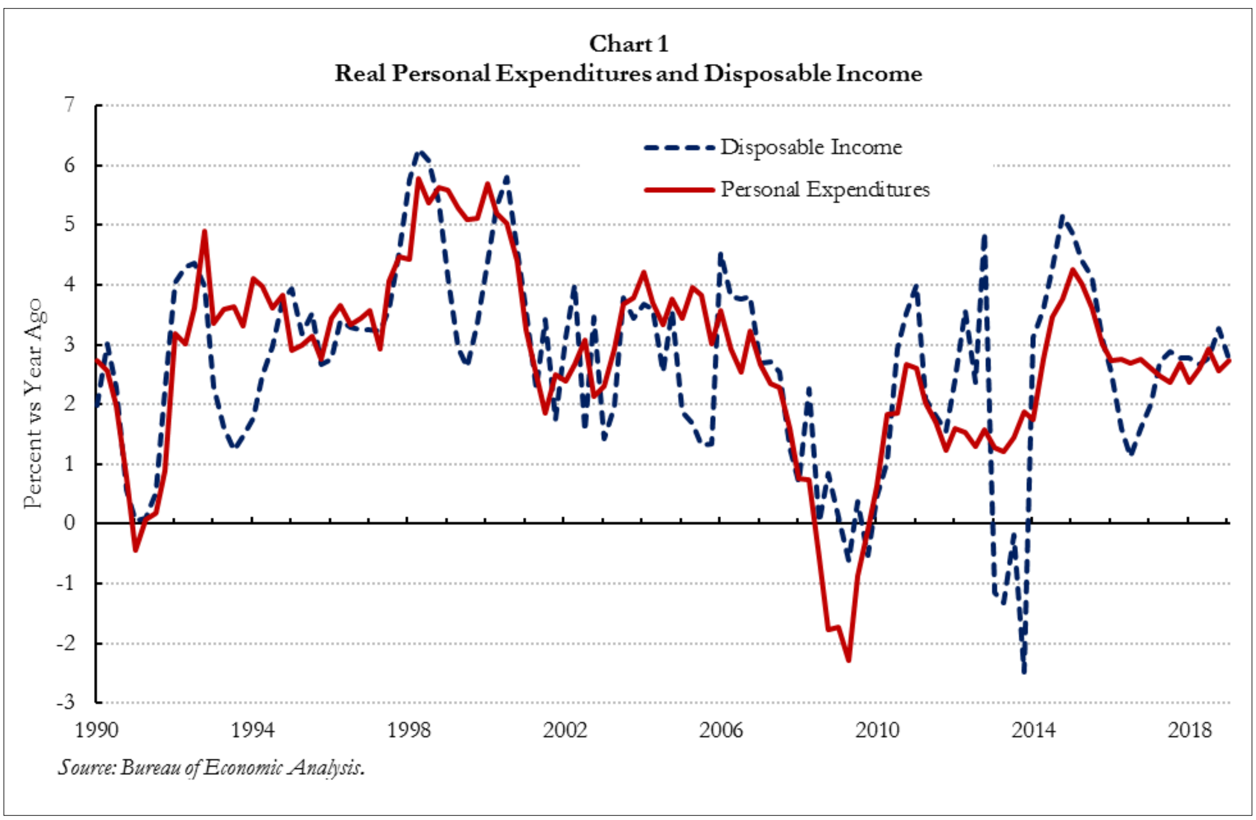
f-forecast; bold type reflects a major change from the previous forecast

Indeed, even the trade skirmish that seems more likely than a trade war could be enough to push the U.S. economy into a recession if it triggers a wave of price increases across the board. Nevertheless, when the U.S. economy stalls, macroeconomic policies of the Trump administration, Congress or the Federal Reserve will be too late to prevent it. The best they can hope for is to soften the blow, but even their ability to do that presently has limits. These limits include ballooning federal debt levels, historically low interest rates for an economy approaching the late stages of a business cycle and an already hefty balance sheet at the Fed.

The surprisingly strong Q1

The U.S. economy grew at a surprisingly solid pace in the first quarter of 2019, registering a gain of 3.2 percent at an annual rate. This compares to a 2.2 percent pace expected in the February forecast. Recall that the expectation was that consumer spending would be sluggish owing to bad weather over most of the country especially in February, and to a lesser degree the government shutdown in January, and that the other sectors of the economy would contribute very little to overall first-quarter growth. The expected outcome was a growth rate close to trend, which is estimated at about 2 percent.

