GPA GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update

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November 23, 2018

Financial Indicators

Interest Rates	Latest	Previous Month	Previous Year
Fed Funds - Upper Boundary	2.250	2.250	1.250
3-Month Tbill	2.360	2.329	1.287
6-Month Tbill	2.463	2.471	1.444
3-Month Libor	2.691	2.490	1.462
2-Year T Note	2.840	2.881	1.729
5-Year T Note	2.901	3.013	2.043
10-Year T Note	3.071	3.169	2.320
30-Year T Note	3.322	3.368	2.740
1-5 Year AAA-AA Corporate Benchmark	3.350	3.350	2.190
1-5 Year Agency Bullet Benchmark	2.870	2.910	1.840
Spread=	0.480	0.440	0.350
Tax-Exempt Revenue Bonds(AAA)			
5- Year	2.255	2.306	1.631
10-Year	2.658	2.739	2.094
30-Year	3.352	3.417	2.825
Mortgages			
30-Year Fixed Mortgage Rate	4.760	4.740	3.800
15-Year Fixed Mortgage Rate	4.000	4.100	3.140
5/1-Year ARM	4.230	4.320	3.510
Stock Market			
Dow Jones Industrials	24,631.33	25,191.43	23,526.18
S&P 500	2,665.76	2,740.69	2,597.08
NASDAQ Composite	7,059.25	7,437.54	6,867.36
Commodities			
Gold($ per troy ounce)	1,223.23	1,230.30	1,292.12
Oil($ per barrel) - Crude Futures(WTI)	52.00	66.43	58.02
USD Currency Index	96.99	95.96	93.22

Economic Indicators

	Latest	Previous Month	Previous Year
Real GDP (qoq %)	3.50	3.50	3.20
Real GDP (yoy %)	3.00	3.00	2.30
Nominal GDP (yoy %)	5.50	5.50	4.10
Gov't Spending (qoq %)	3.30	3.30	0.70
Core Price Deflator (qoq %)	1.60	1.60	1.30
CPI (yoy %)	2.50	2.90	2.00
CPI (mom %)	0.30	0.20	0.10
CPI x-Food/Energy (yoy %)	2.10	2.40	1.80
CPI x-Food/Energy (mom %)	0.20	0.20	0.20
Unemployment Rate	3.70	3.70	4.10
U6 Underemployment Rate	7.40	7.50	8.00
NonFarm Payrolls (mom chng, '000)	250.00	118.00	271.00
Average Hourly Earnings (yoy %)	3.20	2.80	2.20
Average Hourly Earnings (mom %)	0.30	0.30	-0.10
Industrial Production (yoy %)	4.11	3.80	2.65
Industrial Production (mom %)	0.10	0.62	1.54
Capacity Utilization	78.39	77.99	76.76
Durable Goods Orders (yoy %)	7.50	10.30	2.90
Durable Goods Orders (mom %)	-4.40	-0.40	-4.10
ISM Manufacturing Index	57.70	59.80	58.50
Composite PMI	54.40	53.90	55.20
Conference Board Leading Ind.	112.10	109.50	105.90
Housing Starts	1228.00	1350.00	1265.00
Retail Sales (mom %)	0.80	0.50	0.60
Retail Sales (yoy %)	4.60	6.60	5.30
Consumer Confidence	137.90	135.30	126.20
Personal Income (yoy %)	4.40	4.00	4.60
Personal Income (mom %)	0.20	0.40	0.40
Trade Balance (USD bn)	-54.02	0.30	-0.10
Total Debt Outstanding(USD bn)	21702369.8	21516058	20442474

Other Sources: Bloomberg, L.P.

