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2019 ECONOMIC OUTLOOK: THE LATE INNINGS OF GROWTH?

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With decade-low unemployment and accelerating labor productivity – but also a trade war with China and a sputtering stock market – where will our focus lie when we look back on 2018?

It may be that when we look back at 2018 in a few years, we'll conclude it was the best year in the current economic cycle, and perhaps the best in several decades. The job market took off. Unemployment hit decadal lows. Labor productivity accelerated and the broadest measure of economic activity — real, inflation-adjusted gross domestic product (GDP) — posted a growth rate 50 percent higher than the average annual rate since the Great Recession ended.

Yet the year also displayed some worrisome trends. The stock market sputtered. Inflation edged higher. The "trade war" with China continues. And the Federal Reserve pursued their determined policy of gradually raising interest rates, thereby ending the era of super low-cost borrowing.

Do these trends portend a future of slower economic growth, if not an outright recession? To use a baseball metaphor, are we indeed in the late innings of economic growth?

A Look at 2018

Table 1 compares national economic performance in 2018 on major measures to the average for the period extending from the end of the recession in 2009 to 2017, as well as to the prior long-run average from 1960 through 2009. The values for 2018 (fourth column) clearly show strength in a variety of measures of economic growth. Real GDP growth rate was a full percentage point higher than the average since the end of the recession, and was even higher than the long-run average from 1969-2009. Growth in the size of the labor force, payroll jobs and labor productivity were all stronger than in the post-recessionary period, though each fell short of the longer-run (1960-2009) averages.

Business investment also came in strong, beating both the post-recessionary and longer-run averages. A major reason is the federal tax cut, which sought to stimulate business investment through reduced corporate tax rates and immediate deductibility of business investments.

Table 1. Performance of Key National Economic Measures.

Measure	Annual average 1960-2009	Annual average 2009-2017	2018	Forecast 2019
Annual growth rate in:				
Real GDP	3.1%	2.2%	3.2%[1]	2.7%
Labor force	1.6%	0.5%	1.4%[2]	0.5%
Payroll jobs	1.8%	1.6%	1.7%[2]	0.6%
Labor productivity	2.4%	1.3%	1.9%[2]	2.2%
Real wage rate	0.4%[3]	0.6%	0.3%[2]	0.5%
Stock Market[4]	12.6%	13.8%	2.8%	2.0%
Business investment (% of GDP)	17.6%	15.8%	17.7%[5]	17.5%
All-items inflation rate	4.0%	1.6%	2.5%[2]	2.6%
Core inflation rate	4.0%	1.7%	2.1%[2]	2.3%
Short-term interest rate[6]	5.4%	0.2%	1.7%[8]	2.6%
Long-term interest rate[7]	6.9%	2.4%	2.8%[8]	3.5%

Source: U.S Dept. of Commerce; Federal Reserve

[1] Annualized through quarters I, II, and III; [2] October 2017 – October 2018; [3] 1962 – 2009; [4] Dow-Jones Industrial Average; [5] Based on 2018 quarters I, II, III; [6] 3-month Treasury bill rate; [7] 10-year Treasury note rate; [8] through November.

Yet 2018 wasn't all pretty — there were some disturbing elements. Average wage rates just barely kept pace with inflation, and actually fared worse against inflation compared to the post-recessionary years. This is a surprising result given the tightening labor market during the year. Some argue worker pay gains look much better when benefits are included. Others say slow wage improvements are a continuing sign of the power of foreign labor competition.

But perhaps the most worrisome trend in 2018 was the jump in inflation and the steady upward climb in interest rates. The overall all-items inflation rate hit 2.5 percent, and the core (excluding volatile food and energy prices) rate exceeded 2 percent. While both rates are still moderate and a far distance from historic highs, they are a break with the recent past (2009-2017) of inflation rates trending between 1 percent and 2 percent.

"Perhaps the most worrisome trend: the jump in inflation and the steady upward climb in interest rates."

