The Economy in Focus
Fourth Quarter 2018

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Executive Summary
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The Fourth Quarter of 2018 will be remembered as a quarter when an unusual dichotomy existed between the U.S. economy and financial markets. The U.S. economy was very strong on many accounts in the fourth quarter, yet financial markets were generally weak and volatile. Fears of excessive monetary policy tightening and international trade tensions likely led to the underperformance of financial markets. In this report we review the recent performance of the economy and our outlook for 2019. Overall, our view is while uncertainties regarding monetary policy and international trade may not go entirely away, developments in both areas are likely in the coming year that should be supportive of continued economic expansion. However, risks to our positive outlook could emerge if business confidence, employment and capital spending decisions become cautious in the face of policy uncertainty.

We begin with a review of the Economy in the Fourth Quarter.

- Record economic activity growth in 3 months through November.
- Lowest unemployment rate since the late 1960s.
- Rising labor force participation among 25-54 year-olds.
- Consumer spending has been accelerating.
- Personal saving rate is up from the last decade.
- Consumer Confidence remains high.
- Inflation slows in late 2018.
- Energy prices crater again.
- Capital spending growth disappoints.
- Housing markets cooling.
- World economy slows.
- Yield curve narrower, but still pointing towards economic growth.
Review of the Fourth Quarter

The U.S. economy in the fourth quarter has been generally strong, with high economic activity, the strongest labor markets of the economic expansion, and solid consumer spending going into the important holiday shopping season.

- The ISM Manufacturing and Non-Manufacturing Composite index showed the strongest 3-month overall economic activity in the economy since records of the index began in July 1997. New orders, production, employment and supplier delivery times have all pointed to strong economic growth. Profit growth has further supported high business confidence. NFIB Small Business optimism recently reached a new record. Small business plans to expand are at high levels, although confidence declined somewhat at year-end, probably in response to general financial market volatility.

Economic Activity Strongest in Decades in the Fourth Quarter

[Graph showing ISM Index -- Manufacturing and Non-Manufacturing Composite (Greater than 50 = Growth)]

Most Recent Data: November 2018
- At 3.7%, the unemployment rate is at its lowest point since the period between 1966 and 1969. Jobs grew by 237,000 in October, followed by somewhat slower growth of 155,000 in November. The Private Services Sector continued to be the main engine of job growth with especially strong job creation during October and November in Wholesale Trade (18,800 jobs), Transportation and Warehousing (41,100 jobs), Professional and Business Services (90,000 jobs), Education and Health (73,000 jobs), and Leisure and Hospitality (71,000 jobs). Manufacturing job growth has remained solid, adding 53,000 jobs in October and November, and a total of 249,000 net jobs year-to-date in 2018, even as jobs growth in motor-vehicle production represented a relatively modest 11,900 of the total.

Unemployment Rate Lowest Since the 1960s
• Labor markets are tight, but not insurmountably tight. Labor force growth has slowed but has continued to be fueled by graduating students, immigrants (over 1.1 million in 2017), labor market reentrants, rising prime age labor force participation rates (the chart below), and a still high number of those not in the labor force who would take a job now.

However, the long-term growth of available labor may require increased private and public sector investment in addressing structural challenges facing potential workers. The structural challenges have been formed from an unusually slow economic recovery that has increased skill atrophy and reduced employment experience, among other labor market challenges from social/medical issues.

