

U.S. Economic Metrics Continue to Impress, Reinforcing Higher Interest Rates

U.S. economic metrics continue to be impressive. The economy added 250,000 net new payroll jobs in October, putting the average monthly gain for 2018 through October at 212,500. It will be increasingly difficult to maintain that strong pace of job growth going forward because the pool of available labor is getting smaller. Increased competition for labor is pushing wages up. Average hourly earnings for private sector workers were up by 3.1 percent in October, over the previous 12 month period. This is the strongest year-over-year gain in wages since April 2009. The Federal Reserve Bank of Atlanta's wage growth tracker is stronger at 3.5 percent wage growth.

U.S. businesses are enjoying strong demand growth. Real GDP expanded at a 3.5 percent annualized rate in the third quarter, after growing at a 4.2 percent annual rate in Q2. Industrial capacity utilization appears to be closing in on a cyclical high. The cyclical high points in overall capacity utilization have been trending down since the late 1960s, so 78 percent capacity utilization in September 2018 may be on par with 88 percent capacity utilization from early 1967.

With labor markets tight, and industrial capacity utilization high, there is relatively little slack in this economy. In a low slack economy the potential for demand-pull inflation is higher. We believe that the Federal Reserve will respond to the increased potential for demand-pull inflation with more interest rate hikes over 2019. We expect the Fed to leave interest rates unchanged at the Federal Open Market Committee this week over November 7/8. We look for the next fed funds rate hike to come at the conclusion of the December 18/19 FOMC meeting. We have three more 25 basis point fed funds rate hikes on our interest rate forecast for 2019, beginning on March 20, 2019. The implied odds of a December 19 rate hike have fallen in recent weeks due to the sell-off in U.S. and global stock markets. According to the CME, they are down to about 73 percent. We expect the implied odds to increase quickly after the stock market stabilizes and the dust settles after the mid-term election.

With wages going up, interest rates going up and import prices going up, it is fair to say that corporate profits are facing some headwinds. Fortunately, corporate tax reform came at an auspicious time and helped to boost corporate profits when they otherwise would have been squeezed. As of 2018Q2, after-tax corporate profits were up by 16 percent over the previous year. However, the support to corporate profits from tax reform will fade in 2019. Meanwhile, the pressure from wages and interest rates will increase. Import price pressure from tariffs could go either way depending on trade negotiations between the U.S. and China.

Global economic growth is slowing. The European Union posted weak Q3 GDP of just 0.2 percent over the previous quarter. Some of that can be blamed on a hiccup in German auto production due to new emissions tests. Italian GDP was unchanged in Q3 over Q2. China's manufacturing sector is barely expanding. The Caixin China Manufacturing Purchasing Managers Index inched up from a flat 50 in September, to a faintly positive 50.1 in October. China's service sector is also showing reduced growth. The trend in China's economy looks ominous with likely spillover effects on other Asian economies. Japanese industrial production fell by 1.1 percent in September. South Korea posted a 2.5 percent decline in industrial production in September.

So even with current strong U.S. economic metrics, we believe that downside risk factors for the U.S. economy are increasing. Cooler U.S. and global economic growth in 2019, combined with higher interest rate and higher labor costs could start to put pressure on corporate profits and increase stress on corporate debt markets.

U.S. Economic Outlook, Summary

	2Q'18a	3Q'18a	4Q'18f	1Q'19f	2Q'19f	3Q'19f	4Q'19f	1Q'20f	2017a	2018f	2019f
Real GDP (Percent Change Annualized)	4.2	3.5	2.8	3.0	2.7	2.4	2.5	2.4	2.2	2.9	2.9
CPI (Percent Change Year-over-Year)	2.6	2.6	2.3	2.1	2.2	2.2	2.1	2.0	2.1	2.5	2.1
Payroll Jobs (Average Monthly Diff., Ths.)	211.4	207.7	195.4	182.1	160.7	139.1	135.4	126.9	181.4	206.3	154.3
Unemployment Rate (Percent)	3.9	3.8	3.7	3.6	3.6	3.6	3.6	3.6	4.3	3.9	3.6
Federal Funds Rate (Effective)	1.74	1.92	2.21	2.45	2.69	2.94	3.13	3.13	1.00	1.83	2.80
10-Yr. Treasury Rate	2.92	2.93	3.23	3.31	3.35	3.55	3.68	3.70	2.33	2.96	3.47

