GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update

Statistics………Page 2
Commentary….Page 5

Deanne Woodring, CFA
deanne@gpafixedincome.com

Dave Westcott, CFA
dave@gpafixedincome.com

Mike Clark
mike@gpafixedincome.com

Susan Munson, CFP
susan@gpafixedincome.com

Prepared by:
Christopher Bates
chris@gpafixedincome.com

2188 SW Park Place, Portland, OR. 97205
(503) 248-9973

GOVERNMENT PORTFOLIO ADVISORS

November 30, 2018

Financial Indicators

Interest Rates	Latest	Previous Month	Previous Year
Fed Funds - Upper Boundary	2.250	2.250	1.250
3-Month Tbill	2.310	2.329	1.287
6-Month Tbill	2.470	2.471	1.444
3-Month Libor	2.736	2.490	1.462
2-Year T Note	2.818	2.881	1.729
5-Year T Note	2.830	3.013	2.043
10-Year T Note	2.992	3.169	2.320
30-Year T Note	3.288	3.368	2.740
1-5 Year AAA-AA Corporate Benchmark	3.390	3.320	2.260
1-5 Year Agency Bullet Benchmark	2.870	2.870	1.910
Spread=	0.520	0.450	0.350
Tax-Exempt Revenue Bonds(AAA)			
5- Year	2.160	2.306	1.631
10-Year	2.548	2.739	2.094
30-Year	3.275	3.417	2.825
Mortgages			
30-Year Fixed Mortgage Rate	4.680	4.740	3.800
15-Year Fixed Mortgage Rate	3.960	4.100	3.140
5/1-Year ARM	4.180	4.320	3.510
Stock Market			
Dow Jones Industrials	25,727.80	25,191.43	23,526.18
S&P 500	2,779.22	2,740.69	2,597.08
NASDAQ Composite	7,408.91	7,437.54	6,867.36
Commodities			
Gold($ per troy ounce)	1,234.02	1,230.30	1,292.12
Oil($ per barrel) - Crude Futures(WTI)	52.46	66.43	58.02
USD Currency Index	96.90	95.96	93.22

Economic Indicators

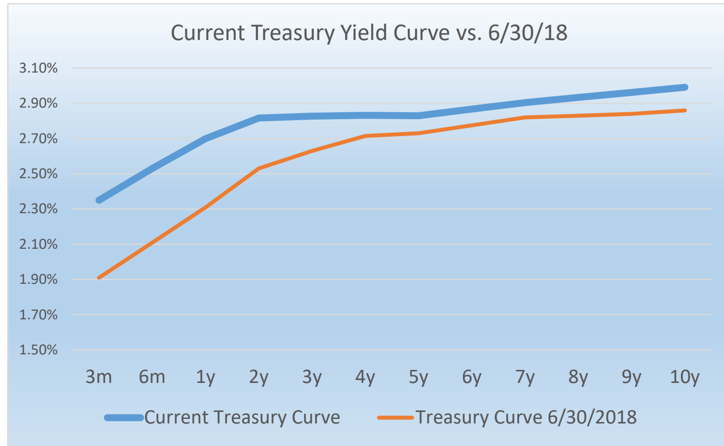
	Latest	Previous Month	Previous Year
Real GDP (qoq %)	3.50	3.50	3.20
Real GDP (yoy %)	3.00	3.00	2.30
Nominal GDP (yoy %)	5.50	5.50	4.10
Gov't Spending (qoq %)	2.60	3.30	0.70
Core Price Deflator (qoq %)	1.50	1.60	1.30
CPI (yoy %)	2.50	2.90	2.00
CPI (mom %)	0.30	0.20	0.10
CPI x-Food/Energy (yoy %)	2.10	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	59.30	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	135.70	135.30	126.20
Personal Income (yoy %)	4.30	4.00	4.60
Personal Income (mom %)	0.50	0.40	0.40
Trade Balance (USD bn)	-54.02	0.30	-0.10
Total Debt Outstanding(USD bn)	21702369.8	21516058	20442474

