LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

December 4 2017

# 2018 ECONOMIC OUTLOOK

## EXPECT BETTER GROWTH WORLDWIDE

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### KEY TAKEAWAYS

We look for the global economy to expand at a healthy rate of 3.7% in 2018.

In the U.S., we project real GDP growth of around 2.5% as monetary tailwinds give way to fiscal support.

We forecast GDP growth of approximately 1.8% in international developed economies.

In emerging economies, we expect growth near 4.8%, as advantageous demographics, stable commodity prices, and early cycle acceleration help offset slowing but stable growth in China.

We look for the global economy to expand at a healthy rate of about 3.7% in 2018 thanks to an improved overall policy, economic, and investment environment across developed and emerging markets [Figure 1]. While accommodative monetary policies have been attributed to propelling both employment and consumption in developed markets, business investment lagged behind. But the length of the expansion should have forced many businesses to increase investment or risk losing market share. In developed markets, where monetary policy has a global impact, fiscal steps can now be taken to spur growth and extend the duration of the expansion. Meanwhile, most emerging economies continue to draw investors in, as others come out of recession.

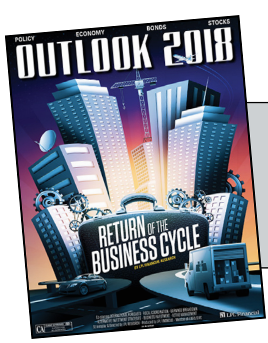
**1 GLOBAL GROWTH EXPECTED TO ACCELERATE IN 2018**

| | 2016 | 2017 (Estimate) | 2018 (LPL Estimate) |
|---|---|---|---|
| **Real GDP (Year over Year, %)** | | | |
| U.S. | 1.5% | 2.2% | **2.5%** |
| Developed ex-U.S. | 1.1% | 1.6% | **1.8%** |
| Emerging Markets | 4.4% | 4.5% | **4.8%** |
| Global | 3.2% | 3.5% | **3.7%** |
| **U.S. Economic Data** | | | |
| Real GDP (YoY%) | 1.5% | 2.2% | **2.5%** |
| Consumer Price Index (YoY%) | 1.3% | 2.1% | **2.0%** |
| Unemployment | 4.9% | 4.4% | **4.2%** |

Source: LPL Research, Bloomberg 10/31/17

2017 estimates are based on Bloomberg-surveyed economist consensus given year-to-date data. 2018 estimates are LPL Research projections.

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.




Please see our *Outlook 2018: Return of the Business Cycle* publication for insights on the economy, stock and bond markets, and investments for the year ahead. This week's commentary features content from that publication.



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## U.S. ECONOMY PLAYS A LEAD ROLE

In the U.S., we project real gross domestic product (GDP) growth of around 2.5% as monetary tailwinds give way to fiscal support, whether in the form of government spending, tax cuts, or deregulation.

While the Federal Reserve (Fed) is still supportive, we have seen steady progress in normalizing policy with minimal negative consequences for markets or the economy thus far. After four increases since December 2015, the fed funds rate is between 1.0% and 1.25%. In addition, despite inflation readings that remain below forecast, it appears policymakers are poised to increase their target for the benchmark overnight lending rate by another quarter-point in December 2017. Moreover, the central bank has already initiated the process of gradually unwinding its $4.5 trillion balance sheet by ceasing to reinvest the proceeds of maturing securities, resulting in an expected runoff of approximately $300 billion in 2018. This is a powerful symbolic move, as it formally begins to unwind the quantitative easing (QE) program that was such an important part of the Fed's response to the financial crisis.

The economy has exhibited impressive momentum after a disappointing start to 2017, despite the destructive regional impact of three hurricanes in the Gulf Coast and Caribbean and devastating wildfires in California. These extreme events have taken a large personal toll while also weighing on growth, but we expect some relief as the impacted areas recover and rebuild, providing a small tailwind in 2018. On the industrial side, solid gains in manufacturing and services have been accompanied by mild inflation. Full employment and gradually higher wage increases should also continue to boost consumption, while a weaker U.S. dollar has provided additional benefits for exports and the profits of multinational corporations. To the degree that corporate earnings help drive future economic growth, we believe this will prove to be an important development.

