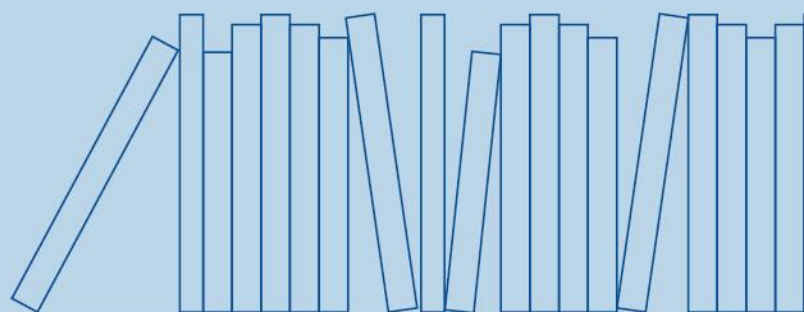


Economic Commission for Latin America and the Caribbean  
**ECLAC OFFICE IN WASHINGTON, D.C.**



# **U.S. Economic Outlook**

Quarterly developments



UNITED NATIONS



Washington, D.C., December 2018

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## Highlights

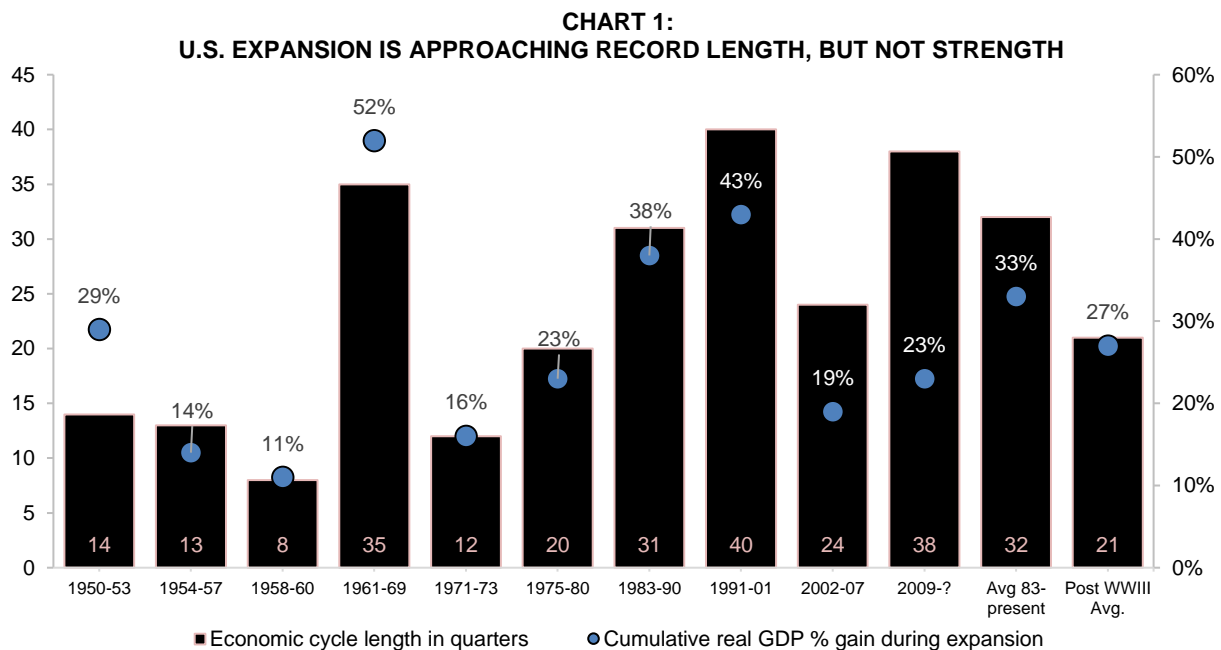
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- In the third quarter of 2018, the U.S. economy grew at an annualized rate of 3.5% after rising 4.2% in the second quarter. Growth remained strong, but its composition deteriorated, as inventories accounted for almost two-thirds of the growth. Growth was led by consumer spending, which contributed 2.45% to growth, down from 2.6% in the second quarter, and inventories, which contributed 2.3%.
- U.S. employers added 2,268,000 jobs from January to November 2018, more jobs than in 2017. Unemployment rate held steady at 3.7% at the end of November, the lowest level since 1969, while year-on-year wage growth was unchanged at 3.1%, equal to the quickest pace since April 2009.
- The productivity of nonfarm workers increased at a 2.3% rate in the third quarter, a deceleration from the 3% advance in the second quarter. Labor costs cooled, signaling an easing in inflation pressures.
- The trade deficit widened to its highest level in 10 years in October, rising more than expected. Imports have surged due to solid demand growth, while exports have dipped from their May highs due to rising tariffs and a relatively strong dollar.
- The Federal Open Market Committee (FOMC) raised interest rates by a quarter point three times in 2018 so far – in March, June and September – and signaled that one more increase is on the way in December, as Fed officials expressed confidence on the strength of the U.S. economy.
- The U.S. economic outlook becomes murkier in 2019, as policymakers weigh risks including slower global growth and less fiscal stimulus.



## Overview

The U.S. economic expansion, which is in its tenth year, is approaching record length but not strength. November marked the 113<sup>th</sup> month of growth for the U.S. economy, and there have been 38 consecutive quarters of growth. This is the second longest expansion on record, only the 1991-2001 expansion is longer, and it is expected to continue into next year and become the longest on record. However, growth has not been as strong as in some previous cycles, with the current expansion ranking fifth in terms of cumulative real GDP percentage gain, and below the post-World War II Average (chart 1).



Source: ECLAC Washington Office, based on data from the U.S. Bureau of Economic Analysis and NBER. Number of quarters from start of recovery to onset of next recession. Cumulative gain based on Billions of Chained (2012) dollars.

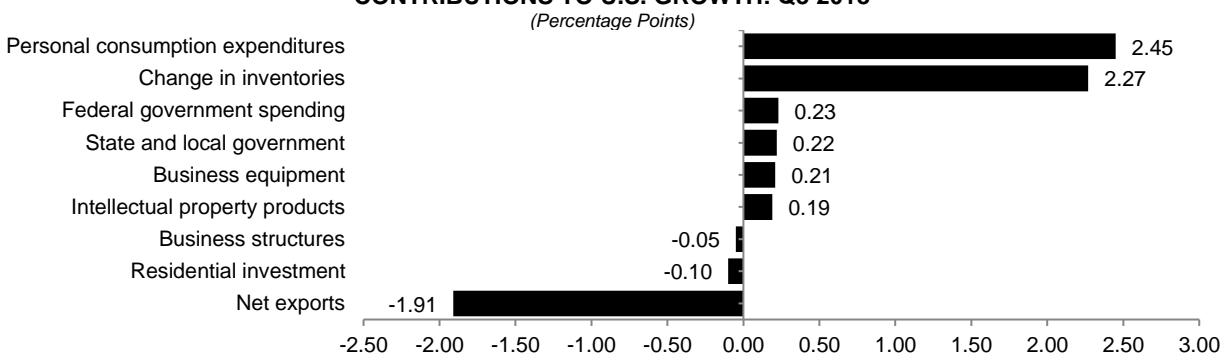


After robust growth in the middle of the year, the U.S. economy has been flashing mixed signals as of late. Equity markets are markedly down from early October and yields on Treasury bonds have declined, suggesting diminishing investor expectations for growth and inflation. Business investment data have softened, the trade deficit has widened and concerns over global growth are mounting.

Business investment grew at 11.5% annual rate in the first quarter, but it has slowed to a modest 2.5% in the third quarter. One reason for the slowdown is in the energy sector, where oil prices are falling. When oil prices fall, so does investment in energy structures, which is down in the third quarter after an 18-month run higher, according to the Commerce Department.

Gross domestic product expanded at a seasonally and inflation-adjusted annual rate of 3.5% in the third quarter of 2018, according to the Commerce Department's second estimate released at the end of November. Personal consumption expenditures were the main driver of growth (contributing 2.45% to growth in the third quarter), followed by inventories (which contributed 2.27% to growth), government spending, business equipment and intellectual property products. Business structures and residential investment subtracted from growth (-0.05% and -0.10%, respectively), but the biggest subtraction came from net exports (-1.91%), as trade battles started to show an impact on growth (chart 2).

**CHART 2:**  
**CONTRIBUTIONS TO U.S. GROWTH: Q3 2018**



Source: Bureau of Economic Analysis, U.S. Department of Commerce

Most private economists expect U.S. growth to slow in the fourth quarter (table 1) and in 2019, in part because the initial impetus of fiscal stimulus is set to wane, meaning slower profit growth and more calls for a pause in the U.S. Federal Reserve interest-rates increases. However, as market analysts attempt to forecast what the coming year will look like, this task seem to be harder than ever, as turbulent financial markets, souring investor sentiment, and trade disputes in a moment when global growth is slowing suggest more uncertainty for the policy outlook. Uncertainty about trade policy has been a major source of anxiety.

