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US economy continues to lead the pack

The US economy has been the exception to slower growth across the G7 this year. Canadian GDP growth has moderated from last year's impressive 3% pace, activity in Japan has softened, and Europe has been hit by both transitory factors and political uncertainty. But fiscal stimulus has helped the US economy accelerate in 2018, even as higher interest rates and capacity constraints would typically see growth leveling off at this point in the cycle. US GDP was up an annualized 3.5% in Q3, building on a 4.2% gain in Q2 to deliver the best back-to-back growth in four years. Consumer spending led the way as a strong job market, rising wages, and near-record confidence have Americans opening up their pocketbooks. The public sector also provided support, with federal government spending running at its fastest year-over-year pace since 2010. It wasn't all positive—business investment was softer than expected after strong gains earlier this year. And net trade was a sizeable drag in Q3, more than retracing the previous quarter's add when purchasers likely tried to get ahead of rising import tariffs. But those factors only served to partially offset robust consumer and government spending.

The question is, how long will this strength be sustained? In the near-term the economy looks set to maintain an above-trend pace of growth. The household savings rate is healthy and wages are picking up, suggesting continued momentum on the consumer side. Rising protectionism and higher interest rates present headwinds to business investment, but sentiment remains strong and financial conditions are still broadly accommodative. We doubt Q3's soft business investment is the start of a trend. And while much of the boost from government stimulus will occur this year, the fiscal impulse will remain positive in 2019. The trade outlook is less rosy—protectionist measures have failed to rein in the trade deficit and relative strength in the domestic economy points to imports outpacing exports again next year. On balance, we look for GDP growth to moderate slightly to 2.5% in 2019 from 2.9% this year—still well above potential growth of around 2%.

Midterm elections limit prospects for further tax cuts

US Treasuries sold off throughout September and in early October with 10-year yields hitting a seven-year high of more than 3.20%. Real yields are rising while implied inflation expectations remain at or below highs seen earlier this year. The US economy's persistent strength seems to have investors thinking the current cycle has plenty of legs. That sentiment was expressed by Fed Chair Powell, who recently said, "there's no reason to think that this cycle can't continue for quite some time." His comment that rates might eventually rise above 'neutral' levels—a view we've expressed for some time, but that markets have been slow to price in—also contributed to the selloff. Even the usually dovish head of the Chicago Fed recently advocated for rates to eventually rise to a slightly restrictive setting.

The rise in longer-term yields wasn't matched at the short end. So the curve-flattening trend seen throughout this year that has cause so much consternation among market watchers has stalled. We don't see the yield curve inverting over the next year. The combination of investors pricing in more significant Fed tightening, inflation expectations creeping higher, and plenty of supply to fund government deficits should keep upward pressure on longer-term yields. We see US 10-year yields ending this year at 3.30% and continuing to rise throughout 2019.

No surprises in latest Fed announcement

September's rate hike came as no surprise, though a change in the Fed's policy statement caught investors off guard and seemed to cause a bit of confusion. The longstanding reference to monetary policy remaining accommodative was removed, which markets took as a dovish development. But in his press conference, Chair Powell clarified that monetary policy is still accommodative—certainly relative to the Committee's 'neutral' estimates that range from 2.5-3.5%. He noted the previous language had "run its useful life" and the shift didn't reflect a change in the Fed's approach to raising rates. That was backed up by a little-changed 'dot plot' that continued to flag another hike this year and three increases in 2019. The only notable forecast change was an upward revision to GDP growth this year and next—a nod to the US economy's considerable momentum even as it pushes beyond longer run capacity limits. With little need for monetary policy accommodation at this point, we see the Fed continuing to raise rates once a quarter through the end of next year.

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