Economic Insights: **Misplaced fears**

Weekly update: November 19 - 23, 2018

Commentary by Robin Anderson and the Economic Committee

Germany and Japan contracted in the third quarter. The US economy probably peaked in the middle two quarters of this year. Recently, Federal Reserve (Fed) Chair Jerome Powell and Vice Chair Clarida have voiced concerns about a global growth slowdown. But, we feel like fears are overdone.

The declines in Germany and Japan are old news and temporary. Problems in the auto industry surely drove Germany's contraction. Car companies stopped production to get ready for new emission standards. In addition, according to *Bloomberg*, services sector data may be upwardly revised in subsequent releases of the GDP report. Natural disasters, flooding, earthquakes, and a typhoon, weighed on Japan's economy hitting consumption, inventories, exports, and investments hard.

Growth should rebound in both countries this quarter. Japanese exports already bounced back sharply in October as did a key business survey. German auto production has started to pick up and that should lift broader manufacturing output. In both countries, labor markets are the best in years, and that's going to support domestic demand.

Concerns about slowing US growth are grossly exaggerated. Fiscal stimulus may have temporarily boosted consumer spending close to 4%. But, wage growth is picking up and that should keep consumers humming along. The recent softness in capital spending may bounce back, leading indicators such as corporate profits, business surveys, and bank lending standards suggest that investment is well buttressed.

Housing has slowed, but fears of a collapse are unfounded. Last week, the National Association of Homebuilder's Index (NAHB) sharply declined, but that was likely catching up to other weak housing data. Demographics remain a tailwind. Household

Week in review

Tech export controls?

The Trump administration opened a public comment period to potentially establish export controls on 14 categories of technology. According to the *Washington Post*, while this is only an initial phase of possible new regulations, the Trump administration could impose export restrictions on a broad range of technologies, including driverless cars and voice-activation for smart phones. This notice is clearly targeted at China and is part of a strategy to curb intellectual property theft. If the export controls do go through, depending on their breath, they could have significant negative implications for supply chains and for the US tech sector. It's also unclear how China will respond.

Stock market troubles:

The stock market rout that started in October continued last week. As of Tuesday, the S&P 500 was also down nearly 10% from its September 20 peak. While a year-end rally could still happen, more market volatility is likely in store for 2019. Higher wages and interest costs will likely eat into corporate profits. And, credit stress has picked up, whether it be in emerging markets or most recently in US high yield. Credit stress is a good leading indicator of stock market troubles.

Fed tone shift:

On October 3, Fed Chairman Powell stated the US economy was "particularly bright" and that the Fed was a long way from neutral. In recent weeks, Federal Reserve speakers have changed tone. As noted above, both Powell and Vice Chair Clarida have raised concerns about slowing global growth. Powell stated that fading fiscal stimulus and rate hikes were headwinds. Atlanta Fed Chair Raphael Bostic and Vice Chair Clarida stated that the Fed was close to neutral, not far from it.

The Federal Open Market Committee may stop their pattern of quarterly rate hikes and focus more on incoming data. Clarida stated, "We are now at the point where we need to be especially data dependent." Powell stated that the Fed needs to be "thinking about how further to raise rates, and the pace at which we will raise rates." Next year, the path of the Fed is far from certain. While global growth worries are overdone, market volatility and tightening financial conditions will likely be enough to force the Fed to pause in early 2019.

formation is picking up; homeownership rates are turning around. The homeowner vacancy rate remains very low and the construction sector is still adding jobs. Capping the state and local tax deduction (SALT) likely dragged down home sales this year but its impact will probably roll off the data next year.

Raw industrial commodity prices have recently started to pick up, a good bellwether for global growth. Emerging-market export growth, another good measure of global activity, has only mildly decelerated this year. In contrast, in 2015, during the commodity price rout, emerging-market exports contracted.

We expect growth to mildly slow next year, not sharply decelerate. Europe and Japan may grow at about the same pace next year as this year. But the United States will likely slow down a little bit. Chinese growth is slowing, but stimulus should prevent a hard landing.

Investment implications

Global growth concerns are likely overrated but concerns about markets are not. Some investors may be relieved by the recent fall in interest rates. The US 10-year dropped to 3.05% last Tuesday. But, that level is surely too low, given the pace of the US economy. We expect interest rates to resume their upward trajectory. Higher-rate driven market volatility is likely here to stay.

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