**TABLE 1:**  
**QUARTERLY FORECASTS FOR U.S. ECONOMIC GROWTH**

	Q4 2018 (qoq)	Q1 2019 (qoq)	Q2 2019 (qoq)	Date of Forecast
<b>What Markets Say</b>				
Bank of America/Merrill Lynch	2.8%	2.4%	2.6%	Nov-18
J.P. Morgan	2.5%	2.2%	2.0%	Nov-18
Moody's Economy.com	2.6%	3.0%	3.2%	Nov-18
Mortgage Bankers Association	1.9%	1.5%	1.5%	Nov-18
National Association of Realtors	2.5%	2.4%	2.4%	Dec-18
National Bank of Canada	2.4%	1.9%	2.3%	Nov-18
TD Bank Financial Group	2.9%	2.6%	2.4%	Nov-18
Wells Fargo/Wachovia	2.2%	2.3%	2.6%	Nov-18
<b>Forecasts average</b>	<b>2.5%</b>	<b>2.3%</b>	<b>2.4%</b>	

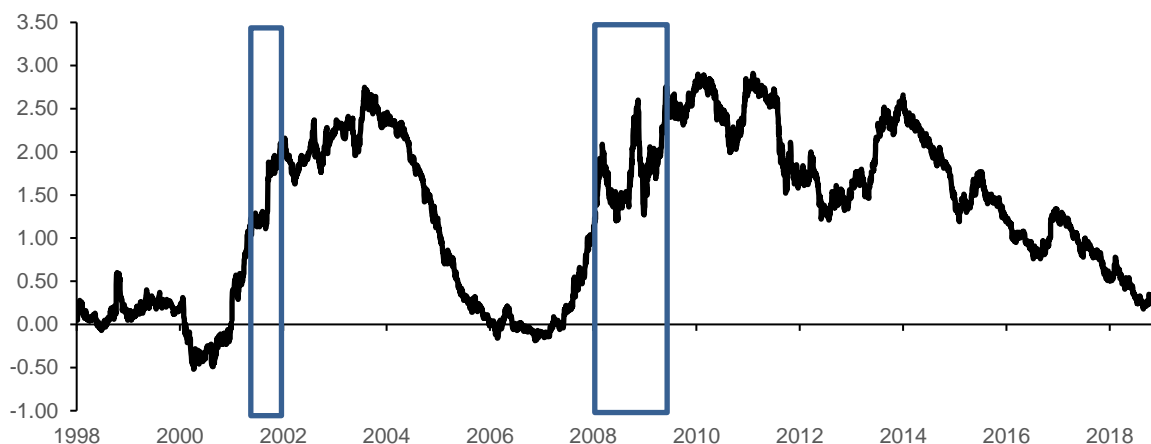
Source: ECLAC Washington Office, based on several market sources.

Trade disputes have already taken a toll on parts of the global economy. China is growing at its slowest rate in nearly a decade, and momentum in the export-driven economies of Japan and Germany has been undermined by antagonistic trade rhetoric (both economies contracted in the third quarter, but are set to rebound). Thanks in part to deficit-fueled stimulus, particularly tax cuts, the U.S. has been an outlier so far. However, even in the United States there are emerging pockets of weakness, particularly in parts of the economy that are sensitive to rising borrowing costs. Pending home sales have declined for eight straight months, as interest-rates on 30-year fixed mortgages have climbed. Monthly auto sales have plateaued, prompting job cuts at General Motors and Ford.

The U.S. economy grew 2.3% in 2017, and growth is now expected to accelerate to close to 3% this year, according to private forecasters (table 2). U.S. consumer price inflation was 2.1% last year, but according to market projections, the CPI is expected to increase at a 2.5% rate on average in 2018. The economic forecast for 2019 suggests less growth and more uncertainty. Growth in 2019 is expected to slow to 2.5% and consumer price inflation to 2.2%.

The Treasury yield curve has continued to flatten as the spread between 10- and 2-year Treasuries shrinks, getting closer to predicting a recession, something it has done before with surprising accuracy (chart 3). Even as the economy is showing strength, bond yields have signaled slowdown fears. Long-term bond yields have been slow to rise, suggesting traders are concerned about long-term growth. If the curve keeps moving in this direction, eventually long-term interest rates will fall below short-term rates.

**CHART 3:**  
**GAP BETWEEN 10-YEAR AND 2-YEAR TREASURY YIELDS**  
(Percentage Points)



Source: ECLAC Washington Office with data from the Federal Reserve Bank of St. Louis. The blue boxes indicate recessions.

The shrinking gap between long- and short-dated U.S. Treasury securities and the decline in stocks that has been taking place in the past two months are both harbingers of past downturns, while oil prices have been falling, signaling weaker global demand and a supply glut. This is feeding investors' anxieties, but most forecasters do not yet envision a recession beginning within the next year.

Nonetheless, there are reasons for caution. The labor market is at full strength, asset prices are frothy, monetary policy is tightening, and rising trade tensions have increased anxiety among investors, who worry that profits and equity performance may have already peaked. Risks for next year include a reassessment of global growth forecasts, less fiscal stimulus from the U.S. government, a reassessment of the path of monetary policy, and trade uncertainties, with U.S.-China tensions expected to remain elevated. The question of how far the Fed will raise interest rates remains an open question. Fed policy and the U.S. - China relations are expected to play key roles next year.

**TABLE 2:  
ANNUAL FORECASTS FOR U.S. ECONOMIC GROWTH**

		Real GDP (% change, y/y)		CPI (% change, y/y)		Unemployment Rate (%)		FED Funds Rate (%)		Date of Forecast
		2018	2019	2018	2019	2018	2019	2018	2019	
<b>A. What Government Agencies Say</b>										
	<b>FED*</b>	3.1%	2.5%	2.1%	2.0%	3.7%	3.5%	2.4%	3.1%	Sep-18
	<b>CBO</b>	3.0%	2.8%	2.5%	2.2%	3.8%	3.4%	<i>na</i>	<i>na</i>	Aug-18
	<b>OMB</b>	3.0%	3.2%	2.5%	2.1%	3.9%	3.7%	<i>na</i>	<i>na</i>	Jul-18
<b>B. What Markets Say</b>										
	Bank of America/Merrill Lynch	2.9%	2.7%	2.4%	1.6%	3.9%	3.4%	2.38%	3.38%	Nov-18
	JPMorgan	2.9%	2.4%	2.4%	1.7%	3.9%	3.5%	2.50%	3.25%	Nov-18
	Moody's Economy.com	2.9%	2.9%	2.5%	2.3%	3.9%	3.4%	1.80%	2.90%	Nov-18
	Mortgage Bankers Association	3.1%	2.0%	2.5%	2.5%	3.9%	3.5%	2.38%	3.13%	Nov-18
	National Association of Realtors	3.1%	2.5%	2.3%	2.1%	3.9%	4.0%	1.80%	2.60%	Dec-18
	National Bank of Canada	2.9%	2.4%	2.5%	2.3%	3.9%	3.6%	2.50%	3.00%	Nov-18
	TD Bank Financial Group	2.9%	2.7%	2.5%	2.2%	3.9%	3.7%	2.15%	3.05%	Sep-18
	The Economist Intelligence Unit	2.9%	2.2%	2.6%	2.4%	3.9%	4.0%	<i>na</i>	<i>na</i>	Nov-18
	Wells Fargo/Wachovia	2.9%	2.6%	2.5%	2.5%	3.9%	3.6%	2.13%	3.06%	Nov-18
	<b>Market Average</b>	<b>2.9%</b>	<b>2.5%</b>	<b>2.5%</b>	<b>2.2%</b>	<b>3.9%</b>	<b>3.6%</b>	<b>2.2%</b>	<b>3.0%</b>	
<b>C. What International Organizations Say</b>										
	United Nations DESA (Baseline)	2.5%	2.3%	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	May-18
	World Bank	2.7%	2.5%	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	Jun-18
	OECD	2.9%	2.7%	2.2%	2.2%	3.9%	3.6%	<i>na</i>	<i>na</i>	Nov-18
	IMF*	2.9%	2.5%	2.4%	2.1%	3.8%	3.5%	<i>na</i>	<i>na</i>	Oct-18

Source: ECLAC Washington Office based on official and market sources.

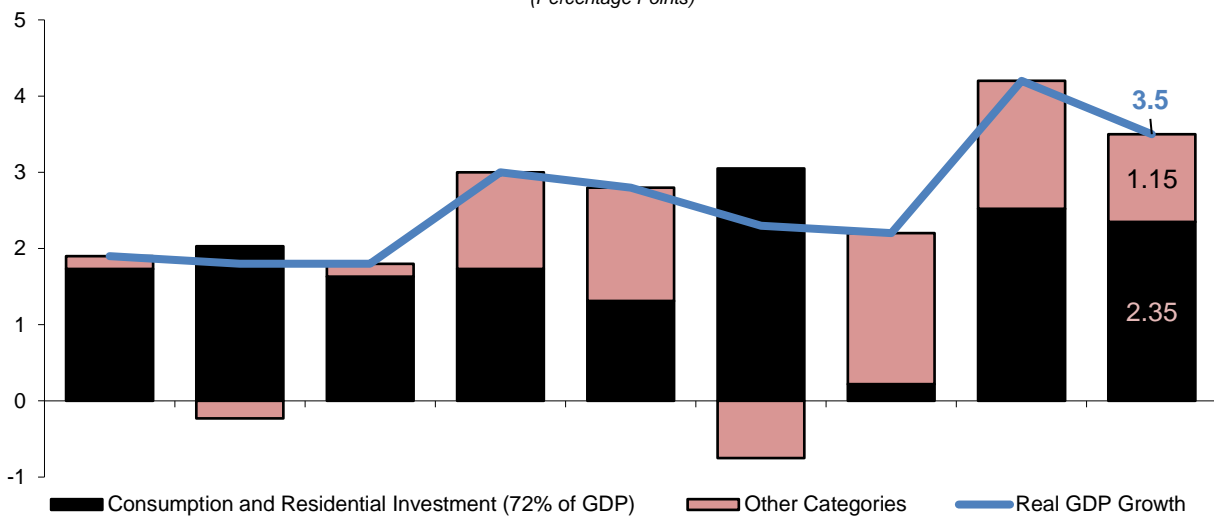
Note: FED: Federal Reserve; CBO: Congressional Budget Office; OMB: Office of Management and Budget (U.S. Administration's forecasts).

