

WEEKLY ECONOMIC COMMENTARY—WEEK OF APRIL 1, 2019

With the government's latest GDP revision, the handoff to the first quarter just got weaker as the 2.6 percent growth rate previously reported for the fourth quarter has been reduced to 2.2 percent. Taken at face value, this is not terrible news; it merely brings the growth trajectory of the U.S. economy back to the average pace seen throughout the expansion. But as they say in football, it's momentum that carries the day and Big Mo has moved to the sidelines. Not surprisingly, the fans are in an uproar, screaming that a recession is just around the corner. What's more, some believe the team leaders, captained by Fed chair Powell, may have had a big hand in bringing an unceremonious end to the growth season.

We are not of the camp that believes the December rate hike broke the back of the expansion. Still, the optics are not good. After peaking at 4.3 percent in the second quarter, the economy's growth rate hopped on to a slippery slope, slowing to 3.4 percent in the third quarter and 2.2 percent in the fourth. All the while, the Fed was raising rates, culminating with the fourth hike of the year in December. Undaunted by the slowing economy amidst a weakening global backdrop and a stock-market rout, the majority of Fed officials at the December policy meeting still thought that two more rate increases would be forthcoming this year.

To be sure, the Fed had some compelling reasons to feel confident the economy could weather the headwinds and still post solid, if slowing, growth in 2019, and that inflation would move up to its 2 percent target. At the time of the December 19-20 FOMC meeting, policymakers had no inkling that consumer spending was about to crater as reports of a festive holiday shopping season still filled the air. After all, the job market was robust, sustaining an elevated level of household confidence. Meanwhile, wage growth was accelerating, underpinning the Fed's conviction that inflation was poised to gravitate towards its 2 percent target. Indeed, the annual increase in the core personal consumption deflator – the gauge most closely monitored by the Fed – had actually hit 2.0 percent in December, rising from 1.8 and 1.9 percent in October and November.

But the positive vibes over the economic and inflation landscape quickly faded after that fateful meeting. The astonishing plunge in retail sales in December took the markets as well as the Fed by surprise. Conditions overseas worsened, the stock-market rout deepened, taking down bond yields, recession fears escalated and a Polar Vortex combined with the 35-day government shutdown all conspired to cast a dark cloud over the economy as the curtain rose on 2019. The Fed quickly took a U-turn towards a much more dovish stance beginning in January, which culminated with the promise at last week's policy meeting to keep its finger off the rate trigger for the rest of this year. To some, however, the about face came too late, and calls to rescind the December rate hike are reverberating in some quarters. The markets are already pricing in higher odds of a rate cut than a rate increase as the Fed's next move.

From our lens, the December rate hike was probably the last of the cycle, but calls for a rate cut are premature at this point. True, the early months of 2019 are not looking promising, as the aforementioned headwinds that prompted the Fed's U-turn took a bigger toll on the economy in January than expected. Friday's report on personal income and spending solidifies that perception, as households remained in the doldrums during the month. Total spending on goods

and services – the key driver of economic growth—edged up by a slim 0.1 percent, recovering a miniscule portion of the harsh 0.6 percent contraction in December. Nor did price swings have an influence, as the exact same pattern occurred after adjusting for inflation.

The good news is that the 0.1 percent increase following the 0.6 percent decline in December gave real consumption some momentum, lifting the annual pace to 2.3 percent from 2.0 percent in December. The bad news is that the January level of consumption is still below the average for the fourth quarter, which means that spending would have to pick up significantly in February and March to yield a decent growth reading for consumption in the first quarter. We expect some rebound in those months, but the quarterly growth rate is still likely to be among the weakest in more than five years, topping only the weather-battered 0.5 percent gain posted in the first quarter of last year.

One reason for the tepid near-term recovery is that little help is coming from the income side of the balance sheet. Thanks to the government shutdown and inclement weather that restrained working hours, incomes also came in on the weak side over the first two months of the year. Personal income eked out a 0.2 percent gain in February, less than the 0.3 percent expected, following a 0.1 percent decline in January. Compared to a year-earlier, growth in personal income slipped to 4.2 percent from 5.0 percent in December. But the headline decline is not as bad as it seems on the surface, as the wage and salary component, which is the key influence on spending decisions, held up well, increasing by 0.3 percent for the second consecutive month in February and is still up by a respectable 4.3 percent from a year ago.