As inflation rates rise so generally do interest rates, and 2018 was no exception. Pushed by the Federal Reserve's policy of raising interest rates, short-term interest rates were 1.5 percentage points higher than their post-recessionary (2009-2017) average. Likewise, long rates were 0.4 percentage points higher than their post-recessionary average.

Higher interest rates have several impacts. They increase the cost of borrowing and thereby moderate loan-making. Already by the end of 2018, home-buying, which is enabled by mortgage lending, showed significant slowing. Higher interest rates increase earnings on safe financial assets, a benefit for investors seeking to lower risks. Higher interest rates also can impede the stock market in three ways. By increasing the rewards from financial assets, they provide investors with a viable alternative to stocks, and thus can reduce purchases of stocks. They also make business investments more costly and thereby work to reduce profit-making investments that could boost stock values. Third, higher interest rates lower the present value of future earnings. Since stock values are tied to future earnings, this impact has a negative impact on the stock market.

Worries over a Possible Recession

If the economy continues growing until June 2019, the current growth period—which began in June 2009—will be the longest period of sustained economic growth in the nation's history. So even if there weren't already some potentially troubling signs in the economy, it would still be prudent to examine possible factors that might generate a recession. Here I'll look at five factors that could spark a recession—excessive debt, high oil prices, a large retreat in the stock market, the Federal Reserve's policies, and world economic problems.

Excess Debt

Excessive debt is the classic cause of a recession. The reasoning is straightforward. Optimism during a period of economic growth motivates consumers to borrow in order to spend and businesses to borrow in order to expand. Both occur due to a willingness of banks and other financial institutions to lend because they too are optimistic. The optimism also motivates lenders to lower their standards to facilitate more loans.

Then something happens to reduce the optimism. It might be higher interest rates. It might be a reassessment of risks in the economy. Regardless, lending becomes more expensive and attitudes become more cautious. Businesses stop their expansions and curtail employment. Consumers turn frugal. The economic engine slows to a stop and then moves in reverse. A recession (negative economic growth) occurs and gloom prevails.

So is excessive debt evident in the economy now? Though both consumer and business (as well as government) debt have grown, the "carrying costs" of the debt — that is, the periodic debt payments as a portion of the debtor's resources — have not. Debt payments relative to disposable income for households and relative to wealth for businesses have barely budged in the last five years. The largest increase has been for consumer auto, personal and student related debt, but this gain has been countered by decreases in home mortgage payments relative to household income. Also, each of these measures is far lower than their levels prior to the Great Recession.

Oil Prices

Skyrocketing oil prices were behind two recessions in the 1970s. However, today's oil market is much different. The United States is now a leading (and sometimes the leading) oil producer in the world. This means when oil (and by extension, gas) prices rise, the country both loses through consumers paying more, but also wins from U.S. producers earning more. Also, the strength of OPEC (Organization of Petroleum Exporting Countries) to control prices has been much diminished. At the end of 2018 oil prices tumbled by one-third.

Stock Market

> **"Another year of economic growth is forecast for North Carolina in 2019."**

The stock market was jittery in 2018. One correction (a 10 percent or more reduction) occurred early in the year, and another near-correction happened later in the year. Several factors could be behind the corrections, including fears of a prolonged trade war with China, concerns about overvaluations for tech companies, and worries about divided government after the mid-term elections. It is always difficult to disentangle the various motivations of investors. Certainly, if a stock market downturn is large enough it can push the economy into a recession. Lower stock values reduce the ability of companies to invest and produce. Lower stock values also depress consumer spending. On average, every one dollar reduction in wealth reduces consumer spending by between 4 and 7 cents.

At the end of 2018, by the most common measure (the stock price to stock earnings ratio) stock values appeared to be modestly overvalued. Some retreat in stock values would therefore not be unexpected. The larger a retreat, the more likely a recession could occur.

Federal Reserve Policy

The Federal Reserve (the "Fed") has a dual mandate — keep unemployment low and keep inflation low. From 2008 to 2015 the Fed concentrated on the first goal by keeping interest rates low (effectively at 0) and by purchasing financial assets.

