Weekly Economic Update

October 26, 2018

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GOVERNMENT PORTFOLIO ADVISORS

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Financial Indicators

Interest Rates	Latest	Previous Month	Previous Year
Fed Funds - Upper Boundary	2.250	2.250	1.250
3-Month Tbill	2.280	2.194	1.035
6-Month Tbill	2.410	2.368	1.191
3-Month Libor	2.520	2.386	1.158
2-Year T Note	2.836	2.817	1.440
5-Year T Note	2.947	2.945	1.875
10-Year T Note	3.112	3.049	2.268
30-Year T Note	3.348	3.182	2.809
1-5 Year AAA-AA Corporate Benchmark	3.280	3.220	2.030
1-5 Year Agency Bullet Benchmark	2.840	2.840	1.680
Spread=	0.440	0.380	0.350
Tax-Exempt Revenue Bonds(AAA)			
5- Year	2.296	2.240	1.266
10-Year	2.717	2.650	1.926
30-Year	3.390	3.302	2.825
Mortgages			
30-Year Fixed Mortgage Rate	4.700	4.630	3.790
15-Year Fixed Mortgage Rate	4.040	3.970	2.990
5/1-Year ARM	4.260	4.480	3.180
Stock Market			
Dow Jones Industrials	24,945.28	26,385.28	22,412.59
S&P 500	2,697.13	2,905.97	2,508.24
NASDAQ Composite	7,241.95	7,990.37	6,456.04
Commodities			
Gold($ per troy ounce)	1,230.65	1,194.44	1,301.10
Oil($ per barrel) - Crude Futures(WTI)	66.87	71.57	50.41
USD Currency Index	96.61	94.19	92.51

Economic Indicators

	Latest	Previous Month	Previous Year
Real GDP (qoq %)	3.50	2.00	2.80
Real GDP (yoy %)	3.00	2.80	2.30
Nominal GDP (yoy %)	5.50	4.70	4.20
Gov't Spending (qoq %)	3.30	1.30	-1.00
Core Price Deflator (qoq %)	1.60	2.30	1.40
CPI (yoy %)	2.30	2.90	2.20
CPI (mom %)	0.10	0.20	0.50
CPI x-Food/Energy (yoy %)	2.20	2.40	1.70
CPI x-Food/Energy (mom %)	0.10	0.20	0.10
Unemployment Rate	3.70	3.90	4.20
U6 Underemployment Rate	7.50	7.40	8.30
NonFarm Payrolls (mom chng, '000)	134.00	270.00	14.00
Average Hourly Earnings (yoy %)	2.70	2.90	2.60
Average Hourly Earnings (mom %)	0.30	0.40	0.40
Industrial Production (yoy %)	5.14	3.80	1.22
Industrial Production (mom %)	0.25	0.62	-0.02
Capacity Utilization	78.11	77.99	75.66
Durable Goods Orders (yoy %)	6.50	10.30	8.20
Durable Goods Orders (mom %)	0.80	-0.40	4.70
ISM Manufacturing Index	59.80	61.30	60.20
Composite PMI	54.80	54.70	54.80
Conference Board Leading Ind.	111.80	109.50	104.50
Housing Starts	1201.00	1350.00	1158.00
Retail Sales (mom %)	0.10	0.50	1.80
Retail Sales (yoy %)	4.70	6.60	5.20
Consumer Confidence	138.40	134.70	120.60
Personal Income (yoy %)	4.40	4.00	4.60
Personal Income (mom %)	0.20	0.40	0.50
Trade Balance (USD bn)	-53.24	0.40	0.40
Total Debt Outstanding(USD bn)	21516058	21458849.7	20244900

Other Sources: Bloomberg, L.P.