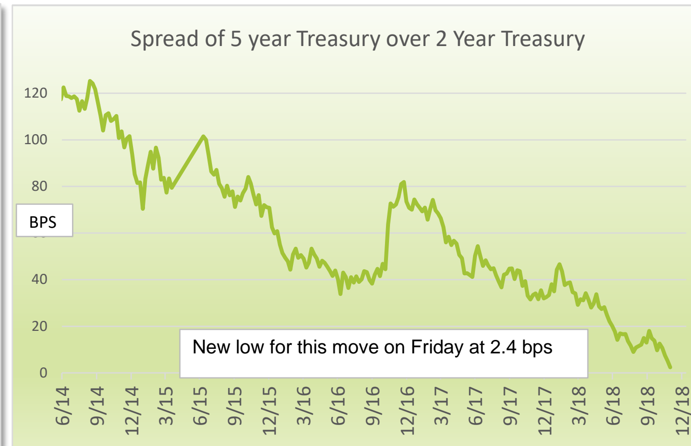
Other Sources: Bloomberg, L.P.

GOVERNMENT PORTFOLIO ADVISORS

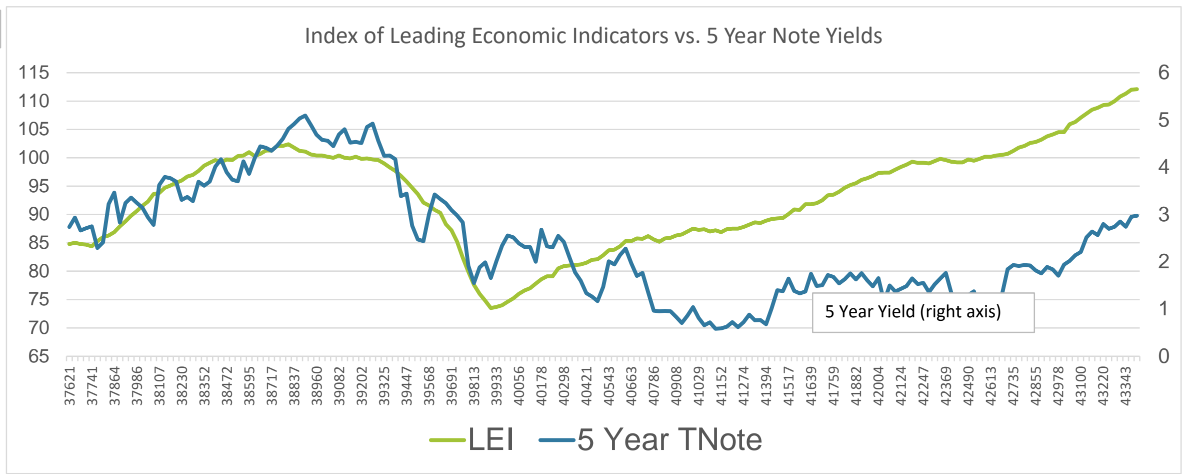
November 30, 2018

Selected Charts





Selected Chart:



Source: Bloomberg L.P.

Cons
near
duri

Other Sources: Bloomberg, L.P.

This page intentionally blank.

WEEKLY ECONOMIC COMMENTARY – WEEK OF November 30, 2018

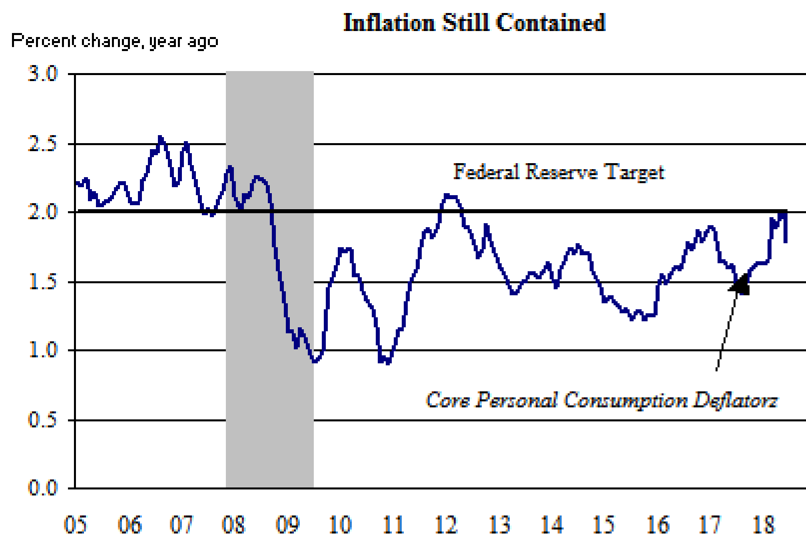
"Sticks and stones may break my bones, but …." Given the fusillade of words being bandied about recently, we wonder if the phrasing of that old adage should be rearranged. For sure, words spoken by key figures in the halls of power had a meaningful impact on the markets this week. The loudest, and most impactful, came from Fed Chair Jerome Powell on Wednesday. In an attention-getting speech at the New York Economic Club, Powell asserted that interest rates are just below neutral, i.e. the level that neither stimulates nor retards growth. His comments ignited a powerful rally in the stock market, as it conveyed the impression that the Fed was closer to the endgame in raising rates than had been perceived. Recall that in early October Powell gave just the opposite impression, noting in a speech that rates were still a long way from neutral.

