ECONOMIC OUTLOOK

REGIONS

January 2019

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2019 Economic Outlook: Gloom, Despair, Agony, And, Oh By The Way, Above-Trend Growth

Wow, where are those "Gloom, Despair, and Agony" guys when you really need them? Probably just as well they're not around anymore; really, if they were around, they wouldn't have time to be singing us a song about how bad things are, as they'd be too busy selling every asset they own, packing up their cash and all the canned goods they could carry, and heading for the hills. You know, kind of like what everyone who is still around is doing. Okay, that may be a bit of an exaggeration, but it doesn't feel like too much of an exaggeration given the dour tone of the equity markets over the past two months, increasing talk of recession, and what has been a rising volume of noise on the political front, both at home and abroad. And, as if all of that isn't gloomy enough, we now have to worry about Randall and Beth, at least based on one of those look-ahead things they do on *This Is Us*.

In the midst of all of that, how could you not feel down? The irony is that 2018 will go down as the best, even if just barely, year of economic growth of the current expansion, now in its tenth year and which, if it endures until July, will become the longest U.S. economic expansion on record. By the end of 2018, however, that "if" sounded like a mighty big if, at least if all you knew about the U.S. economy came from reading headlines. The most obvious explanation for swooning equity prices in Q4 2018 is that the economic fundamentals must be deteriorating rapidly. And, sure, between trade policy, monetary policy, and political unrest, there was no shortage of things to worry about as 2018 crawled to a close. "Most obvious," of course, is not the same as "correct," but those of us who have pointed out that the economic data remain fairly solid have found that seems to not matter much these days.

Indeed, the U.S. economy evolved largely as we expected it to in 2018, thanks in part to a substantial degree of fiscal stimulus and a lighter regulatory burden. We do expect growth to decelerate this year, and further still in 2020 as the boost from fiscal stimulus runs its course. This is the same pattern of growth that has been part of our baseline outlook for well over a year. There are some, however, who seem unable to distinguish between slower growth and the end of growth, which added to the dour mood that prevailed over the final phases of 2018.

Simply put, an awful lot would have to go wrong for the U.S. to slip into recession in 2019, and while the probability of recession rises once we get to 2020, that is not a foregone conclusion. To be sure, one would do well to heed the words of Rudi Dornbusch (a giant in our field), who pointed out that "in economics, things take longer to happen than you think they will and then they happen faster than you thought they could." We keep that quote in a place where we see it each and every day. If nothing else, we think it a useful reminder that it's not what you know that you don't know that's dangerous, it's what you don't know that you don't know. Which is why we spend so much time trying to identify and monitor the downside risks to any forecast we make, which takes on added significance at present given that the current expansion is closer to its end than to its beginning.

Still, while it does seem that the downside risks are intensifying, we nonetheless expect the current expansion to endure at least into 2020. In what follows we'll discuss some of the main elements of our baseline 2019 forecast. And, as we do each year at this time, we'll look both back and ahead; back to see how we did with our 2018 forecast and ahead to discuss what we think 2019 holds in store. We do so in a series of questions touching on what we see as the main points of interest for the U.S. economy in 2019. Our answers will lay down markers for how we expect 2019 to turn out, and as we go we'll look back to our answers for 2018 and see how our calls turned out. As always, we reserve the right to be wrong, and, if history is any guide, we'll exercise that right to the fullest extent of the law.

QUESTION 1: Real GDP growth – over or under 2.25 percent? Over – we look for real GDP growth of 2.6 percent in 2019. Last year, we set the bar for real GDP growth at 3.0 percent, and we took the under, with our forecast calling 2.8 percent growth. While we won't have the initial Q4 2018 data until later this month, Q4 real GDP growth is tracking right around 3.0 percent, which would put full-year 2018 real GDP growth at 2.9 percent, just a notch above our forecast. We did think the 2017 tax bill would boost growth in 2018, but our expectations were a bit more restrained than those of many others, who felt 3.0 percent growth would be an easy bar to clear. While we were close on top-line growth in 2018, the mix of growth was a bit different than our forecast anticipated. Relative to what our forecast anticipated, consumer spending, business investment, and government spending were a bit stronger, while residential investment was weaker.

While we thought expectations for 2018 were too lofty, we think expectations for 2019 are too low – and seemingly sinking by the second. We set the bar for 2019 real GDP growth at 2.25 percent for a specific reason. If 2018 growth does come in at 2.9 percent, that would put average annual real GDP growth over the life of this expansion at . . . wait for it . . . 2.25 percent. So, in that sense, we think that real GDP growth will be above-average in 2019. Also, 2.25 percent is above the economy's "speed limit," or, the rate of growth that can be sustained over time without sparking inflation pressures, which at present we peg at right around 2.0 percent.