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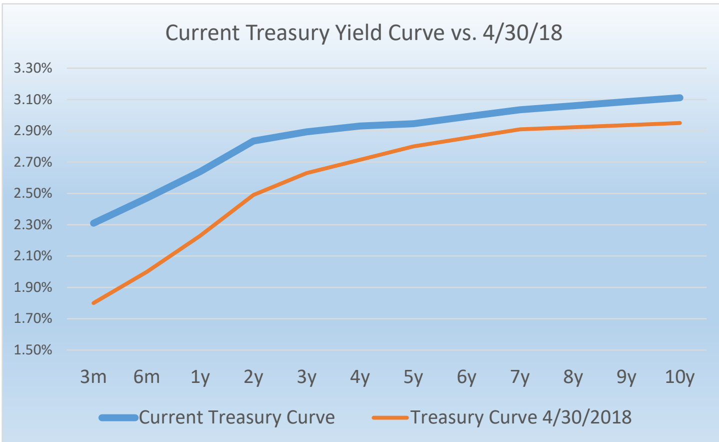
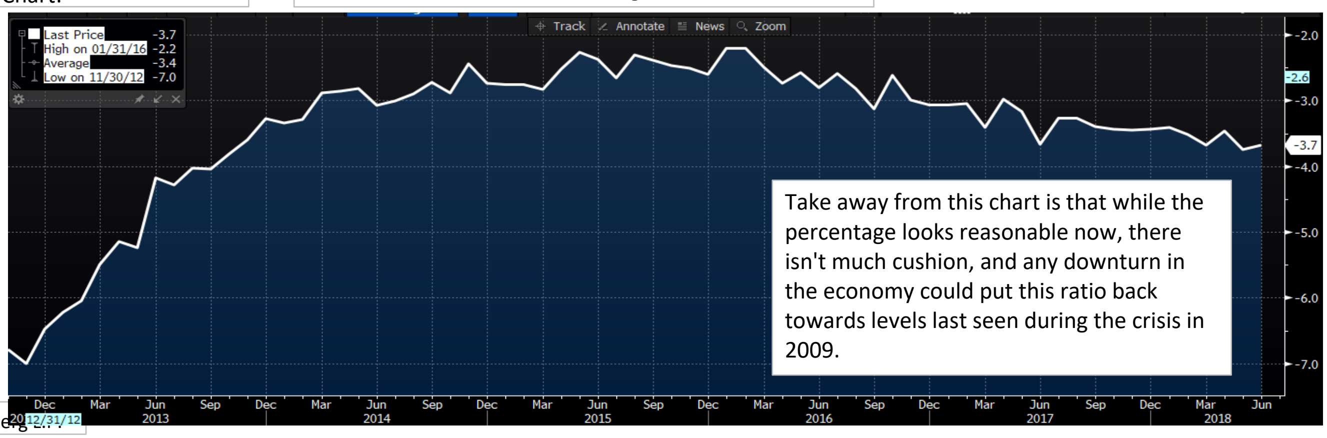
Selected Charts



Selected Chart:

US Federal Deficit as a Percentage of GDP



Take away from this chart is that while the percentage looks reasonable now, there isn't much cushion, and any downturn in the economy could put this ratio back towards levels last seen during the crisis in 2009.

Source: Bloomberg L.P.

Other Sources: Bloomberg, L.P.

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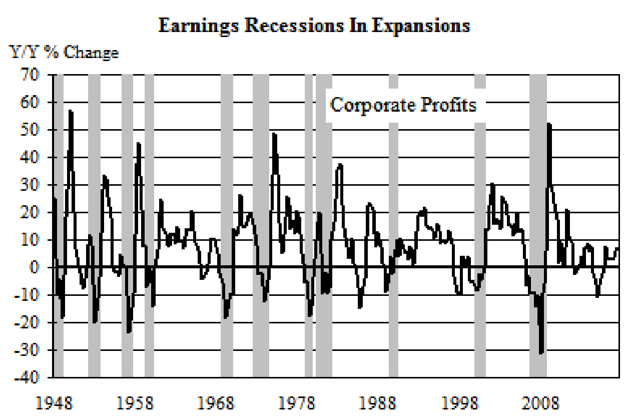
WEEKLY ECONOMIC COMMENTARY – WEEK OF October 26, 2018

