GPA GOVERNMENT PORTFOLIO ADVISORS

WEEKLY ECONOMIC COMMENTARY—WEEK OF JUNE 17th, 2019

The financial markets are anxiously awaiting two critical events next week – the Federal Reserve policy meeting and the G20 Summit when President Trump and China's President Xi will hopefully meet and strive to defuse escalating trade tensions between the world's two largest economies. Needless to say, there is much at stake in the outcomes of these confabs. Over the past several weeks, the markets have been deeply embroiled in speculation regarding the upcoming FOMC meeting, with the consensus steadily moving towards the belief that the policy makers will signal a rate cut sooner rather than later.

Reflecting this building sentiment, bond yields have plunged and stock prices have rallied in moves that depict contrasting views over the economy's prospects. Bond investors view the Fed's increasingly dovish stance as confirmation of a weakening economy that is in the grips of stubbornly low inflation, a combination that is a time-honored recipe for lower rates. Equity investors, however, believe the Fed's likely rate-cutting moves will go a long way towards sustaining the expansion and, more important, benefit the bottom line of corporations, fueling a stock-market rally. Interestingly, both camps have compelling arguments that are not entirely incompatible. But they can coexist only in a Goldilocks setting that is free of external disruptions, which is hardly the case in the current environment.

That said, the latest batch of economic data released this week clearly dilutes the argument of the dovish camp. No doubt, the Fed will still sound a dovish note at the upcoming FOMC meeting on June 18-19 given the uncertain trade backdrop, the persistence of low inflation and the weak reading on a number of key economic indicators, including the May employment report, in recent weeks. However, the more dire prospects spurring calls for a quick rate cut as early as July are overblown in our view. These calls reflect a growing recession bias that is typical in the late stages of an expansion when the data flow comes in weaker than expected. That heightens the perception the expansion is getting long in the tooth and vulnerable to adverse shocks that could tip the economy over the recession edge.

But the data, like market perceptions, are fickle and can lead to misguided decisions if they are hastily taken at face value. A stark example is this week's retail sales report, which is a key barometer of consumer spending trends, the economy's main growth driver. Last month's report was a major disappointment as the initial tally showed that sales slumped in April after a strong showing in March. The setback confirmed the perception that the momentum heading into the second quarter vanished, portending a marked slowdown in overall economic activity during the period. Without the fuel from consumption, the economy's growth engine was missing a key cylinder, pointing to a sputtering start to the second quarter.

However, a second look provides a new, and much more optimistic, perspective on the economy's performance. According to the latest retail sales report, it appears that consumers didn't empty their wallets in March after all but had the firepower to keep spending in April and May. Instead of falling by 0.2 percent in April, as initially reported, the revised figures show that total retail sales actually rose by 0.3 percent during the month, a hefty swing of 0.5 percent. What's more, the control group of sales that feeds directly into GDP, rose a respectable 0.4 percent in April, a sharp improvement from the original estimate of no change. Not only was the momentum in March sustained at the start of the second quarter, it continued to build in May.

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While the 0.5 percent increase in total retail sales last month was not surprising – it generally conformed to expectations – the real story lies with the control group of sales, the component that feeds into GDP. That measure, consisting of retail sales less autos, energy and building materials, also posted an impressive 0.5 percent gain, which solidly beat expectations and suggests that the consensus outlook for tepid growth in the second quarter will be adjusted upward. For sure, with consumers still doing the heavy lifting, the case for an imminent recession falls by the wayside. As well, the impressive retail sales report takes some pressure off the Fed to cut rates next month; indeed, the futures market lowered the odds of a cut at the July meeting from about 85 percent to under 70 percent on Friday following the release of the retail sales report.

But that's still a non-trivial possibility, reflecting lingering worries over upcoming trade negotiations and the persistence of low inflation, which is turning out to be more permanent than transitory. Both the overall consumer price index and the less volatile core CPI (excluding food and energy prices) rose by a tame 0.1 percent in May and the increase in both measures drifted lower compared to a year ago. The annual increase in CPI slipped from 2.0 percent to 1.8 percent between April and May and the core CPI fell from 2.1 percent to 2.0 percent. Keep in mind that the Fed's preferred inflation gauge, the core personal consumption deflator, runs several tenths of a percent below the core CPI, clocking in at 1.6 percent in April. The May CPI report suggests that it has slipped further behind the Fed's 2 percent target.

