WEEKLY ANALYSIS

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Consumption to boost US GDP in Q2

Growth will improve in Q2. Employment is the key variable. Rising wages will boost consumption. No Fed action. Upswing in inflation. Take profits on equities.

Key points

- Sustained pace of growth in the US
- GDP up +2.2% in Q4 2018
- Annual growth exceeds +3%
- Likely slowdown to +1.5% in Q1 2019
- Growth expected to accelerate to +2.6% in Q2
- No further rate hikes by the Fed in 2019
- Leading indicators persistently anaemic
- Employment figures are strong
- Pace of wage increases accelerates (+3.4%)
- Upswing in inflation and long-term rates
- Consumption further confirmed as the main driver of growth
- Moderately positive outlook for the dollar
- Take profits on equities after an exceptional Q1

Sustained pace of growth in the US

US GDP growth clocked in at an annual rate of +2.2% in Q4, which is obviously somewhat less robust than in Q2 and Q3 (+3.4%) 2018. However, this result is in line with the consensus forecast (+2.2%). The economy slowed less than expected due to several positive factors. Consumption grew by +2.5%, contributing significantly to the economy's strong showing. Capital expenditure progressed by +6.2% in the equipment, software, and research segments. Public spending (+0.4%) and rising inventories also contributed positively (+0.13%) to GDP growth, while real estate and foreign trade (-0.22%) contributed negatively. The impact of the government shutdown was ultimately estimated to be -0.1% of GDP. This negative impact notwithstanding, the performance of the economy remains excellent and above the historical average, as well as substantially higher than the Fed's longer-run potential growth rate (+1.9%). In light of these economic results, the fears of a recession that rocked financial markets in Q4 again clearly appear to a very large extent unfounded. Yoy GDP growth at the end of the year (+3.1%) thus slightly exceeded Trump's 3% objective.

Growth expected to accelerate in Q2 2019

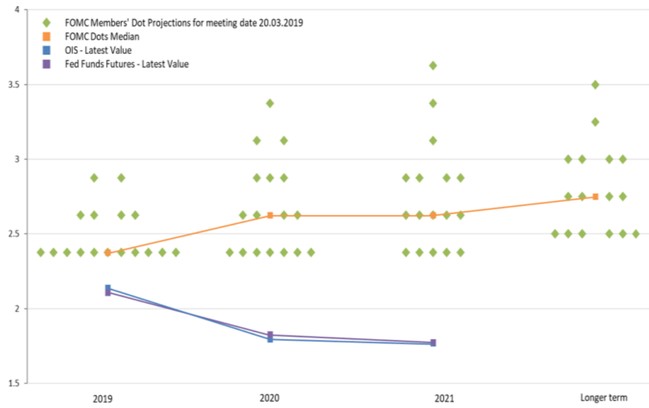
The strong growth of private consumption is heartening and in line with expectations following an already significant increase of +3.5% in the previous quarter. Consumption does not seem to have been affected too negatively by the uncertainty caused by the fall in financial markets and will likely be further bolstered by a robust job market in 2019. Inventories, which rose relatively substantially at the end of the year, will likely decline in Q1 2019, which could affect industrial production and manufacturing jobs in the short term. In our view the growth outlook for Q1 2019 remains unquestionably positive, even though a temporary slowdown remains likely before an upturn in Q2. Several factors that will likely penalise economic performance at the beginning of the year include the shutdown that took place during the first quarter, which will have a non-negligible impact, the persistence of tensions between China and the US, which continue to hamper overall consumer and business confidence, and a decline in the manufacturing sector. However, US GDP will likely grow by +1.5% in Q1 before resuming a more sustained pace of +2.6%.

No further rate hikes by the Fed in 2019

The US Federal Reserve, already discomfited by its ninth rate hike in December 2018, will have to adopt a particularly prudent policy in 2019 to avoid any risk of slippage of the economy. FOMC members will likely have to wait quite some time before proceeding with a tenth increase. The target rate's current level is now termed 'neutral'. There is thus very little risk that the Fed will raise rates given the likely temporary economic downturn in Q1. President Powell remained positive with regard to the economic situation in the US during the Fed's last press conference, but he also succumbed to the general tendency to revise the outlook for 2019 downwards and significantly recalibrated his monetary policy projections, announcing a time horizon of three years for the next rate hike. The Fed lowered its GDP growth forecast from +2.3% to +2.1% and its inflation forecast from +1.9% to +1.8%. Its unemployment forecast remains unchanged at 3.7%. In our view, this change in attitude reflects increasing concern with regard to the potentially negative implications of continuing to normalise monetary policy in the current slightly more uncertain context. However, this caution is consistent with our belief that the Fed will prefer to delay reacting to any future upswing in inflation than to implement a normalisation policy prematurely. The recent decline in price indices since the highs of 2018 will bolster the Fed's wait-and-see approach. We continue to anticipate that the Fed will exercise considerable flexibility in managing its monetary policy in 2019, although we discard for now the possibility of a rate cut, which is nevertheless suggested by the fed funds futures curve, which shows a 50% chance of a cut at the beginning of 2020.