Workforce Participation Has Begun to Rise in Non-retirement Ages. Potential for New Workers May be Large

![Labor Force Participation Rate: 25-54 Years](chart)

Source: Bureau of Labor Statistics/Haver Analytics
• Consumer Spending has been accelerating. Strong labor markets, rising incomes and generally strong overall consumer finances, have increased the rate of consumer spending growth. In the 12 months through October, Total Personal Income rose 4.3%, and is expected to continue to grow at a solid pace. Real (inflation-adjusted) Disposable Personal Income rose a strong 2.76% during the same period. Although retail sales have been showing increased seasonal volatility, the overall trend has remained positive and broad-based. While retail sales excluding vehicles have exhibited the greatest strength in the last year, total spending on vehicles has continued to grow. Despite higher interest rates and several years of very strong sales, motor vehicle sales held at 17.5 million units on a seasonally adjusted annualized rate basis in October and November, only 0.3 million shy of 17.8 million unit sales during the same period last year. Although purchases of traditional cars has declined, total spending has remained high as consumers have been switching to larger vehicles with higher price tags. While interest rates are rising, so are jobs and incomes, thereby providing a sustaining force for consumer spending going forward.
Retail Sales Are on an Accelerating trend, But With Increased Seasonal Volatility

- The Saving Rate is still low relative to its long-term history, but has risen in this decade. High Consumer spending always raises the question of whether consumers are overextending themselves. While the personal saving rate is still historically low, consumer have saved a higher portion of their disposable personal incomes in the current economic cycle than in the last, when the saving rate dipped well below 5%. Personal incomes have risen, yet consumers have consistently saved 6% to 8% of that income in recent years. The saving rate is expected to remain relatively steady in that range.
Consumer Confidence remains elevated. According to the survey of Consumers conducted by the University of Michigan, consumer confidence has remained high in the fourth quarter even as it has eased somewhat from its recent high in August of this year. For 2018 overall, total consumer confidence and Consumer Views of their Current Conditions were both at their highest levels since 2000. Consumer expectations were below consumer present conditions, but were still the highest since 2004. Consumers are prepared to express that confidence in projected high spending levels in the fourth quarter and 2019.
Led by Strong View of Current Economic Conditions, Consumer Confidence is at Highest Level since 2000

- Inflation slowed in the Fourth Quarter. Producer Price inflation peaked and began to decline in the fourth quarter, probably ending the acceleration in producer prices that began in 2016. The widely watched Consumer Price Index for Urban Consumers (CPI-U) also slowed in the fourth quarter, up 2.2% in the 12 months through November, down from a recent high of 2.9% in July. Consumer prices in the GDP accounts, referred to as Personal Consumption Expenditures or (PCE), have also been on a slowing trend in the second half of the year. Core PCE inflation, the measure watched most closely by the Federal Reserve, dropped from 2.0% to 1.8%, below the 2% intermediate inflation objective of the Federal Reserve. As predicted initially in the Third Quarter 2018 Economy in Focus, inflation is edging downwards, and should gain added downward momentum in the coming months from the recent sharp decline in energy prices.
Inflation Eases after Strong Acceleration

Energy prices dropped dramatically in the fourth quarter. West Texas Intermediate plummeted from $76.41 per barrel on October 3 to a low of $46.24 on December 18. Three major forces brought energy prices down.

1. OPEC encountered new challenges in engineering supply cuts.
2. The U.S. Federal Reserve’s public comments were strongly hawkish towards interest rate increases, although Federal Reserve commentary has since moderated.
3. The world economy exhibited increased signs of slower economic growth, and hence slower demand growth for energy when U.S. output was increasing.

Lower energy prices at the gas pump began to emerge in earnest during December, and will likely be a retardant rather than a stimulant to inflation during 2019. Hence, consumers will likely get another boost to their purchasing power from lower fuel prices. Lower energy prices should also exert downward pressures on inflation at both the consumer and producer levels, reducing direct costs for
many businesses. Slower inflation should augment factors indicating slower interest rate increases in the next year, as well. In contrast to heavy energy consumers, energy producers will likely encounter another period somewhat akin to 2015 when energy prices dropped dramatically. Many energy-related producers will likely see their profit margins squeezed. Their spending on capital equipment will likely also decline if energy prices are slow to recover, actions that already may be occurring.

