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# BUSINESS CONDITIONS MONTHLY

November 2018 Vol. 5 Issue 11

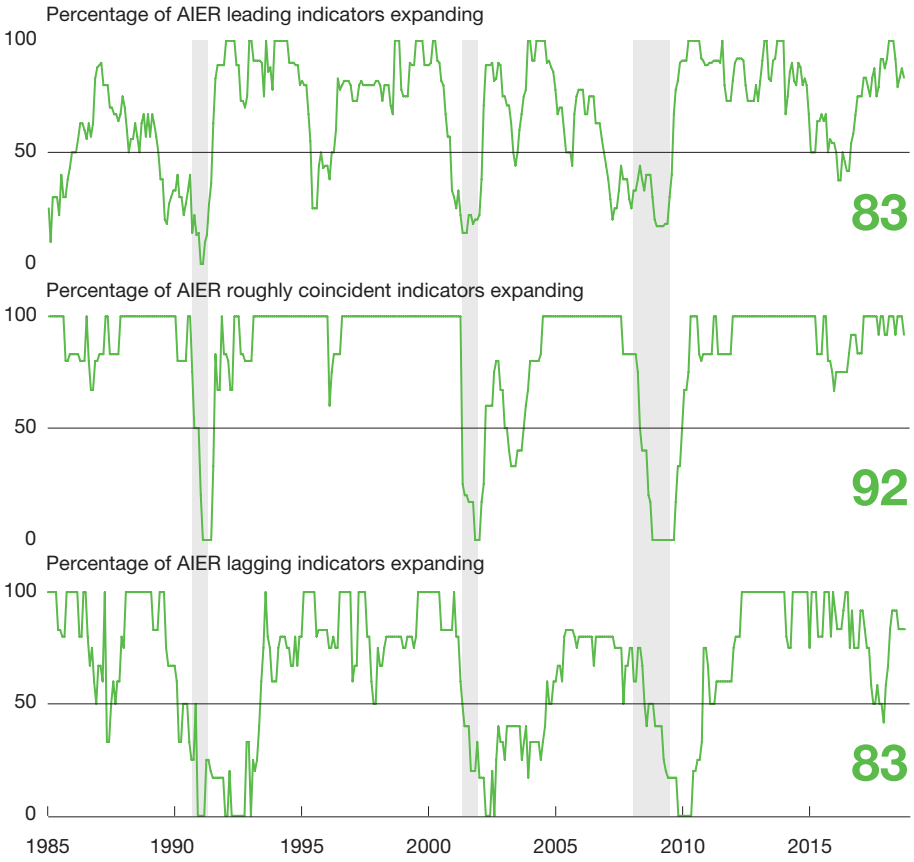
**AIER's leading and coincident indicators fell slightly in October; third-quarter GDP posted a solid gain, led by consumers.**

AIER's Business Cycle Conditions Leading Indicators index pulled back in October, dropping to 83 following an 88 in September. The Roughly Coincident Indicators index dropped to 92 while the Lagging Indicators index held steady, posting an 83 (see chart). Despite the declines, the AIER business cycle indicators suggest broad-based economic expansion and continue to support a positive outlook with a low probability of recession.

The economy expanded at a solid pace in the third quarter led by a strong gain in consumer spending. Other sectors of the economy were mixed.

Federal debt and worsening deficits remain a significant risk. Other lingering concerns include the impact of tariffs and other trade policies and the typical late-cycle risk of accelerating price increases. For now, the outlook remains positive, but careful monitoring of potentially destabilizing risks is warranted.

