A strong U.S. labor market is setting the stage for a sustained expansion into 2019. A confident consumer, buoyed by low layoffs and a high level of job openings and bolstered by a strong balance sheet, should allow consumption growth to be maintained through 2019. The same tight labor market that is bolstering the consumer should provide the impetus for companies to invest in capital equipment to reduce their need to find new workers. A gradually rising rate environment should support both of these trends.

Interest rates are typically believed to drive savings in a linear manner. That is, if interest rates are low, consumers will save less as the return for putting off consumption is not high. Conversely, if interest rates are high, consumers will save more as they are being well compensated for putting off consumption. However, the facts suggest this view only works to a point. In the real world, consumers will reduce savings as interest rates decline, but, below a certain interest rate, they begin to save more. This could be driven by fear of the environment.
represented by low rates or it could be a response linked to an aging population’s need for income certainty in their retirement years. Companies are thought to behave in a similar manner. Low rates should boost investment while higher rates reduce investments. This view stands in contrast to the behavior seen post the financial crisis. Companies boosted dividends and buybacks.

Put together, the behavior of savings and investment during this past cycle suggests that a gradual rate hike cycle should boost consumption (at the expense of savings) and result in more investment (at the expense of capital return), boosting overall growth in the economy and keeping the economic expansion on solid footing.

Margins also remain quite healthy. Indeed, the most recent data shows an acceleration in margins. It would be unusual for there to be a recession when margins are behaving in this manner. Typically we would expect to see declining margins for a number of quarters before we began to worry about elevated recession risk.

Tax reform is also likely to play a role. For 2018 Fed officials estimate it may have added up to 100 basis points to growth and could boost 2019 growth by up to 50 basis points. While reform may increase the budget deficit and heighten concerns about the fiscal situation, the net effect over our forecast horizon is positive.

Finally, a healthy amount of government spending seems likely to support 2019 relative to 2018. Absent a significant deficit reduction plan in the short term, this should result in a sizeable fiscal impulse during the year and keep the U.S. economy growing.

Sustained healthy growth should boost both productivity and labor force participation. While the latter may continue to decline, it seems reasonable to believe that the decline will be less substantial than would otherwise have been the case. As a consequence, we would anticipate expectations for the potential growth rate of the economy to rise. Higher expected potential growth should, all else equal, result in higher expectations for the terminal Fed funds target rate and a higher 10-year yield.

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**Figure 2 | Economic Margins Prior to Recession are Typically Much Lower Than Today**

![Figure 2](image)

*Source: BEA and MetLife Investment Management*
The Federal Reserve, the Balance Sheet and the Outlook for Interest Rates

We look for the path of the Fed funds target rate to follow the recent Federal Open Market Committee (FOMC) projections throughout the end of 2019. That is, we expect the Fed funds rate to end 2019 at 3.125%. Current FOMC forecasts place the peak Fed funds target rate at 3.375% even as the FOMC suggests the “longer-run” Fed funds target rate, a proxy for the neutral rate, is just 3.0%. Given our outlook we would anticipate the Federal Reserve’s view of the neutral rate will move higher as that outlook confirms that potential GDP growth is on the rise.

We expect the Fed will also continue to reduce the size of the balance sheet through at least 2019. We see the optimal balance sheet as being roughly $2.4 trillion, well below market expectations. As we expect the balance sheet to be significantly larger than that level through the end of our forecast horizon, we would expect that the balance sheet reduction will remain on course until the Fed begins to consider a change in rate policy.

Given our outlook for growth, we expect 10-year Treasury yields will increase by 50 basis points over 2019, taking the 10-year yield to 3.75% versus our year-end 2018 forecast of 3.25%. A rethinking of the currently historically low level of inflation risk being priced into Treasury securities, rising auction sizes and higher potential growth estimates should all contribute to a move higher in Treasury yields.

Risks to the Outlook

The key risks to the outlook remain the ongoing trade frictions and the potential for those frictions to impact growth, corporate margins and the willingness of firms to invest. Our forecast assumes that these frictions remain manageable over time. Financial market turmoil resulting from trade or other factors also poses a risk to our outlook as does any action that results in reduced hiring or investment.

Drew T. Matus
Chief Market Strategist
drew.t.matus@metlife.com  |  +1.973.355.4887
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Our investment methodology is based on a disciplined in-house credit research and underwriting process which leverages the deep expertise of our seasoned investment teams. Institutional investors can have access to MIM’s in-house investment capabilities, including deal originations, asset acquisition, rigorous portfolio monitoring, proprietary risk analytics and risk management. Our expansive global footprint, with strong capabilities in key markets, makes us well positioned to serve our clients’ investment needs.

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