GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update

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December 14, 2018

Financial Indicators

Interest Rates	Latest	Previous Month	Previous Year
Fed Funds - Upper Boundary	2.250	2.250	1.250
3-Month Tbill	2.358	2.355	1.328
6-Month Tbill	2.475	2.513	1.482
3-Month Libor	2.801	2.601	1.574
2-Year T Note	2.715	2.959	1.829
5-Year T Note	2.711	3.080	2.173
10-Year T Note	2.872	3.236	2.402
30-Year T Note	3.126	3.442	2.777
1-5 Year AAA-AA Corporate Benchmark	3.340	3.360	2.260
1-5 Year Agency Bullet Benchmark	2.790	2.920	1.920
Spread=	0.550	0.440	0.340

Tax-Exempt Revenue Bonds(AAA)	Latest	Previous Month	Previous Year
5- Year	2.054	2.356	1.682
10-Year	2.435	2.790	2.077
30-Year	3.202	3.476	2.748

Mortgages	Latest	Previous Month	Previous Year
30-Year Fixed Mortgage Rate	4.570	4.800	3.870
15-Year Fixed Mortgage Rate	3.920	4.130	3.170
5/1-Year ARM	4.110	4.460	3.590

Stock Market	Latest	Previous Month	Previous Year
Dow Jones Industrials	24,067.10	26,180.30	24,504.80
S&P 500	2,591.38	2,813.89	2,664.11
NASDAQ Composite	6,922.91	7,570.75	6,862.32

Commodities	Latest	Previous Month	Previous Year
Gold($ per troy ounce)	1,242.68	1,226.49	1,244.49
Oil($ per barrel) - Crude Futures(WTI)	50.61	61.67	57.14
USD Currency Index	97.22	96.00	94.10

Economic Indicators

	Latest	Previous Month	Previous Year
Real GDP (qoq %)	3.50	3.50	2.30
Real GDP (yoy %)	3.00	3.00	2.30
Nominal GDP (yoy %)	5.50	5.50	4.10
Gov't Spending (qoq %)	2.60	2.60	0.70
Core Price Deflator (qoq %)	1.50	1.50	1.30
CPI (yoy %)	2.20	2.90	2.20
CPI (mom %)	0.00	0.20	0.30
CPI x-Food/Energy (yoy %)	2.20	2.40	1.70
CPI x-Food/Energy (mom %)	0.20	0.20	0.10
Unemployment Rate	3.70	3.70	4.10
U6 Underemployment Rate	7.60	7.50	8.00
NonFarm Payrolls (mom chng, '000)	155.00	119.00	216.00
Average Hourly Earnings (yoy %)	3.20	2.80	2.30
Average Hourly Earnings (mom %)	0.30	0.30	0.20
Industrial Production (yoy %)	3.89	5.60	3.40
Industrial Production (mom %)	0.61	0.15	0.51
Capacity Utilization	78.48	77.99	77.07
Durable Goods Orders (yoy %)	7.80	10.30	8.90
Durable Goods Orders (mom %)	-4.30	-0.40	2.20
ISM Manufacturing Index	59.30	59.80	58.20
Composite PMI	53.60	53.90	54.50
Conference Board Leading Ind.	112.10	109.50	106.30
Housing Starts	1228.00	1350.00	1303.00
Retail Sales (mom %)	0.20	0.50	0.70
Retail Sales (yoy %)	4.20	6.60	6.10
Consumer Confidence	135.70	135.30	128.60
Personal Income (yoy %)	4.30	4.00	4.60
Personal Income (mom %)	0.50	0.40	0.30
Trade Balance (USD bn)	-55.49	0.30	0.20
Total Debt Outstanding(USD bn)	21850093.9	21516058	20590391.8

Other Sources: Bloomberg, L.P.

