July 2018

As good as it gets?

June was busting out all over
June was a great month for the economy, with light vehicle sales up strongly and business surveys near expansion highs. There are few signs that trade and tariff concerns are having an impact on economic activity, at least for now.

Where in the world are financial market results?
Financial market results have varied sharply thus far in 2018 depending upon location, with U.S. equity market results modestly positive but declines in Europe and significantly worse results in emerging markets.

The (economic) song remains the same
We expect that over the second half of 2018 the economy will look much as it did over the first half of the year: above-trend real GDP growth, falling unemployment rates, rising interest rates, and further uncertainty with respect to trade.

Charts & Commentaries

Forecast Table
Economic Review

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Business Cycle Update

The economy is in the part of the business cycle where growth is positive, but with inflation and interest rates moving upward. Given only modest expected increases in both inflation and interest rates, it is likely that this expansion will set a record for longevity in July 2019.

Yield Curve Update

Spread between the 10-year and 1-year U.S. Treasury yields
Percentage points

One of the best predictors of an economic downturn is an inverted yield curve, when short-term rates are above long-term rates. While the yield curve has flattened over the past year, it still has not inverted – suggesting that a recession in the next year or two is unlikely.
June busted out

As summer temperatures rose, so did consumer appetites. Buyers rushed to auto dealerships, emboldened by a strong job market and unfazed by higher borrowing rates. Confidence held steady, not yet deterred by higher tariffs.

Businesses rushed to meet the rising demand, with the manufacturing and service sectors both up. Fed policymakers noted rising risks from trade wars, but it continued to normalize rates as the expansion grinds on.

Auto sales surprise
Auto sales were robust in June, topping 17.4 million units (annualized rate), with almost all manufacturers beating expectations. So far this year, sales are nearly 1 percentage point above the same period a year ago, busting past estimates that looked for a decline from previous strong results.

Overall retail sales jumped by 0.8 percent in May and were even a bit stronger excluding solid auto sales. Results show the continued strengthening of the expansion, fueled by surprisingly strong job growth and incipient wage increases.

Payrolls exceed estimates, too
Nonfarm payrolls were stronger than expected for June, rising by 213,000 on top of an upwardly revised increase of 244,000 in the prior month. Wage gains remained surprisingly modest — up by only 2.7 percent over the year. As the job market tightens further in coming months, the odds of faster wage increases have risen.

The U-3 unemployment rate surprisingly rose from an expansion low of 3.8 percent to a still-low 4.0 percent. But sometimes rising unemployment can be a positive signal. June’s bump came as a result of an increase in the labor force participation rate to nearly the highest level in the expansion. The rise in the number of workers is a sign that at least some discouraged workers view the job market as strong enough to return to.

Business surveys very strong
The Institute for Supply Management’s (ISM) nonmanufacturing survey index rose in June to 59.1 (figures above 50 indicated expansion) — the strongest in three months and one of the highest levels in the past decade. This suggests the service sector is growing strongly.

The National Federation of Independent Business’s (NFIB) small business optimism index slipped a tad in June but to a level that is not only still near the top for this cycle, but remains one of the strongest readings in this survey ever. Of particular note was the difficulty firms are having in finding qualified workers, with a record share reporting few or no qualified applicants for job openings.

Manufacturing surges
The ISM manufacturing index was stronger than expected for June, rising by 1.5 points and topping 60 — a level rarely surpassed in the past 30 years. New orders, production, and employment all remained at lofty levels, but the big story was the delivery performance issues that reflected transportation delays and heightened uncertainty in the steel and aluminum markets.

Inventories for manufacturers remain lean with long supplier lead times and freight disruptions limiting firms’ ability to replenish their stock. These imbalances along with price pressures suggest that supply chains continue to struggle with robust demand.

In response to the strongest growth of the expansion, inflation continues to edge higher. While the monthly gain in the June CPI was only 0.1 percent, the 12-month trend rate accelerated to 2.9 percent — the fastest since 2012.
Financial Markets Review

Where in the world…?

