



Special Edition

CRF's Annual Focus on the Economy for 2019 Projections from Leading Economists

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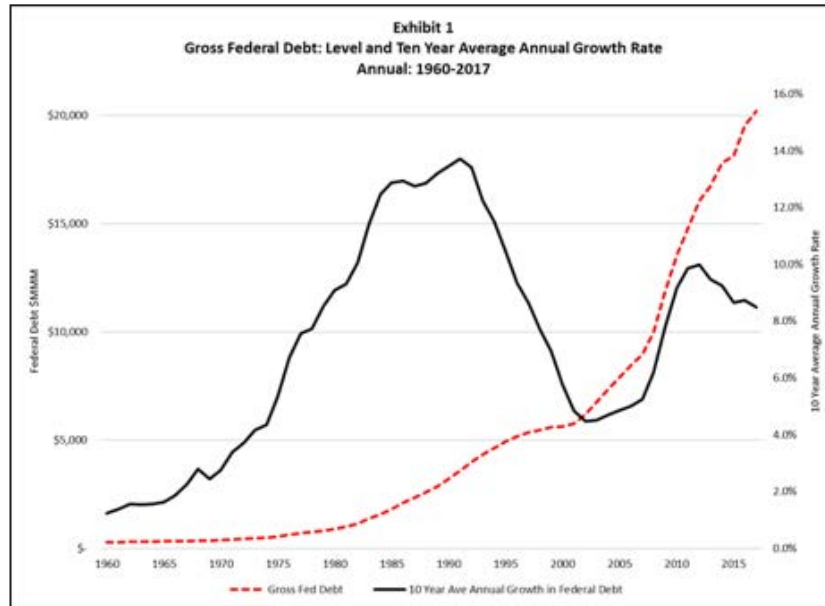
2019: How Long is the Debt Bomb's Fuse?

By: Steven C. Isberg, Ph.D.
Senior Research Fellow
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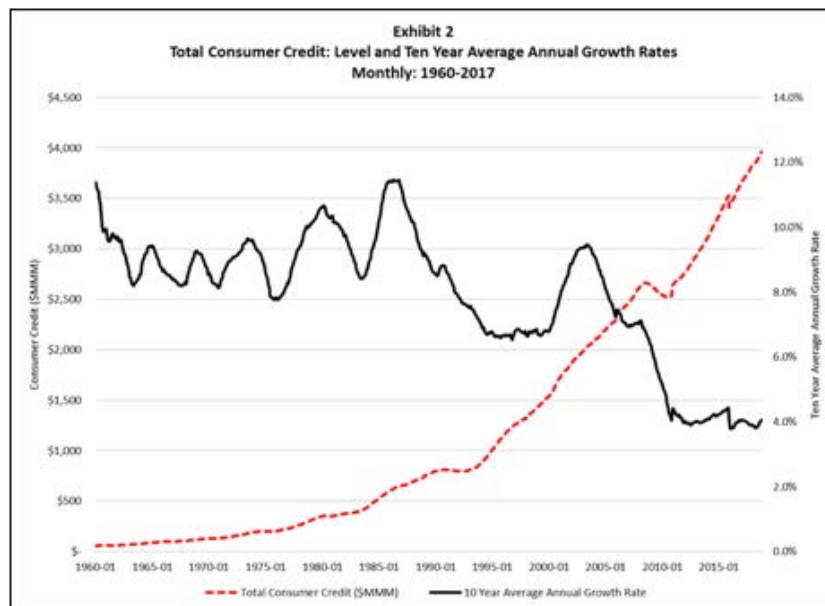
This year seems to remind me of some of the economist jokes I have heard over the years, such as: "All I want for Christmas is a one-armed economist, so she would stop saying 'But on the other hand;'" and, "If you lined up all the economists end-to-end you still wouldn't reach a decision;" and, "Economists predict the GDP growth down to three significant decimal places to prove that they have a sense of humor." This year certainly appears to be lacking in agreement on where things are headed. In diving headlong into this melee, I am once again going to view things from a longer-term perspective.

One of the questions we received during a recent CRF webinar on the economic outlook was: "For how much longer can the federal government sustain its accumulating debt level?" Indeed, one of the most interesting---and scary---things about recent



economics news coverage is how **little** attention is being paid to the accumulated levels of government debt and their impacts on economic growth. Current debt levels are now well over \$21 trillion for the federal government and \$4 trillion for consumers. Both of these accumulations, I would suggest, are serving as a

drag on economic growth, and it doesn't appear that it will get better any time soon. In the following paragraphs, we will take a look at how the situation has evolved, what it has meant, and where it is headed in the longer term.



As we examine a broad variety of economic performance measures, one thing becomes clear: growth is slowing down. This even applies to both federal government and consumer indebtedness. Both Exhibit 1 and Exhibit 2 show two meaningful outcomes: 1) government and consumers

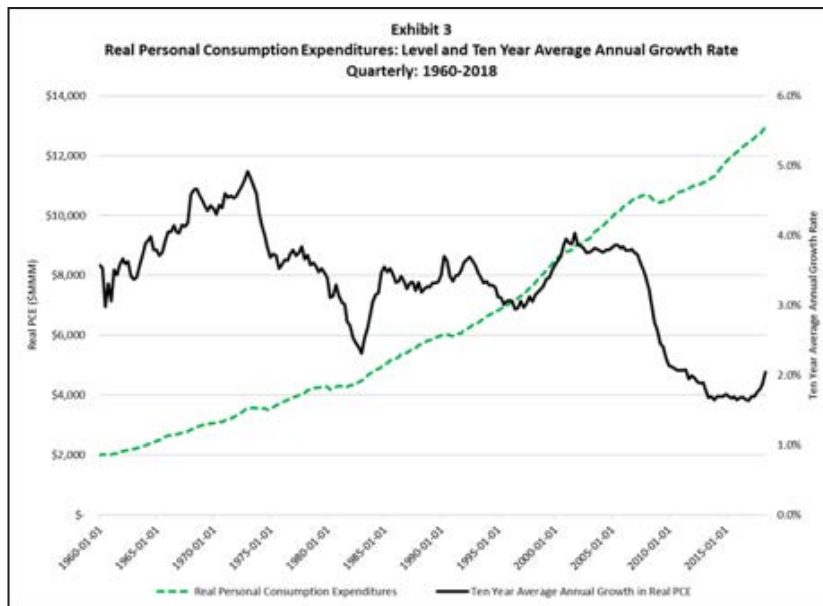
have steadily accumulated debt to monstrous levels, and 2) the rate of growth in each has been **slowing** over the longer term.

Debt and economic performance are interactive with each other. Better economic performance creates the ability to borrow and service higher levels of debt. However, an increasing debt burden requires higher levels of service, redistributing funds from borrowers to lenders, hence cutting into income available for spending by one group, and increasing for another. When the borrowers constitute a large group, and the lenders a smaller group, the net effect on spending will more than likely be negative.

As individual consumers take on more debt, they will have less money to spend on other things. Higher levels of government debt also require more of the government's income to go toward servicing debt, leading to either additional borrowing or increased taxes to finance government spending.

Ultimately, the bill for all of this ends up back on the desks of consumers in the form of higher taxes and/or reduced government service levels (for example: extending of the age at which one becomes eligible for full social security retirement benefits).

On the other side of the debt transactions, lenders will end up with more money after debts

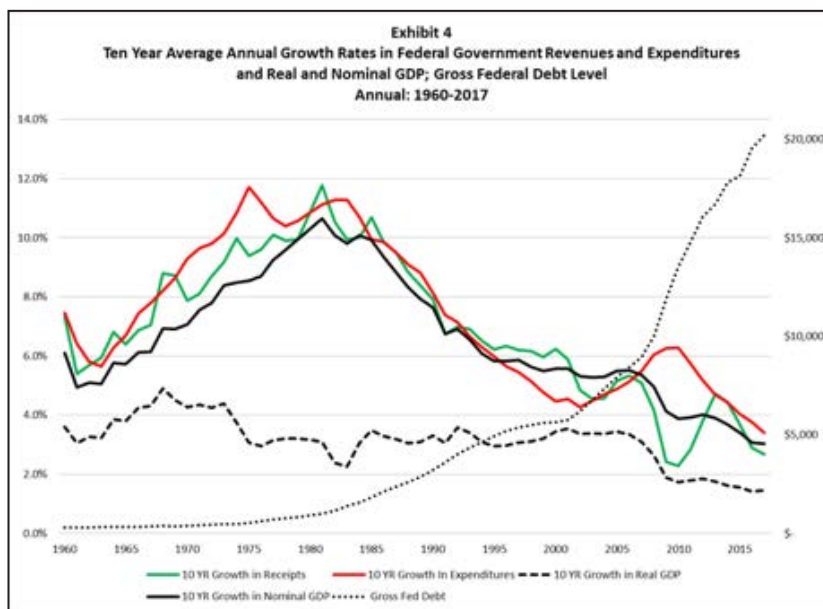


have been paid. The smaller this group relative to the whole, the less of that money will find its way back into the economy as spending that will make up for the lack of spending by the larger group of borrowers. True: this money will be available for investment, which may ultimately provide economic opportunities and growth for others, but as we will

see below, the benefits of those investments tend to accrue back to the smaller group.

