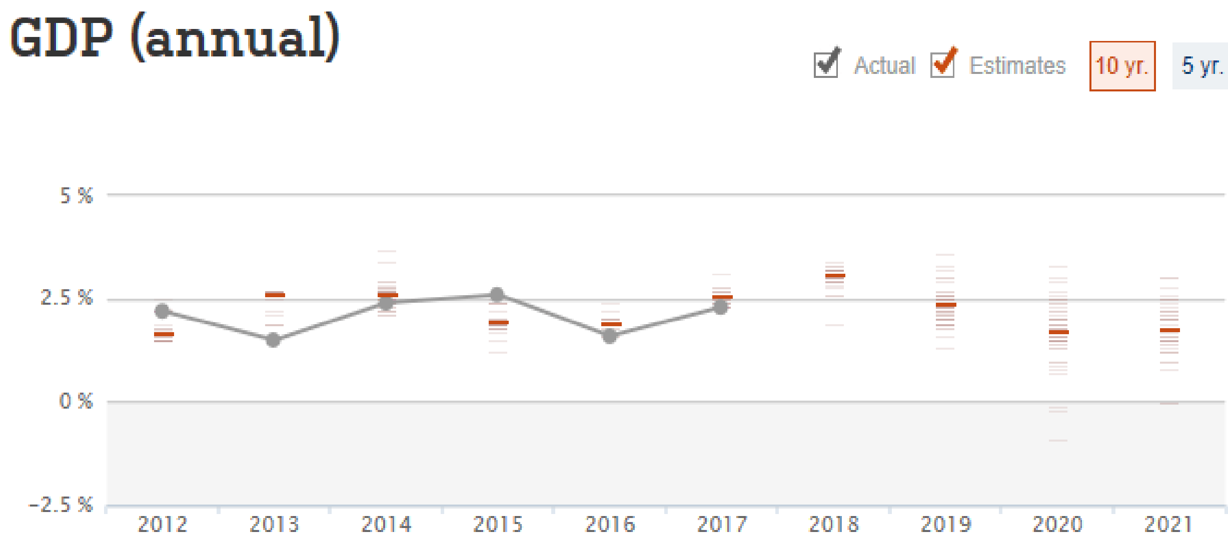
2019 Economic Outlook

The forecasts, estimates, risks below are a summary of 2019 outlooks from Barron's, Wall Street Journal (WSJ), Fortune, BusinessWeek, Charles Schwab, Merrill Lynch, Capital Group and my analysis of economic, business, and investment trends. Some of the forecasts below are from WSJ surveys of over 60 economists from Wall Street, academia, and corporate America.

Most 2019 outlooks see more volatility and slower growth. Risks are rising, especially geopolitically.

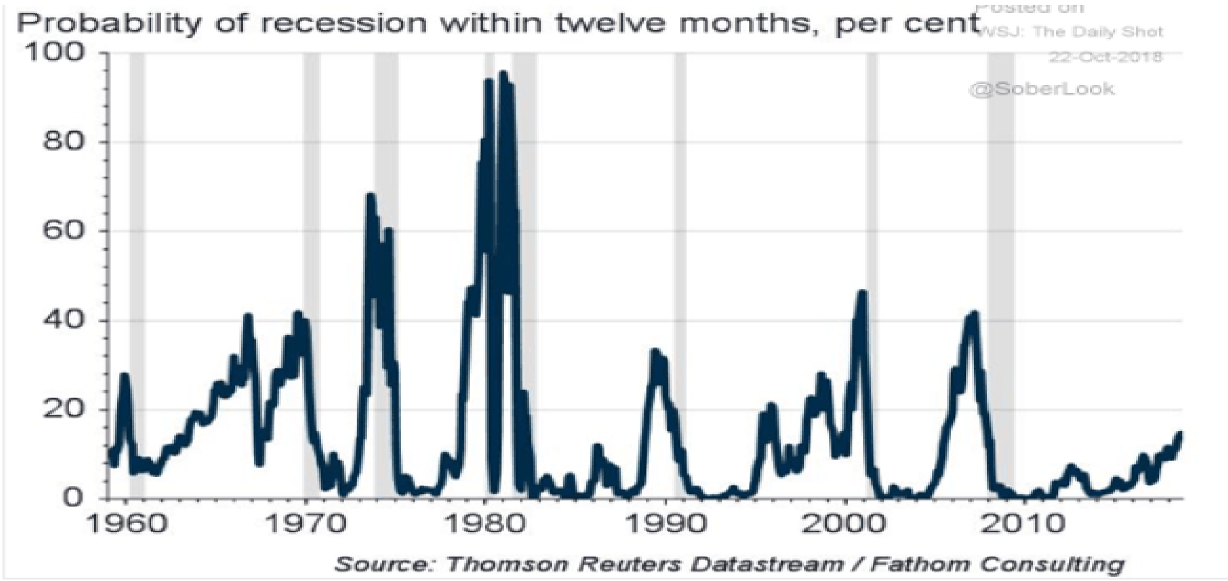
GDP

Most economists believe the stimulus from the tax cuts is anticipated to fade this year, but there is enough momentum to continue in to 2019. Below is the trend for GDP and forecasts for the next few years.



Source: WSJ

Most economists don't expect a recession this year, but economists are bad at forecasting recessions. Below is a chart that shows how the track record of the Fed of anticipating recessions.



