

Our Perspectives

Commentary on Legal, Regulatory and Economic Issues Affecting Financial Services Companies

The Longbrake Letter*

2019 Outlook – February Assessment

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2019 Outlook - February Update: As was the case in 2018, above potential economic growth continues to be a global theme. However, reflecting growth deceleration in the second half of 2018, over the course of 2019, global growth is expected to slow gradually and converge to its long-run potential level by the end of the year.

What economists refer to as “**tail risk**,” which is large deviations from generally anticipated outcomes, is unusually high as 2019 commences. While the consensus does not expect recession to commence during 2019, “tail risk” is significant and the probability of recession occurring in the U.S., and some other countries, is rising.

Specific outcome projections in this “**Outlook**” are tied to an overall assumption that growth slows gradually from 2018’s significantly above potential pace but that no recession occurs. However, if recession does begin before the end of 2019, actual outcomes by the end of 2019 will differ considerably, and negatively, from projections.

At the beginning of 2019 in the case of the U.S., unemployment is significantly below the natural rate and this gap is expected to widen during the course of 2019 and will add to wage and inflation pressures. However, increasing labor scarcity will result in slower employment growth and that will have knock on impacts resulting in slower spending, investment and GDP growth. In addition, the benefits of fiscal stimulus will wain during 2019 and turn negative by the end of the year.

We are in the mature phase of the business cycle. Best to enjoy the good times now because we know from history that strong economic momentum, when the economy

is operating above full capacity, usually eventually leads to recession and correction of the imbalances that built up during the euphoric period of strong growth.

Recession risks are rising but the timing of onset of recession is uncertain. In the best case, growth will slow to a sustainable level and economic imbalances will moderate without recession. Such a benign “**soft landing**,” based on history, is not a high probability outcome.

Views about timing of a recession and its severity differ. A recession could commence as soon as sometime during 2019, although most view this as a low probability. As time passes it is likely, although not assured, that the probability of recession will increase. Political developments, policy errors, or sharp declines in consumer, business, and investor sentiment could accelerate the timing of recession and its severity.

There are significant risks facing the U.S. and global economies as 2019 commences:

- **The U.S. economy is operating above full capacity.** Based upon Congressional Budget Office (CBO) analysis, the U.S. economy enters 2019 operating about 0.35% above capacity on a four-quarter moving average basis. This is expected to grow to approximately 0.9% to 1.1% by the end of the year. In the past the economy has rarely operated at full capacity for very long before recession occurred. Soft landings don't usually occur. ***Economic expansions don't die of old age, they die when the economy operates above capacity and overheats.***
- **Excessive corporate debt.**
- **Leveraged loans and collateralized debt obligations (CLOs)**
- **Deteriorating residential loan credit standards.**
- **Trade war** – this risk will depend upon the outcome of U.S.-China negotiations and whether the U.S. decides to impose tariffs on automobiles and auto parts.
- **Tight monetary policy** – the FOMC's change to a neutral monetary policy in January lessened this risk.
- **Tightening financial conditions** – since the beginning of the year this risk has lessened, but greater than expected deceleration in global growth could easily reignite tightening.
- **Declining consumer, business, and investor sentiment.**
- **Escalating political uncertainty.**
- **Rise of populism and nationalism.**

- **Brexit and the European Union** – the risk of “no deal” is rising and if realized would have negative consequences for economic activity in the U.K., but also in Europe.
- **Slowing growth – Italy, France and Germany** – Italy is in recession and if it deepens this could strengthen populist and nationalist political movements, which could threaten the euro and trigger an existential crisis for the EU.
- **Slowing growth – China, emerging markets** – economic conditions are expected to improve in China during the second half of 2019; if this does not occur as expect, global growth will decelerate more than expected.

Recession risks were very much on the minds of many as the stock market plunged in December 2018.

- Almost half of CEO’s attending a Yale C.E.O. summit expected the U.S. economy to be in recession by the end of 2018 (that is not a misprint).
- Corporate CFO’s are also gloomy – according to the Duke University/CFO Global Business Outlook survey, 48.6% expect the U.S. economy to be in recession by the end of 2019.
- Each month the Conference Board asks CEOs to rank their concerns. In January 2018, recession risk 19th out of 19 choices. In January 2019, recession risk ranked first.
- Over half of the economists polled by the Wall Street Journal expect recession to begin in 2020; 10% expect recession to begin in 2019.
- Goldman Sachs pegs recession odds at 15% in 2019, but notes that the market’s probability is 50%
- Bank of America/Merrill Lynch recession model indicates a 10% to 20% chance of recession, but an alternative recession model, based upon financial markets measures, places the odds of recession in 2019 at approximately 40%

However, economic activity data in January did not validate December’s extreme pessimism. In addition, the FOMC’s moderation of monetary policy in late January from a tightening bias to neutral contributed to a lessening of fear that recession might be imminent. Optimism re-emerged. Neither the extreme pessimism in December nor the optimism of January and early February appear to be consistent with evolving trends in global economic activity. Data clearly indicate that global growth is slowing gradually and the preponderance of risks to the outlook are negative.

What we know from past experience is that forecasting a recession’s onset is notoriously difficult. The fact is that we are usually well into recession before the

consensus acknowledges it. What we do know from history is that when risks are unusually high, as they are at the beginning of 2019, the economy is especially vulnerable to unexpected shocks. Consumer, business and investor sentiment can plunge quickly and propel the economy into a downward spiral. Trying to forecast the pivotal shock and perhaps more importantly, its timing, is a crap shoot. The best policy is to be prepared for disaster while hoping for benign outcomes.

**The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only. Bill Longbrake is an Executive in Residence at the Robert H. Smith School of Business, University of Maryland.*

2019 and Beyond – Forecast Summary for the U.S. and the Rest of the World, Highlights of Key Issues, and Identification of Risks

Observations about the 2019 U.S. and global economic outlook and risks to the outlook are listed below. As events unfold during 2019, this will enable the reader to track my analytical prowess. Observations which are on track are denoted by “+”; observations not on track are denoted by “-”; indeterminate observations are denoted by “?” and general observations are denoted by “√”.