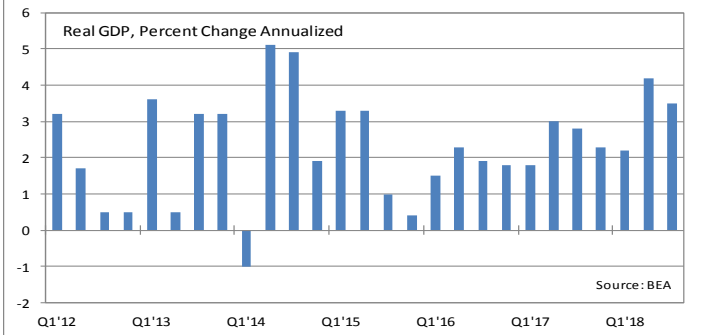
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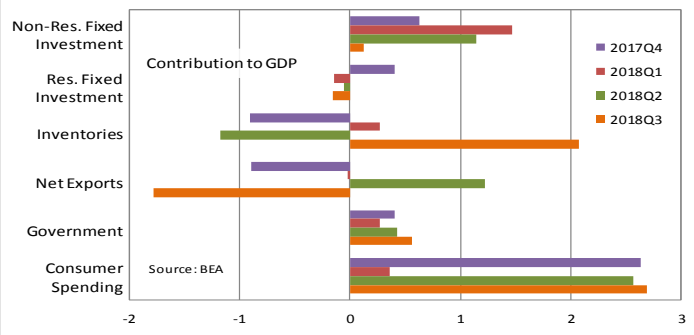
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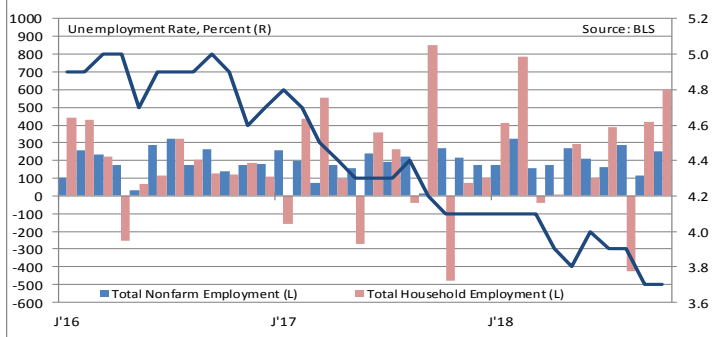
Q3 GDP 1st Estimate at 3.5%



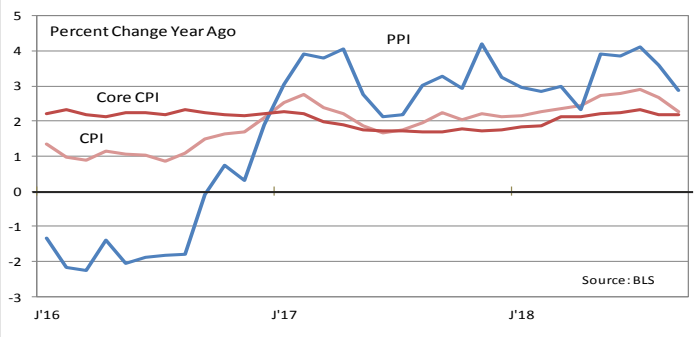
Net Exports Dropped Off in Q3



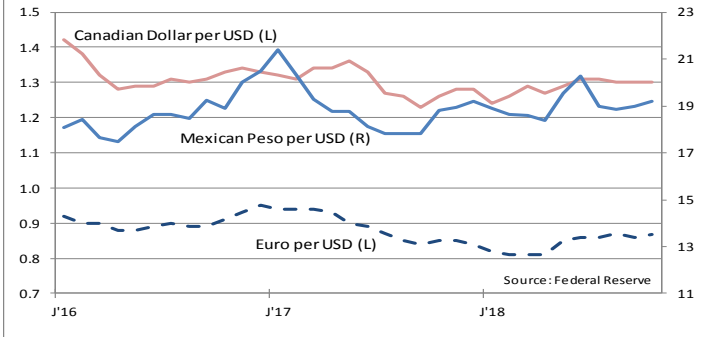
U.S. Added a Net 250,000 Jobs in October



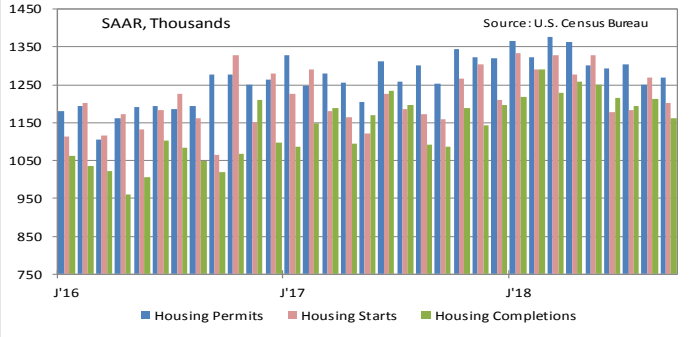
Inflation Metrics Easing After Peak Y/Y Gains