**Spot and Future Petroleum Prices Drop Dramatically in the Fourth Quarter**

![Spot and Future Petroleum Prices Chart](chart.png)

**Capital Spending orders slow in the fourth quarter.** Non-residential capital investment growth has been generally strong in the last 2 years, but the 12-month percent change in new orders for business equipment slowed to 3.4% in October from 10.5% in December 2017. (Please see the chart below). The slowdown in the energy sector resulting from the recent sharp dip in energy prices probably reduced demand for business capital equipment, much as it did during the 2015-2016 dip in energy prices. However, given the strong new incentives for business capital investment provided by the “Jobs and Tax Cuts Act of 2017,” the slowdown indicates the possibility of some business caution in the acquisition of new equipment in other areas of the economy, as well. Investment in structures and intellectual property, have been growing at a strong pace. Total Real Non-residential Fixed Investment rose 6.8% in the third quarter from the previous year, but ‘Transportation & Related Equipment and Equipment Investment’ slowed during the quarter. Further slowing in business capital investment is forecasted in the fourth quarter real GDP report that is scheduled for release in late January.
New Orders for Business Equipment Slow in Fourth Quarter

World Economy continued to grow, albeit a slower pace.

Exports were volatile in 2018, but continued to grow 6.25% in October from the same month last year. Buoyed by a strong U.S. economy, imports grew 8.5% during the same period. Unusual events continue to dominate the international scene, including Brexit, Middle East tensions, economic crises in Turkey and Argentina, natural disasters in Japan, domestic disorders in France and shocks to Germany’s automobile sector from changing emissions standards. China garnered the most attention with its slowing economy and trade tensions with the United States. However, the world economy overall continued to grow at a steady pace. As is the case in the United States, policy initiatives are generally shifting from monetary stimulus to fiscal and structural efforts to support continued economic growth. The hand-off may not be entirely smooth in places such as the EU, where fiscal policies are constrained by strict debt-limit restrictions. Italy ultimately found a way to appease the EU on debt while customizing its own form of fiscal stimulus. Other challenges are likely on the world scene in 2019. China may be the largest risk as a slowdown in China, should it occur, would likely result in a general slowdown in the Asia economy, as well as significant downward pressures on world commodity prices. Although a significant slowdown in China is not forecast, should such an outcome occur, exports could repeat the dip incurred during the last China-related slowdown of 2015-2016. (Please see the following chart.) Such a decline in
total exports is not anticipated, but it is a risk in 2019 should China’s economy weaken enough to slow the countries with which it does significant business.

Exports and Imports growth Holding Steady in Fourth Quarter

Housing Markets Cooling. Housing markets continued to cool in the fourth quarter as affordability became a higher hurdle for an increasing number of individuals. While mortgage rates have been gradually rising, the biggest challenge to housing is probably its success in recent years. Home prices have been rising strongly somewhat ahead of the pace of disposable personal income. (For more on this topic, please see the Third Quarter 2018 Economy in Focus.) Much of the housing slowdown has been occurring in the Multi-family and rental areas of housing. As the chart below indicates, the largest segment of decline in building units authorized during 2018 was for Multi-unit structures. A long economic expansion that adds significantly to jobs, wages and disposable personal income is the best input for achieving a strong housing market.
Housing Markets Cool in Second Half of 2018

Yield Curve Inversion Fears Impact Financial Markets

Flattening of the U.S. Treasury yield curve in the fourth quarter raised concerns that the U.S. economy was approaching recession. These concerns revolved primarily around the leveling of interest rates between the 2-year Treasury securities and the long-end 10-year Treasury securities. As of December 10, this spread was only 0.13%, or 13 basis points in bond jargon. Despite this flattening of the middle of the yield curve, which occurs often during the middle of economic expansions, the primary yield curve spread that is utilized as a leading indicator by the Conference Board and others is the spread between the 10-year Treasury interest rate and the Fed Funds rate target. (Please see the spread between the 10-year Treasury constant maturity yield and the Fed Funds rate target in the chart below, shown in BLUE.) When this economically sensitive spread becomes negative for a sustained period, as it did prior to the 2 most recent recessions, then the probability of recession occurring becomes elevated. The interest rate spread between the 10-Year Treasury bond and the Fed Funds rate target has been on a declining trend, but was solidly positive at 0.73%, or 73 basis points, as of December 11, 2018. Therefore, the yield curve continues to predict continued economic expansion in 2019.

