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Economic Research
Published by Raymond James & Associates

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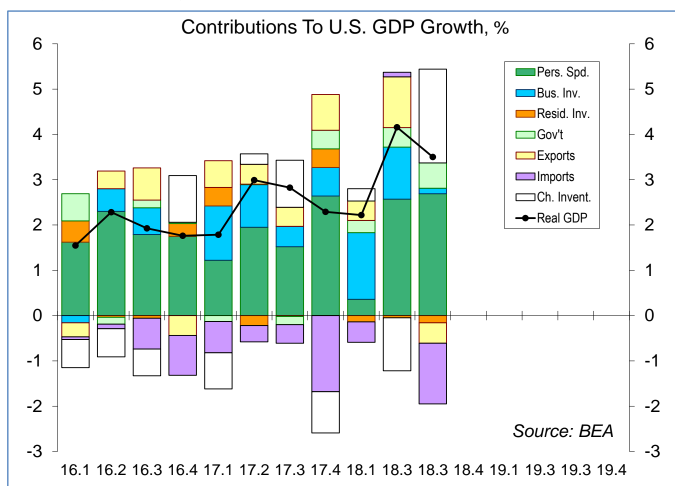
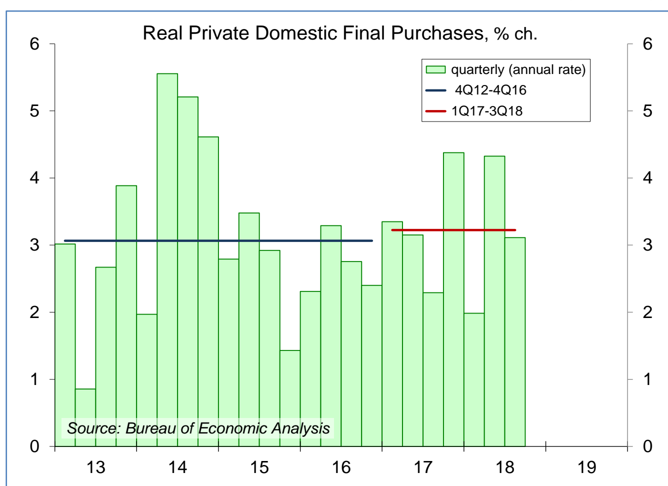
Economic Trends

Transitioning into 2019

- *Recent data have remained consistent with moderately strong economic growth into 4Q18. There is more fiscal stimulus in the pipeline for early 2019, but growth should slow to a more sustainable pace as the impact of stimulus fades and labor market constraints become more binding. Risks for the second half of 2019 may be tilted slightly to the downside.*
- *Trade tariffs and foreign retaliation are having a broader impact on U.S. businesses but a limited effect on overall economic growth and inflation. Unless an agreement is reached, U.S.-China trade tensions are set to become more disruptive in early 2019.*
- *The Federal Open Market Committee is expected to raise short-term interest rates in mid-December. The monetary policy outlook for 2019 is uncertain, but the pace of tightening is likely to slow.*

Real Gross Domestic Product (GDP) rose at a 3.5% annual rate in the advance estimate for 3Q18, up 3.0% y/y. A faster pace of inventory accumulation added 2.1 percentage points to the headline GDP growth figure, while net exports (a wider trade deficit) subtracted 1.8 percentage points. This was a reversal from what we saw in 2Q18 (where a narrower trade deficit added to GDP growth and slower inventory growth subtracted), but the large swings suggest that we could see significant revisions to the headline 3Q18 growth figure (2nd estimate due November 28). Focusing on underlying domestic demand, Private Domestic Final Purchases (consumer spending, business fixed investment, and residential fixed investment) rose at a 3.1% annual rate in 3Q18, up 3.4% y/y.





Trade policy may have had something to do with the inventory and trade balance swings between the second and third quarter. To some extent, both imports and inventory growth may have increased due to stockpiling ahead of tariffs. A 10% tariff on $200 billion in Chinese goods (industrial supplies and materials, capital equipment, and consumer goods) went into effect on September 24 (this will rise to 25% in 2019 and President Trump has threatened to impose tariffs on an additional $267 billion in Chinese goods, mostly consumer goods). As Fed Chairman Powell recently noted, there is a growing chorus of concern from businesses about tariffs. However, the impact of overall growth and inflation has been minor. Tariffs are a tax and are not counted directly in inflation. However, they are likely to provide an indirect boost to consumer price inflation as firms pass higher costs along.