The next step for the U.S. economy involves fiscal coordination. While President Trump ran on a platform including infrastructure spending, tax reform, and regulatory relief, few concrete plans have emerged and political discontent has escalated. Nevertheless, there has been policy follow-through on several fronts. Executive orders have put energy infrastructure programs in place and new supervisory leadership at the Fed supports reduced regulatory burdens for the financial sector, likely freeing up lending opportunities in the coming year.

Though odds may not favor true comprehensive tax reform, tax cuts are still very much in play, with potential decreases in both individual and corporate tax rates likely contributing to economic activity in 2018. On the corporate side, historical data suggests every percentage point reduction in the corporate tax rate will create a similar percentage point increase in corporate profitability. Considering that profits help drive growth in employment, wages, consumption, and investment, tax policy may play an important role in helping to sustain the economic expansion.

When considering the contributions to economic growth, our focus is on business spending. As the Fed pulls back and fiscal policy steps in, businesses that want to succeed will be forced to increase market share and secure their future success by increasing capital expenditures and investing in property, plants, and equipment. Though consumer spending will remain the largest component of GDP, we look for business spending to have the fastest growth trajectory in 2018 [Figure 2].

## INTERNATIONAL ECONOMIES CONTINUE TO SHOW RESILIENCE

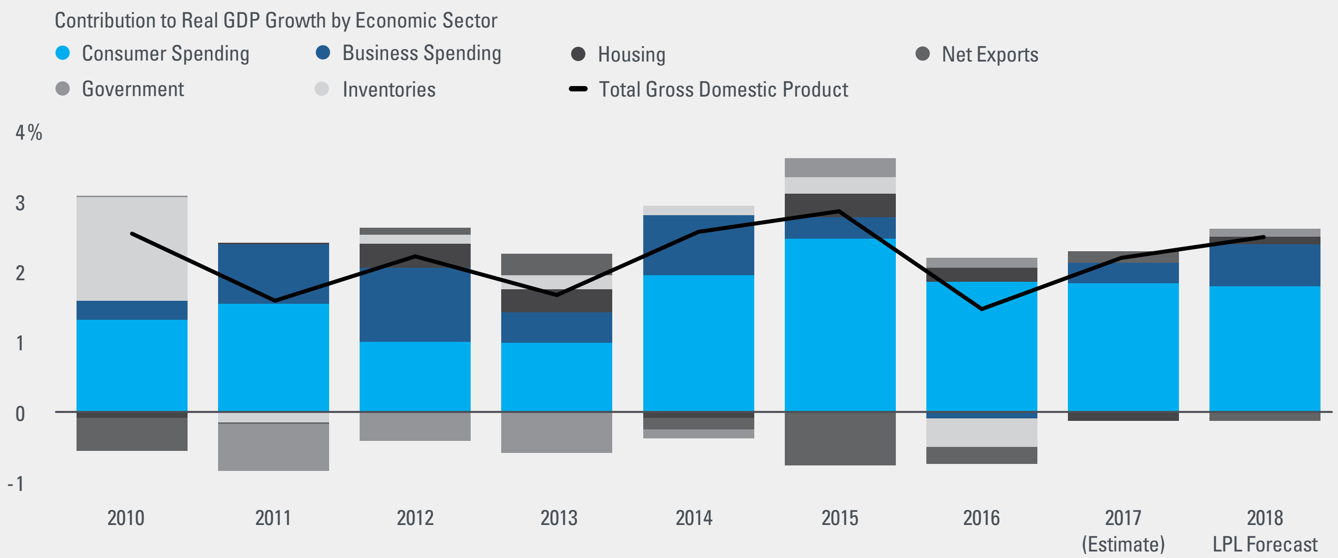
Economic activity in international developed economies has also been powered by accommodative monetary policy during the last few years. Looking ahead, we forecast GDP growth of approximately 1.8%, supported by rising global demand and further potential business-friendly reforms, as elected officials and monetary policymakers look for a set of policies that may also turn international developed economies to more traditional business cycle drivers.

