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 9, 2018

Financial Indicators

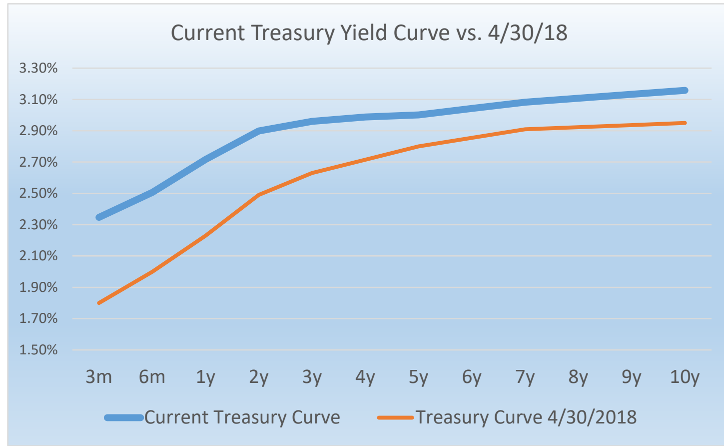
Interest Rates	Latest	Previous Month	Previous Year
Fed Funds - Upper Boundary	2.250	2.250	1.250
3-Month Tbill	2.300	2.211	1.242
6-Month Tbill	2.450	2.400	1.386
3-Month Libor	2.614	2.408	1.158
2-Year T Note	2.901	2.813	1.685
5-Year T Note	3.002	2.952	2.032
10-Year T Note	3.159	3.064	2.323
30-Year T Note	3.377	3.218	2.765
1-5 Year AAA-AA Corporate Benchmark	3.400	3.230	2.110
1-5 Year Agency Bullet Benchmark	2.990	2.850	1.750
Spread=	0.410	0.380	0.360
Tax-Exempt Revenue Bonds(AAA)			
5- Year	2.334	2.228	1.548
10-Year	2.761	2.618	2.017
30-Year	3.450	3.265	2.762
Mortgages			
30-Year Fixed Mortgage Rate	4.820	4.690	3.780
15-Year Fixed Mortgage Rate	4.130	3.930	3.120
5/1-Year ARM	4.470	4.330	3.390
Stock Market			
Dow Jones Industrials	25,510.30	26,773.94	23,271.28
S&P 500	2,747.38	2,923.43	2,564.62
NASDAQ Composite	7,319.09	7,999.55	6,706.21
Commodities			
Gold($ per troy ounce)	1,203.55	1,203.32	1,278.14
Oil($ per barrel) - Crude Futures(WTI)	57.55	75.23	55.33
USD Currency Index	97.23	95.51	93.81

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 %)	2.30	2.90	2.00
CPI (mom %)	0.10	0.20	0.10
CPI x-Food/Energy (yoy %)	2.20	2.40	1.80
CPI x-Food/Energy (mom %)	0.10	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 %)	5.14	3.80	2.65
Industrial Production (mom %)	0.25	0.62	1.54
Capacity Utilization	78.11	77.99	76.76
Durable Goods Orders (yoy %)	6.40	10.30	2.90
Durable Goods Orders (mom %)	0.70	-0.40	-4.10
ISM Manufacturing Index	57.70	59.80	58.50
Composite PMI	54.90	53.90	55.20
Conference Board Leading Ind.	111.80	109.50	105.90
Housing Starts	1201.00	1350.00	1265.00
Retail Sales (mom %)	0.10	0.50	0.60
Retail Sales (yoy %)	4.70	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.

Selected Charts



Selected Chart:

Ratio of inventories to sales. Worsening into 2016 nearly, but not fully, erased. Direction implies no let up in growth however.

Source: Bloomberg L.P.

Other Sources: Bloomberg, L.P.

This page intentionally blank.

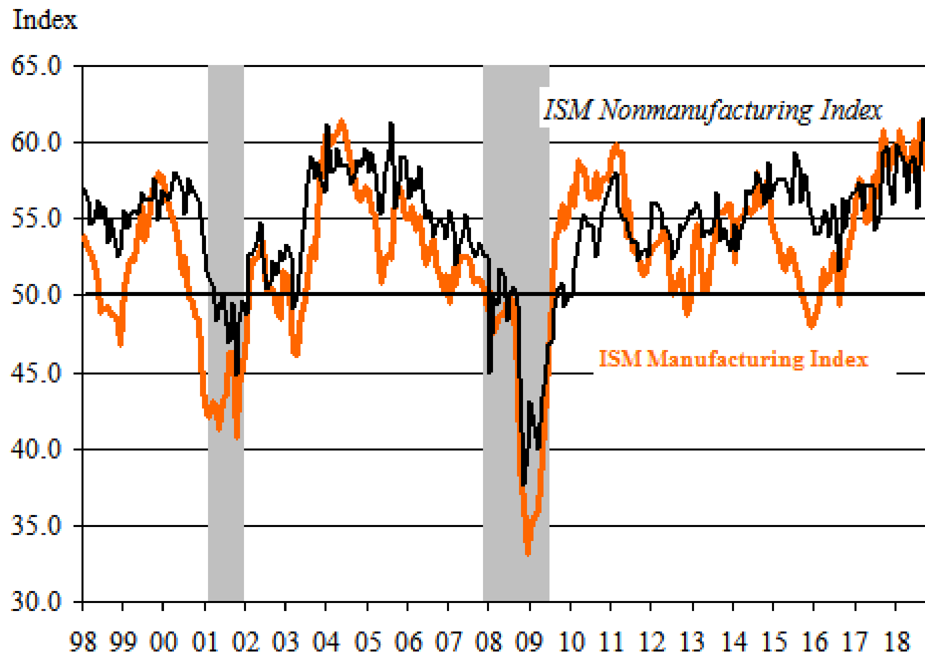
WEEKLY ECONOMIC COMMENTARY – WEEK OF November 13, 2018