Whether the Chairman is having second thoughts about the economic outlook or is merely attempting to walk back earlier comments that he regrets having made is really unanswerable. No doubt, the market's debilitating slide in October and over the first three weeks of November is linked in good part to investor anxiety over rising interest rates, which appears to be taking a toll on some sectors of the economy. To the extent that Powell's more dovish comment on Wednesday allays those fears, it also removes a heavy anchor that has weighed on stock prices. But the words of another powerful figure, president Trump, are also playing havoc with the market. Along with fears of rising rates, investors are deeply concerned about a budding trade war with China, and Trump's tweets and public comments have both assuaged and amplified those concerns depending on the day of the week. Going into the weekend, his words were soothing, hinting that some sort of deal may be in the works, which would postpone the planned increase in tariffs, from 10 percent to 25 percent, on $200 billion of Chinese goods scheduled for January. Presidents Trump and Xi will meet on Saturday, December 1, during the G20 summit so more information could be forthcoming on this important issue before trading gets underway on Monday. Fasten your seat belts if a rancorous post-meeting message hits the headlines.

Given the sensitivity of the economy to interest rates and trade policy, the erratic market response to unexpected verbal pronouncements by the Fed and president is understandable. What is somewhat perplexing is the exaggerated move in market prices to Powell's assertion that rates are just below neutral. From our lens, this pronouncement should have been self-evident. After all, at the September FOMC meeting, Fed officials had already estimated that neutrality would be in the range of 2.50-3.50 percent. At that policy meeting, the fed funds rate was raised to a range of 2.00 – 2.25 percent, which, by even a cursory assessment, puts it one more quarter-point hike away from the lower bound of that range. And at both the September and the November meetings, for which the minutes were released this week, Fed officials strongly intimated that a rate increase would be forthcoming at the upcoming December 18-19 meeting. If that transpires, which the markets are fully expecting, the "just below" phrase would be rendered moot.

That said, both Powell's recent speech and the minutes of the November meeting did suggest that the path of future rate increases would be more gradual than perceived over the spring and summer, when Fed officials appeared poised to raise rates beyond neutral to prevent an undesirable increase in inflation. No mention of that inclination occurred at the November meeting or in Powell's speech this week. Indeed, the tone appears to have shifted to reflect more concerns over headwinds that would retard the economy's growth than fears of higher inflation. We concur with that pivot in emphasis, as the long expansion is showing signs of fatigue. The wind has been taken out of the housing and auto sectors; capital spending is in the doldrums; global growth is slowing and fiscal stimulus from the tax cuts is fading. After posting a solid 3.5 percent growth rate in the July-September period, the economy is tracking a slower 2.0- 2.5 percent pace in the current quarter, with only consumers and the government providing fuel to the growth engine.