As one might expect given the past history of consumer and government borrowing, growth in real personal consumption expenditures (PCE) has generally declined over the past 60 years. As can be seen in Exhibit 3, the ten-year average

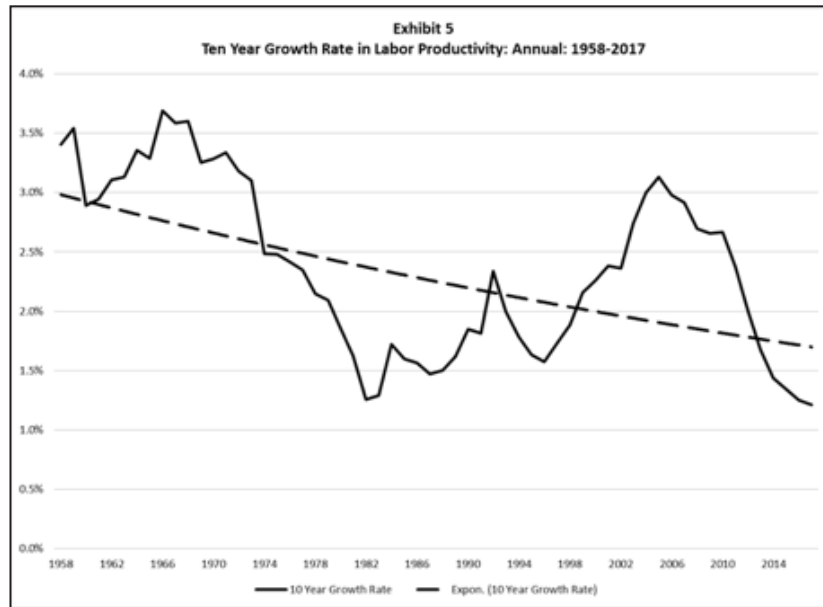
annual growth in real PCE actually topped out in the mid-1970s. It partially recovered after declining into the recession of 1982, but it maxed out again around 2000, and has fallen since. While it does appear to be turning upwards over the past two years, it has settled at a level of about 2%, which is about the same as the long trend growth rate in



real GDP. Let's turn our attention to how this situation has evolved over time.

It is often argued that debt financed government (and consumer) expenditures in the 1960s and 70s fueled the inflationary growth of the economy over that time period. The basis for that argument can be seen in Exhibit 4, which shows the ten-year average annual growth

rates in government revenues and expenditures matched up with the ten-year average annual growth rates in nominal and real GDP, along with the accumulated federal debt as a reference. The real impact of nominal economic growth in the 1960s and 70s was severely dampened by inflation. As the **growth rates** in government economic activity have steadily fallen since the early 1980s, so has the growth rate in nominal GDP. Since 2000, however, the growth rate in real GDP has fallen by over 100 basis points, re-emphasizing the point that we are experiencing a **declining growth** economy. The accumulated debt level is only going to act as an anchor upon future growth. The same appears to be true at the consumer level.



As shown earlier in Exhibit 2, growth in consumer indebtedness topped out in the mid-1980s. While the growth rate increased during the housing boom in the early 2000s, it has fallen further since the collapse of that market, beginning in 2006. As we have seen in Exhibit 3, however, growth in real personal consumption expenditures peaked in the early 1970s. Why didn't it continue at least into the 1980s, at which point growth in consumer indebtedness began to slow down?

Slow growth in real personal consumption spending was also driven by slow growth in earnings for wage and salary employees, which in real terms has been less than one percent since 1979. This slowing growth has been driven by falling growth in labor productivity, which dates back to about the time that the growth rate in PCE reached its high point.¹ As can be seen in comparing Exhibit 5 to Exhibit 3, labor productivity growth and PCE growth demonstrate the same pattern. This is a consequence of the restructured business

1 For a more detailed treatment of these cause and effect relationships, see Isberg. Steven: Business and Manufacturing Process Reengineering: Have We Gotten Too Good for Our Own Good? *Credit and Financial Management Review*, Fourth Quarter 2018.

economy. It looks as if consumers attempted to maintain their standard of living into the mid-1980s by borrowing while their real incomes were falling. The tax law changes of 1986 may have accelerated this coming to an end.²

Labor productivity has been impacted by the transformative economic restructuring that has taken place in stages since the early 1980s. This began with restructuring of the manufacturing base that accompanied the leveraged buyout movements of that decade. Restructuring continued into the 1990s as the advent of increasingly sophisticated technology applications enabled automation

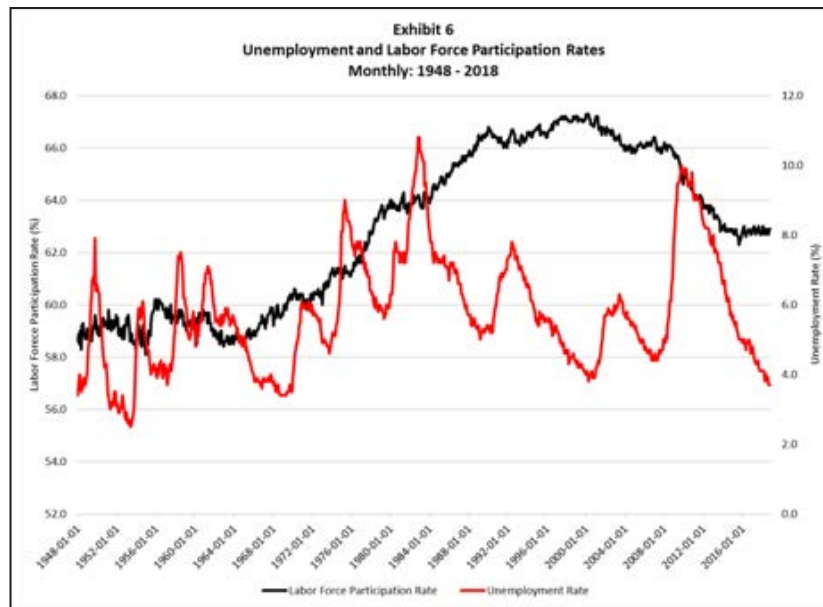
and business process reengineering. This restructuring continues today, with the focal point being the use of robotics to replace functions in both manufacturing and general business processes that were formerly completed by manual workers. Declining labor productivity has accompanied this transformation.

The high return to capital over this time period, combined with falling interest rates and continued consolidation and concentration of corporate ownership, helped drive stock market values to higher and higher levels, in spite of the dot.com bust of 2001 and financial meltdown of 2008. This trend, however, now appears to be ending, as interest rates are starting to rise and it is becoming clear that overall growth is declining. Once again, the slowing growth can be at least in part traced back to real consumer spending, which can be traced back to declining labor productivity, which can be linked to manufacturing and business process restructuring.³

2 The changes made in 1986 eliminated the tax deductibility of credit card debt, which greatly increased the cost of revolving credit for middle class consumers.

3 See again, Isberg. Steven: Business and Manufacturing Process Reengineering: Have We Gotten Too Good for Our Own Good? *Credit and Financial Management Review*, Fourth Quarter 2018.

Many currently point to the falling unemployment rate as evidence that the economy has recovered, and that near-term growth will be strong. As can be seen in Exhibit 6, the unemployment rate hasn't been this low since the early 1970s. Extending the trend analysis back to the early 1950s and including the labor force participation rate sheds additional light on the perspective we have thus far developed in the previous analysis of economic growth, productivity, and government and consumer spending and debt.



Labor force participation grew substantially beginning in the mid-1960s, as more and more women went to work full-time. The participation rate for women began at 37% in 1960 and continued to grow to 60% by 2000. At the same time, the participation rate for men went from 84% down to 75%. While the rate for women has remained about the same since then, the rate for men has continued to fall, and is now at about 69%. This explains the pattern observed in the overall labor force participation rate, which has been in decline since 2000, and now seems to have settled at about 63%.

One of the more easily observable impacts of increased labor force participation is the higher rates of unemployment accompanying economic cycles between 1963 and 1982. Unemployment rates for the recessions of 1975 and 1982 were much higher than during prior recessions. As economic restructuring took place through the remainder of the 1980s and through the 1990s, the unemployment rates fell, even as the labor force participation rate continued to increase. As in the case of the other elements of analysis in this overview, the year 2000 seems to represent a significant turning point. Labor productivity growth in Exhibit 5 can be seen to drop off from 2000 until now. Both the real and nominal GDP growth rates, shown in Exhibit 4, begin to decline at the same time, as do the growth rates in personal consumption expenditures (Exhibit 3) and consumer credit (Exhibit 2). The growth rate

in federal debt is the only element under study here that increases after 2000.

At least part of the explanation for this lies in understanding the impacts of technology and the "Y2K" phenomenon. As many of you may recall, there was great concern over the impact of date coding and the turn of the millennium,

namely, what would happen when we moved from the year 1999 (which showed as "99" in most coded databases) to "2000," which would logically show up as "00" if the same formatting was kept. Literally thousands of people were employed in the process of changing two year into four-year date formats, and an untold number of lines of computer code were rewritten in order to keep systems from imploding at midnight on January 1, 2000. Once that work was finished, there was little more for those people to do, so it shouldn't be surprising that the economy went into recession later that year.

As companies engaged in business process reengineering during the 1990s more employees (and consultants) were required to manage those transformations. Once those projects were completed, many of those positions were no longer needed. Many of the jobs that were permanently lost in the market meltdown of 2008 ended up being in the financial industry, where technologies had been put into place to do even more of the work of managing investments. Current portfolio management practices emphasize the use of technology to construct and maintain index portfolios, eliminating many jobs for analysts and other portfolio managers.

