GOVERNMENT PORTFOLIO ADVISORS

WEEKLY ECONOMIC COMMENTARY—WEEK OF JULY 15th, 2019

Fed Chair Powell has improved his communication skills since last October when he inadvertently commented that the federal funds rate was a “long way from neutral”. Having to walk back that gaffe a few weeks later, Powell has since committed few, if any, verbal mishaps that roiled the financial markets as much as it did then. That said, the Fed chief might be better served by focusing more on the forest than the trees when providing policy guidance to the markets. For the past several weeks, Powell has been diligently making the case for a rate cut, noting the need to inoculate the economy against the downside risks associated with numerous headwinds that are gathering force. These include slowing global activity, uncertainty regarding trade developments, high debt ratios, the persistence of low inflation and signs of weaker job growth.

As long as Powell bases the case for a rate cut on these broader influences he is on firm ground, as they clearly constitute dark clouds overhanging the economic landscape. However, in both the press conference following the two-day policy meeting that concluded on June 16 and the semiannual testimony on monetary policy delivered before Congress this week, the Chairman delved through the forest into the trees – and that’s where the message can get muddied. For example, at the post-FOMC press conference on June 16, he cited the tepid job growth in May – which came in at a much weaker than expected 75 thousand – as a sign that the economy’s job-creating engine may be running low on fuel.

But the Labor Department wagged its finger at that notion last week, reporting that a sturdy 224 thousand jobs were created in July, easily overshadowing the downbeat message conveyed in the May report. Likewise, Powell appears to have displayed poor timing in his congressional testimony this week by doubling down on the notion that “… weak inflation may be even more persistent than we think.” Within a heartbeat of that statement, the Labor Department once again threw cold water on the Chairman’s message, reporting that core inflation in June jumped by 0.3 percent, the strongest monthly increase since January 2018. Both incidents highlight the risk of citing noisy monthly data to support an argument that otherwise rests on a firm foundation.

To be sure, Powell acknowledged last month’s rebound in job creation in his congressional testimony, but insisted that it does not alter his view on the risks facing the economy. Nor should it. Even with the rebound, the pace of job growth is slowing to a more moderate, but still healthy, average of 172 thousand a month this year compared to a 223 thousand monthly average in 2018. While that’s more than enough to absorb the increase in the working-age population and drive the unemployment rate down to a near half-century low of 3.7 percent, it is not generating an overheated job market that in the past would have stoked wage inflation and higher inflation expectations. As Powell noted in his testimony, “ to call something hot, you need to feel the heat.”

At best, wage growth is cooling, not simmering. After hitting a cycle high of 3.4 percent in February, the annual increase in average hourly earnings for all private sector workers has slipped to 3.1 percent in June. Over the past three months, the pace has drifted still lower, falling to an annual rate of 2.8 percent. The persistence of lackluster wage growth in the face of an ever-tightening job market has changed the narrative within the Fed regarding the tradeoff

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between unemployment and worker pay. In essence, the focus has shifted from the negative to the positive. Instead of worrying about an undesirable pickup in wage inflation, the Fed is welcoming the prospect that the tightening labor market is finally delivering benefits long denied to less advantaged workers, those with fewer skills and positioned on the lower end of the wage scale.

By all accounts, those benefits are trickling down. Lower-paid workers are enjoying faster wage growth than their higher-earning colleagues. That's not surprising, as these workers tend to benefit the most when companies are faced with labor shortages and need to compete more aggressively to retain staff, as is currently the case. While job openings have tapered off in recent months, consistent with the more modest gains in employment, they still exceed the number of job-searchers by a considerable margin. Importantly, companies are hiring applicants that have long been sidelined for various reasons, providing day care services and flexible schedules for single mothers and taking on workers that had been shunned for previous drug addiction. What's more, with the pool of skilled as well as unskilled workers running dry, companies are turning to other means to bolster workforce efficiency, offering retraining to a wider swath of existing workers. Amazon highlighted this trend on Friday, announcing that it will spend $700 million to retrain one-third of its workforce.

It is unclear how much longer the labor market can tighten before stoking an unwelcome surge in wages and inflation that would prod the Fed to alter its rate-cutting plans. Chair Powell acknowledged that the natural rate of unemployment – one that is consistent with stable inflation – is lower than perceived last year. Not only is that altered view justified by the moderation in wage growth, but actual and expected inflation has remained stubbornly below the Fed's 2 percent target. As much as anything, this persistent inflation undershoot has moved the central bank away from last year's rate-hiking strategy to the more accommodative stance that it is currently embracing. Nor should this week's report of a surprising 0.3 percent spike in the core consumer price index last month dissuade the Fed from that approach – as ill timed as it was following Powell's testimony.