In other words, 2019 should prove to be another year of solid growth for the U.S. economy. While there are clearly downside risks, it helps to consider all that the economy as going for it as we start out the new year. The pace of job growth accelerated in

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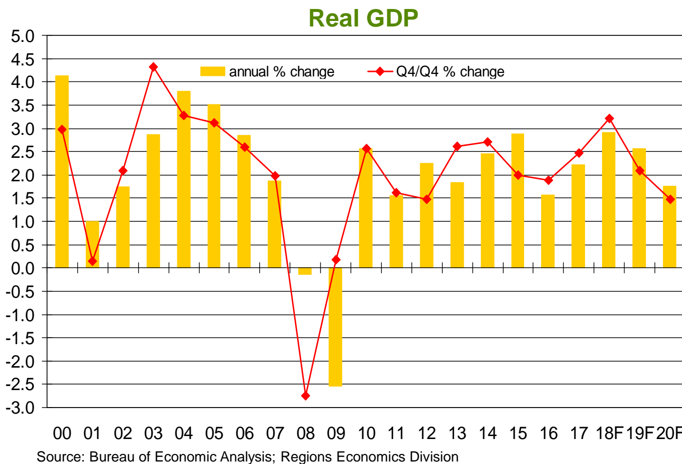
2018, pulling the jobless rate below 4.0 percent and pushing wage growth to a cycle-high, which helps account for consumer confidence hovering near an almost two-decade high. Though having slowed in late-2018, business investment spending is still in a good place and, while margins will be slimmer in 2019, corporate profits aren't going to simply evaporate. Finally, there is still a high degree of fiscal stimulus in the pipeline in the form of higher federal government spending. So, even if real GDP growth falls short of our forecast, it should still be above potential in 2019.

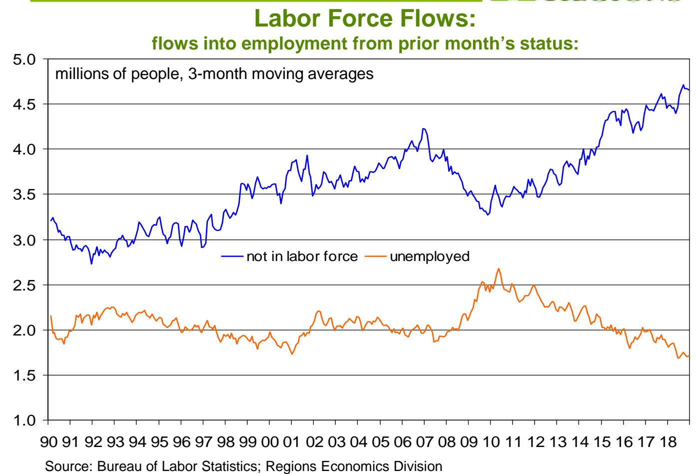


Source: Bureau of Economic Analysis; Regions Economics Division

We do not look for the mix of growth to change materially in 2019, with consumer spending, business investment, and government spending more than taking up the slack from flattish residential investment and a wider trade deficit. Perhaps of more significance, we think that by time 2019 winds to an end there will be a clear deceleration in real GDP growth. We look for Q4/Q4 growth to be below full-year growth in 2019 which, as seen in the above chart, would be the first such instance of this since 2015.

Though many interpret it as such, Q4/Q4 growth is not the correct measure of full-year growth, but it is nonetheless a useful indicator of what kind of momentum the economy carries from one year into the next. We think that by Q4 2019, fading fiscal stimulus and the cumulative effects of tightening financial conditions will begin to weigh on real GDP growth, and if we are correct on this point it sets up a marked deceleration in growth in 2020. Given how much uncertainty looms over trade policy, monetary policy, inflation, and the political landscape, and given how quickly things can change, 2020 seems a long way off. For now, though, we continue to expect another solid year of economic growth in 2019.

QUESTION 2: Growth in total nonfarm employment – over or under 2.0 million jobs? Over, but not by much. As noted above, the pace of job growth actually accelerated in 2018, and the 2.638 million net new nonfarm jobs added was the most in any year since 2015. On a monthly average basis, growth of 167,000 jobs per month would clear our 2.0 million jobs threshold for 2019, which we think is doable. As a point of reference, the U.S. economy added an average of 220,000 jobs per month in 2018 (2018 data are still preliminary). As such, our expectation of monthly growth of just under 170,000 jobs in 2019 may seem like a sharp drop-off, but keep in mind that job growth had been slowing slightly over the second half of 2018 before a blowout December job growth number, and we expect the gradual deceleration in job growth to resume over the course of 2019.