This is just one example of how important it is for all of us to understand the impact of technology, which is now moving more heavily into robotics, on the labor markets and the economy. Apple has just announced that it will be hiring over 21,000 employees to work in its new Texas-based facility over the next three years. Employees in that industry are

currently well compensated. Conversely, GM has announced an additional 14,000 in layoffs as it streamlines by eliminating sedans from its fleet and shuts down facilities used to make them.

Even if motor vehicle assemblies in the US increase, it may not result in substantial increases in employment. In the 1990s, the motor vehicle industry employed over 11 workers per 100 units assembled. It currently requires only 6.5 employees to do the same work, as robotics and automated technologies have replaced manual functions across the industry.⁴

So, as I have commented before: How well **your** economy goes depends upon what you are doing and where you are doing it. If you are a tech worker in California, you may be earning a six-figure income and living in an upscale home. If you are a manufacturing employee in Ohio, you may be out looking for a job as soon as the Chevy Cruze plant shuts down for good.

These disparities will continue to act as a drag on overall economic growth until the labor markets fully adjust to the impact of technological change on the way we do business and earn a living. Historical examples of societies where rapidly changing technology reduced the productivity of labor and displaced many workers are often characterized by wide gaps between the upper and lower classes of income and wealth (for example: the UK and the US during the industrial revolutions of the nineteenth century). A case can be made that the primary equalizing forces that reduced these gaps were actually the two world wars, and to a degree, the Cold War. The impacts of these wars are clearly visible in the economy.⁵

So, here is the upside of what I think we should expect in 2019:

- Higher interest rates will continue to muffle stock market growth as those markets have now fully adjusted to the impact of lower corporate tax rates;
- Growth rates in real GDP will be dampened by low growth in real personal consumption expenditures;

⁴ See again, Isberg. Steven: Business and Manufacturing Process Reengineering: Have We Gotten Too Good for Our Own Good? *Credit and Financial Management Review*, Fourth Quarter 2018.

⁵ The biggest single impact is observable in the growth rate of government debt, which spikes in 1918, 1945, 1991, and 2012, following the commencement of the war on terror. GDP also rises at higher rates, and unemployment rates tend to fall. The income gap that existed prior to the Crash of 1929 was virtually gone by the end of the Second World War.

- Retail performance will vary depending upon the customer base, with the middle market retailers once again feeling the greatest pinch. As more commerce moves online, retailers not following this movement may fall by the side of the road;
- Low oil prices will encourage the demand for larger motor vehicles, but growth may be slowed by price increases needed to recover the cost of tariffs on aluminum, steel, and electronic components going into the motor vehicles;
- Congress and the administration will continue to struggle over government spending and the federal debt. As of this writing, they are working to avert a shut-down during the holiday season. That struggle will become more volatile once the new congressional session begins with a democrat controlled House of Representatives.

Here is the downside:

- If oil prices substantially rise, all bets are off.
- If the federal debt crisis comes to a head, we could see another major meltdown in the global financial markets. It is not as far off and the seismic impact is not as unimaginable as we would like to think. The falling growth rates in federal government spending and debt indicate that we are rapidly approaching a point at which further growth will not only be unsustainable but may bring down the entire house.

Happy New Year!

About the Author:

Steven C. Isberg is an Associate Professor of Finance. He teaches graduate and undergraduate courses in corporate finance, financial analysis and valuation, and financial economic history. As Sr Research Fellow at the Credit Research Foundation he conducts various research studies and delivers online financial analysis courses as part of the CRF Online Classroom™ program.

He has over 25 publications in academic and professional journals and has served as a professional business consultant to a variety of firms. He frequently appears or is quoted in television, radio, and print media on financial and economic issues.

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Finding the Dark Cloud Behind the Silver Lining

By: Chris Kuehl
Managing Director
Armada Corporate Intelligence

It has been a pretty good year from an economic standpoint. When talking about the US economy, there always have to be caveats though. The GDP of the US is by far the largest in the world – close to \$20 trillion – and it dwarfs the other nations in the top five. China is in second place but roughly half the size of the US with just a \$12 trillion GDP. Every single state in the union has a GDP the size of a country, with California the size of France, and Texas the size of Canada. Even lightly populated Idaho corresponds to Uzbekistan. Sectors of the US economy likewise correspond to national GDPs. The manufacturing sector alone is the ninth largest GDP in the world and is larger than the GDP of Russia or Canada. How does all this relate to whether 2018 was a good year or not? The fact is that a country this big can play host to boom and bust in the same year. Parts of the US economy were surging in 2018 and other parts were stumbling, and this is not at all unusual. It happens every year. On balance there were more growing sectors than sectors that were in trouble, and with any luck that will turn out to be the case in 2019. The big question is whether there are serious threats to the growth the US has experienced the last few years and if there are, what will trigger them and how bad could it get. It is not for nothing that economics is called the dismal science, so it behooves me to point out the three biggest threats to continued growth and expansion.

Number One - Inflation

This has been discussed and warned about for the better part of three years but has thus far not manifested in a way that poses an immediate threat. Will this trend continue into 2019 and beyond? If not, what can we expect and how soon?

It is important to understand why inflation is such a concern for economists – more of a worry than recession to be honest. A recession doesn't hit an economy equally. Even in the worst of these downturns there are those that continue to make money and there are sectors that actually thrive in a recession. Through history there have been examples of people accumulating great wealth during a recession and in most of the downturns the majority of the population is only slightly inconvenienced. Inflation attacks everybody

and every business. The price hikes will have a bigger impact on those that have fixed incomes or who are poor, but even the very wealthy will find themselves paying more. From a business point of view, the damage from inflation is in terms of higher cost inputs that force higher prices to consumers. If the price is too high, they may lose the consumer altogether as non-essential items will be rejected. Banks are far less likely to lend during an inflation surge as they will be getting paid in devalued currency down the road. You get the idea – inflation simply gums up the works.

The threat has been subdued for the last few years as there has not been the usual fuel. Traditionally the driver for inflation is a combination of commodity price hikes and higher wages. For a variety of reasons, the commodity side of this equation has been manageable as oil prices have tended to stay lower than would be expected. The wage inflation that had been expected has not occurred either. The Philips Curve is a theory developed in the 1950s that stated, logically enough, that when the unemployment rate fell there would be more competition to find and hire available workers, and as a result they would be paid more. Even with jobless rates as low as 3.8% there had not been a reaction as far as higher wages. The fact is that those workers seeking jobs did not have the qualifications that would merit a high wage and there was no corresponding hike.

Both of these situations are changing (and rapidly) and that makes many worry about the inflation numbers in 2019. The commodity prices are going up and fast. Steel and aluminum have seen price hikes of around 40% due to the imposition of tariffs on imported metal. Oil prices had been down but that was before OPEC members, in cooperation with Russia, elected to start reducing output. The price per barrel jumped back up and now the thinking is that oil may hit closer to \$80 per barrel than the \$60 it was settling into. Wages are now going up at an annual rate of 3% and that is fast compared to the 2.3% pace set just a few years ago. Employers are still not paying the inexperienced more money than can be justified but there is considerably more poaching of other people's workers and that is expensive as larger pay packages are needed to get people to move, and that triggers employers to pay their existing workers more so they don't feel tempted to move.

Number Two – Trade

The US under the Trump White House has adopted a more contentious and protectionist approach to trade and this has involved fights with allies and foes alike. The US economy remains dependent on global business as 15% of the national GDP is tied to exports. The consumer in the US has long benefited from the imports that stream into the US as these are cheaper than domestic alternatives would be. On the other hand, the plethora of imports has resulted in considerable stress on companies in the US that struggle to compete with foreign manufacturers. Many of those in other countries have advantages that have been deemed unfair to US competitors. They have fewer protections for their workers and can pay them far less. They are often in nations that pay little attention to environmental or safety regulations, and these are often governments that subsidize and support the domestic business community through a wide variety of tactics.

It can be argued the US has been taken advantage of in some trade deals and it would make sense to revisit and renegotiate these pacts. The challenge going forward is how to go about this. The tactics employed by the Trump team have been confrontational and this has created a great deal of tension. There has also been a lot of deal making and one can argue the US accomplished what it set out to do with pacts like NAFTA. This has essentially been modified into the US Mexico Canada Agreement and all three states seem reasonably happy with it. Tensions with Europe are not as pronounced as they once were, and an agreement now seems possible. The one partner the US has not been able to work with as yet would be China.

China is threatened by billions of dollars in tariffs and they have retaliated in kind. The impact on the global community has been dramatic and this has triggered a lot of investor unease. It is entirely possible a deal will be struck between China and the US but right now the two sides are dug in. If the trade talks hit an impasse and the tariffs and other restrictions go through, the impact will be severe for all concerned. The US will lose access to billions in imports and will lose the farm market in China, but China stands to lose more as they need the consumer in the US. The ripple effect around the world will be unpredictable but most nations will suffer if there is slowdown in either the US or China.

