WEEKLY ECONOMIC COMMENTARY—WEEK OF APRIL 29th, 2019

The U.S. economy increasingly resembles Wile E. Coyote, the Looney Tunes character who briefly stays aloft after running off a cliff. Of course, the Coyote abruptly descends into a cloud of dust when he realizes the floor below has vanished. A similar fate may occur in the real world of GDP statistics, which this morning tracked an economy that was propped up by thin air in the first quarter. On Friday, the Commerce Department reported that gross domestic product increased by a 3.2 percent annual rate during the period, blowing through virtually all expectations but greatly exaggerating the economy's underlying strength.

Admittedly, forecasts for the first quarter had steadily strengthened over the past month or so. Recall that as the curtain rose on calendar 2019, the near-term outlook looked grim. The economy was in the midst of a record-long government shutdown, consumers pulled in their horns over the holiday shopping season, the stock market had just tumbled into correction territory, a polar vortex crippled business activity across wide swaths of the nation, and darkening clouds were overhanging the global landscape. Following a dismal jobs report for February, recession fears escalated, prompting the Federal Reserve to abandon its rate-hiking campaign and driving investors into risk-free assets, causing the Treasury yield curve to invert. For much of the early part of the year, incoming data and anecdotal reports indicated that the first-quarter growth rate was tracking perilously close to stall speed, hovering around 1.0 percent.

But the skies brightened as the winter progressed and economists, realizing that the economy was not about to fall off a cliff, steadily upgraded their forecasts for the first quarter. The stock market staged a powerful rally, recouping virtually all of its fourth-quarter losses by March, consumers reopened their wallets and purses and the Labor Department confirmed that the February plunge in job growth was a one-off event, revealing a huge rebound the following month. Meanwhile, trade tensions that weighed on business confidence last year eased, as the U.S. and China engaged in what appears to be fruitful negotiations. Reflecting the combination of these promising influences, expectations for first-quarter growth had more than doubled from the start of the year. Heading into Friday's GDP report, the consensus forecast had been revised up to about 2.0 – 2.5 percent.

But as noted, the preliminary report released on Friday blew through even those upwardly revised expectations, as none of the widely followed models pegged growth as high as 3.2 percent. Importantly, however, hardly anyone believes that the economy is as strong as the headline growth rate suggests. Just as the ground was pulled out from under the Coyote, the underpinnings that are keeping GDP aloft are not sustainable. In particular, two relatively small components of GDP had an outsize influence on the overall growth rate during the period. Neither is expected to punch above its weight for much longer.

Net exports, for example, contributed an eye-opening 1.03 percentage points to the increase in GDP, thanks mainly to a steep fall in imports. Most likely, a good portion of that decline reflected an unwinding of accelerated imports over the second half of last year when many companies attempted to beat the higher prices caused by threatened increase in tariffs at the start of this year. Some of the decline may also have simply reflected weaker domestic demand for foreign goods, hardly a sign of economic strength. Likewise, inventory accumulations, a highly volatile category, accounted for 0.65 percentage points of the GDP growth rate. Given the widespread perception that the economy was slowing, it is hard to believe that businesses would be stockpiling inventories in anticipation of stronger sales. Rather, most of the inventory build was probably involuntary, which will be unwound in coming quarters.

If the first quarter's performance is stripped of the improbable contributions from trade and inventories, as well as from a surprising jump in state and local spending, a better sense of its bedrock strength in the private sector can be obtained. The relevant yardstick in this reckoning is 'final sales to private domestic purchasers', which reveals a starkly different picture from that portrayed by the headline GDP. This measure increased by a 1.3 percent annual rate during the period, which is not only half the increase of the fourth quarter, it is the weakest advance since the second quarter of 2013. Indeed, you would have to go back to the second quarter of 2011 to find a wider gap between growth in headline GDP and this measure of private demand.

Importantly, personal consumption expenditures, which account for about 70 percent of GDP, downshifted considerably in the opening quarter, slowing to a 1.2 percent pace from sturdier gains of 2.5 percent and 3.8 rates over the previous two quarters. Households slashed spending for durable goods, paced by a dramatic setback in motor vehicle purchases. As a result, consumers accounted for only about one-quarter of the 3.2 percent growth rate during the period compared to a 75 percent contribution in the previous quarter. Likewise, business investment spending was a big drag on growth in the January-March period, posting a slim 2.7 percent increase compared to 5.4 percent in the fourth quarter. If not for a sizeable 8.6 percent increase in spending for intellectual property, things would be far worse. Outlays on structures actually declined by 0.8 percent and equipment spending rose by a barely perceptible 0.2 percent. Rounding out the growth drags last quarter, residential outlays fell by 2.8 percent, the fifth consecutive quarterly contraction for this beleaguered sector.