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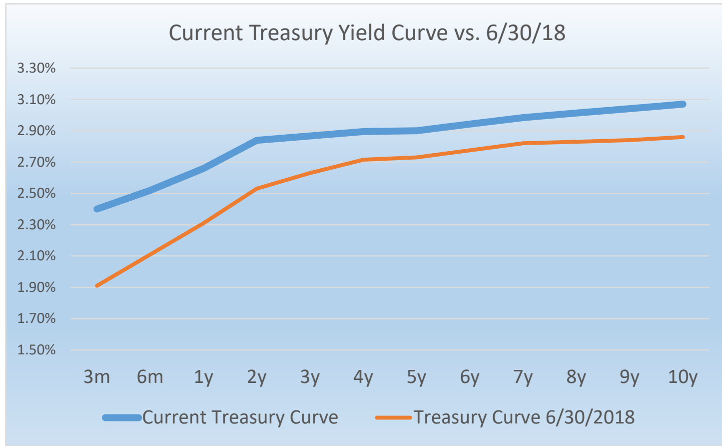
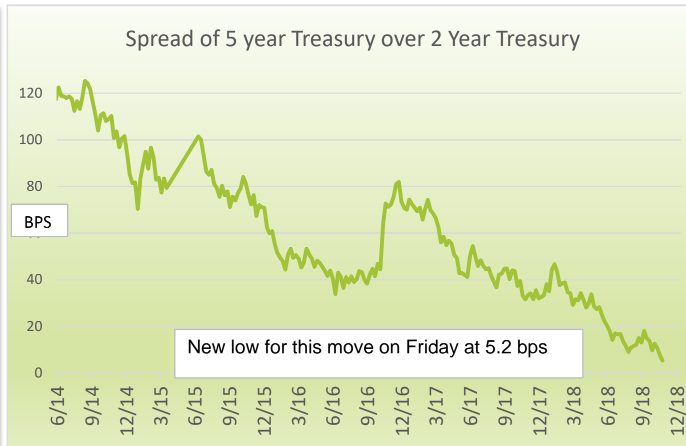
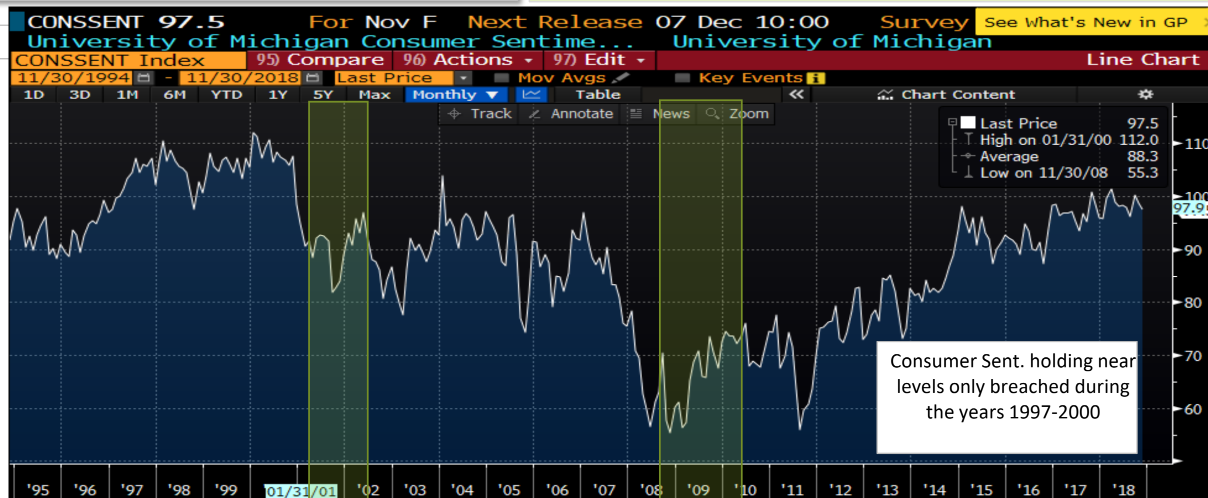
Selected Charts





Selected Chart:

Recessionary Period



Source: Bloomberg L.P.

Other Sources: Bloomberg, L.P.

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WEEKLY ECONOMIC COMMENTARY – WEEK OF November 23, 2018

In a holiday-shortened week, investors were mercifully spared at least 1-½ days of market volatility and falling prices that have decimated portfolios over the past month. As the official start of the holiday shopping season gets underway, there are a few things to be thankful for. One is the early start to the season, as this was the earliest Thanksgiving since 2012. Hence, consumers will have several more days to visit the shopping malls, both the virtual and brick and mortar variety, to spend their hard-earned cash. We suspect that the experience won't be quite as festive as last year, which was the strongest in more than a decade, but the registers should still be humming briskly. The fundamentals underpinning household spending are solid. Job growth is robust, workers are getting fatter paychecks and confidence is high.

