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US economy is doing well. Beware the adverse effects of tariffs

Exceptional GDP growth of +4.2% in Q2. Inevitable deceleration in 2019. Risk centred on tariffs. Long-term rate increase. Keep an eye on profits. Caution with regard to the S&P 500.

Key points

- Exceptional GDP growth of +4.2% in Q2
- Eighth rate hike by the Fed, moving towards the 3.1% fed funds target for 2019
- Fed remains confident, not worried about inflation
- Fed raises 2018 GDP growth outlook to +3.1%
- Growth will inevitably decelerate
- Leading indicators are ambiguous, but consumer confidence is sky high
- Trade tensions already affecting US foreign trade?
- Slight pressure expected on long-term rates
- Medium-term outlook on rates: 3-3.5%
- Relative attractiveness of dollar decreases
- Keep an eye on profits and equity valuations
- US market not immune to knock-on effects of tariffs
- Possible PE contractions and price drops
- Trends remain favourable to equities

Eighth rate hike by the Fed, moving towards the 3.1% fed funds target for 2019

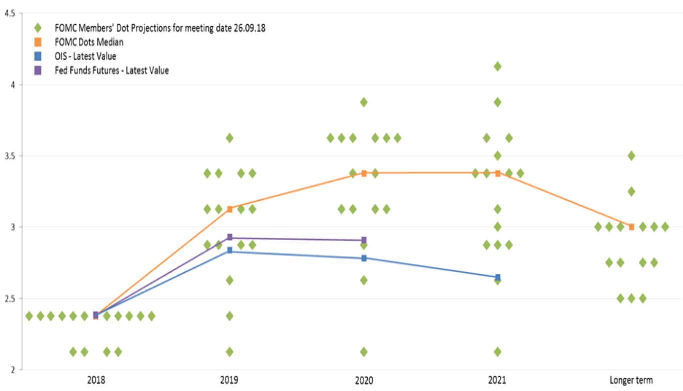
At its last meeting, the FOMC unanimously decided to raise rates by 0.25%. The fed funds rate hike was expected and did not have any major impact on financial markets. The Federal Reserve thus increased its rates for the eighth time in a process described, since the beginning, as rate normalisation and not monetary tightening. Until this last hike, the US central bank was still regularly using the term 'accommodating' to describe its monetary policy. However, this time the bank aimed to send a new signal, without actually precisely characterising the state of its monetary policy.

Thus, the Fed is conveying increasingly clearly that the normalisation process is well underway and that rates are gradually nearing the levels expected given the current growth context. The bank still seems to be committed to managing monetary policy with a steady hand, minimising any risk to current economic growth to avoid stoking concerns of excessive action.

Current economic conditions are thus benefitting from a convergence of positive factors, which could sustain GDP growth above its normal capacity for several more quarters. Thus, the current normalisation could lead to another rate hike before the end of the year, followed by two further increases in 2019.

The fed funds rate should thus have reached 2.4% by the end of 2018, 3.1% by the end of 2019, and 3.4% in 2020.

FOMC fed funds projections

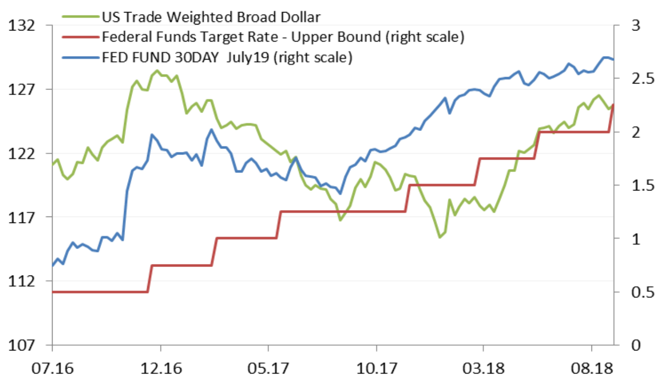


Sources: Bloomberg, BBGI Group SA

This decision was generally expected and thus did not surprise the markets. Hence it is unlikely to have any major impact on the investment climate.

The Fed will be particularly attentive to risks of derailment of current growth trends and to the knock-on effects of tougher foreign trade conditions. In this context, we believe that the Fed is unlikely to overreact to potential accelerations of inflation or economic growth.

Fed funds, target rates and trade-weighted dollar



Sources: Bloomberg, BBGI Group SA

The Fed remains confident, not worried about inflation

The Federal Reserve further raised its GDP growth outlook from +2.8% to +3.1% in 2018 and from +2.4% to +2.5% for 2019, without significantly changing its assessment of current and future economic conditions, however.

US growth is still considered strong, in particular following the release of Q2 figures.

No change in the inflation outlook either. According to the Fed, the strength of the job market is unlikely to have a major impact on inflation, which is now deemed to be nearing its target. However, an increase of inflation above the 2% target is considered likely in the short term and probably acceptable, as it is unlikely to spiral up further.

Monetary policy is thus in a phase of normalisation, in a context of historically low unemployment. For now, the labour force participation rate is not increasing, and if the current full employment situation were to lead to a decline in growth to below its potential, the Fed could be inclined to slow its rate normalisation process in 2019.