Source: Bureau of Labor Statistics; Regions Economics Division

One reason the economy has been able to sustain such a robust rate of job growth is that significant numbers of people continue to flow into the labor force each month, either new entrants or re-entrants into the labor force. We have routinely stated our view that there is more slack in the labor market than implied by the "headline" unemployment rate, one manifestation of which is the number of people who transition from out of the labor force in one month to employed in the next month (shown by the blue line in the above chart). To some extent, this reflects what has been a steadily rising participation rate amongst 25-to-54 year-olds, i.e., the "prime" working age population. While this obviously cannot persist forever, we think it has further to run, which will help sustain job growth as the economy continues to expand in 2019.

Aside from the pace of monthly job growth, we'll point to two "beneath the headlines" labor market indicators to keep an eye on for signs that the business cycle is about to turn. One is the one-month hiring diffusion index, which measures the breadth of job growth across private sector industry groups. One hallmark of the current expansion is how notably broad based job growth has been. If we see a sustained downturn in the hiring diffusion index, this will be a sign that hiring has become increasingly concentrated in a smaller number of industry groups, which would be a sign of vulnerability for the expansion.

The second labor market indicator is aggregate private sector hours worked, which for us is one of the most reliable forward looking indicators of turns in the business cycle. Simply stated, when firms see demand rising (falling), before they react by adding (laying off) workers, firms will typically adjust hours worked by their current workforce, thus buying time to discern whether the shift in demand is transitory or something more lasting. It is when firms have an answer to this question that they begin to adjust head counts. As such, changes in aggregate private sector hours worked have a better track record as a forward looking indicator than monthly changes in private sector employment.

QUESTION 3: Average hourly earnings growth (year-on-year) – above or below 3.5 percent in Q4 2019? Below. In our 2018 outlook we set the bar for growth in average hourly earnings at

3.0 percent in Q4 2018, and took the over. This proved the correct call, as average hourly earnings were up 3.2 percent year-on-year in Q4 2018. While we look for some further acceleration in wage growth as the labor market tightens further over the course of 2019, we think growth will nonetheless be shy of 3.5 percent at year-end. Over the past few years, our forecasts of wage growth have consistently been below-consensus, but have been closer to the mark. Our view is that, on net, labor force flows have acted as a drag on wage growth, and this has been reflected in our below-consensus forecasts of wage growth.

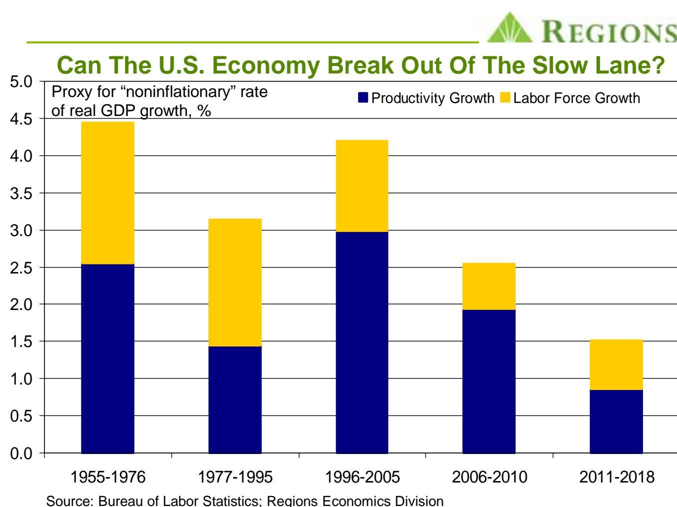
On average, 4.573 million people per month transitioned from not in the labor force in one month to employed in the following month in 2018, the highest number on record (again, this can be seen in the prior chart). To be sure, over this same time there has been a steady, but slower, flow out of the labor force, hence our view that net labor force flows have been a drag on wage growth. One way to think about this is that those transitioning from not in the labor force to employed tend to have less experience or have, due to having been out of the labor force for some length of time, seen their skills lapse (or at least face this perception). These factors tend to hold down wages for those transitioning into the ranks of the employed. To the extent those leaving the labor force – the vast majority of whom are employed upon exit – are older and have earned higher wages, this would be a drag on growth in average hourly earnings even if labor force inflows and outflows exactly offset each other.

Of course, on net, inflows have easily topped outflows, which only reinforces the "flow effect" we've outlined here. Those who have been in the labor force for longer periods of time, whether in the same job or moving from one job to another, have seen stronger growth in earnings (the "tenure effect"). The broad average hourly earnings metric, however, captures both of these effects. If we are correct that by year-end 2019 we will see inflows into the labor force taper off, that will lead to faster growth in measured average hourly earnings, and if this happens either sooner or to a greater degree than we expect, wage growth will outperform our forecast.

That said, there are other factors that have weighed on wage growth over the course of the current expansion, some of which will remain in play in 2019. For instance, the length of the average workweek is still below where it would be were the labor market truly at full employment. We have referred to the still-short workweek as an underappreciated form of labor market slack, and firms still have ample capacity to add to total labor input by adding hours rather than by adding workers. Adding hours does not put material upward pressure on wages, so to the extent firms go this route it won't bolster hourly earnings growth.