While earlier in the economic cycle than the U.S., recent improvements in economic growth in the Eurozone have escalated calls to begin removing monetary accommodation. This shift makes it more pressing to implement fiscal and structural measures that can take advantage of the cyclical upswing that monetary policy has provided thus far. Growth in the Eurozone gained traction over the past year, with improving business confidence leading to higher investment as the worst of the political fears failed to materialize. However, given the uncertainties associated with the surge in nationalism, Brexit negotiations, and the upcoming elections in Italy, European Central Bank President Mario Draghi announced plans to only modestly reduce stimulus by purchasing fewer bonds over a longer period in the coming year, leaving changes to policy rates on hold until 2019.

Prospects in Japan have also brightened, as the combination of government spending and monetary accommodation finally pulled GDP higher for five consecutive quarters, the best performance in a decade. Though GDP growth is expected to hover around 1.0%, inflation is projected to remain well below the Bank of Japan's 2.0% target, likely keeping the zero percent target for the 10-year Japanese government bond in place for the next year or two. The Japanese yen should therefore remain within a range supportive for export growth. Considering the snap election and the current environment, we look for Prime Minister Shinzo Abe's ruling Liberal Democratic Party to delay the sales tax hike planned for October 2019, which should further boost consumer and business confidence in the year ahead.

Looking at emerging economies, we expect growth near 4.8%, as advantageous demographics, stable commodity prices, and early cycle acceleration

**2 BETTER GROWTH, IMPROVED BUSINESS SPENDING EXPECTED IN 2018**




Source: LPL Research, U.S. Bureau of Economic Analysis, Bloomberg 10/31/17

For GDP growth, 2017 estimate based on year-to-date data through the third quarter, Bloomberg-surveyed economist consensus for the fourth quarter. For sector contributions, 2017 estimates based on year-to-date data through third quarter and LPL estimates for fourth quarter. Estimates may not develop as predicted.



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help offset slowing but stable growth in China. India's role as "the new China," given its size and growth potential, and possible rebounds in Latin American economies will be among the stories to watch, but the return of the business cycle will be most evident from the lenses of China and the U.S. dollar. Despite the slowdown in the pace of output growth in China, emerging economies have held up well, showing resilience and flexibility in economic performance. The challenge now for elected officials and monetary policymakers is to ensure sufficient currency strength to prevent inflation and sustain interest payments on ~$3.5 trillion in dollar-denominated debt.

At the conclusion of the Chinese Communist Party Congress in the fall of 2017, President Xi consolidated power and has since emphasized finding a balance between market-driven forces and state-owned enterprises. Nonetheless, demand from China remains strong for commodities and inputs from emerging nations, many of which remain export driven. As its economy continues to transition, we expect China's GDP to expand near 6.5% in 2018 (down slightly from 2017 estimates of 6.8%), supported by the powerful combination of gains in retail sales and industrial production. ■

## HOW TO INVEST

Economies around the globe are at different stages of the economic cycle, with varying investment implications.

| | Stage of Economic Cycle | Business Cycle Drivers | Potential Investment Implication |
|---|---|---|---|
| **U.S.** | Mature | Return of business fundamentals and fiscal stimulus may create opportunities. | One- to two-year boost from return of business cycle, but watch rising volatility. |
| **International Developed** | Early mature | Structural problems persist but there is slow improvement. | Accelerating growth, but business environment may not match 2017. |
| **Emerging Markets** | Recovery (especially commodity producers) | Disruptions of recent years have helped set stage for reform. | More volatile, but may reward patient investors. |

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

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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.

Quantitative easing (QE) refers to the Federal Reserve's (Fed) current and/or past programs whereby the Fed purchases a set amount of Treasury and/or Mortgage-Backed securities each month from banks. This inserts more money in the economy (known as easing), which is intended to encourage economic growth.

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