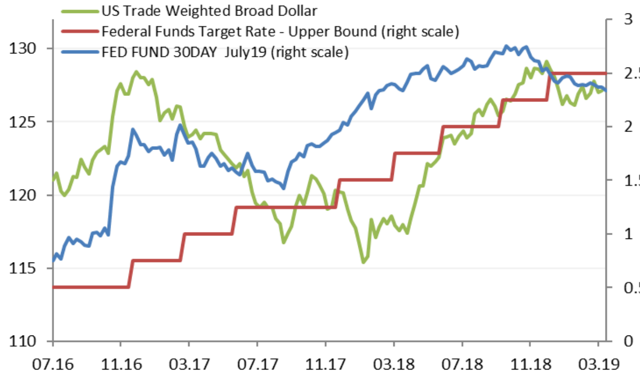
In our view the flattening of the US yield curve following the decline in long-term rates does not signal a recession in the current context as we have been hearing too often. However, this situation is clearly an inhibiting factor for FOMC members, who are not willing to risk taking action in the absence of an upturn in the economy. According to the Fed, it is thus no longer necessary to tighten rates in order to check inflation. The Fed also decided to slow its balance sheet reduction programme by lowering the amount it is unwinding from $30 to 15 billion per month. It is also prepared to simply stop unwinding if necessary as of September. In so doing, the Fed is clearly demonstrating its willingness to interrupt its normalisation process to factor in the risks of a downturn in global growth. The fed funds target range is still 2.25 - 2.50%.

FOMC fed funds projections



Sources: Bloomberg, BBGI Group SA

Fed funds, target rate and trade-weighted dollar

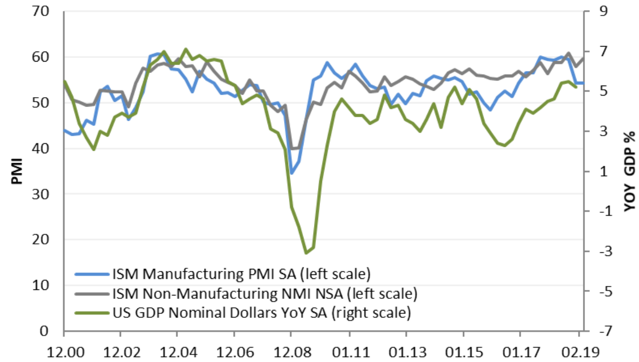


Sources: Bloomberg, BBGI Group SA

Leading indicators persistently anaemic

At the end of the current quarter leading indicators are still declining steadily as they have over the past five months since the trend reversal that occurred in November. The manufacturing PMI index lost yet more ground in March (52.5) compared to the preceding month (53), reaching its lowest level in 21 months. The services PMI also slipped from 56 to 54.8, thus unable to prevent a further decline of the composite index. However, while according to these indicators confidence does not seem to have returned, it is interesting to point to several signs of improvement, such as the Philadelphia Fed's manufacturing index, which rebounded sharply, jumping from -4.1 to +13.7 in March.

GDP and PMI

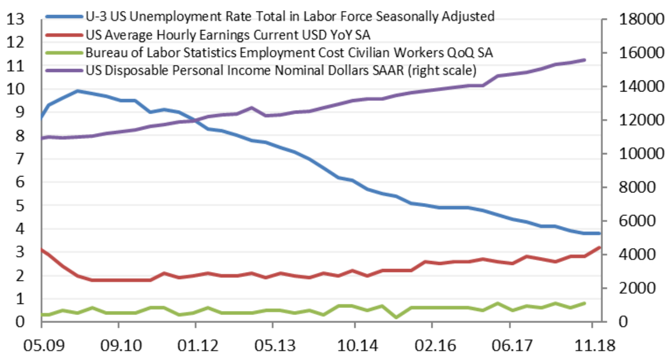


Sources: Bloomberg, BBGI Group SA

Employment numbers are strong

The job market continues to strengthen in spite of several temporary surprises and is very likely to be a key factor boosting consumption, GDP, and inflation in 2019. Sluggish job creation in February (20,000) after the extraordinary number of jobs created in January (311,000) is likely temporary. The volatility of these figures is primarily a result of the government shutdown and weather conditions, which had a significant impact on the construction sector (-31,000 jobs). Overall, the number of unemployed workers decreased by 300,000 to 6.2 million, while the unemployment rate dropped further to 3.8%.

Unemployment, earnings, employment cost, wages



Sources: Bloomberg, BBGI Group SA

Job creation in March will likely be robust and amount to close to 175,000 new jobs. Jobless claims fell to 211,000, highlighting the continued strength of the job market. At 0.86, the ratio of job-seekers to vacancies, an indicator of job market tightness, continues to suggest that supply exceeds demand, signalling a vigorous job market. There are currently 7.581 million job vacancies, namely +4.7% more than in the previous month. The pace of hiring also progressed from +3.8% to +3.9% month on month.