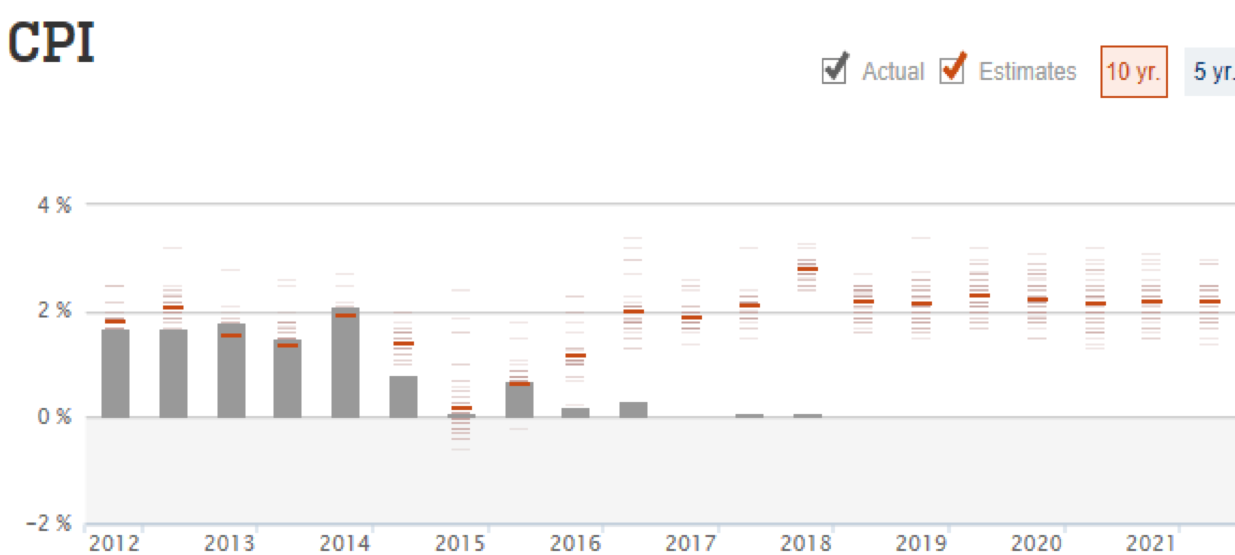
The average probability of a recession before a recession is about 30%. The Wall Street Journal Forecasting Survey for a 2019 recession of over 60 economists has increased to about 23%.

Forecasting the future is very difficult.

Because of the cold weather, the government shutdown and trade wars, inventory buildups, some economists believe we could have negative growth for the first quarter, but most economists see growth slowing to about 2.1% in the 1st quarter of 2019. More on this below in the Risk section.

CPI, Federal Reserve, Interest Rates

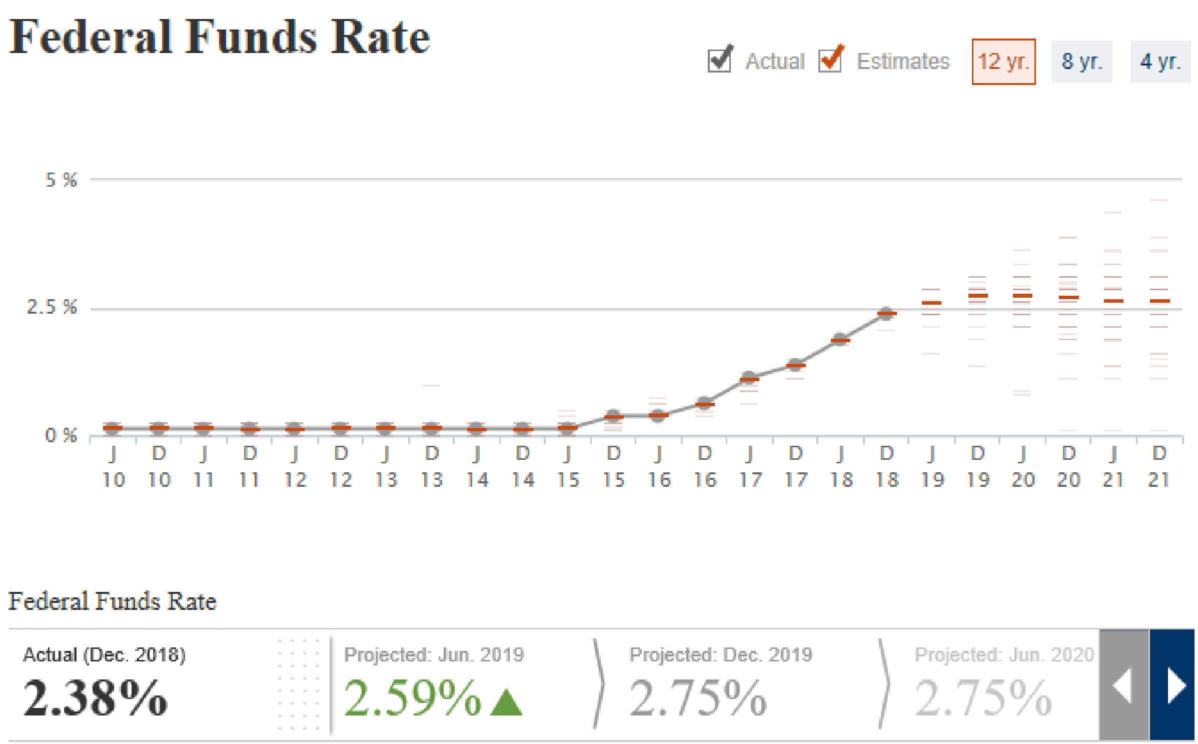
Below is a chart of the trend and forecasts for inflation:



Source: WSJ

Inflation has been very low for most of this cycle, and it's expected to move up to about 2% (the Fed's target for inflation) going forward.

