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VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

by Thomas Goho, Ph.D.

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It seems we are living in a world of dizzying cacophony: daily Trump tweets, divisive political rhetoric, shifting statements from the Federal Reserve, "fake" news, an aggressive media. This dissonance can eclipse real economic signals.

In his excellent book, *The Signal and the Noise*, Nate Silver describes the difficulty in discerning authentic conditions because reality can be obscured by noise in economic and political data.

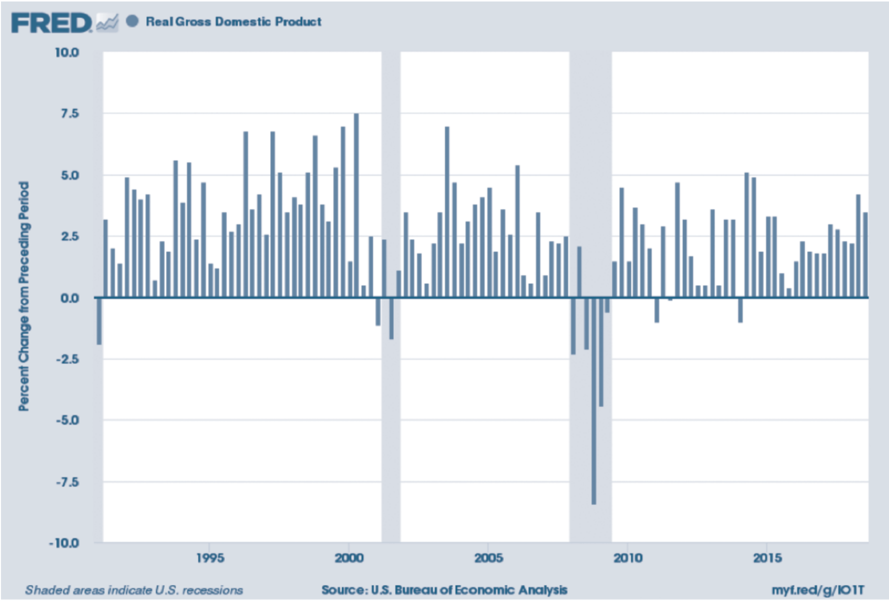
This issue of *Viewpoint* will mute the outside noise, focus on current economic conditions and provide a forecast of key economic indicators for 2019.

Economic Growth

Economic analysis after the financial crisis suggested that America's future growth was destined to be about 2% per year. This 2% figure is consistent with the two key elements of growth: labor productivity and size of the labor force. In fact, the post-crisis growth from 2009 to 2016 was 2.1%.

Notwithstanding the media chatter surrounding the 2017 Tax Cut and Jobs Act, the Act appears to have jumpstarted America's meager economic growth. For the past six quarters of the Trump administration growth has averaged 3.0%, and growth in 2018 thus far is 3.3%. (*See Figure 1.*)

Figure 1:
Quarterly Changes in Real Gross Domestic Product from 1991 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Economics Database (FRED). Extracted from the database on December 18, 2018.

There are a number of reasonable and non-partisan observations about U.S. economic growth over the past several decades:

- Growth in the Clinton presidency was consistently strong, averaging 3.9%
- After the recession at the very start of the George W. Bush terms, growth was reasonably strong but collapsed at the start of the financial crisis. On average growth was a mediocre 2.1%
- After the economic disaster of the financial crisis, the Obama economy grew in an erratic fashion with both very strong quarters of growth and very weak or negative quarters. On average growth was a lackluster 2%. When you include the fiscal-crisis years, growth was 1.5%
- The early quarters of the Trump administration are encouraging. Growth appears to be consistent at 3%

Neither Democratic nor Republican administrations have found the key to strong and consistent economic growth over the past 28 years encompassing four presidential administrations.