Perspective matters. June was shaped by volatility in markets globally, as has been the case in many of the months thus far in 2018. Multiple reasons, including late-cycle dynamics and trade tensions, should keep market instability elevated for some time to come.

International woes
Most major equity indices are still below their 2018 highs, which were reached at the end of January. Some, however, have suffered more than others. The S&P 500 is still off by about 5 percent from its peak, the DAX is down by over 8 percent, and the Shanghai Composite has fallen by 23 percent.

U.S. markets have been rather upbeat despite burgeoning trade conflicts. International markets, on the other hand, have been impacted far more. For example, out of 95 major foreign equity indices, only four had a negative return for the year at the end of January while the total was up to 72 through June.

Emerging markets (EM) have been particularly impacted. The MSCI Emerging Markets Index is down by 7.7 percent so far this year. Some of this is owed to the trade spat, but it also represents idiosyncratic risk that is borne of investing in these types of countries.

Structural economic issues can have a much larger impact on markets in developing nations as opposed to markets in developed countries. For instance, political turmoil regarding employment in Brazil has aided in a drop in the Bovespa index of 18 percent so far this year.

While these large market moves are troubling, the fact that the problems should be contained is at least a bright spot in a dim cave at the moment.

China concerns
Equity markets in China have been a big drag on the overall EM landscape this year. The effects from the looming trade conflict have had a much more dramatic impact on China than on the U.S., at least so far.

Besides the equity markets, this can also be seen in each country’s currency. Thus far in 2018, the dollar has risen a little over 2 percent while the yuan has retreated by a similar margin. The yuan’s decline followed a start to the year that saw a strengthening of more than 3.5 percent. It’s difficult to know how the trade conflict will play out, but volatility is likely to be heightened for some time.

Solid first half for 2018
Although volatility has seen a significant rise this year compared with last, risk assets are still performing well. The S&P 500 index was up by 1.67 percent through the end of June. The S&P 600 index (small-cap stocks) has outpaced the large-cap index, increasing by 8.66 percent. Some of this was to be expected given the tax changes passed late last year provided more benefits to smaller domestic companies that generally pay a higher tax rate.

Finally, the yield curve has reached a new cycle low. The spread between the 10-year and 2-year U.S. Treasury note yields narrowed to 33 basis points (bps) by the end of June. Financial conditions are still accommodative, but tightening.

<table>
<thead>
<tr>
<th>Asset Class Performance</th>
<th>1-month</th>
<th>6-months</th>
<th>12-months</th>
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<tbody>
<tr>
<td>S&amp;P Composite 500 Index</td>
<td>0.62%</td>
<td>2.65%</td>
<td>14.37%</td>
</tr>
<tr>
<td>S&amp;P Midcap 400 Index</td>
<td>0.42%</td>
<td>3.49%</td>
<td>13.50%</td>
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<tr>
<td>S&amp;P Smallcap 600 Index</td>
<td>1.13%</td>
<td>9.39%</td>
<td>20.50%</td>
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<tr>
<td>EAFE&lt;sup&gt;1&lt;/sup&gt;</td>
<td>-1.39%</td>
<td>-4.49%</td>
<td>4.01%</td>
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<tr>
<td>U.S. Dollar Index&lt;sup&gt;2&lt;/sup&gt;</td>
<td>0.52%</td>
<td>2.55%</td>
<td>-1.21%</td>
</tr>
<tr>
<td>CRB Commodity Index&lt;sup&gt;3&lt;/sup&gt;</td>
<td>-1.21%</td>
<td>3.36%</td>
<td>14.65%</td>
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<tr>
<td>Intermediate Treasuries&lt;sup&gt;4&lt;/sup&gt;</td>
<td>-0.01%</td>
<td>-0.69%</td>
<td>-0.76%</td>
</tr>
<tr>
<td>Long Treasuries&lt;sup&gt;5&lt;/sup&gt;</td>
<td>0.18%</td>
<td>-3.00%</td>
<td>-0.13%</td>
</tr>
<tr>
<td>Investment-grade Corporate Bonds&lt;sup&gt;6&lt;/sup&gt;</td>
<td>-0.58%</td>
<td>-3.27%</td>
<td>-0.83%</td>
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</tbody>
</table>