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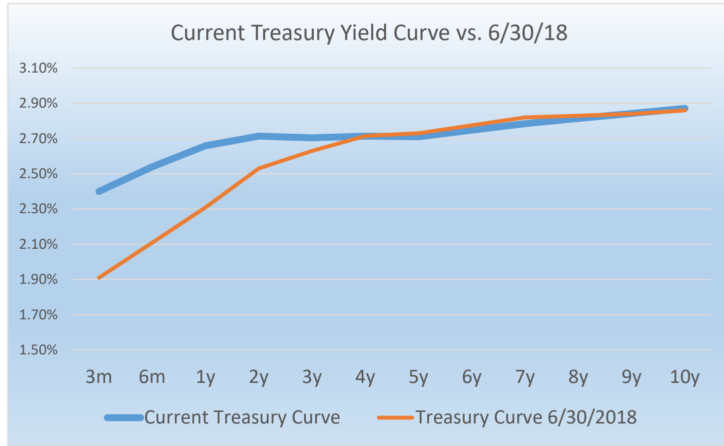
Selected Charts



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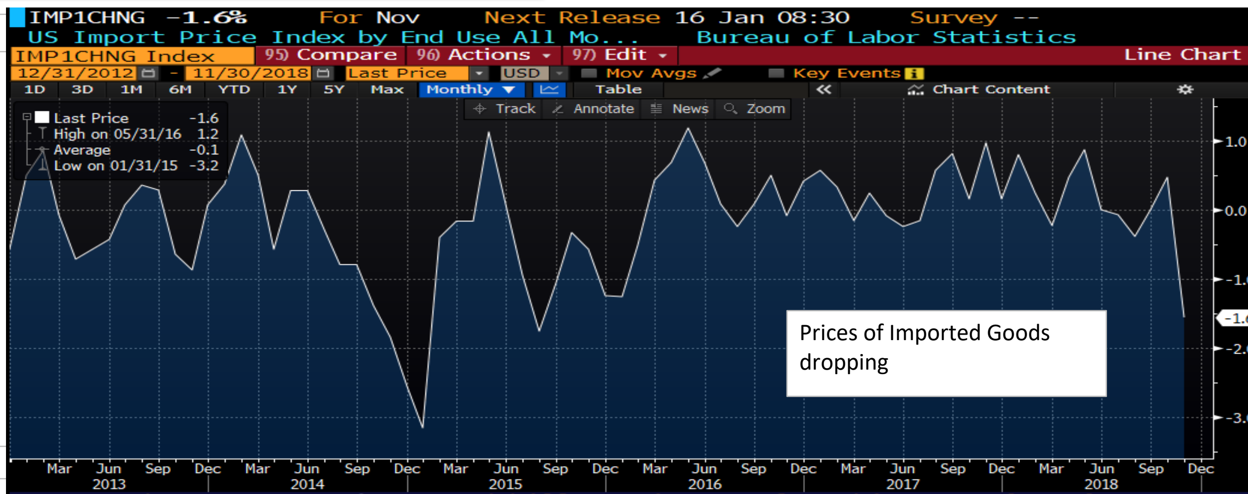

Source: Bloomberg L.P.

Other Sources: Bloomberg, L.P.

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WEEKLY ECONOMIC COMMENTARY – WEEK OF December 14, 2018

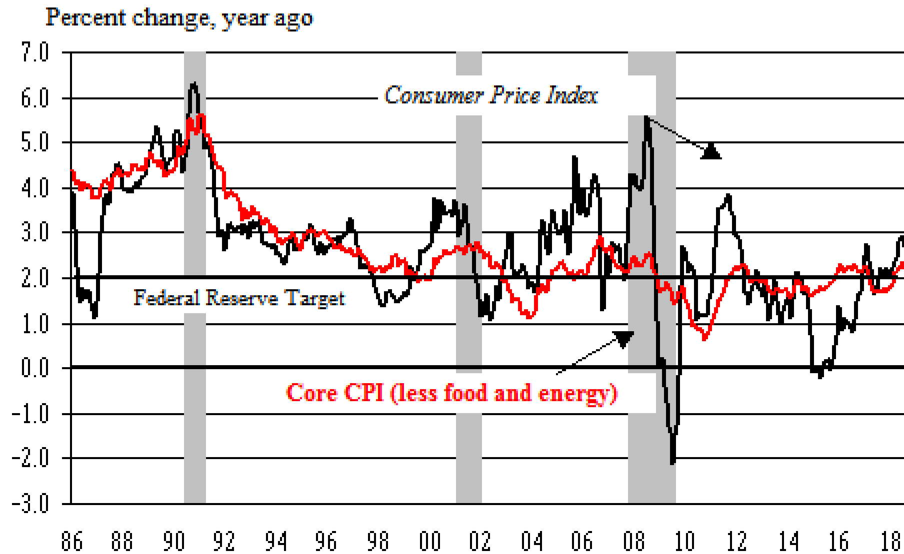
If the Fed needs an excuse to skip the much-anticipated rate hike at the December 18-19 policy meeting, it could probably find something among the batch of recent data and events. After all, job growth slowed in November, key inflation gauges eased in October and November, housing activity is languishing and business investment spending is stagnant. Add to this mix of downbeat data the ongoing turmoil in the financial markets, a flattening yield curve, slowing global growth, a heated trade dispute with China and a Duke University survey revealing that 50 percent of CFOs expect a recession in 2019, and the Fed could find enough reasons to justify a pause in its rate-hiking campaign. In fact, some economists believe that there would be little harm if the Fed waited another six weeks until the January meeting to see how things play out.