Number Three – Debt and Deficit

Remember these? Apparently very few of the political leaders do. Once upon a time the watchword for the GOP was reduction. The intent was to see a smaller national debt and a

smaller deficit. Today the debt is 110% of the national GDP (and this debt should never be more than 60% of GDP) and the deficit is now 4.5% of that GDP when it should never be above 3.0%. The GOP has been just as profligate as the Democrats have been. There has been additional spending during the last two years, and at the same time, there was a tax cut that took billions out of revenue. The rules of controlling debt are the same as they always have been. There are just two choices – either cut spending or raise revenue. The only response to the burgeoning deficit has been to borrow more every year and bring debt service to the point that it is close to the size of the military budget.

There is nothing that suggests that either of these issues will be addressed next year, and by the conclusion of 2019, the debt will be larger and the deficit will be worse.

As we contemplate the coming year, we know that there is likely to be more uncertainty and volatility as there will be a tug-of-war between the positive trends that dominated 2018 and the anticipated issues that will mark 2019. There are several measures we will want to compare to last year. Interest rates are now sitting at 2.75% but by the end of 2019 they will be between 3.25% and 3.50%. The rate of unemployment will remain fairly stable at between 3.6% and 4.0% but not because of a lot of additional hiring. It will be due to the exodus of Boomers - retiring at the rate of 10,000 a day. There is only minimal threat from inflation as commodity prices have been holding and there has yet to be a significant wage increase. This all assumes there are no unexpected developments and there always will be. Much of the doubt is political in nature - the outcome of the trade war, major disputes between Trump and the House of Representatives, contests between the US and its allies and adjustments to new global leaders. Stay tuned, this will be a tumultuous year.

About the Author:

Chris Kuehl is the co-founder (with Keith Prather) and Managing Director of Armada Corporate Intelligence, a company created in 1999 to provide strategy foundation, competitive intelligence, business analysis and economic forecasting for corporate clients.

Armada's clients include YRC Worldwide, TranSystems, Spencer Fane Britt and Browne, KPMG, Hallmark International, Weitz Industrial among others.

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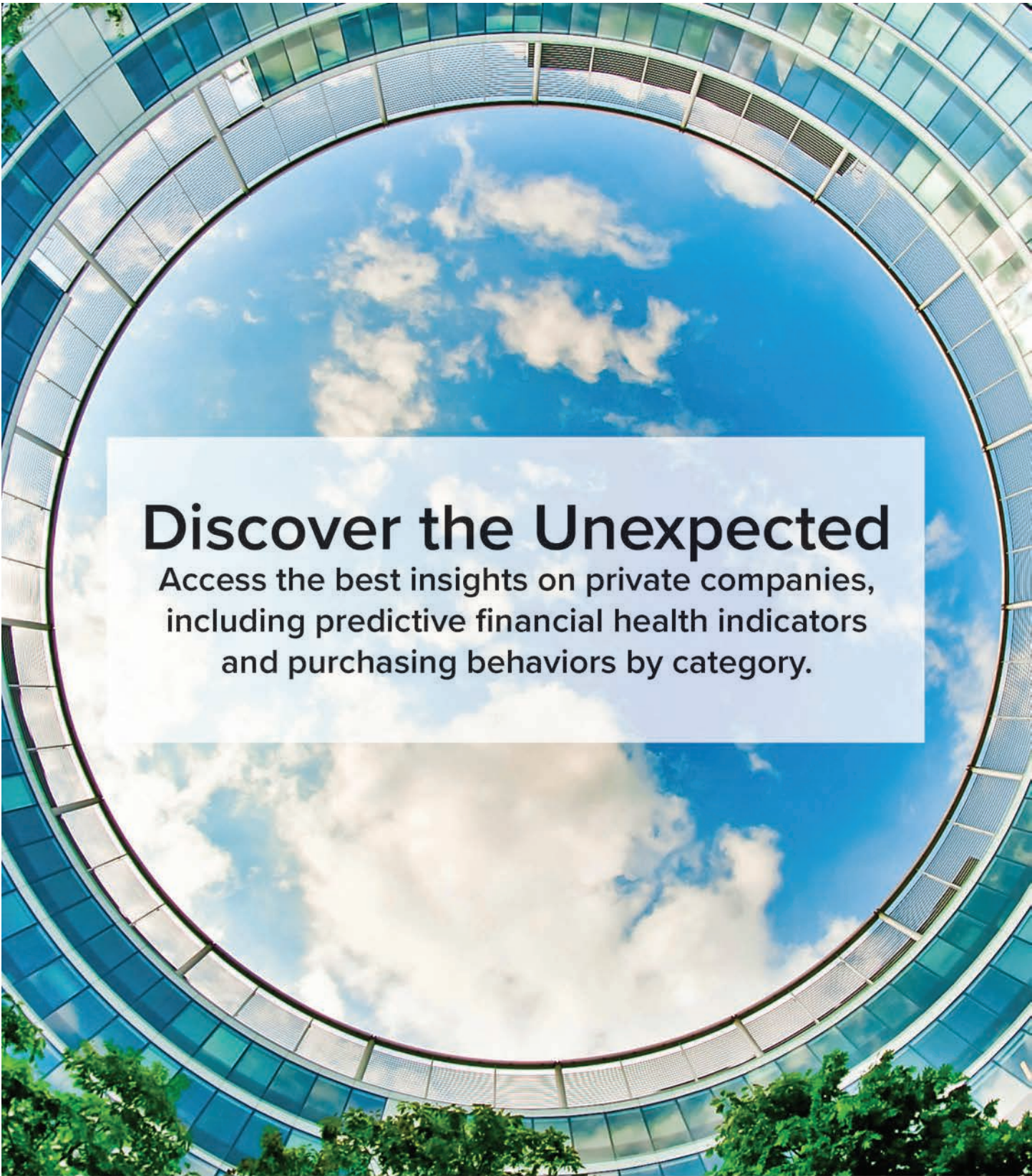
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2019 Is Likely to Start Clean and Finish Messy

By: Dan North
Economist
Euler Hermes

The economy performed very well in 2018.

GDP growth, expected to be 2.9% for the year, tied 2015 for the strongest of the nine-year recovery. Recent growth was particularly impressive in Q2 at 4.2% q/q annualized and 3.5% in Q3. The all-important consumer sector flexed its muscles at 3.8% and 3.6% in Q2 and Q3. Manufacturing was strong. Wages grew at the fastest in nine years. Job creation was vigorous. Inflation and interest rates remained low, and corporate profits set records. It was as good as it's going to get.

In other words, it's not going to get any better. While we expect the economy to remain vibrant for the next few quarters, it is starting to show signs of frailty which give us concern towards the end of 2019 and into the beginning of 2020. GDP will likely grow over 2% for all of 2019, but the going could get rough, primarily because fiscal stimulus will be drying up, and the Federal Reserve has been tightening monetary policy. When the Fed tightens, it is trying to fend off inflation and keep the economy from growing too fast, and it always works.

For now the outlook is positive.

Current conditions have laid a smooth path for growth into the beginning of the year. Perhaps most importantly, the consumer appears to be in a strong position to fuel the economy. Growth in real disposable income is currently running at 2.8% y/y vs the recovery average of 2.4%, providing the ability to spend. Wage growth recently reached 3.1% y/y, the highest in nine

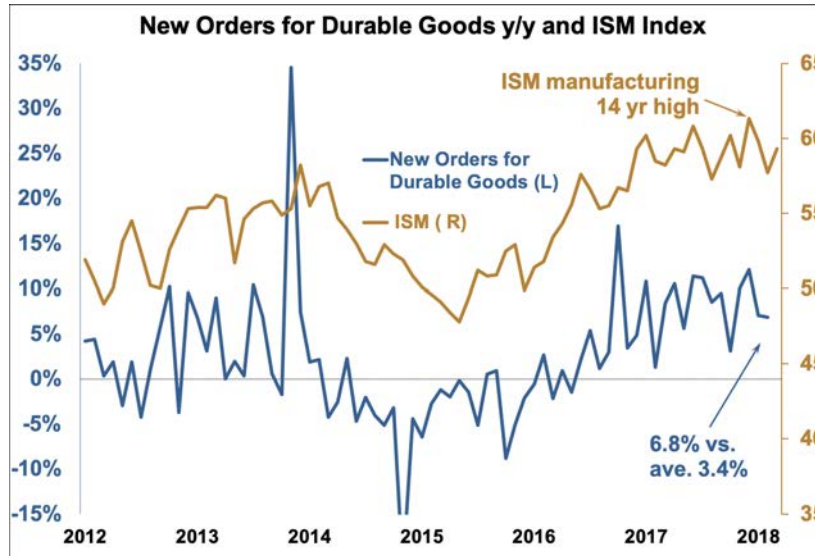
years. Consumers have a low debt burden, and confidence is hovering near an 18-year high, providing the willingness to spend. The combination of growing income, low debt, and high confidence strongly suggest that solid spending will continue through most of 2019.

