GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update

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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

GPA GOVERNMENT PORTFOLIO ADVISORS

December 7, 2018

Financial Indicators

Interest Rates	Latest	Previous Month	Previous Year
Fed Funds - Upper Boundary	2.250	2.250	1.250
3-Month Tbill	2.333	2.355	1.297
6-Month Tbill	2.470	2.513	1.480
3-Month Libor	2.771	2.601	1.515
2-Year T Note	2.689	2.959	1.820
5-Year T Note	2.676	3.080	2.144
10-Year T Note	2.831	3.236	2.352
30-Year T Note	3.111	3.442	2.732
1-5 Year AAA-AA Corporate Benchmark	3.330	3.420	2.270
1-5 Year Agency Bullet Benchmark	2.770	3.000	1.920
Spread=	0.560	0.420	0.350

Tax-Exempt Revenue Bonds(AAA)			
5- Year	2.058	2.356	1.696
10-Year	2.411	2.790	2.041
30-Year	3.134	3.476	2.673

Mortgages			
30-Year Fixed Mortgage Rate	4.590	4.800	3.830
15-Year Fixed Mortgage Rate	3.940	4.130	3.180
5/1-Year ARM	4.100	4.460	3.570

Stock Market			
Dow Jones Industrials	23,919.86	26,180.30	24,180.64
S&P 500	2,588.26	2,813.89	2,629.57
NASDAQ Composite	6,891.12	7,570.75	6,762.21

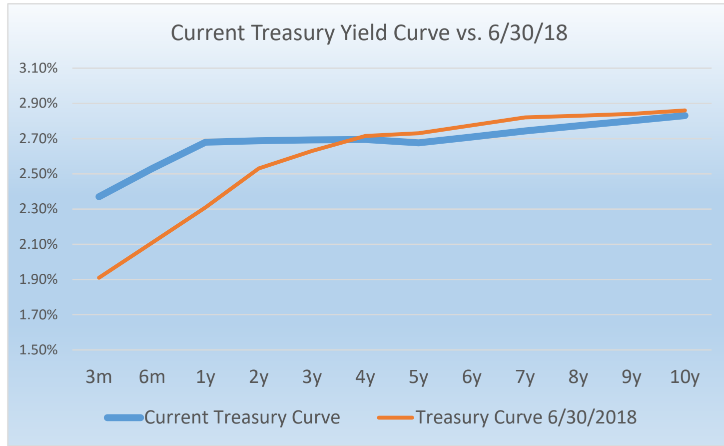
Commodities			
Gold($ per troy ounce)	1,246.89	1,226.49	1,265.77
Oil($ per barrel) - Crude Futures(WTI)	51.60	61.67	57.62
USD Currency Index	97.10	96.00	93.38

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 %)	3.30	2.60	0.70
Core Price Deflator (qoq %)	1.60	1.50	1.30
CPI (yoy %)	2.90	2.90	2.20
CPI (mom %)	0.20	0.20	0.30
CPI x-Food/Energy (yoy %)	2.40	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 %)	7.80	5.60	3.40
Industrial Production (mom %)	0.10	0.15	0.51
Capacity Utilization	78.39	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	54.70	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 %)	0.80	0.50	0.70
Retail Sales (yoy %)	4.60	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)	0.30	0.30	0.20
Total Debt Outstanding(USD bn)	21850093.9	21516058	20590391.8

Other Sources: Bloomberg, L.P.

Selected Charts



Selected Chart:

Source: Bloomberg L.P.

Other Sources: Bloomberg, L.P.

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WEEKLY ECONOMIC COMMENTARY – WEEK OF December 7, 2018

A Santa rally is being derailed by escalating fears of a trade war with China and a global growth slowdown. Stock investors ran for the hills this week, sending prices sharply lower amid heightened volatility.

