4Q18 Economic Summary

I hope you had your seatbelts fastened because the fourth quarter of 2018 was a wild ride. The quarter started with equity markets at record highs. Economic confidence was up, and the main concern was that the US may be growing too quickly. Fear that the Fed may need to raise rates at a faster pace to keep the economy from overheating and to curb rising inflation pushed US Treasury yields up across the curve. By December, however, economic confidence had waned as higher interest rates, weaker global growth, rising geopolitical tensions, and a partial government shutdown threatened to derail US economic momentum. Equity markets plummeted, ending the year lower than where they began, and Treasuries rallied as investors became convinced that the Fed was due for a pause in the tightening cycle.

The US economy continued to expand during the fourth quarter; however, the pace of growth is expected to have moderated as the year came to a close. Growth in manufacturing and services cooled as business investment took a pause amid signs of slowing global growth and uncertainty surrounding the US-China trade dispute. The labor market, however, did not reflect the slowdown. Job gains averaged 254,000 per month, marking the biggest quarterly increase in jobs for the year. The unemployment rate ticked up slightly to 3.9% as healthy labor market conditions encouraged more people to begin actively seeking employment. In addition, average hourly earnings rose 3.2% year-over-year in December, matching the fastest pace in wage growth since 2009. Rising incomes and lower gas prices boosted American's discretionary spending power, resulting in strong advances in retail sales during the quarter. Although consumers appeared eager to spend, housing demand remained subdued as higher interest rates, elevated home prices and lean inventories continued to negatively impact affordability. Overall, economic data points to another solid quarter for US GDP growth. However, financial market volatility and political bickering over the government shutdown are weighing on consumer sentiment and could dampen spending going into 2019.

While the US economy ended the year on solid footing, slowing global growth remained a primary concern for markets. The World Bank recently cut its 2019 forecast for global economic growth, citing softening international trade and manufacturing activity, elevated trade tensions, and substantial financial market pressures on emerging economies. The deterioration in global manufacturing is due in a large part to slowing growth in China, which is the world's second largest economy behind the United States. China has been struggling with weakening domestic investment and demand brought on by a government crackdown on riskier lending earlier in the year. The ongoing dispute with the US is only exacerbating the issue as the disruption in China's trade sector has weighed heavily on Chinese business and consumer confidence. There was some progress made on the trade front in early December when Presidents Trump and Xi reached a three-month truce to roll back tariffs and restore trade between the two nations. Markets were skeptical of the truce, however, and it did little to halt the route in equities. Although negotiations are ongoing, tensions remain high and progress has been slow, leaving uncertainty as to whether the two countries can reach a resolution by the March 1 deadline.

The slowdown in global growth was not lost on the Fed. While they raised rates by another 25 basis points to a target range of 2.25-2.50% at the December FOMC meeting, Fed officials acknowledged that concerns about the global growth outlook and escalating trade tensions were impacting financial markets and posed downside risk to their forecasts for US GDP growth. As a result, some participants lowered their projections for rate increases, and the dot plot median dropped from three hikes in 2019 to two. Despite the dovish lean to the December meeting, markets were not happy. Investors wanted the Fed to signal a clear pause in their hiking cycle. Instead, the Fed said that economic data remained strong and that "some" further gradual increases in the federal funds rate were expected. Although Chairman Powell reiterated that monetary policy was not on a preset course and all rate decisions were data dependent, fear of Fed over-tightening sent equity markets into a tail spin, and the risk-off sentiment resulted in further declines in Treasury yields. As equities tumbled, criticism of the Fed ramped up. President Trump and Wall Street economists bashed Chairman Powell for excessive hawkishness. In response, Fed officials went on the offensive, assuring markets that the Fed was indeed flexible and would pause the tightening cycle if economic data warranted it. The effort appeared to pay off as markets calmed somewhat and criticism of Fed policy died down – at least for now.

Despite all the market volatility, 2018 was a good year for the US economy. GDP growth was solid, labor market conditions were strong, and inflation remained near the Fed's 2% objective. While the expansion is expected to continue in 2019, the economy is facing many headwinds, including fading fiscal stimulus in the US, slowing global growth, strained US-China trade relations, a potential no-deal Brexit, financial market volatility and political discord at home. Given all the uncertainty, we would not be surprised if the Fed takes a pause in policy firming to assess how these risks unfold.

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