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Amid a flurry of risks, U.S. GDP should chug along

Despite slowing manufacturing, ugly U.S.-China trade talks, Brexit mess and more, 2019 GDP likely to be solid.

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BOTTOM LINE

Investors are facing a classic tale of two markets. The labor market is strong, consumer spending has rebounded nicely from its December/February doldrums and key confidence metrics such as the LEI and the Michigan Consumer Sentiment indexes have reaccelerated to new cycle highs. The economy and the financial markets have successfully shrugged off a series of transitory speed bumps, such as the fourth quarter's negative wealth effect, the government shutdown, the brutal winter and the uncertainty over Fed policy.

Will next U.K. PM make a difference?

Theresa May's announcement today she will step down as U.K. prime minister has been speculated for some time and is not a surprise. After all, she already offered to resign in March if a Brexit deal passed. Certainly, the markets seem to be brushing off the news. The big question becomes will the next Tory leader to occupy No. 10 Downing St. when she leaves on June 7 deliver a better Brexit deal for the U.K.? Boris Johnson and Dominic Raab, who both voted to leave the EU, are seen as front runners. If that process proves difficult, the markets likely won't take another prolonged period of uncertainty as well as they have today. We would expect U.K. equities to be challenged

But the concerns du jour for investors have a decidedly overseas flavor, including the escalating trade and tariff war with China; rising Brexit uncertainties (exacerbated this morning by Theresa May's resignation as U.K. prime minister); recession risks associated with another increase in Japan's consumption tax later this year; and oil market volatility related to the forced reopening of the U.S.'s nuclear pact with Iran and mounting political instability in Venezuela.

until new leadership emerges as investors have opportunity to evaluate their Brexit strategy.

It is almost certain whoever replaces May will feel the pressure to demand a tougher (better for U.K.) agreement from Brussels. But European politicians and negotiators have repeatedly said they are not prepared to renegotiate and further concessions are out of the question. This sets up the probability of a prolonged confrontation markets will not like.

-- Richard Winkowski Jr., head of international equity team

The next step with China will be the June G-20 meeting in Japan, at which we're hopeful Presidents Trump and Xi will make progress on narrowing their trade differences. Brexit uncertainty swirls, with that deadline pushed out to Halloween and a new U.K. election coming over the summer.

Consequently, manufacturing data here in the U.S. has weakened considerably over the past several months, witnessed by the deterioration in the ISM index, industrial production and capacity utilization rates, durable and capital goods orders and shipments, factory orders and business and wholesale inventories. So the powerful build-up in inventories we've seen over the past three quarters may soon begin to recede.

As a result, benchmark 10-year Treasury yields plunged to an 18-month low of 2.30% this week. With the upper band of the fed funds rate stuck at 2.50%, this modestly inverted yield curve is sparking recessionary concerns the Fed's next monetary policy move will be to cut interest rates before year end, a view that we don't share.

Similar story with stocks. After the S&P 500's powerful rally of nearly 26% since its Christmas Eve trough to its May Day record high, stocks have corrected by about 5%—

roughly half of the 5-10% correction we envisioned, given the current gathering storm clouds on the horizon.

First-quarter corporate profits were much better than the 3-5% year-over-year declines expected. Both revenues and earnings per share were up about 2.5%, with three quarters of the companies beating their earnings estimates by an average of about 6.5%. We still do not expect a recession before 2021 at the earliest, and with a host of transitory issues now behind us, earnings could re-accelerate later this year.

So while these near-term concerns about heightened geopolitical risk, weak domestic manufacturing trends and bloated inventories may fuel a healthy, moderate correction in share prices after a powerful snap-back rally, we believe that would represent a longer-term buying opportunity, as we reiterate our year-end target of 3,100 for the S&P.

Trimming our quarterly GDP forecasts The equity and fixed-income investment professionals who comprise Federated's macroeconomic policy committee met Wednesday to discuss the global outlook and its impact on domestic economic activity:

- The Commerce Department flashed first-quarter of 2019 GDP at a much stronger-than-expected 3.2% versus 2.2% in the fourth quarter. Federated's forecast was 1.8%, and the Blue Chip consensus was 1.5%. Why the big miss? Domestic final sales rose only 1.3%, but inventory restocking (0.65%), net trade (1.03%) and state and local government infrastructure spending (0.41%) were much stronger contributors to GDP than expected. This result could be revised lower.
- While the consumer has strengthened, manufacturing has weakened, we have not yet resolved the China trade deal and the pace of inventory accumulation may slow from unsustainable first-quarter levels. So we are cutting our second quarter of 2019 growth estimate from 2.7% to 2.3%, while the Blue Chip consensus is cutting its from 2.6% to 2% (within a range of 1.4% to 2.6%).
- We still expect strong Back-to-School retail sales, but the timing of an eventual China trade resolution remains highly uncertain. Additionally, any stocking up on inventories by U.S. companies ahead of any deal to beat the higher tariffs, may

begin to liquidate in the third quarter, which could pressure GDP. As a result, we also lowered our third quarter of 2019 estimate from 2.7% to 2.3%, while the Blue Chip consensus is standing pat at 2.2% (within a range of 1.7% to 2.7%).

- We are still forecasting a much better Christmas this year compared to 2018, but the stronger pace of China exports we were expecting is clearly contingent on the uncertain timing of an eventual trade deal. So we are reducing our fourth quarter of 2019 GDP growth estimate from 2.9% to 2.6%, while the Blue Chip consensus remains unchanged at 2% (within a range of 1.3% to 2.6%).
- The much stronger-than-expected first-quarter GDP, however, prompts us to raise our full-year 2019 growth estimate up a tick, from 2.6% to 2.7%, while the Blue Chip consensus also raised its estimate from 2.3% back up to its previous forecast of 2.6% (within a range of 2.3% to 2.8%).
- Our full-year 2020 GDP growth estimate remains unchanged at 2.4%, the same for the Blue Chip consensus at 1.9% (within a range of 1.2% to 2.3%).

We wish everyone a happy Memorial Day weekend!

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TAGS

MARKETS/ECONOMY EQUITY

DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

The Conference Board's Composite Index of Leading Economic Indicators is used to predict the direction of the economy's movements in the months to come.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

The Institute of Supply Management (ISM) nonmanufacturing index is a composite, forward-looking index derived from a monthly survey of U.S. businesses.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

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