For one, the spike was unduly influenced by some one-off factors, including a 1.1 percent surge in apparel prices and a 1.6 percent jump in used car prices. It is unlikely that these increases mark the start of a trend, but rather a snapback from several months of declines. Nonetheless, they contributed to an uptick in the annual pace of core inflation, which rose to 2.1 percent in June from 2.0 percent the previous month. While that's a trivial increase that may be reversed in coming months, it did cause a stir in the financial markets, sending long-term yields significantly higher. It also at least temporarily arrested the long skid in market-based inflation expectations, as the spread between nominal and inflation-indexed yields widened by several basis points.

But inflation expectations on Main Street should remain subdued, thanks to falling energy and other commodity prices that enter into the day-to-day shopping experience of households. Indeed, the overall consumer price index that includes volatile food and energy items, increased by a tame 0.1 percent in June, the same as in May and down from 0.3 percent and 0.4 percent increases in each of the previous two months. Compared to a year ago, the increase in the headline CPI slipped from 1.8 percent to 1.6 percent, the weakest since February. According to the University of Michigan's latest survey, household long-term inflation expectations are at historic lows, and the latest price readings should do little to change that outlook.

The good news is that tame inflation is boosting the purchasing power of worker paychecks. Although nominal wage gains are still lagging, they are increasing faster than the inflation rate. That was true again in June, as inflation-adjusted hourly earnings increased by 1.5 percent from a year ago, up from a 1.3 percent gain in May. The bad news is that if inflation expectations continued to sink, these inflation-adjusted dollars might not flow into the spending stream; households would, instead, be encouraged to hold back purchases in anticipation of still lower prices in the future. That, of course, sets in motion the vicious self-reinforcing downward spiral of the dreaded deflationary cycle the Fed desperately wants to avoid.

No doubt, the economy is a comfortable distance from that ominous condition. The low level of inflationary expectations has not impeded consumer-spending propensities, which if anything have experienced a revival in recent months. We will have more insight into that trend with next week's retail report for June. But for a deflationary mind-set to become firmly entrenched among households, it would need to be accompanied by a corresponding fall in consumer confidence. For the most part, confidence levels remain elevated; indeed, the Bloomberg Consumer Comfort Index hit the highest level in nearly two decades in the latest week.

Simply put, the latest batch of data on jobs, consumer spending and core inflation, would seem inconsistent with the Fed's dovish pivot towards a rate-cutting campaign. But that would be focusing more on the trees than the forest. Looking beyond noisy monthly numbers, the economic landscape is facing a more uncertain future. Trade tensions remain palpable and are discouraging some investment spending, global growth is slowing, threatening U.S. exports, geopolitical strains are appearing more frequently, which could undercut consumer confidence, and inflation is still dormant, although not weakening further. The Fed views these omens as heightening the downside risks to the outlook and believes that a preemptive rate cut is appropriate. Odds are, a quarter-point reduction will be taken at the upcoming policy meeting at the end of this month, and another is likely in the fall. The risk of going too far in cutting rates is outweighed by the risk of waiting too long, particularly since the time-honored inflation threat that an easier monetary policy stoked in the past is not relevant in the current setting.

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FINANCIAL INDICATORS

INTEREST RATES	Jul 12	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.15	2.23	2.18	1.98
6-month Treasury bill	2.08	2.13	2.18	2.16
3-month LIBOR	2.30	2.30	2.41	2.34
2-year Treasury note	1.85	1.87	1.84	2.58
5-year Treasury note	1.86	1.83	1.84	2.73
10-year Treasury note	2.11	2.04	2.09	2.83
30-year Treasury bond	2.64	2.54	2.59	2.93
30-year fixed mortgage rate	3.75	3.75	3.82	4.53
15-year fixed mortgage rate	3.22	3.18	3.26	4.02
5/1-year adjustable rate	3.46	3.45	3.51	3.86

STOCK MARKET				
Dow Jones Industrial Index	27,332.03	26,922.12	26,089.61	25,019.41
S&P 500	3,013.77	2,990.41	2,886.98	2,801.31
NASDAQ	8,244.14	8,161.79	7,796.66	7,825.98

COMMODITIES				
Gold ($ per troy ounce)	1,416.80	1,403.10	1,345.30	1,241.40
Oil ($ per barrel) - Crude Futures (WTI)	60.24	57.54	52.52	70.65

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (June) - % change	0.1	0.1	0.3	0.2
Core CPI (Ex food and energy) - % change	0.3	0.1	0.1	0.2
Producer Price Index (June) - % change	0.1	0.1	0.2	0.2
Consumer Credit (May) - $blns	17.1	17.5	11.0	15.0