Forecasting accuracy, which is always difficult, becomes much more so when the economy is strong and above the long-term sustainable trend level, and when significant economic imbalances have accumulated, which is the situation in which the U.S. economy finds itself at the beginning of 2019. The difficulty in forecasting involves pinpointing the turning point. Almost no one does this well. Recession forecasting models are relatively crude and reliable forecast lead times have been very short. What we know from experience is that recessions occur when the economy becomes overheated and the Fed is tightening. Both of these phenomena are in place. The timing of recession onset, however, depends upon human psychology. And, when human psychology is highly positive, it tends to feed upon itself and sustain momentum, often for longer than seems possible. While consumer sentiment was at a very high level at the beginning of 2019, business and investor confidence had deteriorated from peak levels reached in 2018. Strong consumer optimism based on rising employment and incomes could outweigh business and investor anxieties. Alternatively, investor driven financial market volatility could erode consumer confidence and slow spending growth with the consequence of hastening recession onset.

In any event, 2019 looks set to be a volatile year with a higher than normal chance that outcomes by the end of the year will be significantly different and worse than outcomes expected at the beginning of the year.

1. **U.S. – Outlook: February Assessment:** Calm returned to financial markets in *January and early February* as investors realized that economic growth remains strong and the threat of recession is not imminent. The reversal in sentiment was helped by soothing words from Federal Reserve officials and reinforced by the FOMC’s monetary policy change from a tightening bias, foreshadowing two rate hikes during 2019, to a neutral bias, indicating a pause in rate changes and a data-dependent patience in determining whether the next rate change is an increase or decrease. The partial government shutdown in January will reduce 2019 Q1 GDP growth but about 75% of the loss will be

recouped in Q2. All employment indicators remain very strong and the labor market is operating above full capacity; however, inflationary pressures remain quiescent. Real GDP growth is in a slowing trend but remains well above full potential. Measures of business, consumer, and investor sentiment weakened some in January but remain near cyclical highs.

- **2019 real GDP Y/Y** growth projections range from 2.4% to 2.6%, still well above the long-term potential growth rate of 1.6% to 2.0%. The FOMC's central tendency Q4/Q4 projections range from 2.3% to 2.5%. (Q4/Q4 projections are highly dependent upon potential anomalies in Q4 data; therefore, Y/Y estimates, which average all four quarters, usually are more stable estimates.) Risks are tilted to the downside because of slowing international growth, tightening monetary policy and financial conditions, elevated political uncertainty, a heightened potential for declines in consumer, business, and investor optimism.
 - ✓ **B of A 2019 original real GDP forecast = 2.7%, revised = 2.5%; GS original = 2.4%; Bill's original BASE scenario = 2.47%, revised = 2.43%; Bill's original STRONG GROWTH scenario = 2.53;**
 - ✓ **GS Q4 2018 estimate = 2.5%; B of A = 2.3%, down from 2.8% due primarily to weaker growth in investment and inventories**
 - ✓ **GS Q1 estimate = 1.9%; partial government shutdown will depress Q1 GDP, but about 75% of the decrease will be recovered in Q2; tighter financial conditions during 2018 Q4 will slow real GDP growth in the first half of 2019, but easing financial conditions should aid growth in the second half**
 - ✓ **B of A Q1 estimate = 2.2%, but with downside risk because of the federal government shutdown**
 - ✓ **GS's U.S. Current Activity Indicator (CAI), which is a proxy for real GDP growth, was 2.1% in December 2018, above GS's long-term potential level of 1.6%, but below its forecast 2019 GDP growth rate; January = 1.7%**
 - ✓ **2018 Q4 data delayed due to partial federal government shutdown**
- **Real GDP output gap**, which moved from negative to positive (overheated) during 2018, will become even more positive, which means the economy will overheat to an even greater extent during 2019. By the end of 2019 the positive output gap should be in a range of 0.9% to 1.1%. (CBO will revise its estimates of potential real GDP growth sometime during 2019, which could change the end of the year forecast output gap.)
 - ✓ **2018 estimated output gap was a positive 0.35%, indicating the economy was operating slightly above its potential**

- ✓ **CBO revised 10-year economic projections did not change the year end 2018 output gap, but lowered the forecast year end 2019 output gap from 1.1% to 0.9%**
- **Potential structural rate of real GDP growth** will remain well below actual real GDP growth during 2019 in a range of 1.5% to 1.6%. Long-term potential real GDP growth will edge up in coming years to between 1.7% and 2.0%, based upon improving productivity.
 - ✓ **According to CBO 2019 potential growth = 2.1%**
 - ✓ **Bill's 2019 estimate of potential growth is between 1.5% and 1.6%**
 - ✓ **Long-term potential GDP growth: CBO = 1.75%; B of A = 1.70%; GS = 1.75%; FOMC = 1.80% to 2.00%; Bill's BASE scenario = 1.80%; Bill's STRONG GROWTH scenario = 1.90%**
- **Productivity** should remain relatively stable in 2019 in a range of 1.2% to 1.4% compared to an expected 1.3% gain in 2018; it will continue to fall well short of the historical 2.1% average.
 - ✓ **The government shutdown delayed publication of the initial 2018 Q4 and full year 2018 productivity estimate**
- **Payroll and household employment** growth should slow during 2019 because employment is well above its long-term natural level and should converge closer to the natural rate of growth in the labor force which is about 80,000 to 100,000 new entrants monthly; however, given the strength in expected economic activity during 2019, payroll and household employment growth should average between 160,000 and 190,000 per month; risks are tilted to the downside
 - ✓ **Jobless claims fell to the lowest level in 69 years in January**
 - ✓ **Payroll employment grew 222,833 (219,833 before annual benchmarking adjustments) monthly during 2018; January = 304,000; household employment grew 199,500 monthly (240,167 monthly excluding a downward adjustment of 488,000 for 2018 stemming from updating of population controls) during 2018; January = 236,000**
 - ✓ **BLS benchmarked payroll employment in February but the impact on 2018 payroll employment was negligible – average 2018 monthly payroll employment increased 3,000**
 - ✓ **Census Bureau updated population controls in February which reduced the number of people eligible to work by 800,000, the number in the labor force by 506,000, the number employed by 488,000, and the number unemployed by 18,000 – the adjustments**