Additionally, as we've often discussed, the combination of anemic growth in labor productivity and persistently low inflation has acted as a material drag on wage growth over recent years. Unless and until these factors begin to reverse – and the signs are mixed as we head into 2019 – even as labor force inflows begin to diminish wage growth will remain below the 3.5-to-4.0 percent range that would be more consistent with a labor market at full employment. While we don't think we'll see wage growth above 3.5 percent rate at year-end 2019, we do think it will be closer than at any point in the current expansion. And, as a side note, in last year's outlook we stated that we looked for the unemployment rate to end 2018 at 3.7 percent; the actual year-end rate was 3.9 percent. We look for the jobless rate to end 2019 at 3.5 percent.

QUESTION 4: Nonfarm labor productivity growth – above or below 1.6 percent in 2019? Push. We look for productivity growth of 1.6 percent in 2019. That was also our forecast for 2018, which proved too ambitious – while Q4 data are not yet available, it looks like productivity growth for 2018 as a whole will come in at 1.3 percent. This is better, but not by any means good. As in better than the post-recession average but still below the longer-term historical average, and way, way short of miracle status – the average annual productivity growth of 3.0 percent over the 1996-2005 period is commonly referred to as the "productivity miracle."



Our regular readers are by now familiar with (some to the point of contempt for) the above chart showing the economy's "speed limit" – or, the rate at which it can grow on a sustainable basis without sparking inflation pressures. The speed limit is basically the sum of the rates of productivity growth and labor force growth, and over the past several years both have been sorely lacking. We have argued that the anemic trend rate of productivity growth over the past several years is primarily due to underinvestment on the part of firms over the course of the current expansion. Clearly this has begun to change and productivity growth has picked up but, as noted above, there is still a long way to go.

We do think there is further upside room for business investment (see below), which should help push productivity growth higher. We'll also note that history shows us that, rather than being a slow steady progression, productivity growth tends to come in spurts, which makes it difficult, if not impossible, to forecast meaningful turns in the productivity growth cycle. So, take the strength seen in business spending on R&D and on computers/software over the past several quarters, couple that with the fact that as labor becomes more scarce and more expensive firms become much more focused on efficiency gains, and it is reasonable to suspect that productivity growth could surprise us to the upside.

Given that the rate of labor force growth is unlikely to pick up materially on a sustained basis over the next few years, faster productivity growth will be the key to upping the economy's speed limit. This has implications for wage growth, corporate profit margins, and monetary policy. Productivity growth acts as a buffer

between wage growth and profit margins, and the larger that buffer, the less inclined firms are to become aggressive on the pricing front, which in turn gives the FOMC latitude to move at a gradual pace when adjusting the Fed funds rate. But, while we look for faster productivity growth in 2019, the key questions are the extent to which productivity growth picks up and to what extent this faster growth can be sustained over time.

QUESTION 5: Growth in real business fixed investment in 2019 – above or below 4.0 percent? Above. Our marker for 2018 was 5.0 percent, and we took the over, which looks like it will be the right call. On a year-to-date basis through Q3, real business fixed investment was up 6.9 percent in 2018, and it would have taken an epic collapse, the likes of which have never been seen, in Q4 2018 to pull full-year 2018 growth below 5.0 percent.

While there was no such collapse, at least not that we've heard about, business investment did end 2018 on a soft note. Many were quick to pounce on that as "proof" that the 2017 tax bill was a "flop," on the grounds that it failed to produce the highly touted "boom" in business investment. This gets no less nonsensical no matter how many times we hear it – once was way too many – particularly since we've yet to hear anyone in this camp point out that real business investment in equipment and machinery grew at an average annual rate of better than 8.0 percent from Q1 2017 through Q2 2018.

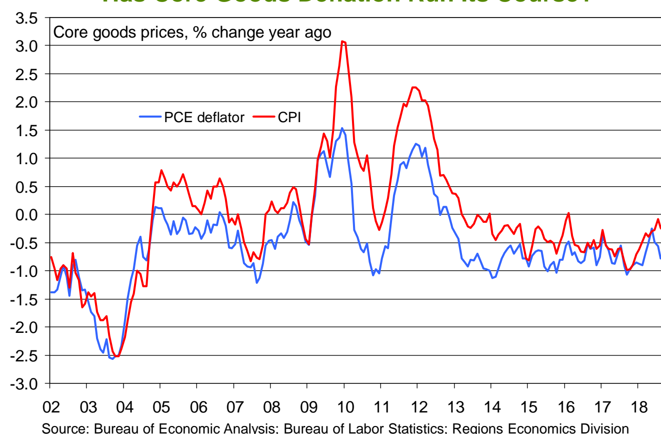
As this is a topic which we've devoted considerable attention to, most recently our December 2018 *Monthly Economic Outlook*, we won't spend much time on it here, other than to once again say that we see further upside room for business investment. Our view is that growing uncertainty over trade policy and fears of the potential adverse impact on global economic growth from a bad outcome weighed heavily on business investment over the final months of 2018. While at this point no one can rule out the worst-case outcome, we see that as unlikely. As such, continued, albeit slower, growth in the U.S. and abroad, an aged and less efficient capital stock, and labor becoming increasingly scarce and costly combine to give U.S. firms the incentive to invest further in physical capital and R&D. These factors, not the 2017 tax bill, have been the key drivers of our forecasts for business investment.