Probably more important to the Fed than the benign inflation readings is the continuing decline in inflation expectations. Market-based inflation expectations have been falling for months and have recently touched the lowest level in more than two years. But they are still not as low as they were in late 2015 and early 2016 when plunging oil prices and a pullback in growth stoked deflation fears that had not completely disappeared following the Great Recession. However, inflation expectations on Main Street are following a much more dangerous downward path. Ironically, given all the headlines about tariffs and how they threaten to boost prices on consumer goods, it would be logical for households to have higher inflation expectations. But the latest survey by the University of Michigan does not bear that out.

To be sure, the survey does confirm that the prospect of higher tariffs is taking a toll on consumer sentiment. In its preliminary June survey, the University of Michigan's sentiment index slipped by 2.1 points from May as households had a dimmer view of future economic conditions, even as they had a more upbeat assessment of present conditions. But the ongoing threat of higher tariffs, which was the primary cause of the diminished sentiment, did not stoke fears of higher inflation. Instead, household inflation expectations over the next five to ten years plunged from 2.6 percent to 2.2 percent, the lowest for this reading in the 40 years the University has been conducting the survey.

For many years, the Fed had taken comfort that inflation expectations had remained well anchored. Chairman Powell like his predecessors at the central bank firmly believes that inflation expectations have the biggest influence on actual inflation. Hence, as long as expectations remained anchored, the Fed was willing to tolerate an inflation shortfall, believing that the shortfall would not bleed into the spending decisions of households and businesses. However, that perception has been steadily eroding as the persistent inflation shortfall amid steady growth and a tight labor market has convinced some Fed officials that low inflation is more structural than transitory. What's more, the longer it persists, the more likely it is that households would lower their inflation expectations and alter their behavior accordingly.

If the latest University of Michigan survey is any indication, the first part of that sequence may have arrived. To be sure, the survey is preliminary and the final result could change over the course of the full month. Importantly, the decline in inflation expectations is not fostering the kind of pernicious behavior that Fed officials dread. That occurs when consumers hold back spending in anticipation of lower prices, setting in motion a self-reinforcing deflationary cycle that is difficult to reverse. Based on the upbeat retail sales report for May and a still-firm job market, that cycle remains more of a distant threat than a near-term prospect.

Nonetheless, while the strong retail sales report gives the Fed some breathing room to stay the course in holding rates steady, the decline in inflation expectations is likely to push it further towards the dovish side at the upcoming policy meeting. We suspect it will give a strong signal that it is ready to cut rates sooner than later if upcoming data come in weaker than expected. The conditions for a reduction may not be evident at the July meeting; but if the U.S./China trade negotiations collapse at the G20 Summit, the Fed would undoubtedly come under intense pressure by the financial markets to move quickly.

FINANCIAL INDICATORS

INTEREST RATES	Jun 14	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.18	2.28	2.39	1.95
6-month Treasury bill	2.18	2.16	2.42	2.08
3-month LIBOR	2.41	2.45	2.52	2.33
2-year Treasury note	1.84	1.86	2.20	2.57
5-year Treasury note	1.84	1.85	2.18	2.80
10-year Treasury note	2.09	2.08	2.39	2.93
30-year Treasury bond	2.59	2.57	2.82	3.05
30-year fixed mortgage rate	3.82	3.82	4.07	4.62
15-year fixed mortgage rate	3.26	3.28	3.53	4.07
5/1-year adjustable rate	3.51	3.52	3.66	3.83
STOCK MARKET				
Dow Jones Industrial Index	26,089.61	25,983.94	25,764.00	25,090.48
S&P 500	2,886.98	2,877.34	2,859.53	2,779.42
NASDAQ	7,796.66	7,742.10	7,816.28	7,746.36
COMMODITIES				
Gold ($ per troy ounce)	1,345.30	1,345.20	1,277.60	1,283.00
Oil ($ per barrel) - Crude Futures (WTI)	52.52	54.10	62.68	64.72

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average- Past Six Months or Quarters
Consumer Price Index (May) - % change	0.1	0.3	0.4	0.2
Core CPI (May) - % change	0.1	0.1	0.1	0.1
Producer Price Index (May) - % change	0.1	0.2	0.6	0.1
Retail Sales (May) - % change	0.5	0.3	1.8	0.2
Industrial Production (May) - % change	0.4	-0.4	0.1	-0.1