did not impact the employment participation ratio or the unemployment rate

- ✓ The Conference Board's difference between jobs plentiful and jobs hard to get was 33.3% in December 2018; it is likely to fall, perhaps substantially in 2019; **January = 33.7%**
 - ✓ Evercore ISI employee placement (average of temporary and permanent) index = 61.3 in December (a value above 50 indicates expansion); the index declined to 60.7 on February 8th, foreshadowing a slowdown in employment growth
- **Employment participation** should edge down slightly from its December 2018 level during 2019 in a range of 62.75% to 63.05%, as strong employment growth offsets the longer-term declining trend in participation due to demographically-embedded retirements of baby boomers.
 - ✓ The participation rate was 63.05% in December 2018; **January = 63.21%**
 - **Unemployment rate** should edge down slightly from 3.9% to between 3.2% and 3.6%.
 - **January = 4.0%; the increase in the unemployment rate in January occurred because the increase in the participation rate caused the labor force (495,000) to increase much more than the number employed (236,000)**
 - **Hourly wage** growth, reported by BLS for all employees and non-supervisory and production workers, should edge up slightly during 2018 to a range of 3.2% to 3.6%.
 - ✓ Hourly wage growth for all employees (12-month moving average) was 2.88% in December 2018; **January = 2.92%**
 - ✓ Hourly wage growth for production and nonsupervisory employees (12-month moving average) was 2.85% in December 2018; **January = 2.94%**
 - + Evercore ISI employee pricing power (average of temporary and permanent) index = 68.6 in December (a value above 50 indicates increasing pricing power); **employee pricing power = 69.2 on February 8th**
 - ✓ GS's wage tracker was 3.04% in Q4 2018; **January = 3.2%**
 - ✓ The Atlanta Federal Reserve Bank wage tracker was 3.8% in December 2018; **January = 3.7%**

- ✓ **2018 employment cost index increase: total = 2.89%; wages and salaries = 3.00%; benefits = 2.75%**
- **Nominal consumer disposable income** growth, measured on a 12-month moving average basis should increase during 2019 primarily because of rising wage rates; growth should be in a range of 5.0% to 5.5%.
 - ✓ **Nominal disposable income grew an estimated 4.9% in 2018**
 - ✓ **December data delayed due to partial federal government shutdown and will be reported on March 1st along with January data**
- **Nominal consumer spending** growth on a 12-month moving average basis should slow during 2019 because of slower employment growth, much slower growth in wealth (financial assets and housing), moderating levels of optimism; growth should be in a range of 4.25% to 4.75%.
 - ✓ **Nominal consumer spending grew an estimated 4.9% in 2018**
 - ✓ **\$30 billion increase in tax refunds should boost consumer spending in early 2019, but possibly contrary to this forecast the average refund so far is 8.4% smaller than in 2018; for the forecast to prove accurate, either the average size of refunds needs to increase or more refunds need to occur**
 - ✓ **December data delayed due to partial federal government shutdown and will be reported on March 1st along with January's data**
- **Auto sales** should decline during 2019
 - ✓ **Auto sales averaged 17.19 million units during 2018; January = 16.60 million units**
 - ✓ **Auto production is forecast to decrease 15% in 2019 Q1 from 2018 Q4 to 11.1 million units, which is still above the January sales rate**
- **Retail sales** growth should be stable or slightly slower during 2019
 - ✓ **Retail sales grew 4.1% through November 2018**
 - ✓ **December data report delayed until Feb. 14th due to partial federal government shutdown**
 - ✓ **B of A credit card data indicate that growth in retail sales slowed in December**
- **Consumer confidence** in 2019 should decline from historically high levels in 2018.
 - ✓ **Conference Board = 126.6 in December 2018; January preliminary = 120.2, almost all of the decline was in expectations sub-index,**

possibly influenced by the partial government shutdown, while the current conditions index was stable

- ✓ University of Michigan = 95.3 in December 2018; January = 91.2, which was worse than expected and a two-year low
 - ✓ Bloomberg = 59.6 in December 2018; 58.2 on February 2nd
 - + Evercore ISI = 54.5 in December 2018; February 8th = 53.9
 - + B of A's consumer January survey indicated increasing pessimism: 34% feel that the economy has weakened since a year ago and 34% expect the economy to be weaker in the next year
- **Consumer credit growth** should slow during 2018; however revolving credit growth could rebound from 2018's depressed level which was caused primarily by cuts in personal income taxes.
 - ✓ Total consumer credit grew 4.7% in 2018
 - ✓ Revolving credit grew 2.4% in 2018
 - ✓ Non-revolving credit grew 5.6% in 2018
 - ✓ Federal Reserve Senior Loan Officer Opinion Survey: residential mortgage underwriting standards were unchanged in 2018 Q4, but demand weakened; underwriting standards tightened on credit cards but were unchanged for other types of consumer loans, but demand weakened moderately for all categories; banks expect higher residential mortgage delinquencies in 2019 and intend to tighten underwriting standards
 - **Household personal saving rate** will rise as growth in disposable income exceeds growth in consumer spending; the saving rate should improve to a range of 6.5% to 7.5%.
 - ✓ The average consumer saving rate in 2018 was 6.6% (through November)
 - ✓ December data delayed due to partial federal government shutdown
 - **Stock prices**, as measured by the S&P 500 average, should be between 5% higher or 15% lower: on the downside reflecting pressure on profit margins, slower revenue growth, rising labor costs and higher short-term interest rates; on the upside reflecting growth friendly fiscal policy and investor optimism.
 - ✓ Analysts expect S&P 500 earnings per share to increase 7% from \$162 in 2018 to \$174 in 2019
 - + 2018 Q3 earnings = \$160; 2018 Q4 earnings are on track to = \$163, slightly higher than the 2018 forecast
 - ✓ Stock prices were +8.1% YTD on February 11th