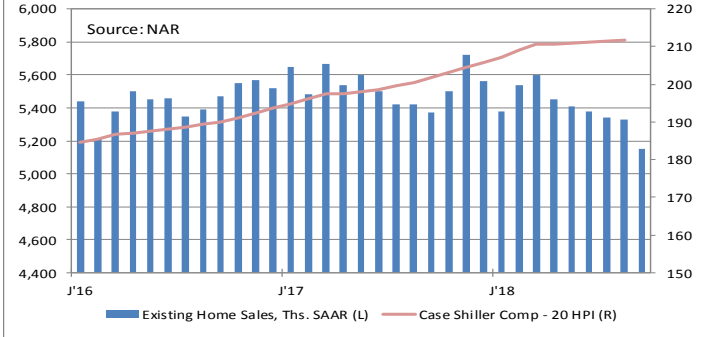
US Dollar Remains Strong through Oct.



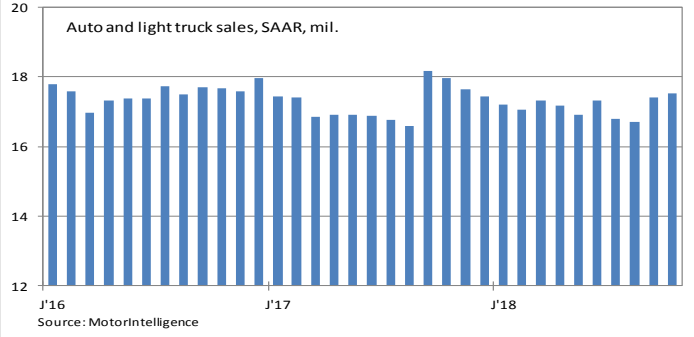
Housing Starts Cool Off in September



Existing Home Sales Are Falling



Auto Sales Ticked Up in October



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	2Q'18a	3Q'18a	4Q'18f	1Q'19f	2Q'19f	3Q'19f	4Q'19f	1Q'20f	2017a	2018f	2019f
Output											
Nominal GDP (Billions \$)	20412	20659	20902	21165	21414	21651	21895	22134	19485	20503	21531
Percent Change Annualized	7.6	4.9	4.8	5.1	4.8	4.5	4.6	4.4	4.2	5.2	5.0
Real GDP (Chained 2012 Billions \$)	18512	18671	18801	18941	19067	19182	19303	19418	18051	18577	19123
Percent Change Annualized	4.2	3.5	2.8	3.0	2.7	2.4	2.5	2.4	2.2	2.9	2.9
Pers. Consumption Expenditures	12842	12969	13040	13130	13205	13282	13361	13435	12559	12893	13245
Percent Change Annualized	3.8	4.0	2.2	2.8	2.3	2.4	2.4	2.2	2.5	2.7	2.7
Nonresidential Fixed Investment	2710	2716	2760	2806	2848	2885	2918	2950	2538	2710	2864
Percent Change Annualized	8.7	0.8	6.7	6.8	6.1	5.3	4.6	4.4	5.3	6.8	5.7
Residential Investment	613	607	603	609	615	619	624	628	611	610	617
Percent Change Annualized	-1.3	-4.0	-2.7	4.4	3.6	3.1	2.9	2.6	3.3	-0.2	1.2
Change in Private Inventories	-37	76	52	57	60	60	60	60	23	30	59
Net Exports	-841	-939	-899	-917	-930	-944	-950	-953	-859	-895	-935
Government Expenditures	3172	3197	3199	3209	3222	3233	3242	3251	3130	3180	3226
Percent Change Annualized	2.5	3.3	0.2	1.2	1.7	1.3	1.2	1.1	-0.1	1.6	1.5
Industrial Prod. Index (2007=100)	107.3	108.2	108.9	109.7	110.2	110.7	111.0	111.3	103.7	107.6	110.4
Percent Change Annualized	5.3	3.3	2.9	2.7	2.1	1.6	1.2	0.8	1.6	3.7	2.6
Capacity Utilization (Percent)	77.8	78.0	78.7	79.1	79.4	79.6	79.8	80.0	76.1	77.9	79.5
Prices											
CPI (1982-84=100)	250.5	251.7	253.1	254.6	255.9	257.2	258.5	259.8	245.1	251.2	256.6
Percent Change Annualized	1.7	2.0	2.2	2.4	2.2	2.0	2.0	2.0	2.1	2.5	2.1
PCE Price Index (2012=100)	108.1	108.5	109.1	109.7	110.3	110.8	111.4	111.9	106.1	108.3	110.5
Percent Change Annualized	2.0	1.6	2.2	2.3	2.1	2.0	2.0	2.0	1.8	2.1	2.1
GDP Price Index (2012=100)	110.2	110.6	111.2	111.8	112.3	112.9	113.5	114.1	107.9	110.3	112.6
Percent Change Annualized	3.0	1.7	2.0	2.1	2.1	2.1	2.0	2.0	1.9	2.2	2.1
PPI, Final Demand (Nov. 2009=100)	116.0	116.4	117.0	117.6	118.2	118.8	119.4	120.0	113.0	116.1	118.5
