2018 Outlook: Moving Into the End of the Cycle

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As year-end approaches, signs indicate the expansion is peaking. Job growth is trending down due to low labor supply, the Fed is planning to raise rates, and consumer and business confidence are sitting at multi-year highs. There’s nowhere to go but down.

This doesn’t mean a recession is imminent, but it does mean growth is likely to slow through 2018. With that, confidence is likely to decline, along with corporate earnings growth. Stock markets will be affected, potentially giving back some of 2017’s gains.

On the economic front, four factors will affect growth:

1. Consumer spending: Though it’s held steady for several years, I think it could slow in 2018, dragging on growth.
2. Business investment: As the pool of new workers has run out, companies have invested to make existing employees more productive. I expect this trend to continue through 2018, supporting economic growth.
3. Net exports: With a cheaper U.S. dollar, exports have exceeded imports in recent quarters. As the dollar gets more expensive, the balance is likely to shift back to negative, dragging on growth.
4. Government spending: This has had no noticeable contribution to economic growth, and I don’t expect that to change.

Inflation also can be expected to rise slowly, putting the Fed in a difficult position. Current low unemployment says to raise rates, but low inflation says not yet. Which side will win in 2018? Markets largely expect policy tightening, so the impact of any rate increases should continue to be minimal.

This brings us to the stock markets, which are likely to face headwinds. Revenue and earnings growth has exceeded expectations at the start of the year—a trend that should continue—but valuations have risen with confidence. If confidence moderates as growth slows, valuations may well pull back.

What does this mean for 2018? I believe the economy is likely to grow by 1.5 percent to 2 percent. Inflation, constrained by that growth, is likely to remain around 2 percent. Interest rates should rise, though they also will be constrained by slower growth and central bank intervention, leaving the 10-year U.S. Treasury bond yielding around 2.75 percent at year-end. Stocks may appreciate modestly from current levels to around 2,600–2,700 for the S&P 500.

The risks to this are largely political, but sound fundamentals should continue to support markets. We’re approaching the end of the cycle, but it’s not over yet.

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