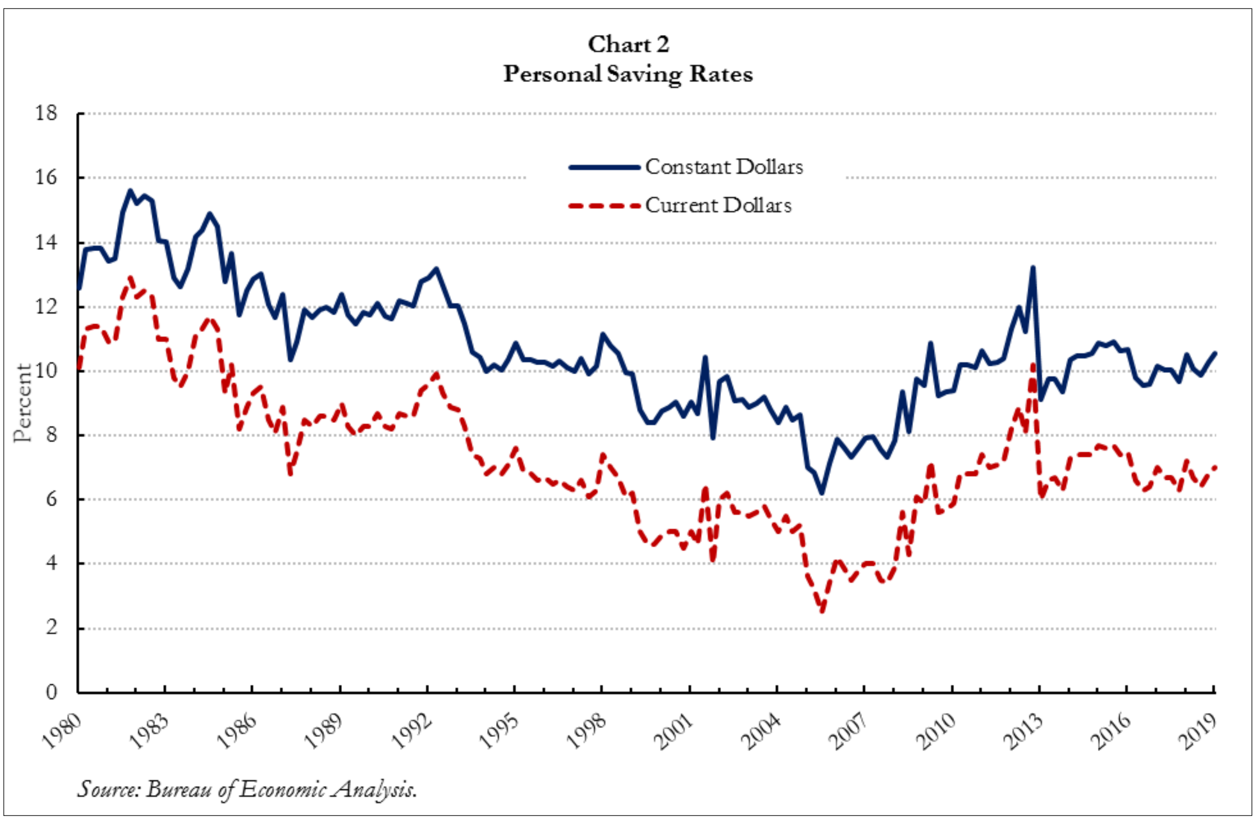
In large part, consumers did exactly as expected, increasing real personal consumption expenditures only 1.2 percent at an annual rate following a gain of 2.6 percent over the four quarters of 2018. In the first quarter, real spending on goods actually declined at a 0.7 percent pace, while real spending on services edged up at only a 2.0 percent pace. Interestingly, real personal disposable income, which is personal income after taxes and adjusted for price changes, increased at a 2.4 percent pace in the first quarter, double the growth rate of real expenditures. However, as shown



in Chart 1, the gain in real disposable income in the first quarter from a year ago was very much in line with the gain in real personal consumption expenditures. More importantly, the growth rates of the two series over the last two years has been roughly in line with each other.

