2018 Outlook: Moving into the End of the Cycle

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As 2018 begins, the good economic news continues. Companies are hiring, both consumers and businesses feel confident, and economic growth is good and getting better. Even as conditions remain very positive, though, there are signs that the trend is changing. Job growth is slowing as we run out of available workers, and confidence seems to have peaked. The Federal Reserve (Fed), spurred on by the good conditions, is likely to continue raising rates, which would act as a headwind. These and other factors all suggest that, right now, things may be as good as they get. The end of 2018 may look different from today.

What to watch

Changing trends are certainly not indicators of immediate trouble, but they could indicate that growth is likely to peak sometime in 2018 and slow thereafter. For the stock market, which is now expecting strong growth in corporate investment and earnings, a slowdown—even as growth continues—could hit confidence and, thus, valuations.

On the economic front, four factors will affect growth:

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

Inflation also can be expected to rise slowly, putting the Fed in a difficult position. Current low unemployment says to raise rates, but low inflation says not yet. Which side will win in 2018? The Fed is likely to raise rates again as early as March in anticipation of inflation, rather than waiting until the evidence is unmistakable, which could be another change during the year.

The bigger picture

When we look at 2018 as a whole, the economy should grow between 1.5 percent and 2 percent, but that may consist of faster growth in the first half and slower growth in the second. Corporate profits should also grow at healthy rates. Inflation is expected to run around 2 percent for the year, but it may be slower in the first half and pick up in the second half. As the Fed raises rates in response to faster growth and rising inflation, the 10-year U.S. Treasury note should yield around 2.75 percent by year-end.

Solid fundamentals poised to calm turbulence

With both economic and profit growth likely to continue, sound fundamentals should support financial markets. But if confidence pulls back to more normal levels, lower valuations may offset those improvements. Thus, the real risks are to confidence; stocks are likely to rise in the first half of the year, only to give back much of the year's gains in the second half, ending around 2,700 for the S&P 500.

At this point, the biggest apparent risk is political, not economic. With the mid-term elections approaching and political dysfunction rising, the potential for shaken confidence—and valuations—is very real. Fortunately, the solid economy should help mitigate any political turmoil. We are approaching the end of the cycle, but we're not there—yet.

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