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GLOBAL ECONOMIC OUTLOOK: U.S. AND EM POISED TO UNDERPIN GROWTH

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KEY TAKEAWAYS

We expect global growth to slow in 2019 but remain strong enough to continue to support the broad global economy and markets.

Developed economies will benefit from continued solid growth in the U.S. and potential upside in Japan.

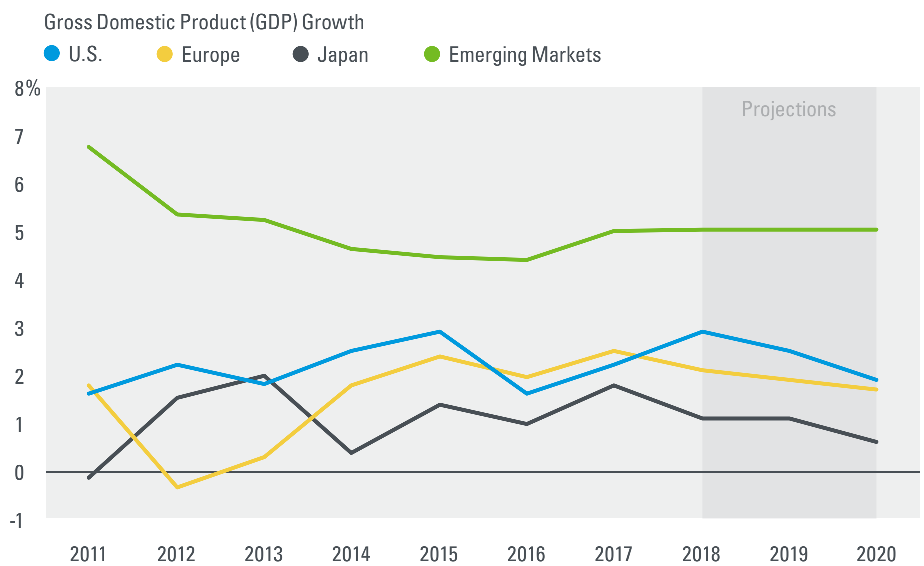
Economic growth in emerging markets will, in our view, continue to outpace developed markets, although we acknowledge there are risks to this positive outlook.

Investors have been digesting a number of important global developments this year: fiscal stimulus, trade tensions, divergence in global policy and currencies, and political developments. As 2018 heads into the fourth quarter, we've put together what we believe these developments mean looking forward to 2019. Overall, we expect global growth to slow in 2019 but remain strong enough to continue to support the broad global economy and markets. The United States will continue to be the growth engine for developed markets, although we see some upside for Japan, but the front-loaded impact of fiscal stimulus is likely to fade somewhat. In the meantime, we expect some emerging market (EM) headwinds to fade, allowing EM economies to enjoy a stronger pace of growth than developed economies. We do expect China's growth to slow, but it will likely avoid a hard landing as the economy rebalances [Figure 1].

DEVELOPED ECONOMIES

Developed economies are growing solidly, thanks to accelerating growth in the U.S. However, we expect the pace of growth in developed economies to slow

1 U.S. LEADS GROWTH PROSPECTS IN DEVELOPED MARKETS



Source: LPL Research, Bloomberg 10/04/18

Projections are from Bloomberg's survey of economists. Projections may not develop as predicted.

going into next year as the Federal Reserve (Fed) tightens policy further, the impact of fiscal stimulus decreases, and Europe struggles with fiscal and political issues.

United States

The U.S. has led the global economic recovery among developed economies since it entered expansion territory more than nine years ago. As the expansion reaches its later stages, we've emphasized that this leg of growth will be driven by the return of more traditional business cycle drivers. This year, we've seen this theme materialize in several economic trends.

- Tax relief and deregulation have lifted profits for U.S. firms, allowing them to invest in hiring and productivity, while deficit spending has increased the government's contribution to growth.
- Growth in capital expenditures has accelerated over the past 12 months, and nonfarm productivity growth is at its highest level in over three years.
- The labor market has continued to tighten, as job growth remains solid and the unemployment rate hovers near a 48-year low.
- Wage growth and tax cuts have emboldened the U.S. consumer, evidenced by higher confidence and a pickup in consumer spending, which accounts for about 70% of gross domestic product.
- Inflation hasn't threatened output or forced a change in monetary policy: Pricing and wage pressures remain manageable, allowing the Fed to continue on its path of gradual rate increases.

While the U.S. economy has hummed along, trade tensions have emerged as a modest risk to growth, although the impact on the data to date has been minimal, and we continue to believe that any negative impact will be small compared to the positive impact of fiscal stimulus. U.S. manufacturing health has led other global regions [Figure 2], but underlying data hint at supply chain constraints and a decline in international orders. U.S. firms surveyed recently have also noted labor shortages, rising input costs, and bleaker outlooks amid tariff uncertainty.

