The traditional signals of an impending recession are not widely evident, suggesting the business expansion is sustainable at least through the end of next year. There are five major risks to the economic outlook: Continued tightening in labor market conditions; a spike in long-term interest rates; an unexpected acceleration in wage and price inflation; an aggressive tightening in monetary conditions; and an escalation of current trade tensions into a full-blown trade war.

**Summary and Major Conclusions:**

- The pace of economic growth accelerated during the second quarter. Compared with only 2.2% growth in Q1, real GDP growth increased at an estimated 4% annual rate, the fastest quarterly gain since 2014. Real GDP has risen by an estimated 3% over the past four quarters, the fastest year-over-year gain since 2015.

- Corporate earnings continue to expand at a rapid pace. As measured by the companies in the S&P 500 Index, earnings per share (EPS) rose by an estimated 20% versus the same quarter in 2017, augmented by lower taxes. On a pretax basis, operating earnings rose by a still impressive 12%.

- The US economy is in transition and crossed an important inflection point late last year, strongly suggesting that business conditions in coming years could differ markedly from those of the past decade. This transition can be best understood as a powerful trend reversal involving macroeconomic supply and demand conditions.

- The current 3% trendline growth in GDP exceeds the country’s underlying long-term growth potential, defined as growth in productivity and the labor force. As a result, resource utilization has tightened significantly over the past two years. This is a sharp reversal from the abundant economic slack of previous years.

- An economy at full resource utilization is at greater risk of rising wage and price inflation. Currently at the Federal Reserve's long-term target of 2%, core consumer inflation is likely to drift modestly higher over the next two years, peaking at just under 3% in 2020.

- The Federal Reserve is determined to normalize monetary policy but will likely proceed at a cautious pace. The critical inflection point in monetary policy will occur when the FOMC fears an escalation in inflation and begins to deliberately target slower economic growth to avert an overheating economy.

- Compared with extremely tight fiscal policy during the six years ending in 2017, a major reversal is under way owing to large tax cuts and increased government spending. Fiscal policy could accentuate the risks of higher interest rates and inflation and increase the odds of an overheating economy.
The common denominator of these underlying trends is an increasing probability of recession over the next two years. Currently at less than 20%, the estimated probability of recession could rise to 40% next year and to 60% in 2020.

The overarching conclusion is that the sands beneath the US economy are in motion and are likely to shift significantly in coming years. Investors should assume that economic and policy trends will differ radically from those of the past decade, with crucial implications for investment strategy.

Recessions come about because of cyclical imbalances and excesses that develop over the course of a normal economic expansion. The most important of these are wage and price pressures, credit pressures, and resource bottlenecks as an economy approaches full employment.

A prerequisite for recession is an aggressive tightening in monetary conditions as the central bank attempts to cool an overheating economy. While the FOMC has raised its policy rate from 0.25% to 2%, monetary policy is still far from restrictive, with real short-term rates near zero.

Compared with growth of 2.2% over the past two years, US real GDP could expand at a 3% annual rate over the next four quarters, led by residential construction, consumer spending, and business investment in plant and equipment.

My forecast assumes a gradual slowdown later next year, with further weakness expected in 2020, possibly morphing into a recession later in the year. The world economy appears to have passed its maximum growth rate during 2017, but fears of a major economic slowdown are overblown.

Growth in China has slowed but continues at a solid pace. Similarly, although the European economy was weak during the first half of this year, the slowdown appears to be temporary. World GDP growth could average close to 4% over the next year, down slightly from its 4.3% pace in 2017, the fastest growth rate in a decade.

There are numerous risks to the outlook, most importantly the potential economic dislocations associated with a possible trade war. Trade frictions between the US and Canada, Mexico, Europe, and China could deteriorate further in coming weeks, undermining business confidence and constraining company expansion plans.

ECONOMIC REVIEW

The pace of economic growth accelerated during the second quarter. Compared with only 2.2% growth in Q1, real GDP growth increased at an estimated 4% annual rate, the fastest quarterly gain since 2014. Output was fueled by robust growth in consumer spending and business investment. US real GDP has risen by an estimated 3% over the past four quarters, the fastest year-over-year gain since 2015 (see chart 1).
Business Profits: Corporate earnings continue to expand at a rapid pace. Second quarter earnings per share (EPS) for the companies in the S&P 500 Index rose by an estimated 20% versus the same quarter in 2017, on revenue growth of 8%, helped by lower taxes. On a pretax basis, operating earnings rose by 12%.

- Wages and Prices: Inflation continues to drift higher but at a moderate pace. Core consumer inflation rose at an annual rate of roughly 2% in the quarter, up from 1.5% one year ago. Wages rose at a 2.9% annual rate during the past three months, up from only 2% one year ago (see chart 2).