- **Business activity** will weaken slightly but remain positive with both the PMI manufacturing and service indices averaging above 50.
 - ✓ PMI manufacturing index = 54.3 in December 2018; January = 56.6, reflecting increases in the orders and production sub-indices
 - ✓ PMI non-manufacturing (services) index = 58.0 in December 2018; January = 56.7
 - + New orders for manufactured goods have declined 2.1% since October
 - ✓ NFIB optimism index = 104.4 in December
 - GS analyst index = 61.3 in December; January = 67.9
- **Industrial production** will increase in 2019 but at a slower rate than in 2018.
 - ✓ The industrial production index was 109.9 in December 2018, up 4.1% over December 2017
- **Capacity utilization** will be stable to slightly higher, but will remain below 80%, which is traditionally considered to be a capacity level that stimulates investment spending.
 - ✓ Capacity utilization = 78.7% in December 2018
- **Business investment** inflation-adjusted spending growth should decrease as U.S. economic growth slows; growth in 2019 is expected to be in a range of 3.0% to 3.5% (the average for the past 20 years = 3.24%).
 - ✓ GS original 2019 forecast = 3.3%; revised = 3.2%
 - ✓ B of A original 2019 forecast = 3.5%; revised = 3.4%
 - + Evercore ISI capital goods index was 64.3 in December (acceleration above 50; deceleration below 50); it was 62.4 on February 8th
 - + Spending for non-aircraft capital goods, a proxy for all capital spending, has increased 6.1% over the past year, but new orders, a leading indicator, have declined gradually since peaking in July
 - ✓ NFIB net percentage planning to increase capital spending = 25% in December 2018
 - ✓ NFIB percentage reporting making capital outlays = 61% in December 2018
 - ✓ 2018 Q4 data reports indicate weakening residential and business investment and slower inventory accumulation
 - ✓ According to an Evercore ISI survey, satisfactory resolution of trade negotiations with China will have limited favorable impact on

business investment, but the negative impact if talks fail could be substantial

- ✓ Favorable tax changes have had limited impact on business investment spending; expectations for economic growth are the principal driver and falling expectations are leading to lower business investment spending
- **Business credit** growth should continue to expand near levels experienced in 2018, but credit spreads should widen.
 - ✓ **Federal Reserve Senior Loan Officer Opinion Survey: underwriting standards for business and commercial real estate loans tightened in 2018 Q4 and demand weakened; banks expect to tighten underwriting standards further in 2019 and demand to continue to weaken**
 - + **BAA and high yield bond credit spreads blew out during December's severe market correction and only partially recovered during January**
- **Residential housing investment** should decline in 2019 in a range of 0% to -3%; housing starts should also rise in a range of -6.5% to +3.0%.
 - ✓ **GS 2019 original forecast = -2.1%; revised = -1.4%**
 - ✓ **B of A 2019 original forecast = -1.3%**
 - ✓ **GS housing starts original forecast = -0.7%**
 - ✓ **B of A housing starts original forecast = 2.9%; revised = 1.4%**
 - ✓ **Bill's BASE housing starts scenario = -6.4%**
 - **The NAHB December 2018 housing index = 56 (value greater than 50 means is favorable); January = 58**
 - ✓ **Existing home sales peaked in November 2017, but higher interest rates and higher housing prices depressed affordability and caused sales to decline during 2018 (most adversely affected were investor, vacation and second homes); the January decline in mortgage interest rates could result in a temporary increase in sales**
- **Residential housing prices** should rise more slowly in 2019 in a range of 2% to 4%.
 - ✓ **GS 2019 housing price 2019 Q4 forecast = 3.1%**
 - ✓ **B of A 2019 original housing price 2019 Q4 forecast = 3.2% (average for 2019 = 4.0%); revised 2019 Q4 = 3.1%**
 - ✓ **Bill's BASE scenario 2019 housing price forecast = 2.2%**

- ✓ The S&P Core Logic Case Shiller national housing price index **slowed** to 5.2% in November 2018; the 20-city index **fell** to 4.7% in November 2018
- ✓ The FHFA housing price index was unchanged in November 2018 at 5.8%
- **Trade deficit** should rise in 2019 in a range of -3.0% to -3.5%.
 - ✓ December 2018 estimated trade deficit = -2.90%
 - ✓ Trade deficit declined in November more than expected, driven by a large decline in imported goods, which probably reflected a return to normal after front-loading of imports earlier in 2018 to avoid the impact of tariffs; December data will be reported March 6th a month behind schedule
 - ✓ Evercore ISI reported in January slightly diminished concern about the impact of tariffs: of businesses surveyed negative = 30% and positive = 9%, compared to 39% and 4%, respectively, in October
- The **dollar's value** on a trade-weighted basis should be stable to slightly stronger as U.S. economic growth exceeds global growth, in a range of 0.0 to 3.0%.
 - ✓ 2018 dollar change = 3.7%
 - ✓ January 12-month change = 5.5%; **January 2019 YTD change = -1.0%**
- **Oil prices** are likely to remain in the long-term range of \$40 to \$55 that balances global supply and demand because weaker global growth and abundant and flexible supply in the U.S. which will continue to constrain prices.
 - ✓ West Texas Intermediate oil prices averaged \$49.52 per barrel in December 2018
 - + WTI: January = \$52; February = \$54
- **Monetary policy** – the Federal Reserve might raise the federal funds rate twice during 2019 in 25 basis point increments or it might decrease rates once.
 - + FOMC – 2 increases; January FOMC meeting changed policy to neutral – data dependent, raising the possibility of no further increases
 - + Market forward yield curve – between no increases and one decrease
 - + Original GS – pause early in the year followed by 2 increases;
 - + revised GS – one increase in Q4

