



## Economic Review - Fourth Quarter 2018

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### Summary

The state of the general economy can help or hinder a business' prospects by influencing the demand for its goods and services and the availability and price of inputs such as capital and labor. The prevailing economic conditions therefore directly impact the value of a business at a specific point in time. The economic expansion that began in June 2009 is the second longest since the 1850s,<sup>1</sup> but growth has been modest, especially considering the severity of the "Great Recession" of 2007–2009. Recoveries after severe recessions have historically been more robust, as the economy recovers lost ground. The absence of stronger growth is particularly noteworthy given the extraordinarily accommodative monetary policy in recent years.

Following the December 18-19, 2018, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity increased at a strong rate in the fourth quarter of 2018. Labor market conditions continued to strengthen in the fourth quarter as non-farm payroll employment expanded, the unemployment rate remained low at 3.9 percent in December, and the labor force participation rate rose slightly. Additionally, the rate of private sector job openings remained near the previous quarters' high levels, and average hourly earnings increased 3.1 percent over the 12 months ending in November.<sup>2</sup> U.S. consumer price inflation and core price inflation, which excludes consumer food and energy prices, have remained near the Committee's long-run objective of 2.0 percent.

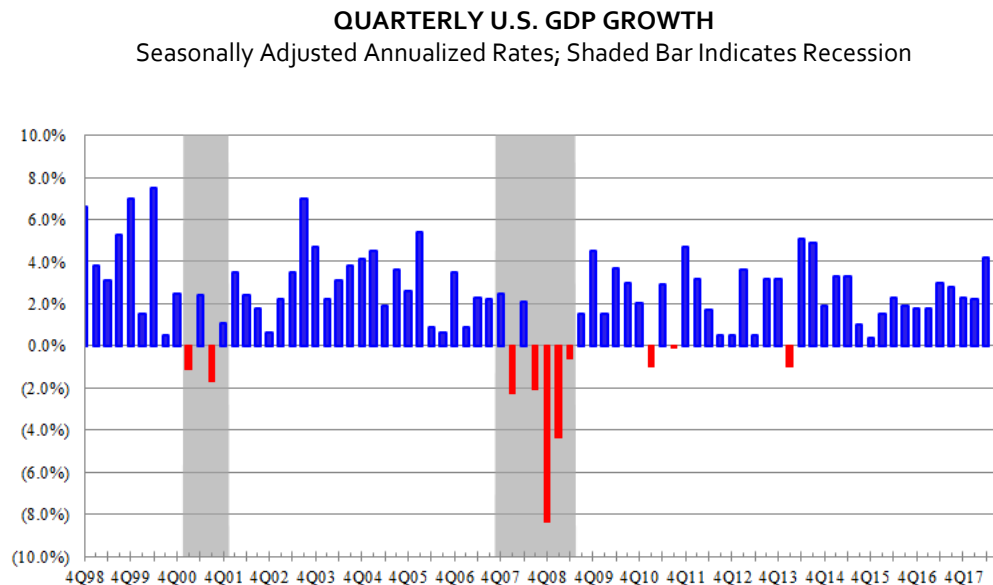
Industrial production expanded in the fourth quarter of 2018. Household spending grew at a strong pace in the fourth quarter, supported by strong employment levels, gains in real disposable income, and the tax cuts in December 2017. Housing activity was mixed, with starts on single-family homes continuing to decline below third quarter rates, while multi-family homes rebounded from recent declines with a strong December. Issuance of building permits continued to fall throughout the fourth quarter, and sales of new homes declined while existing home sales increased moderately. Real private expenditures grew modestly in the fourth quarter following a flattening in the third quarter of 2018. Nominal shipments and new orders of non-defense capital goods excluding aircraft grew in October and is expected to continue its growth in the near-term based on forward-looking factors. Additionally, real business spending for nonresidential buildings grew in October, and the number of



crude oil and natural gas rigs in operation held steady, following similar patterns from the third quarter 2018.

## Gross Domestic Product

The U.S. Bureau of Economic Analysis estimates that real gross domestic product (GDP)—the output of goods and services produced by labor and property located in the United States — increased at an annual rate of 3.4 percent in the third quarter of 2018. Quarterly GDP data for the preceding 20 years is shown in the following figure.