Now that unemployment is low and the inflation rate has been rising, the Fed has shifted its focus to inflation. It is trying to contain inflation by raising interest rates and selling financial assets in order to provide some brakes to the economy. The Fed has no intent of pushing the economy into a recession, although this is exactly what happened in the early 1980s under former Fed Chairman Paul Volcker. However, in the early 1980s the inflation rate was 13 percent; today it is under 3 percent. So I expect the Fed's "braking" to be modest.

World Economic Problems

Our economy interacts substantially with the world economy, so we must always pay attention to other countries' economic paths. The current concern is that there are signs of economic growth slowing in several major countries, particularly Germany, Japan, and China. China's issues are in part related to the trade dispute with the U.S. A question is whether this trade dispute will be resolved relatively quickly, or whether it will drag on and also intensify. If the latter occurs, the impact would be a reduction in the pace of economic growth, although not necessarily a recession.

In summary, there are no imminent signs of a recession on the horizon. Debt is not over-burdensome, oil prices are not overly high, and foreign economies are not plunging. Currently, the two biggest concerns are the stock market and how far and how fast the Fed will increase interest rates.

National Forecasts for 2019

The right column of Table 1 gives 2019 forecasts for the nation on the key economic measures. Economic growth is expected to continue, but at more modest rates than in 2018 both in the general economy (GDP) and in the labor market. However, the more rapid pace of business investment in recent years is expected to improve labor productivity and, by extension, real wage growth.

On the negative side, the stock market will show little, if any, improvement, partly as a result of higher expected inflation and interest rates. Federal Reserve policymakers will be challenged to implement an interest rate policy that sustains growth while limiting inflation.

The North Carolina Economy: Pluses and Minuses

Ahead and Behind

Table 2 shows the comparative performance of the North Carolina and U.S. economies during the current economic expansion. The post-recessionary period of 2009 to 2017 is split into two time periods: prior to the major tax changes enacted in North Carolina in 2013 and after those changes.

North Carolina's economy continued to grow in 2018, and all measures were improved compared to both 2009-2013 and 2013-2017 except for one—real GDP per capita. Of note is the significant acceleration in both payroll jobs and payroll jobs per capita in 2018 relative to the two earlier periods.

Comparing North Carolina's 2018 performance to the U.S. 2018 performance reveals some key differences. Both measures of job growth (payroll jobs and payroll jobs per capita) were much stronger in North Carolina than in the nation. In contrast, both measures of economic production (Real GDP and Real GDP per capita) were weaker in North Carolina than in than in the nation. These differences were not evident in the 2013-2017 period when North Carolina's growth measures either equaled or exceeded the national growth measures.

Table 2. Comparative Performance of the North Carolina and U.S. Economies, 2009-2018

	NC Annual Average			U.S. Annual Average		
Growth Rate of:	2009-2013	2013-2017	2018	2009-2013	2013-2017	2018
Real GDP	0.9%	2.3%	2.6%[1]	1.7%	2.2%	3.2%[1]
Payroll Jobs	1.6%	2.1%	2.4%[2]	1.4%	1.8%	1.7%[2]
Real GDP Per capita	-0.4%	1.5%	1.6%[1]	1.0%	1.5%	2.7%[1]
Payrol jobs per capita	0.4%	1.0%	1.3%[2]	0.7%	0.7%	1.0%[2]

Source: U.S. Dept. of Commerce

[1] Annualized rates based on growth rates in first and second quarters of 2018; [2] based on October to October data.