We have long argued that a necessary precondition for a material and sustained improvement in productivity growth would be a prolonged period of stronger business investment. We were off to a solid start before momentum faded over the latter months of 2018; while we don't think growth in business fixed investment will return to the pace seen from Q1 2017 through Q2 2018, we do think growth will be firmer than it was at year-end 2018.

QUESTION 6: Core PCE inflation – above or below 2.2 percent at year-end 2019? Above. In last year's outlook, our question was whether headline PCE inflation would be above or below 2.2 percent in 2018, and we took the under. On a year-to-date basis through November, the total PCE Deflator was up 2.1 percent and, though not yet available, the December data will push that lower thanks to declining energy prices. With energy prices biasing headline inflation lower in the early months of the year, we thought it would be more sporting to challenge our forecast of core inflation at year-end 2019. Core PCE inflation was running at 1.9 percent as of November 2018, and seems poised to accelerate. While on an annual average basis we think core PCE inflation will be below 2.2 percent for full-year 2019, we think it will be above that pace at year-end (the PCE Deflator is the FOMC's preferred measure of inflation, which is why we focus on it here).

Heading into 2018, we thought one of the main downside risks to our baseline forecast was that inflation would accelerate at a faster pace than anticipated, which in turn could have prompted the FOMC to push the Fed funds rate up more aggressively. That did not turn out to be the case, but we do not discount the possibility that inflation, at least core inflation, could surprise to the upside in 2019. At any given time there are many forces pushing and pulling on inflation, and 2019 will be no different, but on net we look for at least some acceleration over the course of the year.

Services prices tend to be more sensitive to changes in labor costs, as service providers generally have more latitude to pass along higher input costs in the form of higher output prices than do producers of goods. As such, to the extent growth in labor costs accelerates further in 2019, this will be a source of upward pressure on services prices. Even so, the path of core inflation will be more influenced by what we refer to as the "big three" drivers of core inflation – rents, medical care costs, and core goods prices.



Core goods (i.e., consumer goods excluding food and energy) price deflation has been a persistent drag on broader inflation over the past several years. In last year's outlook, we noted that we expected some firming in core goods prices over the course of 2018. As seen in the above chart, core goods prices did have some upward momentum at year-end. If tariffs are imposed on all imports from China in 2019, there would be a commensurate increase in core goods prices which would bias year-on-year reads higher. More broadly, core goods prices are sensitive to changes in exchange rates – a stronger (weaker) U.S. dollar puts downward (upward) pressure on core goods prices. This is one place where differences in the stance of monetary policy between the FOMC and their foreign counterparts will come into play. On net, we look for core goods prices to push higher at a modest pace in 2019.

Conversely, we look for rent growth to soften in 2019, which will act as a moderating force on broader core inflation. Given what should be a pick-up in the pace of multi-family completions in 2019, growth in apartment rents should slow and we think it

unlikely that growth in rents on single family homes, which now comprise a larger share of the rental housing stock than has been the case in the past, will accelerate further in 2019. Additionally, with house price appreciation likely to slow further in 2019, growth in owners' equivalent rents should also slow.

That patterns in health care costs will continue to confound us is about as definitive a forecast as we can make about health care costs in 2019. We've been waiting for a more significant acceleration in health care costs than we've seen over the past couple of years, so whether, and to what extent, that happens in 2019 could be what makes or breaks our forecast for core PCE inflation. On the whole, we think there will be enough of an acceleration in core inflation to warrant a higher Fed funds rate in 2019, but we do not think inflation will be far enough above their 2.0 percent target rate to push the FOMC onto a more aggressive path of funds rate hikes.

QUESTION 7: Housing starts – over or under 1.265 million units in 2019? Under. Housing is the sector of the economy that surprised us the most in 2018. And not in a good way. Our marker for 2018 was 1.350 million housing starts, and we took the under. Sure, that seems blatantly obvious today, but a year ago it was a tougher call. Honest, it was. Either way, housing starts fell well short of our forecast in 2018. Through November, total housing starts were running at annualized rate of 1.264 million units, up 4.7 percent from the same period of 2017. It is the split between single family and multi-family starts, however, that surprised us the most; single family starts underperformed our forecast, with growth of just 3.2 percent, while the 8.2 percent increase in multi-family starts easily outperformed our forecast. Home sales, new and existing, fell short of our forecasts in 2018.

