January 2019
Vining Sparks' 2019 Forecast—Tailwinds Turn to Headwinds as Expansion Faces Pains of Aging

Last year saw the economy expand on a year-over-year basis for a record ninth consecutive quarter. This was the outworking of corporate tax cuts which yielded the best business confidence in 35 years, an ever-improving labor market and the lowest unemployment rate in 49 years, record-high stock prices and low gasoline prices, the strongest consumer confidence in 18 years, and an unexpected boost from federal expenditures. However, in the second half of the year, uncertainty and trade disruptions from ongoing trade negotiations began to weigh on business confidence and manufacturing sentiment. Moreover, global growth and economic sentiment began to turn lower, representing one of the many challenges heading into the new year. All told, the economy likely expanded 3.0% in 2018, 0.3% above expectations.

Heading into 2019, economic growth is likely to face more challenges as the second-longest economic expansion on record begins to face the pains of aging. The catalysts that pushed optimism to cycle-high levels are unlikely to be replicated. On a positive note, the consumer continues to be in a strong position, benefiting from improved wage growth, a strong labor market, tame inflation, and a healthy balance sheet (record-high net worth and manageable debt levels). However, the biggest impact from individual and corporate tax reform has likely already been realized; although, the ongoing benefits of a lower, more competitive tax code should continue to boost overall economic dynamism. The federal government is now even more limited in its fiscal stimulus efforts given the burgeoning debt. Additionally, the Federal Reserve has been focused on tamping down the late-cycle risk of faster-than-desired inflation. Interest rates have risen and are now proving to be a moderate headwind to activity and financial conditions. Market volatility has increased dramatically, evidenced by the S&P 500 yielding its worst December performance since the Great Depression. In addition to higher interest rates, the markets are wrestling with the continued reduction of the Fed's balance sheet. The convergence of global growth appears to have ended. With this backdrop, economic growth is likely to slow in 2019 although an outright recession does not appear imminent. Time will tell how well policymakers manage this phase of the economic cycle; but, the risks of a policy mistake have certainly increased.

Business Investment

Business investment accelerated in the first half of 2018 but proved weaker-than-expected in the second half of the year. The 2017 tax cuts were expected to lift investment, particularly investment in structures, for several years. However, the uncertainty about trade policy has apparently offset the impact of lower tax rates and accelerated expensing, slowing business investment to a very moderate growth rate in the second half of the year. A trade agreement with China by the March 1 deadline would likely lift the fog and result in an improved rate of growth for investment. Our basecase view is that a deal will be struck similar to the USMCTA (replacement policy for NAFTA), with limited changes to existing trade policy. However, we also cite this as the largest risk to our forecast for 2019.

Personal Consumption

Consumers are poised to be a steady engine of growth for the economy, although the risks to a disruption increased in 2018 as the Fed tightened monetary policy and pushed the markets to the brink. The ever-lower unemployment rate, an average of 220k nonfarm payrolls created each month (55k more than economists expected), acceleration in wage growth, and record-high stock prices boosted consumer confidence once again in 2018. While the labor market is unlikely to see another year with such strong results, the foundation is set for the consumer to, again, be a stable source of growth. Additionally, gains in consumption have not been driven by an accelerated leveraging cycle as seen in the early 2000s. Overall debt levels remain well contained. One exception, younger generations are facing elevated debt from burgeoning student loans which will continue to be a challenge for that demographic. The biggest risk to the consumer appears to be more financial market volatility if the Fed were to continue its tightening cycle. Our basecase expectation is that the pace of rate hikes will slow to one, possibly two, in 2019. If not, the markets could disrupt the euphoria for consumers.

Government Spending

Government spending was finally a positive boost to growth in 2018. As expected, a large infrastructure deal was not passed but a small deal lifting the self-imposed, annual spending limits was. The deal lifted spending caps for 2018 and 2019, meaning the benefits should carry over into this year. However, they will then revert to the originally prescribed limits causing a small fiscal cliff in 2020. While the drag should not be as significant as the one created by the conclusion of the A.R.R.A., it will come at a time when the economy is likely back to a modest growth rate. Additionally, because of the increase in government spending, the budget deficit has accelerated to 4.3% of GDP by the end of 2018. Going forward, it will be increasingly difficult for fiscal policymakers to add stimulus to the economy through expenditures. Moreover, the potential increase in interest expense from the outstanding debt

($21 trillion) will be a compelling incentive to keep interest rates low - insomuch as fiscal or monetary policymakers can affect such an outcome.