Business confidence as measured by the National Federation of Independent Business (NFIB) Small Business Optimism Index remains near record highs, as does the net percentage of respondents in

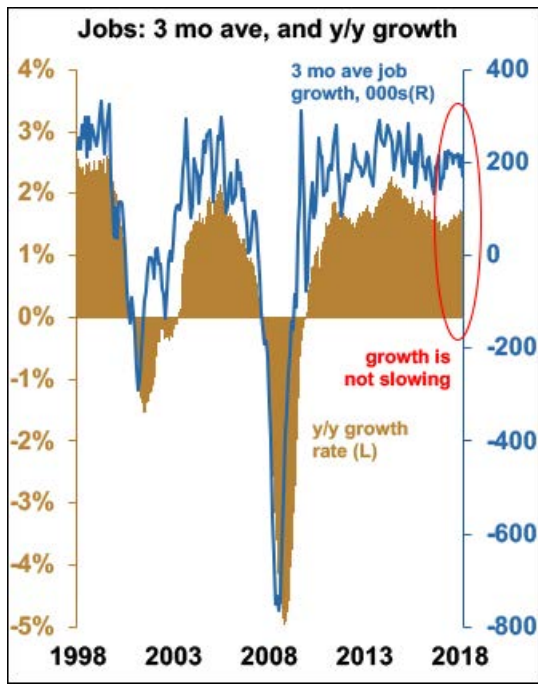
the survey saying now is a good time to expand business. The manufacturing sector still has plenty of momentum to carry it into the New Year. The ISM manufacturing index recently reached a 14-year high. New orders for durable goods are growing at 6.8% y/y, twice the long-term average of 3.4%. On the services side, the ISM non-manufacturing index is hovering near a 13-year high.

The labor market remains very strong with no letup in sight. Job creation has actually accelerated this year, from 1.5% y/y last November to 1.7% currently, something you wouldn't expect this late in the cycle, and indeed the labor force has grown by 2.2 million people in the past 12 months. More importantly, demand for labor is terrific as there are now 7 million job openings, compared to 6 million unemployed persons, a ratio of 1.2 suggesting that job creation will extend well into 2019.

There has even been progress on the trade front as the new US-Mexico-Canada (USMCA) trade agreement has been negotiated and symbolically



Source: IHS, ISM, Census, Euler Hermes



Source: IS, BLS, Euler Hermes



Source: IHS, BLS, Euler Hermes

signed (although it could face some tough going in Congress). And trade negotiations with China, as bumpy as they are, have shown some progress, although we still have a very long way to go.

Finally, inflation and interest rates are expected to remain low, productivity has grown for three straight quarters, and corporate profits after the tax cuts are growing at 19% y/y vs. the long-term average of around 8%. Things look good for the next few quarters.

But that bright picture is starting to get cloudy

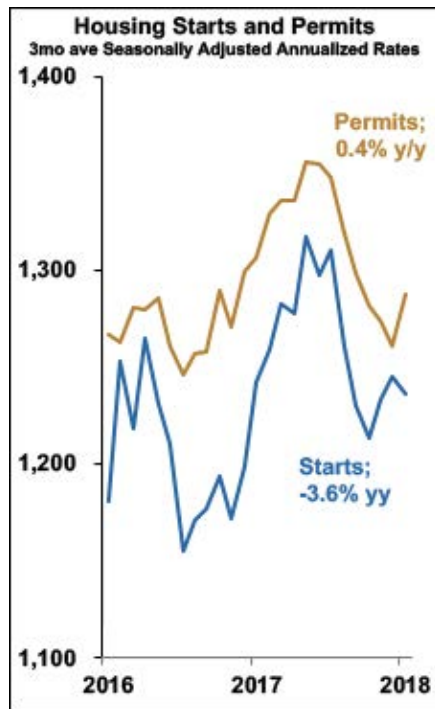
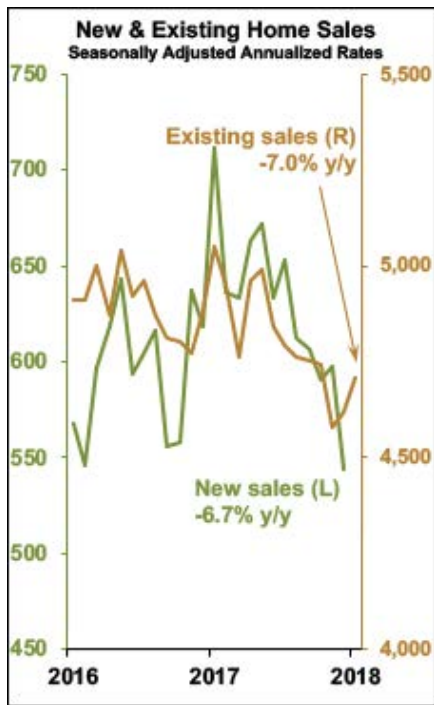
As we try to look into the future, there are some specks on the horizon that are causing us to squint our eyes, strain to look out in the distance, and swallow just a little bit hard. What is that coming our way?

Uncertainty will weigh heavily on the economy in the next year. We will have a divided government where very little will get done legislatively, with the possible exceptions of infrastructure spending and drug pricing. President Trump will take to governing by issuing Executive Orders that will be immediately challenged. Trump will also come under intense scrutiny, and could actually suffer impeachment, although he is quite unlikely to be removed from office. The nation will not enjoy this arrangement and social division is likely to increase.

Another source of uncertainty is the ongoing trade dispute with China. Tariffs have clearly had a negative effect on the US economy, particularly on agriculture. Business leaders are openly worried about tariffs as heard on earnings calls, and as seen in quotes from participants in the two ISM surveys. Respondents to the Fed's November Beige Book survey mentioned tariff concerns 39 times. And while the USMCA has been agreed upon, tariffs on steel and aluminum remain in place, putting significant cost pressures on metals users. GM estimates that it has lost \$1B last year due to the metals tariffs. Harley Davidson has suggested that tariffs on metals plus retaliatory tariffs will cause them to take jobs overseas, the opposite of what is intended.

The housing market, which never fully recovered from its collapse in 2005, now appears to be in trouble again. Prices are too high relative to incomes, and mortgage rates are up on the year. As a result, leading indicators such as starts, permits, inventories, and the National Association of Homebuilders (NAHB) index are all in decline (see charts at the top of the next page).

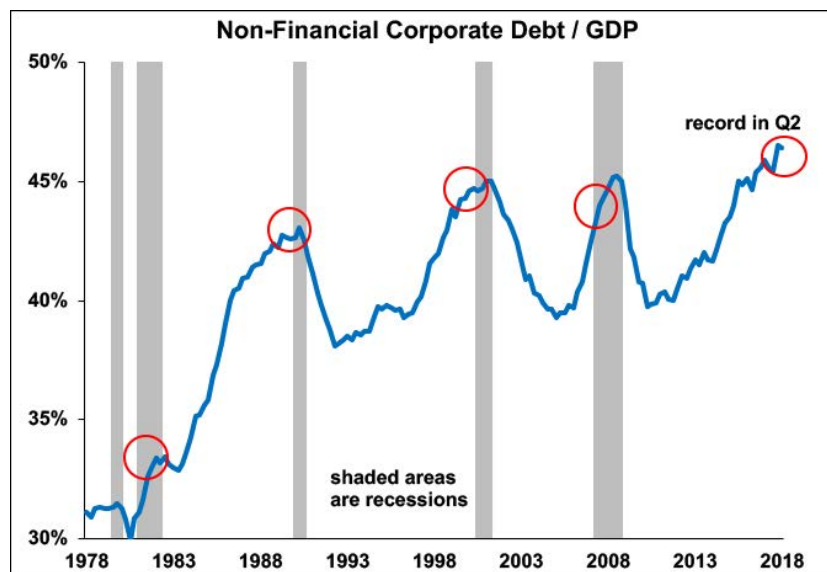
There are several indicators that suggest that we are in the late stages of the economic expansion. For instance, the details of the Conference Board's Consumer Confidence survey are disturbing. The difference between consumers' assessments of the present situation and the future outlook has gapped wide open, and this condition is often seen before a recession.



Another indicator suggesting a coming downturn is the relationship between the unemployment rate and the “natural rate” of unemployment. When the current unemployment rate drops below the natural rate, as it has now, it suggests a state of unsustainable growth, and rising inflationary pressures which will damage the economy. It also happens to coincide frequently with Fed tightening.

However, the most significant risk to the economy is that the Federal Reserve has been tightening monetary policy, which will surely slow the economy. The Fed is charged with balancing inflation and unemployment, and when it is raising rates as it is doing now, it senses that unemployment is too low (at a 45-year low), inflationary pressures are building (wages at a nine-year high), and the economy must be cooled off. So, after an extraordinary seven-

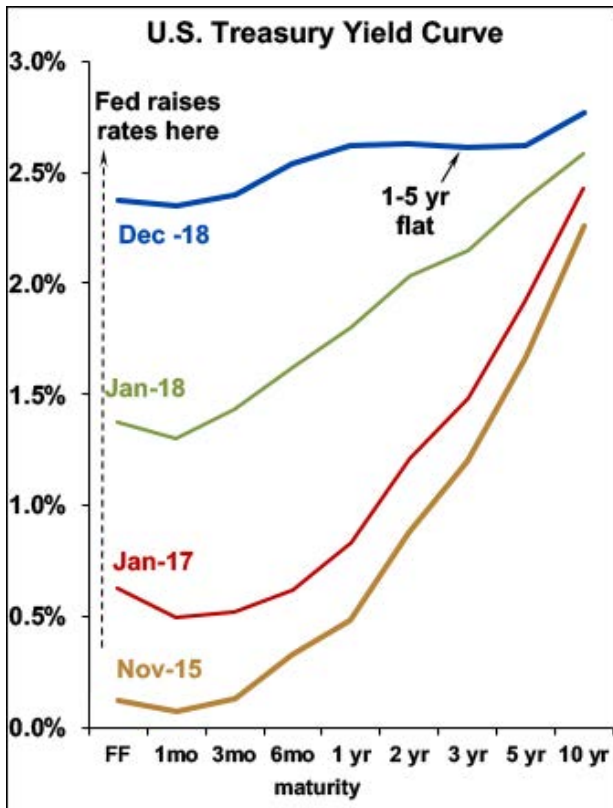
year period of 0% interest rates and quantitative easing, the Fed started to raise interest rates very slowly at the end of 2015 and has now arrived at a range of 2.25%-2.5%. The problem is, this approach of raising interest rates to fend off inflation and slow the economy usually works so well, that the Fed drives the economy into a recession. When the Fed pushes short-term rates higher than long-term rates and inverts the yield curve, a recession almost always follows, and the Fed is perilously close to having done just that. In fact, December’s