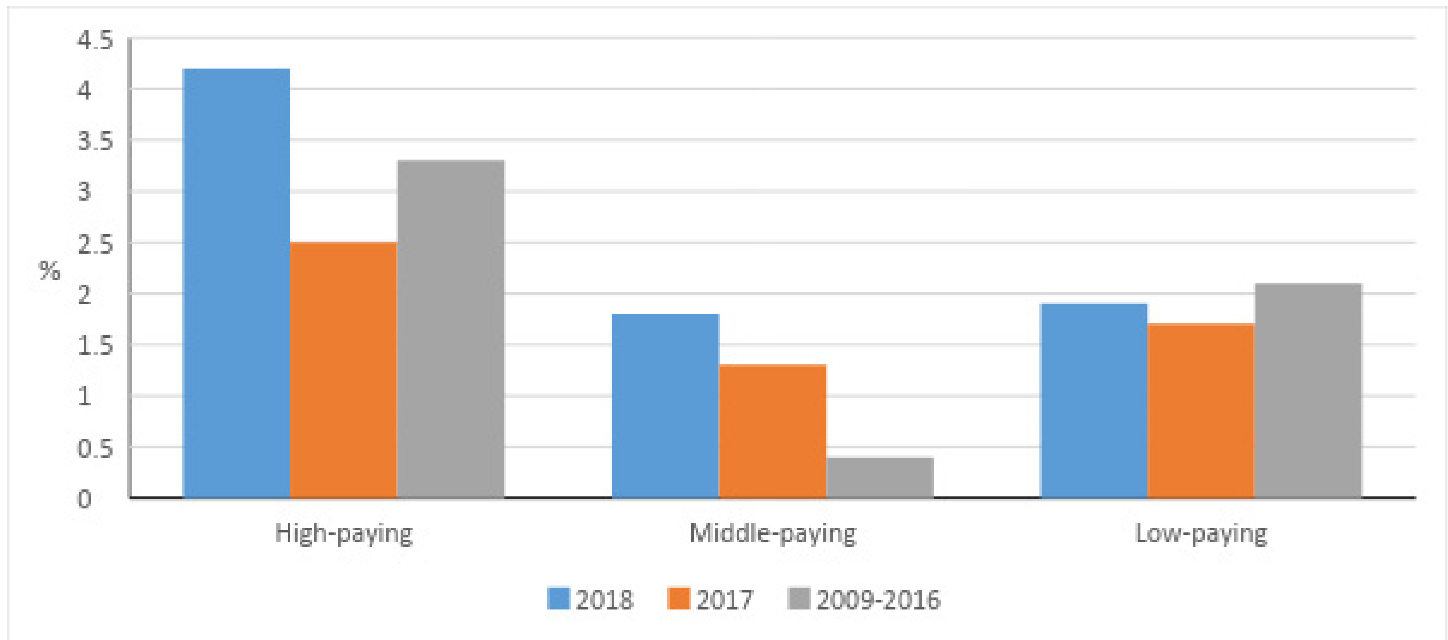
North Carolina's relatively lackluster GDP improvement in 2018 could be only a one-year occurrence, and it could change once full GDP data are available for all of 2018. The state did match the nation in Real GDP growth per capita during the 2013-2017 period. Yet if the slower growth rate in the state stands after full data are available for 2018, it suggests North Carolina's job growth in 2018 was in relatively lower-valued GDP sectors compared to the nation.

The Occupational Divide

As in most states, two divides have become evident in North Carolina in the 21st century—an occupational divide and a geographic divide. The occupational divide refers to the observation that strongest job growth during the century has been in both high-paying and low-paying occupations, with the slowest growth occurring in middle-paying occupations. Likewise, a geographic divide has resulted from fastest job growth occurring in the large metropolitan areas of the state, with the slowest job growth happening in the smaller towns and rural regions.

Figure 1 illustrates North Carolina's recent results for the occupational divide. While high-paying and low-paying occupations led in growth rates in all three periods, the good news is middle-paying jobs have staged a comeback in both 2017 and 2018. Indeed, in 2018, the growth rates for middle-paying and low-paying occupations were very similar. The relative improvement in middle-paying occupations in both 2017 and 2018 is mainly due to gains in manufacturing and construction occupations during the two years.

Figure 1. North Carolina Payroll Job Growth in High, Middle, and Low-Paying Sectors (annualized percentage change) [a]



Source: U.S. Dept. of Commerce.

