Dow 28750, S&P 500 3100

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Early in 2018 we said the US economy has gone from being a Plow Horse to Kevlar. Nothing that has been thrown at the economy since – neither trade conflicts nor tweets, not higher short-term interest rates nor the correction in stocks – is likely to pierce that armor.

A year ago the economic consensus was that real GDP would grow 2.5% in 2018. And yes, that was *after* the tax cuts were passed. By contrast, we were more optimistic, projecting that real GDP would be up 3.0% in 2018. If we plug in our forecast for 2.0% real GDP growth in the fourth quarter, the economy will have grown 2.9% for the year. If, instead, we use the Atlanta Fed's estimate of 2.7% for Q4, we'd get 3.1% for the year. Either way, we just about nailed it.

Now, the same consensus that a year ago suggested the economy would only grow 2.5% in 2018 with the tax cuts is saying the economy is going to slow down to a pace of 2.3% in 2019, in part because of the supposed reduction in stimulus related to those very same tax cuts.

Once again, we're not buying it. The benefits to growth from having a lower tax rate on corporate profits and less regulation are going to take years to play out. Companies and investors around the world have only begun to react to the US being a more attractive place to operate. As a result, we're forecasting another year of 3.0% economic growth.

Further, we expect the unemployment rate to keep gradually falling, as continued job growth offsets an expanding labor force to push the jobless rate down to 3.3%, the lowest since the early 1950s. Last year the consensus predicted the jobless rate would decline to 3.8% in 2018; we predicted 3.7%. Right now it's already 3.7% and we think a drop to 3.6% is likely for December when that report comes out January 4.

On inflation, it looks like we'll finish this year with the Consumer Price Index up about 2.0%, although it would have been higher were it not for what we think is a temporary downdraft in oil prices. The consensus had projected 2.1% and we had been forecasting 2.5%. Look for a rebound in oil prices and ample monetary liquidity to help push the CPI gain to 2.5% in 2019, which would be the largest gain since 2011.

The tricky part is what to expect from the Federal Reserve in 2019. Based on our economic projections, and if the economy were the Fed's only consideration, we could get as many as four rate hikes in 2019. After all, nominal GDP growth – real GDP growth plus inflation – is up 5.5% in the past year and up at a 4.8% annual rate in the past two years. Raising rates four times in 2019, which is more than any Fed decision-maker projected at the last meeting in December, would only take the top of the range for the federal funds rate to 3.5%, still well below the trend in nominal GDP growth.

But we think the Fed will have a two-part test for rate hikes in 2019. First, as we just explained, the economy itself. Second, the yield curve. We think the Fed will be very reluctant to see the federal funds rate go above the yield on the 10-year Treasury Note and will strive to avoid either an active or passive inversion of the yield curve. An active inversion would be the Fed directly raising the federal funds rate above the 10-year yield; a passive inversion would be raising the federal funds rate so close to the 10-year yield that normal market volatility could send the 10-year lower than the funds rate.

As a result, we think the Fed will want to leave a "buffer zone" between the 10-year and the funds rate of about 40 basis points. So, for example, if the 10-year yield stays near its current level throughout all of 2019, we could end up with no rate hikes at all in spite of economic conditions.

Our projection, though, is that the 10-year yield moves higher to reflect more strength and resilience than the consensus now expects. **If the 10-year yield finishes 2019 at 3.40%, as we expect, that would leave room for two rate hikes, maybe three.**

For the stock market, we expect a soaring bull market, with the S&P 500 reaching the 3100 we projected for 2018 a year ago. Yes, we know that sounds bold, but our Capitalized Profits Model is screaming BUY.

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The model takes the government's measure of profits from the GDP reports divided by interest rates to measure fair value for stocks. Our traditional measure, using a current 10-year Treasury yield of about 2.75% suggests the S&P 500 is still massively undervalued.

But if we use our forecast of 3.40% for the 10-year yield, the model says fair value for the S&P 500 is 3100. And that leaves room for equities to go even higher if, as we think, profits move higher next year, as well. The model needs a 10-year yield of about 4.35% to conclude that the S&P 500 is already at fair value, with current profits.

The bottom line is that we're calling for the S&P 500 to finish at 3,100 or higher next year, which would represent a nearly 25% gain from Friday's close. The Dow Jones Industrial Average should end the year at 28,750.

Yes, this is likely to be one of the most optimistic forecasts you see, if not the most optimistic one of all. But, in the end, we do best by our readers when we tell them exactly what we think is going to happen, without altering our projections so we can run with the safety of the herd. Grit your teeth if you have to; those who stay invested in the year ahead should earn substantial rewards.

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