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ECONOMIC UPDATE

FOURTH QUARTER 2018

Quarterly Key Points

- Fourth quarter was characterized by substantial volatility across asset classes. Concerns about global growth, continued monetary policy tightening, trade policy, and growing budget deficits weighed heavily on market expectations.
- U.S. GDP grew at 3.4% in third quarter, carrying momentum from a strong second quarter. Personal consumption growth of 3.5% following 2Q growth of 3.8% continues to lead the way. Forward looking indicators are pointing to slower growth going forward.
- After peaking at a multi-year high of 2.95% in mid-summer, the Consumer Price Index (headline CPI) fell to 2.2% in November. Core CPI (ex-food and energy) continues to hover at 2.2% but more importantly Core PCE, the Federal Reserve's preferred measure of inflation, has dipped to 1.9%.
- The Fed raised its policy rate during the quarter by a single 25 bps hike at its December meeting and continued to signal two more rate hikes in 2019. The market has not reacted well to Fed policy commentary and is now pricing in a very low probability of rate hikes in 2019.

Our View

- Despite a continued strong labor market and healthy consumer spending, GDP growth is expected to slow to 2.5%-3.0% in 4Q.
- Business activity remains robust; however, data coming in may start to reflect the negative feedback loop created by forward looking market signals.
- The Fed may find it challenging to tighten monetary policy further given recent market volatility and tepid core inflation.
- We continue to advocate for investors to be cautious in the face of a global economic cycle in the late stages of expansion.

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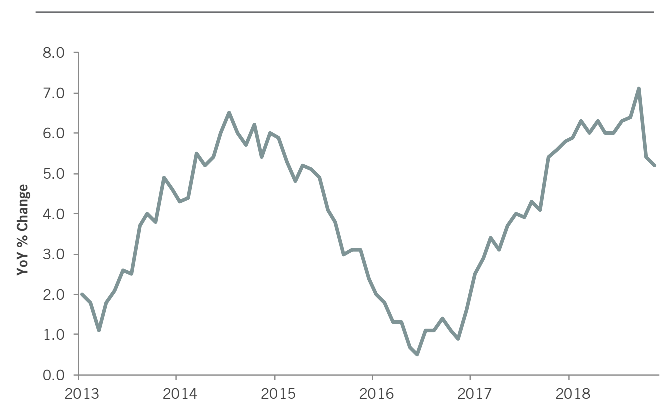
4Q SUMMARIZED BY VOLATILITY AS MARKETS REPRICE GROWTH EXPECTATIONS

No sooner had third quarter ended did global markets begin to change. Starting in early October, it became apparent that investors had grown weary in the face of slowing global growth forecasts, Fed policy commentary, trade wars, and deficit spending. Consequently, the last quarter of the year witnessed a dramatic repricing of risk across asset classes. By Christmas Eve, the S&P 500 Index had fallen 20% from the all-time high water mark struck in late September (gained back ~5% the last week of the year to wind up down ~15% from the high). Furthermore, the 10-Year Treasury rallied 55 basis points between November 8th and December 31st (3.24% to 2.69%). Market moves of this magnitude are a strong leading indicator of a slowdown in economic activity. Indeed, the Conference Board U.S. Leading Indicator Index slowed to 5.2% y/y in November from an 8-year high point of 7.1% y/y measured in September (See Figure 1).

FIGURE 1 CONFERENCE BOARD U.S. LEADING INDICATOR INDEX[1]



Looking backward, the U.S. economy grew at 3.4% in 3Q18. Following 2Q growth of 4.2%, this marked the strongest consecutive quarters of growth since 2014. Personal consumption growth led the way again, growing at 3.5% q/q annualized. Feeding this consumption, retail and wholesale inventories both increased 0.8% m/m in October. Business activity continues to expand; however, there are signs that this may be slowing. The Institute for Supply Management (ISM) Manufacturing Index saw a steep decline in December; from 59.3 to 54.1. While still signaling expansion, this was the largest one-month drop since October 2008. Considering the aforementioned market repricing, it would come as no surprise if upcoming data releases reflect lower expectations (negative feedback loop). On that note, market consensus is calling for 4Q GDP growth of 2.5% to 3.0%.

HOUSING MARKET SHOWING SIGNS OF SLOWING

A decade into recovery, the housing market is showing signs of cooling. A monotonic string of 6%+ y/y home price appreciation, as measured by the S&P Core Logic Case-Shiller Home Price Index, has driven home prices past pre-crisis highs. With mortgage rates averaging 4.50% over the last year, which is the highest they've been since 2011, home price affordability has suffered. As a result, new home sales were down 12% y/y in October while existing home sales had negative growth y/y in 10 of the last 12 months. Furthermore, the MBA Weekly Mortgage Applications Index is hovering at the lowest level in almost 20 years. With unemployment at historic lows and consumer leverage that remains in check, it seems unlikely that a sizable housing market correction lays in store. Rather, a return to 2%-3% annual home price

1 Endnote is located on reverse page

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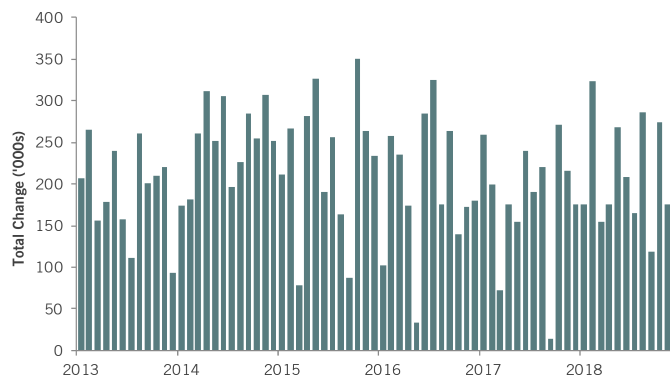
appreciation, in-line with wage growth, seems more appropriate.

DESPITE SOLID LABOR MARKET, TEPID INFLATION MAY PROVE DIFFICULT FOR CONTINUED FED RATE HIKES

Job creation remained robust, adding 274k, 176k, and 312k jobs in October, November, and December respectively (See Figure 2). The unemployment rate ended the year at 3.9% after dipping to an almost 40-year low of 3.7% in November. Notably, average hourly earnings rose 3.1% to 3.2% y/y in each month during the quarter, marking a post-crisis high mark for wage growth and stoking consumer spending and wage inflation. On the flip side, leading indicators like Initial Jobless Claims and Continuing Jobless Claims both increased during the quarter.

FIGURE 2 NON-FARM PAYROLLS[1]



Although hourly earnings growth has been strong, virtually all measures of inflation have been tame. Headline inflation is down to only 2.2% in November while the Fed's preferred measure of core inflation, the Personal Consumption Expenditures Core Price Index, dipped to 1.8% and 1.9% in October and November. Furthermore, measures of core producer price inflation have been flat to slightly lower, in the 2.8% to 3.0% range, over the recent past.

As planned, the Fed raised its policy rate in December by another 25 bps; however, market expectations for future policy tightening have been dramatically reduced. At the end of September, the forward rate markets implied a high probability of two rate hikes in 2019. By the end of December, there was a very low implied probability of a rate hike in 2019. Policymakers have also changed their tone, recently suggesting policy flexibility rather than a rigid path to higher rates.

LOOKING AHEAD

As previously noted, incoming data for the U.S. economy suggests GDP growth in the 2.5% to 3.0% range in 4Q. On a forward looking basis, muted economic growth expectations have triggered a repricing of risk across financial markets. Coupled with tame inflation, these signals bring into question the likelihood of continued monetary policy tightening in 2019.

[1]Source: Bloomberg

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