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# OUR FINAL FOUR FOR THE U.S. ECONOMY

John Lynch *Chief Investment Strategist, LPL Financial*  
Barry Gilbert, PhD, CFA *Asset Allocation Strategist, LPL Financial*  
Callie Cox, *Senior Analyst, LPL Financial*

## KEY TAKEAWAYS

We've picked our Final Four, or factors, to watch in this leg of the economic expansion.

The Fed's patience is appropriate in guiding the U.S. economy through late-cycle volatility.

A rebound in global conditions, capital expenditures, and sentiment may help fuel growth.

Wall Street is watching a litany of telling economic and market signals, but the rest of the world is watching college basketball. Four teams will be left standing after tonight (April 1) in both the NCAA men's and women's college basketball championships, and new national champions will be crowned in just a week.

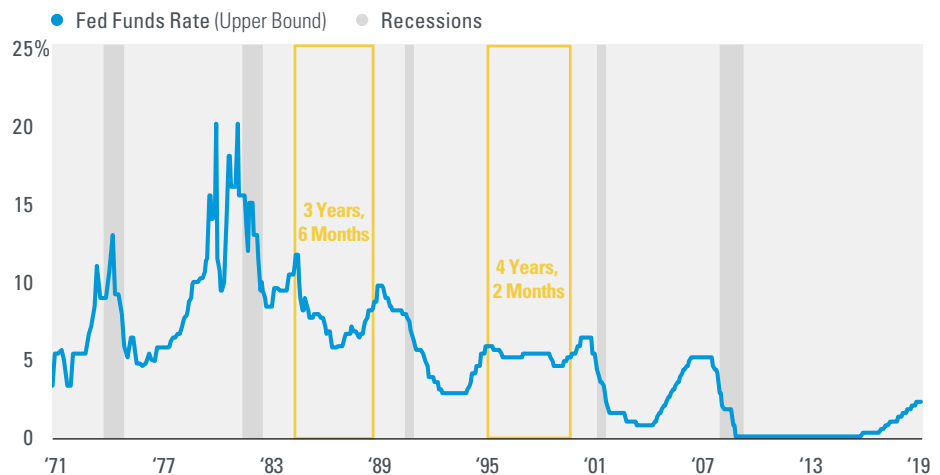
A few upsets have happened this quarter, and both brackets and economic forecasts have been busted. As investors sift through conflicting signals in economic and market data, we thought we'd highlight our own Final Four, or the four biggest catalysts we think could jump-start economic growth nearly 10 years into this expansion.

## #1: A CAUTIOUS FED

Defense wins championships, and Federal Reserve (Fed) bankers are defenders of a healthy economy by promoting maximum employment and stable inflation. The durability of the current economic cycle has been helped in part by the Fed's gradual approach to tightening policy. The labor market is at its tightest point of the cycle, and inflation has hovered around the Fed's target for several months.

But the Fed may be done tightening for now, and investors are scrambling for clues on what the U.S. economy could look like during this policy switch.

### 1 FED ADJUSTMENT PERIODS CAN LAST FOR YEARS WITHOUT RECESSION



Source: LPL Research, Federal Reserve 03/28/19  
The economic forecasts may not develop as predicted.

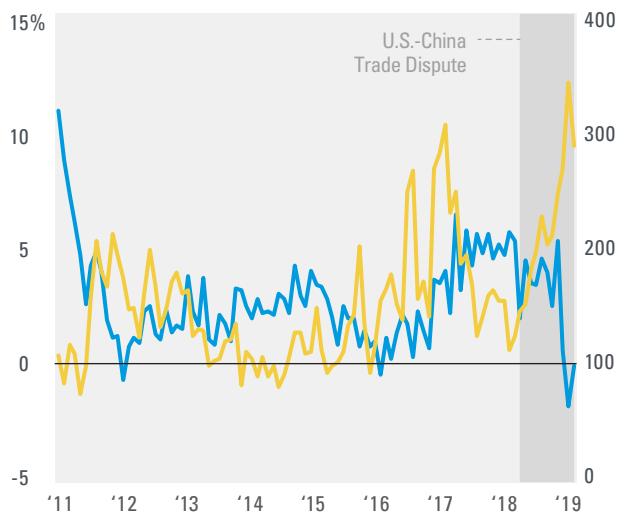
Policymakers have maintained that U.S. economic fundamentals are sound and the pause is due to a lack of global clarity. However, the bond market has flashed some recessionary signals through the yield curve, and signs of slowing have emerged in pockets of the domestic economy.