Best Guess on Economic Growth

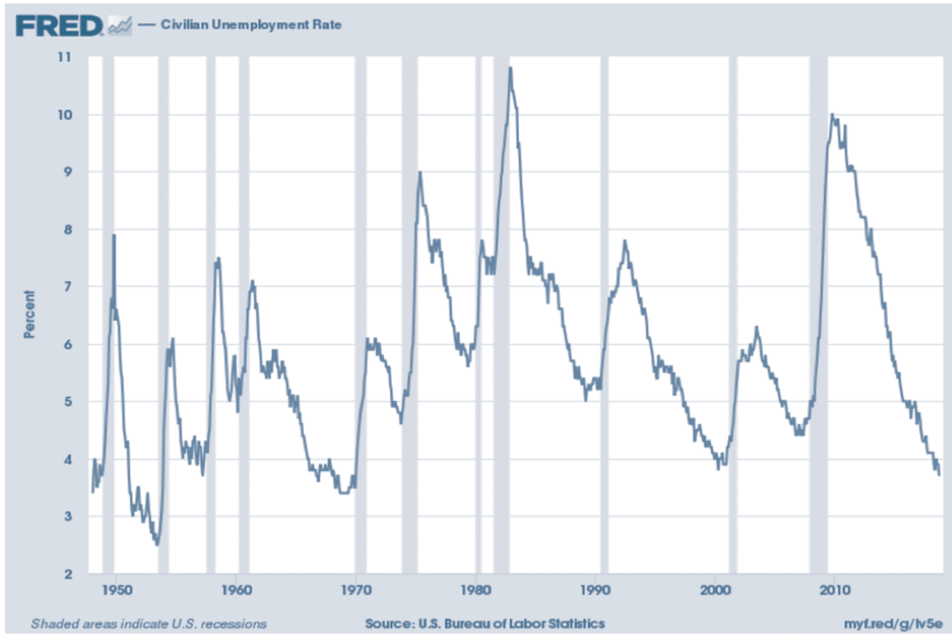
The economy is poised to continue real GDP growth of about 2.5% over the next several quarters. But note that the **risks to growth are clearly to the downside.** Those risks include:

- Tariffs and trade wars
- Higher short-term interest rates
- Subdued business investment despite passage of the 2017 corporate tax cuts
- Slow growth in the labor force and labor productivity

Labor Markets

Almost all headline labor market indicators continue to show impressive performance consistent with America's accelerating economic growth in the late-stage of this ten-year old expansion. The Department of Labor reported 321,000 new jobs in December. The unemployment rate at 3.9% is near a multi-decade low. (*See Figure 2.*)

Figure 2:
U.S. Civilian Unemployment Rate (1948 to Present).



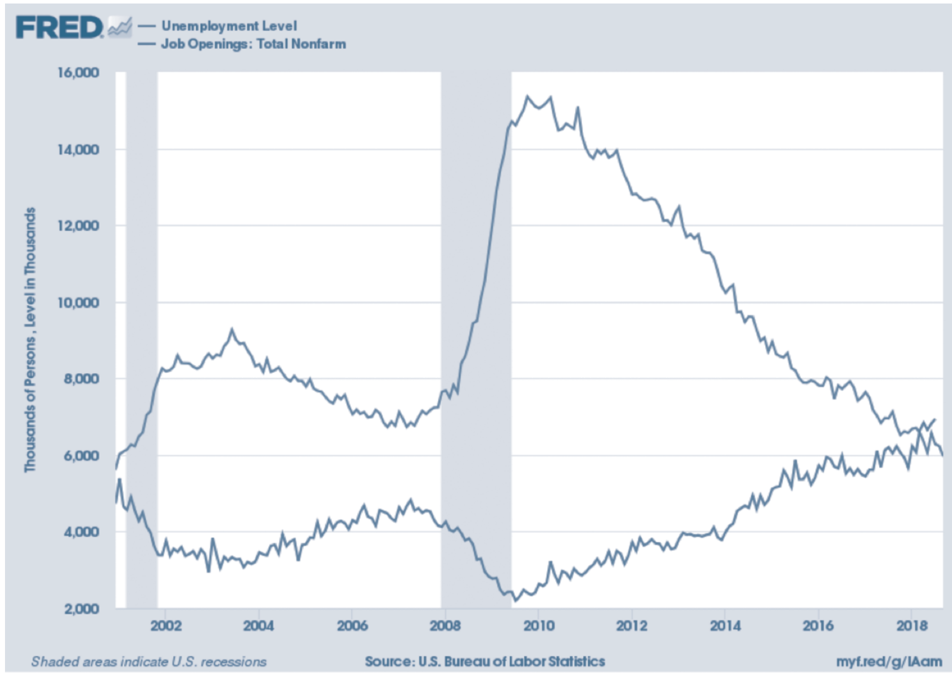
Source: Federal Reserve Bank of St. Louis. Federal Economics Database (FRED). Extracted from the database on December 18, 2018.

