LPL RESEARCH
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COMMENTARY

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MODERATE GROWTH AHEAD

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KEY TAKEAWAYS

Fundamentals continue to support steady but moderate economic growth.

Even if growth slows, the U.S. job market continues to be a bright spot.

Productivity growth is the key to sustaining a virtuous cycle.

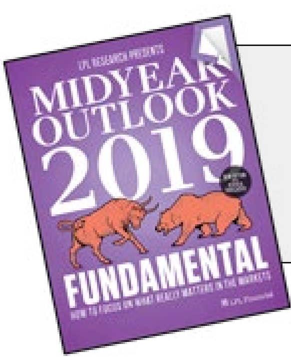
Progress on trade is central to our growth projections.

Fundamentals continue to support steady but moderate economic growth in 2019. That said, progress on trade is central to our growth projections, so we've slightly reduced our gross domestic product (GDP) forecast to 2.25–2.5%. Here we share our domestic and global economic growth outlooks for the second half of this year, featuring content from our just-released *Midyear Outlook 2019*.

U.S. ECONOMY

The U.S. economy grew at 3.1% in the first quarter as domestic demand held up well in the face of a government shutdown and trade headwinds. Consumer spending was a modest contributor to GDP, while business investment slowed but still posted growth. Data have weakened some in the second quarter but bright spots remain, including a healthy job market.

With the Fed on hold and fiscal stimulus in place, we believe fundamentals are supportive of continued moderate GDP growth this year. We believe fiscal stimulus from the Tax Cuts and Jobs Act of 2017, along with decreased regulation and increased government spending, will continue to support the U.S. economy in 2019, and that the potential impact is both larger and more durable than consensus expectations. However, progress on trade remains central to our growth projections, and continued uncertainty, despite recent positive news of resumed U.S.-China negotiations following the meeting between President Trump and China's President Xi at the G-20 summit in Japan, has led us to



Please see our *Midyear Outlook 2019: FUNDAMENTAL: How to Focus on What Really Matters in the Markets* publication for insights on the economy, stock and bond markets, and investments for the remainder of the year.

slightly reduce our 2019 GDP forecast compared to our outlook at the end of 2018 [Figure 1].

INFLATION

We believe this pace of growth is consistent with an economy that is able to generate solid demand without creating excessive inflationary pressure—a situation that benefits investors while giving the Fed added flexibility. Year-over-year growth in consumer inflation ran just under 2% in the first half of 2019, well contained despite tightening labor markets.

This disconnect between a tight labor market and inflation has puzzled monetary policymakers, whose goal is to maintain low and stable inflation. We suspect several longer-term trends have kept inflation at bay, including globalization, retiring baby boomers, and a strong U.S. dollar.

Wages and wholesale prices continue to grow at a healthy clip, showing us that pricing pressures are building underneath the surface. Based on these building pressures, we expect the core Consumer Price Index (CPI), which excludes food and energy prices, to grow 2–2.25% year over year in 2019. At that pace, consumer inflation would grow roughly at the same rate as it did in 2018.

JOBS AND PRODUCTIVITY

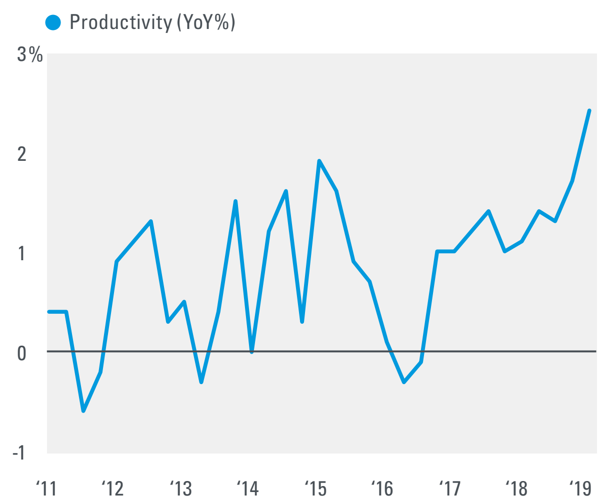
Even if growth slows, the U.S. job market continues to be a bright spot. Hiring has continued at an above-average pace for the expansion, and weekly claims for unemployment benefits have dropped to cycle lows several times this year. Strong job growth leads to higher incomes, stronger business and consumer spending, and improved corporate profitability. Productivity growth, though, is the key to sustaining this virtuous cycle. We saw a glimpse of this in the first quarter, as productivity grew at the strongest pace since 2010 [Figure 2].