This stability is reinforced by the personal saving rates shown in Chart 2. In fact, despite the noise on a quarterly basis, the gap between expenditures and income in the first quarter of 2019 was in line with the averages for the current expansion, which started nearly 10 years ago. In particular, the personal saving rate in constant dollars (the blue solid line in Chart 2) rebounded to 10.5 percent, very close to the average of 10.3 percent since the third quarter of 2009. In addition, the personal saving rate in current dollars (the red dotted line in Chart 2) rebounded as well in the first quarter to 7.0 percent, which is exactly equal to the average since mid-2009. Clearly it was not the loss of purchasing power that prevented consumers from spending in the first quarter.

The implication is that the sluggishness in consumer spending in the first quarter most likely was temporary. This conclusion is supported by the momentum in real personal consumption expenditures (PCE) at the end of the first quarter. According the Bureau of Economic Analysis, the level of real PCE in March was already 1.7 percent at an annual rate above the first-quarter average. Unfortunately, some of the weakness in consumer spending early in the first quarter, especially in February, was due to bad weather and was canceled rather than postponed. On the other hand, any rebound in real spending in the second quarter may be



constrained a bit by the anticipated spurt in consumer prices in that quarter owing to a rebound in energy prices. This will be discussed in more detail later.

In contrast, the other sectors of the economy contributed much more to first-quarter GDP growth than expected. Although the surprises were relatively widespread, they were led by net exports and government spending, as well as a larger-than-expected increase in business inventories. The trade deficit—exports less imports—improved considerably in the first quarter, contributing over a full percentage point to real GDP growth at an annual rate. The expectation was that net exports would continue to be drag on growth, given the ongoing uncertainty about trade policy. As it turned out, the impact of uncertainty on net exports was positive as U.S. companies were able to sell more and import less in the first quarter. It is doubtful that this situation will persist into the current quarter and beyond with the new tariffs on imports from China and the assumption that China will retaliate with new trade barriers of its own.

Government spending, owing in large part to state and local government spending, added nearly a half of a percentage point to real GDP growth in the first quarter. State tax revenue apparently was not constrained as much by the new tax code as I had anticipated—at least not yet. The limitation on state and local taxes as a deduction in federal income tax returns could eventually cause a shift of taxable income away from high tax states if it looks as if the loss of this deduction will be permanent.

In the February forecast, businesses were expected to accumulate more inventories in anticipation of higher tariffs being imposed on imports. An interesting, as well as confusing, aspect of first-quarter GDP was that business inventories actually increased more than expected despite the decline in imports. Obviously, it was not necessarily imports that were added to inventories last quarter. If the tariffs are expected to be temporary, then there would be some incentive to operate out of existing inventories for as long as possible. If the tariffs are expected to be in place for a while, then businesses will import enough product only to meet demand.

On balance, the U.S. economy delivered a very solid growth rate in the first quarter but many of the sources of that growth appear to be temporary. The expectation for real GDP growth in the second quarter is a mere 1.1 percent at an annual rate, which would put the average growth rate for the first half of 2019 at 2.1 percent, not that different from the first-half average shown in the February forecast.

Inflation ahead

With regard to overall inflation, the Bureau of Economic Analysis estimated that the GDP price index increased a mere 0.9 percent at an annual rate in the first quarter, at least a percentage point lower than shown in the previous forecast owing in large part to the sharp drop in energy prices. Interestingly the annual rate of gain in nominal first-quarter GDP implied in the February forecast was 4.2 percent, which was actually higher than the 3.8 percent increase reported in the advance estimate by the Bureau of Economic Analysis. Apparently the surprisingly strong real GDP growth rate reported for the first quarter was due to a miss in the inflation forecast more so than a miss in the forecast of nominal GDP.