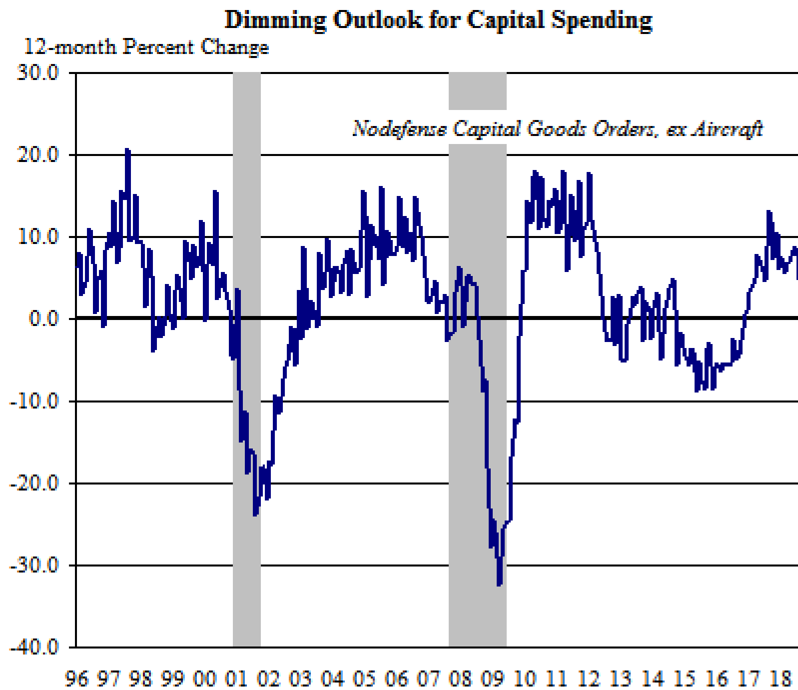
But conditions are not as festive outside of the household sector, something that is clearly unsettling the financial markets. To be sure, the critical influences stoking investor angst in recent weeks have more to do with global economic and geopolitical matters than domestic events. Trade tensions between the U.S. and China show no sign of letting up, at least judging from the uncompromising comments made by American and Chinese representatives at the recent Asian-Pacific Summit. Cooler heads may prevail at the upcoming G20 meeting in Buenos Aires on December 1, when President Trump and President Xi will meet face-to-face. We'll see. Meanwhile, the global economy is slowing and the Eurozone is embroiled in a contentious brouhaha, involving a recalcitrant Italy refusing to meet Brussels' budget demands and a conflicted Britain struggling to find a smooth path out of the European Union. The halcyon days of 2017, when the healing power of synchronized global growth prevailed, are a thing of the past.

On the domestic front, investors are also reassessing what was long thought to be a Goldilocks economy. True, the porridge is still more than lukewarm. As noted, consumers are keeping the growth engine cruising at a decent speed. If the holiday season lives up to optimistic expectations, the economy should wind up the year with another solid quarter, which is tracking a growth rate of around 3.0 percent. That would be modestly slower than the 4.2 percent and 3.5 percent pace registered in the second and third quarters, respectively, but still punctuate the strongest full-year growth since 2005. But the headline performance masks some underlying weaknesses that suggest the economy will continue to lose momentum heading into 2019. Indeed, two of the growth cylinders have been sputtering for some time and prospects for their revival do not look promising.

Topping the list of disappointments is business investment spending. As advertised by the Trump administration, the $1.5 trillion tax cut enacted last year – which greatly padded the cash coffers of corporations and included tax-saving investment incentives – spurred a sizeable pick-up in capital spending over the first two quarters of this year. Outlays for nonresidential fixed investment increased by annual rates of 11.5 percent and 8.5 percent, the strongest back-to-back quarterly gains in six years. But the trend since then has been downhill. In the third quarter, these outlays edged up by a miserly 0.8 percent; if not for a respectable increase in spending on computer software, the reading would have been worse, as equipment spending barely increased and outlays on structures registered an outright decline.

More ominously, the trend is still heading south. A key leading indicator of capital spending – new orders for nondefense durable goods less volatile aircraft bookings – fell for three consecutive months, with the 0.5 percent drop in October the steepest since March. Last fall, these orders were growing at a double-digit pace; this October, they are up just 3.4 percent compared to a year ago. Here may be a perfect example of how adverse trade policies may be feeding back to the domestic economy. Expectations of increased tariffs appear to have boosted orders earlier in

the year, pulling forward purchases that accounts for some of the recent weakness. But even last winter, when business optimism was high and investment spending was stronger, business leaders were expressing concern about the administration's hard-nose approach to lowering trade deficits, imposing tariffs on steel and aluminum as well as on $250 billion of Chinese goods, dismantling Nafta and ramping up trade tensions with European allies.

