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U.S. ECONOMIC & INTEREST RATE OUTLOOK

IN THIS ISSUE

- **Stretching Our Legs**

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Rumors of a contraction to start the year were overblown. Since March, a string of positive economic headlines have helped soothe investor sentiment and maintain economic momentum. We are still in a growth cycle with room to run.

We have lingering concerns about the potential impacts of trade policy and international decisions that may undermine stability. Risks in this area escalated over this past weekend; negotiations were resuming as this issue goes to press.

Key Economic Indicators

	2018				2019				Q4 to Q4 change			Annual change		
	18:1a	18:2a	18:3a	18:4a	19:1f	19:2f	19:3f	19:4f	2017a	2018a	2019f	2017a	2018a	2019f
Real Gross Domestic Product (% change, SAAR)	2.2	4.2	3.4	2.2	3.2	1.7	2.0	2.0	2.6	3.0	2.2	2.2	2.9	2.6
Consumer Price Index (% change, annualized)	3.2	2.9	2.0	1.5	0.9	3.0	2.3	2.1	2.1	2.2	2.1	2.1	2.4	1.9
Civilian Unemployment Rate (%, average)	4.1	3.9	3.8	3.8	3.9	3.7	3.7	3.7				4.4*	3.9*	3.7*
Federal Funds Rate	1.40	1.67	1.88	2.16	2.38	2.38	2.38	2.38				1.00*	1.65*	2.38*
2-yr. Treasury Note	2.16	2.47	2.67	2.80	2.48	2.50	2.57	2.61				1.40*	2.44*	2.54*
10-yr. Treasury Note	2.76	2.92	2.93	3.03	2.65	2.60	2.75	2.85				2.33*	2.87*	2.71*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- The initial estimate of real gross domestic product (GDP) for first quarter 2019 reflected a surprisingly strong 3.2% annualized growth rate. However, a review of the components of GDP revealed an unflattering mix of growth drivers.
    - Inventory accumulation is unlikely to continue as inventories will be drawn down.
    - Net exports provided a boost, but were driven by a reduction in imports due to a fall in domestic demand, rather than growth in exports.
    - Consumer spending and business investment grew slowly. Early indicators for second quarter suggest consumer activity is rebounding, but business investment seems to be regressing.
- Inflation on personal consumption expenditures (PCE) fell to 1.5% year-over-year. Core PCE was a similarly modest 1.6%, below the Fed's target of 2%. In comments to the press, Fed Chair Jerome Powell pointed to transient factors that suppressed inflation, including a technical change to the measurement of wardrobe prices and a temporary fall-off in financial product commissions. We also observe that PCE is currently showing the lowest reading of inflation relative to other indicators, including

the consumer price index (CPI) and trimmed-mean measures that exclude outliers.

- The unemployment rate fell to 3.6%, a 50-year low, though the marginal decline was driven by a reduction in the pool of available labor. Payroll gains of 263,000 jobs took the 3-month moving average to 170,000, a strong rate for an economy ten years into a growth cycle.
- Wage growth has remained in the same steady range for the past year, most recently growing at 3.2% year-over-year. Employers have not yet been forced to make outsized increases to wages to attract or retain workers. The employment cost index, reflecting the total cost of employment including benefits, showed similarly subdued growth of 2.8% year-over-year.
- The U.S. manufacturing purchasing managers index (PMI) fell to a two-year low of 52.8, reflecting a slowing in industrial activity. However, any reading above 50 indicates expansion, and the elevated readings of recent years were due to revert to the mean.
- As expected, the Federal Open Market Committee undertook no rate changes at its May meeting. Chair Powell affirmed the Fed's patient stance and said the committee saw no "strong case for moving rates in either direction." This commentary deflated hopes of for a defensive rate cut due to below-target inflation. Given the current environment of strong growth, low unemployment and generally positive equity market performance, we agree that any rate movement at this juncture would be premature. The negative signal of a rate cut may outweigh the intended market support to boost inflation. We expect no rate changes for the remainder of the year.
- The trade war has resumed, with President Trump threatening to increase tariff rates on $200 billion of Chinese goods from 10% to 25%, and exploring levies for the remaining $325 billion of Chinese imports not currently subject to tariffs. These measures would be economically jarring to businesses and consumers in both countries. In the best case scenario, this threat is merely a tactic to speed the progress on a negotiated U.S.-China trade agreement. In a worst-case scenario, additional trade restrictions would impair market and economic performance.
- Income tax season has concluded. Though the majority of consumers did indeed pay lower income taxes during the course of 2018, many were disappointed by smaller refunds. This shortcoming may have contributed to the low consumer spending in the first quarter. The weak performance of business investment in the first quarter suggests that instead of being reinvested, most gains to corporations were paid as dividends and share buybacks

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