\*Forecast for PCE inflation.

## I. Quarterly Developments

U.S. growth remained strong in the third quarter of 2018, despite a small moderation with respect to growth in the second quarter. The contribution of the core of the U.S. economy – consumption and residential investment – lowered slightly from the second quarter but was a lot higher than in the first quarter (chart 4). It was mostly because of consumption, which has remained strong, contributing 2.57% and 2.45% in the second and third quarters, respectively. A downturn tends to be preceded by a slowdown in consumer spending, which is currently not happening in the U.S. However, residential investment has subtracted from growth, -0.05% and -0.10% in the second and third quarters, respectively.

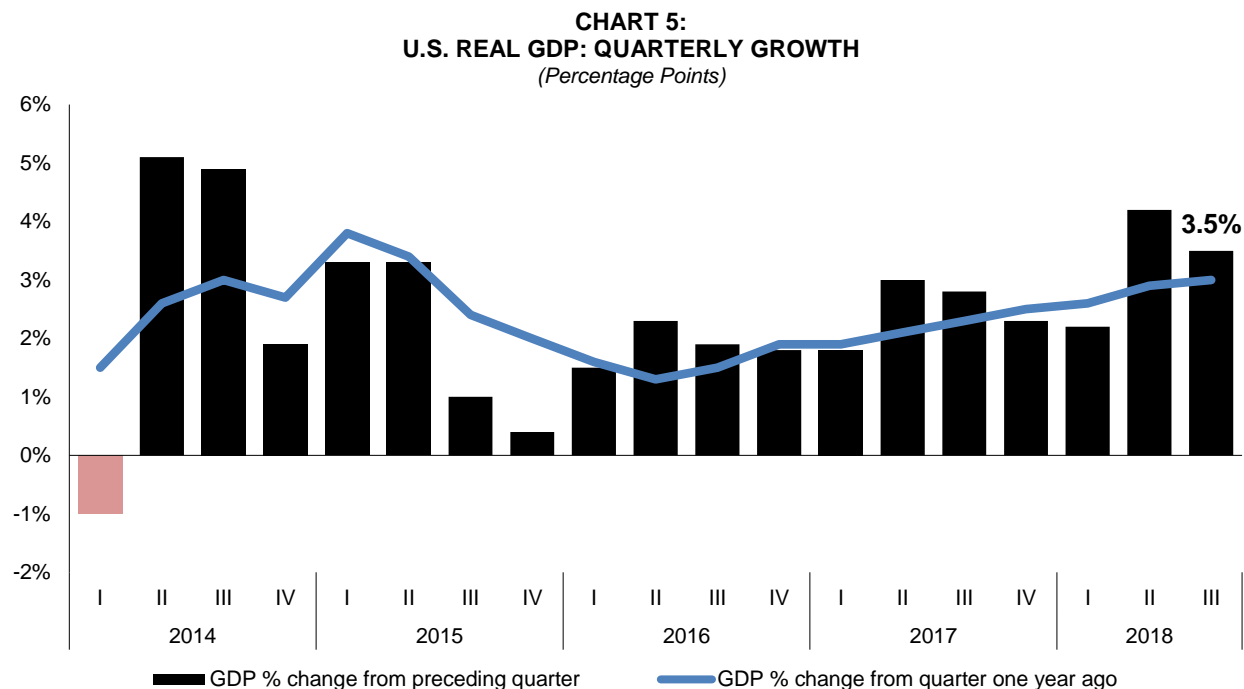
**CHART 4:**  
**CONTRIBUTIONS TO U.S. REAL GDP GROWTH**  
(Percentage Points)



Source: ECLAC Washington Office, based on data from the Bureau of Economic Analysis, U.S. Department of Commerce.  
 Note: Contributions to growth are measured at seasonally adjusted annual rates.

## A. GDP Growth

According to the second estimate released by the U.S. Department of Commerce on 28 November 2018, the U.S. economy grew at an annual rate of 3.5% in the third quarter, following an increase of 4.2% in the previous quarter (chart 5). According to the Commerce Department, the increase in real GDP in the third quarter reflected positive contributions from personal consumption expenditure, private inventory investment, nonresidential fixed investment, government spending (federal and state and local) that were partly offset by negative contributions from exports and residential fixed investment. Imports, which are a subtraction in the calculation of GDP, increased.



Source: ECLAC Washington Office, based on data from the Bureau of Economic Analysis, U.S. Department of Commerce.

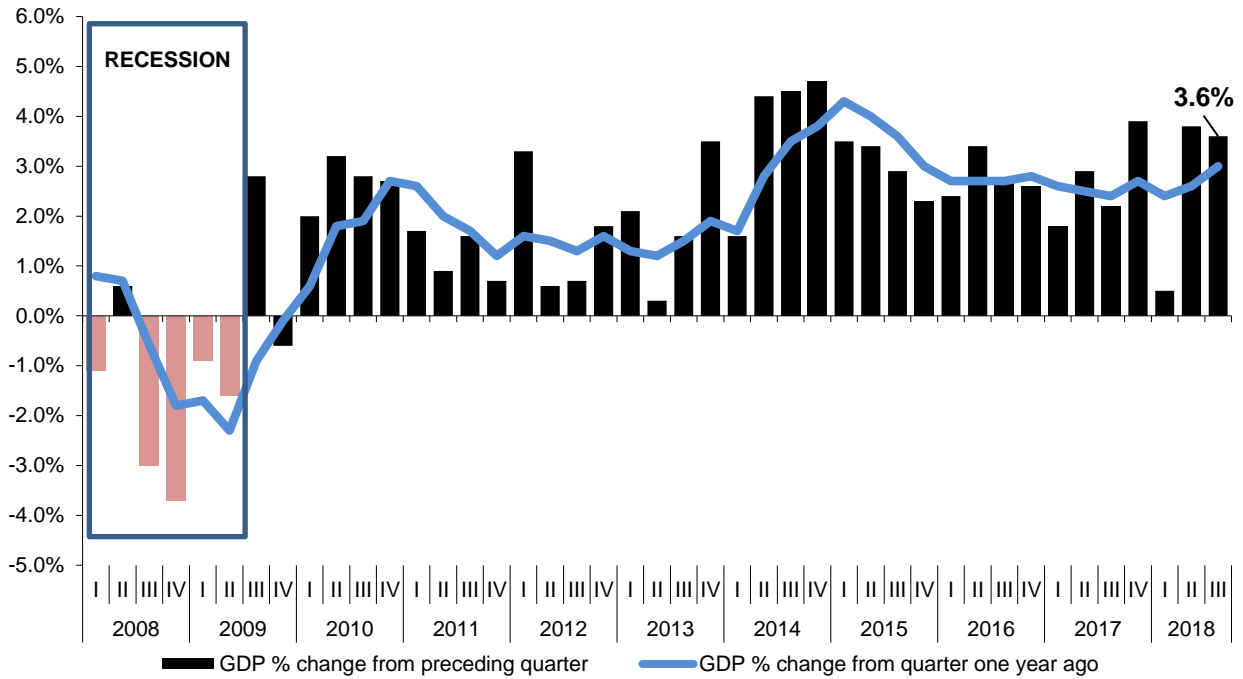
The largest component of GDP, real personal consumption expenditures, grew 3.6% in the third quarter of 2018, after increasing 3.8% in the second (chart 6). Consumer spending was the main driver of growth, contributing 2.45% to growth. This was slightly down from the 2.57% contribution in the second quarter.

Fixed investment added 0.25% to growth in the third quarter, with nonresidential investment increasing 2.5% and adding 0.35%, and residential investment falling 2.6% and subtracting 0.10% (chart 7). The change in private inventories contributed 2.27% to the third quarter change in real GDP, after subtracting 1.17% from growth in the previous quarter. Overall, gross private domestic investment increased at a 15.1% annual rate in the third quarter, adding 2.52% to third-quarter GDP growth (with 0.25% due to business fixed investment – 0.35% from nonresidential and -0.10% from residential – and 2.27% due to inventories).

Overall, government spending increased 2.6% and added 0.44% to growth in the third quarter. State and local government spending increased 2% and federal outlays increased 3.5% (national defense spending increased 4.9%, while nondefense spending increased 1.5%).