Yield Spread Tightens, but Continues to Point to Economic Growth
The Economic Forecast

- Our economic forecast remains largely positive for 2019, but with a tilt toward domestic economic growth over foreign economies. **Real GDP growth is forecasted to moderate from 2.9% in 2018 to 2.5% in 2019**, somewhat below 2.6% in our previous forecast, but above average for the current economic recovery that began in mid-2009. This recovery has been buoyed by strong jobs and real income expansion, and consumers will likely continue to be the major drivers of economic growth. However, higher interest rates in 2019 over 2018 are projected to moderate housing and unit vehicle sales somewhat next year.

- **Business capital investment is expected to slow somewhat from 2018**, but continue to benefit from recent business tax cuts, the need to expand productivity growth in tight labor markets, and generally rising obsolescence compounded by years of underinvestment in the U.S.

- **Inflation is expected to decline from 2.4% in 2018 to 1.9% in 2019 for the lowest inflation since 2016.** Lower energy prices, slower expected growth in the international economy, lower commodity prices and tightened U.S. monetary policy are expected to contain inflationary
pressures. Wages will likely continue to rise, but are not expected to create significant cost push pressures.

- The Federal Reserve has tightened monetary policy in 2018 with 4 Fed Funds rate target increases totaling 1.0% and the continuation of its balance sheet reduction program that has reduced excess reserves in the banking system. With inflation expected to be low, and past interest rate increases already exhibiting slowing effects on interest-rate sensitive areas of the economy, the Federal Reserve is forecasted to raise the Fed Funds rate target only once in 2019 to 2.75%. The timing of the increase is less certain, but it will likely occur when international and trade headwinds are not significantly impeding large ticket expenditures by business and consumer. We view this plateau of the Fed Funds rate target as largely neutral, and consistent with our fundamental forecast of a solid but not over-heated economy.

- Recent developments in international trade have been generally positive with an agreement subject to Congressional approval to replace NAFTA with the new USMCA, and China's agreeing to reduce tariffs on U.S. autos from 40% to 15%. If high level trade talks with China do not yield concrete results in the next 90 days, then rising tariffs on $200 billion in goods from China would likely result in a one-time increase in the prices of imported goods. However, the ultimate increase in import prices would probably be well below the 25% maximum potential tariff threatened by the Administration. It is in China's interest to absorb a high proportion of any new tariffs in order to sustain its own economic growth and especially its share of U.S. markets. Furthermore, in the worst case scenario, a 25% tariff on $200 billion on imported goods represents less than 1.0% of U.S. GDP in 2019, with tariffs at 0.25% of GDP. This is only the worst case scenario, and not the most likely outcome. Despite the rancorous international trade events, we continue to think that the current period is one of trade renegotiation rather than trade war.

- International trade growth is expected to slow in 2019 as economic growth in many of the large world economies is expected to continue, but at post-peak rates.
  - Labor markets have firmed significantly in the developed economies in Europe and Japan, creating strong consumer demand potential.
  - Monetary policy in Europe and Japan is firming, but still relatively accommodative.
  - China’s economy is somewhat uncertain as the country grapples with its transition to a major economy, although its fiscal stimulus will likely be significant next year.
  - Tensions and uncertainties in international trade are creating general uncertainties in the world economy. As a result, the International Monetary Fund recently revised its world economic outlook down in 2019.
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- Trade surpluses with the United States in places such as Germany are expected to obtain increased attention from the U.S. Administration in the coming year.
- Trade tensions could raise business uncertainty and reduce capital investment, as a result.
- Europe will likely continue to grapple with internal tensions. Italy may breach its EU mandated deficit target in 2019, and the interest rate on its bonds will likely rise. Spain will likely continue to have budget challenges including domestic tensions with Catalonia. France is challenged by its own high debt and internal political tensions.
- Brexit will likely finally occur in March, whether the United Kingdom is ready or not. Uncertainties remain for the U.K. and especially Ireland. However, trade agreements between the EU and the U.K will likely be put in place that should minimize the greatest potential negative impact of Brexit on European and world economic growth.

