

WEEKLY ECONOMIC COMMENTARY—WEEK OF MARCH 18, 2019

With the start of spring less than a week away, is it time to start looking for green shoots? For sure, the current quarter is not looking particularly lush. Coming on the heels of a December slump in consumer spending, a drag from a widening trade deficit and another pullback in residential activity, the economy is climbing out of a deep hole that handicaps its growth prospects for the period. The scant data available through February is tracking a GDP growth rate of less than 1 percent, which by any definition is perilously close to a stall speed. Nor did the key jobs report for February released last week provide much uplift, thanks to the tepid payroll increase and decline in hours worked during the month.

That said, the expected slowdown in the opening quarter should not be seen as a harbinger of persistent weakness. No doubt, recession fears have gained some traction in recent months, and an increasing number of forecasters believe the Fed's next move will be to cut rates, either as insurance against a possible downturn or in response to a stream of weak data.

Underpinning the downbeat view is the myriad global risks that show little sign of abating, including the still-unsettled trade dispute with China, the downshifting in global growth and messy prospects for Brexit, which became even more chaotic this week after the British Parliament voted to delay the exit from the EU beyond the scheduled May 29 departure date. Should these risks morph into worst-case scenarios the U.S. would feel some pain, with the immediate hit channeled through the financial markets.

We agree that the Fed is on hold for an extended period, reminiscent of the hiatus taken during the tightening cycle that began in December 2015 and not resumed until a year later. Then, as now, the central bank was blindsided by an abrupt growth slowdown in the quarter following its rate hike, with GDP downshifting to a 0.4 percent annual rate in the first quarter of 2016. The catalyst then was the plunge in oil prices, which decimated energy-related investment spending and took a severe toll on manufacturing activity. Similar to today, the inflation genie was bottled up and overseas economies struggled, with growth in Europe falling into negative territory. Only after the U.S. economy regained its footing, exhibiting steady growth in the following three quarters, and oil prices stabilized did the Fed feel comfortable about resuming its policy of normalizing interest rates from emergency-era levels.

While there are similarities to the 2015 episode, the current growth-stifling primary catalyst – a 35-day partial government shutdown – should have a less enduring impact. Indeed, the seeds for some green shoots are already sprouting, as consumers have reopened their wallets and purses after an astonishing turn to frugality over the holiday shopping season. True, the 0.2 percent increase in retail sales reported for January this week is hardly a head-turning reversal of the 1.6 percent plunge seen in December. Nor are the reasons for that setback – the steepest since the recession—entirely clear, although the sharp correction in stock prices and the escalation of trade tensions with China clearly had an influence.

Even more worrisome was the 2.3 percent nosedive in the control group of sales, which excludes food, autos, building materials and gas, and is a proxy for consumer goods consumption in the GDP calculation. That decline was revised down from an original estimate of a 1.7 percent drop, which ranks it as the worst reading for this core sales group in nineteen years. But the reversal from that pullback is considerably more impressive than the tepid rebound in overall retail sales. Indeed, the 1.1 percent jump in the control group of retail sales in January was the strongest since February 2014, which ties it for the largest monthly gain since the recession.

We suspect that households resumed their zeal for shopping in January as the negative influences from December abated. The debilitating plunge in stock prices – which helped wipe out \$3.7 trillion in household net worth during the fourth quarter – ended as the calendar page turned to 2019, setting the stage for the strongest two-month rally to start a year since 1991. Meanwhile, prospects for a trade deal with China turned somewhat brighter in January and the job-creating engine cranked up, delivering a blockbuster 311 thousand increase in nonfarm payrolls before downshifting to a mere 20 thousand in February. But the pullback in job creation in February did not derail the upward climb in wages, as average hourly earnings last month recorded the strongest annual growth rate of the expansion.

More than anything, the improving job and income fundamentals validate the brighter prospects for consumer spending in coming quarters. The rebound in stock prices is certainly a positive influence, but fatter paychecks have a much bigger impact on household confidence and consumption habits than does swollen stock portfolios, as far more households benefit from the former. What's more, lower and middle wage earners, who spend a larger fraction of their paychecks than upper-income households, are enjoying stronger wage gains than higher wage earners. Not coincidentally, the University of Michigan's preliminary survey of consumer sentiment posted a big jump in early March; importantly, households on the lower two-thirds of the income scale accounted for all of the increase.

Meanwhile, lower prices at the pump, cheaper imports and lower interest rates are collectively bolstering the purchasing power of households. Overall consumer prices increased by a tame 0.2 percent in February, leaving the annual increase at 1.5 percent, the lowest since September 2016. If not for the modest gain in volatile food and gasoline prices, the monthly inflation rate would have been even lower, as the core CPI that excludes those items edged up by only 0.1 percent. The annual increase in the core CPI receded to 2.1 percent from 2.2 percent in January. Not only does the tame inflation reading boost real earnings, it gives the Federal Reserve more reason to sit on the sidelines, putting an extended hold on further interest rate increases.

The bond market is increasingly pricing in that perception. At the end of this week, the 10-year Treasury yield slipped to just under 2.60 percent, down from 2.75 percent at the start of the month and from a nearby peak of 3.23 percent in late November. The current yield is the lowest since mid-January of 2018. To be sure, long-term rates are influenced by a number of factors, including weakening inflation and growth expectations, safe-haven demand, supply considerations and expected policy changes.

But the drop late in the week coincided with a significant move in the Federal funds futures market, where the odds of a Fed rate cut nearly doubled to about 30 percent.

No doubt, the bond market is accenting the negative over the positive economic prints this week. Global growth concerns, for example, have weighed heavily on the outlook for manufacturing activity for some time and that pessimism only deepened with Friday's report on industrial production. While total output did eke out a slim 0.1 percent gain in February, the advance was driven entirely by increases at mines and weather-sensitive utilities. The manufacturing sector, on the other hand, turned in another dismal performance. The good news is that the eye-opening 0.9 percent drop in manufacturing output previously reported for January was revised up to a smaller 0.5 percent decline. The bad news is that the January setback was followed by another one in February, this time by 0.4 percent, marking the first back-to-back monthly declines in factory output since the summer of 2017.

Within the details, a disturbing 1.0 percent decline in business equipment output, following a 0.2 percent decline in January, suggests that business capital spending will be a drag on economic growth in coming quarters. But an encouraging rebound in capital goods orders in January belies that notion. For sure, weakening exports, trade uncertainty, reduced fiscal stimulus and the strong dollar all weigh on capital spending; but businesses still have a strong incentive to continue spending on productivity-enhancing machinery and software to offset rising labor costs and retain a competitive edge in the global market. What's more, the new bonus depreciation rules implemented by the Jobs Cut and Jobs Act in late 2017 remains in effect.

Likewise, while the weak housing data out this week – with new home sales falling by 6.9 percent in January – added fuel to the pessimistic view, that too should be seen in the context of strong upward revisions to the sales total over the previous two months. Importantly, the housing market should get a lift from lower home prices (down 3.8 percent over the past year) and mortgage rates, which fell to the lowest level since February 2018 this week. As noted at the outset, some green shoots are sprouting.

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