Percent Change Annualized	3.2	1.4	2.2	2.0	2.0	2.0	2.0	2.0	1.8	2.2	2.2
Crude Oil, WTI (\$/barrel)	68.0	69.7	71.0	73.0	75.0	75.0	75.0	75.0	50.8	67.9	74.5
Labor Markets											
Payroll Jobs (Average Monthly Diff., Ths.)	211.4	207.7	195.4	182.1	160.7	139.1	135.4	126.9	181.4	206.3	154.3
Unemployment Rate (Percent)	3.9	3.8	3.7	3.6	3.6	3.6	3.6	3.6	4.3	3.9	3.6
Average Weekly Hours	34.5	34.5	34.5	34.5	34.5	34.5	34.5	34.5	34.4	34.5	34.5
Population (Millions)	328.1	328.7	329.3	329.8	330.4	331.0	331.6	332.2	326.0	328.4	330.7
Percent Change Annualized	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Personal Income											
Average Hourly Earnings (\$)	26.93	27.16	27.38	27.60	27.81	28.02	28.23	28.44	26.31	27.06	27.92
Percent Change Annualized	2.7	3.5	3.2	3.3	3.1	3.1	3.0	3.1	2.5	2.8	3.2
Real Disp. Income (2012 Billions \$)	14307	14394	14506	14604	14695	14790	14878	14965	13949	14357	14742
Percent Change Annualized	2.5	2.5	3.2	2.7	2.5	2.6	2.4	2.4	2.6	2.9	2.7
Personal Saving Rate (Percent)	6.8	6.4	6.5	6.5	6.5	6.5	6.5	6.5	6.7	6.7	6.5
Housing											
Housing Starts (Ths., Ann. Rate)	1261	1218	1231	1233	1234	1234	1234	1233	1208	1257	1234
Exst. SF Home Sales (Ths., Ann Rate)	4797	4690	4696	4697	4709	4720	4725	4723	4910	4772	4713
New SF Home Sales (Ths., Ann Rate)	633	580	604	605	606	606	607	606	616	618	606
Case/Shiller HPI (Jan. 2000=100)	202.0	203.9	205.6	207.2	208.8	210.6	212.5	214.5	191.6	202.8	209.8
Year/Year Percent Change	6.4	5.9	4.8	3.7	3.4	3.3	3.4	3.6	5.8	5.8	3.4
Consumer											
Household Economic Stress Index	0.2	0.6	1.2	2.0	2.4	2.5	2.4	2.1	0.7	0.5	2.3
Auto Sales (Millions)	17.1	17.0	17.2	17.1	16.9	16.7	16.5	16.2	17.2	17.1	16.8
Interest Rates (Percent)											
Federal Funds Rate (Effective)	1.74	1.92	2.21	2.45	2.69	2.94	3.13	3.13	1.00	1.83	2.80
Prime Rate	4.80	5.01	5.29	5.55	5.79	6.04	6.23	6.23	4.10	4.91	5.90
1-Month LIBOR	1.97	2.11	2.34	2.54	2.76	3.01	3.21	3.21	1.11	2.02	2.88
3-Month LIBOR	2.34	2.34	2.55	2.67	2.83	3.08	3.30	3.31	1.26	2.29	2.97
1-Yr. Treasury Rate	2.25	2.47	2.71	2.83	2.97	3.21	3.32	3.33	1.20	2.34	3.08
5-Yr. Treasury Rate	2.77	2.81	3.09	3.22	3.29	3.49	3.60	3.60	1.91	2.80	3.40
10-Yr. Treasury Rate	2.92	2.93	3.23	3.31	3.35	3.55	3.68	3.70	2.33	2.96	3.47
30-Yr. Fixed Rate Mortgage	4.54	4.57	4.89	5.00	5.07	5.28	5.41	5.42	3.99	4.57	5.19

a = actual f = forecast

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