(International Data Sources: Cornerstone Macroeconomics, Factset, FocusEconomics, Haver Analytics, Strategos, UBS)

Summary Table

Key Economic Indicators
Dec. 19, 2018

<table>
<thead>
<tr>
<th>Real GDP Annual Growth Rates 2012 Chained Dollars</th>
<th>2016</th>
<th>2017</th>
<th>2018*</th>
<th>2019*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumption</td>
<td>2.7%</td>
<td>2.5%</td>
<td>2.7%</td>
<td>2.7%</td>
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<tr>
<td>Non-Residential Fixed Investment</td>
<td>0.5%</td>
<td>5.3%</td>
<td>6.8%</td>
<td>6.0%</td>
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<tr>
<td>Residential Fixed Investment</td>
<td>6.5%</td>
<td>3.4%</td>
<td>0.1%</td>
<td>-1.4%</td>
</tr>
<tr>
<td>Exports</td>
<td>-0.1%</td>
<td>3.0%</td>
<td>4.0%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Imports</td>
<td>1.9%</td>
<td>4.6%</td>
<td>4.6%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Government Purchases</td>
<td>0.8%</td>
<td>-0.1%</td>
<td>1.6%</td>
<td>2.1%</td>
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<tr>
<td>Change in Private Inventories (Billions 2012 Chained Dollars)</td>
<td>$23.4</td>
<td>$22.5</td>
<td>$41.5</td>
<td>$42.5</td>
</tr>
<tr>
<td></td>
<td>1.6%</td>
<td>2.2%</td>
<td>2.9%</td>
<td>2.5%</td>
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<td>--------------------------------</td>
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<tr>
<td><strong>Total Real GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Nominal GDP</strong></td>
<td>2.8%</td>
<td>4.2%</td>
<td>5.1%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Current dollars</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Consumer Price Index for Urban Consumers (CPI-U) - Annual Rate</strong></td>
<td>1.3%</td>
<td>2.1%</td>
<td>2.4%</td>
<td>1.9%</td>
</tr>
<tr>
<td><strong>Federal Funds Rate Target</strong></td>
<td></td>
<td></td>
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<tr>
<td>Year-end range</td>
<td>0.50% to 0.75%</td>
<td>1.25% to 1.50%</td>
<td>2.25% to 2.50%</td>
<td>2.50% to 2.75%</td>
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<tr>
<td><strong>10-year Treasury Note</strong></td>
<td></td>
<td></td>
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<tr>
<td>Year-end interest rate yield</td>
<td>2.45%</td>
<td>2.40%</td>
<td>2.95%</td>
<td>3.25%</td>
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<tr>
<td><strong>National Income Corporate Profits</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Average annual growth rate</td>
<td>-0.1%</td>
<td>3.2%</td>
<td>8.3%</td>
<td>5.5%</td>
</tr>
<tr>
<td><strong>Net New Average Monthly Non-farm Payrolls (Thousands of Workers)</strong></td>
<td>195K</td>
<td>182K</td>
<td>185K</td>
<td>140K</td>
</tr>
<tr>
<td>Unemployment Rate -- Annual Average</td>
<td>4.9%</td>
<td>4.4%</td>
<td>3.9%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

Data Sources: Haver Analytics, Factset Inc., and other sources noted in text.
*Forecasts: Huntington Investment Management of the Private Bank, Division of Huntington National Bank*
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