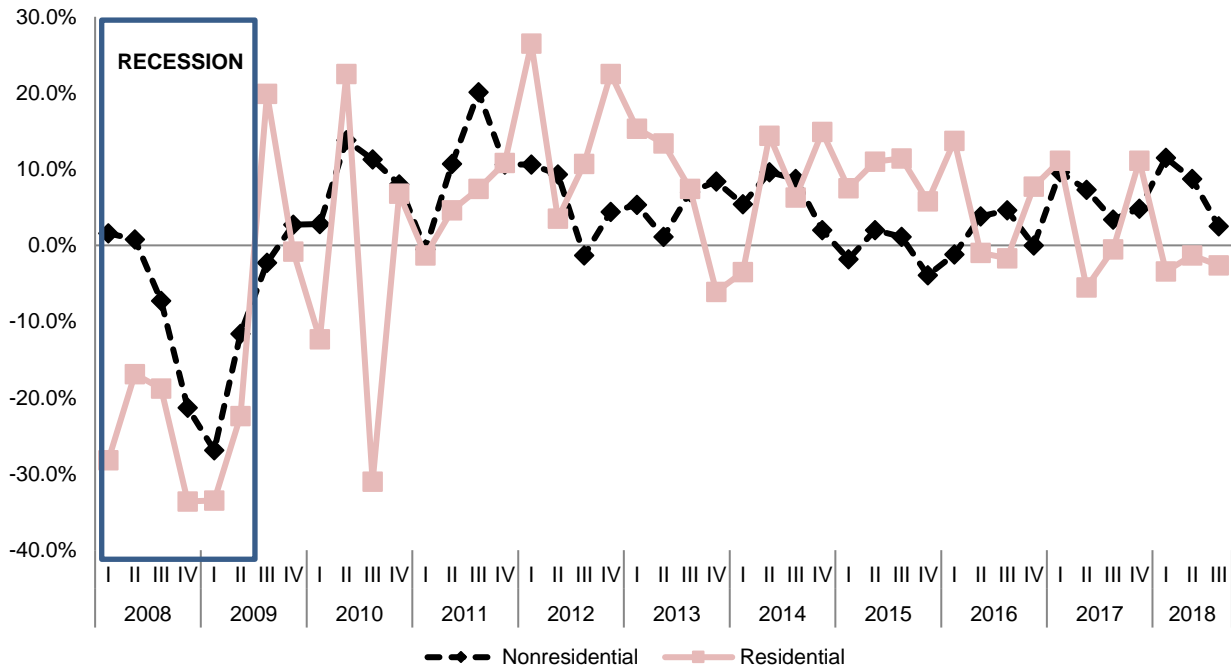
Finally, net exports subtracted 1.91% from growth in the third quarter. Exports fell 4.4% and imports increased 9.2%, subtracting 0.55% and 1.36% from third-quarter growth, respectively (chart 8).

**CHART 6:**  
**PERSONAL CONSUMPTION EXPENDITURE: QUARTERLY GROWTH**  
(Percentage Points)



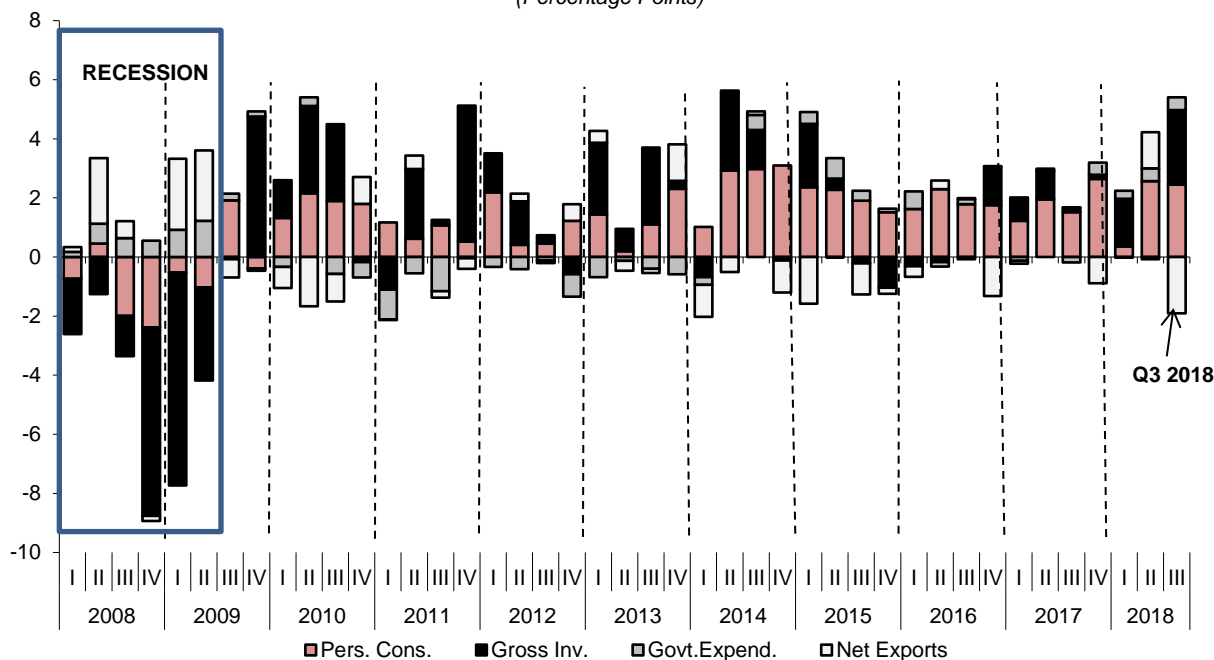
Source: ECLAC Washington Office, based on data from the Bureau of Economic Analysis, U.S. Department of Commerce.

**CHART 7:**  
**GROSS PRIVATE DOMESTIC INVESTMENT: QUARTERLY GROWTH**  
(Percentage Points)



Source: ECLAC Washington Office, based on data from the Bureau of Economic Analysis, U.S. Department of Commerce.

**CHART 8:**  
**CONTRIBUTIONS TO REAL GDP GROWTH**  
(Percentage Points)



Source: ECLAC Washington Office, based on data from the Bureau of Economic Analysis, U.S. Department of Commerce.  
Note: Contributions to growth are measured at seasonally adjusted annual rates.

## B. Industrial production

Industrial production increased 0.1% in October, marking the eighth increase in the last nine months (table 3). Overall, industrial production stands 4.1% higher over that of a year earlier. Trade remains the biggest wild card for the factory sector.

**TABLE 3:**  
**U.S. INDUSTRIAL PRODUCTION**

	Total Industrial Production		Capacity Utilization Rate
	Index 2012=100	Percentage Change From Previous	Total Industry (%)
<b>2018 Q1</b>	<b>105.9</b>	<b>2.5</b>	<b>77.2</b>
January	105.4	-0.3	77
February	105.9	0.5	77.2
March	106.4	0.5	77.5
<b>2018 Q2</b>	<b>107.3</b>	<b>5.3</b>	<b>77.8</b>
April	107.7	1.1	78.2
May	106.8	-0.8	77.5
June	107.5	0.6	77.8
<b>2018 Q3</b>	<b>108.5</b>	<b>4.7</b>	<b>78.3</b>
July	107.9	0.4	78
August	108.8	0.8	78.5
September	109	0.2	78.5
<b>2018 Q4</b>	<b>na</b>	<b>na</b>	<b>na</b>
October	109.1	0.1	78.4

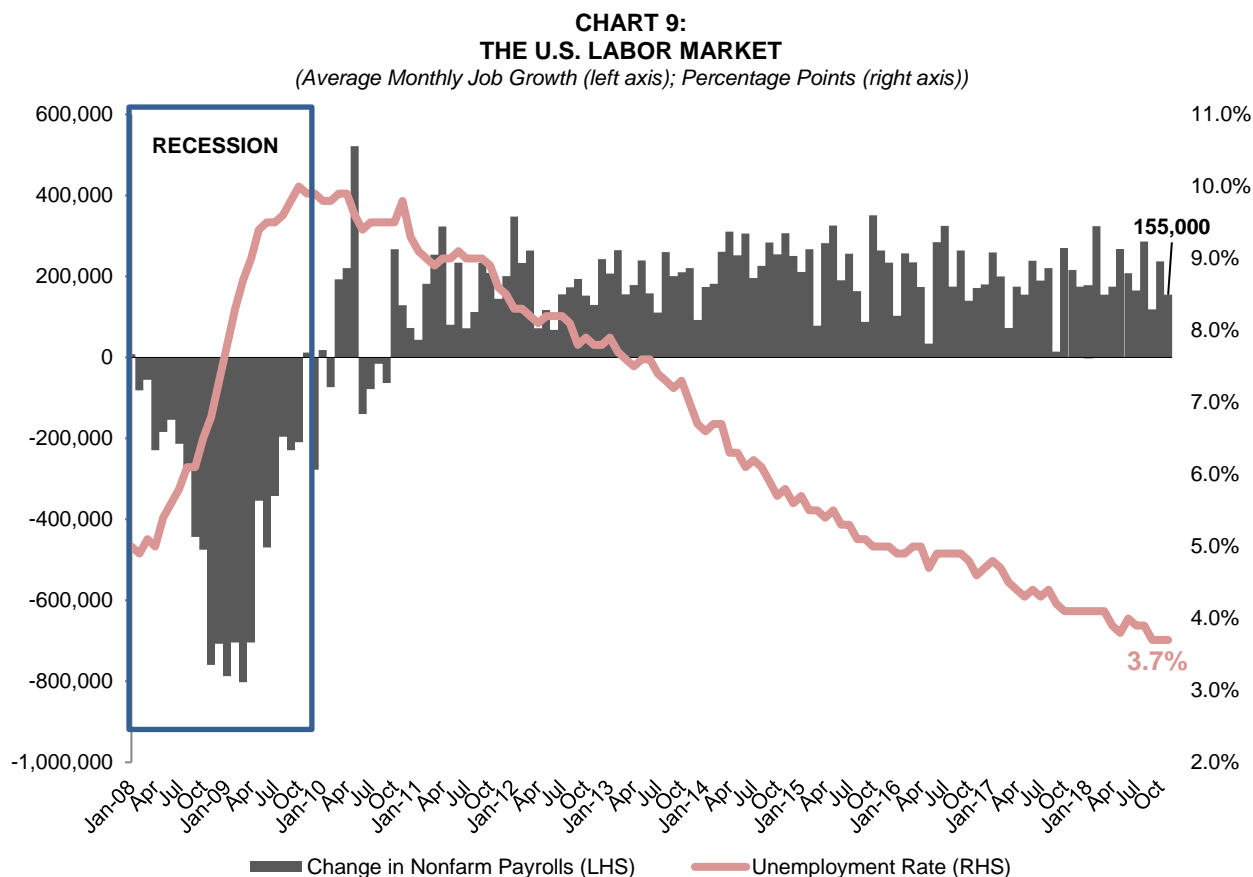
Source: ECLAC Washington Office, based on data from U.S. Federal Reserve, Industrial Production and Capacity Utilization  
Note: Quarterly changes are at annual rates. Annual changes are calculated from annual averages.