Growth will inevitably decelerate

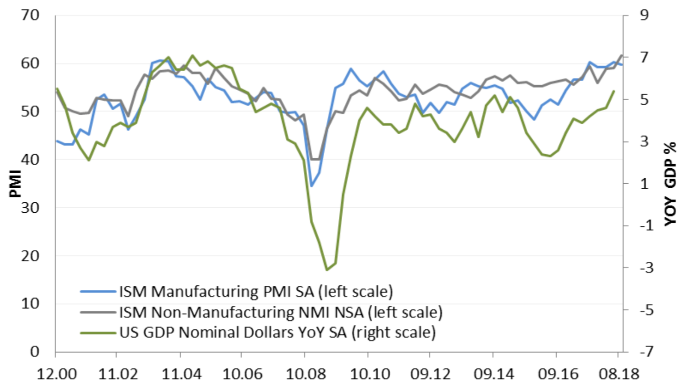
After the rapid growth of real GDP in Q2 (+4.2%), some are now wondering whether the US economy's long-term growth potential is not higher than before. The acceleration from +2.2% in Q1 to +4.2% is indeed remarkable, but it stems from policies whose impact should become less pronounced in 2019. Following less aggressive results in Q1, we had revised upward our outlook for H2, even though we thought it would likely be very challenging for the US economy to sustain a pace of growth exceeding +3% over the long term. The current economic cycle is indeed one of the longest we have seen, but it is still not presenting the classic signs of the end of a cycle (pressure on wages and inflation).

The likelihood that the growth rate will exceed +3% is now higher, in particular because US consumers continue to buoy domestic demand and investment is bolstered by fiscal policy.

Leading indicators are ambiguous, but consumer confidence it sky high

Leading indicators for the manufacturing sector remain positive, but signs of weakness are visible in the service sector.

GDP and PMI



Sources: Bloomberg, BBGI Group SA

The manufacturing PMI had in fact declined in Q3, partially offset by an increase to 55.6 in September. With regard to the manufacturing ISM index, the signal is more positive, as the index remains at a 20-year high and is not showing signs of potential weakness stemming from Hurricane Florence or the trade tensions.

The services PMI is painting a less positive picture of the next few months, following a sharp drop between May and September (from 56.8 to 52.9). Most indicators continue to point to a clear continuation of the economic expansion currently underway, but an increasing number of sectors are announcing a slowdown in the pace of expansion. The current situation thus seems slightly unstable, while certain elements appear to point to visible effects of the tariffs war initiated by the Trump administration.

However, consumer confidence is at an 18-year high, and it would thus behoove us not to underestimate the impact of consumption on H2 GDP figures.

Are trade tensions already affecting US foreign trade?

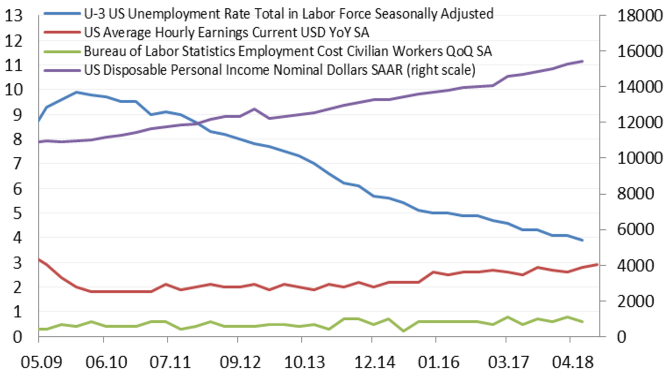
As we have mentioned numerous times, the main risk factor with regard to the US economy continues more than ever to be the showdown with China instigated by the US president. The latest available foreign trade figures show that the trade deficit, contrary to expectations, actually grew to 75.8 billion dollars in August, its worst showing in the past six months. The decrease in food, industrial materials, and vehicle exports was cited by the Department of Commerce as the main contributor to this decline. The DHL Global Trade Barometer also fell to its lowest level since 2016, indicating a deterioration in international trade over the next few months. In the meantime, the WTO also downgraded its outlook for world trade. The intensification of the crisis between Washington and Beijing could well have even more significant effects at the beginning of 2019, should all the measures proposed by President Trump ultimately be implemented. Recall that the first phase in the showdown targeted 50 billion dollars in imports from China, of which only a small portion impacted US consumers. The second wave of tariffs, introduced a few weeks ago, targets an additional 200 billion in imports, of which a substantial portion will impact consumers. Trump announced that, if China was not more conciliatory after this second wave of tariffs, he would extend tariffs to all Chinese imports and would reserve the right to increase the additional tariffs by 10% to 25%, a move which would end up having a considerable impact on US consumers by raising prices on consumer goods and diminishing consumers' purchasing power.

Trump's strategy involves risks not only with regard to consumption but also to GDP growth, which do not yet seem to have been incorporated into the consensus forecast.