- + **B of A – 2 increases Q3 and Q4, but risk in direction of fewer increases**
- ✓ **The Fed’s January Beige Book, which surveys economic conditions in the 12 Federal Reserve districts, indicated weakening economic activity; scarcity of skilled labor and upside pressure on input costs continue to be concerns; ISI’s diffusion index at -7.0 was the weakest for this report since 2012**
- **Total inflation** measures (CPI and CPE) will rise decline in 2019 as the impacts of the 2018 rise in energy prices falls out of the indices: total CPI will rise 1.6% to 1.8% and total CPE will rise 1.7% to 1.9%.
 - ✓ **December total CPI = 1.95%**
 - ✓ **Estimated December total CPE = 1.82%; December data delayed because of partial government shutdown**
 - ✓ **GS total 2019 CPI original forecast = 1.6%; revised = 1.8%**
 - ✓ **B of A total 2019 original CPI forecast = 1.5% (average for year), revised = 1.6%; total PCE = 1.6%**
 - ✓ **FOMC total 2019 PCE forecast = 1.8% to 2.1%**
 - ✓ **Market expected long-term CPI inflation rate, embedded in TIPS (Treasury Inflation Protected Securities) = 2.02% (approximately 1.72% CPE) in December 2018; February 8th = 1.99% (CPE equivalent = 1.69%)**
 - ✓ **Consumer long-term expected CPI (University of Michigan Survey): December 2018 = 2.6%; January = 2.6% (this survey consistently reports higher inflation expectations than TIPS, so what is important to watch is directional changes in consumer expectations)**
- **Core inflation** (CPI and CPE) will rise slightly from 2018’s level in response to an economy operating above full capacity: core CPI will rise 2.2% to 2.4% and core CPE will rise 1.9% to 2.1%.
 - ✓ **December core CPI = 2.21%**
 - ✓ **Estimated December core CPE = 1.84%; December data delayed because of partial government shutdown**
 - ✓ **GS core 2019 CPI forecast = 2.3%; core PCE = 2.0%**
 - ✓ **B of A core 2019 CPI original forecast = 2.2%, revised = 2.3%; core PCE original = 2.0%, revised = 1.9%**
 - ✓ **FOMC core 2019 PCE forecast = 2.0% to 2.1%**
- **The 10-year Treasury rate** is likely to remain relatively stable during 2019 and fluctuate during the year in a range between 2.00% and 3.00%. Strong

real GDP and employment growth would push the rate toward the top end of the range; soft inflation and/or heightened financial instability would push the rate toward the bottom end of the range.

✓ **The 10-year Treasury Note yield was 2.69% on the last trading day of 2018**

+ **The 10-year Treasury Note yield was 2.65% on February 11th**

- **State and local investment spending** growth will be modest within a real growth rate of 1.0% to 1.5%.
 - ✓ **State and local investment spending is expected to rise 1.0% or less in 2018**
 - ✓ **GS forecasts state and local government investment spending will increase 1.4% in 2019**
- ✓ **State and local tax receipts stopped growing in January: Evercore ISI diffusion index = 57.2 in December and 50.0 in January – softening driven primarily by declines in estimated income tax payments**
- The **federal budget deficit** as a percentage of nominal GDP will increase from fiscal year 2018's level of 3.77% to a range of 4.5% to 5.0%. Stronger than expected growth would push the deficit toward the lower end of the range.
 - ✓ **CBO fiscal 2019 deficit: original = 4.62%; revised = 4.16% due to stronger revenue growth (tariffs and individual income taxes – stronger personal income growth), reduced overseas military spending and emergency spending for disaster recovery, return to prior lower spending caps, and lower interest rates on the federal debt**
 - ✓ **GS fiscal 2019 deficit forecast = 4.72%; (likely to be revised lower)**
 - ✓ **B of A fiscal 2019 deficit: original = 4.69%; revised = 4.34%, but higher than CBO's projection due primarily to the elimination of "return to prior spending caps" assumption**
 - ✓ **Bill's BASE scenario fiscal 2019 deficit: original = 4.73%; revised = 4.25%**
 - ✓ **November 2018 12-month deficit-to-GDP ratio = 4.22%; December estimate = 4.16% (December data delayed by partial government shutdown)**

2. **Rest of the World: February Assessment:** Global economic activity, which peaked in mid-2018, continues to slow in early 2019. The OECD global leading indicator index continued to decline at the end of 2018, driven by Europe, the U.S., and particularly China.
- ✓ **Global economic activity in January weakened slightly in developed economies and strengthened modestly in emerging economies**
 - ✓ **GS's current activity indicator (CAI, which is a proxy for real GDP growth) was 3.1% in December 2018, below the potential growth rate of 3.5% and the expected 2019 global growth rate of 3.5% to 3.7%**
 - **January CAI = 3.2%**
 - ✓ **CAI for major advanced economies was 1.7% in December 2018, and was decelerating, but still above the potential growth rate of 1.4%**
 - **January CAI = 1.6%**
 - ✓ **CAI for emerging markets (which includes China) was 4.2%, and was decelerating and below the potential growth rate of 5.1%**
 - + **January CAI = 4.5%, better, but still below the potential growth rate**
 - + **Reflecting improvements in the U.S., global financial conditions eased slightly in January**
 - ✓ **The mood at the Davos World Economic Forum in late January was “subdued, cautious and apprehensive; Fareed Zakaria commented: “There is no great global political crisis, yet people speak in worried tones about the state of democracy, open societies and the international order;” globalization has given way to a new era of sluggishness, or “slowbalization,” which will lead to stronger ties to regional blocs as supply chains seek sources closer to home; mounting debt in developed countries could lead to financial panic; increasing social and political division risks economic calamity; growing discomfort with corporate influence over society, particularly Big Tech**
 - ✓ **B of A has concluded that policy shocks (trade war, Brexit, U.S government shutdown, French yellow jackets, etc.) over the past year have depressed confidence and growth expectations and reduced capital spending, which leads to a self-fulfilling outcome of slower growth**
- **Global growth** is likely to slow from 3.8% in 2018 to 3.5% to 3.7% in 2019. Global economic momentum decelerated in the last few months of 2018 and this should carry over into 2019. However, downside risks, such as U.S. trade policies and an emerging global monetary tightening cycle, and, of course the

risks of political turmoil in Europe, the Middle East, Korea, and possibly elsewhere could contribute to even slower growth.