### C. Labor market

The U.S. economy added 155,000 jobs in November, falling short of expectations. October's gain was revised down by 13,000 to 237,000. The average jobs growth for the third quarter of 2018 was 190,000 a month. Trend job growth has been solid, averaging 206,000 over the past eleven months. In the past three months, however, job growth averaged 170,000, marking the lowest trend growth of the year. The unemployment rate was unchanged at 3.7%, a historical low (chart 9). Another measure of unemployment, including those too discouraged to look for work, plus the ones in part-time jobs but who want to work full-time, rose to 7.6% from 7.4% the prior month. The rate, known as U-6, has trended this year at the lowest level in 18 years. While unemployment is historically low, the labor force participation rate, which was unchanged at 62.9%, is only slightly above a recent low of 62.3% it touched in 2015, but still near the smallest share of adults participating in the labor force since the late 1970s.

Average hourly earnings for all private-sector workers increased 6 cents in November, to US\$ 27.35. It rose 0.2%, up 3.1% on a year-ago basis (chart 10). It is the second-straight month hourly wages rose above 3% from a year earlier. That had not previously occurred since the recession ended more than nine years ago. However, the average workweek was slightly shorter, causing weekly wages to decline on the month.

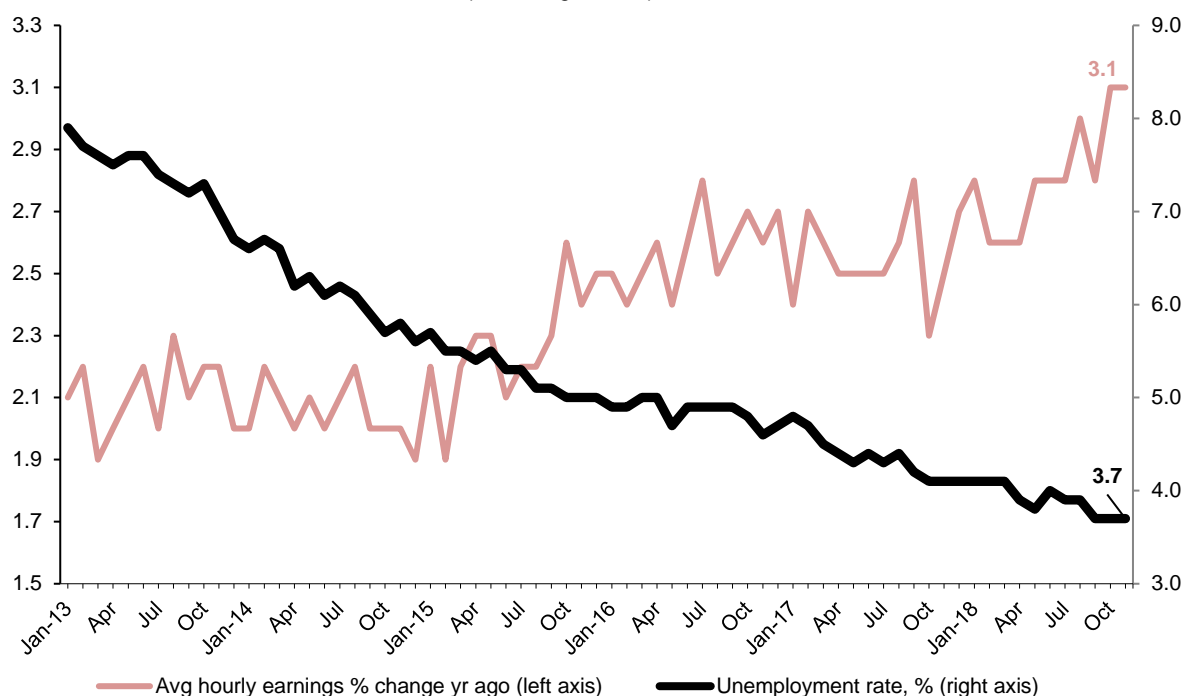
Separate Labor Department data showed the number of unfilled jobs edged higher in October, as openings continued to exceed the number of unemployed workers.



Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics.



**CHART 10:**  
**U.S. UNEMPLOYMENT RATE AND AVERAGE HOURLY EARNINGS**  
(Percentage Points)



Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics.

Revisions show that productivity growth in the third quarter was faster than initially estimated, but the broader trend remains one of lackluster improvement. Nonfarm labor productivity was revised up from 2.2% to 2.3% (table 4).

**TABLE 4:**  
**U.S. PRODUCTIVITY AND RELATED MEASURES: REVISED THIRD-QUARTER 2018**  
(Percent Change from Previous Quarter and from Same Quarter a Year Ago)

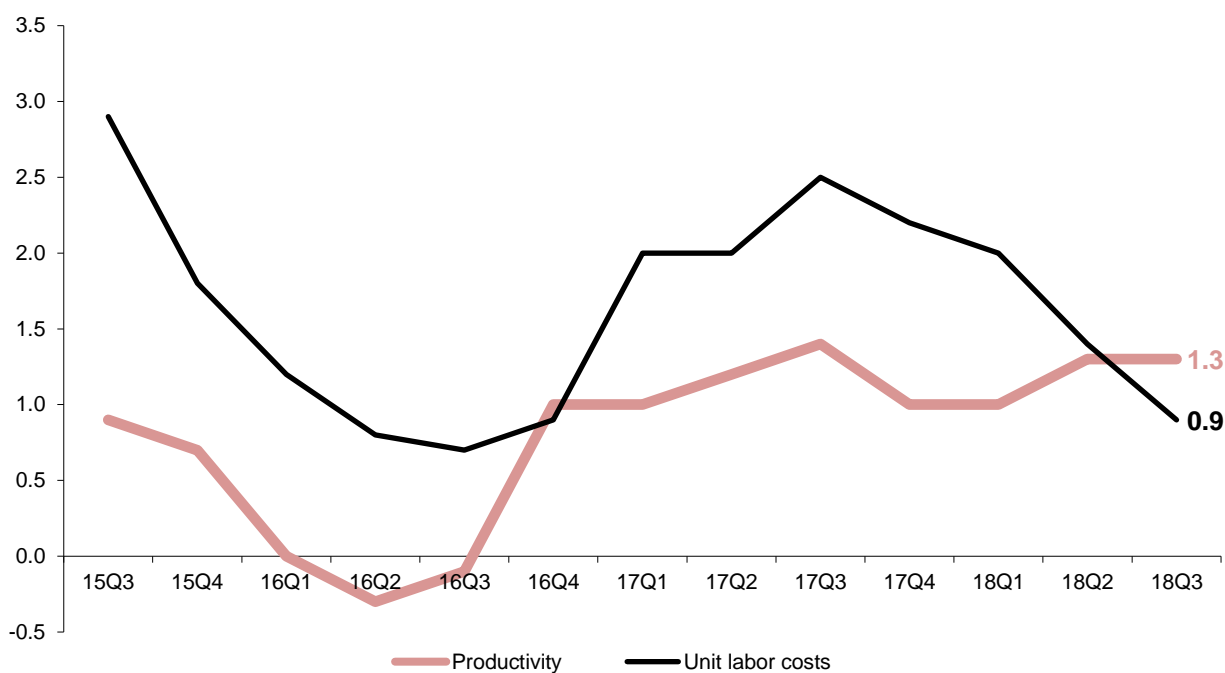
Sector	Percentage change from:	Labor Productivity	Output	Hours Worked	Hourly compensation	Real hourly compensation	Unit labor costs
Nonfarm business	<b>Previous quarter</b>	<b>2.3</b>	<b>4.1</b>	<b>1.8</b>	<b>3.1</b>	<b>1.1</b>	<b>0.9</b>
	A year ago	1.3	3.7	2.3	2.2	-0.4	0.9
Business	<b>Previous quarter</b>	<b>1.9</b>	<b>4.1</b>	<b>2.1</b>	<b>2.8</b>	<b>0.8</b>	<b>0.9</b>
	A year ago	1.2	3.6	2.4	2.2	-0.4	1.0
Manufacturing	<b>Previous quarter</b>	<b>1.0</b>	<b>4.1</b>	<b>3.1</b>	<b>-0.2</b>	<b>-2.2</b>	<b>-1.2</b>
	A year ago	1.4	3.6	2.1	0.2	-2.4	-1.2
Durable manufacturing	<b>Previous quarter</b>	<b>1.7</b>	<b>5.2</b>	<b>3.5</b>	<b>0.3</b>	<b>-1.7</b>	<b>-1.4</b>
	A year ago	1.7	4.1	2.4	0.8	-1.8	-0.9
Nondurable manufacturing	<b>Previous quarter</b>	<b>0.5</b>	<b>2.9</b>	<b>2.4</b>	<b>-1.4</b>	<b>-3.3</b>	<b>-1.9</b>
	A year ago	1.4	3	1.6	-1.1	-3.6	-2.4

Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics.