The Fed Funds rate had been abnormally low for much of this cycle. The Fed received much criticism for keeping rates so low for so long.



Source: WSJ

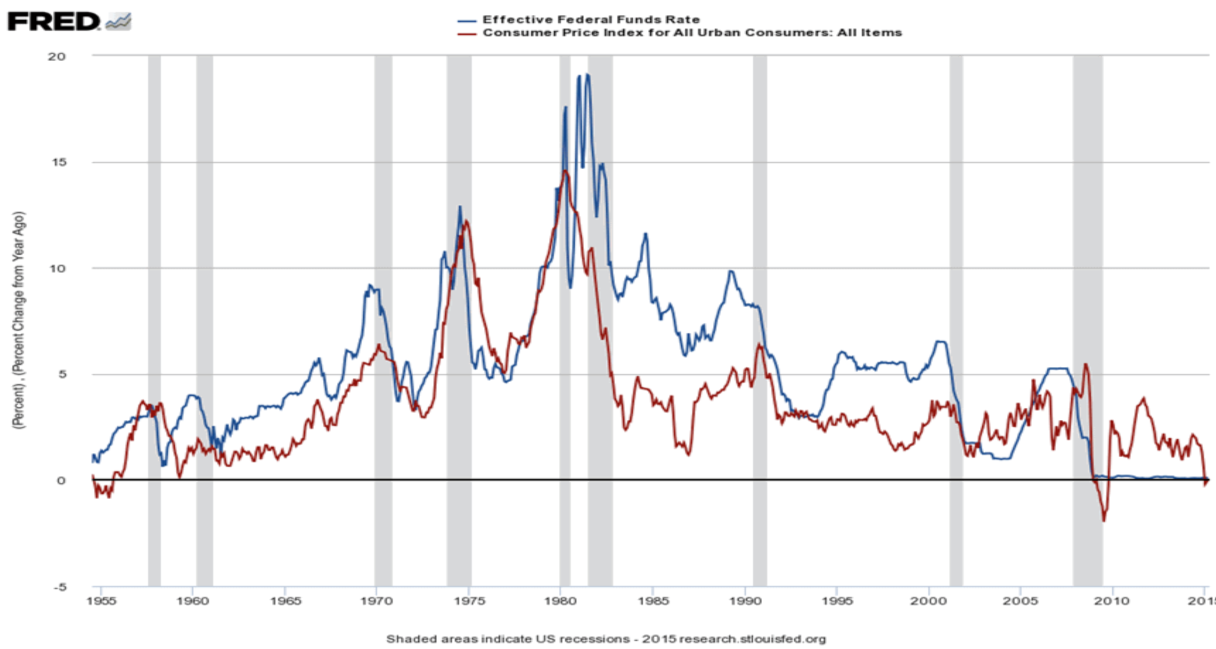
CNBC's Jim Cramer has been criticizing the Fed for raising rates when there is little inflation and the economy is slowing down. There were several reasons why the Fed needs to raise rates, it's not just about inflation. I wrote about this in my 2018 4th quarter Update. Below is an excerpt from the Update:

"I often hear on the cable financial news that inflation is tame and the Fed should not be raising rates. There are other ways to look at why interest rates are rising. There are three main reasons.

Reason 1. Here is what I wrote in my 2018 Economic Outlook, "The U.S. is shifting from monetary stimulus (low rates and quantitative easing) to fiscal stimulus (tax cuts, infrastructure spending, reduce regulations)… this shift could be disruptive to the global economy and markets." The Fed has to reduce the stimulative impact of low rates because of the stimulus of fiscal policies, the lowering of taxes and increased government spending.

Rising rates have made our dollar stronger (we have one of the highest interest rates among developed nations). Rising rates and the stronger dollar is one of the reasons the global economy and markets are struggling.

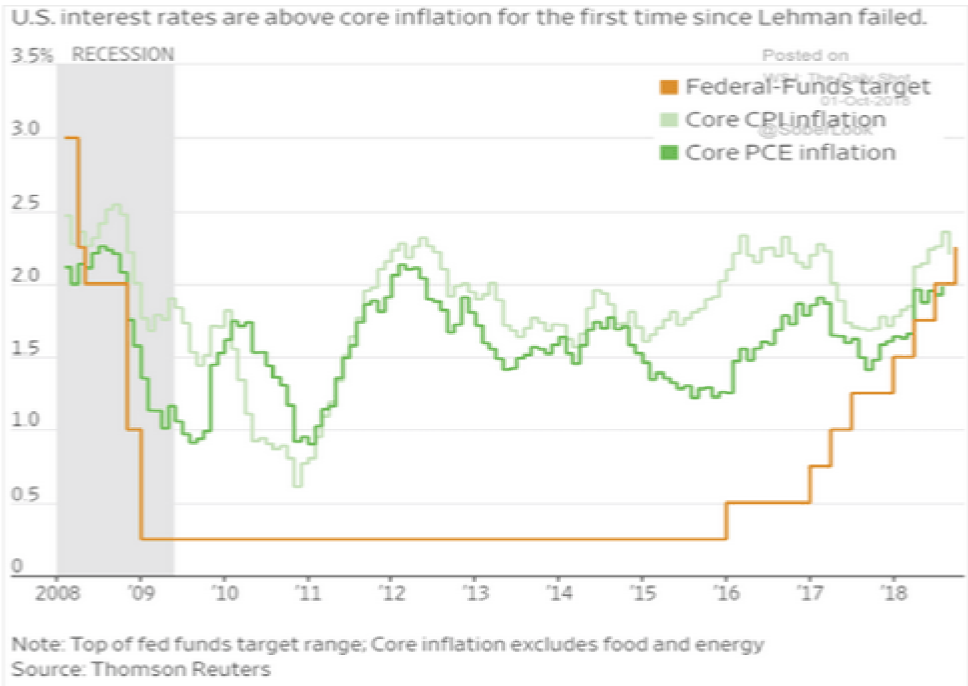
Reason 2: Interest rates need to reflect inflation. Below is one of my favorite charts (I've shown the chart in many past reports) that shows the relationship of inflation, interest rates and the economy.