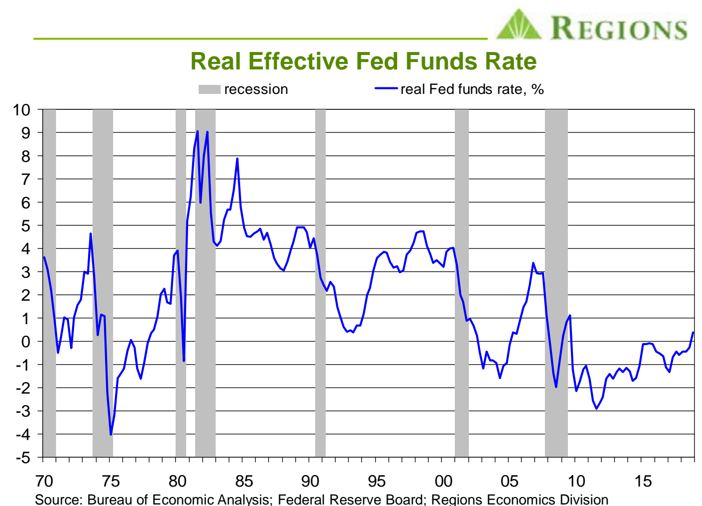
The combination of higher mortgage interest rates and cumulative house price appreciation curbed demand for home purchases over the final months of 2018, which weighed on single family housing starts. That said, we continue to argue that most of the issues in the housing market are on the supply side, not the demand side, of the market. While we've never expected anything approaching robust growth in the single family segment of the housing market, we continue to argue there is sufficient demand to support the slow but steady growth incorporated into our baseline forecasts over the past several years and which is part of our 2019 forecast.

With price appreciation and mortgage rates having eased, builders supplying more moderately priced new homes, and existing home inventories rising, albeit from an extraordinarily low base, we look for modest growth in single family housing starts and sales in 2019. As for the multi-family segment of the market, we were taken by surprise by the vigor shown by permits and starts in 2018. As we routinely note, we think demand for multi-family rental units is strong, just not strong enough to absorb all of the supply coming down the line, and more is coming despite what is the largest and most persistent backlog of multi-family units under construction since the mid-1970s. We look for material growth in multi-family completions in 2019; this should curb growth in apartment rents, which in turn should dampen multi-family construction.

The operative word here being "should" – this was, after all, the premise behind our 2018 housing market forecast, which didn't go all that well for us. But, at the risk of being proven wrong once again, that's our story and we're sticking to it, and are looking for lower multi-family permits and starts in 2019. Combining our calls on the single family and multi-family segments leaves total housing starts down slightly from 2018's total. The housing market has been a relatively unenthusiastic participant in the current economic expansion, and we don't look for that to change in 2019.

QUESTION 8: The mid-point of the Fed funds rate target range at year-end 2019 – over or under 2.875 percent? Under. Our forecast anticipates a single 25-basis point hike in the target range in 2019, which would leave the mid-point at 2.625 percent at year-end. As we've done in past years, our marker for the year-end funds rate mid-point is the projected median from the FOMC's December "dot plot." Last year's forecast anticipated three 25-basis point hikes in the funds rate target range in 2018, as implied by the December 2017 dot plot. The FOMC surprised us (and themselves, apparently) by hiking four times, with the mid-point of the target range standing at 2.375 percent at year-end 2018.

As 2018 ended, it seemed as though there were a contest between market participants, private sector analysts, and the FOMC to see who could scale down their expectations for monetary policy in 2019 the fastest. The two hikes in 2019 implied by the December 2018 dot plot were one fewer than had been implied by each prior 2018 edition of the dot plot, but were two more hikes than were priced into the futures markets as 2019 began. Indeed, some argue that the next move by the FOMC will be a rate cut in an attempt to fend off recession.



That seems a bit much to us, at least given our expectations for growth and inflation in 2019. Additionally, the real, or, inflation adjusted, funds rate is only marginally positive after having been negative since late-2009, which is at odds with an expansion in its tenth year and an unemployment rate below 4.0 percent. That said, we've knocked one rate hike out of our forecast this month. Our thinking is that steadily tightening financial conditions and the ongoing reduction in the Fed balance sheet are in essence making monetary policy tighter than what is embodied in a rising Fed funds rate. This should result in fewer funds rate hikes than would otherwise be the case. At the very least, the FOMC has the latitude to be patient, and we could easily see them being on hold for the first half of 2019 until there is more clarity on trade policy, the extent to which growth is slowing, and whether, or to what extent, core inflation is accelerating.