Investors welcomed back gridlock with open arms. Thanks to a powerful post-election rally that built on the gains leading up to the election, the Dow Jones Industrial average has clawed back almost 65 percent of the outsized losses incurred in October. Even with Friday's modest setback, the Dow stood only about 3.0 percent below its October 3 record high by the end of the week. It seems that participants are pleased with the prospect that sweeping legislative changes will not be forthcoming in the near future, as a divided and highly polarized Congress should put the kibosh on bold policy initiatives pushed by either Democrats or Republicans. With a Goldilocks economy unfolding, investors are understandably loath to have anything rock the boat, something that Washington is fully equipped to deliver with untimely meddling.

To be sure, investors may rescind that optimism in coming months if a highly divisive political climate results in heated battles over the budget, trade policies, immigration and, most notably, the Mueller investigation, all of which sets the stage for heightened uncertainty and market turmoil. A combustible press conference followed by the forced resignation of Attorney General Jeff Sessions signals that the second half of President Trump's first term is not starting on a tranquil note. With regards to the abrupt, but not unexpected, departure of Sessions, it is becoming clear that Trump wished the Federal Reserve Chairman would follow him out the door. The president has been a vocal critic of the Fed's recent rate hikes, which he fears will undermine the economy's sterling performance this year.

But despite Trump's tirade against Chairman Powell, the Fed is poised to pull the rate trigger again next month. At this week's policy meeting Fed officials affirmed the upbeat message conveyed at the previous meeting held in September. As expected, they kept the federal funds rate unchanged at its target range of 2.0 %-2.25% in keeping with the practice of raising rates only once a quarter. But they noted that the economy remains strong, powered by solid consumer spending and continued strengthening in the labor market, while inflation remains near the Fed's 2 percent target. The only downbeat note was the reference to capital spending, which has moderated from earlier in the year. Overall, the policy makers see these trends continuing into next year, which sets the stage for further gradual rate increases. Following next month's expected increase, the Fed plans to raise rates three more times in 2019.

Still Strong But Moderating Growth



Source: Stone & McCarthy

We concur with that prospect. The economy, while slowing from this year's estimated 3.0 percent pace, will still be growing above its potential growth rate for most of next year and sowing the seeds for higher inflation. The Fed has been sounding a more hawkish tone recently as the jobless rate has continued to fall below the level it views as consistent with stable inflation. That view has been corroborated by a pickup in wage growth, which surpassed 3.0 percent year-over-year in October for the first time since the start of the recovery in 2009. According to numerous other indicators, labor cost pressures are building. That's particularly the case with small businesses, where a record-high 34 percent planned to increase worker compensation in September.

The reason for the upward wage pressure is not hard to understand. With job growth exceeding the increase in the working-age population by a considerable margin, companies are competing more vigorously for a shrinking pool of available workers. That trend is starkly revealed in the Labor Department's latest JOLT's report, which showed that job openings continued to exceed the number of people actively searching for a job for the seventh consecutive month in September. The growing scarcity of labor has become the biggest complaint of businesses, both small and

large, stoking the bigger wage increases that companies are forced to pay to attract and retain workers. Indeed, retaining workers has become increasingly difficult, as the quit rate has risen to the highest level since records began.

Source: Stone & McCarthy

No doubt, worker shortages became an even bigger issue in October, when job growth surged to 250 thousand, well above expectations. As a result, companies had to dig deeper into the population to extract workers from outside the labor force, lifting the labor force participation rate. Just how deep is the pool of potential workers on the sidelines remains a source of considerable debate. The greater the supply, the more slack there is in the labor market, which suggests that above-trend growth in jobs would exert less upward pressure on wages than otherwise. Another factor to consider is the ability of companies to pass on higher labor costs to customers.