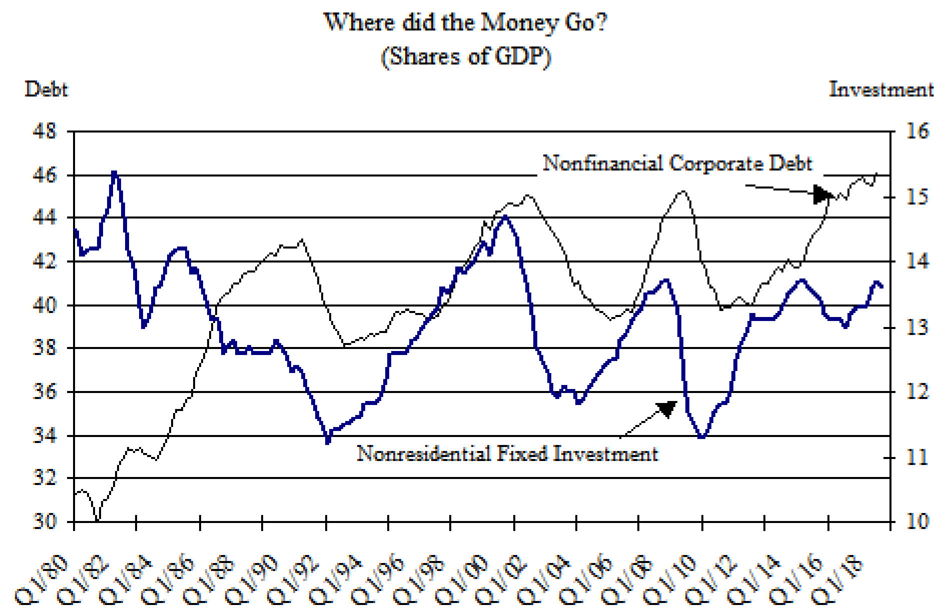


Source: Stone & McCarthy

While the evidence so far has been mostly anecdotal, it is becoming increasingly apparent that the protectionist policies of the U.S. and retaliatory measures by trading partners are disrupting supply chains, increasing input costs and contributing to the global slowdown now underway, all of which are eroding business sentiment and likely putting some investment plans on hold. To be sure, the U.S. economy is less dependent on trade as a growth driver than most other nations. But the S&P 500 corporations derive about 50 percent of their revenues from foreign sales, which makes profits and the stock market vulnerable to slowing global growth. The upsurge in market volatility and dispiriting plunge in stock prices over the past month is in no small measure a reflection of investor angst that trade tensions will escalate and take a bigger toll on earnings. Should the

10-year bull market come to an abrupt end, the positive wealth effect that has provided some support to consumer spending would also vanish, removing another tailwind that has propelled the economy forward.

Importantly, even as investment spending is skidding to a halt, corporate debt is piling up and reaching new heights this year. Outstanding debt of nonfinancial corporations surged to a record 46 percent of GDP in the second quarter while nonresidential fixed investment outlays have never risen above the 13.7 percent share seen four years ago. That raises the question, where did all the money go? No doubt, a major chunk was used to finance mergers and acquisitions and corporate share buybacks, underpinning the strength in stock prices until recently. But the backdrop that encouraged the debt buildup – historically low borrowing costs, a strengthening economy, robust profits and receptive investors – is becoming less favorable. Rates are rising, the economy is slowing and investors are becoming more discerning, spurring widening credit spreads. If profits sag under the weight of a global slowdown and rising cost pressures, debt-servicing issues will become a problem for a growing swath of companies.