**Chart 1. Indicators at a glance**




**Notes**: Shaded areas denote recessions. A score above 50 indicates expansion. **Source**: AIER.

**Average workweek in manufacturing turned neutral; housing is the only leading indicator remaining in a negative trend.**

### Leading indicators dipped in October but remain well above neutral

The AIER Leading Indicators index had just one change in October among the 12 indicators. The average length of the workweek in manufacturing returned to a neutral trend after showing an upward trend in recent months. The workweek in manufacturing is one of the indicators with natural boundaries, as employees can only work so many hours in a week. Therefore the interpretation is somewhat different from an unbounded indicator, such as real retail sales. The average workweek is very long by historical comparison, so it's not surprising to see it plateau. A neutral trend at a high level for an indicator with a natural boundary is less ominous than a neutral trend for an unbounded indicator. If, however, the average-workweek indicator was to turn to and stay in a downtrend, the change would be more significant. Confirmation from other indicators turning weaker would also be very important.

Housing permits remained in a downtrend in October after turning neutral in June and downward in August. As discussed over the last few months, the housing market appears to be struggling with a combination of elevated home prices and rising interest rates. While affordability overall remains favorable, it has become significantly less favorable over the past few years. With interest rates likely to drift even higher over coming months and quarters, the outlook for housing remains cautious.

Overall, 9 of the 12 leading indicators maintained a positive trend in October, with 2 trending flat (average workweek in manufacturing and debit balances in margin accounts) and 1, housing permits, trending lower.

The Roughly Coincident Indicators also had one change in October as the employment-to-population ratio turned neutral. That change pushed the overall index to 92 from a perfect 100 in September. The employment-to-population ratio had been in an uptrend since November 2013. A tight labor market and rising wages might draw more people into the labor force, which would allow the employment-to-population ratio to trend higher in the future.

AIER's Lagging Indicators index held steady in the latest month, posting a reading of 83. October is the fourth month at that level following three months at 92, from April through June. Although the index was unchanged overall, three indicators within the index changed trends in October. Overall, five indicators are trending higher, one is trending lower, and none are neutral. That compares to four trending higher, two trending neutral, and none trending lower in September. Duration of unemployment dropped from a positive trend to a negative trend while both real manufacturing and trade inventories and real private nonresidential construction improved to positive trends from neutral last month.

The three AIER business cycle indicator indexes are well into favorable territory, suggesting a continued positive economic outlook with a low probability of recession in the coming months.

**Consumer spending drove real GDP higher in the third quarter while business investment slowed and housing dropped for the third consecutive quarter.**

### First estimate of third-quarter real GDP growth shows a solid gain

Real gross domestic product rose at a 3.5 percent annualized rate in the third quarter, down from a 4.2 percent pace in the second quarter. Growth was driven primarily by strong gains in consumer spending. Business investment and government spending made small positive contributions while net trade and inventory change made large but mutually offsetting contributions.

Consumer spending accelerated in the third quarter, rising at a robust 4.0 percent pace compared to a 3.8 percent growth rate in the second quarter. The acceleration was broad-based across the major segments of consumer spending, with durable-goods spending rising 5.8 percent, nondurable-goods spending up 5.2 percent, and services gaining 3.2 percent. Consumer spending contributed 2.7 percentage points of the 3.5 percent real GDP growth rate versus contributing 2.6 percentage points in the second quarter.

Real business investment contributed 0.12 percentage points to overall real GDP growth versus a 1.15 percentage-point contribution in the second quarter. Business fixed investment rose at a 0.8 percent annualized rate in the third quarter, slower than the 8.7 percent pace of the second quarter. At annualized rates, the gain was led by a 7.9 percent jump in intellectual property spending while spending on equipment rose 0.4 percent. Investment spending on nonresidential structures fell 7.9 percent following two quarters of double-digit growth.

Residential investment, or housing, fell at a 4.0 percent pace in the third quarter compared to a 1.3 percent decline in the prior quarter and a 3.4 percent drop in the first quarter. Housing continues to face a challenging environment, with rising interest rates and elevated home prices dragging down affordability.

Altogether, business and residential investment declined at a 0.3 percent pace in the third quarter, subtracting 0.04 percentage points from total GDP growth compared to a 1.10 percentage-point contribution in the second quarter.