Booming Labor Market: Labor market data continue to shatter records on a monthly basis. At 3.8%, the unemployment rate is the lowest since 1968. Initial jobless claims are the lowest in 50 years while nationwide job openings are at 6.7 million, the highest on record. For the first time since records began, the number of job openings exceeds the number of unemployed workers. Finally, the unemployment rate for workers with less than a high school degree has fallen to 5.4%, the lowest in the history of the data.
Small Business Sector: May’s survey of small business optimism rose to the highest level in the 32-year history of the survey. Intentions to expand operations through hiring and capital investment remain robust while expectations for sales and earnings growth remain elevated. *Heightened optimism among small- and mid-sized firms reinforces my confidence of strong growth over the next year* (see chart 3).

World Economy: Global GDP growth slowed during the past six months, raising concerns among investors. Economic data in Europe, Japan, and China weakened somewhat from the robust growth in 2017, which was the fastest year of global growth in more than a decade. However, the current soft patch in the three economies appears to be temporary, and a moderate rebound in growth appears likely during the next year. A global recession is highly unlikely through 2019.

ECONOMIC OUTLOOK

The major theme in the economic outlook is an expected transition in the US economy in coming years, which would have powerful implications for world financial markets. *Business conditions during the next several years could differ markedly from those of the past decade. The most notable differences from previous years include the following:*

- **Actual Versus Potential:** Currently in excess of 3%, actual GDP growth exceeds the economy’s growth potential of 2.2%. *Potential growth* is an estimate of an economy’s capacity to expand at a noninflationary rate. The current relationship between supply and demand represents a reversal from most of the past decade when actual growth was either at or below the economy’s so-called speed limit.
Resource Utilization: The obvious implication of a faster actual growth rate versus potential growth is tightening resource utilization. A tightening labor market is the primary risk to sustained economic growth, with bottlenecks becoming increasingly widespread. This is in sharp contrast to the past decade when the domestic economy enjoyed enormous slack and bottlenecks were nonexistent.

Inflation: Investor focus has shifted abruptly from disinflation to inflation. Rising inflation is fully consistent with a tightening in resource utilization. Consumer inflation is in a distinct cyclical upswing that should persist over the next two years.

Monetary Policy: The era of hyper-accommodative monetary policy has ended and the Federal Reserve is determined to tighten monetary conditions steadily over the next several years in an endeavor to restore interest rates to normal.

Fiscal Policy: Government spending and taxation have also shifted abruptly during the past six months. Compared with extremely tight fiscal policy during the seven years ending in 2017, a combination of tax cuts and increased government spending will be additive to GDP growth over the next several years.

Borrowing Costs: The cost of capital for households and businesses is in an uptrend that is likely to persist into 2020 as the Federal Reserve normalizes policy. Rising borrowing costs will act as a headwind to aggregate spending and investment.

Recession Risks: The common denominator of these expected major trend reversals is an increased likelihood of recession. Although still at a very low level, the probability of recession should rise as 2019 unfolds. Currently at less than 20%, the probability of recession could rise to 40% next year and to 60% in 2020, in my judgment.

Trade War: However, these estimated probabilities assume that the current wave of protectionism is transitory and that a full-blown trade war is averted. Unfortunately, the odds of a trade war are far from trivial. In the event of a large-scale escalation in protective tariffs involving China, Europe, Canada, and Mexico, the probability of a recession would rise to 35% this year to 65% in 2019.

The bottom line is that the sands beneath the US economy are in motion and are likely to shift significantly in coming years. Investors should assume that economic trends will differ radically from those of the past decade. As a result, the investment environment is likely to differ greatly from that of the previous five to ten years, with powerful implications for expected rates of return for all asset classes. Prospects of an outright trade war is a major wild card in the outlook.
RECESSION WATCH

Recessions come about because of cyclical imbalances and excesses that develop over the course of a normal economic expansion. The most important of these are inflationary pressures; financial pressures that result from excessive leverage and debt accumulation; bottlenecks as an economy approaches full employment; and monetary restraint as the central bank attempts to cool an overheating economy.

While evidence of a systematic build-up in cyclical pressures is slowly becoming more widespread, most of these are at an early phase. The following is a checklist of key recessionary indicators and an assessment of the risks posed by each.

Consumer Inflation: Inflation has not yet reached a level that would threaten the expansion but is moving in that direction. Wages are also increasing at a moderate pace but are likely to rise at a faster pace over the next two years. Rising inflation is unlikely to compel the Federal Reserve to aggressively tighten monetary policy until later next year.