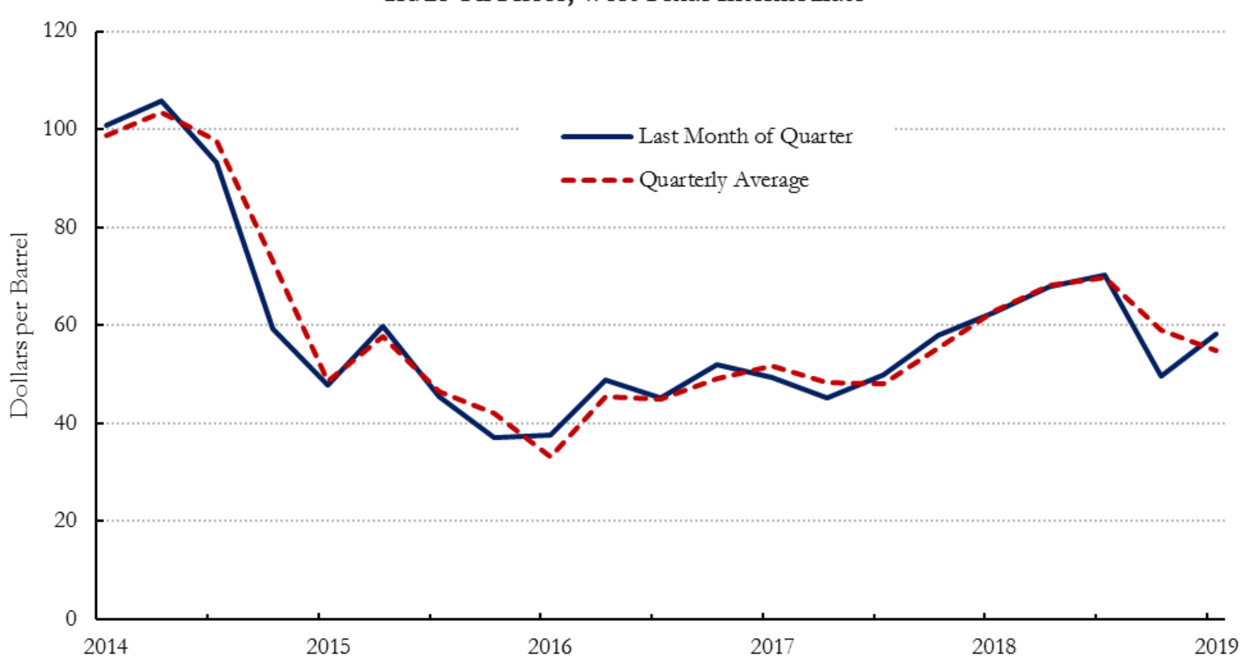
Overall consumer price inflation essentially tells the same story. According to the Bureau of Labor Statistics, the overall consumer price index (CPI) also increased a scant 0.9 percent at an annual rate in the first quarter, following an advance of 2.2 percent over the four quarters of 2018. Excluding energy, the CPI increased at a much stronger 2.5 percent annual rate, as energy prices alone plunged at a 16.4 percent pace and detracted markedly from the overall inflation measure. More recently, crude oil prices, which dropped to an average of $54.83 in the first quarter from $59.08 in the previous quarter, climbed to $58.15 in March and $63.86 in April. It is unlikely that crude oil prices will drop enough over the next month or so to prevent energy prices from making a considerable contribution to overall inflation in the second quarter. As a result, the forecast now expects the overall CPI to jump at a 4.0 percent pace in the second quarter, causing price inflation for the first half of 2019 to average about 2.5 percent.

More importantly, the new tariffs on imports from China increase the likelihood that core CPI (CPI less food and energy) inflation will continue to climb in the 2.3 percent to 2.7 percent range over the remainder of the year. I tend to agree with the analysis that global disinflation has been a result of increased integration of both trade and financial markets. Any move away from such globalization, which has increased the shares of imports in consumption and production, could undermine the competitive pressures from foreign producers to keep domestic price increases in check or from foreign investors to encourage central banks to work toward the same objectives.

The Fed stands ready to stand pat

Investors' perceptions of the Federal Reserve seem to change far more often than Fed policy. The concern that the Fed would push too hard on rates and cause a recession were just as overblown as the hope that the Fed will cut rates soon. The Federal Reserve is always ready to move policy in whatever direction seems appropriate given the economic fundamentals, and at the moment that direction is unclear.

Chart 3
Crude Oil Prices, West Texas Intermediate



Source: U.S. Energy Information Administration.

Unclear I suspect because of the new tariffs recently imposed on imports from China by the Trump administration. This should keep the Fed on the sidelines until the response from China is known, as well what the impact will be on the U.S. economy. I suspect that the frustrating combination of slow growth and higher inflation most likely will keep the Fed from doing much of anything for a while. After all, monetary policy cannot offset the recessionary and inflationary effects of supply shocks at the same time, which is the effect that high tariffs may have on the U.S. economy. The effect of tariffs on the economy is very similar to imposing a federal sales tax on the products of the lowest cost producer. Also like a sales tax, tariffs can be repealed. Until the Federal Reserve has a better understanding of how long the tariffs will be in effect, monetary policy most likely has been moved to the sidelines for now.