Inventory accumulation by businesses surged in the third quarter, adding 2.07 percentage points to third-quarter growth. However, that was mostly offset by weaker net trade. Net trade had a negative impact on overall GDP growth in the third quarter, subtracting 1.78 percentage points. Exports fell at a 3.5 percent pace while imports grew at a 9.1 percent rate. It is unclear whether trade patterns are being impacted by uncertainty over trade policy and the deteriorating environment for global trade.

Government spending rose at a 3.3 percent annualized rate in the third quarter compared to a 2.5 percent increase in the second quarter. The way that GDP is calculated, increases in government spending count as increases in Gross Domestic Product. Many economists dispute that as a real increase in growth. But the way things are currently calculated, those added 0.56 percentage points to growth. Government spending rose in nearly every category, with federal defense spending up 4.6 percent, federal nondefense spending up 1.5 percent, and state and local spending up 3.2 percent. Exploding federal deficits remain one of the most significant risks to the medium- and long-term outlook for the economy.

Real final sales to private domestic purchasers, a key measure of private domestic demand, rose at a very healthy 3.1 percent annualized rate in the third quarter, down from a 4.3 percent pace in the second quarter. The third-quarter gain was the fifth time in the past seven quarters that growth exceeded 3 percent.

The underlying trend in real private domestic demand remains well-supported by continued job creation, rising wages, healthy corporate and consumer balance sheets, solid corporate-sales and corporate-earnings growth, and high levels of business and consumer confidence. The virtuous cycle between the consumer and corporate sectors is likely to provide ongoing support for further gains in real private domestic demand, suggesting continued economic expansion in the months and quarters ahead.

**The U.S. manufacturing sector has been in a long-term decline as a share of total output but the recent trend is more favorable.**

### Manufacturing-sector growth accelerating

Over the last five years, the annualized growth rate for manufacturing output is just 0.7 percent. Prior to the current expansion, there has never been such a low pace of growth for a five-year period that does not include a recession.

The strong economy may be helping. Over the last 12 months, industrial output has grown 3.5 percent, the fastest 12-month gain since 2012. In real terms, manufacturers' new orders for consumer goods and manufacturers' new orders for capital goods excluding aircraft, two of AIER's leading indicators, remain in uptrends, suggesting continued growth in output. Further support comes from the Institute for Supply Management, whose monthly Manufacturing ISM Report on Business shows slightly slower but still solid results for production, new orders, new export orders, employment, and backlogs of orders.

The accelerating pace of growth has contributed to a rising trend in capacity utilization for manufacturers. Utilization rose to 75.9 percent in September, the second-highest level since 2015. The combination of accelerating output growth, strong new orders and backlogs of orders, and rising utilization suggests a positive outlook for manufacturing over coming months and quarters.

The primary risks are the rising trend in input costs and the scarcity of qualified labor. Escalating trade disputes are increasing the risk of disruption to global supply chains and global demand.

**Overleveraging is a concern for every sector, but federal debt appears out of control.**

### FY2018 Federal deficit totals $779 billion

September closed out the fiscal year for the federal government. For FY2018, the federal government ran a deficit of $779 billion, the fifth largest on record, exceeded only in the four years following the Great Recession of 2008–9. As a share of GDP, the deficit came in at 3.8 percent, the worst since 2012.

Even more concerning than the size of the deficits is the trend over the past three years. Since the Great Recession was the worst recession since the Great Depression, it may be understandable that the federal deficit exploded in 2009, totaling $1.4 trillion, or 9.8 percent of GDP, dwarfing the previous record deficit of 5.7 percent of GDP in 1983 following the severe double-dip recession in the early 1980s. The deficits remained enormous in 2010 and 2011 but, thanks to GDP growth, began to shrink on a percentage basis. Actual dollar amounts also began to fall in 2012 and hit a relative low of $438 billion, or 2.4 percent of GDP, in 2015.

