Economic Outlook

The US economy is continuing to perform well overall, though there are some concerns that momentum may be peaking and there are growing concerns about global growth weakening, trade tensions and tightening financial conditions.

In the end, most of the evidence suggests that US activity will continue to advance, supported by solid fundamentals.

Our labor markets are near full employment and still tightening, while inflation is back near the Federal Reserve's target, but not exceeding. In short, the economic news continues to be quite favorable.

Economic forecasts have been emphasizing the US economy cannot continue indefinitely on its recent trajectory. The persistence of above-trend growth and ever-tightening labor markets would not only increase the chances of an overheating but might also suggest that the kinds of broader financial and economic excesses that have often spelled trouble in the past could yet develop.

We agree that a moderation in activity is necessary and likely to occur.

We feel that a combination of tighter financial conditions and a gradual weakening of fiscal stimulus, coupled with some slowing abroad and a mild drag from trade frictions, would guide the US economy onto a more moderate trajectory.

This would moderate growth in 2019 into 2020 to a pace more in line with its longer-term potential, helping prolong the expansion by limiting potentially destabilizing excesses.

That seems a reasonable outlook, although risks have been rising lately. One reason is that financial conditions have tightened more sharply than anticipated.

If this scenario continues or intensifies, it could raise meaningful downside risks to the outlook curtailing the amount of further Fed tightening likely to be needed to guide the economy onto a more sustainable path.

Additionally, global growth momentum has been weakening, with uncertainties about China, raising the risk that these drags could have a negative impact and trade uncertainties would remain largely unresolved.

Currently, these developments do not have enough impact to change the central forecast because they have already been anticipated, but they are raising downside risks.

On the domestic political front, the recent election resulting of a divided government is unlikely to alter the fiscal trajectory and will have no material shift in what is already in place.

We do see the increase to demand from fiscal stimulus gradually fading over the next year or two.

Regulatory and trade policies are unlikely to change much either, though the latter remains a wild card. The agreement between the US, Canada and Mexico removes the risk of what could have been a highly disruptive repeal of NAFTA, but risks of other trade restrictions remain.

The fact that the US and China have resumed negotiations, thus delaying another round of tariffs, is a positive step toward resolution.

Although the direct macroeconomic effect on the US of another round of tariffs and subsequent retaliation are apt to be modest, a temporary lift to inflation and drag on growth, cannot be dismissed and, over time, protectionism can weigh on the economy's potential growth by limiting the efficiency gains that trade can deliver.

Housing activity has been sluggish lately but should not cause undue alarms. The tighter financial conditions that will likely be needed to guide overall economic activity onto a more moderate, sustainable path are bound to have a lopsided impact on the interest-sensitive housing sector, which is also contending with the reduced subsidy featured in the new tax bill.

Whatever weakness we experience in housing, which hasn't been that noticeable so far, may not get much worse given the still-favorable fundamentals such as strong income gains and job markets and the recent dip in mortgage rates.

Trade is another area that may contribute to the moderation in cumulative activity. A stronger dollar resulting from tighter financial conditions, some cooling in global growth and increasing trade restrictions could all weigh on exports.

Business capital expenditures may be impacted by tighter financial conditions, worries about global trade and stretched finances in certain sectors.

Overall, financial conditions remain favorable, supported by high confidence, tax reform, strong profits and still-supportive financial conditions.

Similarly, households continue to benefit from sound finances, elevated confidence, and firm labor markets.

Although growth is expected to moderate over the next year or two, we don't see a recession in the cards. On the contrary, we expect this expansion to persist, becoming the longest ever by next summer and continuing even beyond that.

Even more encouraging is the private sector remains largely void of the kinds of large-scale excesses and imbalances that precipitated recessions in the past.

Humbled by the effects of the 2008 crisis, households and businesses, borrowers and lenders, savers and spenders and regulators have been much more cautious this time. The private sector learned from the past.

The economy also seems less vulnerable to the inflationary overheating that brought on recessions in past cycles, in part by provoking aggressive Fed tightening.

Labor markets are tight and wage pressures have been building, but only modestly.

Moreover, well-anchored inflation expectations, a decreased responsiveness of inflation to slack, a stronger dollar and some hints of at least modest improvement in the economy's supply potential should all work to prevent a material inflation overshoot enabling the Fed to tread carefully, avoiding the over-tightening that often-doomed past expansions.

We believe the US has a reasonable chance of pulling off a soft landing by moderating onto a more sustainable trajectory and curtailing potentially destabilizing excesses without jeopardizing the expansion.

Monetary Policy Outlook

It's also the key challenge facing Fed policymakers. They are trying to balance the risk of doing too little in combating potential overheating and broader economic and financial imbalances against that of doing too much and prematurely short-circuiting the expansion.

That task has been complicated by recent developments, especially the turbulence in financial markets and attendant tightening of financial conditions, increased uncertainties about the global outlook and unresolved trade tensions, which further cloud the outlook.

The case for the additional 25 basis point hike in the funds rate in December seemed compelling.

Labor markets were still tightening, domestic fundamentals were sound, inflation was near target and the funds rate was still slightly below FOMC members range of estimates of neutral. Failing to hike would risk stoking the kinds of excesses and imbalances that might necessitate a more abrupt and potentially destabilizing tightening later on.

Policymakers are apt to adopt a more cautious and explicitly data-dependent attitude about the policy path going forward.

Inflation is continuing display little sign of overshooting and the neutral rate of interest, though admitting of wide bands of uncertainty, is likely to remain lower than in past cycles, suggesting that policy may no longer be that accommodative, especially now that financial conditions have begun to tighten. That tightening has become sharper of late, raising downside risks to the outlook.

With this in mind, we expect Fed policymakers to accept that while additional rate hikes will likely still be appropriate, they are apt to be more gradual and modest than they have been and that there is no pre-determined path, thus emphasizing the Fed's flexibility to respond to incoming information and how it shapes the outlook.

Future rates are conditional on how the outlook evolves. We believe that it will evolve in a way that requires further modest increases in the funds rate, though the recent tightening of financial conditions, if sustained, might limit those increases to a maximum of two in 2019 instead of three.

But we still see greater risks that the Fed must tighten a bit further and longer to bring about the desired soft landing. Also, the Fed's balance sheet will likely continue to reduce as planned at least into early 2020, with a cumulative reduction of about $1 trillion.

Financial Market Outlook

Financial markets have become more volatile lately, reacting to slowing global growth concerns, trade war tensions, Fed moves, Brexit woes, political bantering and how difficult it could be for the US to sustain its current cyclical sweet spot. These are event driven, not fundamental breakdowns.

Granted, there's no shortage of things to worry about on the global front and there is concern that domestic markets might question the sustainability of the good news for the US economic cycle.

The longer growth stays above potential, the tighter labor markets become and the more the Fed hikes, the greater the risk that investors might turn persistently more cautious, increasingly aware that the most favorable phase of the economic cycle for financial assets may be behind us.

But the worries have gotten overdone. We still see overall fundamentals as solid, there is no recession on the horizon, no material inflation overshoot and a moderation to a more sustainable pace that enables the Fed to slow down, all of which are broadly supportive of risk assets.