A very encouraging component of the job market is the low unemployment rate among groups that are prone to high rates of joblessness: (1) African-Americans and (2) individuals with less than high school diplomas. The unemployment rate for African-Americans is 6.1% – the lowest on a record going back to 1972. Still, it remains high compared to other groups: Asian-Americans (3.0%), Whites (3.3%), and Hispanics (4.3%).

For individuals with less than a high-school diploma, the unemployment rate of 6% is high compared to the overall national average of 3.9%. But for these individuals, the rate has significantly improved compared to October 2010 when it peaked at 15.6%, but it still lags considerably compared to individuals with at least a college degree (2.0%).

Overall employment strength can be attributed in part to the unprecedented number of job openings. (*See Figure 3.*) For the first time in almost 18 years there are more job openings (6.5 million) than the number of officially-unemployed workers (6.2 million).

Figure 3:
Number of Job Openings Versus the Number of Unemployed Workers (2000 to August 2018).



Source: Federal Reserve Bank of St. Louis. Federal Economics Database (FRED). Extracted from the database on December 18, 2018.

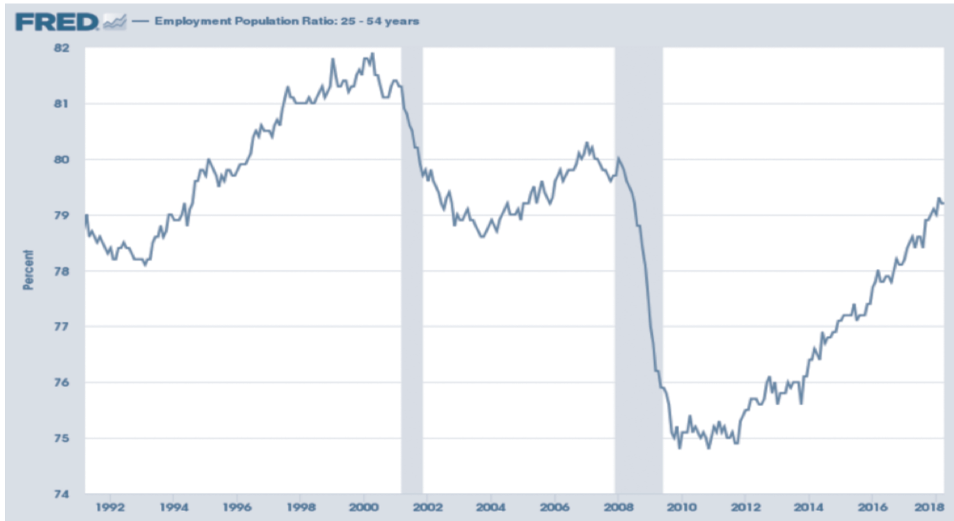
With such a favorable ratio of job openings to job seekers, it is reasonable to expect that the employment picture will be positive for most, if not all, of 2019.

Best Guess About Labor Markets

The unemployment rate will likely remain under 4% in 2019. The unemployment rate is unlikely to drop below 3.5% anytime during 2019. Even in healthy labor there will be some modest unemployment reflecting the normal rates of hiring and firing.

Notwithstanding all of the positive headline news about employment, some disturbing labor market conditions remain. The employment-to-population ratio for prime-age workers (age 25-54) has not yet returned to the healthy level seen at the end of the Clinton presidency. In 2000 almost 82% of prime-age workers were employed. Today that figure is about 79.5% even with the significant improvement we've seen since the end of the fiscal crisis.