Still, the third-quarter gain was a deceleration from the 3% advance in the second quarter. Productivity was up 1.3% on a year-ago basis; growth is volatile from quarter to quarter and even year to year. Over the past five years, productivity has risen 1%. Moody's Analytics has suggested that two general trends are relatively clear. Compared with its pace before the recession, productivity growth is disappointingly slow. This trend has significant consequences for long-term well-being and wage growth, as how much output an economy produces for the given level of inputs is crucial for economic growth. The second trend is that productivity has improved from the worst point in the recession.

Unit labor costs were up 0.9% in the third quarter. On a year-on-year basis those costs have been trending down over the past year, a sign of easing inflation pressures (chart 11).

**CHART 11:**  
**U.S. NONFARM BUSINESS SECTOR: PRODUCTIVITY VS UNIT LABOR COSTS**  
(Percentage Change from Same Quarter A Year Ago)



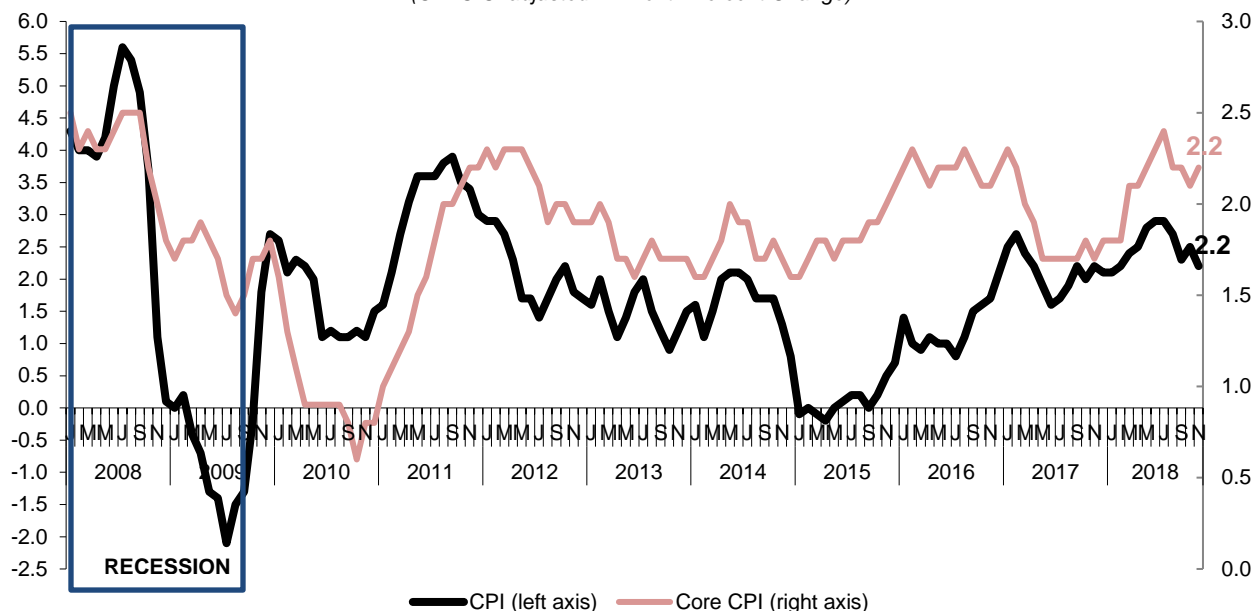
Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics.

## D. Inflation

In November, the Consumer Price Index for All Urban Consumers (CPI-U) was unchanged on a seasonally adjusted basis, in line with consensus, after rising 0.3% in October, according to the U.S. Bureau of Labor Statistics. Over the last 12 months, the all items index increased 2.2% before seasonal adjustment. Energy prices fell 2.2% led by the gasoline index.<sup>1</sup> Food prices increased 0.2% in November after being little changed in the prior two months. Excluding food and energy, the CPI rose 0.2%. On a year-ago basis, the headline and core CPI were both up 2.2% (chart 12).

<sup>1</sup> The gasoline index declined 4.2% in November, while other major energy component indexes were mixed, with the index for fuel oil falling but the indexes for electricity and natural gas rising.

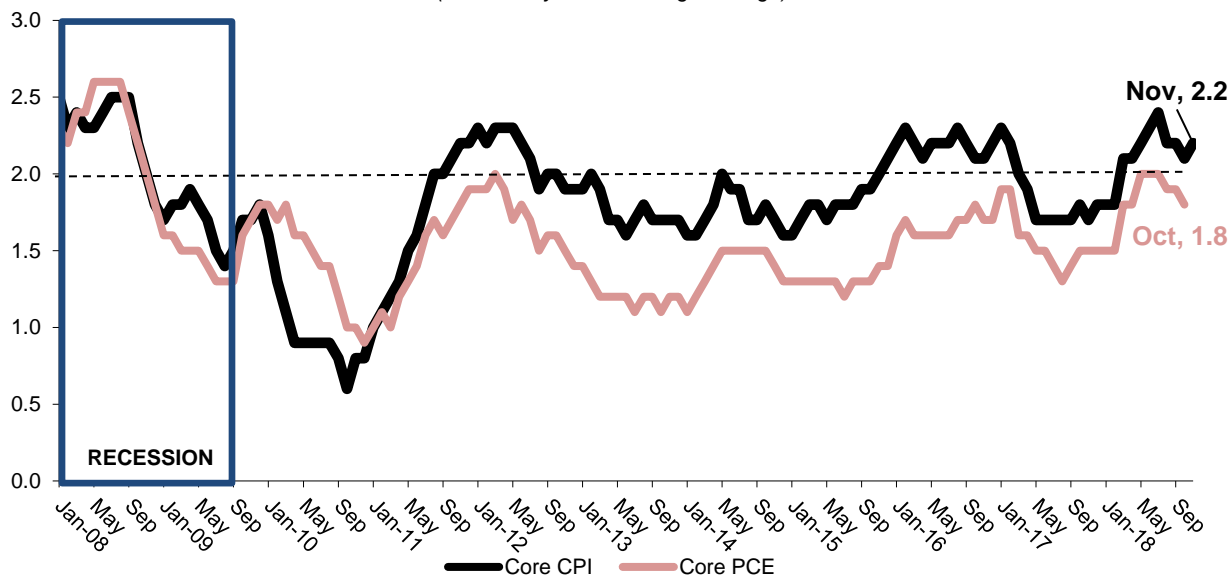
**CHART 12:**  
**U.S. DOMESTIC PRICES: MONTHLY EVOLUTION**  
*(CPI-U Unadjusted 12-month Percent Change)*



Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics.

The most closely watched measure by the Federal Reserve – the Personal Consumption Expenditure (PCE) core price index– increased at an annualized 1.5% in the third quarter. In October, the core PCE advanced at 1.8%, a touch weaker than that seen over the past few months (chart 13). Year-over-year growth in the core PCE deflator was 0.4 percentage point below the core CPI, less than its historical average of 0.5 percentage point, according to Moody’s.