Republicans retained control of the Senate in the midterm elections. Beginning in January, the Democrats will be in charge of the House of Representatives. That means hearings and investigations into the executive branch. However, House Democrats will be unable, by themselves, to significantly alter tax policy and regulations. Optimism that the two sides will be able to work together may be short-lived. There is a possibility of a showdown over the budget. A large-scale infrastructure spending package, financed by government borrowing, was never likely under Republican control in the House. The Democrats are seen as in favor of an infrastructure package but will likely reinstitute pay-as-you-go (PAYGO) rules. That means any additional spending (beyond what's already legislated) would have to come through spending cuts in other areas or by raising taxes – neither is likely.

In hindsight, there appears to have been more slack in the labor market than was generally believed at the start of the year. Growth in nonfarm payrolls has remained brisk, more than double the pace needed to absorb new entrants into the labor force. A tight job market should lead to a more efficient allocation of labor, reduce underemployment, and provide younger workers with the opportunity to develop work skills. However, the unemployment rate has continued to trend lower, which can go on forever.

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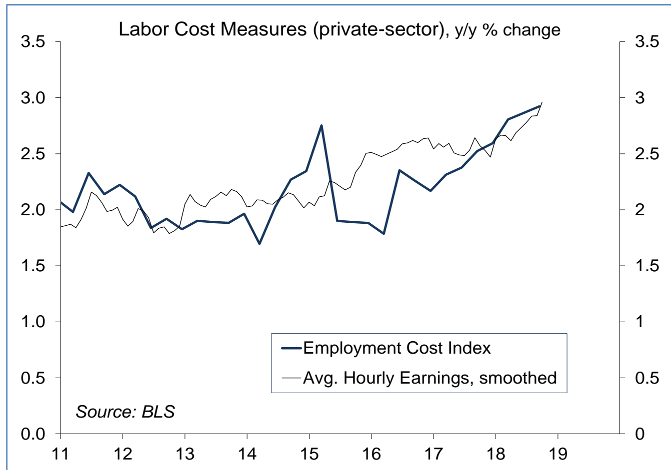
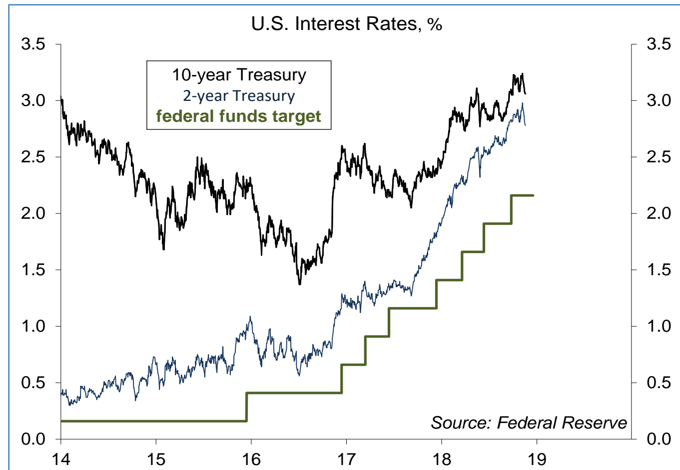
Tariffs add to inflation but are unlikely to be passed through fully to the consumer. Moreover, excluding food & energy, consumer goods account for a little less than 25% of the CPI. For Federal Reserve policymakers, the more immediate concern is the labor market, the widest channel for inflation pressure. In recent decades, wage bargaining power has shifted away from labor and toward businesses. Tight labor market conditions have led firms to be more creative in attracting workers (offering signing bonuses and other perks) but have still resulted in a gradual uptrend in the year-over-year increase in average hourly earnings. Annual cost of living increases ought to be higher this year, and we'll see further increases in state minimum wages. Firms tend to try to raise prices at the start of the year to see if they stick, but while some of that will be captured by the seasonal adjustment, these increases can be expected to be higher than normal in early 2019 – lifting inflation somewhat in the first half of the year. However, that's unlikely to lead to runaway inflation. Inflation expectations remain well anchored, which should pull the rate of inflation down in the second half of the year. Federal Reserve officials have signaled a tolerance for inflation being above the 2% goal "for a while."





The Federal Open Market Committee is expected to raise short-term interest rates again on December 19, bringing monetary policy closer to normal. Fed Chairman Powell has not shown much concern regarding the impact of tariffs or recent stock market volatility. However, he and other Fed officials are aware that monetary policy affects the economy with a long and variable lag. As the Fed nears a neutral position, the risks of moving too rapidly or too slowly intensify. Fed policy decisions will remain data-dependent in 2019 – specifically, that means what the incoming data imply for the economic outlook. The labor market is expected to be the key driver, but officials will also be monitoring financial conditions closely.