To be sure, the prospect of a rate increase at the December meeting is no longer as near a certainty as it was a few months ago, thanks to the aforementioned array of influences. Keep in mind too that just two days after the FOMC meeting, the government could partially shut down if President Trump and Congress can't agree on seven appropriations bills by December 21. The likelihood of such an event increased this week following a rancorous meeting between the president and Democrat leaders Nancy Pelosi and Charles Schumer, in which Trump asserted that he would be proud to shut down the government for the sake of border security. Starkly put, he wants funding for the wall but is meeting stiff resistance from the Democrats. The potential market-shaking impact of a partial shutdown adds another layer of gloom for investors hoping that a Santa rally would lift stock prices into positive territory by the end of the year.

From our lens, a rate increase at the upcoming policy meeting is still an odds-on bet unless some unexpected shock over the next few days causes the Fed to blink. For one, standing pat risks sending the wrong signal to the financial markets, implying that the Fed sees more weakness in the economy than is evident in the data. That, in turn, could amplify recession fears expressed by corporate leaders, resulting in a self-fulfilling prophecy. Corporations could decide to cut back hiring as well as spending plans, having spillover effects on household confidence and consumption. For another, it might give the impression that Chairman Powell is caving in to political pressure, highlighted by Trump's harsh criticism of the Fed for raising rates "every time something good happens". Any hint that the Fed's independence is being compromised weakens its credibility as an inflation-fighting force, which could wreak even more havoc on the financial markets.

Most important, the economic backdrop fully justifies another rate increase, notwithstanding the soft spots in recent data. Yes, key inflation measures have eased, with the annual increase in the core personal consumption deflator falling below the Fed's 2 percent target in October; what's more this week's consumer price report showed that headline inflation remained unchanged from October to November. But the stagnant headline reading was held back by plummeting oil prices, which continued to fall through the first two weeks of December. The annual increase in the core CPI, which excludes volatile food and energy items and is a better barometer of underlying inflation trends, actually ticked up to 2.2 percent from 2.1 percent in October.