**CHART 13:**  
**U.S. CORE CONSUMER PRICE INDICES**  
*(Year-over-year Percentage Change)*



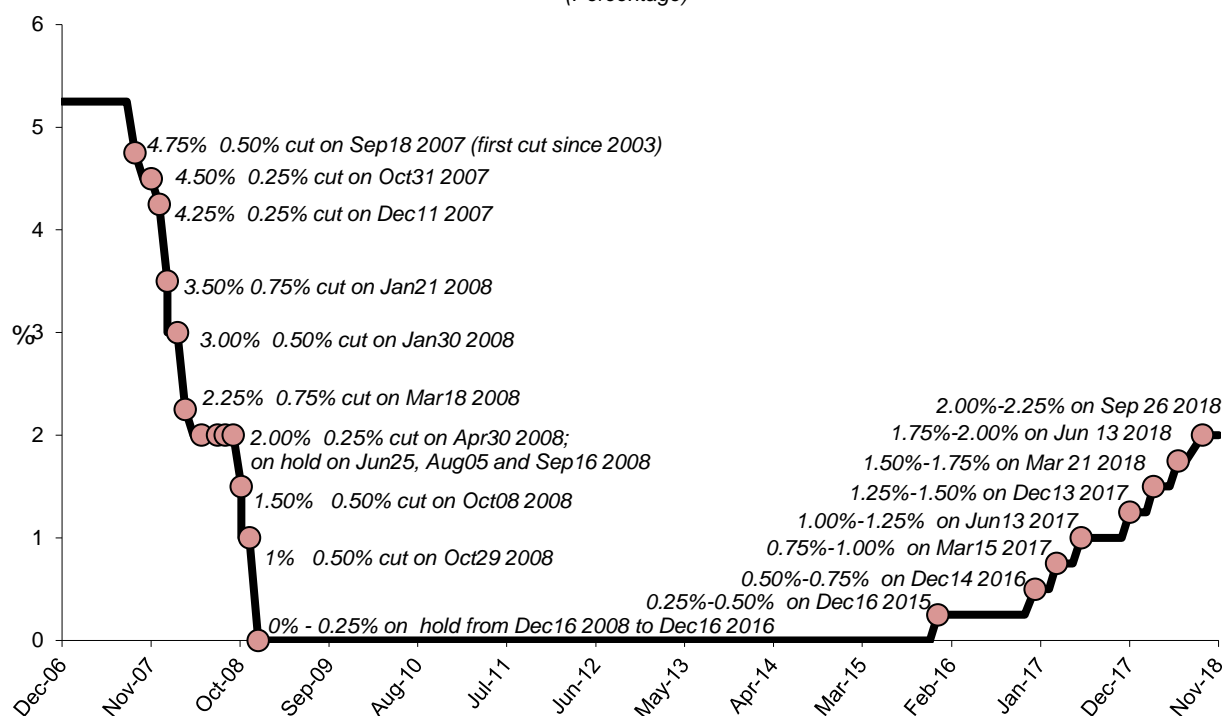
Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics (BLS), Department of Labor and the Bureau of Economic Analysis (BEA), U.S. Department of Commerce.

Overall, inflation is hovering around the Fed’s target. Though the economy has been growing comfortably above trend and the labor market has tightened, inflation has remained in check. Inflation will likely determine whether the Federal Reserve pauses interest rates raises sometime in 2019. There is little evidence that inflation will noticeably overshoot the Fed’s 2% objective soon, and risks are weighted toward inflation falling short of the central bank’s expectation.

## E. Monetary policy

The Federal Open Market Committee (FOMC) raised the target range for the fed funds rate in March, June and September (chart 14). In September, the Committee raised the target rate to a range of 2%-2.25%. After saying in October that monetary policy was “a long way from neutral,” Fed Chairman Jerome Powell argued at the end of November that interest rates stand “just below the broad range of estimates of the level that would be neutral for the economy.”

**CHART 14:**  
**U.S. FEDERAL FUNDS TARGET RATE**  
(Percentage)



Source: ECLAC Washington Office, based on data from the U.S. Federal Reserve.

The minutes from the November FOMC meeting underscore a shift toward a more data-dependent, flexible policy stance. They signaled an interest rate hike at the December FOMC meeting, which would be the fifth straight quarterly increase. There was no discussion on the interest rate outlook beyond December. It seems that Federal Reserve officials are moving into a more unpredictable phase of policy-making after two years of removing economic stimulus in regular, quarterly intervals. From Fed officials’ recent interviews and public comments, they will be deciding whether and when to raise interest rates more on the basis of latest economic signs – such as inflation, unemployment and growth – and less on forecasts of how the economy is expected to perform in the months and years to come. This could mean more uncertainty for markets about the likely path of interest rates. The biggest source of policy uncertainty is

thus the U.S. economy itself. Although most Fed officials expect it to slow next year, they don't know how smooth or bumpy the process will be and how the economy will react to the continued withdrawal of monetary stimulus. Rising interest rates have already slowed the housing sector.

Fed Vice Chairman Richard Clarida said in a recent speech that fresh economic data should determine not only how the Fed's rate-setting committee plots individual rate moves at each meeting but should also produce regular reappraisals of two key policy signposts. The first is the neutral rate of interest, and the second is the unemployment rate consistent with stable inflation.

Future markets continue to price a high chance of a December hike, but the path next year has become more uncertain. Their expectations for 2019 have been trimmed from more than two rate hikes a few weeks ago to about one 25 basis points hike currently.

At the end of November, the Federal Reserve released its inaugural *Financial Stability Report*, highlighting the increase in leveraged lending and the potential for declines abroad as possible risks to financial stability. It identified elevated asset prices, historically high debt owed by U.S. businesses and rising issuances of risky debt as top vulnerabilities facing the U.S. financial system. Risky business debt – which includes high-yield bonds and leveraged loans – rose 5% in the year ending in the third quarter of 2018 and now stands at over US\$ 2 trillion. Firms with high leverage, high interest expense ratios and low earnings and cash holdings have been boosting their debt loads the most.

The analysis comes amid broader worries about corporate lending. Janet Yellen, the former Fed Chair, warned last month in an interview to the Financial Times that the U.S. needs to deal with a “huge deterioration” in the standards of corporate lending instead of focusing on deregulation. High leverage has been associated in the past with sharp retrenchment by businesses during downturns.

The stability report also identified potential economic shocks that could test the stability of the U.S. financial system, including potential spillover effects to the U.S. from a messy exit of Britain from the European Union, slowing economic growth in China and other emerging markets, and trade tensions.

## **F. Financial and fiscal conditions**

Financial markets have recently been turbulent and suffered wild swings. Investors have pulled money from equity and corporate bond funds in recent weeks, preferring the safety of U.S. government debt as trade uncertainties and a re-assessment of global growth forecasts have roiled U.S. markets

In the past two months, the Dow Jones Industrial Average, the S&P 500, and NASDAQ lost 3.71%, 6.14%, and 9.36%, respectively, reducing the gains for the year. From January to November, they gained 2.91%, 2.21% and 5.03%, respectively (table 5). The S&P-stock index has entered a correction, technically defined by a decline of at least 10% from the market's peak. Although an arbitrary threshold, it is often seen as a symbol of souring investor sentiment. Given the age of the current bull run, some are wondering if the recent selling in stock markets indicates that an end to the nearly decade-long rally is near.

Investors are growing more concerned about the outlook for corporate profits next year, despite third-quarter results that showed that profits at S&P 500 companies rose at the fastest pace since 2010. There is a broader sense among analysts that much of the gains from stimulative U.S. policies have played out and the outlook for future earnings growth is less favorable. There have been large market swings on trade-related news, underscoring the importance investors place on a resolution to the impasse between the United States and China. Other risks have worried investors as well, such as political risks domestically and abroad, and the uncertainty regarding the path of U.S. interest rates next year. Expectations for Fed policy and U.S.-China relations will play a key role next year.

TABLE 5:

STOCK PRICES				U.S. TREASURY SECURITY YIELDS			
Monthly Stock Prices				Constant Maturities			
2017	Dow Jones	S&P 500	Nasdaq	Monthly Yields			
	Industrial Average			2017	3-year	10-year	30-year
December	24,545.38	2,664.34	6,889.74	December	1.96	2.4	2.77
<b>2018</b>				<b>2018</b>			
January	25,804.02	2,789.80	7,279.50	January	2.15	2.58	2.88
February	24,981.55	2,705.16	7,161.77	February	2.36	2.86	3.13
March	24,582.17	2,702.77	7,311.51	March	2.42	2.84	3.09
April	24,304.21	2,653.63	7,084.14	April	2.52	2.87	3.07
May	24,572.53	2,701.49	7,339.33	May	2.66	2.98	3.13
June	24,790.11	2,754.35	7,645.14	June	2.65	2.91	3.05
July	24,978.23	2,793.64	7,756.86	July	2.70	2.89	3.01
August	25,629.99	2,857.82	7,892.23	August	2.71	2.89	3.04
September	26,232.67	2,901.50	7,983.31	September	2.84	3.00	3.15
October	25,609.34	2,785.46	7,527.08	October	2.94	3.15	3.34
November	25,258.68	2,723.23	7,236.08	November	2.91	3.12	3.36

Source: Economic Indicators, U.S. Government

U.S. Treasury security yields have gained more than stock prices this year, especially short-term maturities. The difference between the short-term and longer-term yields are thus compressing, meaning the yield curve has been “flattening,” which has previously been a strong predictor of recessions. From January to November 2018, 3-year Treasury yields gained 48.5%, while 10-year and 30-year Treasury yields gained 30% and 21%, respectively.

A key challenge for the U.S. bond market next year is the need to absorb the higher supply of new bonds. The Fed’s balance sheet unwinding will increase the supply of Treasury and mortgage-backed securities, and interest rate hikes will probably raise bond market volatility. An additional headwind will likely be reduced foreign demand for dollar-denominated paper because of higher dollar funding costs. Dollar funding will remain expensive as long as the major central banks follow divergent rate paths.

Moreover, U.S. government borrowing is surging, and the amount and speed of the increase is impacting bond indexes and posing a challenge for investors looking for the best returns when interest rates are rising. The U.S. Treasury is set to issue twice as much debt in 2018 as it did in 2017, according to Treasury Department borrowing estimates. That’s because budget deficits are rising, the result of slow revenue growth associated with tax cuts and this year’s bipartisan deal to increase spending.