Resource Utilization: Although the US economy is approaching full utilization of productive resources, there is further room to expand. The primary bottlenecks are within the labor market, where the number of job openings (demand) exceeds the number of unemployed workers (supply) for the first time in the history of the data (see chart 4).
Federal Reserve Policy: Monetary conditions remain accommodative as the FOMC raises its policy rate at a moderate pace. On an inflation-adjusted basis, the federal funds rate is still close to zero — the Fed’s policy rate and core inflation are each at 2%. The Fed is steadfast in its determination to normalize rates but feels no urgency. Policy is unlikely to become a threat to the expansion until the second half of next year.

The Yield Curve: The Treasury yield curve is a bond market gauge of the tightness of monetary policy. Although the curve has flattened in recent years, the spread between long-term and short-term yields is positive and not indicative of monetary restraint. The yield curve is unlikely to become inverted until later next year at the earliest.

The Housing Market: A peak in the housing cycle typically leads the onset of the next recession by two years. Monthly housing indicators have been volatile but remain in a moderate uptrend. Weakness in sales and new construction is a result of supply constraints rather than demand, which remains robust. A steady rise in nationwide house prices is a manifestation of the large shortfall of supply relative to demand (see chart 5).
Profit Margins: Company margins tend to peak approximately two years prior to the next recession. Profit margins for the companies in the S&P 500 are currently at a cyclical peak and should begin to compress within the next several quarters.

Credit Problems: Despite scattered evidence of credit pressures in some segments of the banking sector and credit markets, overall credit conditions should remain favorable over the next year. According to Moody’s, the corporate bond default rate is expected to decline from 3.5% currently to 2% one year from now.

- A New Credit Cycle: However, credit problems are likely to become more widespread next year and in 2020 in an environment of slower economic growth, higher borrowing costs, narrowing profit margins, and a more severe tightening of monetary policy. A trend increase in defaults and nonperforming loans at banks is a leading indicator of recessions.

Cyclical Spending: The ratio of spending on cyclical goods and structures to GDP has been an excellent indicator of the business cycle. Cyclical spending includes residential and commercial construction, autos, household durable goods, and business investment in plant and equipment. This ratio has been a reliable indicator of impending recessions at peak levels and economic recoveries at depressed levels. The current ratio is unusually depressed for the ninth year of a business cycle expansion, indicating considerable room for further expansion (see chart 6).
The bottom line is that the traditional signals of an impending recession are not widely evident, suggesting the business expansion is sustainable at least through the end of next year. There are three major risks to the sustainability of the expansion: (1) Continued rapid tightening in labor market conditions and a spike in long-term interest rates; (2) An unexpected acceleration in wage and price inflation and aggressive tightening in monetary conditions; and (3) An escalation of current trade disputes between the US and China, Canada, and EU into a full-blown trade war.

**ECONOMIC FORECAST**

The US economy is currently in a mild accelerating phase that could persist over the next several quarters. Compared with growth of 2.2% over the past year, US real GDP could expand at an average 3% annual rate over the next four quarters, led by consumer spending, business capital investment, and construction of single-family homes. My forecast assumes a gradual slowdown as 2019 unfolds, with further weakness expected in 2020, possibly morphing into a recession later in the year. Compared with 3% this year, real GDP could grow by only 2% in 2019 and 1% in 2020.

**Inflation and Business Profits:** Consistent with the final phase of a business expansion, inflation should drift higher. Currently at nearly 2%, core consumer inflation could peak slightly below 3% in 2020; wage inflation could peak near 4% in 2020, up from 2.8% currently. Corporate earnings are on track for a 20% gain for 2018, slowing to only 5% to 8% in 2019 and to 3% or less in 2020. Profit margin compression is likely later this year and during both 2019 and 2020.

**Diverging Growth Rates:** The world economy appears to have passed its maximum growth rate during 2017, as GDP growth rates in Europe, Japan, and China have slowed abruptly. Many analysts are predicting an end to the synchronized global boom of the previous 12 months. However, fears of a major world economic slowdown are overblown.

**Europe and China:** Growth in China has slowed but continues to proceed at a solid pace. Similarly, although the European economy was weak during the first six months of this year, economic weakness appears to be temporary and resembles a classic mid-cycle slowdown. Aggregate spending and output in China, Europe, and Japan are expected to expand at above-trend growth rates over the next year, with projected GDP growth rates of 6%, 2%, and 1%, respectively.

- **Eurozone Resiliency:** The European economic recovery is following the same track as that of the US, albeit with a lag of three to four years. Underlying fundamentals within the euro economy appear strong: Employment is growing, capital investment is in an upswing, consumer confidence is high, and house prices are rising at a steady pace. Company profit margins are in a decisive cyclical uptrend (see chart 7).
Engine of Growth: As the traditional locomotive for the global economy, US economic growth is in a strengthening phase, and should provide strong support for world exports. On balance, the world economy should grow at a 3.8% rate over the next year, slightly below the 4.3% mini-boom in 2017, but slightly above its long-term growth potential. A world recession is unlikely prior to 2020 at the earliest.