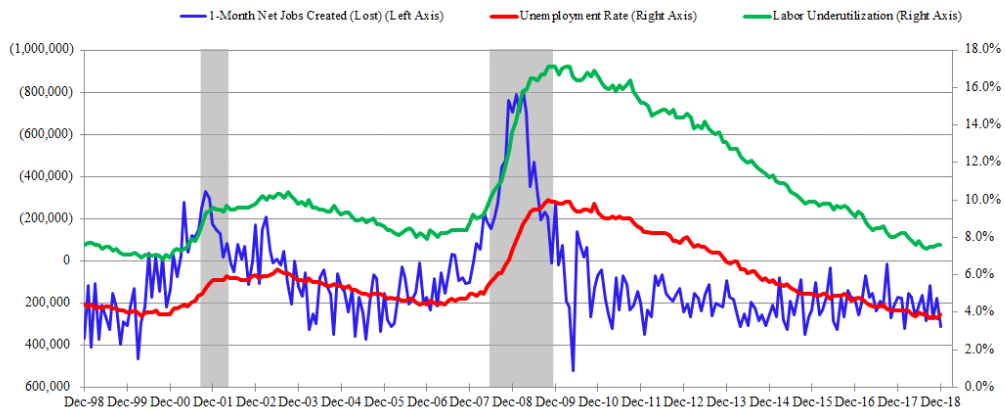
Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research. GDP percent change is based on chained 2012 dollars.

## Employment

Employment conditions in the United States have been improving. In the 25 consecutive months from February 2008 to February 2010, 8.7 million non-farm jobs (net) were lost. In the 106 consecutive months from March 2010 to December 2018, 20.5 million non-farm jobs (net) were created.<sup>3</sup> The unemployment rate peaked at 10.0 percent in October 2009, fell to a 49-year low of 3.7 percent in September 2018, and was 3.9 percent in December 2018.<sup>4</sup> A more expansive measure of labor underutilization, including discouraged workers who have left the workforce and part-time workers who would prefer full-time work, was 7.6 percent as of December 2018, near the 17-year low of 7.4 percent in August 2018.<sup>5</sup> Unemployment and underemployment restrain economic growth as consumers are unable or hesitant to spend. The past 20 years of employment data are presented in the following figure.



### MEASURES OF STRESS IN THE LABOR MARKET Shaded Bar Indicates Recession



*Sources:* Department of Labor, Bureau of Labor Statistics, and National Bureau of Economic Research. Data represents non-farm payrolls.

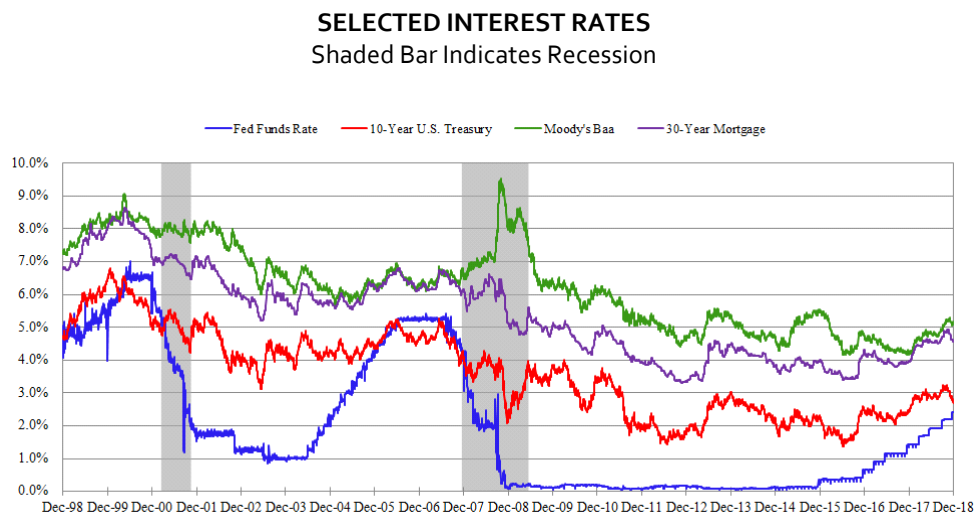
## Interest Rates

The Committee meets periodically to assess economic conditions and determine appropriate policies to fulfill its dual mandate of fostering maximum employment and price stability. At its December 18-19, 2018, meeting, the Committee considered the outlook for economic activity, the labor market, and inflation. The Committee weighed the uncertainties associated with the economic outlook and raised the federal funds rate from a range of 2.00-to-2.25 percent to a range of 2.25-to-2.50 percent. The Committee expects that gradual increases in the target range for the federal funds rate to be consistent with the sustained growth of economic activity, labor conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term.

United States financial markets were supportive of economic growth and employment in the fourth quarter of 2018. Both corporate bond spreads and short-term Treasury yields rose in the fourth quarter, although both rates remained near the lower end of their historical range. Long-term Treasury yields and 30-year mortgage rates, however, decreased during the quarter reflecting a flattening of the yield curve. Measures of inflation based on treasury-inflation-protected securities decreased notably, largely credited to declines in oil prices throughout the fourth quarter. Municipal bond issuance remained accommodative in the fourth quarter. The issuance of institutional leveraged loans slowed in November, while corporate bond issuance began to flatten and settled near its historical norm. Financing conditions for consumers remained supportive of growth in household spending; however, consumer credit decreased in October and November below their average levels. Conditions for commercial real estate loans remained accommodative and consistent with previous quarters' growth. Conditions for residential mortgage financing remained accommodative for most



borrowers; however, the demand for mortgage credit lightened. The past 20 years of historical interest rate data are shown in the following figure.