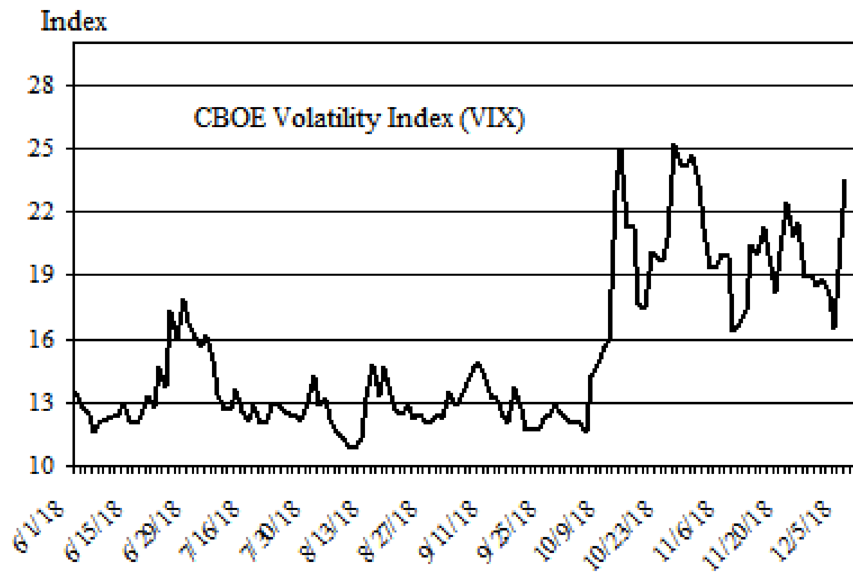
The wild gyrations in the financial markets belie the steady drumbeat of consistency in the economy. Growth is slowing as expected, raising hopes that the Fed is successfully engineering a soft landing, but not falling off a cliff. Manufacturing activity is holding up well amid trade tensions and the service sector is still thriving.

Importantly, the most tangible barometer of the economy's performance, the job market, remains on a healthy path. The increase in nonfarm payrolls came in weaker than expected in November but was still solid and exceeded growth in the working-age population. Growth in worker earnings held steady at cycle highs, and more of the benefits are trickling down to lower-paying jobs.

The financial markets are pricing in lower odds of future rate hikes, but the Fed is still expected to raise short-term rates at the upcoming meeting on December 18-19.

The Santa rally, if it comes, might have to wait until the trade Grinch leaves town. So far, it shows no sign of departing and the door may not open for as long as 90 days, which is the deadline for negotiating an exit strategy agreed to last weekend. That makes for an interesting, and potentially explosive, month of March, when the possibility that two "no deals" involving Brexit and a U.S/China trade accord could potentially blow up the place. If it takes that long for a deal to be worked out, be prepared for a rocky ride in the financial markets as twists and turns in negotiations will light up the twitter feed and hammer investor psychology. We always knew the Ides of March would come back to haunt us.

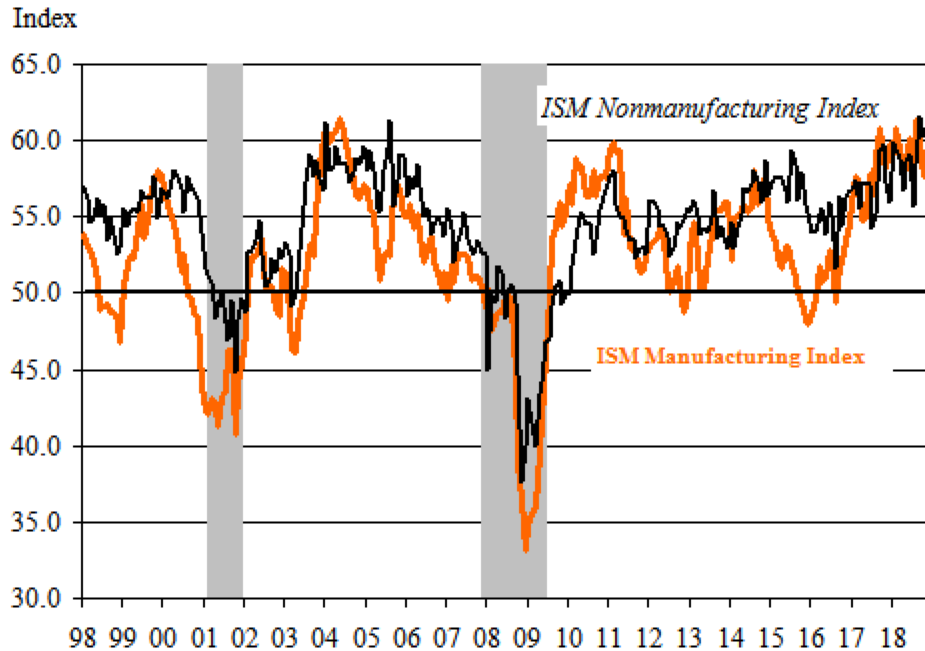
To be sure, the markets have not been a model of tranquility in recent months. Since October 10, two weeks after the Trump administration imposed 10 % tariffs on $200 billion of Chinese imports, the CBOE Volatility Index, or VIX, has surged to an average of 20 compared to about 13 over the previous five months. In fact, the index reached or exceeded 20 fully half of the 40 trading days during the period, a mark that was not reached in even one trading day throughout 2017. The "Wall of Worry" on Wall Street, of course, is not confined to just trade matters. Slowing global growth, rising interest rates, a flattening yield curve, falling oil prices and uncertainty over monetary policy have all contributed to investor anxiety. None of these unsettling influences was erased during the latest trading week.