Net exports and the change in inventories are likely to remain volatile in the near term. Private Domestic Final Purchases should remain moderately strong but will likely slow as fiscal stimulus fades and job market constraints become more binding. The new year can be expected to bring political uncertainties at home and geopolitical uncertainties abroad.

	4Q17	1Q18	2Q18	3Q18	**4Q18**	**1Q19**	**2Q19**	**3Q19**	**4Q19**	**1Q20**	2017	**2018**	**2019**
GDP (↓ *contributions*)	2.3	2.2	4.2	3.5	***1.5***	***2.2***	***2.1***	***1.9***	***1.8***	***1.8***	2.2	***2.8***	***2.2***
consumer durables	0.9	-0.2	0.6	0.5	***0.4***	***0.2***	***0.3***	***0.2***	***0.2***	***0.2***	0.5	***0.4***	***0.3***
nondurables & services	1.8	0.5	2.0	2.2	***1.5***	***1.3***	***1.3***	***1.1***	***1.1***	***1.1***	1.2	***1.4***	***1.5***
bus. fixed investment	0.6	1.5	1.2	0.1	***0.4***	***0.4***	***0.4***	***0.4***	***0.4***	***0.4***	0.7	***0.9***	***0.4***
residential investment	0.4	-0.1	-0.1	-0.2	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	0.1	***0.0***	***0.0***
Priv Dom Final Purchases	4.4	2.0	4.3	3.1	***2.7***	***2.3***	***2.4***	***2.0***	***2.0***	***2.0***	3.0	***3.2***	***2.6***
government	0.4	0.3	0.4	0.6	***0.2***	***0.2***	***0.2***	***0.1***	***0.1***	***0.1***	0.0	***0.3***	***0.2***
exports	0.8	0.4	1.2	-0.5	***-0.2***	***-0.1***	***0.2***	***0.2***	***0.2***	***0.2***	0.4	***0.5***	***0.0***
imports	-1.7	-0.5	0.1	-1.3	***-0.6***	***0.3***	***-0.2***	***-0.3***	***-0.3***	***-0.3***	-0.7	***-0.7***	***-0.3***
Final Sales	3.2	1.9	5.4	1.4	***1.9***	***2.4***	***2.2***	***1.9***	***1.8***	***1.8***	2.2	***2.9***	***2.2***
ch. in bus. inventories	-0.9	0.3	-1.2	2.1	***-0.3***	***-0.2***	***-0.2***	***0.0***	***0.0***	***0.0***	0.0	***0.1***	***0.0***
Unemployment, %	4.1	4.1	3.9	3.8	***3.6***	***3.6***	***3.6***	***3.6***	***3.7***	***3.7***	4.4	***3.9***	***3.6***
NF Payrolls, monthly, th.	221	218	217	190	***185***	***145***	***135***	***130***	***125***	***120***	182	***203***	***134***
Cons. Price Index (q/q)	3.3	3.5	1.7	2.0	***2.4***	***2.4***	***2.5***	***2.4***	***2.3***	***2.2***	2.1	***2.5***	***2.3***
excl. food & energy	2.2	3.0	1.8	2.0	***1.9***	***2.4***	***2.4***	***2.3***	***2.2***	***2.1***	1.8	***2.1***	***2.2***
PCE Price Index (q/q)	2.7	2.5	2.0	1.6	***1.8***	***2.3***	***2.4***	***2.3***	***2.2***	***2.1***	1.8	***2.1***	***2.1***
excl. food & energy	2.1	2.2	2.1	1.6	***1.8***	***2.3***	***2.3***	***2.1***	***2.1***	***2.0***	1.6	***1.9***	***2.0***
Fed Funds Rate, %	1.20	1.45	1.74	1.92	***2.20***	***2.41***	***2.44***	***2.66***	***2.72***	***2.91***	1.00	***1.83***	***2.56***
3-month T-Bill, (bond-eq.)	1.2	1.6	1.9	2.1	***2.4***	***2.5***	***2.7***	***2.8***	***2.8***	***3.0***	1.0	***2.0***	***2.7***
2-year Treasury Note	1.7	2.2	2.5	2.7	***2.9***	***3.1***	***3.2***	***3.2***	***3.3***	***3.3***	1.4	***2.5***	***3.2***
10-year Treasury Note	2.4	2.8	2.9	2.9	***3.2***	***3.4***	***3.4***	***3.5***	***3.5***	***3.6***	2.3	***2.9***	***3.4***

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