LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

February 25 2019

ECONOMIC DATA FAQs

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KEY TAKEAWAYS

Recent economic data have been consistently missing consensus estimates.

We still see signs of sound economic fundamentals, even as some data point to weakness.

We expect growth to stabilize as near-term headwinds subside.

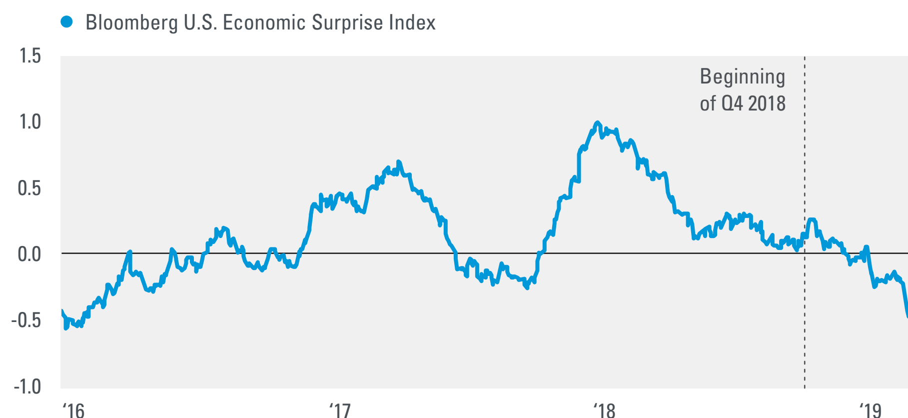
Investors are sifting through a deluge of backlogged data after a historic U.S. government shutdown. As data have caught up, many reports have missed consensus estimates, stoking fears that Wall Street may be overlooking a slowdown in the U.S. economy [Figure 1].

To help allay those fears, we're addressing some questions we've received about the economic landscape recently, and provide our thoughts on what to look for in gauging economic health.

ARE WE NEARING A RECESSION?

We don't expect a U.S. economic recession this year for several reasons, many of which we outlined in our *Outlook 2019*. The best gauge of output, though, is the U.S. consumer, as consumer spending accounts for about 70% of gross domestic product (GDP). While a healthy job market and solid wage gains are more conducive to consumer activity than at any other point in this economic cycle, a wave of negative headlines has hampered spending as of late. December's retail sales unexpectedly fell 1.2% year over year, the worst drop since September 2009 and far below consensus estimates for 0.2% growth.

1 ECONOMIC DATA RELATIVE TO CONSENSUS HITS 3-YEAR LOW



Source: LPL Research, Bloomberg 02/21/19

The Bloomberg U.S. Economic Surprise Index shows the degree to which economic analysts under- or over-estimate the trends in the business cycle. The values of the index are Z-scores, which represent the number of standard deviations that analyst expectations lie above or below normal surprise levels.

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Some economists have questioned the report's accuracy, but consumer confidence has dropped sharply over the past few months, so lower spending is somewhat warranted. Trends in retail sales have historically been tightly correlated with longer-term GDP growth, and year-over-year retail sales growth has slipped noticeably since July 2018 [Figure 2]. Since the latest retail sales report was released, consensus expectations for fourth quarter GDP have dropped to 1.5–2.5%. If GDP growth comes in at the lower end of that range, it would be the slowest quarter of growth in three years.

Slowing growth is expected this late in the cycle, and we expect GDP growth to moderate from the 3% quarterly growth we saw last year. We do expect a slower pace of growth in 2019, but we believe the odds of a recession remain low. With fiscal stimulus still in play, the government shutdown drama resolved, the Federal Reserve (Fed) on hold, and a strong rebound in equity markets, consumer spending is likely to bounce back, even if the full recovery may be delayed into the second quarter. We'll be monitoring this week's GDP report for more clues on the factors driving output growth.