That said, the heightened gyrations in the financial markets belie a remarkable drumbeat of consistency in the domestic economy. Even as concerns mount that an escalating trade war will take an ever-larger toll on U.S. growth, incoming data reveal an economy that is holding up quite well. True, growth is slowing from the robust pace seen in the second and third quarters, but a modest haircut is both expected and welcome during the late stage of an economic expansion. Importantly, the trade-sensitive manufacturing sector has yet to feel much, if any, impact from trade tensions. In November, the ISM manufacturing index rebounded from softer readings over the previous two months and continue to hover near the highs for the expansion. Even export orders, while down from their peak levels seen earlier in the year, remain comfortably above the 50 mark, which indicates that more factories are seeing orders increasing than decreasing. The resilience in manufacturing activity last month combined with the ISM survey revealing a still-thriving service sector suggest the economy is far from falling off a cliff.

Still, the soft data, as represented by the ISM surveys as well as polls showing elevated levels of consumer and business confidence are overstating the economy's strength, as revealed by incoming hard data on consumer and business spending. The latter depicts a trend that is more consistent with a gradual slowing of activity. Households are still spending freely, as evidenced by the solid increase in personal consumption in October, and are expected to keep their wallets and purses wide open during the holiday season. But they are buying fewer homes and taking on less debt even as auto sales are leveling off. Meanwhile, business investment spending remains in the doldrums, despite

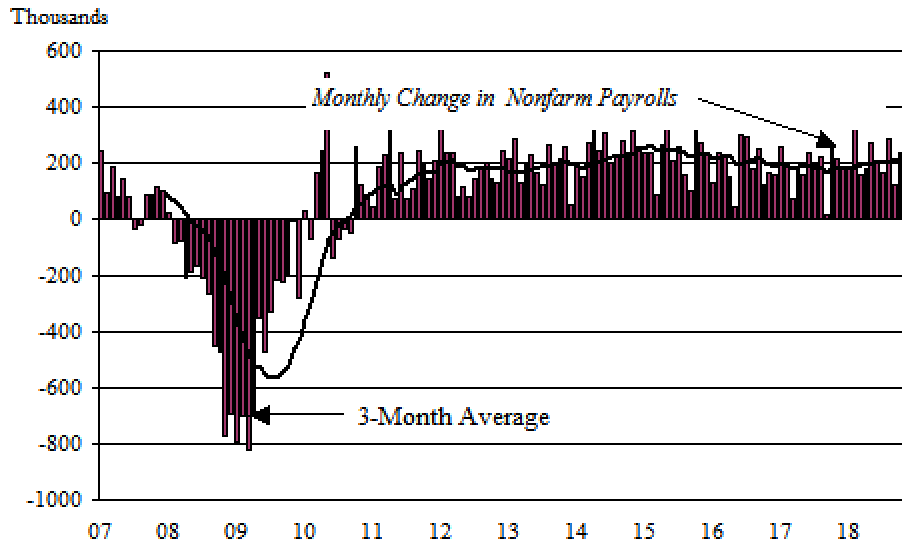
robust profits, and may not provide much if any positive thrust to growth in the fourth quarter. In October, new orders for nondefense capital goods excluding aircraft fell for the third consecutive month.



But businesses are still hiring workers at a decent pace, which is the most important barometer of the economy's performance. True, the economy added fewer jobs than expected in November. During the month, nonfarm payrolls increased by 155 thousand, which is well under the consensus expectation of about 200 thousand. What's more, the Labor Department revised down the increases previously estimated for September and October, shaving 12 thousand from the earlier count. Hence, over the past three months the increase in payrolls slipped to a monthly average of 170 thousand from a six-month average of 195 thousand and a 204 thousand average over the past twelve months. But it would be highly inaccurate to view that slippage as a significant deterioration in the economy's performance.