Halloween has arrived early for investors as the ghosts and goblins are stirring up a virulent storm in the stock and bond markets. To be sure, volatility has been ramping up throughout the month, reflecting the steady drumbeat of crosscurrents buffeting investor sentiment. These include mounting concerns over rising interest rates, a Fed policy that is the target of a critical president, the still-unresolved trade conflict with China, slowing global growth and a potential debt crisis overseas sparked by a budget deficit in Italy that violates European Commission rules. But the turbulence reached a boiling point this week, as a six-day rout in stock prices wiped out all of the year's gains by Wednesday. After a potent rally on Thursday returned the S&P 500 to the plus column, the market sank again on Friday driving the index back into negative territory.

Some experts believe the market's sharp decline from historic highs reached on September 20 is a healthy reset that sets the stage for the next leg up in a long bull market. But just as many analysts worry that the market faces some formidable headwinds, which has historically ushered in a bear market, i.e., a decline of at least 20 percent. The bearish outlook hinges in large part on a downbeat view of profits that, after another stellar performance in the third quarter, is poised to downshift owing to a lethal combination of a slowing economy, rising input costs, weak pricing power and lackluster productivity. Some are predicting an earnings recession, a signal that the economy is also on the cusp of cyclical downturn.

While the heightened volatility seen in recent months may well continue given the myriad uncertainties that continue to underpin investor anxiety, we are less aligned with the bearish sentiment on profits and the economy. Even if an earnings recession –generally defined as at least two quarters of year-over-year declines in corporate profits – comes to pass, it does not necessarily represent the death knell of the expansion. Indeed, the economy has already survived one such earnings recession, in 2015, and similar episodes have occurred in at least five previous postwar expansions. That said, it is rare for two earnings recessions to occur during expansions. That happened during the upturns of the 1980s and 1990s, and in both instances the second earnings slump ushered in an economic recession within the following year.



Source: Stone & McCarthy

While investor sentiment clearly responds to the outlook for profits and the health of the economy, we suspect that a new influence has been particularly unsettling to market participants, namely the heightened uncertainty over monetary policy. Until recently, the markets have been nurtured by the Fed's promise that policy would remain accommodative, even as it gradually raised its policy rate seven times since December 2015. But with the eighth increase at the September 25-26 meeting, that assurance was dropped, as the phrase "the stance of monetary policy remains accommodative " was removed from the policy statement for the first time since the rate-hiking campaign got underway. That, together with increasingly hawkish comments from Fed officials, has raised concerns that the Fed may turn more aggressive to prevent the economy from overheating and stoking undesirable inflation pressures.

Chairman Powell has tried to walk back that perception following the September meeting, asserting that the phrase regarding accommodation has outlived its useful life and it would be misleading to retain it given that rates are moving closer to a neutral level. Indeed, Cleveland Fed President Loretta Mester opined this week that Fed policy is still accommodative, suggesting that further rate hikes are warranted, while other Fed officials seemed to advocate a more cautious approach. The common thread in all Fed comments is that incoming data will be the most important determinant of policy decisions going forward. If the economy meets the Fed's growth and inflation expectations, further rate hikes will be warranted. If it falls short of expectations, the rate trigger could be put on hold. Simply put, for the first time since the recovery began nearly 10 years ago, investors are struggling with a Fed policy that is now on a two-way street, uncertain which way it will go.