Source: FRED, Federal Reserve Economic Data

Notice that most of the time the Fed Funds rate (blue trendline) is higher than inflation (red trendline), except for this cycle where inflation is above the Fed Funds rate. This is unusual, and the Fed was planning to "normalize rates" to reflect inflation once the economy was strong enough. The economy is strong enough so the Fed is "normalizing rates." Also notice that when rates and inflation move up, we normally go into a recession.

Below is a chart that updates the current trend of inflation and the Fed Funds rate:



Source: WSJ.com, h/t Paul Menestrier; [Read full article]

The Fed has been raising rates since 2015. The normal spread between inflation and the Fed Funds rate is normally at least 1%. This means the Fed Funds rate could rise to about 3%, if inflation is about 2%. There could be more fed rate hikes if the inflation continues to rise and if the economic growth stays at current levels. There are two more rate hikes expected in 2019.

Reason 3 – When the economy slows and we go into a recession, the Fed may not only stop raising rates, but they may start to lower them. This is another reason why the Fed needs to raise rates now, so they can lower rates later when we go into a recession.

Lowering rates is one of the best ways to stimulate an economy, but rates may not be high enough to drop to have a stimulative impact."

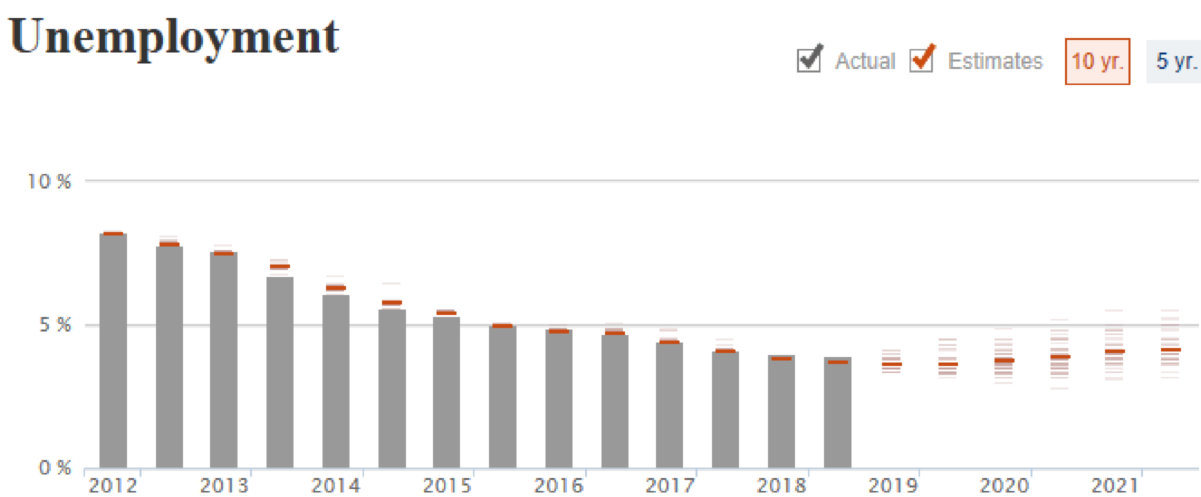
Jim Cramer and others including the President and the volatile markets have convinced the Fed to pause. There may be only one rate increase in 2019 and that would put the Fed funds rate close to about 3%, about where they should be.

Rates did move from .25% to about 2.5%, a dramatic increase on a percentage basis. Also, most valuation models are based on interest rates. When rates are higher, most assets will fall, and when rates are falling valuations normally rise. Higher rates and lower asset valuations is one of the main reasons why the stock market fell.