For one, hurricanes and raging fires in California probably clipped some of the gains over the last three months. That's particularly the case for workers in the construction and leisure and hospitality sectors, where job growth slowed significantly in November. For another, workers are getting harder to find. A record of more than 7 million jobs went unfilled during the past three months and a record share of small businesses are

planning to increase hiring if workers can be found to fill positions. More importantly, the 155 thousand-employment increase in November, much less the 170 thousand average gain over the past three months, exceeds the growth in the working-age population by a considerable margin. The slower pace of payroll increases should be viewed as an inevitable trend towards closing the gap between the demand for and supply of labor.



We suspect that trend will continue into 2019, when the growth in payrolls is expected to eventually subside to about 120 thousand a month. That would still be faster than the increase in the labor force and, consequently, drive the unemployment rate down further from the current 49-year low of 3.7 percent. It should also keep upward pressure on wages, which increased 3.1 percent from a year ago in November, matching the cycle high set in October. But like payrolls, the monthly increase in average hourly earnings came in tamer than expected, increasing by 0.2 percent for all private-sector workers following a downwardly-revised 0.1 percent gain (from 0.2 percent) in October. The softer monthly readings on average hourly earnings may reflect the mix of job growth, as some of the higher paying sectors, most notably information and mining, actually shed workers last month. The 3000 decline in jobs at mining and logging companies reflects the recent weakness in oil and commodity prices.

But the above-trend demand for workers is driving up wages for lower-paid employees, which is a time-honored response to a tightening job market. Average hourly earnings for production and non-supervisory workers increased 0.3 percent in November and are increasing at a 3.4 percent annual rate over the last three months, fully 0.70 % greater than for all private-sector workers. Not only are the lower and middle-wage workers enjoying faster nominal pay raises. They are also getting a nice boost in purchasing power, thanks to the recent easing of inflation, particularly at the fuel pump. No doubt, fatter paychecks are underpinning the stronger confidence readings of lower-income households relative to

those higher up the income ladder that are more sensitive to the recent negative turn in the stock market. It also is a firm signal that consumer spending will hold up well during the holiday season.

The question is, why aren't workers getting even larger pay increases given the sustained above-trend growth in jobs and a historically low unemployment rate? In the past when the jobless rate was this low, hourly earnings were increasing at more than a 4 percent annual rate. One reason is the more sluggish productivity growth this cycle, which historically tracks real wage growth. But another is that there is still more slack in the labor force – and, hence, more supply – than is indicated by the low unemployment rate. Even accounting for the rising tide of retiring baby boomers, there appears to be a sizeable pool of workers on the sidelines that could be lured into the labor force by more attractive job opportunities. That appears to be happening, as the labor force participation rate has been stable or gently increasing this year despite the heavy retirements.

But among prime-age men, there is still room to run. In November, the participation rate for this cohort held steady at 89.0 percent. That's up from 88.6 percent as recently as September, indicating that the strong job market is pulling some of these folks off the sidelines. However, there is a ways to go before reaching the prerecession level of 91.5 percent. There may well be structural impediments that prevent a reversion to this peak, but some fraction of this unemployed pool of workers can surely be tapped to rejoin the workforce under the right conditions. There are currently 55.6 million men in this age group, so 2.5 percent represents 1.4 million workers that for some reason are still on the sidelines.

With the jobs report taking center stage among this week's batch of indicators, the question high in the minds of policy observers is whether it will alter the Fed's plan for future rate increases. The financial markets have marked down the number of hikes it expects next year, from three a few months ago – matching the Fed's own prediction – to less than two this week. More immediately, the market is even pricing in a slimmer chance that the Fed will lift rates at its upcoming meeting on December 18-19, something that was considered virtually baked in until very recently. The headline-grabbing reports of a global slowdown combined with escalating trade tensions and the nosedive in stock prices have all conspired to downgrade rate-hiking prospects in the minds of traders and investors. The decent jobs report reported on Friday will probably not influence their perception unless those fears quickly subside.

However, we doubt the Fed will pay too much attention to the turmoil in the markets unless it appears to be taking a toll on the economy. Recent statements by Fed officials sounded a more dovish note, discouraging the notion that policy is on a preset course of raising rates every quarter. But they also emphasized that the Fed will follow the data; if incoming reports on growth and inflation exceed expectations, the pace of rate hikes will likely accelerate. If growth slows more than expected and inflation stays tame, the Fed will probably pause and take a wait-and-see stance. The jobs report did neither, depicting an economy that is slowing from unsustainable growth rates in the second and third quarters but remaining on firm ground. From our lens, another quarter-point rate increase later this month is still the odds-on bet. Regarding 2019, watch out for the Ides of March.

Source: Stone & McCarthy

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