* Not for nothing has Fed Chairman Powell celebrated the “extraordinary times” the US economy enjoyed in 2018: growth is on pace to exceed 3%, the unemployment rate is at a 48-year low, and inﬂation is right on target. As we look ahead to 2019, the natural question is how long the good times can last.
* Growth is likely to slow signiﬁcantly next year, from a recent pace of 3½%+ to roughly our 1¾% estimate of potential by end-2019. We expect tighter ﬁnancial conditions and a fading ﬁscal stimulus to be the key drivers of the deceleration.
* Robust job creation should push the unemployment rate to 3% by early 2020, well below our 4½% estimate of full employment, the rate consistent with 2% inﬂation. Wage growth should reach 3¼-3½% in this environment, and ﬁrmer wage pressures coupled with additional tariff rounds should boost core PCE inﬂation to 2¼% by end-2019. While Fed ofﬁcials would be comfortable with inﬂation at that level, we also see a risk of a more material inﬂation overshoot.
* The Fed is very likely to raise rates in December, and we expect 4 more hikes in 2019 to bring the terminal funds rate to 3¼-3½%, about two hikes above market forwards. With a large overshoot of its labor market target under way, the FOMC will likely be reluctant to stop until it is conﬁdent that the unemployment rate is no longer on a downward trajectory, a point we expect to reach only in early 2020. We still see the risks to our terminal rate forecast as tilted a little to the upside.
* History counsels that large labor market overshoots raise recession risk down the road. While we take this lesson seriously, we think it is being applied too mechanically in markets today. A ﬂatter and more anchored Phillips curve should allow the Fed to unwind the overshoot more gradually, giving it a good chance of beating the historical odds. For now, neither overheating risks nor ﬁnancial imbalances—the classic causes of US recessions—look worrisome. As a result, the expansion is on course to become the longest in US history next year, and even in subsequent years recession is not our base case.