*Source:* Federal Reserve Statistical Release H.15 (519) Selected Interest Rates.

## Stock Market Activity

The fourth quarter of 2018 provided one of the worst performing and most volatile quarters since the 2008 recession, with all major U.S. stock market indices reporting double digit losses, driving negative returns for calendar year 2018. The sizable losses during the fourth quarter reverted market benchmarks back to levels last seen in the summer of 2017.

The stock market became very volatile in the fourth quarter. The ongoing trade dispute between the United States and China led to continued uncertainty as to when or if the conflict will settle. In addition to trade, pessimism and volatility in the stock market were fueled by rising interest rates, yield curve inversion, concerns of growing inflation, weaker jobless claim data, and the federal government shutdown that began on December 22, 2018.

As discussed, all the major stock market benchmarks suffered severe losses in the fourth quarter. The Chicago Board Options Exchange Volatility Index (VIX) surged in the fourth quarter to its highest mark in over three years. The technology sector plummeted, propelling the NASDAQ Composite Index to the biggest loss among the three main indices, followed by the S&P 500 Index and the Dow Jones Industrial Average Index. The Russell 2000 Index trailed the major indices as small-cap companies were impacted even more than large-cap firms. The lone segment to experience any gains during the fourth quarter was the defensive utilities sector. Total returns for U.S. stock indices during the fourth quarter of 2018 are shown in the following figure.



### TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Fourth Quarter	
	2018	2018
S&P 500	(13.5%)	(4.4%)
Dow Jones Industrial Average	(11.3%)	(3.5%)
NASDAQ Composite (1)	(17.5%)	(3.9%)
S&P MidCap 400	(17.3%)	(11.1%)
Russell 2000	(20.2%)	(11.0%)

*Note:*

(1) Return represents principal only.

## Trade

The trade dispute between the U.S. and China continued in the fourth quarter of 2018, with both countries failing to develop any form of a free trade agreement or mutually-agreed policy. The United States has focused tariffs on Chinese technology imports, while China has aimed tariffs on U.S. agricultural goods. There is some optimism, however, as both sides agreed to temporarily refrain from additional tariffs following a meeting between the U.S. and Chinese presidents in December.<sup>6</sup> While this is not a complete halt to the trade war, it is an agreement not to escalate tariffs or trade policy until China and U.S. trade officials meet in 2019.

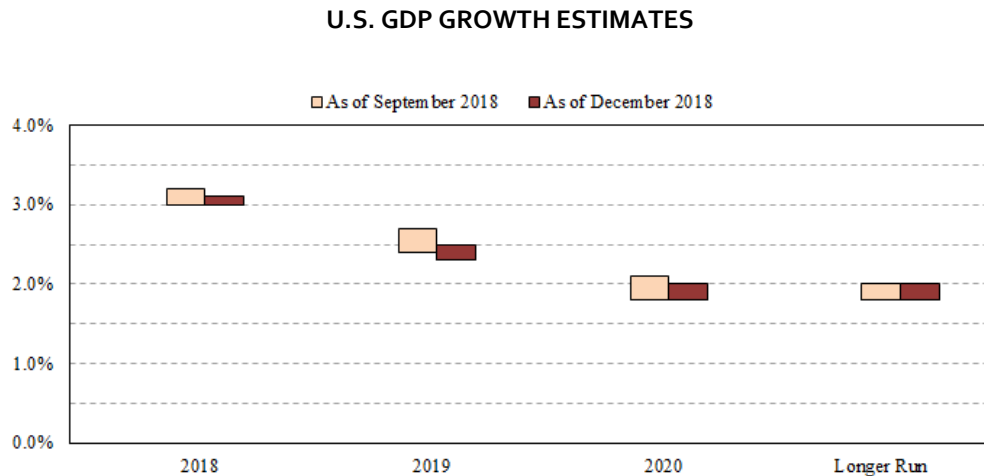
## U.S. Federal Government Shutdown

As of December 22, 2018, the U.S. Federal Government failed to pass a continuing resolution to fund roughly 25 percent of its operations, excluding a handful of agencies that are deemed "essential" (such as the Transportation Security Administration, the Social Security Administration, Medicare and Medicaid, the U.S. Postal Service, as well as others). However, the following departments of the Federal Government will remain closed until an appropriations bill is signed by the President: the Departments of Commerce, Agriculture, Interior, Transportation, Justice, Treasury, Homeland Security, Housing and Urban Development, and State. The closure of these nine government departments is expected to directly impact an estimated 800,000 federal employees who may be forced to work without pay, or be furloughed for the duration of the shutdown, plus federal contractors and others indirectly employed by the U.S. government.<sup>7</sup> While the immediate effects of the government shutdown are unknown, some reduction to GDP is likely. Most studies suggest for every week the shutdown lasts, GDP growth that quarter will decrease 0.05 to 0.1 percentage points.<sup>8</sup>



