CLEARWATER CAPITAL

Thought Leadership

THINK19

March 2019

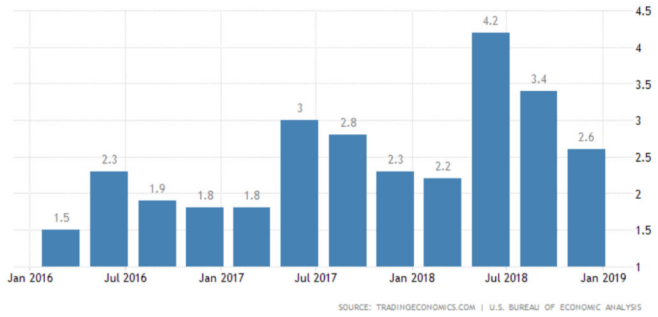
Private Client Letter

A Late-Cycle Soft Patch

On February 28th the U.S. Bureau of Economic Analysis (BEA) released its initial estimate of the fourth quarter 2018 real gross domestic product (GDP) growth. According to the report, GDP increased at an annual rate of 2.6% in the fourth quarter and was revised higher for the third quarter, showing real GDP Q3 growth at 3.4%.

The fourth quarter GDP growth of 2.6% was actually higher than consensus expectations for 2.2%.

Depending on the media outlet covering this report, two narratives have emerged. The first reports that GDP grew at an annual rate of "only 2.9%" in all of 2018. This, of course is an accurate average of the four quarterly growth numbers.



Each of these quarterly numbers represent an annualized number of that quarter's economic activity. The full year average of the individual quarters gives us the 2.9% growth number and, as a whole, 2018 proved to be the best full year of economic growth since 2005.

Calendar year 2018 saw an improvement over 2017's full year GDP average growth of 2.48%, and 2016's full year GDP average growth of 1.88%. It was also far better than the average of the prior five years of 2.09% (2011—2015).

Still the headline most often associated with the recent GDP report generally read ***"US GDP Growth Slows Less Than Expected"*** leaving many readers with the impression that the U.S. economy was faltering. This view fits with the story line that the economy is weaker than most people realize and will soon tip into recession, however we believe this narrative distorts the true strength of the current U.S. economy.

The problem with the "average annual" method of calculating GDP activity is that it fails to factor in the overall size of the economy from one year to the next. In other words, it compares economic activity for all of one year to the total activity of the next year.

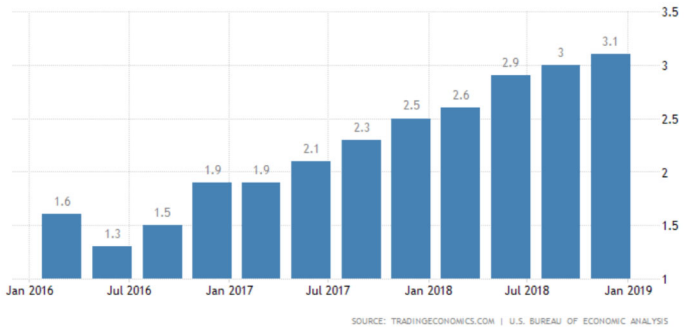
John E. Chapman

John is the Chief Executive Officer at Clearwater Capital Partners and serves as the firm's Managing Partner. With thirty four years of Wall Street experience, John directs all wealth management and advisory services for the firm. He also serves as the firm's Chief Investment Strategist and chairs the firm's Investment Policy Committee.

Key Takeaways

- GDP increased at an annual rate of 2.6% the fourth quarter and was revised higher for the third quarter, showing real GDP Q3 growth at 3.4%.
- On a year-over-year basis, real GDP growth has accelerated in every quarter since the beginning of 2017.
- The year-over-year 3.1% growth for 2018 was the strongest in more than a decade.
- Business investment grew at 7.2% in 2018. This represented the fastest calendar growth for business investment for any year since 2011.
- We recognize that there has been some weakness in the economic data in recent weeks.
- We are expecting a reacceleration of U.S. economic activity later in 2019.

We prefer a second narrative that shows quarterly year-over-year growth data. Using this approach we see that real GDP growth has accelerated in every quarter since the beginning of 2017.



This view of economic activity leads one to a far more constructive view of economic progress. Still, there are additional observations that can be made about the most recent report that are not widely reported, or well understood. Looking "under-the-hood" reveals other important details.

First, a quarterly year-over-year approach shows 2018 GDP growth at 3.1%, which was the strongest in more than a decade. Second, the increase in real GDP in the fourth quarter reflected positive contributions from personal consumption expenditures (PCE), nonresidential fixed investment, exports, private inventory investment, and federal government spending (BEA).

Of these components, we are most encouraged by nonresidential fixed investment. This category represents the investment activity of businesses across the nation that are attempting to anticipate future demand. Looking at this component we see that business investment grew at a 6.2% rate in the fourth quarter and was up 7.2% in 2018. This represented the fastest calendar growth for business investment for any year since 2011.

This category is so important because in order for the economy to break out decisively from a disappointing 2.3% average annual growth rate since 2009, the country will need to see a pickup in business investment. Last year's growth rate of 7.2% was substantially higher than its long-term average of about 4% and could signal an uptick in economic activity later this year (Califia Beach Pundit).

We recognize that there has been some weakness in the economic data in recent weeks. Retail sales, construction spending, and housing data have all disappointed. Economic data has become mixed and concerns over future growth are not entirely unwarranted. Still, the Leading Economic Index has been roughly flat since October of last year and we regard this "soft patch" as a normal late-cycle pause. Absent an adverse development in the U.S. trade negotiations with China, or some exogenous geopolitical event, we are expecting a reacceleration of U.S. economic activity later in 2019.

Lastly, it is important to note that the February 28th GDP report (along with other economic reports) was based on source data that was incomplete due to the government shutdown. This preliminary GDP estimate will be subject to further revisions and will be updated with a subsequent report scheduled for release on March 28th. Given the trends in other economic data sets, we suspect that the GDP numbers for the fourth quarter could be revised higher.

We will continue to monitor all developments closely. Thank for your continued confidence.

John E. Chapman
March 2019

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