

## WEEKLY ECONOMIC COMMENTARY—WEEK OF JULY 22<sup>nd</sup>, 2019

In the movie, *Duck Soup*, Groucho Marx famously asked a befuddled woman “who are you going to believe, me or your eyes.” Economists may soon be asked the same question by Fed chair Powell. Barring a miraculous about-face, the central bank is all but sure to lower the federal funds rate at its upcoming policy meeting at the end of the month. Yet recent data are prodding some to question the logic of such a move. By all accounts, the economy is holding up quite well, supported by vibrant consumers who drive about 70 percent of economic activity. And while growth is slowing from the artificially-inflated 3.1 percent pace in the first quarter, the slowdown is turning out to be considerably less pronounced than thought a month or so ago. Meanwhile, the latest inflation data, while still disappointingly weak, is comfortably above the deflationary threshold that would generate sleepless nights for central bankers.

No doubt, Powell along with most of his colleagues at the Fed, are aware of these developments. Indeed, the chairman has recently opined that he is quite satisfied with the economy’s current performance. But his message to skeptics is to focus their eyes on the future instead of what they are seeing now. The rate cut that is fully priced into the markets is aimed at cushioning the economy from the headwinds that may well crimp growth later on. It is not the first time the central bank has tried to guide the economy into a soft landing by cutting rates before it seemed necessary; two episodes in the 1990s are the most recent examples. But the longer the data point to economic strength, the greater will be the skepticism, even within the Fed itself. One Fed official, Kansas City Fed President Esther George will likely dissent from the decision to cut rates at the upcoming meeting. In a recent speech, she noted that she doesn’t yet see the case for a rate cut.

Admittedly, George is a long-time Fed hawk and will probably be the lone dissenter on the FOMC wanting to keep the funds rate unchanged. In fact, there is growing expectation that the Fed might go the extra step and reduce the rate by a half-percentage point instead of the quarter-point cut widely assumed. That sentiment grew following a speech by New York Fed President John Williams on Thursday, which the markets interpreted as extremely dovish, although a spokesman for Williams subsequently insisted that his speech was purely “academic” and not aimed at conveying a message regarding current policy. But George at least can point to substantive reasons for dissenting from the crowd. In addition to the persistence of a robust job market, households continue to flex their spending muscles and factories are showing more resilience than expected in the face of global headwinds. Both trends highlighted this week’s batch of data, which is clearly bolstering the case of the rate-cutting skeptics.

The most striking sign of the economy’s resilience was this week’s retail sales report. Total sales in June increased by a sturdy 0.4 percent for the third consecutive month. The increase was not only stronger than the consensus forecast of a 0.2 percent gain, it also reflected strength throughout the retail sector. The only weak readings were for service stations, where price declines at the pump dragged down sales, and for beleaguered department stores, which continue to lose sales to online merchants. Elsewhere, the gains were solid, and some were eye opening. E-commerce sales, for example, continue to garner an increasing share of consumer purchases, jumping by 1.7 percent for the second consecutive month and accounting for a record 12.5 percent of all retail sales (and 15.6 percent of nonauto sales). Their revenues are likely to show another outsize jump in July, as Amazon’s Prime Day sales on July 15 and 16

was augmented by the competitive response from an expanding list of high-profile retailers posting heavily discounted items on their web sites.

Meanwhile, the decline in gasoline prices put \$1.2 billion in the pockets of motorists, which was freely dispensed on discretionary purchases. With the cost of driving cheaper and extra cash for a night out, consumers eagerly drove their cars to restaurants and bars, where sales jumped by 0.9 percent following a 1.0 percent surge in May, when gas prices also fell. Except for one month earlier this year, consumers spent less on gasoline as share of total retail sales than any time since October 2017. Nor were restaurants and bars the only beneficiaries of lower gasoline prices, as solid gains were also posted by other recipients of discretionary purchases, including furniture and clothing stores.

Importantly, the control group of retail sales that enter directly into the GDP calculation of personal consumption expenditures staged an impressive 0.7 percent increase last month. That followed solid increases of 0.5 and 0.6 percent in April and May, pointing to considerable momentum heading into the third quarter. It also punctuates a second-quarter that could reveal a torrid growth rate in real consumption of roundly 4.0 percent. If so, that would rank among the strongest quarterly growth rates for consumer spending since the fourth quarter of 2014. A rebound from the tepid 0.9 percent increase in the first quarter was expected, as consumption then was clobbered by the government shutdown, a late-year plunge in stock prices and household angst over growing trade tensions.

But the rebound is exceeding expectations and a 4.0 percent growth rate in PCE suggests that GDP could advance by a respectable 2.0 percent in the second quarter. That's not a gangbuster pace by any means, but it is a far cry from perceptions earlier in the period, when it looked like the economy's growth engine was downshifting towards stall speed. To be sure, lower gasoline prices as well as tame inflation in general are partly responsible for the more upbeat performance, as worker paychecks are going a longer way even as nominal wage growth is flattening out. But the more important thrust is coming from the sustained strength in the job market, which is keeping the paychecks flowing and stoking a high level of consumer confidence.