Unemployment, the Consumer

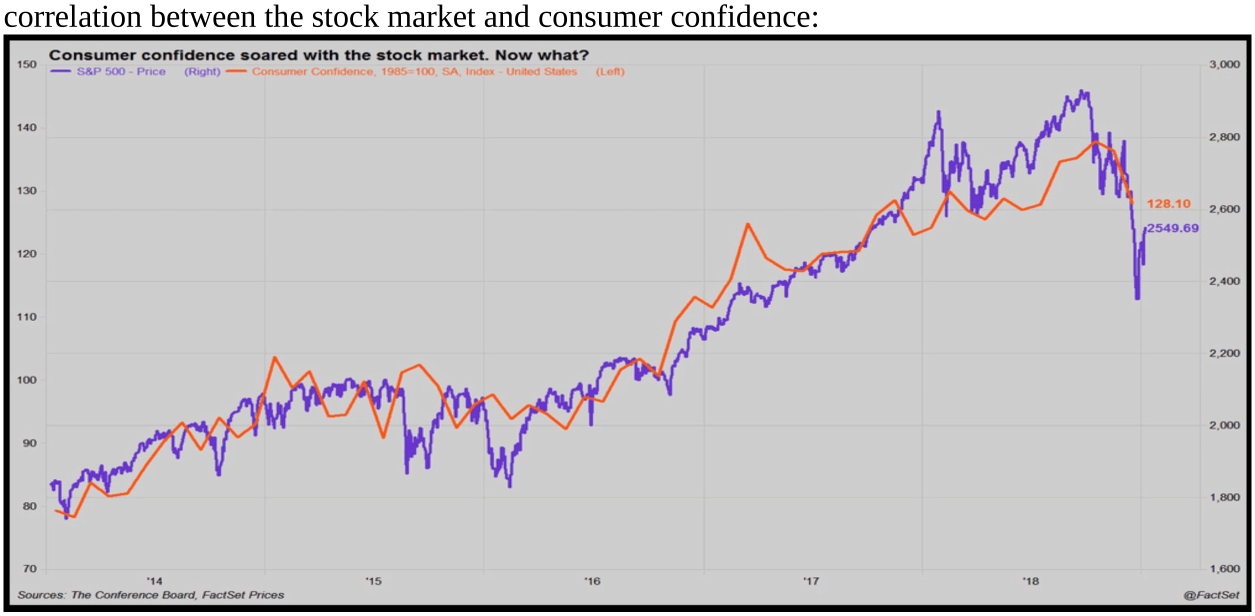
The consumer is key to the U.S. economy. The consumer was one of the bright spots in the economy, but we are seeing trends reverse especially for housing and autos sales.

The economy continues to generate jobs causing unemployment to drop to historic levels.



If we go into a recession this year or next, these forecasts will probably be wrong and unemployment could rise.

Consumer confidence accelerated with the new administration. Below is a chart that shows the correlation between the stock market and consumer confidence:



As the market struggled late last year, we see consumer confidence starting to fall. Economists call this the wealth effect when the markets and real estate values fall, so does consumer confidence and vice versa.

Below is the trend for retail sales:

Retail sales were improving the last few years, but we are starting to see weakness.

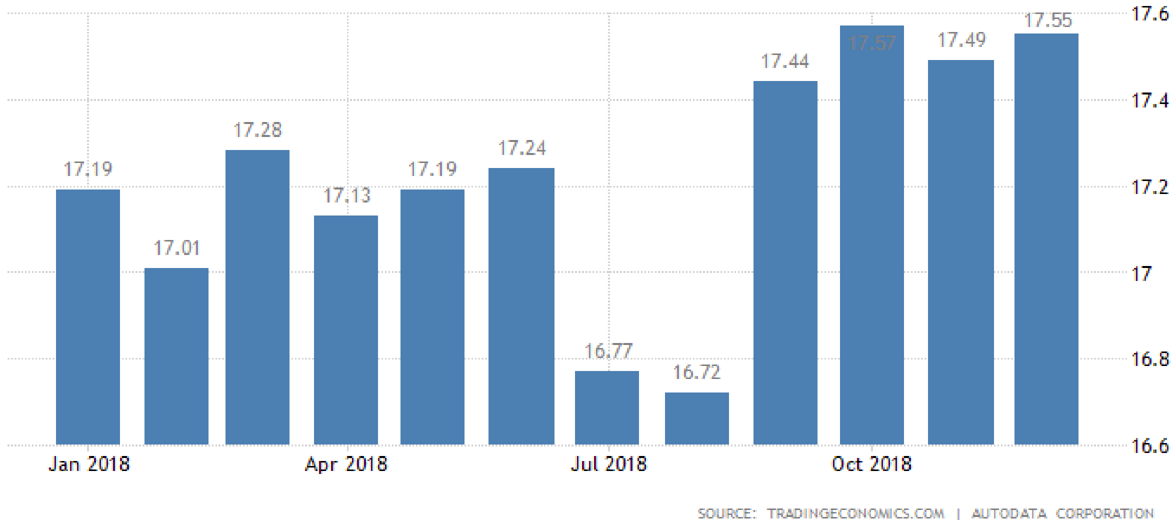
Housing sales have been falling since 2016:

Source: Mott Capital Management

There are several reasons for falling sales: affordability, many new home buyers don’t have the down payment needed, many millennials have too much student loan debt, rising mortgage rates.

As the above chart shows, mortgage rates climbed from 3.50% to almost 5%. Rates have started to fall. I will be monitoring home sales to see if lower rates make a difference in home sales.