Housing

The housing market continues to flounder under the pressure of declining affordability. Rising home prices and higher mortgage rates took a toll on sales and new construction in 2018. Through November's data; new home starts fell 4% YoY, new home sales dropped 12% YoY, the sale of existing home declined 7% YoY, and homebuilder confidence dropped 18% YoY. The only positive signs in the housing sector were the continued gain in home prices, up 5% YoY, and 4% growth in construction payrolls. However, the pace of home price gains slowed in the second half of the year and is poised to continue slowing heading into 2019. The year-end reprieve in interest rates saw 30-year mortgage rates fall from a peak of 4.94% (November) to 4.55% (year-end). This should provide a bit of positive momentum to start the year, but rates remain above the average mortgage rate homeowners currently hold, 3.79%. For 2019, the outlook is modest, particularly if yields move higher from year-end levels. While income growth has finally gained a little steam, it remains insufficient to counter the faster-growing price of purchasing a home. Residential investment has now dragged from GDP growth in seven of the last ten quarters. Our forecast for 2019 remains the same as our outlook coming into 2018, flat. While a major slowdown for the sector is not expected, an acceleration is likely to be a story for future years rather than 2019.

Forecast Implications

GDP Growth

Given the backdrop of a strong consumer, the potential for improving business investment (depending on the trade negotiations), weak global growth, a flat housing market, a slight boost from government spending, and the headwind of tighter financial conditions; we expect economic growth to slow to 2.4% in 2019. In contrast to our 2018 outlook, the risks appear to be tilted to the downside in 2019 with monetary policy bordering on restrictive and market volatility settling in.

Interest Rates

Central banks have played an unusually large role in keeping a lid on interest rates for the better part of a decade, and they continue to have an influence, albeit less of an impact, on rates. The ECB continues to keep its overnight rate at -0.40% and the BoJ continues to hold its rate at -0.10%. In contrast, the Fed has hiked its overnight range to 2.25-2.50% and has now let its balance sheet pay-down from $4.24 to $3.89 trillion. As the Fed did in 2014, the ECB is now ending its balance sheet expansion but appears far from being able to hike rates or let the balance sheet pay-down. While global monetary policy has diverged in recent years, it is positioned to re-converge in 2019 with the Federal Reserve becoming less hawkish and other central banks moving away from emergency-easing policies. This should ease pressure on the Dollar but create more volatility for global markets and, consequentially, for U.S. markets.

The rise in the 2-year Treasury yield this past year was once again larger-than-expected. Our basecase view was that financial conditions would become more volatile as the Fed continued tightening, thereby slowing the rate-hike process. This deterioration failed to materialize until November enabling the Fed to continue with one hike per quarter. Going forward, it now appears that the Fed has reached a level at which markets are less comfortable, presumably very near the neutral rate for this cycle. This will make each rate hike increasingly tenuous and slow the already-gradual path. As such, we expect the Fed to hike one time in 2019 with an outside shot at two. One rate hike is contingent on a trade deal being reached enabling stable growth to continue. Two rate hikes would require surprising strength from economic growth and faster-than-expected inflation.