A pause, or even a rate cut, doesn't necessarily mean impending economic turbulence, though. In fact, there is precedent for the Fed taking a break from tightening in favor of a wait-and-see adjustment period [Figure 1].

From August 1984 to February 1988, the Fed cut rates almost 6% over three and a half years. Another Fed adjustment period took place from June 1995 through May 1999, when policymakers cut rates as much as 1.25% over almost four years. Both pauses occurred about six years before the next economic recession started. We might not have six years left before a downturn, but a change in policy isn't necessarily a reason to expect imminent weakness. The Fed has also engaged in

## 2 UNCERTAINTY RISES AS GLOBAL TRADE STALLS

- Annual Change in World Trade Activity (Left Scale)
- Global Economic Policy Uncertainty Index (Right Scale)



Source: LPL Research, CPB Netherlands Bureau for Economic Policy Analysis, Baker Bloom Davis 03/28/19

The Baker Bloom Davis Global Economic Policy Uncertainty Index is a measure of policy-related uncertainty derived from newspaper coverage of policy-related economic uncertainty.

one of the longest tightening cycles over the past 50 years while unwinding a balance sheet bloated from massive amounts of bond-buying. From that perspective, a break isn't surprising.

## #2: A PICKUP IN CAPEX

The big-name players need to perform late in the game. The U.S. consumer has been (and will be) a pivotal part of the economy, but we believe corporate investment is key in the next leg of this economic expansion. Capital expenditures (capex) are a primary driver of productivity as workers gain access to better equipment, better resources, and better training. Higher productivity boosts output and helps keep labor costs down, which is an important check for overall inflationary pressures.

U.S. companies are in prime condition to boost their capital spending. The benefits of fiscal stimulus, which include tax incentives for business investment, are still flowing through the economy. Corporations just capped a solid year of double-digit profit growth, thanks to lower corporate tax rates, and they've had 15 months to plan expansion projects since new policies were implemented.

However, trade tensions have hindered business spending plans, and recent global weakness has clouded corporations' outlooks further. We are still hopeful that business investment will pick up later this year if trade risk dies down. Pressure is building for U.S. companies to invest in growth, and as business confidence improves, we expect spending to follow.

## #3: GLOBAL GROWTH

The United States has led the rest of the world in this economic expansion, but global economic health is becoming more of a team effort. Global trade has stalled in the year since the U.S.-China trade dispute began, and international demand has declined [Figure 2]. China's manufacturing sector surveys have fallen slightly into contraction

territory, and the country's industrial profits shrank in December for the first time in nearly three years.

Other regions have increasingly felt the impact of the global trade disruption. European economies have struggled with the drop in demand, adding to their issues with uneven growth, political volatility, and austerity measures. In the second half of 2018, Germany, the Eurozone's largest economy, posted its weakest two quarters of growth since 2013, narrowly avoiding a recession in the fourth quarter as gross domestic product stagnated.

The world's economies are more interconnected than ever, and the U.S. economy has been susceptible to global weakness recently. Lower international demand has weighed on manufacturing, and increased geopolitical dissonance has added to economic uncertainty.

## #4: A REBOUND IN BUSINESS AND CONSUMER CONFIDENCE

Economic growth requires confidence, just as a championship team needs confident shooters. Business and consumer confidence can be tougher to gauge than other objective data, but they can be important leading indicators of economic performance, as turns in sentiment can be self-fulfilling.

Sentiment dropped precipitously to start 2019 amid the historic government shutdown, trade

risk, and the aftermath of the near bear market in the S&P 500 Index. We haven't seen much of a rebound yet, even though the government has re-opened and U.S. stocks have largely recovered. The Conference Board Consumer Confidence Index is still significantly below an 18-year high reached in October 2018, while the National Federation of Independent Business (NFIB) gauge of business confidence has slid to a two-year low.

Lower confidence is understandable right now. Uncertainty is still elevated, and negative developments have become more magnified as the expansion ages. Still, we believe that much of this uncertainty stems from trade tensions, and any resolution could help boost consumer and business confidence.

## CONCLUSION

It's a long road to the championship game, and the U.S. economy has weathered a lot of adversity these past years. The current environment has been tough to operate in, but we believe the winning fundamentals are intact. The Fed's patience is appropriate given the age of the cycle and tenuous global conditions, and a pause isn't a reason to fear recession, as history has shown. Uncertainty has delayed the global recovery and weighed on capital expenditures and sentiment, but we think this weakness is temporary and growth will stabilize once headwinds subside. ■

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The economic forecasts set forth in this material may not develop as predicted.

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