[a] High-paying sectors are financial services, information, and professional/business services; middle-paying sectors are manufacturing, government, construction, and education/health care; low-paying sectors are trade/transportation, leisure/hospitality, and other services.

The Geographic Divide

Trends in the North Carolina geographic divide are shown in Figure 2. Like the other divide, there was noticeable improvement in the geographic divide in 2018. Small metros had a gain in jobs in both 2017 and 2018, compared to an absolute decline in jobs during the 2009-2016 period. Even more notable, non-metro areas had the highest job growth rate among all the geographic classifications in 2018.

The improvement in both divides in North Carolina during 2018 likely is a result of stronger overall job growth. Regarding the geographic divide, as labor markets have tightened in the large metropolitan areas, and as the costs of shelter and commuting have risen, it is understandable that both businesses and households would be giving smaller-sized and less dense regions a second look.

Figure 2. North Carolina Payroll Job Growth in Large, Medium, and Small Metro Areas and in Non-Metro Areas (annualized percentage change) [a]

Source: U.S. Dept. of Commerce;

[a] Large metros are Charlotte, Durham-Chapel Hill, Greensboro, Raleigh, and Winston-Salem; medium metros include Asheville, Burlington, Fayetteville, Greenville, Hickory, and Wilmington; small metros are composed of Goldsboro, Jacksonville, New Bern, and Rocky Mount; and non-metros are counties not included in the large, medium, and small metro categories.

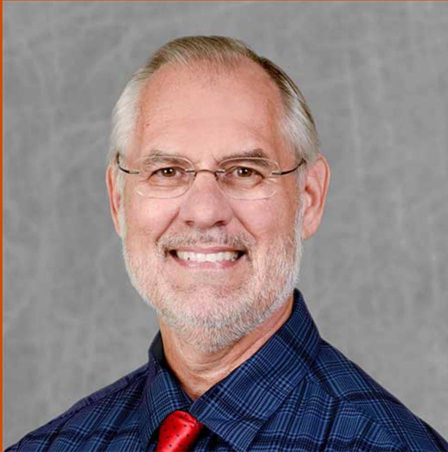
State Forecasts for 2019

Like the nation, another year of economic growth is forecasted for North Carolina in 2019. Job growth will occur, but at a somewhat reduced pace from 2018's 2.4 percent rate, when over 100,000 payroll jobs were added to the state's economy. The prediction is that 85,000 new net payroll jobs in the state for 2019, a gain of 1.8 percent — slower than in 2018 but well ahead of the nation's forecasted job growth rate in 2019.

A question is how those jobs will be filled — that is, what will be the source of the new employees? The state's jobless rate hit 3.6 percent in October 2018 (latest month available for this report's preparation). The most recent lowest state unemployment rate was 3 percent in April 1999. So there is room for the rate to fall further. But North Carolina's labor force participation rate has changed very little in recent years, suggesting little "slack" in the labor market. Thus, in 2019 the state may rely more on attracting workers from other states — something which North Carolina has been able to capitalize on for several decades.

As discussed earlier, in 2018 North Carolina broke its run of outpacing the nation in GDP growth. For 2019, a 2.5% gain in state GDP is anticipated, slightly down from 2018 but closer to the national forecast.

A looming decision that will have a significant impact on North Carolina's 2019 economy will be the vote on approving the revised NAFTA trade agreement (now re-named the U.S.-Mexico-Canada Agreement, or USMCA). USMCA must be ratified by the legislators in the three countries, and passage in the U.S. Congress is not assured. Two big North Carolina winners from USMCA would be farmers — who have large exports to Mexico and Canada — and auto supply workers. Auto supply workers would benefit from the USMCA increasing the percentage of auto parts that must be made in North America from 62 percent to eventually 75 percent. Since North Carolina is a major parts maker, parts manufacturing would likely expand in the state. There is also a treaty requirement increasing the wages of Mexican auto workers, which could result in North Carolina becoming more attractive to future auto assembly plants.



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