Source: IHS, Federal Reserve, BEA, Euler Hermes

trouble is brewing in the credit markets as corporate debt as a percent of GDP has hit a new record, a strong warning sign. Credit spreads are opening rapidly on high yield bonds, and of course government debt is set to continue growing into the foreseeable future. In addition, that increase in debt is partially due to the fiscal stimulus of tax cuts and spending increases, and unfortunately that stimulus will be drying up towards the end of 2019, providing yet another significant drag on economic growth.

short-term rates higher than long-term rates and inverts the yield curve, a recession almost always follows, and the Fed is perilously close to having done just that. In fact, December’s



Source: IHS, Federal Reserve, Euler Hermes

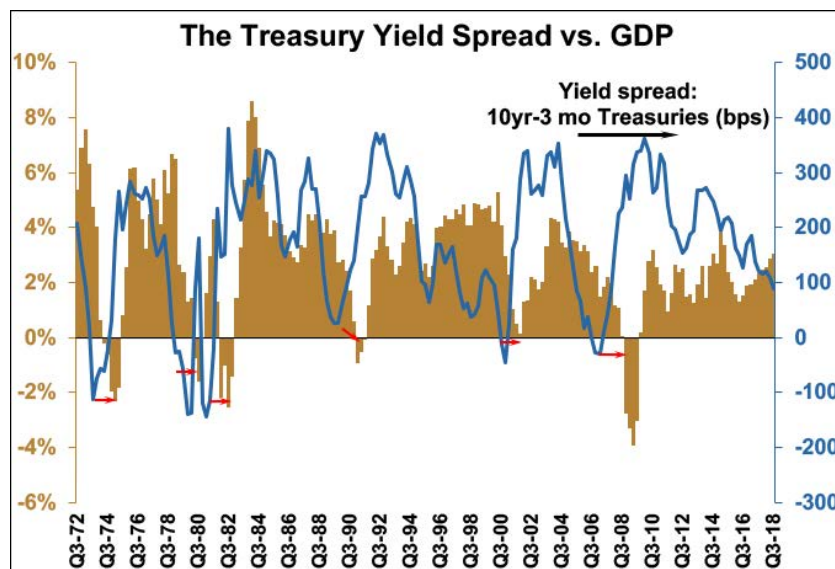
Fed meeting was viewed by financial markets as not being dovish enough, and the curve from 1-5 years essentially became flat. This is unequivocally a bad sign. If the curve between the 10 year and the 3 month becomes inverted (that is the spread between the 10 year and the 3 month becomes negative), even for just a few weeks, a recession is almost certain to follow in three to five quarters.

The balance.

Economic conditions at the moment are setting a fine stage for continued growth through most of 2019. The consumer has increasing wages and confidence. Small business remains optimistic. Manufacturing new orders and a strong ISM index suggest more activity to come. Demand for labor is frantic,

progress is being made on the trade front, and interest rates and inflation are likely to remain low. It's a good setup for now.

But things on the horizon, towards the end of the year, are worrisome. A divided government and



Source: IHS, Federal Reserve, BEA, Euler Hermes

an unpredictable President will provide continued uncertainty. The trade picture is also uncertain and clearly tariffs are already taking a toll. The housing market is decaying. The shortage of skilled labor economy-wide is suppressing growth, and some indicators are strongly suggesting that we are late in the economic cycle. And the Federal Reserve has almost inverted the yield

curve, an ominous sign of an economic downturn coming in the next three to five quarters.

What could change this outlook? First, the Fed could start signaling a much more dovish approach, perhaps including a suggestion of a pause in rate hikes. The yield curve could start to steepen again. Corporations could start paying down debt. The trade dispute with China could get resolved, the metals tariffs could get removed, and bipartisan government cooperation could emerge. All of these things are possible. But we ought to prepare for the less happy scenario.

About the Author:

Dan North is an Economist with Euler Hermes, North America. Mr. North has been with Euler Hermes North America since 1996. He has appeared on CNBC, Fox Business News, France 24, and Bloomberg Radio and Television. He has been quoted by Barron's, Business Week, Paris Le Monde, Tokyo Nikkei, the New York Times and the Wall Street Journal. After having predicted the 2008/2009 recession and its implications accurately, he was ranked 4th on Bloomberg's list of the 65 top economic forecasters in 2010.



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Economic Outlook Symposium: Summary of 2018 Results and 2019 Forecasts

By: William A. Strauss
Senior Economist and Economic Advisor
Federal Reserve Bank of Chicago

According to participants in the Chicago Fed's annual Economic Outlook Symposium (EOS), the U.S. economy is forecasted to grow at a pace somewhat above average in 2019, with inflation ticking down and the unemployment rate remaining low.

The Federal Reserve Bank of Chicago held its 32nd annual Economic Outlook Symposium on November 30, 2018. More than 125 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews the forecasts for 2018 from the previous EOS, and then analyzes the forecasts for 2019 (see figure 1) and summarizes the presentations from the most recent EOS.

The U.S. economy entered the tenth year of its expansion in the third quarter of 2018, already having become the second-longest expansion in U.S. history. While the nation's real gross domestic product (GDP) is at its highest level ever, the rate of economic growth since the end of the Great Recession in mid-2009 has been quite restrained. During the 37 quarters following the second quarter of 2009, the annualized rate of real GDP growth was 2.3%—somewhat above what is considered the long-term rate of growth for the U.S. economy.

The economy expanded by 2.5% in 2017—a bit higher than the current expansion's average. Then, in part boosted by economic stimulus offered by the federal tax reform passed in December 2017 (the Tax Cuts and Jobs Act), the economy's growth accelerated to an annualized rate of 3.3% during the first three quarters of 2018.

The strength in economic growth in 2018 was broad-based. Consumer spending expanded at a solid pace in 2018: Real personal consumption expenditures grew at an annualized pace of 2.6% during the first

three quarters of 2018—virtually the same growth rate recorded for consumers in 2017. The pace of light vehicle sales (car and light truck sales) was 17.1 million units through the first eleven months of 2018, unchanged from the selling rate during the same period in 2017.

Energy prices increased sharply during the first ten months of 2018. Specifically, the average price of West Texas Intermediate oil rose from \$57.90 per barrel in December 2017 to \$70.76 per barrel in October 2018. Oil prices then collapsed in November, partly because of the rising global supply of oil and partly because of slowing economic growth around the world; oil prices fell to an average of \$57 in November 2018.

Even with higher oil prices for most of the year, more consumers chose to purchase larger, less fuel-efficient vehicles than in the year before: Sales of light trucks (including sport utility vehicles) were up 7.5% for the first eleven months of 2018 compared with the same period a year earlier, while sales of passenger cars were down 13.4% over the same period. This shift in consumer demand (which continued a trend from the past couple of years) led to a record-setting share for light trucks of 69.1% of overall light vehicle sales during the first eleven months of 2018.

Despite flat light vehicle sales, industrial production expanded at an annualized rate of 3.8% over the first 10 months of 2018—better than its growth rate of 3.0% in 2017. The improvement in industrial production was largely due to a strengthening investment sector. Real business fixed investment, which had already grown at a strong 6.3% pace in 2017, rose at an even better 7.5% annualized rate over the first three quarters of 2018.

In contrast, residential investment did not fare as well. After expanding by 3.8% in 2017, real residential investment declined at an

Figure 1 - Median forecast of Real GDP and related items	2017 (Actual)	2018 (Forecast)	2019 (Forecast)
Real gross domestic product ^a	2.5	3.1	2.4
Real personal consumption expenditures ^a	2.7	2.7	2.4
Real business fixed investment ^a	6.3	6.4	3.4
Real residential investment ^a	3.8	-2.2	1.8
Change in private inventories ^b	16.1	57.1	45.0
Net exports of goods and services ^b	-899.2	-952.2	-990.0
Real government consumption expenditures and gross investment ^a	0.1	2.3	1.9
Industrial production ^a	3.0	3.4	2.1
Car and light truck sales (millions of units)	17.1	17.1	16.8
Housing starts (millions of units)	1.21	1.26	1.28
Unemployment rate ^c	4.1	3.7	3.7
Consumer Price Index ^a	2.1	2.4	2.3
One-year Treasury rate (constant maturity) ^c	1.55	2.70	3.26
Ten-year Treasury rate (constant maturity) ^c	2.37	3.20	3.55
J.P. Morgan trade-weighted dollar index ^a	-4.1	3.0	1.8
Oil price (dollars per barrel of West Texas Intermediate) ^c	55.39	69.26	68.75

^a Percent change, fourth quarter over fourth quarter.

^b Billions of chained (2012) dollars in the fourth quarter at a seasonally adjusted annual rate.

^c Fourth quarter average.

Note: These values reflect forecasts made in November 2018.