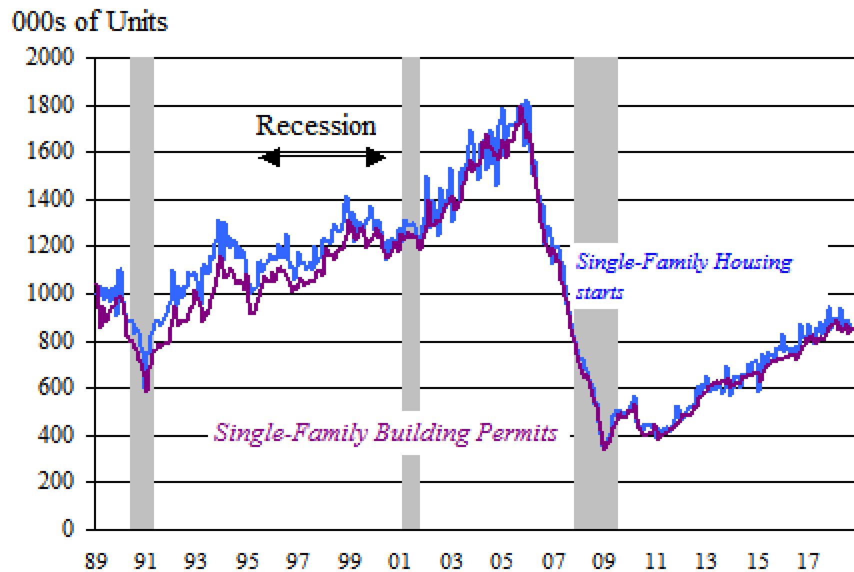


Source: Stone & McCarthy

But while prospects for investment spending are turning dimmer, the housing sector has seen its fortunes dwindle steadily throughout the year. Unlike nonresidential outlays, which had a positive albeit diminishing impact on GDP over the first three quarters of the year, residential outlays have been a outright drag for three consecutive quarters, the longest stretch of declines since the housing collapse during the recession. However, the atypical trend in the residential sector has mostly been a reflection of the supply rather than the demand side of the industry. Builders have

been plagued by a shortage of construction workers, lots to build on and increasing costs of lumber, steel and aluminum (those tariffs again). Demand, on the other hand, has been well supported by strong job growth, expanding household formation, particularly among millennials reaching the home-buying age, rising incomes and, until recently, historically low mortgage rates.

Nonetheless, supply constraints limited the upside potential for residential outlays. Over the first ten months of the year, builders broke ground on 5.4 percent more residential structures than in 2017. But all of the strength came early in the year. Housing starts actually peaked in January, at 1.334 million units, and struggled to stay within 100 thousand of that level for the rest of the year. In October, starts totaled 1.228 million units. More recently, however, problems on the demand side have taken center stage in the housing market. Thanks to the wide demand-supply imbalance, home prices have increased faster than household income, making a home purchase less affordable to potential homebuyers. As a result, realtors who struggled with a lack of inventory earlier in the year are now seeing demand taper off as well. With sales getting hit from both directions, transactions are slowing.



Source: Stone & McCarthy

The good news is that there are many positive features underpinning the housing market. Household formations are still growing, the job market remains strong, incomes are rising and supply constraints are easing, as the slackening in demand has lifted inventories of homes for sale. There is also a good deal of pent-up demand for homes that is poised to juice sales once a home purchase becomes more affordable. It's worth noting

too that the struggles in the housing sector have had less if a negative impact on the overall economy than in years past, if only because its influence has shrunk dramatically since the housing collapse a decade ago.

The bad news is that housing demand is facing increasing headwinds. Not only are prices still rising briskly, albeit at a somewhat slower pace, affordability is also being crimped by rising mortgage rates. This week saw somewhat of a respite, as the 30-year rate on fixed mortgages fell by 15 basis points, echoing the decline in the 10-year Treasury yield. But mortgage rates are up by almost a full percentage point from a year ago, which is about 25 basis points more than the rise in Treasury yields. The two usually move hand-in-hand, but that linkage has been weakened by the Federal Reserve's sales of mortgage-backed securities as it unwinds its bloated balance sheet built up through three rounds of quantitative easing.

Indeed, the Fed's ongoing effort to reduce the size of its balance sheet reinforces the tightening impact of its rate-hiking policy. As it is, the tightening of financial conditions is gaining traction, thanks to the recent rout in stock prices and the steady increase in the dollar. Given the economy's overall strength heading into the fourth quarter and with inflation moving up to the Fed's 2 percent target, another hike in the federal funds rate at the upcoming December 18-19 policy meeting is still widely expected. But not surprisingly, investors are reducing the odds that the Fed will follow through with the three additional hikes next year that it predicted at the September policy meeting. While we concur that a rate hike next month is virtually baked in, it will be interesting to see if Fed officials turn more cautious about 2019 in their updated projections that will be released following the meeting.

Source: Stone & McCarthy

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