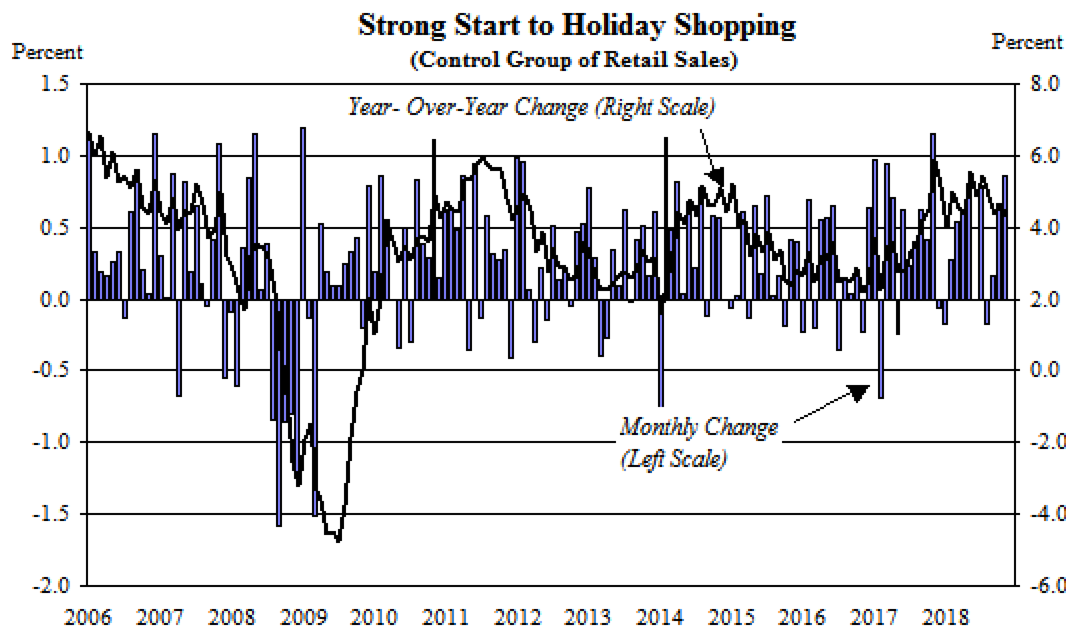
Inflation Still Tame But Rising



The uptick in the core CPI better reflects underlying fundamentals, which point to modestly stronger inflationary pressures in coming months. The economy is on track to slow this quarter, but growth is still outpacing the increase in output capacity, bolstering the ability of companies to charge higher prices. Nearly 30 percent of small businesses plan to increase prices over the next three months, the highest share in more than ten years. Importantly, they are under pressure to do so owing to rising input costs, reflecting in part higher tariffs. Meanwhile, constraints on labor supply are putting upward pressure on wages. While headline job growth slowed in November, the 155 thousand gain in nonfarm payrolls still outpaced the organic increase in the labor force. Only an increase in the labor force participation rate prevented the unemployment rate from falling further below its 50-year low of 3.7 percent. The increased bargaining power of workers along with the strengthening pricing power of businesses justify the Fed's efforts to continue leaning against rising inflationary pressures, at least until the economy shows tangible signs of slowing.

But a key report on Friday indicates that the main cylinder in the economy's growth engine continues to power ahead at a breakneck pace. In particular, household spending is poised to exceed even the most optimistic expectation during the holiday shopping season. On the surface, that assertion appears to be a wild exaggeration. Total retail sales in November increased by a modest 0.2 percent, which is hardly anything to write home about. But even that modest gain exceeded the consensus expectation of a 0.1 percent increase. What's more, the previous month's increase was revised up from an original estimate of a strong 0.8 percent to an eye-opening 1.1 percent spike. Still, even those headline readings fail to accurately describe the underlying strength of retail sales.

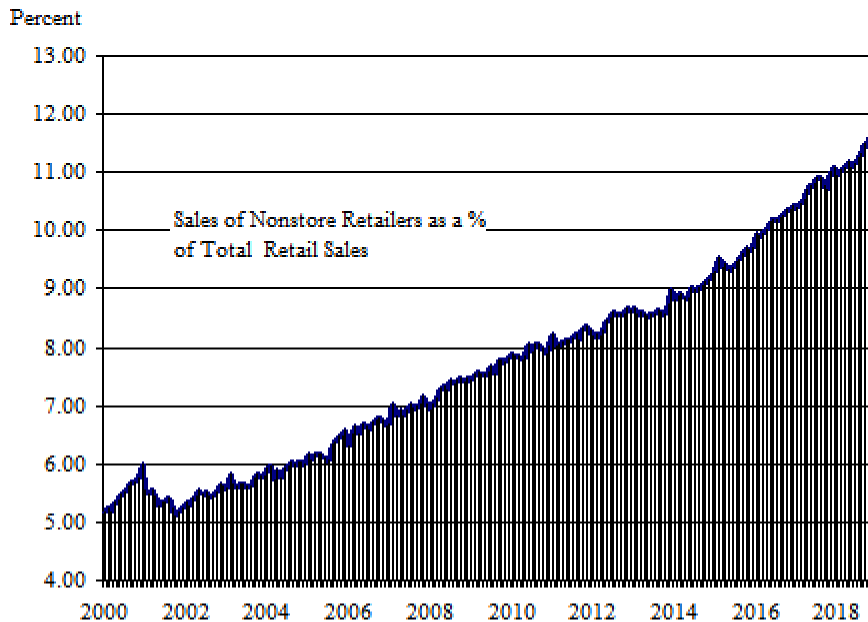
In both months swings in gasoline prices – up in October and down in November – had a big influence on the overall retail sales figures. Also, auto sales, which account for about one-fifth of all retail sales, experienced more than the usual amount of volatility, reflecting hurricane effects on demand. Focusing on the group of sales that feeds directly into personal consumption expenditures in the GDP accounts, the underlying picture of strength is clearly drawn. In November, this category increased by a sturdy 0.9 percent, the strongest in a year. What's more, the October increase was revised up from 0.3 percent to 0.7 percent. You would have to go back to March/April of 2017 to find comparable back-to-back monthly gains. Clearly, consumers are in a festive buying mood, buoyed by a strong job market, fatter paychecks and improved balance sheets. If there is one fly in the ointment, it is that this year's holiday sales have an exceptional precedent to live up to, as last year's shopping season was particularly robust. Sales are unlikely to measure up to the 5.3 percent surge last year, but it is still tracking a solid 4.6 percent gain.