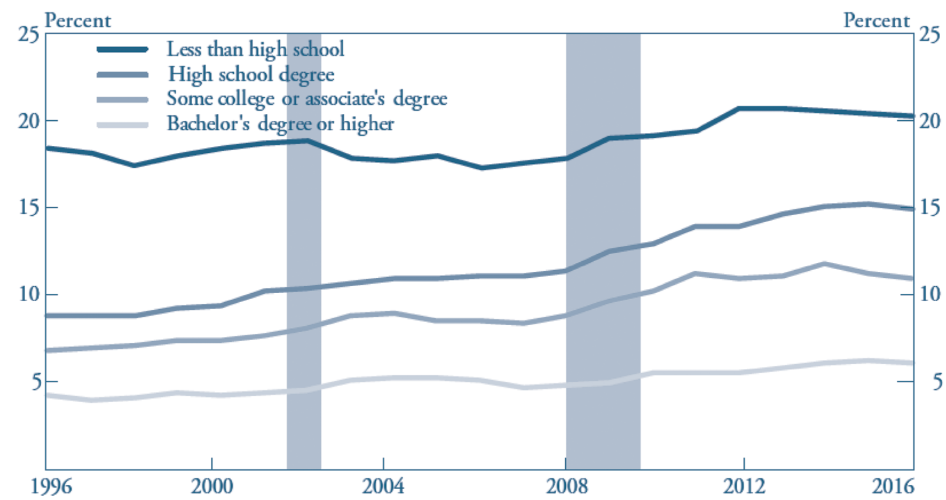
Figure 4:
The Employment-to-Population Ratio for Workers Age 25 to 54 from 1992 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Economics Database (FRED). Extracted from the database on December 18, 2018.

The problem is substantially evident in prime-age male workers broken down by their level of educational attainment. (*See Figure 5.*) The **non-participation rate** (workers not in the workforce) has worsened for all groups whether they have less than a high school diploma or have attained as much as post-baccalaureate degree. The drop in the overall ratio between 1996 and 2016 represents about 2.5 million workers who are neither working nor seeking employment

Figure 5:
The Non-Participation Rate of Prime-Age Men (age 25-54) from 1996 to 2016 by Educational Attainment.



Source: The Federal Reserve Bank of Kansas City. "Why are Prime-Age Men Disappearing from the Labor Force?" (by Didem Tuzemen) *Economics Review*. First Quarter 2018.

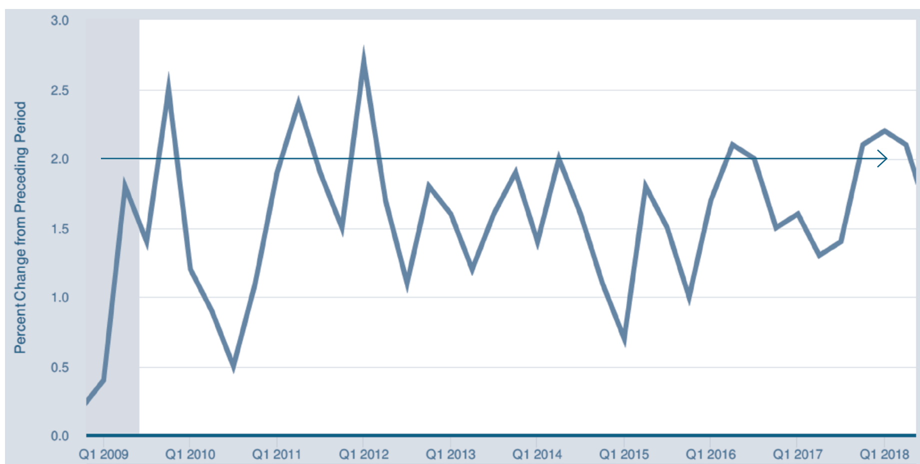
Some labor market economists have suggested that the rise in non-participation is due to automation and globalization, which has decreased the demand for workers with minimal technology skills. Other researchers argue that increased hard-drug use has limited the ability of prime-age workers to pass mandatory drug tests. Either way the loss of workers is a drag on American economic growth, which has persisted since the Clinton presidency.

