WEEKLY ECONOMIC COMMENTARY—WEEK OF APRIL 22, 2019

Resilience has been the hallmark of the U.S. economy since the Great Recession. That impressive feature continues to be on full display. Since the recovery began in mid-2009, a number of headwinds have threatened to derail the upturn, including a sovereign debt crisis, a double-dip recession in Europe, two government shutdowns and more recently, the escalation of trade tensions and a sharp stock-market correction. Through it all, the domestic economy bent but refused to break. Once again, recession fears reared its head early in the year, and once again they are proving to be misguided.

As the calendar turned to 2019, the doomsayers clearly had the upper hand. The government was in the midst of the longest shutdown on record, the financial markets just emerged from a debilitating late-year meltdown in stock prices, China's economy was slowing dramatically and in the midst of a prolonged trade dispute with the U.S., the ongoing Brexit saga cast a dark cloud over Europe, the yield curve inverted and consumers appeared to have gone into hibernation, recovering only a portion of the steep December setback in retail sales in January and then slipping again in February. Following two successive quarters of slowing growth, the first quarter was heading in the same direction, tracking a growth rate perilously close to stall speed.

But as with earlier episodes of adversity, the economy is again showing its mettle. To be sure, the Federal Reserve has to take some credit for the heavy lifting. It's dovish U-turn at recent policy meetings – expecting to hold interest rates steady over the foreseeable future – injected a jolt of optimism into the financial markets. The stock market recovered most of its devastating late-year loss – which wiped out nearly $4 trillion of equity wealth – moving to within 1 percent of its September peak this week. The portentous yield curve inversion of late March reverted to a positive slope, as the 10-year Treasury yield rebounded off its 2.37 percent low to as high as 2.60 percent before easing back to 2.55 percent at the end of this week.

With the negative wealth effect that threatened to undermine household and business behavior taking a back seat and the central bank taking its foot off the monetary brakes, the financial backdrop is no longer a growth impediment. Indeed, the sharp decline in mortgage rates this year appears to be breathing new life into the housing market, spurring a jump in new home sales in February and, more recently, in mortgage applications for home purchases. The major restraint in this sector is coming from the supply side, as homebuilders are being hampered by worker shortages, a scarcity of lots to build on and rising cost pressures. Those obstacles were clearly evident last month as housing starts came in much weaker than expected, although the fall to a 10-month low of 1.139 million units may have been exacerbated by flooding in the Midwest.

The softness in residential outlays is contributing to the ongoing growth slowdown in the first quarter. But the setback in construction activity is not likely to persist. Some of the constraints on homebuilders are easing; lumber prices, for example, have declined significantly in recent months. What's more, weather disruptions have an outsize impact on construction activity during the winter months, and the more temperate climate during the spring and summer seasons should see a pickup in groundbreaking activity. We expect housing starts to rise

modestly over the course of this year after subtracting from the economy's growth rate in each quarter of last year and, most likely, the first quarter of this year as well.

Importantly, while the economy's growth engine appeared to be sputtering out just a few months ago – and stoking recession fears – it is now losing less momentum than feared. One reason: consumers have reopened their wallets and purses. As noted, households followed the unexpected plunge in retail sales late last year with a tepid response, recovering about half the December drop in January and then pulling back again in February. As it turns out, consumers were merely taking a breather, not going into hibernation as many had feared. In March, they broke out with a vengeance, driving up retail sales by 1.6 percent, the largest monthly gain since September 2017. Nor was last month's rebound skewed towards one or two sectors; except for sporting goods, sales across the board showed decent gains.

The so-called control group of sales, which feeds directly into the GDP calculation, gained a robust 1.0 percent, more than reversing a 0.3 percent contraction in February. These figures, of course, are in current dollars and inflation absorbed some of the gain in sales. Even so, after adjusting for the rise in consumer prices last month, total real retail sales increased by a sturdy 1.2 percent in March, lifting the annual gain to 1.7 percent. In the wake of the poor sales over January and February, the March rebound will not salvage the reading for the first quarter, which is still expected to register a lackluster 0.6 percent growth rate for personal consumption expenditures. But the solid increase in March provides positive momentum heading into the second quarter, setting the stage for a respectable rebound during the period.