If that pace holds up through December, consumer spending would impart a significant boost to the economy's growth rate in the fourth quarter. With data for October and November in hand, economists have been marking up their outlook for the period. A week ago, the widely followed Federal Reserve Bank of Atlanta's GDPNow model saw GDP increasing at an annual rate of 2.4 percent. Following Friday's retail sales report, that estimate was bumped up to 3.0 percent. We are not as optimistic as the Atlanta Fed, but are also on board with a stronger near-term outlook, raising our fourth quarter growth estimate a fraction to 2.7 percent. Interestingly, the main drag on headline retail sales in November – the sizeable

decline in gas station sales – is having a positive influence on real personal consumption. That's because the price-driven weaker sales at the pump is giving households extra cash to spend elsewhere.

Not surprisingly, the main beneficiaries of the savings from lower gas prices are online retailers, where sales jumped by 2.3 percent. Indeed, the $1.35 billion increase in online sales last month accounted for nearly 70 percent of the increase in all retail sales outside of autos and gasoline. That's an outsized contribution from a sector that accounts for only 16 percent of these sales. It also extends a relentless trend underway since Internet shopping became more of a ubiquitous habit for at-home shoppers seeking better and more convenient deals on the Internet. Following November's increase, nonstore sales accounted for 11.68 percent of total retail sales and are biting off about 1 percent more each year. The flip side of this trend, of course, is that it is taking a serious toll on brick and mortar establishments, resulting in massive layoffs in the retail sector and excess capacity at shopping centers and malls.



Clearly, consumers have been doing most of the heavy lifting in propping up the economy's growth rate this year. But its muscular contribution is poised to fade, as the tailwinds that propelled it forward will be less powerful in 2019. The tax cuts that swelled bank accounts at the start of 2018

have already found their way into the spending stream. Hence, households will calibrate their purchases more in line with income growth, which is expected to slow along with the growth in jobs in 2019. Meanwhile, consumers will be facing more daunting headwinds. Higher interest rates on mortgages and consumer loans should put a crimp on housing-related purchases as well as auto sales, which are already meeting tougher lending standards. And, while balance sheets are in good shape, that's largely because of the astonishing appreciation in asset prices over the past decade that has made many households vulnerable to a sharp correction in the stock market. In the aggregate, equity holdings as a share of financial assets held by households are only a tad under the peak level that prevailed at the height of the dot.com bubble in 2000.

To be sure, consumers are not expected to go into hibernation. Confidence remains elevated and the labor market continues to generate more job openings than applicants. Consumption gains will slow next year, but to a pace that should keep the economy growing at a decent rate unless dragged down by other forces. The languishing housing market has been a big disappointment this year, held back by a lack of inventory, surging home prices, higher mortgage rates and the shortage of labor and land for developers to build on. But some of these impediments are easing, which, together with favorable demographics, should breathe new life into the housing recovery next year. The surprising weakness in business investment spending since the spring has also put a crimp in the economy's growth. But profits remain strong and the imperative to strengthen productivity to compensate for worker shortages and offset increasing labor costs should bring about some revival in capital spending next year.

That said, there are clearly more question marks as the calendar turns to 2019 than was the case at the start of this year, when fiscal stimulus was a powerful growth catalyst and monetary policy was still accommodative. These tailwinds are fading even as the headwinds from trade tensions and political dysfunction are mounting. The murkier backdrop is not likely to derail the Fed's expected rate hike at the upcoming meeting, but it is undoubtedly curbing its perception, present at the September meeting, that three more increases will be needed next year. We expect a more cautious approach to emerge from this meeting, with the number of rate hikes scaled back to two, which would be consistent with our own thinking.

Source: Stone & McCarthy

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