Prices: Growth with Little Inflation

Strong real economic growth in tandem with robust labor markets is normally a precursor to emergent inflation. Yet this aging recovery is largely free of inflationary pressures. Inflation since the financial crisis has remained below 2% as measured by most price indices.

The most important price index according to the Federal Reserve Bank's policy-makers is the Personal Consumption Expenditures Price Index (PCE), excluding food and energy. (*See Figure 6.*) Until recently this core PCE has remained well below the all-important threshold of 2%. With a rate in excess of 2% monetary decision-makers feel compelled to raise interest rates in order to stifle incipient inflationary pressures.

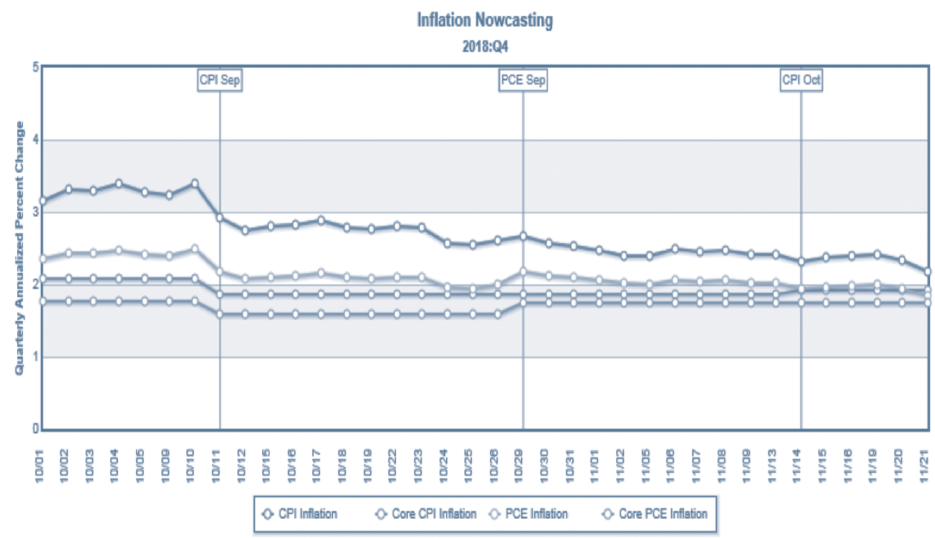
Figure 6:
Personal Consumption Expenditure Price Index, Excluding Food and Energy (2009 to Present).



Source: Federal Reserve Bank of St. Louis. Federal Economics Database (FRED). Extracted from the database on December 19, 2018.

Although the Federal Open Market Committee of the Federal Reserve continues to raise short-term interest rates to minimize the risks of rising inflation, there is scant evidence of significant inflationary pressure in the economy. The inflation forecasting model of the Federal Reserve Bank of Cleveland indicates that the core PCE measure of inflation will remain under 2% at the end of 2018. (*See Figure 7.*) That measurement is shown as the bottom line in Figure 7.

Figure 7:
Federal Reserve Bank of Cleveland's Forecast of Inflation for the Fourth Quarter of 2018.



Source: Federal Reserve Bank of Cleveland. "Inflation Nowcasting." November 2018.

Not only is the core PCE inflation index below the 2% threshold, but the Cleveland Federal Reserve expects that the headline measure of inflation, the Consumer Price Index (CPI) including food and energy, is now moderating in the fourth quarter of 2018 as shown by the top line in Figure 7. This moderation in the headline number is due primarily to softness in energy prices at the retail level.

Best Guess About Inflation and Monetary Policy

Despite a strong economy and a low unemployment rate, inflation is not likely to increase at an alarming rate in 2019. The rate will likely remain about 2% over the next six months. Yet the Federal Reserve decision makers have increased the target interest rates four times in 2018 such that it currently stands at 2.5%. Additionally there are statements indicating that the Fed intends to increase short-term interest rates twice in 2019 and once in 2020.