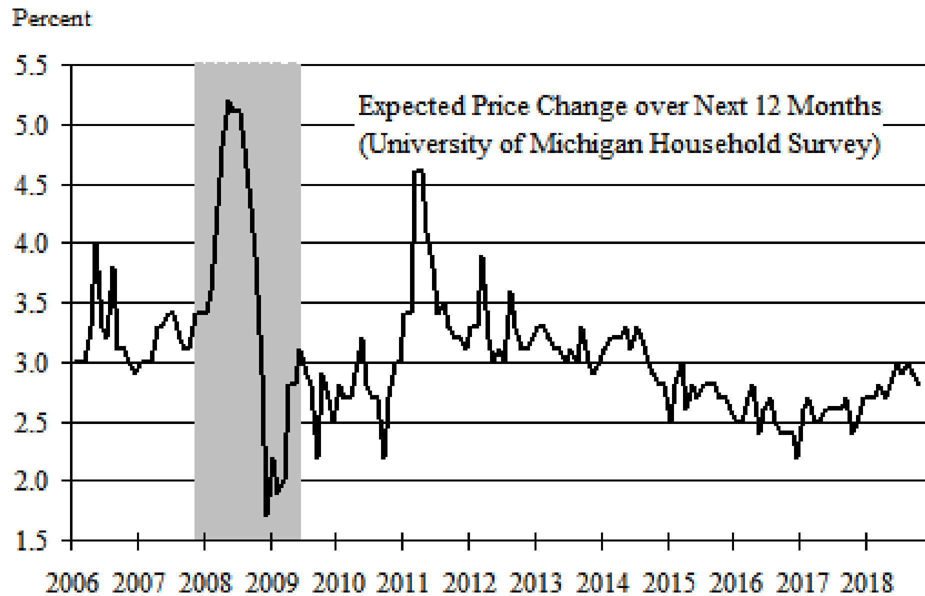
Importantly, that linkage between labor costs and inflation has not been seriously tested since the pickup in wage growth got underway. One reason is that worker productivity has also increased over the past year, more than offsetting the increase in labor compensation. As a result, the increase in unit labor costs for nonfarm companies actually slowed to 1.5 percent in the third quarter from 2.5 percent a year earlier. That slowdown may at least partially explain why inflation has actually eased in recent months, despite mounting concerns over accelerated wage growth. The question is, can productivity growth continue to strengthen and justify steeper wage increases?

At best, the jury is still out on that question. Recall that the administration hailed the tax cuts enacted last year as a powerful incentive for companies to step up capital spending, which is a necessary spur to increased productivity. For a while, it appeared that tax reform did catalyze firms into spending more on plants and equipment. Nonresidential outlays surged by 11.5 percent in the first quarter, the strongest quarterly increase in six years. The pace slowed in the second quarter, but to a still formidable 8.7 percent. Amid strong profits and elevated optimism among business leaders, the capital spending outlook looked promising. However, things quickly turned sour during the late summer months. In the third quarter, fixed investment spending screeched to a virtual halt, showing a slim 0.8 percent gain. Outlays on structures actually fell by 7.9 percent, dragged down by weakness in energy-related spending.

Now the outlook is much more subdued. Orders for core capital goods declined in both August and September according to the latest monthly reports, and prospects for a rebound in energy-related spending look grim owing to the surprising slump in oil prices, which are down more than 20 percent from nearby peaks. Odds are, capital spending will show modest gains outside of the energy sector in the fourth quarter, but the positive impact from the tax cuts is fading and trade tensions with China may well prompt companies to put investment plans on hold. There may still be a long-awaited boost to productivity coming from technological advances in recent years, particularly as companies increasingly leverage artificial intelligence to generate output. But recent data undercut the hope that companies will be meaningfully stepping up spending on productivity-enhancing capital goods.

Keep in mind too that as the labor force continues to tighten amid strong job growth, companies will be hiring less-skilled workers to fill openings, which does not bode well for the productivity outlook over the near term. That said, sluggish productivity growth does not necessarily mean that rising labor cost pressures will stoke an inflation breakout. For one, companies would stiffen their resistance to granting larger wage increases, since the revenues from stronger productivity would no longer be available to justify the increases. Indeed, many labor experts blame the lackluster pace of productivity growth over the last decade as the main reason wage growth has been stagnant until the recent pickup. For another, it is unlikely that companies will have the pricing power to pass through a steep increase in labor costs to their customers. The confluence of events that facilitated the modest pickup in inflation this year – strong fiscal stimulus, robust economic growth and favorable financial conditions – is poised to fade.

Barring an unexpected second round of tax cuts or the passage of a big infrastructure spending bill, this year's fiscal boost will morph into a modest drag in 2019. That, together with capacity restraints, softer global growth and an export-retarding strong dollar will contribute to slower growth that is already underway in the U.S. At the same time, the accommodative monetary policy that has underscored the favorable financial environment for business and household borrowers is in the process of being removed as the Fed sustains its gradual rate-hiking policy stance. No doubt, fears that the Fed will go too far and choke off the expansion will persist, particularly as the job market continues to tighten. However, we doubt that wage growth will accelerate much beyond 3.0 percent next year or that inflation is poised for a breakout, not only for the reasons already cited but also because inflation expectations remain well anchored. The Fed will likely continue to gently press on the monetary brakes to keep expectations in check and as insurance against higher inflation, but its actions should not derail the expansion as much as ruffle the president's feathers next year.



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.