Sources: Actual data from authors' calculations and Haver Analytics; median forecast from Economic Outlook Symposium participants.

annualized pace of 2.5% during the first three quarters of 2018. That said, the annualized rate of housing starts still increased to 1.26 million units for the first 10 months of 2018—up 5.4% relative to the same period in 2017.

On an annualized basis, growth in real government spending was 2.2% over the first three quarters of 2018—well above the annual rate of 1.2% it has averaged over the past 20 years.

Against this backdrop, the U.S. economy continued to increase employment in 2018: In November, over 2.4 million jobs were added compared with a year earlier. Moreover, in November 2018, the unemployment rate stood at 3.7% (the lowest rate since 1969)—below most economists' estimates of the natural rate of unemployment (i.e., the rate that would prevail in an economy making full use of its productive resources).

Inflation, as measured by the Consumer Price Index (CPI), increased from a 2.1% reading in 2017 to a year-over-year rate of 2.5% in October 2018.

Results versus forecasts

According to the consensus forecast from the most recent EOS, the growth rate of real GDP in the fourth quarter of 2018 relative to the fourth quarter of 2017 is estimated to be 3.1%—higher than the 2.3% rate predicted at the previous EOS. (For the remaining comparisons of GDP components, annual values are calculated based on the consensus estimates for the fourth quarter of 2018 from the most recent EOS.) Growth in real business fixed investment was quite a bit stronger than forecasted; growth in real personal consumption expenditures was a little stronger than expected; and growth in real residential investment came in much weaker than predicted. The unemployment is expected to average 3.7% in fourth quarter of 2018—0.4 percentage points lower than

the value forecasted for the final quarter of 2018. Inflation, as measured by the CPI, is now expected to be 2.4% in 2018—0.4 percentage points above the previously predicted rate of 2.0% for the year. Even though oil prices moved up and down sharply in 2018, oil's actual average price in the fourth quarter of 2018 (through December 5, the time this article was submitted) was \$63.62 per barrel—about \$10 higher than its predicted average price of \$53.18 per barrel. The annualized light vehicle sales for the first eleven months of 2018 were 17.1 million units—just above the 17.0 million units forecasted for the year. The annualized rate of housing starts was 1.26 million units for the first 11 months of 2018; right in line with what was previously predicted. The one-year Treasury rate is expected to average 2.70% in the fourth quarter of 2018—well above the 2.01% forecasted. The ten-year Treasury rate is expected to average 3.20% in the fourth quarter of 2018—somewhat above the predicted rate of 3.01%.

Economic outlook for 2019

The forecast for 2019 is for the pace of economic growth to be somewhat above the long-term average. In 2019, the growth rate of real GDP is expected to be 2.4%—lower than the projected 3.1% rate for 2018. The quarterly pattern reveals a fairly steady performance (close to the annual pace) for real GDP growth during the first three quarters of 2019; however, the annualized rate of GDP growth is predicted to slip down to 2.1% in the final quarter of the year. The unemployment rate is expected to remain steady at a very low 3.7% for each quarter through the final quarter of 2019.

Inflation, as measured by the CPI, is predicted to tick down from an estimated 2.4% in 2018 to 2.3% in 2019. As mentioned before, oil prices collapsed in November 2018 (shortly after most of the EOS forecasters had submitted their 2019 projections); oil prices are predicted to be fairly steady in 2019 (but at a much higher level than where these prices had settled by the end of November). Real personal consumption expenditures are forecasted to expand at a rate of 2.4% in 2019. Light vehicle sales are expected to fall to 16.8 million units this year. After two strong years of growth, the pace of real business fixed investment growth is anticipated to moderate to a still solid 3.4% in 2019. Industrial production is forecasted to grow by 2.1% this year—below its historical average rate of growth.

The housing sector is predicted to continue its extremely slow march toward normalization in 2019. The growth rate of real residential investment is forecasted to rebound to 1.8% in 2019 from -2.2% in 2018. And housing starts are anticipated to edge up to 1.28 million units in 2019—nearly in line with the 20-year annual average of roughly 1.3 million starts.

The one-year Treasury rate is expected to rise to 3.26% in 2019, and the ten-year Treasury rate is forecasted to increase to 3.55%. The trade-weighted U.S. dollar is predicted to rise 1.8% in 2019, and the nation's trade deficit (i.e., net exports of goods and services) is anticipated to increase to \$990.0 billion by the final quarter of 2019.

Conclusion

In 2018, the U.S. economy expanded at a pace well above the historical average. The economy in 2019 is forecasted to grow at a slightly slower pace than it did in 2018, though still above the long-run trend. Business investment is predicted to moderate in 2019, while the housing sector is projected to improve this year. The unemployment rate is expected to stay low, at 3.7% through the end of 2019, and inflation is predicted to move down slightly to 2.3%.

About the Author:

William Strauss is the Senior Economist and Economic Advisor in the Economic Research Department at the Federal Reserve Bank of Chicago. His chief responsibilities include analyzing the current performance of both the Midwest economy and the manufacturing sector for use in monetary policy.

He produces the monthly Chicago Fed Midwest Manufacturing Index and organizes the Bank's Economic Outlook Symposium and Automotive Outlook Symposium. In addition, he conducts several economic workshops and industrial roundtables throughout the year.

His research papers include analysis of the manufacturing sector, the automotive sector, the Midwest regional economy, the trade-weighted dollar, business cycles, and Federal Reserve payments operations.

Mr. Strauss has been interviewed on numerous television and radio shows and quoted in the major business magazines and newspapers. He has also provided testimony concerning manufacturing issues to the U.S. Senate.

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U.S. Macro Outlook: Looking Back and Looking Ahead

Strong growth should continue throughout much of 2019, but it won't quite measure up to this year.

By: Mark Zandi
Chief Economist
Moody's Analytics



Overview

- Powering this year's growth have been deficit-financed tax cuts and increases in government spending.
- While markets are sure to remain volatile, key to our 2019 outlook is that the volatility is manageable.
- The U.S.-China trade war and Brexit add to the geopolitical uncertainty.

The U.S. economy stuck very close to script this year. Growth has been strong; real GDP is set to post a just under 3% gain in 2018, employment is up by over 2 million jobs, and unemployment is ending the year in the mid-3s. This is precisely the performance we forecast a year ago.

Powering growth have been deficit-financed tax cuts and increases in government spending.

Together, this fiscal stimulus has added an estimated 0.8 percentage point to real GDP growth this year. Most of the stimulus this year has been from the tax cuts, as the spending gains have been slower to materialize.

As the labor market has tightened, wage gains have steadily accelerated as anticipated. Wage growth is now over 3%, and combined with all the jobs and the massive tax cuts, is empowering consumers, who have had a banner year and appear to be holiday shopping with

gusto. It was also another solid year for the vehicle industry, which had another year of more than 17 million car and light-truck sales.

The Federal Reserve tightened monetary policy as anticipated, increasing the fed funds rate four times in 2018, a quarter percentage point each time. Motivating the Fed is low and falling unemployment, which is well below most estimates of full employment, and firmer inflation, which is back close to the Fed's 2% target. Volatile financial markets and slower global growth have not dissuaded the Fed.

Market ups and downs

On cue, stock and bond markets experienced big ups and downs. It is difficult for investors to adjust to a tightening in monetary policy, particularly when valuations are stretched. Equity investors have also struggled with President

Trump's steadily escalating trade war. As expected, the S&P 500 is set to end the year roughly where it began it.

There were a few surprises. Most notable, oil prices fell short, averaging about \$55 per barrel this year, about \$10 less than anticipated. A key reason is that despite

his heated rhetoric, Trump went easy on Iran, imposing very modest sanctions on its oil exports. Housing construction also fell well short of expectations due to a severe shortage of construction workers and tough restrictions on development in many urban areas.

Moody's Analytics 2018 Economic Outlook		
	Dec 2017 Forecast for 2018	Dec 2018 Forecast for 2018
Real GDP growth, %	2.9	2.9
Employment change, mil	2.0	2.4
Avg hourly earnings growth, %	2.9	2.8
Unemployment rate, %	3.8	3.9
Core PCE inflation, %	1.9	1.9
Vehicle sales, mil	17.0	17.0
Housing starts, mil	1.5	1.3
House price growth, %	4.3	4.7
Stock price growth, %	7.1	12.8
Federal funds rate, %	1.9	1.8
10-yr Treasury yield, %	3.3	2.9
30-yr fixed mortgage rate, %	4.8	4.5

Source: Moody's Analytics

A preview of 2019

Strong growth is expected to continue throughout much of the coming year, although it won't quite measure up to this past year. Real GDP should post another gain of just under 3%, and unemployment will continue to decline, falling into the low 3s. Unemployment has been this low only during World War II and the Korean War, when tens of millions of Americans were in the military.

