GPA GOVERNMENT PORTFOLIO ADVISORS

WEEKLY ECONOMIC COMMENTARY—WEEK OF JUNE 24th, 2019

The Federal Reserve took center stage this week, raising the curtain on a drama that had been building to a feverish pitch in recent weeks. For the most part, the reviews of the policy meeting that concluded on Wednesday were favorable. True, President Trump as expected gave it a thumbs down, as the central bank refused to go along with his repeated demand to lower interest rates. But even the president has to be pleased with the aftermath of the Fed's decision as the stock market gave it a resounding thumbs up, rallying to a record high the day after the meeting. And while, the Fed kept its policy rate unchanged in a range of 2.25-2.50 percent, the capital markets sent yields tumbling, with the bellwether 10-year Treasury yield briefly falling below 2.0 percent on Thursday for the first time since November 2016 before climbing back above it on Friday.

The reaction of the markets, of course, was not in response to what the Fed did, but rather to what it indicated it would do. Some thought the policy makers would take out insurance against gathering global headwinds; indeed, one Fed official (St. Louis Fed President Bullard) voted for an immediate rate cut as insurance against the global slowdown and declining inflation. Instead, the FOMC opted for insurance guidance, which essentially had the same effect. Simply put, the central bank felt that incoming data did not justify a rate cut yet but the case for more monetary accommodation was strengthening.

Accordingly, fully eight of the seventeen members of the voting committee, as reflected in the so-called dot plots, expect to cut rates this year, with seven of them expecting to cut twice. That's a far more dovish mix of votes than seen at previous meetings and sent a strong message to the financial markets that it is only a question of time before the next cut takes place. As is their wont, investors ran with this message and immediately one-upped it, pricing in three rate cuts this year beginning with the next meeting in July. We agree with the expected July move, but are less convinced that three reductions would be needed this year. The economy is slowing but retains a solid underpinning in the form of a tight labor market that is sustaining consumer spending. And while global headwinds are gaining traction – highlighted by trade tensions with China and, more recently, the threat of confrontation with Iran – they could readily be defused through fruitful negotiations.

Indeed, there is a risk in rushing to judgment regarding the July rate cut. Keep in mind that a number of key economic reports will be released prior to the next policy meeting scheduled for July 30-31, including the all-important June employment report as well as a slew of data on consumer spending, production and housing activity. And, coincidentally, the second-quarter GDP report will be released the day of the FOMC meeting. No doubt, if some or all of these indicators show more strength in the economy than expected, the pricing mechanism in the financial markets will shift gears, particularly if favorable news on the trade front also comes into view. And, with crude oil prices jumping 10 percent over the past two weeks, the precipitous fall in inflation expectations that is gnawing at the Fed may get a temporary respite.

That said, if the Fed does pull the rate trigger in July, as expected, it would likely be the first act in this unfolding drama. Historically, there is no "one and done" in the Fed's playbook. The exception was in 1987 following the October stock market crash when the Fed, fearing that the wealth decimation would bleed into the economy, temporarily flooded the system with liquidity that brought the funds rate down by nearly a full percentage point over the next few weeks. But the negative wealth effect never materialized and the funds rate drifted sideways for the rest of the year before resuming an upward climb the following year. That episode was an outlier; in virtually every other easing cycle, the first rate cut was followed by at least three more in rapid succession.

We suspect that the same script will be followed this time, albeit stretched out more slowly than in the past. It's worth noting that some question whether lower rates would do more harm than good over the near term. The skeptics fall into two camps, one on the borrowers side and the other on the side of savers. While the aim of reducing rates is to stimulate borrowing and hence spending, could potential borrowers hold back after the first rate cut, expecting borrowing costs to become still lower later on? This mindset does affect the behavior of consumers when the expectation of lower prices causes them to hold back purchases. The other unintended consequence of lowering rates is that it robs savers of income and thus purchasing power, which depresses spending. A related concern is that lower rates would encourage savers – as well as traditional investors – to channel funds into riskier assets, setting the stage for asset bubbles and financial instability.

But one thing is certain: lower rates do benefit the housing industry, which is an ailing segment of the economy. No sector relies more heavily on credit than housing, although it has struggled to regain its footing following the housing bust mostly for other reasons, including a lack of inventory, a shortage of workers and land, and rapid price increases that made a home purchase unaffordable for a large swath of the population. These impediments have not disappeared, but some are easing. Home prices, for example, are increasing at half the pace they were last year and inventories have been steadily climbing. In May, the supply of existing homes on the market increased 2.7 percent from a year ago, marking the tenth consecutive month of annual inventory gains. Even so, the availability of homes for sale remains tight in the existing home market, particularly for first-time buyers.