As long as consumers are spending, the nation's factories will enjoy a vital source of support. That was evident in June, when manufacturing output increased by 0.4 percent, the strongest monthly increase of the year that builds on the previous month's 0.2 percent output gain. Pacing last month's increase – which again was on the high side of expectations – auto manufacturers ramped up assemblies of motor vehicles by 2.9 percent following a sizeable 2.3 percent increase in May. That was the first back-to-back monthly increases this year and is consistent with the strong gains in auto dealer sales for May and June recorded in the retail sales report. Even more encouraging, output of business equipment increased for the second consecutive month, posting a 0.5 percent gain after a 0.4 percent increase in May. This suggests that capital spending may not be as much of a drag on second-quarter growth as other indicators are tracking, most notably orders and shipments of capital goods.

Despite these encouraging signs, manufacturing activity is not a pillar of strength for the economy. Even with the back-to-back increases in output, manufacturing production fell by 2.2 percent in the second quarter, as the support provided by auto output was more than offset by widespread weakness elsewhere. Even the late period uptick in business equipment production was not enough to offset a large setback in April, resulting in a 3.8 percent decline for the

quarter. As much as anything, the ongoing struggles of the industrial sector highlight the concern over weakening global developments expressed by Fed Chair Powell. With growth overseas continuing to slow, particularly in key export markets like Europe, foreign demand for American made products is poised to suffer.

Making matters worse, the strong dollar is putting American producers at a competitive disadvantage. For a while, the greenback was softening as expectations of a Fed rate cut grew in the spring and the economy looked weaker than it currently does. But since late June, it has recovered most of the ground lost over the previous month, and the dollar still stands 3 ½ percent higher than last September. Even with the expected rate cut later this month, yields in the U.S. are considerably higher than alternative investments overseas, luring foreign capital that is propping up the value of the dollar. That inflow is also facilitated by the relative strength of the U.S. economy, which continues to outperform most other developed economies. Indeed, a widening array of central banks abroad have either already cut or are on the verge of cutting their policy rates, which dilutes the impact that a Fed rate cut would have on lowering the dollar's value.

From our lens, the Fed is almost certain to lower the fed funds rate at its upcoming two-day policy meeting that concludes on July 31. The financial markets have fully priced in a reduction and Fed officials have done little to beat back those expectations. Indeed, failure to follow through would likely generate a good deal of market turmoil, which the Fed is loath to see. But speculation of a half-point cut is overblown in our view, particularly in light of incoming data, which are mostly exceeding expectations. One key exception is a downbeat report on housing construction last month, as starts fell by nearly 1 percent in June and are down more than 4 percent for the year so far. But even here, prospects are looking better as builder sentiment is upbeat, housing formation is picking up, mortgage rates are low, and a strong job market is making a home purchase more affordable to a growing swath of the population.

That said, the case for a rate cut this month, and most likely another later in the year, has a good deal of support. The economy may be retaining more strength than expected a month or two ago, but the risks and the headwinds it faces are undeniably growing. The tailwind from the 2017 tax cut is fading, trade tensions remain on the forefront, geopolitical risks are rising and a possible confidence-shattering fiscal episode may rear its head if legislators can't forge a deal to raise the debt limit and fund the government in coming weeks. The Fed is becoming less data dependent and more of a risk manager, which makes a preemptive strike to cut rates a compelling decision at upcoming meetings.

## FINANCIAL INDICATORS

INTEREST RATES	July 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.07	2.15	2.13	1.98
6-month Treasury bill	2.04	2.08	2.06	2.15
3-month LIBOR	2.28	2.30	2.34	2.35
2-year Treasury note	1.81	1.85	1.75	2.60
5-year Treasury note	1.81	1.86	1.78	2.77
10-year Treasury note	2.05	2.11	2.06	2.90
30-year Treasury bond	2.58	2.64	2.56	3.03
30-year fixed mortgage rate	3.81	3.75	3.84	4.52
15-year fixed mortgage rate	3.23	3.22	3.25	4.00
5/1-year adjustable rate	3.48	3.46	3.48	3.87

STOCK MARKET	July 19	Week Ago	Month Ago	Year Ago
Dow Jones Industrial Index	27,154.20	27,332.03	26,719.13	25,058.12
S&P 500	2,976.61	3,013.77	2,950.46	2,801.83
NASDAQ	8,146.49	8,244.14	8,031.71	7,820.20

COMMODITIES	July 19	Week Ago	Month Ago	Year Ago
Gold (\$ per troy ounce)	1,425.70	1,416.80	1,402.70	1,231.00
Oil (\$ per barrel) - Crude Futures (WTI)	56.13	60.24	57.60	70.31

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (June) - % change	0.4	0.4	0.4	0.7
Industrial Production (June) - % change	0.0	0.4	-0.5	-0.1
Capacity Utilization (June) - Percent	77.9	78.1	77.9	78.3
Housing Starts (June) - 000s of units	1,253.0	1,265.0	1,270.0	1,238.0
Building Permits (June) - 000s of units	1,220.0	1,299.0	1,290.0	1,283.0

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