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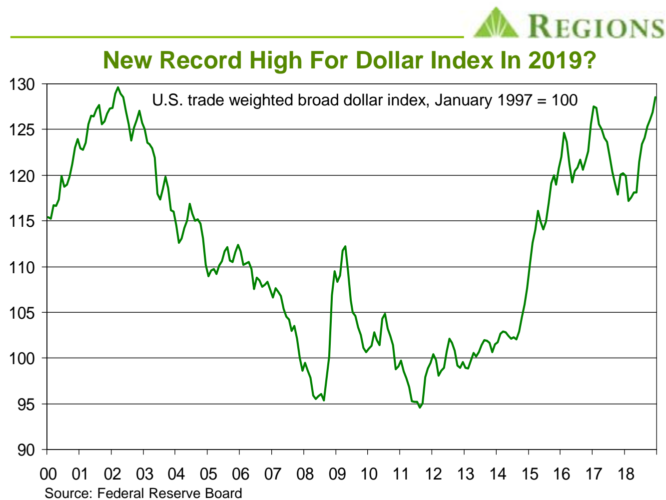
While we think the FOMC can make a plausible case as to why the funds rate should be at, or at least closer to, neutral, where we think some Committee members misstepped, and badly, was by openly talking about pushing past neutral. This rattled many market participants, which is understandable given past instances in which the FOMC went too far and too fast in raising the funds rate. Additionally, while the FOMC is treating it as a nonevent, many market participants see the unwinding of the Fed balance sheet as draining liquidity from the system and effectively making monetary policy tighter than the FOMC seems to think is the case. It was on this point that the markets melted down during Fed Chairman Powell's press conference after the December 2018 FOMC meeting. As such, rather than the path of the Fed funds rate, the Fed balance sheet could pose the biggest policy and communications challenges to the FOMC in 2019.

QUESTION 9: U.S. dollar – year-end 2019 value more than 5.0 percent below its year-end 2018 value? No. As measured by the Fed's Broad Dollar Index, we expect the value of the U.S. dollar to end 2019 no more than 5.0 percent below its year-end 2018 value. We missed big on the dollar in our 2018 forecast – we expected considerable volatility during the year but that by year-end the Fed's Broad Dollar Index would be within +/- 3.5 percent of its year-end 2017 value. Instead, as seen in the following chart, the Dollar Index was on a one-way ride higher for most of 2018 and ended the year over 7 percent higher than at year-end 2017.



With the U.S. outperforming other major economies in 2018 and the FOMC well ahead of their global counterparts in scaling down the degree of monetary accommodation, demand for U.S. dollar denominated assets remained strong during 2018, thus fueling the dollar's upward climb. Though in an absolute sense this year won't be as good as last year, the U.S. will retain its relative advantage over foreign economies, and if the FOMC raises the funds rate at all it will be more "aggressive" than most of its global counterparts. While those factors would support a stronger U.S. dollar, we nonetheless see limited upside from here for the U.S. dollar. Any relaxation of trade tensions or the FOMC taking a dovish turn would put the U.S. dollar under downward pressure, as would a renewed interest in emerging market assets. The obvious caveat here is that any flare-ups of geopolitical tensions would trigger a burst of demand for dollar denominated assets, thus propping up the dollar. That said, while a new record high for the Fed's Broad Dollar Index isn't out of the question in 2019, we expect the index to end 2019 slightly lower than it ended 2018 (FYI – the all-time daily high for the index is 130.1968, on February 27, 2002).

QUESTION 10: What are some of the main risks to our baseline 2019 forecast and which way does the balance of risks tilt? No forecast is complete unless it comes with an assessment of the key risks to that forecast. Still, any assessment of forecast risks reflects only the known unknowns, which isn't what keeps us up at night. What keeps us up at night is worrying about what we don't know that we don't know, which is something you typically only find out the hard way. Either way, it is always a useful exercise to sort through the known unknowns, the main ones we touch on here.

At this point, trade policy is the biggest downside risk staring us in the face. The "temporary truce" between the U.S. and China will expire by the end of Q1, and at this point we don't have any inkling how this will be resolved. We are, at least implicitly, assuming a benign resolution in our baseline forecast, and the softer tone of growth in China of late may make that outcome more likely. But, as we've noted before, it is the issue of intellectual property rights, not the size of the bilateral trade gap, that is the most important area of dispute, and the hardest to solve. Anything that would further inhibit trade flows would be a negative for global growth and domestic growth, including the U.S. manufacturing sector.