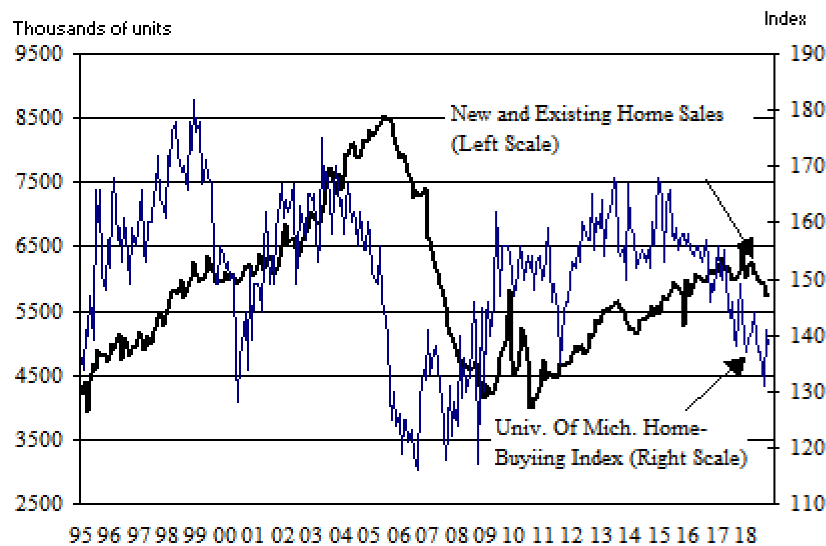
What's more, the Fed can hardly justify fears of an inflation outbreak in light of the recent softness in important inflation gauges. The latest, most striking, illustration came in this week's personal income and expenditure report, which also includes the key inflation indicator that the Fed monitors: the personal consumption deflator. After finally hitting the Fed's 2.0 percent annual inflation target in March for the first times in a decade, the core PCE deflator, which strips out volatile food and energy items, has consistently hovered within 0.1 percent of that mark over the next six months. However, this week's report showed that the annual inflation rate took a step back in October, posting a 1.8 percent increase. Indeed, the last three monthly price increases have been particularly tepid, yielding a 1.1 percent annualized increase. We have not seen a three month annualized advance this low since early 2017, when aggressive cell pricing wars were dragging down the inflation rate.



Source: Stone & McCarthy

The downdraft in the broad inflation measures, including the more widely-followed consumer price index, is baffling policy makers given the lowest unemployment rate in nearly half a century and rising wage pressures. At this juncture, they are not ready to concede that the inflation genie has been permanently bottled up, noting that the tightening labor market and still-solidly growing economy pose upside risks to inflation. Unless the economy slows more dramatically than expected, there is no compelling reason to believe that the recent bout of disinflation will be sustained. To be sure, the headline inflation rate, which held at the Fed's 2 percent target in October, is poised to downshift this month, owing mainly to the tumble in oil prices that is lowering prices at the pump. But as long as resource utilization continues to tighten, as it should if the economy grows above its 2 percent potential next year, upward pressure on wages and prices will be sustained and underpin a gradual increase in inflation.

The question is, is the economy heading for a more abrupt slowdown than is generally expected, which would undercut these prospective price pressures? Recent data have not been particularly reassuring. As noted, the housing market continues to struggle mightily, with new home sales falling like a stone. In October, they fell by an eye-opening 8.9 percent to the lowest level since March 2016. The latest slide was cushioned by modest upward revisions to the previous three months; but the trend in demand is clearly weakening, as prospective buyers are coping with higher mortgage rates and lofty home prices. Home buying plans have been on a steep downtrend, and builder sentiment eroded considerably last month. While the housing sector does not have as big of a direct influence on overall activity as it did a decade ago, it still has potent spillover effects that can weaken the broader economy. Home purchases, for example, influence an array of ancillary transactions, such as spending on durable goods, moving and financial services and employment in construction as well as related industries.