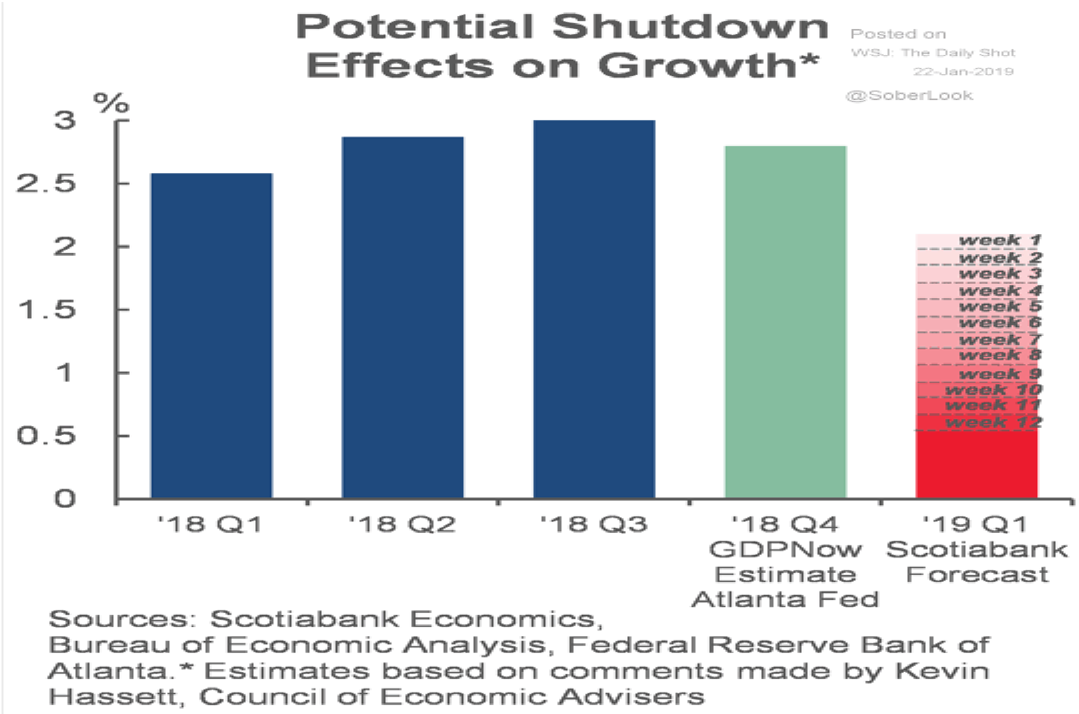
Auto sales have stalled at high levels:



There have been several reports in the financial press that auto sales have not gone down much because the auto companies are making sub-prime, risky loans to customers.

If the U.S. economy loses the consumer, the economy will struggle. As we usually do, we will follow consumer trends.

The partial government shutdown is another drag on the economy and could impact consumer confidence. Below is a chart that shows the potential impact of the government partial shutdown:



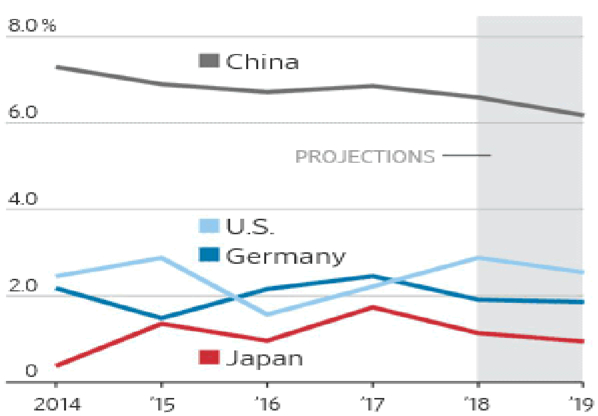
Source: Scotiabank Economics

According to chart, our economy could slow to 1.5% at this point. If the shutdown lasts longer then growth could go much lower (at the time of this writing there was an agreement made to open the government temporarily while lawmakers try to compromise on border security).

Global Economy

One of the reasons the markets have been volatile is the legitimate concerns about a slowing global economy. China's slowdown is especially a major concern.

Below is a chart that shows projected growth rates of the major global economies:



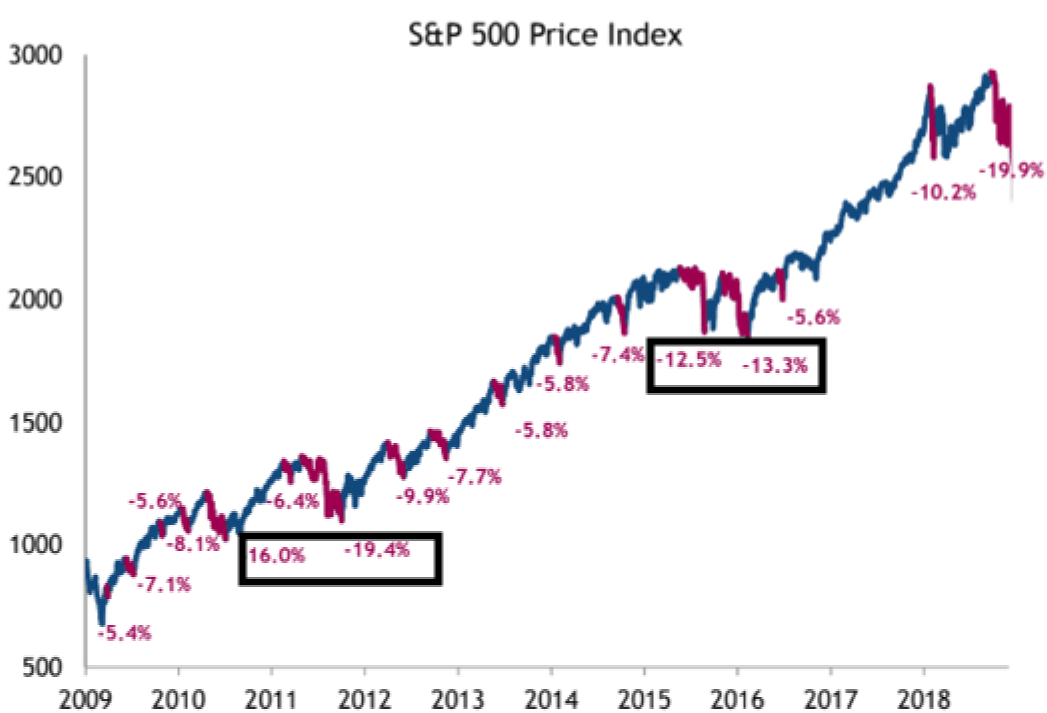
Source: International Monetary Fund

Germany is the biggest and most important economy in Europe (they are the 3rd largest economy in the world) and it's expected to slow. Japan has had a hard time of sustaining growth at the 2% level. Japan's growth rate has been weak for decades. Japan has the second biggest economy in the world.