Other downside risks include significant deterioration in consumer and business confidence. It is actually possible to talk yourself, collectively anyway, into recession, and though both remain elevated, consumer and business confidence dipped as 2018 came to a close. Less confidence on the part of business leaders would mean less capital spending and less hiring, and less hiring would take a toll on consumer confidence, which in turn would curb consumer spending. We've argued that a solid labor market will keep a floor under consumer confidence, but confidence can be a fleeting thing, and once it starts to go, it can go in a hurry. Confidence is also vulnerable to political risk, which seems to be on the rise here and abroad, which could have an adverse impact on growth in 2019. Also, though not our baseline case, we think it would be unwise to dismiss out of hand the possibility of inflation surprising to the upside in 2019. We touched on some factors that could push inflation higher in 2019, but a material upside inflation surprise could easily prompt the FOMC to become more aggressive than is expected to be the case. Keep in mind that the high volume of U.S. dollar denominated debt issued by foreign borrowers injects a global dimension to this risk.

Unfortunately, the list of upside risks is not a long one. The main upside risk is that productivity growth accelerates more sharply than our forecast anticipates, which would be a best-case scenario for real GDP growth, wage growth, corporate profits, and, in turn, monetary policy. No pressure there, right?

Though by no means an exhaustive list, these are what we see as the most significant risks, downside and upside, to our 2019 forecast. At present, we see the risks as weighted to the downside, i.e., if we're wrong on our forecast of real GDP growth, it is more likely actual growth will come in below our forecast than above our forecast. As with each year's outlook, check back next year at this time to see how our 2019 forecast fared.

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ECONOMIC OUTLOOK

Q2 '18 (a)	Q3 '18 (a)	Q4 '18 (f)	Q1 '19 (f)	Q2 '19 (f)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)		2016 (a)	2017 (a)	2018 (f)	2019 (f)	2020 (f)
4.2	3.4	3.2	2.0	2.1	2.4	2.0	1.8	Real GDP[1]	1.6	2.2	2.9	2.6	1.8
3.8	3.5	3.9	2.5	2.7	2.4	2.4	2.1	Real Personal Consumption[1]	2.7	2.5	2.7	3.0	2.1
								Business Fixed Investment:					
7.0	4.3	5.7	5.6	4.9	4.6	3.9	2.9	Equipment, Software, & IP[1]	2.1	5.5	7.3	5.2	3.1
14.5	-3.4	1.4	-1.0	1.3	0.6	1.3	1.7	Structures[1]	-5.0	4.6	5.3	0.8	1.4
-1.3	-3.6	-2.4	-0.7	0.1	2.7	1.3	1.3	Residential Fixed Investment[1]	6.5	3.3	-0.2	-0.7	1.5
2.5	2.6	1.7	1.6	1.9	1.1	0.1	-0.4	Government Expenditures[1]	1.4	-0.1	1.6	1.7	0.0
-841.0	-949.7	-954.8	-937.7	-950.0	-962.1	-978.1	-985.9	Net Exports[2]	-786.2	-858.7	-911.9	-957.0	-993.6
896	877	850	875	899	912	923	938	Single Family Housing Starts, ths. of units[3]	785	852	878	902	949
365	357	381	361	356	353	355	357	Multi-Family Housing Starts, ths. of units[3]	393	356	383	356	355
17.2	16.9	17.5	17.1	17.0	16.8	16.8	16.7	Vehicle Sales, millions of units[3]	17.5	17.1	17.2	16.9	16.6
3.9	3.8	3.8	3.8	3.7	3.7	3.6	3.6	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7	3.5
1.6	1.7	1.7	1.7	1.6	1.5	1.3	1.2	Non-Farm Employment[5]	1.8	1.6	1.6	1.5	1.0
1.8	2.4	2.7	2.5	2.1	1.9	1.9	1.9	Real Disposable Personal Income[1]	1.7	2.6	2.7	2.3	1.7
2.5	2.4	2.3	2.6	2.5	2.7	2.6	2.5	GDP Price Index[5]	1.1	1.9	2.3	2.6	2.3
2.2	2.2	1.8	1.5	1.6	1.8	2.0	2.3	PCE Deflator[5]	1.1	1.8	2.0	1.7	2.3
2.6	2.6	2.2	1.3	1.4	1.5	1.6	2.1	Consumer Price Index[5]	1.3	2.1	2.4	1.5	2.2
1.9	2.0	1.9	1.9	1.9	2.0	2.2	2.2	Core PCE Deflator[5]	1.7	1.6	1.9	2.0	2.2
2.2	2.2	2.2	1.9	2.0	2.1	2.2	2.3	Core Consumer Price Index[5]	2.2	1.8	2.1	2.1	2.4
1.68	1.89	2.16	2.38	2.41	2.63	2.63	2.63	Fed Funds Target Rate Range Mid-Point, %[4]	0.39	0.98	1.78	2.51	2.63
2.92	2.92	3.04	2.75	2.85	2.90	2.90	2.90	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.91	2.85	2.88
4.54	4.57	4.67	4.44	4.52	4.59	4.60	4.61	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.52	4.54	4.61
-2.0	-2.3	-2.4	-2.4	-2.5	-2.7	-2.7	-2.8	Current Account, % of GDP	-2.3	-2.3	-2.4	-2.6	-2.9

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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