- ✓ **GS 2019 global growth original forecast = 3.6%**
- ✓ **B of A 2019 global growth original forecast = 3.6%; revised = 3.4% (developed economies lowered from 2.0% to 1.8%; emerging economies reduced from 4.6% to 4.5%)**
- ✓ **IMF 2019 global growth forecast = 3.7%**

- **Global inflation** is expected to fall from 3.3% in 2018 to 2.8% in 2019, reflecting slowing global growth.
 - ✓ **B of A forecast = 3.0%**

- **European growth** will slow to 1.4% (B of A) to 1.6% (GS) from 2018's 1.9% expected pace. Tighter monetary policy and political uncertainty pose downside risk to growth.
 - ✓ **B of A original forecast = 1.4%; revised forecast = 1.1%**
 - ✓ **Euro area CAI = 1.4% in December, and was decelerating, but well above potential growth of 1.0%**
 - **January CAI = 1.3%**
 - ✓ **IMF and OECD Euro area real GDP growth forecasts for 2019 = 1.9%, but are stale and do not reflect loss of economic momentum at the end of 2018; EC's revised 2019 GDP forecast = 1.3%**
 - **Italy's GDP declined in both Q3 and Q4 2018, qualifying for a technical recession; industrial production declined 5.4% during 2018 with most of the decline concentrated in the production of consumer goods**

- **European total inflation** in 2019 will remain decline from 1.7% in 2018 to 1.0% in 2019 (B of A), reflecting falling energy prices and slowing economic growth: **core inflation** will ebb slightly lower from 1.0% to 0.9%; both measures will remain considerably below the ECB's 2.0% target.
 - ✓ **Data is not yet available, but downside surprises are more likely than upside surprises**

- **European financial markets** should be volatile, reflecting rising political uncertainty, tighter monetary policy and financial conditions, and slowing economic growth.
 - ✓ **Tracking the U.S., volatility moderated in European financial markets in January**

- **European political dysfunction, populism and nationalism** will continue to build in many countries.
 - ✓ **No new developments of consequence have occurred early in 2019; however, this may change if European economic activity continues to deteriorate; for example, the French yellow jackets activism has faded, although it has not disappeared; Italy's populist government had backed away from confrontation with the EC, but this could re-emerge if the recession in Italy deepens**
 - ✓ **European Parliament elections in May could elevate political uncertainty**

- **U.K. growth** is expected to be relatively stable in a range of 1.2% (B of A) to 1.5% (GS and IMF) in 2019 compared to 1.2% to 1.3% in 2018; Brexit and political disarray are downside risks.
 - ✓ **CAI = 0.8% in December 2018 and was decelerating; potential growth = 1.3%**
 - **CAI = 1.0% in January**
 - **2018 Q4 GDP growth was 0.2% (0.8% annualized), which was weaker than expected; without inventory building, growth would have been even weaker**
 - **BOE decreased its 2019 GDP forecast from 1.7% to 1.2%**
 - **January job placement fell, but wage growth remained strong**

- **China's GDP growth** is expected to slow to a range of 6.1% (B of A) to 6.3% (OECD) in 2019 from 6.6% in 2018; risks are to the downside as China's economy transitions from industrial to consumer emphasis, as President Xi continues to emphasize the goal of a "better quality life" over GDP growth, and as global growth slows and the U.S. pursues restrictive trade and technology policies.
 - ✓ **CAI = 5.5% in December 2018 and was decelerating; potential growth = 5.9%**
 - **CAI = 5.4% in January**
 - ✓ **2018 growth = 6.6%; however Q4 2017 to Q4 2018 growth = 6.4%, indicating a modest slowing**
 - **Business conditions have weakened sharply in Australia, confirming the slowdown in China's economy**
 - + **Housing demand is expected to remain strong and provide support to economic growth**
 - **Land sales are slowing which reduces revenue to fund infrastructure development, but this source of funding is declining in importance**

- ✓ **Fiscal and monetary policy adjustments are intended to stabilize economic growth, not stimulate it**
 - **New fiscal stimulus – tax cuts and infrastructure investment – expected to amount to 3% of GDP (\$370 billion); however, tax cuts will benefit only a small percentage of the population; the benefits of lower taxes will be offset by stricter enforcement**
 - **People’s Bank of China easing credit availability through a bond swap facility**
 - **Regulatory policy is aimed at preventing cash hoarding at state owned enterprises which has been limiting credit availability at private businesses**

- **China’s leadership** will continue implementing **economic reforms** gradually; financial and political stability will be maintained.
 - ✓ **Regulation of unconventional credit products and environmental issues continues despite of negative impacts on growth; monetary and fiscal policy adjustments are designed to offset these negative effects**

- **Japan’s** growth is expect to improve modestly from 0.7% in 2018 to a range of 0.9% (GS and IMF) to 1.1% (B of A) in 2019; total inflation is expected to fall from 1.1% (B of A) in 2018 to 0.4% in 2019 (B of A); core inflation is expected to rise from 0.4% in 2018 (GS) to 0.8% in 2018 (GS).
 - ✓ **B of A’s original forecast = 1.4%; revised = 0.6%**
 - ✓ **CAI = 1.2% in December 2018, slightly above the potential growth rate of 0.9%**
 - + **Employment is strong and nominal income increased 3.2% and part-time wages increases 2.6% over the past 12 months; consumer spending is rising gradually; office vacancy rates continue to fall; capital spending plans are strong;**
 - **Slowing global growth is depressing manufacturing and industrial production and is expected to weigh on corporate earnings**

- **India** should continue to experience relatively strong real GDP growth in a range of to 7.0% to 7.5% in 2019. A potential downside risk in 2019 is the defeat of Prime Minister Modi in parliamentary elections.
 - ✓ **CAI = 6.8% in December 2018; potential growth rate = 7.2%**
 - + **CAI = 7.0% in January**
 - ✓ **Parliamentary elections are scheduled for later in 2019; Prime Minister Modi’s BJP party was defeated in three state elections in**