Another reason the outlook for monetary policy may be a bit unclear is the need for legislation to raise the federal debt ceiling later this year. The debt ceiling is a limit imposed by Congress on how much debt the federal government can carry. On February 9, 2018, President Trump signed a bill suspending the debt ceiling until March 1, 2019 when the new debt ceiling would be whatever the level of federal debt outstanding was on March 1. As a result, the current limit is $22,028,945,980,301.65, which was the level of debt on that day. In the absence of new legislation, the U.S. Treasury estimates it will run out of money in September 2019.

Once the debt ceiling is reached, Treasury cannot issue new debt obligations to finance spending. It must rely on incoming revenue to pay ongoing federal government expenses. When that happened in 1996, Treasury announced it could not send out Social Security checks. Competing federal regulations make it unclear how Treasury should decide which bills to pay and which to delay.

At the moment, it is not a crisis and is not expected to become one. The reason is that the House of Representatives agreed in January to reinstate the "Gephardt Rule," which automatically increases the debt ceiling whenever Congress passes a budget that exceeds it. Of course, the Senate and President Trump could still refuse to raise the debt ceiling. However, given past behavior on this matter and the fact that the federal budget for fiscal 2019 has been approved, it seems unlikely. However, politics could still get in the way of policy.

On balance, the Stonebridge Capital Advisors' forecast is for the Federal Reserve to remain on hold with regard to its federal funds rate target over the remainder of the year. The economic expansion is expected to continue, which should refrain the Fed from raising rates, but inflation may never get to a level that requires the Fed to hike rates again. Of course, if the trade war becomes more of a factor for the U.S. economy than currently expected, essentially stagflation, then the Fed still may opt to stay on the sidelines with the hope that changes in trade policy will correct the situation.

Investment implications

Since the economic forecast for 2019 is little changed from the outlook in February, the investment implications for 2019 are little changed as well. Recall that the expectation in February was that equities would "recover completely at some point this year from the severe correction late last year." On May 3, the S&P 500 price index closed at a record high. Since then the S&P 500 has corrected somewhat. Nevertheless, given the forecast of continued real growth and mildly higher inflation, any equity market correction will be temporary and not the start of the next bear market—at least not yet.

Corporate profits are still expected to increase to a record high this year, even though the rate of gain will be considerably slower than in recent years. As mentioned before, the corporate income tax cut helped boost S&P 500 operating profits per share in 2018 but it was never expected to permanently boost profit growth. Indeed, profit growth going forward is more likely to reflect economic fundamentals rather than tax changes or sharp swings in oil prices. In this regard, S&P 500 operating profits per share are expected to increase 5.7 percent in 2019 following an estimated surge of 25.0 percent last year.

Risk still may be okay to own but far less attractive to buy at this point of the business cycle. In this same regard, for those who are more risk averse, it continues to be a good time to reduce risk exposure. Needless to say, the level of confidence around the forecast is much higher this time than it was in February.

Fixed-income investors became a bit more concerned about credit quality late last year but have looked more favorably on credit risk so far this year as measured by Moody's seasoned Baa corporate bond yield relative to the yield on the 10-year Treasury note. The expectation is that credit spreads will continue to trend lower over the remainder of this year but not without hiccups along the way. One such hiccup may be underway at the moment, given the concern that the adverse effect of the new tariffs, as well as the retaliation by China, on the U.S. and global economies could be substantial.

With regard to interest rate risk, the yield on the 10-year Treasury note seems to be stuck in a relatively narrow range and is expected to remain within a range of 2.40% to 2.75% for the remainder of the year, averaging about 2.50%. The expectation is that concern about stagflation, along with the legislative issues involving a higher federal debt ceiling, could remind fixed-income investors of the burden of servicing the enormous federal debt. I suspect that it may be this reminder that pushes the yield on the 10-year note to the upper end of the range. However, given the likelihood that a trade agreement with China will include the repeal of many of the new tariffs and will be reached before the September deadline on the debt ceiling, any backup in the 10-year Treasury yield is expected to be short-lived.

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