Emerging Market Economies: I expect emerging market (EM) economies to maintain their growth leadership over the next two years. However, developing economies will be at increased risk in 2019 and 2020 of rising US interest rates, a strengthening US dollar, progressive weakness in exports to China, and softening commodity prices. Led by China, India, South Korea, Hong Kong, and Singapore, emerging Asia is expected to grow at a 5% pace over the next year, slowing to 4% or less thereafter.

ECONOMIC RISKS

Risks to the outlook have increased significantly during the past six months. These risks are in the realm of geopolitics, domestic politics, a tightening US labor market, rising US interest rates, monetary policy, trade policy, and the world economy.
Trade Wars: Escalating trade tensions are the greatest immediate threat to the world economy and financial markets. The US precipitated a trade dispute with China and the European Union (EU) earlier in the year and the stakes continue to mount. The future of NAFTA is also in doubt as negotiations between the US and Canada and Mexico have stalled. The primary challenge for investors is to gauge whether the heated rhetoric over trade protectionism is merely a negotiating tactic or a prelude to a worldwide trade war.

- **Economic Impact:** The ultimate outcome is impossible to predict. In principle, protective tariffs negatively impact the economy through various channels, including world trade, GDP and profit growth, declining productivity, and higher inflation. On the basis of actual tariff increases currently in place, the economic impact should be minimal. However, threats of additional tariffs continue to escalate raising the amount of world exports subject to higher tariffs.

- **Major Wild Card:** A prediction regarding the future direction of the current trade dispute is not possible and comes down to a judgment call. My assumption is that the announced tariffs on all sides will remain in effect and a tit-for-tat retaliation among all parties will continue — but further escalation in actual tariffs will likely be limited. If so, the economic impact on the US and world economies would be mild in terms of growth and inflation. However, the threat of additional tariffs continues to escalate, in theory raising the amount of world exports subject to higher tariffs.

- **The US and China:** Trade relations between the US and China have very deep roots and must be viewed within the context of an ongoing struggle for world economic, political, and military dominance in the 21st century. Technology and intellectual property are at the forefront of current tensions. The issue of technological leadership in the 21st century is crucial for both China and the US with spillover implications for world economic and military dominance. For this reason, a quick or imminent resolution to current strained US-China trade relations seems unlikely.

The bottom line is that a full-blown global trade war is unlikely but will remain a worrisome wild card in the outlook. Moreover, the current crisis is likely to persist in coming weeks and months and will remain a dark cloud over world financial markets.

**Italy and the Euro:** Economic and financial risks pertaining to Italy have escalated in the aftermath of its recent parliamentary elections. Although conditions should stabilize in the medium term, the crisis has not yet peaked and financial markets in Italy and in the broader eurozone could remain highly volatile.
Sovereign Debt Crisis: A debt crisis is not likely in the medium term because of continued favorable economic and financial conditions and expected eurozone financial support for Italy. The risk of a debt crisis and eurozone existential crisis will escalate only with the onset of the next global recession.

World Oil Prices: The steady rise in world oil prices could be a significant economic risk, but only at much higher levels, which seem unlikely in view of the potential for continued strong growth in oil production worldwide. The major risk would be a geopolitical shock that disrupts production, triggering a disorderly spike in market prices (see chart 8).

Full Employment: Further tightening in the US labor market would negatively impact US growth prospects for several reasons. Bottlenecks in several critical segments of the labor market have already constrained output. In addition, upward pressure on wages would compel the Federal Reserve to tighten monetary policy more aggressively.

US Bond Yields: My forecast assumes a gradual but sustained rise in long-term interest rates over the next several years, ultimately peaking near 4%, as measured by the ten-year US Treasury bond. However, a faster and more disorderly rise in rates would be disruptive for both financial markets and economic growth, as rising business and consumer borrowing costs undermine aggregate spending and economic confidence.
**US Dollar**: The USD has benefited from widening interest rate differentials versus most other countries. The major macroeconomic risk associated with the USD would be an extreme move in either direction: A plunge in the dollar would be inflationary — triggering a more severe tightening response by the Federal Reserve — while a spike in the dollar would be contractionary for the rest of the world.

**US Corporate Debt**: Unlike the household and banking sectors, corporate sector finances are becoming a distinct threat to the expansion — although not likely to have a major economic impact until later next year and in 2020. Credit conditions should remain benign over the next year but could begin to deteriorate during 2019. Slower GDP growth, narrowing profit margins, rising borrowing costs, and record bond refinance requirements could push default rates sharply higher in coming years.

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