Since then, deficits have increased every year, both in dollar terms and as a share of GDP. Since 1950, deficits have tended to improve during expansions as the need for fiscal stimulus declines and economic growth boosts GDP. The fact that deficits are growing in both dollar terms and as a share of GDP more than nine years into economic expansion suggests irresponsible policy. Most concerning is that despite the potentially disastrous path, the topic was hardly mentioned during the recent midterm election cycle.

Debt outstanding by the federal government totaled $21.5 trillion as of the third quarter of 2018. That is 104.1 percent of GDP. Though the U.S. dollar is the world's reserve currency, and the Treasury market is considered the safest, most liquid market in the world, to believe that U.S. deficits and total debt as a share of GDP can grow indefinitely opens the door to potential fiscal and economic catastrophe.

## CAPITAL MARKET PERFORMANCE

(Percent change)

| | October 2018 | Latest 3M | Latest 12M | Calendar Year 2017 | 2016 | 2015 | Annualized 3-year | 5-year | 10-year |
|---|---|---|---|---|---|---|---|---|---|
| **Equity Markets** | | | | | | | | | |
| S&P 1500 | -7.2 | -4.2 | 4.9 | 18.8 | 10.7 | -1.0 | 9.3 | 8.9 | 11.0 |
| S&P 500 - total return | -6.8 | -3.3 | 7.4 | 21.8 | 12.0 | 1.4 | 11.5 | 11.3 | 13.2 |
| S&P 500 - price only | -6.9 | -3.7 | 5.3 | 19.4 | 9.5 | -0.7 | 9.3 | 9.1 | 10.8 |
| S&P 400 | -9.6 | -8.0 | -0.6 | 14.5 | 18.7 | -3.7 | 8.1 | 7.2 | 12.4 |
| Russell 2000 | -10.9 | -9.5 | 0.6 | 13.1 | 19.5 | -5.7 | 9.2 | 6.6 | 10.9 |
| Dow Jones Global Large-Cap Index | -7.3 | -6.3 | -1.9 | 42.9 | -10.0 | -4.4 | 5.9 | 4.1 | 7.0 |
| Dow Jones Global Large-Cap ex. U.S. Index | -8.0 | -9.9 | -10.2 | 41.0 | -10.7 | -8.3 | 1.9 | -0.9 | 3.8 |
| STOXX Europe 600 Index | -5.6 | -7.7 | -8.5 | 7.7 | -1.2 | 6.8 | -1.2 | 2.3 | 5.0 |
| **Bond Markets** | | | | | | | | | |
| iShares 20+ year Treasury bond | -3.1 | -5.1 | -8.7 | 6.5 | -1.2 | -4.2 | -2.6 | 1.1 | 2.0 |
| iShares AAA-A Corporate bond | -1.6 | -2.3 | -6.0 | 2.9 | 1.7 | -2.4 | -1.2 | -0.3 | NA |
| **Commodity Markets** | | | | | | | | | |
| Gold | 2.0 | -0.5 | -4.3 | 12.6 | 9.0 | -10.5 | 2.1 | -1.7 | 5.3 |
| Silver | 0.2 | -7.1 | -14.7 | 3.8 | 17.5 | -13.5 | -2.8 | -8.4 | 4.4 |
| CRB all commodities | 0.3 | -3.7 | -2.7 | 2.2 | 12.9 | -14.4 | 1.7 | -1.9 | 2.3 |