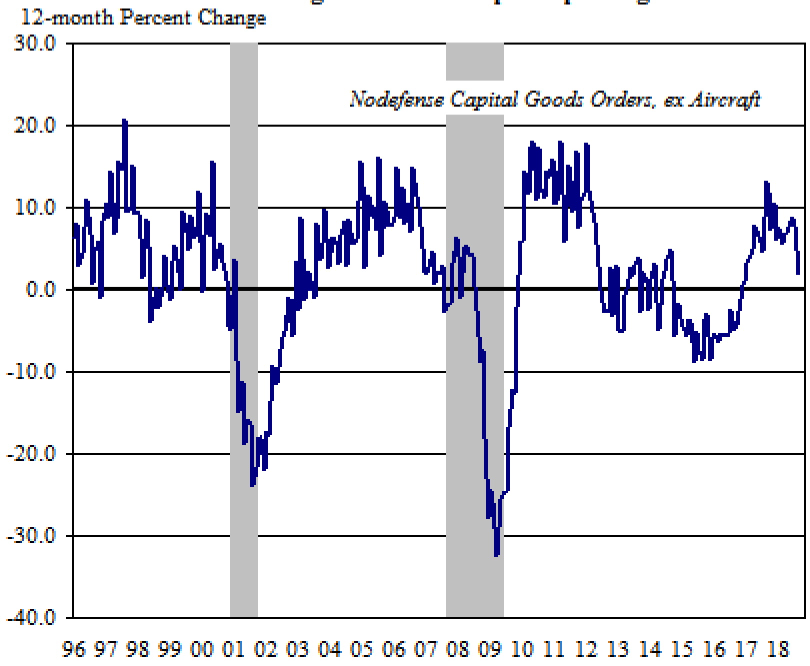
At this juncture, the market has fully priced in another rate increase at the December meeting, but it has lowered the odds of continued rate hikes in 2019. We are still on board for three increases next year, but recognize the downside risks to this forecast, particularly if the dispute with China leads to an outright trade war, which could have severe unintended consequences for the global economy. For the most part, the medium-term prospects are promising, primarily because the main growth driver, households, continues to provide the necessary fuel. That was strikingly illustrated in Friday's GDP report for the third quarter, which revealed that personal consumption expenditures increased by a torrid 4.0 percent annual rate during the period, the strongest quarterly growth rate in nearly four years. The increase, following a sturdy 3.8 percent gain in the second quarter, accounted for nearly 80 percent of the 3.5 percent increase in overall GDP.

Underpinned by a strong job market, growing incomes and elevated confidence, there is no compelling reason to expect that consumers will pull in their horns anytime soon. Retailers are preparing for a robust holiday shopping season, stepping up hiring and inventories, which if realized should provide a foundation for a decent growth rate in the fourth quarter. The sturdy increase in the control group of retail sales in September, reported last week, suggests that consumers provided a strong hand-off from the end of the third quarter. The government should also provide another positive contribution to growth this quarter, reflecting the increased outlays associated with the Bipartisan Budget Act of 2018. That follows a solid 3.3 percent increase in Federal outlays in the third quarter.

It is unlikely, however, that the stronger-than-expected 3.5 percent increase in GDP last quarter will lull the Fed into thinking the economy has more momentum than perceived at the last policy meeting. For one, the headline growth rate masks a number of weaknesses in the underlying details. The huge inventory buildup, which contributed an outsized 2.1 percentage points to the 3.5 percent growth rate, is not sustainable. If final sales fail to meet expectations in the fourth quarter, leaving an unwanted inventory overhang, businesses will cut back on orders, resulting in lowered production and possibly hiring. Indeed, real final sales – total output less inventories – increased by only 1.4 percent in the third quarter, down from 5.4 percent in the first and the weakest increase since the fourth quarter of 2016.

Two key sectors underscored this slowdown. Despite the hype generated by the corporate tax cut, business investment spending skidded virtually to a halt in the third quarter, increasing by less than 1 percent. To be sure, this may have been an aberration, as the setback followed two strong quarterly increases. What's more, the outright decline in spending on structures seems to have been heavily influenced by cutbacks in the energy sector. But the prospect of a snapback in the fourth quarter does not look promising. Unlike consumer spending, which ended the third quarter on a strong note, capital outlays did just the opposite, limping to the finish line. In September, shipments of nondefense capital goods less aircraft, a proxy for equipment spending in the GDP accounts, were unchanged in September for the second consecutive month. Worse, the near-term outlook turned murkier, as orders for the same capital goods fell in both August and September, ending the quarter a mere 1.9 percent above the year-earlier total. It may well be that what the tax cuts gave to capital spending over the first half of the year, increased tariffs and growing concerns over a trade war are now taking back.