## Outlook

Various statistical reporting agencies provide estimates of the U.S. economy's near-term and longer-term growth rates. The Federal Reserve's projected growth rates for the U.S. economy for 2018–2020 decreased slightly from September to December, reflecting the Federal Reserve's continued raising of interest rates. The projected growth rates for the longer run remain unchanged from September's report. The estimates for U.S. GDP growth are presented in the following figure.



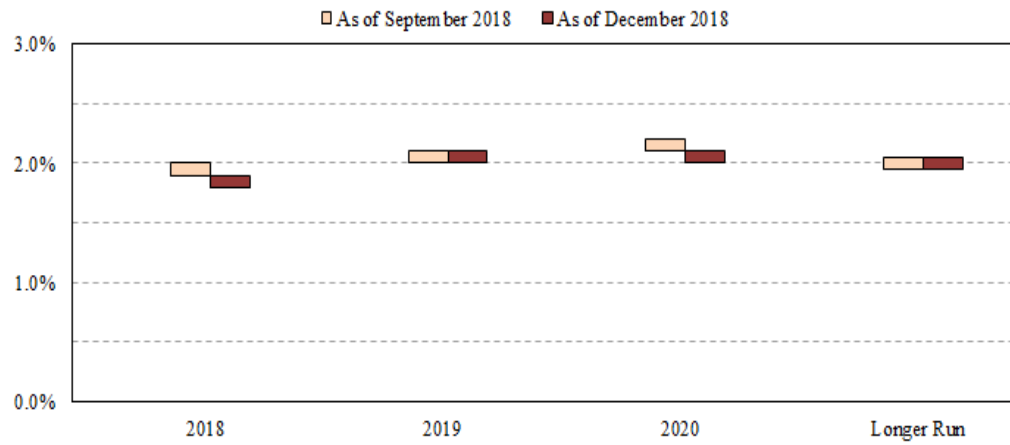
Source: Federal Reserve.

The U.S. Department of the Treasury's November 30, 2018, Treasury Statement of Receipts and Outlays of the United States Government states that the federal budget deficit for the first two months of fiscal year 2019 was \$305 billion, in comparison to \$202 billion for the same period in fiscal year 2018.<sup>9</sup> The CBO August 2018 report expects that the growth in real GDP for 2018 will be driven by business investment and government purchases; growth in 2019 will be primarily supported by consumer spending.<sup>10</sup> Real GDP is projected to grow 3.1 percent in calendar year 2018, 2.4 percent in calendar year 2019, and 1.7 percent in calendar year 2020.<sup>10</sup> The CBO estimates excess demand to push inflation above the Federal Reserve's 2.0 percent target for a brief period this year, then stabilize near 2.0 percent in the following years. Interest rates are expected to increase as the Federal Reserve has indicated further rate hikes to the Federal Funds Rate, which will exert upward pressure on the unemployment rate, which has been below the natural rate since late 2017. Higher interest rates are expected to slow the output growth, and excess demand is expected to begin to diminish after 2019.<sup>12</sup> Real GDP is expected to grow, on average, at an annual rate of 1.7 percent in 2020, 1.6 percent from 2021 through 2022, and 1.7 percent from 2023–2028.<sup>13</sup>

Inflation, as measured by the core personal consumption expenditure (PCE), which excludes the effects of food and energy, is forecast to be 2.0 percent in 2018, 2.1 percent in 2019 and 2020, and average 2.0 percent per year in the longer run.<sup>14</sup> The estimates for core PCE inflation rates are presented in the following figure.



### U.S. CORE PCE INFLATION ESTIMATES



Source: Federal Reserve.

Disclaimer: this article has content that is general and informational in nature. This document is not intended to be accounting, tax, legal, or investment advice. Data from third parties is believed to be reliable, but no assurance is made as to the accuracy or completeness.



*Endnotes:*

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2. Federal Reserve Bank of St. Louis. <<https://fred.stlouisfed.org/series/LMJVPRUVUSQ175S>>.
3. Bureau of Labor Statistics. "Employment, Hours, and Earnings from the Current Employment Statistics survey (National)."  
<[http://data.bls.gov/timeseries/CES0000000001?output\\_view=net\\_1mth](http://data.bls.gov/timeseries/CES0000000001?output_view=net_1mth)>.
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