## CONSUMER FINANCE RATES

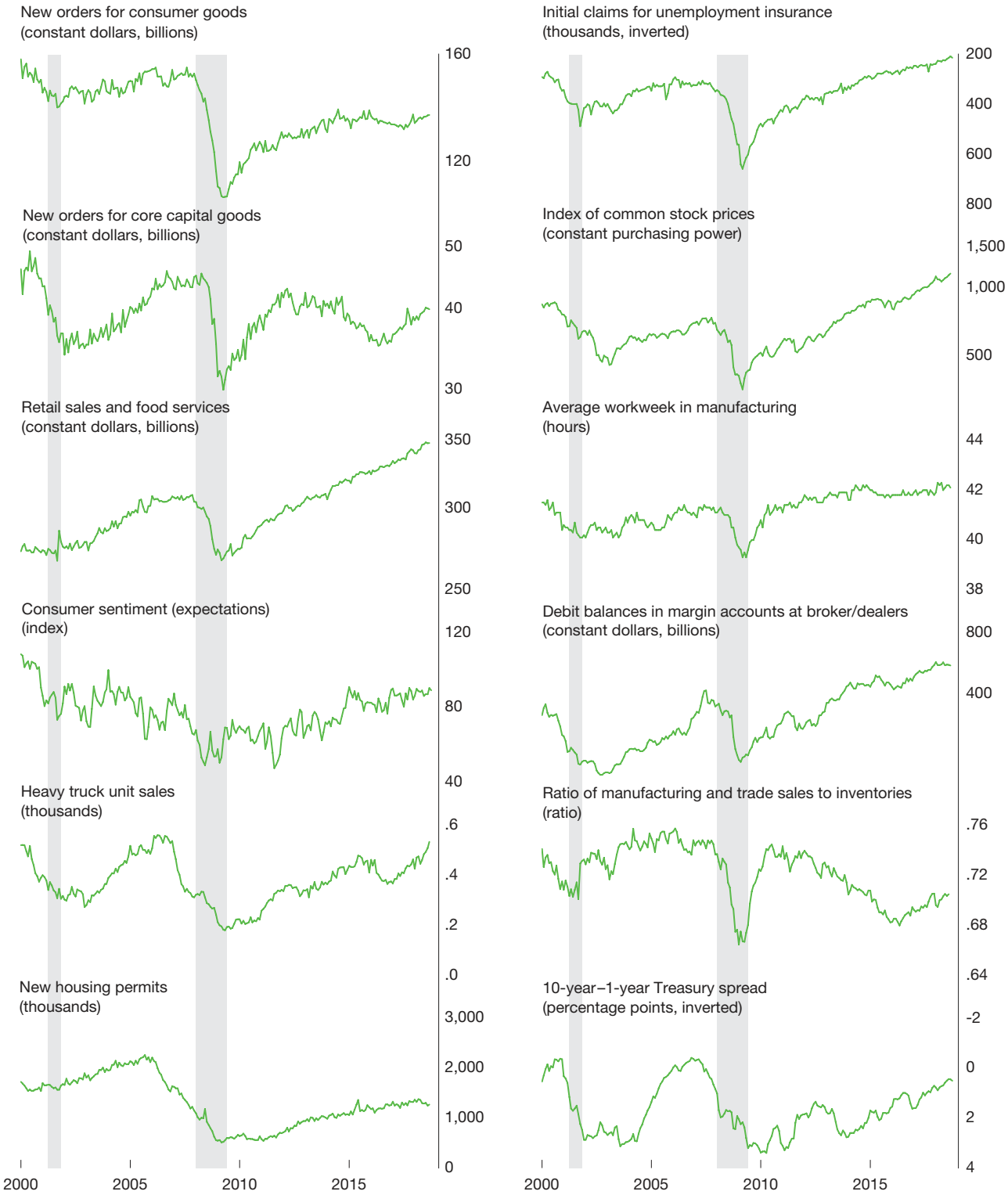
(Percent)

| | October 2018 | Latest 3M | Latest 12M | Average for Year 2017 | 2016 | 2015 | Average over Period 3-year | 5-year | 10-year |
|---|---|---|---|---|---|---|---|---|---|
| 30-yr. fixed mortgage | 4.6 | 4.6 | 4.3 | 4.0 | 3.7 | 3.9 | 4.0 | 4.0 | 4.2 |
| 15-yr. fixed mortgage | 4.1 | 4.0 | 3.8 | 3.3 | 2.9 | 3.1 | 3.3 | 3.3 | 3.5 |
| 5-yr. adjustable mortgage | 3.9 | 3.9 | 3.6 | 3.2 | 2.9 | 2.9 | 3.2 | 3.1 | 3.4 |
| 48-month new car loan | NA | 5.1 | 4.9 | 4.6 | 4.3 | 4.2 | 4.5 | 4.4 | 5.1 |

**Note**: New-car loan rates are quarterly data. Values shown are for latest quarter.
Calculations for annualized returns have changed to use daily data instead of monthly averages.