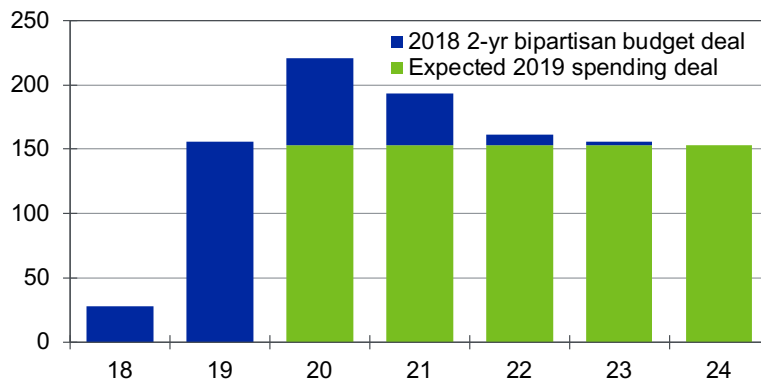
Fiscal stimulus will power growth, adding an estimated 0.6 percentage point to growth in the coming year. The boost from the tax cuts will be much smaller and come mostly from larger refund checks in the next few months. But government spending should soon ramp up as federal agencies finally get around to spending the increased monies that Congress appropriated almost a year ago.

Employment growth will slow, not so much because of weaker demand for workers from employers, but because employers won't be able to find workers to fill the increasing number of unfilled positions. This implies productivity growth will need to accelerate if real GDP growth is to hold up as anticipated. And this won't happen unless business investment, which has been punk in recent months, picks up.

The Fed will continue to normalize monetary policy, increasing the fed funds rate four more times in 2019, a quarter-point each time. By the end of the year, the fed funds rate will be near

More Government Spending

Additional federal outlays by fiscal yr due to...



Sources: CBO, Moody's Analytics

3.5%, just above our estimate of the equilibrium rate. Exceptionally low unemployment, and the resulting heightened wage and price pressures, will be too much for the Fed to look through.

Manageable volatility

Financial markets will have some agita with this normalization in

rates. Investors appear to be anticipating only one or perhaps two quarter-point rate hikes in the coming year, and even some easing in rates by early in the next decade. If they are wrong and are thus forced to eventually mark up their expectations for future rate hikes, prices for all assets, from stocks and bonds to real estate, will come under pressure.

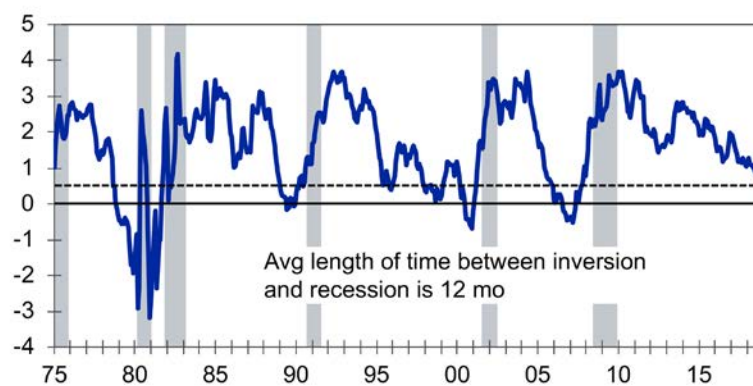
While markets are sure to remain volatile, key to our 2019 outlook is that the volatility is manageable and doesn't undermine consumer and business confidence and thus the economy. There is a potent stock wealth effect, which, given the recent market correction, is already set

to ding consumer spending in coming months. Any further sustained decline in values would meaningfully change our outlook for growth and monetary policy.

Long-term rates are also expected to rise, but not by as much as short-term rates, and the Treasury yield curve will flatten. An inversion of the curve has historically

Yield Curve Sends a Warning

Difference between 10-yr and 3-mo EBY, %



Sources: Federal Reserve, Moody's Analytics

presaged recessions. Particularly prescient is when three-month Treasury bill rates rise above 10-year Treasury bond rates. We avoid an outright inversion in these rates in our forecast,

although they come disturbingly close.

Housing holds its own

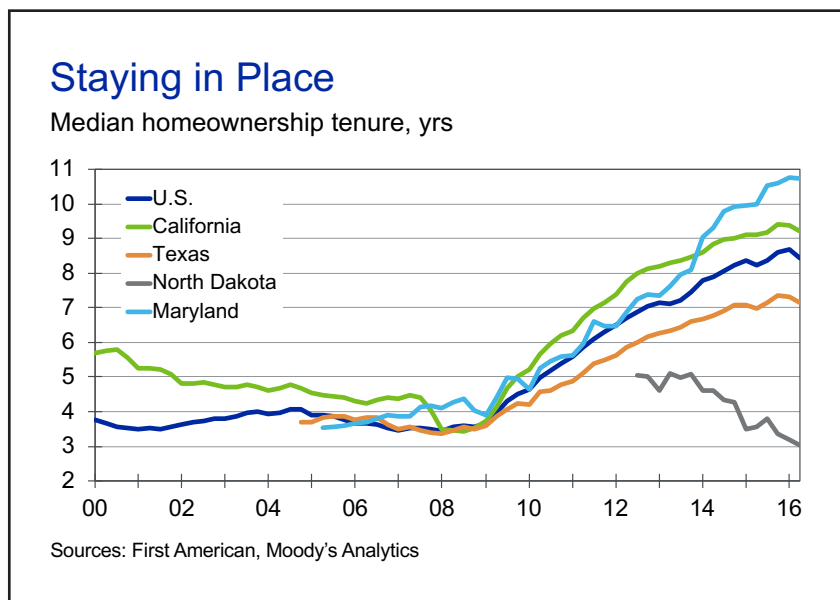
Higher interest rates are already causing some pain for the housing market, which has gone sideways in recent months. Sales of new and existing homes have flat-lined, as have new single- and multifamily homebuilding.

House prices are still rising in much of the country, but the pace of growth is throttling back, and some builders are cutting prices to move homes.

Potential homebuyers are having trouble digesting the higher rates. Not long ago, the typical rate on a 30-year fixed-rate mortgage was no more than 4%. Today, it's closer to 5%. This isn't high by any historical standard, but rates have been so low for so long that most homeowners are now paying no more than 4%. It is too big a financial stretch for many to sell a home with a 4% mortgage and buy one with a 5% mortgage. This interest-rate lock is one reason the typical homeowner has lived in his or her current home for almost a decade, nearly double the average homeowner tenure before the financial crisis.

Higher mortgage rates have also conflated with the robust house price growth since the crash to create a serious affordability problem. This is especially the case in heretofore high-flying markets—particularly in big urban centers along the coasts—where monthly mortgage payments are out of reach for many potential homebuyers, despite their better wages. Qualifying for a loan isn't the ordeal it was, since lenders have normalized their lending standards, but affording the loan is.

While rising mortgage rates will remain a pall on housing demand, buoying the market will be the severe shortage of affordable housing. Construction of high-end homes and apartments recovered strongly after the crash, as higher-income and wealthier households quickly bounced back from the recession. Builders were attracted by the higher prices and rents they could charge, and it didn't take long for them to



put up too many posh apartment towers in cities across the country.

The construction of affordable housing—homes reasonably priced for lower- and middle-income households to rent or own—is a different story. The supply of affordable homes has only recently begun to increase and continues to

significantly lag demand. Vacancy rates are low and falling, supporting house prices and rents, and providing greater financial incentives to builders to put up more affordable homes.

The cross-currents buffeting the housing market have played to a draw this year. This must continue, with housing being neither a significant source of growth nor a drag, for the economy to play out as anticipated in the coming year.

Stable geopolitical instability

It is a given that the geopolitical backdrop will remain volatile and uncertain, and President's Trump trade war with China is sure to remain front and center in coming months. The economic damage from the trade war has been modest so far, but it is mounting. Farmers are smarting from reduced exports, manufacturers are struggling to navigate around higher tariffs on imports of materials and equipment, and global business sentiment appears shaken. It isn't difficult to connect the dots between the trade war and the stock market correction.

However, as long as the trade war doesn't escalate further, the economy will be able to reasonably digest the war's costs. Trump appears motivated by this, and thus the administration's recent overtures toward a face-saving agreement with the Chinese.

The Chinese are unlikely to meaningfully change their objectionable behavior on intellectual property or market access, but they are likely to give Trump enough so he can declare victory and wind down the war. This may take a while, and there is sure to be more vitriolic back-and-forth, but as long as more tariff hikes are avoided, the trade war won't derail the economy's prospects.

Brexit uncertainty

Brexit is also unlikely to be resolved quickly. British Prime Minister Theresa May has put forward a reasonable way for the U.K. to exit the European Union that the EU is willing to live with, but many British aren't. Under this plan, the U.K. would stay in the customs union for goods but not for services, for which it would negotiate some type of free trade deal; the U.K. would maintain control over immigration into the country, but the plan would allow for the free flow of EU skilled and temporary workers; and the U.K. would continue to pay some of the EU's budget.

May rightly argues that this is the best Brexit deal the U.K. will be able to negotiate. While it satisfies neither the hard Brexiteers nor the Remainers, who want to ditch Brexit altogether, it is a political middle ground that will limit the economic damage to the U.K.

The British should ultimately figure this out, but likely only when there is no other option, and only at the last minute. Until then, the uncertainty will be uncomfortable for everyone across the globe, but if the British ultimately

do what is in their best interest, U.S. economic prospects will remain unaffected.

Given the seemingly never-ending political and economic maelstrom, it is shocking that the economy's performance this past year tracked so closely to what we anticipated. The one thing we will be sure to get spot on is that there will be equally as much tumult in the coming year.

About the Author:

Mark M. Zandi is Chief Economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools.

Dr. Zandi is co-founder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations, and policymakers at all levels. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, CNN, Meet the Press, and various other national networks and news programs.

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Providing 70 Years of Service to Credit and Accounts Receivable Professionals

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