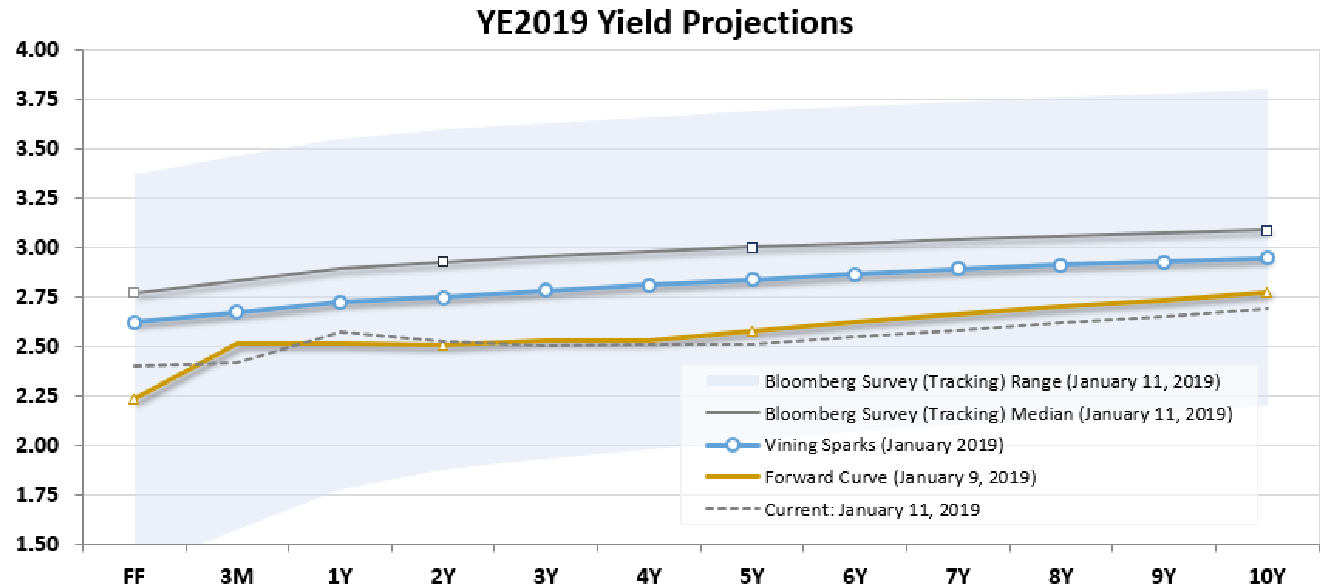
Longer-maturity interest rates continue to be range-bound by two primary factors, sluggish global growth and fears of economic correction. Those fears escalated in the final quarter of 2018 bringing the 10-year Treasury yield down 68 basis points over an eight-week period. That move was likely overblown but highlighted the fragility of the markets in today's environment. For the year, the 10-year yield rose 23 basis points to 2.69%, but rose as high as 3.24% in November. Increased market volatility is likely to define 2019 given that monetary policy is much closer to neutral and valuations on many asset classes are being questioned. Overall, we continue to see reasons that yields should remain anchored with the 10-year near 3.00%, closing the year at a projected-2.95%.

Risks to Forecast

Risks to stable economic growth have grown materially as the expansion has continued. A host of tailwinds have turned to headwinds. Domestically, the impact of higher interest rates on economic growth is a concern on many fronts including housing, corporate balance sheets, federal interest expense, and asset valuations. Additionally, the transmission of monetary policy is most often felt 12 to 24 months after the action. The Fed has now hiked rates 7 times in the past 8 quarters and continues to allow its balance sheet to shrink. Global debt levels have risen, global economic growth has slowed, and central bank balance sheets are slated to collectively contract for the first time since 2008. All of these conditions have increased the risk to weaker-than-expected growth.

However, the largest risk to our basecase forecast is found in trade policy. A larger-than-expected deal between the U.S. and China could set off a wave of optimism, lifting the growth rate in 2019. This could pressure interest rates higher than expected. Conversely, failure to reach a trade agreement could lead to a marked slowdown in global and U.S. growth. In such a scenario, interest rates could move meaningfully lower than expected. This will be a key development to watch.

Finally, with monetary policy closer to neutral, the risk of a Fed mistake has necessarily increased. While a mistake is not in our basecase forecast, any push higher for interest rates is likely to create challenges for the real economy and increase volatility in the markets.



Maturities without published projections interpolated based on historical spread differentials