But transactions are clearly picking up, spurred by lower mortgage rates. In May, existing home sales increased 2.5 percent to an annual rate of 5.34 million units. The gain is modest to be sure, and it just brings the total back to where it was before the tumble of late last year, when sales were hammered by rising mortgage rates and the plunge in stock prices. Keep in mind though that existing home sales reflect contracts that were signed 1 – 2 months earlier, when mortgage rates were at least a quarter-percent higher than they were in May. Since then, rates have come down further, with the 30-year fixed rate resting at 3.84 percent in the latest week, which is a quarter-percent lower than the average for April and May.

Granted, existing home sales do not have much of a direct impact on the economy's growth rate. That's because the transactions involve the shifting of existing assets from one owner to the other and, hence, does not generate additional output, as would be the case for new home construction. The only direct impact a sale has on GDP comes from brokers' commissions. However, there are indirect growth-boosting effects that flow from existing home sales. New homebuyers tend to renovate, hiring contractors and other workers in the process, purchase new furniture and engage moving services, among other ancillary purchase related to a sale.

Importantly, a lower mortgage rate not only stimulates homes sales. It also makes it more rewarding to refinance an existing mortgage. The lower the rate, the more profitable it becomes. With the fixed rate now well below 4.0 percent, it is estimated that nearly 7 million homeowners would find it worthwhile to refinance, nearly 3 million more than two months ago. Not surprisingly, a mini-refinancing surge is already underway, according to the Mortgage Bankers Association. In essence, a reduction in debt-servicing charges is the equivalent of a tax cut, putting more money in the pockets of households. And like a tax cut, the additional cash could well find its way into the spending stream, which would clearly have a positive influence on GDP.

To be sure, lower mortgage rates have more of an impact on the demand than on the supply side of the housing equation. Indeed, sales would no doubt have benefited more from the decline in rates had the supply of homes for sale recovered more quickly than it has. But builders have been restrained by a number of factors, including the aforementioned shortage of workers and land to build on. What's more, the rising costs of labor as well as materials (related to tariffs) have squeezed builder profits, even as selling prices have been tapering off. Hence, builder sentiment has not responded to declining to the more favorable financing environment than have households While the latest National Association of Homebuilder Sentiment Index (HMI) at 64 in June is well above the 50 threshold that separates poor from good conditions in the eyes of builders, it is also well off the cycle peak of the mid-70s. Not surprisingly, the recovery in homebuilding is progressing in fits and starts, with the volume of starts slipping 0.9 percent in May to a seasonally adjusted annual rate of 1.27 million.

However, the April total was revised up, and the average for April and May is running 5.1 percent above the first-quarter average. What's more, building permits – an indicator of future activity – increased last month, with the entire gain in single-family permits, which has a broader impact on the economy than multi-family construction. Because of the restraints on builders, it is unlikely that the Fed's actions or the decline in mortgage rates will lead to a construction boom. However, on the margin, an improving financial backdrop should impart some oomph into building activity and, perhaps, reverse the drag that residential outlays has had on GDP for five consecutive quarters.

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FINANCIAL INDICATORS

INTEREST RATES	Jun 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.13	2.18	2.35	1.92
6-month Treasury bill	2.06	2.18	2.39	2.11
3-month LIBOR	2.34	2.41	2.12	2.34
2-year Treasury note	1.75	1.84	2.16	2.55
5-year Treasury note	1.78	1.84	2.52	2.78
10-year Treasury note	2.06	2.09	2.39	2.90
30-year Treasury bond	2.56	2.59	2.82	3.04
30-year fixed mortgage rate	3.84	3.82	4.06	4.57
15-year fixed mortgage rate	3.25	3.26	3.51	4.04
5/1-year adjustable rate	3.48	3.51	3.68	3.83
STOCK MARKET				
Dow Jones Industrial Index	26,719.13	26,089.61	25,601.32	24,580.89
S&P 500	2,950.46	2,886.98	2,829.02	2,754.88
NASDAQ	8,031.71	7,796.66	7,637.01	7,692.82
COMMODITIES				
Gold ($ per troy ounce)	1,402.70	1,345.30	1,284.20	1,272.00
Oil ($ per barrel) - Crude Futures (WTI)	57.60	52.52	59.06	69.30

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (May) - 000s	1,269	1,281	1,199	1,222
Building Permits (May) - 000s	1,294	1,290	1,288	1,301
Existing Home Sales (May) - 000s	5,340	5,210	5,210	5,195

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