I am going to head out on a limb and predict the Federal Reserve will begin to see some signs of weakness in the economy in 2019. There will not be alarming weakness because the economy will continue to grow but at a moderating pace. Even now there are signs of some economic slowdown including:

- Lower auto/light truck sales compared to the earlier brisk pace
- A slowdown in housing sales and mortgage applications
- A slight drop in consumer confidence in the past two months
- A fall in durable goods orders
- Negative growth for some key economies, especially in developed countries like Germany and Japan, which suggests slowing overall global growth
- Economic turmoil in the United Kingdom created by uncertainty surrounding the U.K.'s exit from the European Union

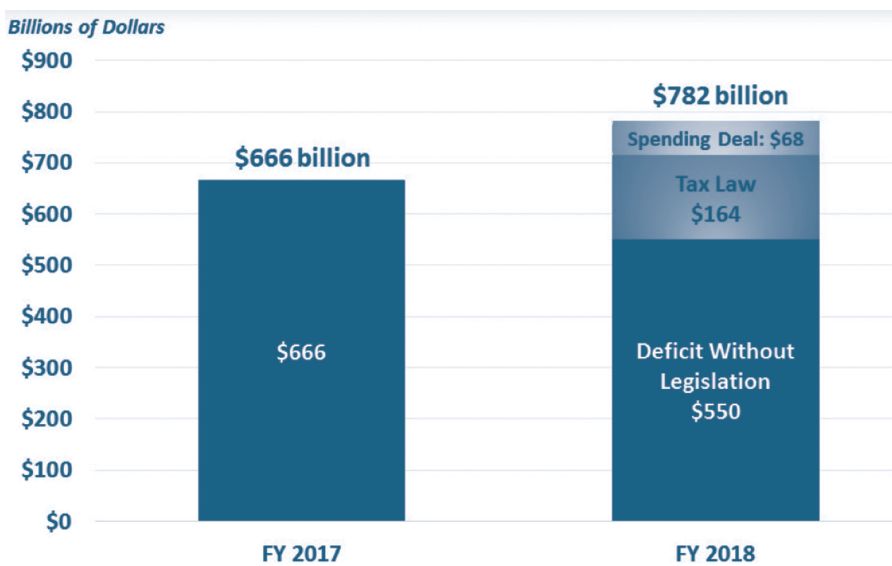
All these "known" signs are occurring against a backdrop of the truly unknowable results of President Trump's trade and tariff battles with China and other trading partners. In addition, no one knows if Congress will ratify the new trade agreement involving United States, Canada and Mexico. As a result of these "unknowables," I expect that the Fed will become very cautious in 2019 and start slowing the rate at which it raises short-term interest rates. I expect no more than one rate increase in 2019.

Government Fiscal Policy

The United States has a fiscal problem occurring in tandem with the Fed's tightening of monetary policy. Government deficits in the short- and long run will continue to provide a stimulus to growth in real GDP. In the third quarter of 2018, government spending at all levels of government added over a half of one percent to economic growth. This stimulus is good in the short run but a fiscal morass over the long run.

Congress in 2017 cut taxes and increased spending. The impact of the 2017 Tax Act combined with additional spending legislated that year caused the Federal deficit to balloon from a projected $550 billion for 2018 to an actual $793 billion. The bulk of the deficit increase was due to the tax cuts. (*See Figure 8.*)

Figure 8:
Contributions of Major Legislation to the Fiscal Year 2018 Deficit.



Source: Committee for a Responsible Federal Budget. "CBO Shows a $782 Billion Deficit for FY 2018." October 9, 2018.

The deficit stimulus is likely to continue for the next decade as the size of the Federal budget deficit grows larger as a percentage of real GDP. The actual budget deficit for 2017 was 3.5% of real GDP and 4.0% in 2018. (*See Figure 9.*)

Most economists think that a prudent government with a GDP growth of about 3% should not generate a deficit larger than 3.0% if the country wishes to keep total federal debt within a manageable range. Intuitively it makes sense that debt load should not grow any faster than a country's economic growth.

Figure 9:
The Congressional Budget Office (CBO) Federal Budget Projections, 2018 to 2028.