**Sources for tables on this page**: Bankrate, Barron's, Commodity Research Bureau, Dow Jones, Federal Reserve, Frank Russell, iShares, Standard & Poor's, STOXX Europe 600, Thomson Reuters.

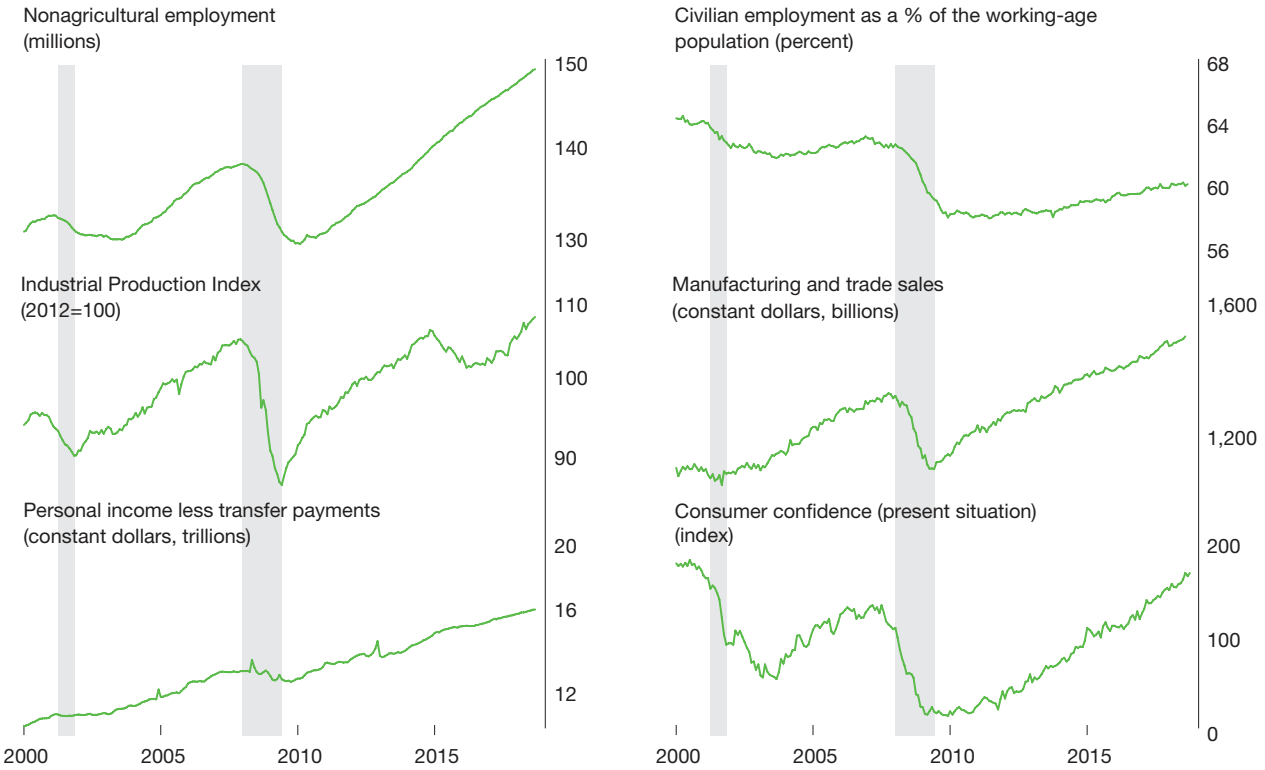
## LEADING INDICATORS (2000–2018)