What's more, the upbeat retail sales report for March goes a long way towards arresting the growth deceleration during the first quarter. Instead of skidding towards stall speed of under 1.0 percent that the economy was tracking just over a month ago, it now appears that growth will come in closer to a 2 percent annual rate in the first quarter. That would still mark the third consecutive quarterly slowdown, but the first-quarter's pace would be more in line with the economy's potential growth rate than flirting with recession. And while consumer spending is the biggest driver of GDP growth, it is not the only reason the first quarter is coming in stronger than expected. A sharp narrowing of the trade deficit and an inventory buildup over the first two months of the year are also contributing to the stronger reading.

In retrospect, the rebound in consumer spending in March should not be too surprising. Even as households pulled back around the turn of the year, the fundamentals pointed to a reversal. The job market remained strong, with the average increase in payrolls slipping only modestly to a still-robust 180 thousand pace over the first three months of the year. Wages continued to firm up and consumer confidence remained elevated. With these underpinnings providing solid support, the more compelling narrative surrounding the spending pullback early in the year is that households grew wary over the government shutdown and were licking their wounds from the late-year meltdown in the stock market.

That said, it would be a mistake to think that the economy is off to the races. Yes, growth is poised to pick up in the second quarter, with our latest estimate pegging it around 2.5 percent, thanks largely to the strong handoff provided by consumer spending in March. But the economy is not running on all cylinders and is facing more headwinds than tailwinds heading into the second half of the year. For one, slowing global growth and trade tensions are taking a toll on the industrial sector. Industrial production fell by 1 percent in March, punctuating the first quarterly contraction since the third quarter of 2017. Notably, manufacturing, which accounts for

about 70 percent of total output, suffered an even greater setback; the 0.3 percent contraction in factory output equaled the deepest fall since the second quarter of 2016.

Although global growth is showing signs of stabilizing, industrial companies are not likely to benefit from strengthening exports in coming quarters. The volume of global trade is shrinking, thanks partly to sluggish growth as well as to protective trade policies, and the dollar is up nearly 10 percent over the past year, putting U.S. firms at a competitive disadvantage. Add to the mix the fact that the tailwind from fiscal stimulus that invigorated the broader economy last year will be fading as 2019 progresses, and the ingredients for a slowdown over the second half of the year are in place. No doubt, as that evolves the voices of recession will again become louder. From our lens, however, unless a policy mistake is in the offing or an external shock hits home, the near future should resemble the recent past, with the economic engine downshifting to a soft landing.

That, in turn, should keep the Fed on the sidelines for the rest of the year. We do expect the next move to be a rate cut rather than an increase, but the timing is up in the air. If the soft landing that we expect over the second half of the year were accompanied by lower inflation or inflationary expectations, the cut would come sooner than later. That said, with labor costs rising, global growth stabilizing and domestic demand still firm, there is a better than even chance that inflation will drift up to the Fed's 2 percent target, which would keep the Fed on the sidelines for the foreseeable future.

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FINANCIAL INDICATORS

INTEREST RATES	April 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.42	2.44	2.46	1.80
6-month Treasury bill	2.47	2.46	2.48	2.00
3-month LIBOR	2.58	2.60	2.60	2.36
2-year Treasury note	2.39	2.40	2.31	2.46
5-year Treasury note	2.37	2.38	2.23	2.8
10-year Treasury note	2.56	2.56	2.44	2.96
30-year Treasury bond	2.96	2.98	2.87	3.14
30-year fixed mortgage rate	4.17	4.12	4.28	4.47
15-year fixed mortgage rate	3.62	3.60	3.71	3.94
5/1-year adjustable rate	3.78	3.80	3.84	3.67

STOCK MARKET				
Dow Jones Industrial Index	26,559.54	26,412.30	25,502.32	24,462.73
S&P 500	2,905.03	2,907.41	2,800.71	2,670.17
NASDAQ	7,998.06	7,984.16	7,642.67	7,146.13

COMMODITIES				
Gold ($ per troy ounce)	1,277.90	1,294.10	1,312.90	1,337.80
Oil ($ per barrel) - Crude Futures (WTI)	64.00	63.78	58.84	68.38

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Industrial Production (March) - % change	-0.1	0.1	-0.3	0.1
Capacity Utilization (March) - % change	78.8	79.0	79.1	79.2
Retail Sales (March) - % change	1.6	-0.2	0.8	0.2
Housing Starts (March) - % change	1,139	1,142	1,298	1,189
Trade Deficit (February) - $blns	49.4	51.1	59.9	53.8

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