One major drag on incomes has been the inexplicable \$54 billion decline in interest income over the first two months of the year. This comes in the wake of four interest rate increases by the Fed, which should have boosted interest payments on financial assets held by individuals. While bank deposit rates may not have increased as much as the Fed's policy rate over the past year, rates on CDs and money market funds did increase. Nor have individuals reduced holdings of these assets, as time and savings deposits have increased briskly over the first two months of the year. Yet, interest receipts as a share of personal income fell to 8.9 percent from 9.2 percent in December, matching the lowest fraction since July 2017. Some further clarification of this perplexing trend will be needed.

Importantly, the personal income and spending report on Friday highlighted another reason the Fed will stay on the sidelines for the foreseeable future. After hitting the 2.0 percent target in December, the key inflation gauge followed by the Fed has once again slid back, as the annual increase in the core PCE deflator slipped to 1.8 percent in January. The headline PCE deflator suggested an even steeper disinflationary trend, as its annual increase plunged to 1.4 percent, a pace not seen since September 2016, from 1.8 percent in December. Fed Chairman Powell has expressed increasing concern about the persistence of low inflation despite the economy's solid growth last year, and recognizes that it will be even more of a challenge to attain the 2 percent inflation target with growth expected to slow this year.

That sentiment is shared by other Fed officials, who are increasingly embracing the notion that inflation is being constrained by deeply embedded structural trends, such as globalization, that are overwhelming the time-honored cyclical forces of wage growth, output constraints and the strength of economic activity. Simply put, the Fed is likely to tolerate faster growth than otherwise if it believes that a tighter monetary policy is not needed to keep inflation in check. That test, of course, is something for another day, as the immediate challenge is to lift inflation

and inflation expectations while preventing the current slowdown from gaining traction. Should the latter appear to be evolving, the case for a rate cut would clearly be stronger.

However, we believe that the economy is going through a soft patch and is poised to stage a modest rebound in the second quarter. Indeed, some encouraging news on the housing front in recent weeks suggests that the extended drag on growth from sagging residential outlays is about to end. Thanks to a dramatic fall in mortgage rates and moderating home price increases, buyers are returning to the market and pumping up sales. We saw that in last week's report on the existing home market, where sales jumped by nearly 12 percent in February. As we noted then, those transactions represented closings on contracts made months earlier when mortgage rates were considerably higher than they are now.

New home sales, however, reflect contract signings and are more indicative of the impact lower mortgage rates are having now. This week, the government reported that new home sales increased by 4.9 percent in January, following an upwardly-revised increase of 8.2 percent in January. Over the first two months of the year, sales are running 11.6 percent higher than the fourth quarter average. To be sure, an earlier report showed that housing starts slumped in February, reversing a strong gain in January, and residential outlays are likely to be another drag on first-quarter GDP. However, if sales remain strong, builders will follow suit and step up construction activity, perhaps as soon as the second quarter. We suspect that the solid pace of job growth, improving wages and increasing housing affordability should underpin a housing recovery as well as a rebound in consumer spending in the upcoming quarter. That, in turn, should keep the Fed on the sidelines and tamp down the rise in recession fears. While the bond market remains skeptical of this rosier outlook, the stock market appears to be all in, staging the strongest quarterly rally for the period just ended since 2009.

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FINANCIAL INDICATORS

INTEREST RATES	March 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.40%	2.46%	2.43%	1.70%
6-month Treasury bill	2.44	2.48	2.51	1.91
3-month LIBOR	2.59	2.60	2.62	2.31
2-year Treasury note	2.26	2.31	2.55	2.27
5-year Treasury note	2.23	2.23	2.56	2.56
10-year Treasury note	2.41	2.44	2.76	2.74
30-year Treasury bond	2.82	2.87	3.12	2.97
30-year fixed mortgage rate	4.06	4.28	4.35	4.44
15-year fixed mortgage rate	3.57	3.71	3.77	3.9
5/1-year adjustable rate	3.75	3.84	3.84	3.66

STOCK MARKET

Dow Jones Industrial Index	25,929	25,502	26,026	24,103
S&P 500	2,834	2,801	2,804	2,641
NASDAQ	7,729	7,643	7,595	7,063

COMMODITIES

Gold (\$ per troy ounce)	1,297	1,313	1,295	1,330
Oil (\$ per barrel) - Crude Futures (WTI)	7,729	59	56	65

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (February) -- 000s	1162.00	1273.00	1140.00	1205
Building Permits (February) - 000s	1,296	1,317	1,326	1,299
New Home Sales (February) - 000s	667.0	636.0	588.0	611.0
Personal Income (January) - % change	0.2	-0.1	0.1	0.3
Personal Consumption (January) - % change	0.1	-0.6	0.5	0.2

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