Bloomberg Survey Tracking Index and Vining Projections

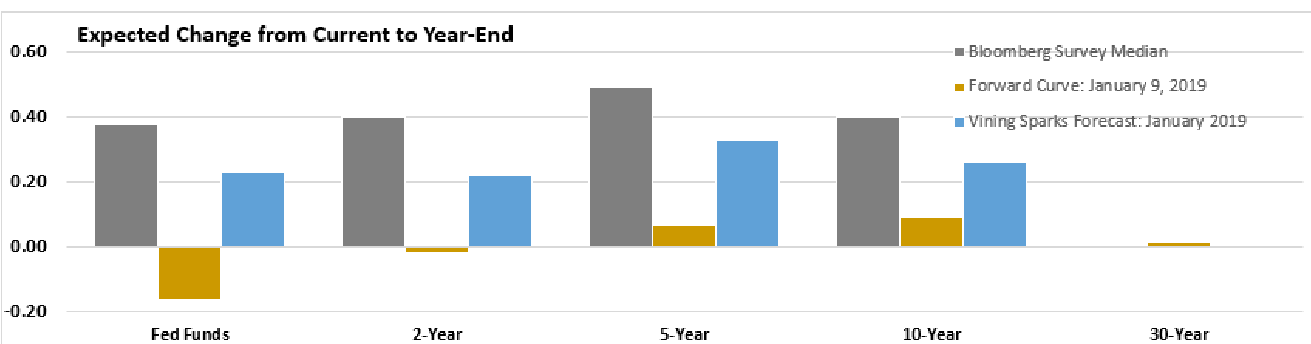
Interest Rate Projections

January 9, 2019

	Fed Funds	3M T-Bill	1-Year	2-Year	3-Year	5-Year	7-Year	10-Year	30-Year
Bloomberg Survey - Tracking: January 11, 2019									
Low Forecast	1.38			1.88		2.03		2.20	
Median Forecast	**2.78**			**2.93**		**3.00**		**3.09**	
High Forecast	3.38			3.60		3.69		3.80	
Forward Curve: January 9, 2019	**2.24**	**2.52**	**2.52**	**2.51**	**2.53**	**2.58**	**2.66**	**2.78**	**3.04**
Vining Sparks Forecast: January 2019	**2.63**	**2.68**	**2.73**	**2.75**	**2.78**	**2.84**	**2.89**	**2.95**	**3.02**
Current: January 11, 2019	***2.40***	***2.42***	***2.57***	***2.53***	***2.50***	***2.52***	***2.59***	***2.69***	***3.03***

Projected Δ by Year-End

	Fed Funds	3M T-Bill	1-Year	2-Year	3-Year	5-Year	7-Year	10-Year	30-Year
Bloomberg Survey - Tracking: January 11, 2019									
Low Forecast	-1.03			-0.65		-0.49		-0.49	
Median Forecast	**0.38**			**0.40**		**0.49**		**0.40**	
High Forecast	0.98			1.07		1.18		1.11	
Forward Curve: January 9, 2019	-0.17	0.10	-0.05	-0.02	0.03	0.07	0.08	0.09	0.01
Vining Sparks Forecast: January 2019	0.23	0.26	0.15	0.22	0.28	0.33	0.31	0.26	-0.01



Sources: Bloomberg Survey of Economists Real-Time Tracking Index, Vining Sparks

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Economic and Interest Rate Projections

Vining Sparks Projections

January 2019

	Q119	Q219	Q319	Q419	Q120	Q220	2019	2020
GDP (QoQ, SAAR)	1.9	2.6	2.5	2.4	1.7	1.9	2.4	1.8
Headline CPI (YoY)	2.1	2.0	1.9	1.9	2.0	1.9	1.9	1.9
Core PCE (YoY)	1.9	1.9	1.9	2.0	2.0	1.9	1.9	1.9
Unemployment Rate	3.7	3.7	3.8	3.8	3.9	3.9	3.8	3.9
Nonfarm Payrolls (Monthly)	160	155	155	150	140	130	155	130

	Q119	Q219	Q319	Q419	Q120	Q220	Q320	Q420
Fed Funds Target	2.38	2.38	2.63	2.63	2.88	2.63	2.63	2.63
2-Year Treasury Yield	2.70	2.70	2.75	2.75	2.65	2.50	2.50	2.50
10-Year Treasury Yield	2.90	2.90	3.00	2.95	2.80	2.70	2.70	2.70
30-Year Treasury Yield	3.12	3.12	3.23	3.17	3.00	2.92	2.92	2.92
Prime Rate	5.50	5.50	5.75	5.75	6.00	5.75	5.75	5.75
30-Year Mortgage Rate	4.55	4.55	4.65	4.60	4.45	4.35	4.35	4.35

Sources: [1] Bloomberg Survey of Economists, [2] Economists' Real-Time Tracking Updates, Vining Sparks