Simply put, the latest GDP report does not refute the narrative that prevailed prior to its release on Friday: the economy's main growth engine has downshifted from the turbocharged pace of 2018, which was fueled by tax cuts and increased government spending. The tailwind from that fiscal stimulus is now fading and its beneficiaries are throttling back in predictable fashion. But just as the headline GDP increase exaggerates the economy's strength, the weaker details in the report outlined above overstates the slowing that is likely to unfold this year. Most notably, the private sector is in much better shape than suggested by last quarter's pullback in spending.

For one, the slowdown in consumption was front-loaded into the early part of the quarter. That's when the government shutdown was in full swing, the stock-market correction was fresh in mind and harsh weather conditions were buffeting many regions of the country. After stumbling out of the starting gate, consumers have regained their footing. As discussed last week, retail sales perked up on March, staging the biggest monthly increase in 1-½ years. A more complete picture of how much momentum there was behind consumer spending at the end of the quarter will be revealed with the personal income and consumption report on Monday; but there is no doubt that the second quarter is starting on a much firmer base than it began, and consumer spending will impart more muscle to the period's growth rate than it had in the first quarter.

At the same time, the setback in business investment spending last quarter was likely overdone. A further contraction in energy-related outlays accounted for most of the weak spending on structures, reflecting a plunge in oil prices from $74/barrel in October to $44 in January. But crude quotes have since recovered, rebounding to over $63/barrel this week, and sanctions on

Iran and Venezuela along with OPEC production cutbacks are likely to keep a floor under oil prices for at least a while longer. Of course, there is a downside to this prospect, as higher prices at the pump will slice into household purchasing power, possibly discouraging some consumption.

The other component of business investment, capital spending, also stands a good chance of reversing the slowdown seen in the first quarter. Indeed, that slowdown was well telegraphed, as new orders for capital goods fell in five of the last six months of last year. But bookings have since turned around, rising in each of the first three months of this year, with the strongest – 1.3 percent – taking place in March. What's more, corporations are well positioned to finance capital outlays, delivering robust profits that swelled cash coffers last year. While some margin compression is expected this year, thanks to rising labor and other costs, the squeeze so far has been less than expected. Incoming earnings reports for the first quarter are generally beating forecasts and propping up stock prices

That said, the financial markets remain split over the economy's performance. Equity investors appear to be looking through the headline slowdown in GDP, focusing on encouraging earnings reports, a possible trade deal with China, the sustained strength in the job market and the Fed's promise to forego further interest-rate hikes, which would sustain the life of the expansion. Bond investors, however, are not so willing to overlook signs of weakness, which through their lens is reflected in the persistence of low inflation. That concern was not allayed in the GDP report, as the core personal consumption deflator – the Fed's preferred inflation gauge – fell further behind the Fed's 2.0 percent target, increasing by 1.7 percent in the first quarter from a year ago.

FINANCIAL INDICATORS

INTEREST RATES	April 26	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.42	2.42	2.4	1.8
6-month Treasury bill	2.45	2.47	2.44	2.00
3-month LIBOR	2.58	2.58	2.59	2.36
2-year Treasury note	2.29	2.39	2.26	2.48
5-year Treasury note	2.29	2.37	2.23	2.80
10-year Treasury note	2.50	2.56	2.41	2.96
30-year Treasury bond	2.93	2.96	2.82	3.13
30-year fixed mortgage rate	4.20	4.17	4.06	4.58
15-year fixed mortgage rate	3.64	3.62	3.57	4.02
5/1-year adjustable rate	3.77	3.78	3.75	3.74
STOCK MARKET				
Dow Jones Industrial Index	26,543.33	26,559.54	25,928.68	24,311.19
S&P 500	2,939.88	2,905.03	2,834.40	2,669.91
NASDAQ	8,146.40	7,998.06	7,729.32	7,119.80
COMMODITIES				
Gold ($ per troy ounce)	1,288.20	1,277.90	1,297.00	1,324.40
Oil ($ per barrel) - Crude Futures (WTI)	63.20	64.00	60.19	68.08

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Existing Home Sales (March) - 000s	5,210	5,480	4,930	5,175
New Home Sales (March) - 000s	692	662	625	618
Durable Goods Orders (March) - % change	2.7	-1.1	0.1	-0.1
Real GDP (Q1) - % change, Saar	3.2	2.2	3.4	2.9

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