Some analysts and the President think that they have the upper hand because the U.S. economy is stronger. Actually, China has a better growth rate and could fall more than the U.S. economy before it enters a recession. China recently announced their growth rate is its slowest since 1990, 6.4%. China's slowdown is having a global economic impact, especially in the emerging markets and global auto sales (China is the largest car market in the world). In the past, China has stimulated growth through lending to help it grow when the global economy slowed. They are stimulating lending again. In the past the capital allocation of the borrowing was poor, I wouldn't doubt that the borrowed money again would not be productive.

Europe, China and Japan are about 45% of the global economy. If they are all slowing, it would be difficult for the U.S. to escape the global downturn.

U.S. investors get blindsided by global trends that impact the U.S. economy and markets. If you review the first chart, GDP, of this Outlook you will see that the U.S. economy slowed in 2011, 2012 due to Grexit, the Arab Spring and the triple tragedy in Japan. In 2015, 2016 the U.S. economy slowed because China was shifting to a consumer driven economy from an export, manufacturing, and capital expenditures focused economy. This caused several resource based economies in the world that was supplying China for its industrial growth into recessions. We can see the impact of global events in the markets:



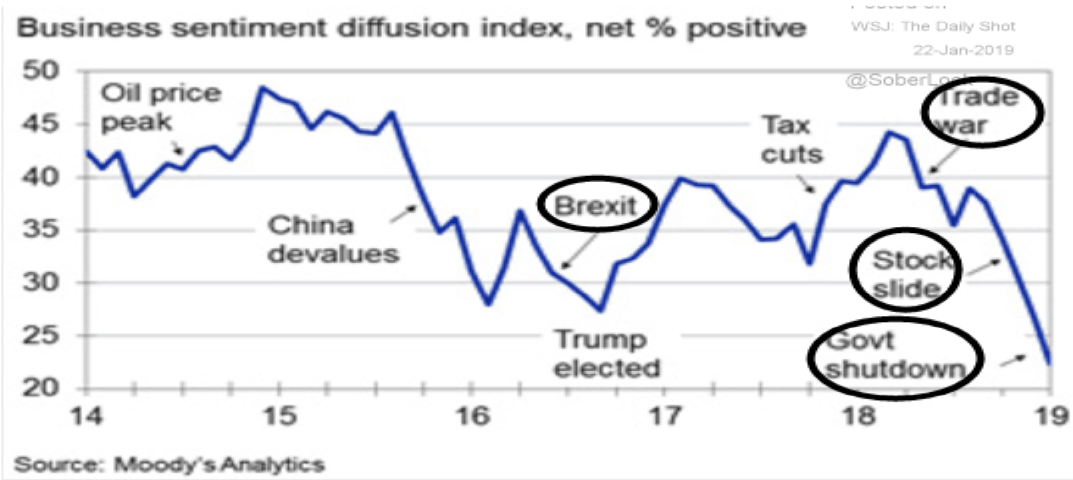
Source: The Daily Shot, SoberLook

The market was impacted by these global events in 2010 to 2012 and 21014 to 2016 and also now.

Risks Are Rising

The many 2019 economic and market outlooks that I reviewed listed many of the risks the global and U.S. economy and markets face.

Below is a chart that shows a few of the major risks for the global economy and markets:



Let's review these risks:

Brexit, there has not been a deal approved for the British to leave the EU, Brexit. As the chart shows they have been working on a deal for almost three years. They have a March 29 deadline. If they have a hard Brexit, no deal, then most economists believe Great Britain will surely have a recession. One of the sticking points ironically is a border that will run through the island of Ireland. Brexit is manifestation of growing populism in the western world. More on populism below.

U.S. tariffs and trade wars were initiated in early 2018. The tariffs are one of the main reasons for the global slowdown, especially in China.

March 1st is important and is when the U.S. may raise tariffs on Chinese imports up to 25%. If this happens, many analysts and economists believe that the global economy will go into a recession. The conflicts between the U.S. and China go beyond trade and reducing the trade deficit of the U.S., the negotiations also include technology theft, mandatory partnerships with Chinese companies, military expansion in the South China Sea.

Most economists and analysts believe there will be an agreement before March 1st, I agree. Recently China did make some concessions, good news that they want to make a deal. But the agreement will probably not include the issues listed above. Past deals have asked for a lot, but settled for less. Politically President Trump has more on the line.

We can take a cue from the theme song that Trump plays at his rallies, the Rolling Stone song 'You Can't Always Get What You Want" the next line of the song is, "but you'll get what you'll need". Has the President been trying to tell us something all along?

An agreement could reduce the uncertainty, but approval could take more time, especially with a new Democratic Congress. The new NAFTA agreement was made at the end of September and Congress has not approved it yet. A vote is expected this fall.