Slight pressure expected on long-term rates

Unexpectedly, the pace of inflation dropped slightly, slipping from +2.9% in July to +2.7% in August. In parallel, inflationary expectations also fell somewhat from +3% to +2.8% yoy. As for the longer term, the expected inflation rate over 5-10 years declined from +2.6% to +2.4%. The production capacity utilisation rate remains high (78%), while unemployment lingers at 3.9%, likely its quasi full employment rate.

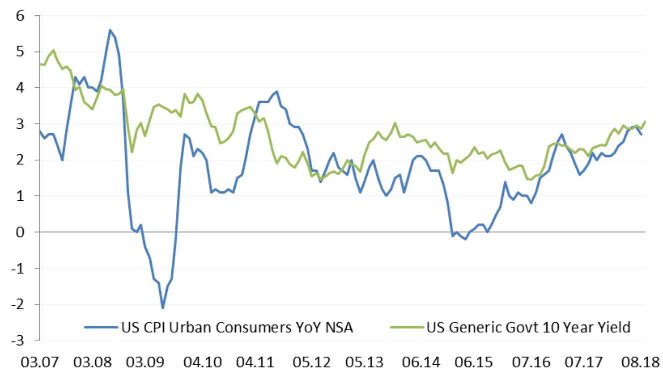
Unemployment, earnings, employment cost, wages



Sources: Bloomberg, BBGI Group SA

The next upswing in inflation should subsequently be bolstered by pressure in the job market, which seems to be slow to materialise, even though the market is nearing full employment. Amazon's recent decision to raise the minimum hourly wage of its employees by +20% may be one of the first signs that businesses are struggling to find employees at this point in the cycle, which may herald the trend mentioned above. The increase in the hourly wage rate, up +2.9% in August, is thus somewhat troubling and, in our view, supersedes the risks of a surprise upswing in inflation.

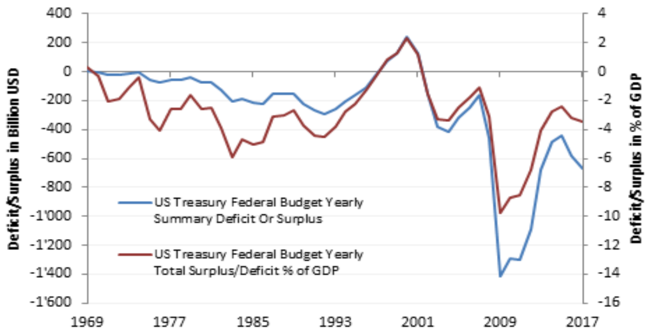
Inflation and 10-yr US Treasury bonds



Sources: Bloomberg, BBGI Group SA

As predicted, long-term rates increased to 3%, and we currently believe that they are likely to exceed this level eventually. Inflation, likely the main catalyst of the increase, is currently not high enough to trigger a further increase in 10-year rates. However, in the slightly longer term, the growth in budget deficits or a change in China's attitude toward financing the US deficit could contribute to a rise in long-term rates. The latter should increase to somewhere between 3% and 3.5% in the medium term.

US Treasury budget deficit



Sources: Bloomberg, BBGI Group SA

Relative attractiveness of the dollar decreases

Policies carried out have been favourable to dollar-denominated investments and to inflows into the US. The dollar is still benefitting from rather attractive yield spreads with respect to most currencies. However, we are approaching an inflection point in interest rates that could be less favourable to the dollar. By 2019, yield spreads will likely shrink due to rising interest rates in the Eurozone and in other developed and developing countries. In the meantime, funds could once again start to flow into impaired emerging market assets and into the Eurozone, whose equity markets are attractively valued. We maintain our bullish forecast with regard to the dollar/Swiss franc exchange rate, which could reach 1 to 1.05 francs. The US currency will likely very gradually lose some of its sheen compared to the euro and to emerging market currencies, as the stock market climate improves at the end of the year.

Keep an eye on profits and equity valuations

US corporate earnings grew by 65 billion dollars in Q2, a substantial increase compared to the 26.7 billion posted in Q1. Financial firms posted earnings of 16.5 billion dollars following a loss of 9.3 billion in Q1. The earnings growth of non-financial firms jumped from 32.3 billion to 53 billion dollars within a single quarter. The earnings growth of firms in the S&P500 certainly helped drive the index up. However, while tariffs are being implemented left and right, it is important to note that US firms are not immune to the risks caused by this showdown.

Indeed, we estimate that a 25% increase in tariffs on Chinese goods would have an impact of -7% on US corporate earnings. Assuming stable PE ratios, corporate earnings growth would be 0% in 2019, a scenario that does not seem to be incorporated into share prices at all. If we assume that, when interest rates are rising, PE ratios have a tendency to contract, then a -10% drop in the PE of the S&P500, namely from 18x to 16.2x, could cause a drop in the index of over -10%.

S&P500, Nasdaq and GAFA

Sources: Bloomberg, BBGI Group SA

In this context, the risks with regard to the US market are not nil. However, in the short term, we are giving current trends the benefit of the doubt, while recommending that investors become increasingly attentive to potential risks of disappointment with regard to corporate earnings announcements and the introduction of tariffs.

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