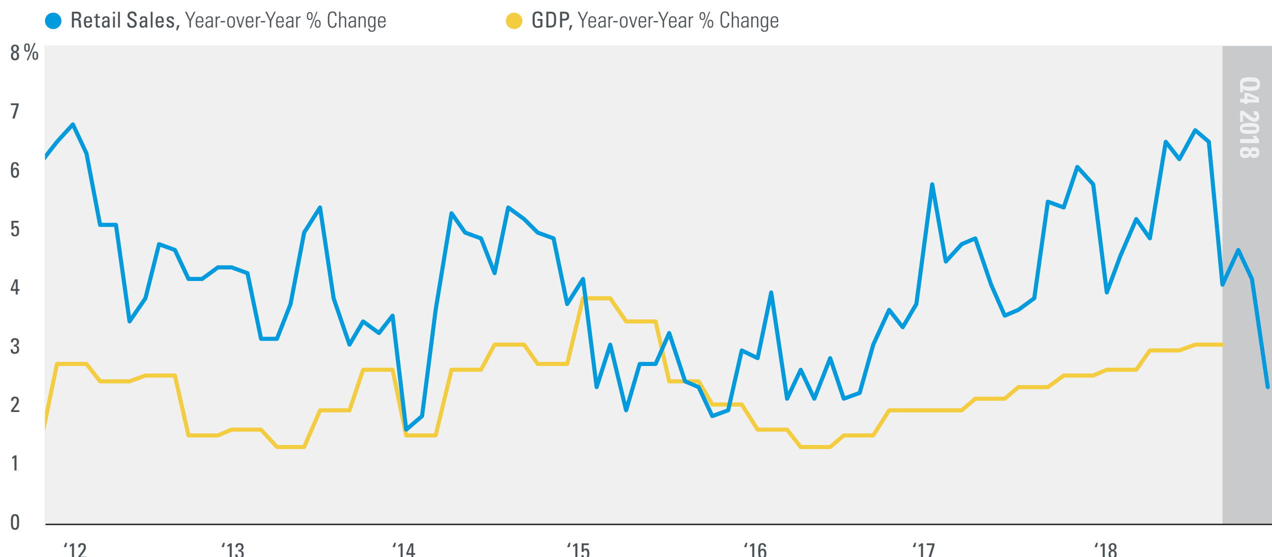
WHAT ABOUT BUSINESSES?

U.S. companies are wrapping up another earnings season of double-digit profit growth. Business's top- and bottom-line health appears solid, but the corporate outlook is dimming. Gauges of business optimism have declined, first-quarter profit expectations have dropped at an above-average rate, and companies have put expansion plans on hold as they wait for a resolution to global headwinds.

We've been especially discouraged by recent data showing tepid growth in capital expenditures, as stronger growth in business investment is crucial this late in the expansion. Higher capital investment boosts productivity, which effectively caps labor costs and helps support profit margins. The latest durable goods report showed growth in new orders of nondefense capital goods (ex-aircraft), our best proxy for capital expenditures, unexpectedly fell 0.7% month over month. Part of the recent drop could be from waning overseas demand, which has weighed on global manufacturing, but declines in other corporate-focused reports show domestic corporate appetite has taken a hit too.

We expect business spending to pick up once corporations get more clarity on trade, helped by

2 RETAIL SALES' SLOWDOWN COULD WEIGH ON FOURTH QUARTER GDP



Source: LPL Research, U.S. Census Bureau, Bureau of Economic Analysis 02/21/19

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aspects of the Tax Cuts and Jobs Act designed to encourage business investment. However, we likely have seen peak earnings growth this cycle, and our lower GDP forecast for 2019 is partially due to muted capital expenditures in the second half of 2018.

TOO MUCH INFLATION, OR TOO LITTLE?

Inflation data have been under a microscope recently as investors have tried to reconcile evidence of a slowing global economy with cycle highs in pricing and wage growth. Financial markets' inflation expectations have fluctuated this year after investors interpreted the Fed's patient policy approach as a sign policymakers won't stifle growth by raising rates at the pace seen in 2017 and 2018. While the Fed has likely paused, we think any future rate hikes will be primarily in response to upside inflationary risks.

Data released this month showed the core Consumer Price Index (CPI) rose 2.2% year over year in January, while the core Producer Price Index (PPI) climbed 2.8%. To us, current core inflation, which strips out the impact from food and energy prices, is manageable enough that it won't force the Fed's hand into additional policy tightening in the near term. U.S. inflation has also been largely immune from declining inflationary pressures overseas, and we see no signs of a domestic deflationary threat. We expect slightly higher (but manageable) inflation in 2019 amid a tight U.S. labor market, a flexible Fed, and prospects for moderate output growth, especially if near-term headwinds subside. Core CPI has hovered around 2% for the bulk of this tightening cycle as quarterly GDP growth has averaged slightly above 2%, which aligns with the Fed's 2% growth target for core personal consumption expenditures inflation.

CONCLUSION

Investors have been understandably skittish about the economic environment these days. While it has been difficult to decipher trends from the recent data deluge, the indicators we track point to sound economic fundamentals despite signs of slowing. Overall, we project 2019 GDP growth around 2.5%, a respectable pace for the tenth year of an expansion, and low odds of a recession this year. ■

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