CBO's Baseline Budget Projections

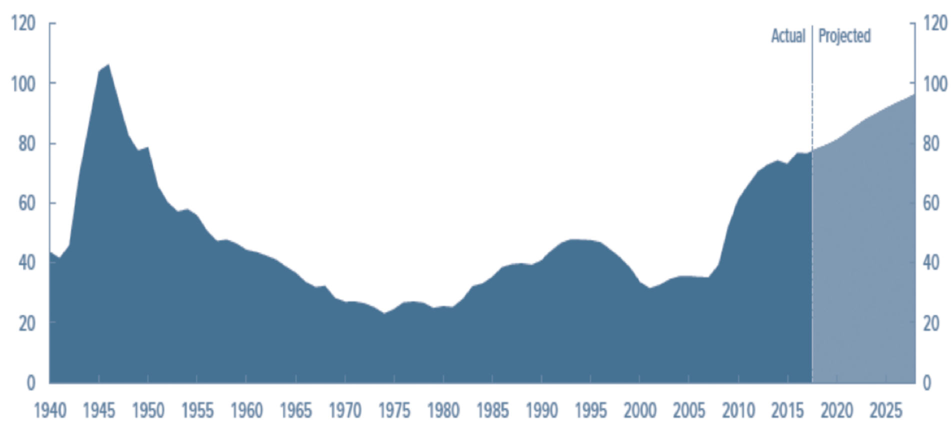
	Actual, 2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	Total 2019–2023	Total 2019–2028
In Billions of Dollars														
Revenues	3,316	3,338	3,490	3,678	3,827	4,012	4,228	4,444	4,663	5,002	5,299	5,520	19,234	44,162
Outlays	3,982	4,142	4,470	4,685	4,949	5,288	5,500	5,688	6,015	6,322	6,615	7,046	24,893	56,580
Deficit	-665	-804	-981	-1,008	-1,123	-1,276	-1,273	-1,244	-1,352	-1,320	-1,316	-1,526	-5,660	-12,418
Debt Held by the Public at the End of the Year	14,665	15,688	16,762	17,827	18,998	20,319	21,638	22,932	24,338	25,715	27,087	28,671	n.a.	n.a.
As a Percentage of Gross Domestic Product														
Revenues	17.3	16.6	16.5	16.7	16.7	16.9	17.2	17.4	17.5	18.1	18.5	18.5	16.8	17.5
Outlays	20.8	20.6	21.2	21.3	21.6	22.3	22.3	22.2	22.6	22.9	23.1	23.6	21.8	22.4
Deficit	-3.5	-4.0	-4.6	-4.6	-4.9	-5.4	-5.2	-4.9	-5.1	-4.8	-4.6	-5.1	-4.9	-4.9

Source: Congressional Budget Office. The Budget and Economic Outlook, 2018-28.

The United States is likely to experience new and disturbing Federal debt conditions. As seen in Figure 10, the country's debt will grow at a rate significantly in excess of its underlying economic growth. From 2018 to 2028, the annual Federal budget deficit is likely to approach or exceed 5% of real GDP. The Congressional Budget Office and other forecasters think that real GDP will probably grow at about 2% to 2.5% per year over the coming decade. The cumulative increase in the Federal debt will be over $12 trillion while the economy will grow by approximately $5 trillion.

The mismatch between high debt growth and low economic growth is not sustainable over the long run if America wishes to address its domestic needs. The debt-to-real GDP ratio will approach dangerous levels, reaching almost 100% in 2028. (*See Figure 10.*)

Figure 10:
Federal Debt Held by the Public as a Percentage of U.S. Gross Domestic Product, 1940 to 2028.



Source: Congressional Budget Office. The Budget and Economic Outlook, 2018-28.

Many economists including fiscal researchers Kenneth Rogoff and Carmen Reinhart have found that a governmental debt-to-real GDP ratio greater than 90% creates drag that slows economic growth significantly. Given the U.S. has recently struggled with sluggish long-term growth, increased federal debt could be very bad news for American fiscal probity.

Best Guess About Fiscal Policy

The Congressional Budget Office's projections, in my opinion, are spot-on. The U.S. is headed toward a fiscal problem of its own making. The Federal debt is and will be a major problem for the country. It will be especially difficult fiscally if interest rates were to spike upward over the coming decade. Interest payments on the debt could begin to erode the ability of the country to fund discretionary spending projects such as education, health care, infrastructure and similar pressing needs.