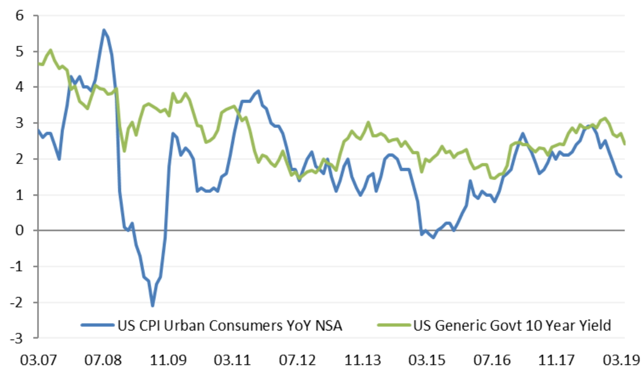
Pace of wage increases accelerates

Given the relatively tight job market, wages continue to increase in the US, bolstering the outlook for private consumption, which remains the main driver of economic growth. The average hourly wage jumped by +3.4% yoy in February, its largest increase since 2008. Adjusted for inflation, real weekly earnings progressed by +1.6% with a parallel increase in real hourly wages of +1.9%, thus substantially expanding US households' purchasing power. This is the largest increase in real hourly wages since November 2015 (+2%). The job market thus does not seem to be affected by the rising uncertainty often mentioned in the media. The current state of quasi full employment will continue to impact wages in 2019. Indeed, upward pressure is likely merely to get stronger, assuming that job creation continues to exceed demand in the job market. The Fed will likely pay close attention to developments in the job market in spite of its recent position affirming a monetary policy status quo in 2019. We believe that, despite its recent shift in perspective, the Fed remains convinced that the expected strength of the job market will have two main impacts on its monetary policy. The first impact will be to rapidly strengthen the outlook for consumption, while the second impact will have a less immediate effect on price index increases.

Upswing in inflation and long-term rates

The decline in inflation over the past few months stemmed mainly from the fall in energy prices and will only be temporary. At the beginning of the year, we expected that the positive economic outlook would rapidly lead to a trend reversal with regards to fuel prices and push price indices back up.

Inflation and 10-year US Treasury bonds



Sources: Bloomberg, BBGI Group SA

Since 1 January, crude prices have surged +33% and should thus start to have an effect on inflation. Rising household income is increasing consumers' purchasing power and businesses' ability to increase their sales prices, thus intensifying inflationary pressures. We expect that before long inflation will once again exceed the Fed's stated target, although the Fed is unlikely to respond. Wage inflation will thus be a key factor in price index growth in 2019, which could be discernible more rapidly in the service sector.

For now, the leading economic scenario in the rates market still seems to be that growth will flag. The outlook for Q1 has indeed deteriorated slightly (+1.5%), but the upturn anticipated in Q2 (+2.6%) could be bolstered by the announcement of a solution to the on-going trade dispute between the Americans and the Chinese. The correction in long-term rates from 3.2% to 2.6% between November and December continued through the last days of March. This decline in long-term rates now seems excessive given the current economic context. We expect 10-year rates to rise concurrently with an improvement in economic figures before summer.

Consumption further confirmed as the main driver of growth

The outlook for consumption will continue to be tied to the evolution of households' disposable income, access to credit, and consumer confidence. The strength of the job market has contributed to improving consumer confidence, but a change in sentiment with regard to US economic conditions and in particular the uncertainty still weighing on international trade could have a significant additional impact on Americans' propensity to consume. US consumers are confident, and the decline in the sentiment indicator in March is probably just temporary. Private consumption will very likely be a key factor boosting GDP growth in Q1 2019.

Moderately positive outlook for the dollar

The dollar is still benefiting from attractive economic growth and interest rate differentials, in particular against the Swiss franc and the euro. This situation should persist and even intensify over the next few months, barring a huge surprise. However, in the longer run, yield spreads will likely be challenged by rising rates in the euro area and in other developed and emerging countries. We continue to forecast an increase in the dollar/Swiss franc exchange rate, which could reach 1-1.05 francs.
The US currency will likely very gradually become less attractive compared to the euro and emerging currencies, assuming the economic climate improves.

Take profits on equities

In our analysis earlier this year, we mentioned the positive outlook for US equities in 2019, noting however that an increase of the S&P500 back up to 2,900 would likely raise questions with regards to valuations. US equities closed the quarter up nearly +14%, the best quarterly performance since March 2013 (+14.14%) as well as the fifth best performance since 2000. The context is not negative for equities. Nevertheless, we recommend at least some profit taking after such a significant progression over barely a quarter.

S&P500, Nasdaq and GAFA

Sources: Bloomberg, BBGI Group SA

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