4th Quarter 2018 Economic and Market Commentary

Economic Outlook

The US economy is cruising right along without any apparent stumbling blocks.

Growth is continuing to run above potential, labor markets are near full employment and continuing to tighten and inflation is back near the Federal Reserve's target, without overshooting its goal.

The near-term economic outlook remains bright with the economic expansion, already the second-longest on record, still displaying little sign of weakening, reinforced by sound domestic fundamentals, fiscal stimulus and still-accommodative financial conditions.

With these fundamentals securely in place, growth is expected to remain above potential into 2019. It, more than likely, will not be as strong as the current trend, but enough to continue tightening labor markets and help solidify inflation's move back to target.

A near-term material inflation overshoot remains unlikely, at this time, given the well-anchored inflation expectations and the decreased responsiveness of inflation to changes in slack.

There are several risks to this favorable outlook. The first is on the trade front, where the status and the ultimate outcome remain uncertain.

There's been potential resolution in the NAFTA negotiations, with a tentative deal reached with Mexico and Canada. The new accord will be named the US-Mexico-Canada Agreement, or USMCA.

Although the tentative accord imposes some restrictions that may impede efficiency relative to current arrangements, it is preferable to the disruptions that would accompany a dissolution of NAFTA.

Similarly, the US and the European Union seem to be moving toward an accommodation, however, on the China front, the US has announced another round of tariffs on $200 billion of goods at a 10% rate to start with then rising to 25% in 2019. China is planning some retaliation.

Even though the direct effects on the US are likely to be modest, we cannot dismiss the potential for a temporary rise in inflation and a slight drag on growth with additional risks of more adverse effects in the financial markets and/or business and household confidence.

Protectionism can further weigh on efficiency and potential growth over time.

The US also faces a future risk of a classic, late-cycle, overheating/Fed-tightening induced slowdown.

The longer growth remains above potential and the further labor markets tighten beyond full employment, the greater the risk that inflation will eventually move materially above the Fed's target.

Economist do not see this as an imminent or unavoidable threat. The economy still seems largely devoid of these kinds of imbalances and soft landings have happened before.

At some point the economy will have to slow back to potential, and possibly below for a while. This is likely to happen by 2020 or at latest 2021, at which time the cumulative effects of tightening financial conditions and a weakening of fiscal stimulus will start to impact the economy.

In the near term, the outlook looks reasonably clear. Households continue to benefit from sound finances, elevated confidence and firm labor markets.

For businesses, conditions remain broadly favorable, supported by high confidence, tax reform, strong profits and still-supportive financial conditions. In some areas increased leverage has begun to stretch finances a bit and an uncertain international trade environment could hamper exports and discourage investment.

The fiscal stimulus is adding to demand and should continue to do so at least into next year. The increase would be larger but effective tax rates have not come down all that much and the economy is near full employment.

We are entering a period where fiscal multipliers tend to be smaller because there are few pent-up demands to be vented and less room to accommodate them without pressuring capacity constraints and pushing up interest rates.

At this point in the cycle, the economy doesn't need demand-side stimulus. In fact, it could be counterproductive, boosting near-term growth but increasing the medium-term risk of overheating and the kinds of excesses that make slowdowns more likely.

To counter this risk, the economy needs help on the supply side with policies to boost potential growth and thereby afford the expansion extra running room.

There are elements in the new tax plan that might help on this front, as may recent regulatory changes, but these kinds of supply-side benefits are of uncertain magnitude and timing.

Even under optimistic assumptions about continuing growth effects from the tax package, the fiscal changes are almost sure to worsen the government's long-term fiscal challenges, likely necessitating more federal borrowing that could eventually crowd out private, productive investment.

Also, trade restrictions can damage efficiency and erode the gains that trade brings via specialization and comparative advantage.

No one is expecting a supply-side miracle. Although potential growth may be improving somewhat, as productivity rebounds from unusual weakness, these additions are apt to be incremental and partly offset by trade and immigration restrictions.

Short of a substantial improvement in the economy's potential, it will be hard to sustain recent rates of growth now that spare capacity has largely been absorbed.

Labor markets seem close to full employment already and still gradually tightening.

Wages continue to accelerate only modestly. If labor markets tighten further, as expected, wage pressures will likely continue to build incrementally.

All these events should help strengthen the move of inflation back to the Fed's target.

It is close already, as some temporary restraints have faded, as the effects of diminished slack and gradually accelerating labor costs are making themselves felt and as inflation expectations have remained generally well anchored.

There is little sign that inflation is about to take off; in fact, the most recent reading was a bit softer.

We believe that concerns about an imminent inflation surge are overblown given the tame inflation expectations, the strengthening of the dollar and the generally reduced responsiveness of inflation to diminished slack.

Monetary Policy Outlook

Fed policymakers are continuing to be on track to reduce and eventually remove what they see as a still-accommodative policy stance. It is, however, becoming less accommodative and will likely be acknowledged as such as the funds rate approaches neutral.

With the Fed's dual-mandate objectives in sight, the outlook suggesting growth will remain above potential for a while and overall financial conditions are not expected to tighten much.

Policymakers are increasingly confident that this is the proper course because keeping policy accommodative too long would risk encouraging the kinds of excesses that might necessitate a more abrupt and potentially destabilizing tightening.

A flattening yield curve, by itself, will not likely reassure the Fed. The curve is nowhere near an inverted position that preceded past downturns, especially when adjusting for expectations of where the economy is headed over the next year or two.

If short-term forward spreads were to invert and there was a real fear that these conditions could cause a recession from overheating or economic and financial excesses, then Fed lenience might worsen the excesses and increase the risk of recession down the road.

Similarly, approaching the neutral rate, by itself, will not likely halt the process. There is considerable uncertainty about exactly where neutral is and if the economy continues to perform well as rates rise, estimates of the neutral rate are likely to rise.

Overall financial conditions, more than just the level of short-term rates, matter for the economic outlook and these conditions have not tightened much.

If risks of overheating and/or financial/economic excesses were to build, we believe the Fed would take the funds rate into preventive territory and policymakers would tread carefully.

Though the neutral rate will not overly constrain them, they won't ignore it entirely, aware that achieving a given policy stance can likely be accomplished at lower levels of short-term rates than in previous cycles.

Even though inflation is back near target, it does not seem in danger of overshooting and given that it has run too low for years, it is important that it return to 2% and stay there for a while to ensure that 2% is viewed not as a ceiling but as the symmetric target it truly is.

How policymakers balance these competing arguments will depend on how the outlook evolves. Our base-case scenario will likely keep policymakers inclined to gradually remove policy accommodation.

We are likely to have further rate hikes, in addition to the 25 basis points rise we had at the September FOMC meeting, followed by a series of gradual moves taking the funds rate back to 3% to 3.25% by the second half of 2019.

This coupled with a cumulative balance sheet reduction approaching $1 trillion should move policy back to a neutral, if not slightly restrictive, stance.

Financial Market Outlook

Our financial markets are continuing to be supported by the strong underlying economic backdrop, but worried about trade tensions.

Although these tensions could persist for a while, in the near term, the overall macro backdrop should remain broadly supportive of risk assets with a slight weight on US Treasury prices.

In the long run, markets may begin to worry about the sustainability of the current sweet spot of the economic cycle in the US.

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