Total returns represented as of 6/30/18
<sup>1</sup> Index measuring equity performance of developed markets outside of the U.S. and Canada
<sup>2</sup> Federal Reserve trade-weighted major currency index
<sup>3</sup> Commodity Research Bureau; commodity futures price index
<sup>4</sup> Index of 1-year to 10-year Treasury notes
<sup>5</sup> Index of 10-year and longer Treasury notes and bonds
<sup>6</sup> Index of U.S. investment-grade corporate bonds

Source: Bloomberg
The Outlook

Second half of 2018 likely to bring more of the same

The first half of this year was in many ways a microcosm of the entire economic expansion. It was highlighted by a choppy pace of real GDP growth, a major political row, a mini-European debt crisis, and sharp moves in the U.S. dollar as well as a tightening labor market and mostly higher domestic equity prices.

While the stories can be expected to evolve and change at least somewhat, the overarching theme should be largely the same in the second half of the year. Amid headline risk and policy uncertainty, above-trend economic growth should continue and financial market fundamentals should remain healthy.

Uneven, but persistent

The course of an expansion never runs entirely smoothly, and this one has been no exception. But while the real GDP growth rate continues to fluctuate on a shorter-term basis, the underlying trend is now in an upswing. The second quarter data out in late July will very likely leave year-over-year growth above 3.0 percent for the first time since 2015, continuing an acceleration that began two years ago.

This would mark the longest sustained pickup in the annual growth rate since the cycle began in mid-2009. There is likely to be a slowdown again before long, but the chance of an outright contraction in the near term is small. Feedback loops are not only strengthening, they are increasingly broadening.

The U-6 unemployment rate, long a signpost of the fragility of this expansion, recently hit its lowest level in 17 years. The jobless rate for those without a high school diploma is similarly just off of its all-time bottom. Student loan delinquencies, another marker of deep-seated structural headwinds in recent years, have declined in four of the last five quarters to reach their lowest point since 2012.

This expansion has been far from robust — in fact, its annualized GDP growth rate is still the slowest for any cycle on record — but its persistence has gone a long way toward diminishing the imbalances that have restrained it from the outset. As a result, it is now on firmer footing than at any time since it began.

Risks remain

This is not to say there will be only smooth sailing ahead. Risks are ever-present and currently include a budding trade war, a resurgent dollar, excessive house price gains, and a global soft patch. While none of these is likely to prove a game changer for the cycle, they will continue to weigh on the near-term pace of expansion. As these effects fluctuate, the impacts on GDP will rise and fall as well.

An extended endgame

The more pernicious risks stem from a nascent pickup in inflation and the ongoing rise in interest rates. Still, these processes are far from advanced enough to fuel a downturn anytime soon.

The spread between the 10-year and 2-year U.S. Treasury yields, for example, has narrowed to its lowest in more than a decade, but it is still at a level that has historically come roughly two years before economic contractions (on average).

Given the very measured pace at which the Federal Reserve is tightening monetary policy, there is the potential for the endgame to be more drawn out than usual in this cycle. There will continue to be ups and downs in the news flow and the data in the second half of 2018, but the underlying story — sustained expansion, tightening labor markets, and a slow removal of monetary accommodation — is likely to remain the same.

U6 Unemployment Rate

Source: Bureau of Labor Statistics/Haver Analytics
Job growth remains solid across the country

- Utah and Idaho lead the country in job growth, each up by more than 3.0 percent over the past year.
- The level of employment has declined in only two states over the past year, North Dakota and Alaska (not shown), but trend growth in many states continues to slowly decrease as the expansion ages.

