The Economy Through 2018: Finally Behaving Well!

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Despite more political uncertainty than usual emanating from Washington, the next 12 months are shaping up well. The odds of a recession remain very low – about 10% -- despite now being in the middle of the second longest economic recovery in US history. Global growth is solid, and while inflation is rising, it's doing so slowly, giving the Fed time to raise rates at a leisurely pace and not upend the fastest economic growth our economy is about to experience since 2005.

Giving the economy a strong boost is a combination of net tax cuts totaling more than $1 trillion passed in December and spending increases totaling $400 billion passed in February. Collectively, these stimuli should raise near-term GDP by half a point. As a result, the Fed is likely to raise rates at least two more times this year – each time by one-quarter point – and possibly three times. This will be done to protect the economy from overheating and proactively prevent inflation from rising much higher than 2 percent/year, the Fed's target inflation rate.

GDP growth during the next 12 months should average 2.8 percent, up from 2.3 percent in Q1 2018. Unemployment will continue to decline from the current rate of 3.9 percent to t least 3.7 percent and perhaps as low as 3.6 percent, rates not seen in more than 50 years. Inflation, as measured by the Consumer Price Index, will rise from 2.0 percent now to 2.5 percent by year-end 2018. As for 10-year Treasury rates; by year-end expect them to be at or near 3.2 percent, up from the current 3 percent.

Regrettably, the worker shortage will worsen. Employer surveys show an ever-increasing number of firms in a growing number of industries facing growing difficulties in the recruitment of skilled workers. With unemployment below 4 percent – and with labor force growth weak – the struggle to find workers will get worse before it gets better. More and more firms will be forced to turn away work due to a lack of skilled labor. With both U.S. population growth and immigration slowing, an advantageous solution is for firms to invest in labor-saving technology to boost output. Fortunately, due to the recent tax reform, tax treatment of purchases of plant and equipment is more favorable today than at any time in recent memory.

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Because of the ongoing labor shortage, skyrocketing input costs including lumber, aluminum, and rising land costs, single-family housing starts will rise by no more than 5 percent over the next 12 months and multifamily activity should remain where it is. By contrast, remodeling activity looks to grow by a strong 7.5 percent due to a combination of ever-rising home prices boosting home equity, shrinking inventory of existing houses, and limited starts, all of which are causing homeowners to remodel rather than move. As for existing sales activity, it might grow by as much as 1 or 2 percent, but not more; home prices will rise by 6.5 percent over the next year.

Growth during the rest of 2018 looks to be meaningfully better than what we have experienced since the end of the Great Recession. This is due to decent global growth and passage of tax cuts and spending increases here in the US.

A wildcard in all this is trade. A dissolution of the North American Free Trade Agreement (NAFTA) and a trade war with China or Europe would weaken growth – albeit not substantially – at least in the short-run. The knock-on effects such as a possible decline in consumer confidence are of more concern. Lastly, while interest rates will rise in the second half of 2018 (as they have in the first half), the increases will be measured, and the chances of a recession are very low.

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