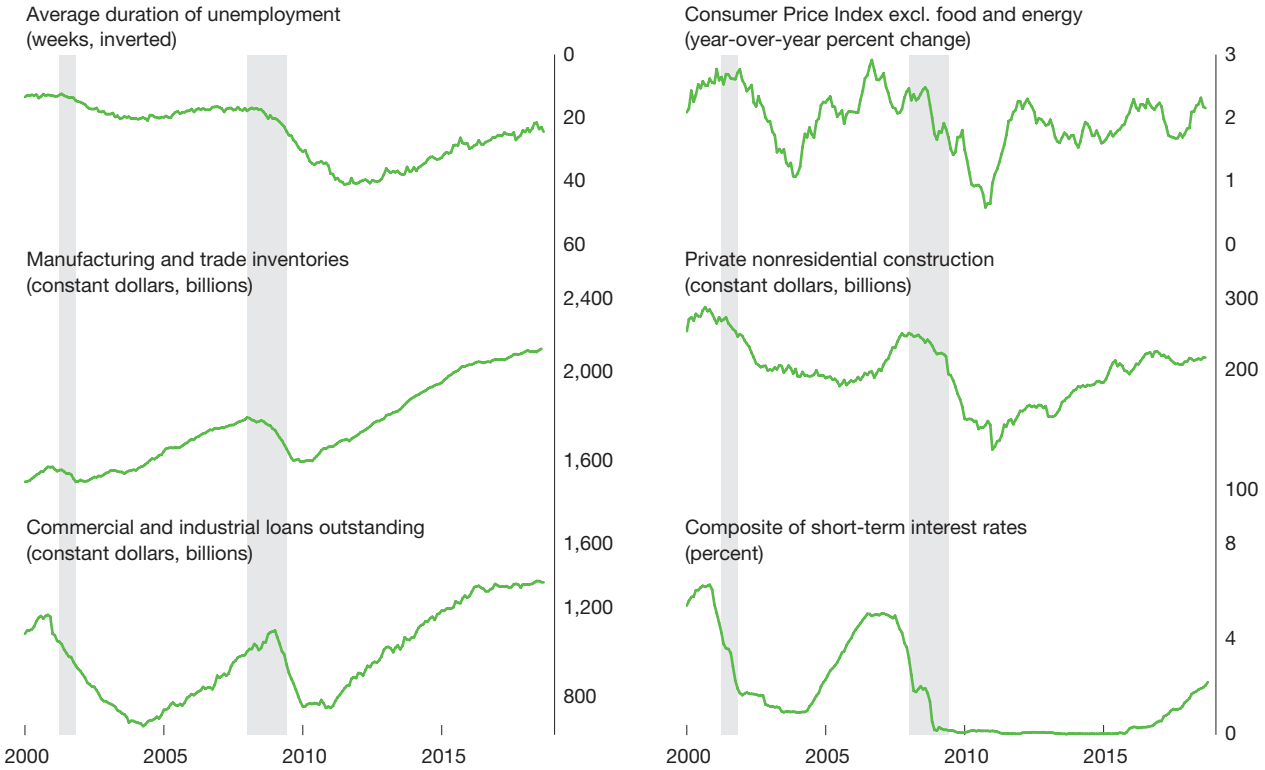

**Sources for Appendix**: Bureau of Economic Analysis, Bureau of Labor Statistics, Department of Labor, Federal Reserve, New York Stock Exchange, Standard & Poor's, The Conference Board, University of Michigan, U.S. Census Bureau (Thomson Reuters Datastream).

**Note**: Shaded areas denote recessions.

## ROUGHLY COINCIDENT INDICATORS (2000–2018)




## LAGGING INDICATORS (2000–2018)



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