The longer it takes to make a deal, the more uncertainty and damage is done to the global economy. If the trade war causes Europe and China to continue to slow, it would be difficult for the U.S. to balance its trade deficit with China, it could be a Pyrrhic victory for the U.S.

The **government shutdown** is impacting consumer and business confidence and the chart on page 8 shows the potential impact on the economy. There are over 800,000 government employees impacted but if we count family members the impact is closer to 3 million citizens.

Below are more of the risks and deadlines I read about:

- The debt ceiling needs to be raised again by March 1st. Fitch, the debt rating agency warned that the government shutdown and the debt ceiling negotiations could cause them to downgrade the U.S.'s AAA rating. A downgrade would have many negative implications for our debt and borrowing needs, the interest rates we pay on our debt, and also on equity valuations.

- The Barron's 2019 outlook included an interview with bond guru Jeffrey Gundlach. He is very worried about debt around the world. Here in the U.S. he pointed out that government and corporate debt is too high. Corporate debt is about $9.6 trillion compared to $5.5 trillion 10 years ago. Corporate debt is about 45% of GDP, a historic high and the 40% of the debt is rated BBB. If we go into recession, it will be difficult for some of these companies to service or rollover their debt.

Bond and income investors are vulnerable. Several of the outlooks were concerned about big and small investors in a low interest rate environment reached for higher yields and took on much more risk by investing in "alternative" income investments. Businessweek stated that these type of investments are worth about $1 trillion. When the economy slows down some of these investments could get in trouble and some could go into default.

I mentioned in my *Trumponomics and Tax Reform* report that when we go into a recession the Treasury will have less revenue from the tax cuts and a slowing economy. Also, expenses due to increased Social Security and Medicare payouts because of baby boomers retiring in large numbers will cause the deficits to explode and the national debt to get worse. Click here to read my Trumponomics and tax reform report.

- The U.S. pulled out of the global nuclear agreement with Iran and established harsh sanctions with Iran. The U.S. did give waivers to many of the buyers of Iranian oil. The waivers were established in early November and were for six months. If the sanctions are put back on, oil prices could spike and Iran could retaliate militarily or through cyberattacks as they have in the past.

- Venezuela is a problem on two fronts: 1. Oil production continues to fall. Before Hugo Chavez came to power, oil production was more than 3 million barrels a day it is now 1.4 million barrels a day and going lower. Oil prices could move higher if sanctions are put back on Iran, and Venezuela oil production continues to fall 2. The Venezuelan economy is crumbling with 1,000,000% inflation and is causing social unrest.Venezuelans are fleeing to neighboring countries as refugees.

- Populism, I was surprised to read that several analysts had mentioned populism as a risk to the global economy. Countries like the U.S., Great Britain, Italy, Germany are against the elites running things while the average citizen is being left behind, they are also against immigrants and becoming nationalists and against globalism. The populism movement is causing changes and disruptions to the global economy.

- The Mueller report and Democrat investigations could sidetrack the President and his administration. So far there have been 5 guilty pleas and a growing list of indictments. This will probably get worse and is getting closer to the President. Businessweek reported that there will probably be about a dozen investigations into the Presidents financial ties to Russia, campaign contributions, potential tax evasion, business dealings, handling of Hurricane Maria and Puerto Rico…

- The President has lots of balls in the air (North Korea, Iran, Russia, Afghanistan, trade wars especially with China, healthcare, budgets, the Russian investigation, immigration reform, the U.S. economy, improving job skills and education of U.S. workers) and the probability of mishap has increased. Will the President be able to deliver positive outcomes for all these important issues?

- Cyberattacks were also mentioned. Cyberattacks by criminals and U.S. adversaries will continue to be disruptive and could be serious especially if they go after our infrastructure like our power grids, water supplies, food supplies….

- Black swans, low probability but high impact events, are always a risk, this includes: wars; weather related droughts, floods, hurricanes; major energy supply disruptions….

Conclusion and Summary

- Most economists see momentum from the tax cuts, high consumer and business confidence extend into 2019. GDP growth is expected to be about 2.5%. The first quarter for 2019 will probably be weak because of the government shutdown, trade wars and cold weather. This cycle we have had several weak 1st quarters.

- Most economists don’t see a recession in 2019. Economists have been bad at predicting recessions as predicting the future is very difficult. Most economists agree we are in the very late stages of this economic cycle that started about 10 years ago. This cycle may be the longest in our economic history.

- 2018 saw increased volatility in all markets. We will probably see increased volatility as there will probably be more bad headline news versus good headline news.

- Most of the bad news will probably be geopolitical: North Korea, Iran, the Middle East, Brexit, and growing Western populism.

- Most economists and analysts believe the biggest risk is the trade war with China. If the trade war drags on more, China and the rest of the world could fall into a global recession.

- When we eventually go into a recession, corporate and government debt could make the recession worse. Rising rates, a slowing economy and too much debt and bad allocation of capital is normally what causes recessions.

- The President has lots of balls in the air: North Korea, Iran, trade war with China, Afghanistan, Yemen, the Mueller and Democrat investigations, budget negotiations, immigration reform and border security…. The probability of a ball being dropped keeps increasing.

I will issue my 2019 Market Outlook in a few weeks. Again, expect more volatility than last year.

If you would like to have a second opinion on your portfolio, I do provide a free portfolio review, including up to three full stock analysis including price targets and fundamental and technical analysis.