December and the national standing of the Congress Party is rising based upon its promise to provide a minimum income guarantee for India's poorest citizens

- **Emerging market countries, including China**, should experience slower growth of 4.8% in 2019 compared to 5.1% in 2018.
 - ✓ **CAI = 4.2% in December 2018 and was decelerating; potential growth = 5.1%**
 - **CAI = 4.5% in January**
- **Brazil** will benefit from improved political stability; Brazilian growth is expected to improve from 1.2% (GS) to 1.5% (B of A) in 2018 to 2.6% (GS) to 3.5% (B of A) in 2019
 - ✓ **CAI = 1.7 % in December 2018 compared to potential growth = 2.2%**
 - + **CAI = 3.8% in January**
- **Russia** will continue to grow well below potential in 2019; growth is expected to range from 1.5% (OECD) to 1.8% (GS) compared to potential growth of 3.3%.
 - ✓ **CAI = 2.4% in December 2018**
 - + **CAI = 2.4% in January**
- **Venezuela's** economy continues to implode; regime change is unlikely, however, unless the military intervenes.
 - + **The political situation deteriorated sharply in January when xxx declared himself to be the rightful president and several countries, including the U.S., recognized him as the legitimate president; however, the military continues to support Nicolas Maduro**
 - + **The U.S. imposed oil sanctions with the intent to expedite regime change; initially the impact of sanctions has fallen most heavily on the general populace**

3. **U.S. Risks** – stated in the negative relative to the forecast; “+” **risk realized**; “-“ **risk not realized**
- **U.S. real GDP growth** falls short or exceeds expectations; falling short is the more serious risk as this is likely to happen only if recession occurs.
 - **Risk not realized, Q1 data not available until late April**
 - **GDP positive output gap** rises less than expected or turns negative; this is likely to happen only if recession occurs.
 - **Risk not realized, Q1 data not available until late April**
 - **U.S. productivity** falls below the bottom end of the forecast range.
 - **Risk not realized, data not yet available to assess**
 - **U.S. employment growth** is slower or faster than expected; slower growth is the more serious risk as this is likely to happen only if recession occurs.
 - + **Employment growth was very strong in January, continuing the trend that prevailed during 2018; this has been possible because the participation rate has increased bringing more people into the labor force; this trend is not likely to be sustained for much longer**
 - **Employment participation rate** falls below the bottom of the forecast range rather than remaining relatively stable or rising modestly.
 - + **Participation was above the upper end of the projected range in January, reflecting continuation of the recent pattern of re-entry of people into the labor force who had either been discouraged or disinterested; forecasters generally have been surprised at the strength of this phenomenon**
 - **U.S. unemployment rate** rises above the forecast range; this is likely only if recession occurs.
 - **Risk probably not realized, because of the unexpected increase in the participation rate, the unemployment rate in January was above the expected range; however, it is expected to fall in coming months and be within the forecast range by the end of the year**
 - **U.S. hourly wage rate growth** is lower or higher than the forecast range; lower wage growth is the more serious risk.

- **Risk probably not realized, wage growth rose in January, but was below the bottom end of the range; however, wage growth is expected to continue rising during 2019 and be within the forecast range by the end of the year**
- ***Nominal U.S. consumer disposable income*** increases less or more than expected; a less than expected increase is the more serious risk.
 - **Risk not realized, data not yet available to assess**
- ***Nominal U.S. consumer spending*** increases less or more than expected; a less than expected increase is the more serious risk.
 - **Risk not realized, data not yet available to assess**
- ***Auto sales*** are less than expected.
 - **Risk not realized, data not yet available to assess; however, December sales were weaker than expected**
- ***Retail sales growth*** is lower than expected.
 - **Risk not realized, data not yet available to assess**
- ***Measures of consumer confidence*** drop substantially.
 - **Risk not realized, measures declined modestly in January**
- ***Consumer saving rate*** rises or falls more than expected; a higher than expected saving rate is the greater risk because that is likely only in the event of recession.
 - **Risk not realized, data not yet available to assess**
- ***U.S. stock prices*** fall more than or rise more than the forecast range.
 - + **Stock prices rose strongly in January and are above the forecast range for 2019**
- ***U.S. business activity*** contracts or expands more than expected; contraction is the more serious risk.
 - **Risk not realized, changes in survey measures in January were small, some stronger, some weaker**
- ***U.S. private business investment*** does not improve as much as or more than expected; falling short of expectations is the more serious risk.
 - **Risk not realized, data not yet available to assess**

- **Industrial production** rises less than expected.
 - **Risk not realized, data not yet available to assess**
- **Capacity utilization** falls.
 - **Risk not realized, data not yet available to assess**
- **Growth rates in U.S. residential housing investment and housing starts** are less than or more than expected; below expectations is the more serious risk.
 - **Risk not realized, data not yet available to assess**
- **U.S. residential housing price increases** are stronger than or less than expected; stronger than expected price growth would be an indication of price speculation, while slower than expected price growth would most likely be caused by recession or deteriorating consumer confidence.
 - **Risk not realized, data not yet available to assess**
- **U.S. trade deficit** does not widen as much as expected.
 - **Risk not realized, data not yet available to assess**
- **Value of the dollar** falls rather than remaining stable or rising modestly.
 - + **Trade-weighted value of the dollar fell 1.0% in January**
- **Oil prices** rise above or fall below the expected range; prices below the forecast range is the greater concern because it would be indicative of global recession.
 - **Risk not realized**
- **U.S. monetary policy** tightens more than 50 basis points, spawns financial market uncertainty and contributes to global financial instability.
 - **Risk not realized, FOMC changed policy from a tightening bias to neutral; it will be patient and any increase or decrease in interest rates will depend on the strength or weakness of incoming data**
- **Financial conditions** tighten and cause financial market volatility.
 - **Risk not realized, financial conditions have eased since the beginning of the year**
- **U.S. inflation** falls or rises more than expected.