Having said that, American federal debt is somewhat exceptional compared to other countries. Global liquidity is always seeking a safe haven, and American governmental debt offers the largest, most liquid and legally safe place to park money. Demand for American governmental debt should continue dependably for a very long time. The U.S. is not facing a Greek-style financial crisis for at least the next decade, if not longer.

Given America's debt exceptionalism, neither Democrats nor Republicans will take any meaningful steps to solve the U.S. fiscal problem. Both parties know that when "crunch-time" comes for our Federal debt burden, global money managers will flee to U.S. debt, not the bonds of Saudi Arabia, Russia, China, the United Kingdom, Italy or several hundred other countries. In other words, America will be able to fund its fiscal irresponsibility at the cost of neglecting its pressing domestic needs.

Final Thoughts

In general, the Main Street economy is doing well with growth slightly in excess of 2.5%. Evidence of this solid American economy includes:

- Solid fourth quarter retail sales
- Expanding manufacturing output
- High consumer confidence especially among low-income households
- Strong employment in most segments of labor markets
- Strong (but decelerating) corporate profitability
- Relatively tame inflation which will forestall harsh Fed actions on interest rates

Notwithstanding the strong economic signals from Main Street, some signs point to a slowing global economy that will quickly impact the United States. Some of these signals include:

- Slowing growth in Europe with negative growth in Germany, Europe's largest economy
- Negative growth in Japan, Asia's second-largest economy
- Slowing growth in China tied in part to Trump's trade and tariff policies directed at Chinese imports

- Slowing growth in emerging markets
- The uncertain direction of U.S. trade and tariff policies toward a number of countries, especially China

This uncertain course of U.S. trade policy is creating economic and political jitters throughout the world. Some of the unknowns going into 2019:

- Will the Trump administration work out a viable trade relationship with China?
- Will Congress, now with a Democrat-controlled House of Representatives, be willing to pass the new NAFTA-type trade deal with Canada and Mexico?
- Will Trump impose significant tariffs on auto imports?

These are important political and economic issues with unpredictable outcomes at the present time. The current political rhetoric suggests that U.S. trade policy could be in disarray in 2019.

A Final Guess

The economic and political risks to the U.S. economy are clearly to the downside. The media headlines are likely to start a drumbeat of a deceleration in U.S. economic growth. In fact on January 2,. 2019, Bloomberg Opinion started the new year with a headline reading "Markets keep flashing recession warning."

This warning is premature. I suspect that Q4 2018 growth will be closer to 2.5% than Q3's 3.5%. This drop in real GDP growth will continue to fuel the media hunger for slow-growth or recession stories in 2019. A recession in 2020 will possibly become a concern but not in 2019.

The Federal Reserve will definitely begin to take a fresh look at its plans to raise interest rates in 2019. I expect by the end of 2019 there will be no more than one interest rate increase. Notwithstanding the mounting concerns about slowing growth in 2019, there will not be a recession in calendar year 2019. That's what the economy is signaling for 2019.

If you thought last year was full of noise and fury, 2019 is likely to be even more cacophonous, creating difficulty in discerning the reality from blather. If you don't own any noise-cancelling headphones, you might want to consider purchasing a pair this year.

Thomas Goho, Ph.D. is formerly the Chief Economic Consultant for Stephens Inc. He also served as the Co-Director of Stephens University at Wake Forest University. Tom enjoys a successful career in both education and business. He served as a professor of finance, Wayne Calloway School of Business and Accountancy, Wake Forest University for 30 years. Before retiring in 2007, Tom was the first to hold the Thomas S. Goho Chair of Finance. Tom also served on the Board of Directors of the Wells Fargo Family of Mutual Funds for 20 years, and also was on the Board of Directors of Lifepath Funds of Barclay's Bank. A former Certified Financial Planner, Tom earned his BS and MBA from Pennsylvania State University and his Ph.D. from the University of North Carolina-Chapel Hill.

Stephens

111 Center Street
Little Rock, AR 72201
501-377-2000
800-643-9691
stephens.com

linkedin.com/company/stephens-inc-
@Stephens_Inc
facebook.com/about.stephens

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