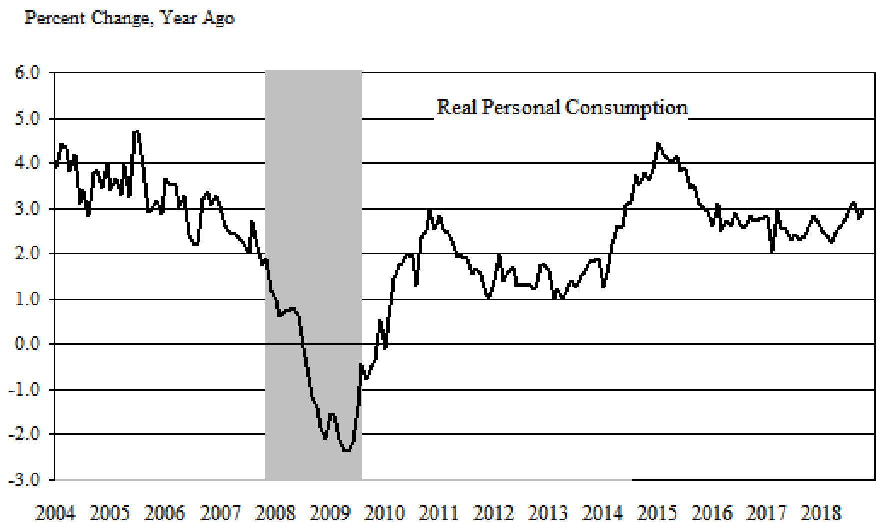
Source: Stone & McCarthy

A similar story describes the auto sector, which is under less duress than the housing industry but is nonetheless seeing its peak sales activity in the rear-view mirror. Like builders, auto manufacturers are coping with higher input costs from tariffs on steel and aluminum and weakening demand from buyers who are facing increased financing costs and more selective lending from banks. This industry strikes a more political chord than housing, which put the announced closing of several GM plants this week in the cross hairs of the Trump administration. Indeed, the layoffs associated with these closings may take on more meaning if the recent uptick in claims for unemployment benefits continues. The three

consecutive weekly increases in filings comes off historically low levels in October and may be related to the California fires more than a sign that demand for workers is weakening. Still, it lends an air of mystery to the upcoming employment report this Friday, which is generally expected to show another solid increase in payrolls.

Taken together, these sectoral weaknesses underscore our belief that the economy is moving onto a slower growth trajectory. But they are not severe – or broad – enough to move the growth needle down to near zero. That would be the case if the main growth driver, consumers, decided to go into hibernation, something that seems highly unlikely. Household confidence continues to hover near the highs for the business cycle and their mindset should remain upbeat as long as job and income prospects are improving. By all accounts, that confidence booster shows no sign of fading. Companies, both large and small, are reporting record numbers of unfilled jobs, workers are quitting at a record pace to obtain better positions and wage growth is finally picking up.

This week's aforementioned personal income and spending report highlights the positive thrust still coming from the consumer sector. In October, both sides of the household ledger showed solid gains. Personal income staged a respectable 0.5 percent increase, the strongest since January, and personal consumption advanced by an even more impressive 0.6 percent during the month. Importantly, most of the spending increase was real, as the inflation-adjusted gain hit a seven-month high of 0.4 percent. If not for the inflation-boost provided by higher gasoline prices, the real gain would have been even larger. With the October oil price increase fully reversed, and then some, in November, the purchasing power of households will get a corresponding lift, which should contribute to the real gain in consumption month.



Source: Stone & McCarthy

Simply put, households are in good shape to power the economy through the headwinds this quarter and sustain growth at a respectable pace of just under 2.5 percent. Depending on how many workers on the sidelines can be drawn into the labor force, that should be strong enough to drive the unemployment rate further below the already-low 3.7 percent. No doubt, some Fed officials will grow alarmed that the ever-tightening labor force will spur accelerating wage growth, tilting them to a more hawkish policy stance. However, the recent tame inflation readings should give the Fed cover to allow the job market – and even the economy – to run hotter than otherwise. Against that backdrop and the more dovish tone recently sounded by Fed officials, we have dialed back our expectations of the number of rate hikes expected next year from three to two.

Significantly, the bond market appears to be fully on board with that scaled-back assessment. As recently as three weeks ago, the bellwether 10-year Treasury note was flirting with a 3.25 percent yield, the highest in more than seven years, reinforcing the steep decline in stock prices that was still underway. On Friday, the yield had fallen back to just above 3.0 percent, reflecting lower inflation expectations and worries about an economic slowdown. That setback contributed to the rally in stock prices this week and could be good news for the economy if sustained, as it portends lower mortgage rates. The bad news is that it moves the yield curve closer to the dreaded inversion, which is a time-honored precursor of recessions. There is still a gap of about 20 basis points between the10- year and 2-year yield, but the narrowing spread is no doubt being closely monitored by the Fed along with inflation and other indicators as inputs to its upcoming decisions on rate hikes.

Source: Stone & McCarthy

DISCLAIMER: This communication contains views and opinions of Government Portfolio Advisors LLC and has been prepared solely for informational purposes for institutional clients. The material has been prepared by the individual authors and is intended only to provide observations and views of the individual authors and may not necessarily reflect those of Government Portfolio Advisors LLC. Sources for this commentary include Bloomberg and Stone McCarthy Research Associates. Observations and views expressed herein may be changed by the individual authors at any time without notice. It is not an offer, recommendation or solicitation to buy or sell, nor is it an official confirmation of terms. It is based on information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete or that any returns indicated will be achieved. Changes to assumptions may have a material impact on any returns detailed. Past performance is not indicative of future returns. Price and availability are subject to change without notice. Additional information is available upon request.