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# UPDATES TO OUR ECONOMIC FORECASTS

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## KEY TAKEAWAYS

We've lowered our 2019 forecasts for Fed policy moves, GDP growth, and rates.

We expect the Fed to pause through the end of 2019 as it waits for clarity on global conditions.

GDP may grow at the lower end of our forecast as capital expenditures have slumped recently.

**2019 has been a busy year so far.** The United States has weathered a 35-day government shutdown, global data have deteriorated further, trade headlines continue to dominate the news, and the Federal Reserve (Fed) has made a significant U-turn in monetary policy plans, all on top of the sharp market sell-off in late 2018. In response to the collective impact of these events, we've adjusted our 2019 economic forecasts [Figure 1].

## FED FORECAST

In January, policymakers removed language from the Fed's policy statement that "some further gradual (rate) increases" would be consistent with economic conditions and added language that they would be "patient" when determining future rate adjustments. The Fed has been messaging all along that policy decisions would be data dependent, but markets were becoming increasingly concerned that the Fed was on autopilot despite a slowing global economy and tightening financial conditions. More recently, the Fed demonstrated its commitment to flexibility, and it will likely pause on further rate tightening as the world waits for greater clarity on global conditions.

We've long emphasized our faith in the Fed's commitment to flexibility and said in our [Outlook 2019](#) that policymakers likely would not be as aggressive in 2019 as investors have feared. Based on recent Fed commentary, we expect the Fed's pause to continue through the end of 2019. The Fed may need to briefly pump the brakes with an additional rate hike, potentially in the second half of this year, if business investment rebounds, the labor market tightens further,

### 1 FED PAUSE, HEADWINDS WARRANT CHANGE IN ECONOMIC FORECASTS

	2019 Initial	2019 Revised	Revision?
Fed Policy	2 Hikes	1 Possible in Second Half of 2019	Lower
GDP	2.5–2.75%	Near 2.5%	Lower
Inflation (YoY Core Consumer Price Index)	2.25–2.5%	2.25–2.5%	Same
10-Year Treasury Yield	3.25–3.75%	3.00–3.25%	Lower

Source: LPL Research, 02/19/19

The economic forecasts set forth may not develop as predicted.

and economic growth picks up. To be clear, we think the U.S. economy could digest another rate hike, and it would be prudent to increase rates if there were signs of excesses or overheating. However, the Fed must consider global stability in its monetary policy moves, as an accelerating U.S. dollar could disrupt trade further and curb growth in struggling economies internationally.

Recently, the Fed has also messaged flexibility in the pace of balance sheet runoff, which is likely to calm investors' nerves. No official changes have been made yet, and we don't expect any in the near term. Further balance sheet reduction still gives policymakers a more subtle tool to influence interest rates, helping to provide some tightening while hikes remain on hold. Despite continued balance sheet runoff, global liquidity remains more than adequate, and the impact on global markets should be modest.

## GDP FORECAST

We see enough evidence to think 2019 gross domestic product (GDP) growth is likely to be closer to the lower end of our original 2019 forecast with risks balanced to the upside and downside. Heightened trade and political uncertainty have clearly weighed on corporate and consumer sentiment, and capital expenditures growth stalled in the second half of 2018 as U.S. corporations waited for greater clarity on trade risk before investing in their businesses. Growth in capital spending, measured by new orders of nondefense capital goods (ex-aircraft) slowed through November, so we wouldn't be surprised to see tepid business investment weigh on last quarter's output. December's historic slide in retail sales points to fourth quarter weakness in consumer spending as well. Control-group retail sales, which are used to calculate GDP, decreased 1.7% in the month, the worst drop since September 2001. Fourth quarter GDP data are scheduled to be released February 28, with the consensus predicting from 1.5% to 2.5% growth.

As we mentioned in *Outlook 2019*, we still believe stronger growth in business spending may drive this leg of the economic expansion, as higher investment leads to greater worker productivity and profit growth. However, spending growth will likely be muted until the trade dispute with China is resolved.

## INFLATION FORECAST

We believe U.S. inflation will remain manageable, even as domestic growth slows and the Fed pauses. We predict the core Consumer Price Index (CPI), which excludes food and energy components, will rise 2.25–2.5% year over year in 2019, consistent with our *Outlook* view. The pace of year-over-year core CPI growth has been about 25–50 basis points (0.25–0.50%) higher than growth in core personal consumption expenditures (PCE) this cycle. Therefore, if we trust the Fed's ability to target roughly 2% core PCE growth, we would expect core CPI growth to be slightly above 2.25%.

Core CPI growth of 2.5% would be the fastest pace of price growth in the economic cycle, just above the 2.4% growth in July 2018. However, we think a slight increase in inflation would make sense given the firm U.S. labor market and the possibility that economic activity could stabilize after trade headwinds subside. If price growth does hold steady near 2.5%, we don't expect inflation to significantly curb the domestic economy. Slowing global economic growth should cap U.S. price growth, and the Fed has room to adjust rates if inflationary threats emerge.

To us, wage growth is an important indicator of overall inflationary pressures, as wages constitute about 70% of business costs. Average hourly earnings for nonsupervisory workers have climbed as much as 3.5% year over year recently, but are still well below the 4% often seen late in the economic cycle. We don't expect much upside in wage growth from these levels given the long-term structural forces driving the labor market right now, such as globalization and age demographics.

## RATE FORECAST

Given our lower expectations for U.S. GDP and deteriorating global conditions this year, we expect the 10-year U.S. Treasury yield to trade in a range of 3–3.25% at the end of 2019. Our forecast implies about 30–50 basis points (0.30–0.50%) of upside from the 10-year yield's current levels, due to accelerating inflation and still solid domestic growth prospects. U.S. government debt is attractively valued relative to other sovereign debt, so we expect global interest in Treasuries to counteract any further appreciation in longer-term yields.

## CONCLUSION

We're in a complicated environment right now, and uncertainty around global headwinds has roiled many economists' predictions (including ours). Even though we've adjusted a few forecasts, our overall belief that the U.S. economy is on solid footing hasn't wavered. We don't expect a recession in 2019, and we have yet to see the red flags that in the past have signaled a large increase in recession risk. ■

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