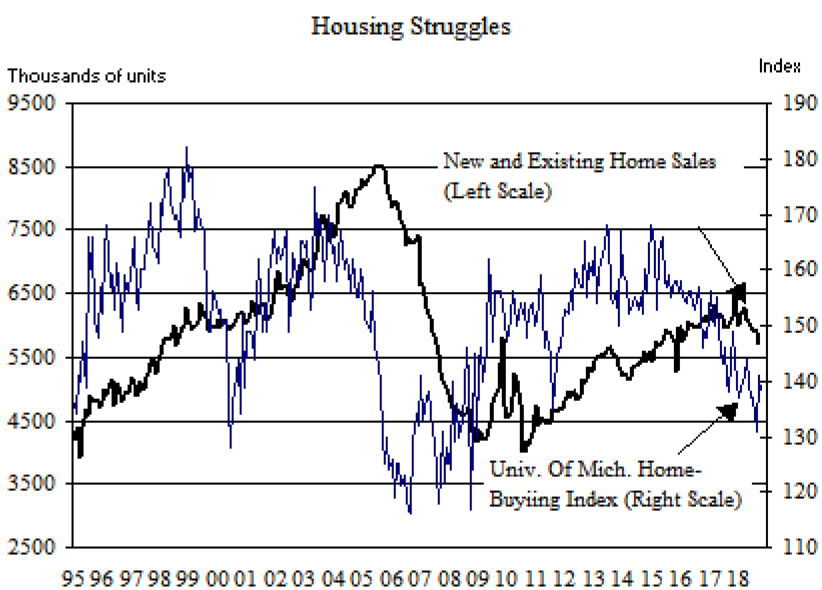
Dimming Outlook for Capital Spending



Source: Stone & McCarthy

And while business investment provided a meek contribution to growth in the third quarter, the housing sector turned out to be an outright drag – again. For the third consecutive quarter residential outlays declined, with the 4.0 percent contraction in the July-September period the largest of the three. The slippage in housing comes as no surprise, as sales and construction have been on a downward slope since the spring. Indeed, the combined total of new and existing home sales fell to the lowest level in September since December 2015. For sure, recent hurricanes may have temporarily depressed sales somewhat and construction is no doubt being hampered by a shortage of workers and builder lots. The housing sector is still underpinned by some bright spots, most notably a strong job market and favorable demographics with millennials moving into the home-buying stage of life.

But the near-term outlook is not looking promising. A broadening swath of potential homebuyers is being shut out of the market by rising mortgage rates and home prices. Builders, in turn, are not filling the void by stepping up construction of lower-priced homes, which would make a purchase more affordable for first-time buyers. That could change if the market for luxury properties continues to soften, as is currently the case, which is lowering prices on those units and, hence, making them less profitable for builders. But the current environment is anything but appealing to potential buyers, as reflected in several surveys. The University of Michigan compiles a housing conditions index based on household responses to home buying plans, and the trend points to continued weakness in home sales.



Source: Stone & McCarthy

We suspect that there are enough favorable fundamentals to keep housing activity afloat over the near term, albeit this sector is not likely to provide more than a meager contribution to growth in coming quarters. The heavy lifting will come from consumers, whose buying attitudes remain upbeat. But the economy is clearly losing momentum and the tailwinds that have propelled growth over the past year, fiscal stimulus, strong global growth and low interest rates, are fading. Needless to say, the debate over whether or not the Fed is moving at the right pace to keep the economy on a balanced upward trajectory is destined to heat up next year – if not sooner.

Source: Stone & McCarthy