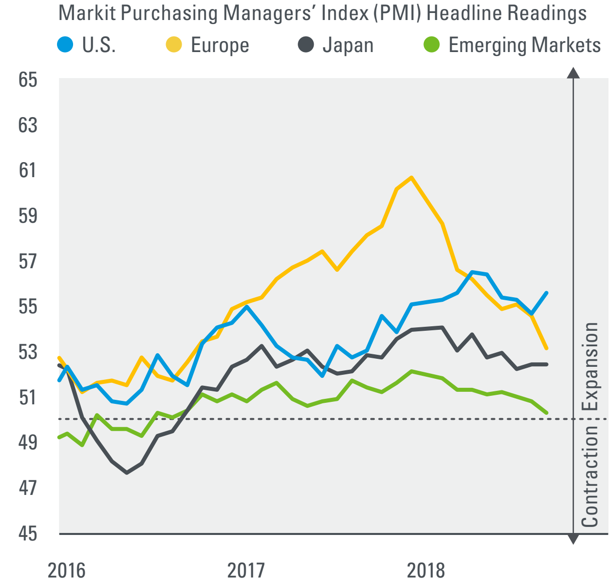
Overall, we expect the U.S. economy to continue expanding at a moderate pace, averaging a 3% growth clip in 2018 and slowing some in 2019, as strong underlying economic trends outweigh negative impacts from tariffs.

Europe

Europe's economy has been a laggard in the current expansion, plagued by fiscal and political issues in several countries and a continued need for structural reforms that will help unleash economic potential. Europe's latest troublemaker is Italy, whose populist leaders earlier this month boosted the country's proposed budget deficit to 2.4% last week, exceeding the 2% limit agreed upon with

2 TRADE TENSIONS WEIGH ON INTERNATIONAL MANUFACTURING ACTIVITY

Markit Purchasing Managers' Index (PMI) Headline Readings



Source: LPL Research, Bloomberg 10/04/18 the European Union (EU). The U.K. government and the EU are also negotiating plans for the U.K.'s exit from the EU ("Brexit"), a complex process that could include unintended economic consequences for all parties.

Europe's economic data have also started to deteriorate. Eurozone manufacturing health fell to its lowest point in two years, weighed down by slowing activity in several countries, including Germany, Spain, and Italy. Europe's political volatility and declining global trade activity will continue to weigh on domestic and international demand, so we don't expect manufacturing to recover substantially in the short term. Eurozone services activity has also declined significantly this year. To complicate matters further, the European Central Bank has publicly announced plans to start tightening policy by reducing bond purchases this month, and ending its bond buying entirely by the end of the year. Bloomberg-surveyed economists' consensus projects slowing growth for Europe over the next few years. We agree with the consensus here, given disappointing economic reports, trade tensions, and political dissonance.

Japan

Developed markets' economic growth story becomes slightly more compelling as we move outside Europe. While it's true that Japan's economic data have been trending lower, fiscal stimulus and structural reforms are having an impact and monetary policy remains supportive. The Bank of Japan has provided a backstop of relatively loose monetary policy, and we don't expect them to change course given recent disappointing economic data and trade challenges. Japan is also in the earlier stages of its economic expansion, and its output could pick up significantly if underlying economic trends improve. Because of this, we are more optimistic on Japan's economic potential than Europe's, but we don't expect this surge in output to eclipse the pace of growth in the U.S. anytime soon.

EMERGING MARKET ECONOMIES

EM has had a challenging year compared to expectations, weighed down by a strong U.S. dollar, Fed policy, trade headwinds, and political uncertainty. We expect overall economic growth, however, to continue to outpace developed markets, thanks to improving demographics and the globalization of manufacturing. However, we acknowledge there are significant risks to our positive outlook.

China

China's economic future could be one of those risks. While China is considered an emerging market, it boasts the world's second-largest economy, although it still significantly lags developed markets on a per capita basis. China is also a valuable trade partner to countries around the world, including the U.S. Any hiccups in China's growth or production could significantly weigh on regional and global economic growth.

Right now, China is struggling with the fallout from its trade spat with the U.S. The U.S. has imposed tariffs on about $250 billion in Chinese imports, and has threatened to increase the tax on $200 billion in goods if no trade deal is reached by the end of the year. While the U.S. has been mostly immune to economic impacts from tariffs, China's economic data are starting to show cracks. China's manufacturing expansion has slowed for four straight months and may be vulnerable to a period of contraction, although the impact on the economy would be less than what it once was as the country continues to shift to an economy more focused on services and domestic consumption. China's industrial profits have also slowed significantly this year as corporations fight higher costs and cooling demand. Even so, we expect the U.S. and China to reach a trade agreement before tariffs cause any significant economic damage to either country.

Rest of Emerging Markets

The Fed's monetary policy tightening has strengthened the dollar versus other currencies, which has indirectly weighed on EM economies. A flight of capital from EM currencies has fueled rampant inflation in a few EM countries, like Venezuela and Turkey, threatening their economic progress and forcing central banks to intervene. As the U.S. moves forward with gradual tightening, further gains in the dollar magnify the currency risk to EM. On the other hand, the dollar's appreciation curbs demand for U.S. exports, which become more expensive, and potentially supporting manufacturing activity overseas.

Despite the current headwinds, we remain optimistic that EM growth prospects may prevail, supported by regions that don't always grab headlines, such as India and Latin America. We expect EM economic activity from advantageous consumer demographics and early cycle acceleration to help offset any negative impacts from weakening currencies or geopolitical turmoil. EM stands to benefit significantly from 6 billion consumers and innovation from businesses embracing global output changes.

CONCLUSION

Based on what we know now, we expect the global economic expansion to continue through the next few years, led by the U.S. and its contribution to growth in developed markets. Emerging economies may also fuel global growth as volatility in those markets subsides, giving way to higher output powered by demographics and stronger manufacturing as trade disagreements are resolved. While there will be several risks to negotiate, looking into 2019 we continue to see solid prospects for steady—if somewhat slower—economic growth that can still provide support for markets and the overall global economy. ■

DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

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