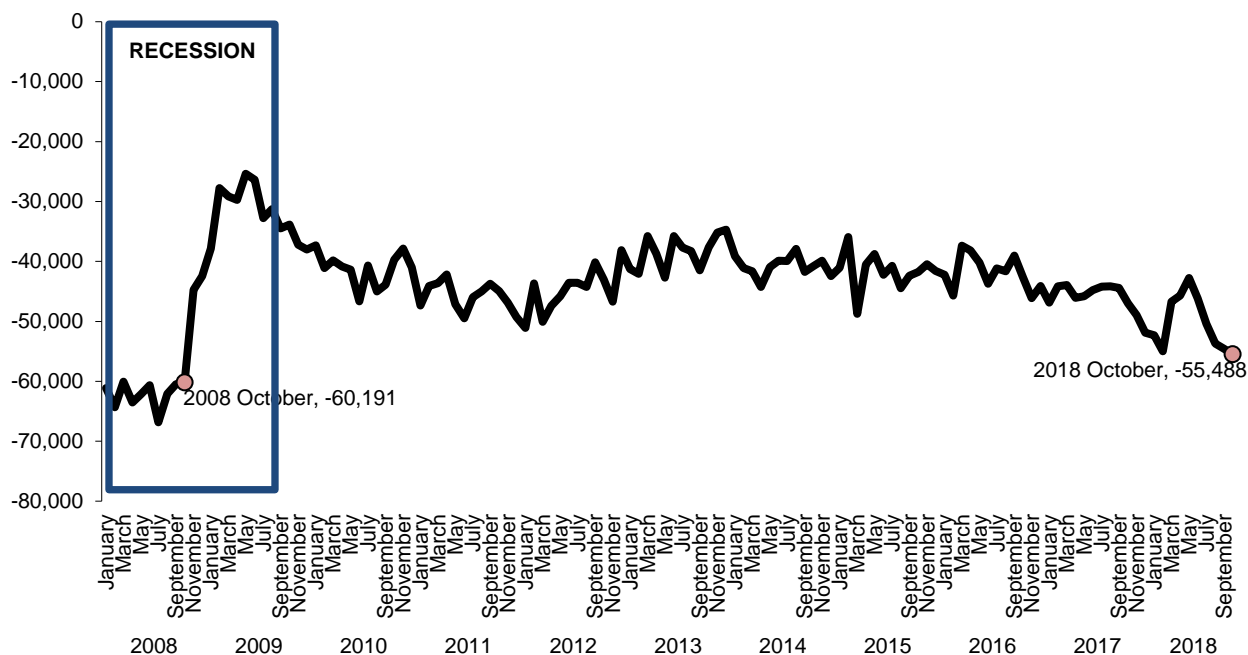
In the past decade, U.S. debt held by the public has risen to US\$ 15.9 trillion from US\$ 5.1 trillion. The sheer scale of debt being accumulated by the federal government and increases in interest rates by the Fed have put the U.S. on a path of rising interest costs that in the years to come could crowd out other government spending priorities and rattle markets. The Congressional Budget Office estimates interest spending will rise to US\$ 915 billion in 2028, or 13% of all outlays and 3.1% of GDP.

Along that path, the government is expected to pass the following milestones: it will spend more on interest than it spends on Medicaid in 2020; more than it spends on national defense in 2023; and more than it spends on all nondefense discretionary programs combined, from funding for national parks to scientific research, to health care and education, to the court system and infrastructure, according to the CBO. Debt as a share of GDP is projected to climb over the next decade, from 78% at the end of this year – the highest it has been since the end of the World War II – to 96.2% in 2028, according to CBO projections. As the overall size of the U.S. debt load grows, so too do the size of interest payments.

## G. External sector

The U.S. trade deficit reached the highest level in 10 years in October, driven by a bump in imports and falling exports of U.S.-made products. The trade gap in goods and services widened to a record seasonally adjusted US\$ 55.5 billion in October, a 1.7% rise from the prior month, according to the Commerce Department. This is the largest deficit since October 2008 (chart 15).

**CHART 15:**  
**U.S. BALANCE ON GOODS AND SERVICES TRADE**  
(US\$ Million, Monthly)



Source: ECLAC Washington Office, based on data from the Bureau of Economic Analysis, U.S. Commerce Department.

Imports grew 0.2% in October, while exports edged down 0.1%. The fall in exports was partly driven by declines in exported aviation products, such as aircraft engines. Soybean exports, which had contributed significantly to economic growth earlier this year, also declined. On the other hand, imports of multiple categories of foreign-made goods, ranging from consumer goods to vehicles, rose in October. Imported vehicles, parts and engines reached the highest level on record. In the first 10 months of 2018, the overall trade deficit increased 11.4% when compared with the same period in 2017.

While trade tensions with Canada and Mexico appear to be winding down after the negotiation of the U.S.-Mexico-Canada Agreement, they have escalated with China, though U.S. and Chinese officials recently agreed to hold off on any further trade barriers for 90 days while they negotiate. The feud between the two countries has caused volatility and led to losses in the U.S. stock markets. In late October, the U.S. imposed a 10% tariff on US\$ 200 billion of Chinese goods, which will increase to 25% on January 1st, bringing cumulative tariffs to almost half the value of Chinese imports in 2017. The odds are high that the next round of levies, on US\$ 267 billion in Chinese goods, will be implemented if recent talks between the U.S. and China fail. This will increase the impact on U.S. GDP and inflation and keep trade uncertainty elevated.

## **II. Recent U.S. trends and Latin American and Caribbean**

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Tighter U.S. monetary policy via higher short-term rates and a shrinking balance sheet has, through a stronger dollar, hit global risk assets. Trade has compounded the challenges for emerging markets already under duress from a firm U.S. dollar. In addition, a serious headwind for next year remains the unevenness of global growth, and a more negative reassessment of emerging market growth prospects may emerge, which would dampen asset returns.

A resurgent dollar alongside rising short-term U.S. interest rates has started to shake investors' confidence in Latin American and Caribbean (LAC) assets this year. For example, debt issuance from Latin America and the Caribbean in the third quarter of 2018 was the lowest quarterly issuance since the second quarter of 2009 (US\$ 6 billion). From January to October 2018, total international debt issuance amounted to US\$ 86 billion, 33% lower than in the same period last year.

The Federal Reserve raised interest rates three times this year so far and has signaled that it will raise interest rates one more time in December, which would keep the pressure on Latin American and Caribbean assets and test the ability of some issuers to repay dollar-denominated debt. Higher U.S. interest rates dim the allure of LAC assets, where investors often take on greater risk in exchange for higher yields and returns. Higher U.S. interest rates together with the unwind of the Fed's balance sheet would support a continuation of the appreciation of the dollar. Withdrawal of dollar liquidity through the Federal Reserve balance sheet unwinding, which is absorbing U.S. dollars, and the ensuing strengthening of the U.S. dollar, are among the main concerns for LAC financial assets.

U.S. trade policy is expected to add to the pressure on LAC assets. A possible fresh round of U.S. tariffs in the coming year if the U.S. and China do not reach a compromise on trade, combined with retaliation measures from U.S. trade partners will likely lead to additional volatility in debt, equity and commodity markets.





### III. Looking ahead

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The U.S. expansion has been remarkably stable in recent years. With the economy seemingly at full employment and monetary policy expected to tighten further, the expansion is likely entering its later stages.

Growth remained strong in the third quarter of 2018, but the composition of growth deteriorated, suggesting that the pace of growth in the middle two quarters of the year is not sustainable. Nonetheless, taken together, the second and third quarters of the year paint a picture of an economy that is expanding strongly, and near-term growth prospects remain positive. The economy is being pushed forward by deficit-financed tax cuts for businesses and individuals and increases in government spending.

The outlook for 2019 is slower growth and more uncertainty. Cause for concern is a widening gap between the strength of the economy in 2018 and weakness in economic indicators that look ahead to coming years. At the end of November consumer confidence data showed U.S. consumers are becoming less confident that growth will continue. Businesses are also less optimistic about the U.S. outlook than they were 12 months ago, according to the Institute of Supply Management in its semiannual economic forecast.

Market projections for real GDP growth in 2019 now range from 2% to 2.9% (see table 2). On average, growth in 2019 is expected to expand at an annual pace of 2.5%, a slower pace than in 2018. While there is a lot of concern about a late-cycle U.S. economy, many forecasters believe activity will simply retreat towards a trend level next year. The tailwind from stimulus, they say, may take a while to diminish and thus keep the Fed's monetary policy in play for next year, with the current tightening cycle possibly running for longer. The debate about a Fed pause in 2019 has helped some of the more battered emerging market currencies to enjoy a reprieve in recent weeks, reinforcing the case that the Fed policy has a strong effect on emerging markets. The danger of an early pause in the Fed's interest rate increases, however, is that it may embolden the market's animal spirits and fire up asset valuations, making the eventual end of the cycle more problematic.

Regarding near-term challenges, the U.S. administration and congressional leaders are racing against a looming deadline to avert a partial government shutdown at the end of the year, which brings to the fore difficult disputes over a border wall and an array of legislation that touches a range of issues.



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