1 ECONOMIC FORECASTS

	2018	2019 (Est.)
REAL GDP (YEAR OVER YEAR, %)		
U.S.	2.9%	2.25–2.5%
Developed ex-U.S.	1.8%	2.1%
Emerging Markets	4.5%	4.4%
Global	3.6%	3.5%
U.S. ECONOMIC DATA		
Inflation (YoY%)	2.2%	2.25–2.5%
Unemployment	3.9%	3.6%

Source: LPL Research, Bloomberg, International Monetary Fund (IMF) 05/31/19
2019 U.S. GDP estimates, global GDP estimate, inflation, and unemployment are LPL forecasts. Developed ex–U.S. and emerging markets GDP forecasts are IMF projections. Inflation is measured by the Consumer Price Index excluding food and energy.

2 PRODUCTIVITY IMPROVING



Source: LPL Research, U.S. Bureau of Labor Statistics 05/31/19

Higher productivity becomes the primary driver of economic growth for an economy near full employment, and it lifts profit margins by boosting output and lowering labor costs. Trade uncertainty is becoming an increasing risk to productivity-supporting business investment, countering a boost from pro-growth deregulation and tax relief. If trade uncertainty or a failed negotiation dampens business investment, strong productivity growth may be difficult to sustain. If U.S.-China trade talks stall further or fail, we estimate the hit to confidence and business investment could subtract 0.5–0.75% from U.S. GDP growth over the next year. On the other hand, trade clarity could motivate businesses to resume expansion plans and capital investment.

GLOBAL ECONOMY

Even if revised downward, U.S. growth expectations have been holding up relatively well compared with global growth prospects. While trade-related tensions have had some impact on global growth, we believe the repercussions have been small to date and that structural issues abroad have been the main culprit in the global slowdown.

Europe in particular still faces a variety of political and economic challenges. The United Kingdom's Brexit process, messy from the start, continues to unravel; France is contending with the "yellow vest" protests; Germany is battling weaker manufacturing; and Italy is struggling with the difficult budget negotiations of an unsettled governing coalition. Trade concerns also remain in play for Europe, with important trade discussions with the United States on agriculture and autos still outstanding.

These structural issues have also impacted the monetary policy outlook, with the European Central Bank (ECB) pushing back plans to raise rates and reduce the size of the ECB's balance sheet. In fact, speculation of an ECB rate cut and another round of quantitative easing ramped up last week after comments from ECB President Mario Draghi.

In Japan, programs to increase government spending and reduce rates have supported growth. However, true structural reforms remain elusive. Consumer sentiment has also weakened ahead of the value-added tax (VAT) increase scheduled for the fourth quarter of 2019. Though Japan's recent GDP growth has exceeded expectations, we suspect higher activity comes at the expense of growth in subsequent quarters.

We still expect emerging markets (EM) to set the pace for global GDP. Beijing's intervention has stabilized demand in China, but trade uncertainty continues to weigh on confidence and investment, suggesting the possibility for further stimulus. These policy efforts should support export growth in the rest of emerging Asia. In India, we still expect GDP growth to outpace the rest of EM over the next few years, even as stimulus wanes following the Indian elections. Growth in emerging Europe remains weak, indicating the need for central bank accommodation in Turkey and Russia. We expect Mexico to continue to lead growth in Latin America, as Brazil struggles to gain traction.

We still see the United States as a growth leader in the developed world, but emerging markets continue to play an increasing role in the global economy, with the pace of growth leadership shifting from China to India.

CONCLUSION

At the halfway point of 2019, the U.S. economy has held steady, supported by fiscal stimulus, and corporate profits continue to grow. At the same time, trade tensions are increasingly weighing on the economic outlook, although recent progress at the G-20 meeting in Japan was encouraging, while slowing global growth and political uncertainty have forced global central bankers to extend extraordinary levels of support. We will continue to monitor the impact of trade developments on the indicators we watch. For now, the odds of a near-term recession appear to remain low. ■

DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

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