- **Risk not realized, data not yet available to assess**
- ***U.S. long-term interest rates*** fall or rise more than expected.
 - **Risk not realized**
- ***U.S. fiscal policy*** is less expansionary than expected due to political uncertainty and congressional paralysis.
 - + **Partial government shutdown had a small transitory negative impact; at this writing domestic security negotiations (border wall) were not going well, which raises the possibility of another shutdown, although both political parties have strong incentives to avoid such an outcome**
 - + **According to CBO's updated projections, government spending will be somewhat lower in fiscal 2019 than originally expected**
- ***State and local investment spending*** increases less than expected; this would be indicative of slower than expected growth or recession and falling tax revenues.
 - ✓ **Data will not be available until 2019 Q1 GDP report released in late April**
- ***Federal budget deficit*** increases more than expected.
 - **Risk not realized, tariff revenues and reduced disaster recovery and foreign military spending are reducing the size of the project deficit**

4. **Global Risks** – stated in the negative relative to the forecast; “+” risk realized; “-“ risk not realized

- **Rising pessimism** – 30% of business leaders expect global growth to slow in 2019 a six-fold increase from 2018
- **Global risks to monitor in 2019**
 - ✓ U.S.-China trade war – will it be resolved amicably?
 - ✓ Brexit – will exit occur without a deal or the exit date be delayed?
 - ✓ Japan’s consumption tax increase – will implementation be delayed or offset with fiscal stimulus?
 - ✓ Will oil shocks occur? – six-month waivers on Iran oil exports expire in May
 - ✓ Political turmoil – India’s parliamentary elections, European parliament elections, U.S. government shutdown potential
 - ✓ Financial shocks that morph in political shocks – Italy tops the list
 - ✓ Inability of monetary policy to respond to recession, particularly in Europe and Japan
 - ✓ Chinese policy intervention has limited impact in reversing decelerating growth with knock on adverse impacts on global growth
- **Global GDP growth** slows more than expected.
 - + The managing director of the IMF, Christine Lagarde, warned that the global economy “is growing more slowly than we had anticipated” and cited trade tensions, financial tightening, Brexit uncertainty, and slowing growth in China; “When there are too many clouds it takes just one lightning bolt to start the storm”
- **Global trade** declines as the U.S. and other countries pursue protectionist policies.
 - Data not yet available to evaluate this risk
- **European growth** slows more than expected.
 - + B of A expects growth to slow to 1.1% or less
 - + Italy’s GDP declined in both Q3 and Q4 2018, qualifying for a technical recession; industrial production declined 5.4% during 2018
 - ✓ Europe’s export-heavy economy is especially susceptible to slowing global growth and trade restrictions; recent underperformance of Germany’s economy is indicative of this risk

- ✓ **The European economy would be adversely impacted if the U.S. imposes tariffs on cars and automobile parts**
- **Europe** – financial conditions tighten more than expected, financial market volatility escalates and the ECB’s monetary policy is relatively ineffectual.
 - **Risk not realized; along with other global financial markets, financial conditions eased slightly in January**
- **Europe** – political instability and social unrest rises more than expected threatening survival of the Eurozone and the European Union.
 - ✓ **May elections for the European Parliament could exacerbate growing political fragmentation in the EU**
 - ✓ **Slowing economic growth will contribute to deepening political discord**
 - ✓ **Dislike for EC Brussels technocrats and economic recession could create a politically unstable climate in Italy that leads to a euro crisis and poses existential risk to the EU**
- **UK** political instability escalates leading to new parliamentary elections and worse than expected economic performance.
 - **Risk not realized; Prime Minister May narrowly survived a no-confidence vote, but parliament has not approved May’s Brexit plan and failure to do so before the March 29th deadline could lead to new elections; uncertainty about Brexit is contributing to deceleration in U.K. economic growth**
- **China’s growth** slows more than expected.
 - **Too soon to determine; however, this risk appears to be increasing and whether it is realized will depend on the effectiveness of Chinese policy intervention**
 - ✓ **Analysts expect growth to strengthen in the second half of 2019 as policy intervention gains traction, which assumes policies will be effective, which is not a certainty**
- **China’s trade war with the U.S.** worsens and adversely impacts global growth.
 - **Risk not realized; however, no agreement has been reached; the March 1st deadline may be extended; however, this is not a high stakes issue for the Chinese leadership and thus resolution in ways that satisfy U.S. agricultural and industry appears likely**

- **China's and U.S. global leadership confrontation** – cold-war sparring could adversely affect global growth
 - ✓ **Chinese policy aims to reduce dependence on the U.S. dollar by broadening acceptance of the renminbi as a global transactions and settlement currency**
 - ✓ **China and the U.S. are engaged in a race to dominate technology development; China is overly dependent on the U.S. dominated semi-conductor market and will seek to build its own independent capability**
- **Japan's** economic growth slows more than expected.
 - **Risk not realized, however, several negative factors bear watching: trade war is depressing corporate earnings, financial conditions are tight**
- **Emerging economies** – a strong dollar leads to serious difficulties especially for countries with large amounts of dollar-denominated debt.
 - ✓ **Political risk is rising in India: Parliamentary elections are scheduled for later in 2019; Prime Minister Modi's BJP party was defeated in three state elections in December and the national standing of the Congress Party is rising based upon its promise to provide a minimum income guarantee for India's poorest citizens; the concern is that India's fiscal situation will deteriorate – already fiscal deficits have exceeded targets over the past two years**
 - ✓ **Venezuela's political crisis is deepening and oil sanctions could negatively impact global oil prices**
- Severe and, of course, unexpected **natural disasters** occur, which negatively impact global growth.
 - **Risk not realized**
- **Global trade war** threatens global economic growth
 - **The possibility that the U.S. might impose tariffs on imports of autos and auto parts, which would impact Europe, Japan and Korea in particular, remains but is unlikely to occur; however, a period of uncertainty seems likely while negotiations are underway**