Unemployment rates indicate tight labor markets

- Unemployment rates have decreased in 39 states over the past 12 months. While many states have seen only modest declines, rates in New Mexico and Kentucky each dropped by a percentage point or more.
- There are now only three states (including Alaska, not shown) with unemployment rates above 5.0 percent.
Manufactured exports are important for several states

- Relative to gross state product (GSP), exports of manufactured goods are most important in Louisiana, South Carolina, Kentucky, and Washington (followed by Michigan, Indiana, Alabama, and Mississippi).
- Potential tariffs on U.S.-made exported goods would have a greater impact in these states.

Sources: Census Bureau; Haver Analytics
Exports of manufactured goods as share of gross state product, May 2018

Some states depend upon manufactured imports also

- Manufactured imports to Michigan, Kentucky, and Tennessee among other states are relatively high.
- Tariffs on imports would raise production costs in these areas, making them less competitive.

Sources: Census Bureau; Haver Analytics
Imports of manufactured goods as share of gross state product, May 2018
Charts & Commentaries

Job gains maintain a strong pace

- Nonfarm payrolls have added an average of 215,000 jobs per month in 2018, faster than last year’s pace.
- The U-3 unemployment rate rose in June to 4.0 percent as the labor force jumped (a positive for the economy), while the U-6 rate (which includes all measures of underemployment) increased to 7.8 percent.

Wages still struggling to gain momentum

- The year-over-year change in average hourly earnings has moved sideways over the past two years, while the wage growth tracker from the Atlanta Fed has fallen back since mid-2017.
- The low unemployment rate and still-solid pace of hiring should push up wages more rapidly at some point.
Core inflation hits the Fed’s long-term goal

- The Federal Reserve’s preferred inflation measure, year-over-year change in the core PCE, climbed to 2.0 percent in May for the first time since 2012 in response to ongoing above-trend economic growth.
- The New York Fed’s underlying inflation gauge (UIG) is over 3.0 percent and implies accelerating inflation ahead.

Exports are up sharply in 2018

- Despite the higher U.S. dollar, growth in exports has picked up this year, mostly from stronger global growth.
- The surge in exports reduced the U.S. trade deficit during the second quarter with trade expected to provide a solid boost to real GDP growth for the period.
## Nationwide Economics Forecast

### As of July 2018

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<thead>
<tr>
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<td>Real GDP 1</td>
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<td>3.0%</td>
<td>2.6%</td>
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<td>Unemployment Rate 2,7</td>
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<td>Inflation (CPI) 5</td>
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<td>Total Home Sales 3,7</td>
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<td>S&amp;P/Case-Shiller Home Price Index 9</td>
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<td>Mortgage Originations 10 (Refinance Share %)</td>
<td>$2,051 (49%)</td>
<td>$1,750 (35%)</td>
<td>$1,680 (26%)</td>
<td>$1,650 (23%)</td>
<td>$1,510 (20%)</td>
<td>$1,450 (18%)</td>
<td>$1,350 (17%)</td>
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<td>Light Vehicle Sales 3,7</td>
<td>17.5</td>
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<td>16.7</td>
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<td>1-Year Treasury Note 2,4</td>
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<td>30-Year Fixed-Rate Mortgage 2,4</td>
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<td>Money Market Funds 2,8</td>
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<td>1.14%</td>
<td>2.00%</td>
<td>2.95%</td>
<td>3.86%</td>
<td>4.22%</td>
<td>4.27%</td>
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</table>

1) Percent change year-to-year  
2) Percent  
3) Million units  
4) Year end  
5) Percent change Q4-to-Q4  
6) Target rate, lower limit  
7) Year average  
8) Annual return  
9) Percent change December-to-December  
10) $ Billion  
* Estimated value

Sources: Haver Analytics (actuals); Nationwide Economics (estimates and forecasts); except Money Market Funds (all data from Nationwide Economics)

### Major forecast changes from last month:

1) There were no significant changes to the forecast this month.

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