GPA GOVERNMENT PORTFOLIO ADVISORS

WEEKLY ECONOMIC COMMENTARY—WEEK OF JULY 29th, 2019

There were few surprises in the Commerce Department's second-quarter GDP report released on Friday. But like the response to Mueller's congressional testimony this week, observers can interpret the findings in either a positive or negative light. That said, the report does little to alter widespread perceptions that the Federal Reserve will reduce its policy rate at the upcoming FOMC meeting at the end of this month. Only a breakout from the expected 2.0 percent growth rate or a significant pickup in inflation would have altered the minds of the Fed doves. Neither occurred, and the global headwinds facing the economy in coming months remain as threatening as ever.

On the surface, the economy's growth engine downshifted considerably, slipping from a 3.1 percent pace in the first quarter to 2.1 percent in the April-June period. What's more, the scheduled revisions of past data reveals that the economy had less vigor last year than thought, particularly in the fourth quarter, which now sports a growth rate of only 1.1 percent instead of the 2.2 percent previously estimated. That, in turn, means that the annual growth rate from the fourth quarter of 2017 through the fourth quarter of 2018 did not hit 3.0 percent after all as the original data indicated, but clocked in at a much more modest 2.5 percent. Still, the average for all of last year increased by 2.9 percent over 2017, which is still the strongest pace since 2005.

As expected, the very forces that propelled growth in the first quarter were largely responsible for the slowdown in the second. Inventory stockpiling contributed 0.5-percentage point to the 3.1 percent advance in the first quarter, but subtracted 0.9 percentage points in the second. Likewise, net exports swung from providing a 0.7 percentage point boost to a 0.7 percentage point drag over the two periods. Stripping out these volatile components from the calculation uncovers a much stronger domestic economy than portrayed by the headline GDP data. Final sales to domestic purchasers increased by a formidable 3.5 percent in the second quarter, and sales to domestic private purchasers gained 3.2 percent; both were considerably stronger than the increases in the first quarter as well as showing greater strength than the 2.1 percent GDP growth rate.

The good news is that the economy's main growth driver is alive and kicking. Consumer spending, which accounts for about two-thirds of total activity, surged by 4.3 percent in the second quarter following a tepid 1.1 percent increase in the first. Except for a 4.6 percent jump in the fourth quarter of 2017, that was the strongest increase in personal consumption since 2014. Nor was the strength confined to a few items; households spread their dollars over a wide variety of goods and services, including cars, furnishings, clothing, recreational goods, health care and restaurants. The Federal government also provided a notable boost to activity in the second quarter, lifting nondefense spending by an eye-opening 15.9 percent annual rate. But that was likely a snapback from two quarters of contraction, reflecting the government shutdown that spanned the end of the fourth quarter of last year and the start of this year's first quarter.

Importantly, the resurgence in consumer spending has solid underpinnings, which should sustain the life of the now record-long expansion. Thanks to a still-strong job market and rising wages, household incomes are rising comfortably faster than inflation. Real disposable incomes increased by a sturdy 2.5 percent in the second quarter, building on the robust 4.4 percent increase in the first. What's more, households have been socking away more of their incomes

than thought, thanks to upward revisions to income, resulting in a higher savings rate than previously estimated. Over the first half of the year, the personal savings rate averaged 8.3 percent, which is well above the 6.7 percent average over the last 35 years. Hence, households still have a considerable amount of firepower to sustain spending going forward.

However, it's noteworthy that an outsize portion of the income gains last quarter came from dividend and interest receipts. Revenues from financial assets are about one-third the size of wage and salaries, yet they contributed nearly 60 percent of the increase in personal incomes last quarter. While that's a reversal of what occurred in the first quarter, it does dilute the significance of the elevated savings rate, as most financial assets are held by wealthier households who tend to spend a smaller proportion of their incomes. Reinforcing this point, the growth rate in wages and salaries slowed to about half the pace of the first quarter. That's consistent with the slowing trend in worker earnings depicted in the monthly employment reports.

From our lens, job and income prospects should provide sturdy, albeit waning, support to consumer spending over the second half of the year. The income boost provided from the 2017 tax cuts and increased government spending is easing and job growth is poised to slow, reflecting both a growing shortage of workers and slowing economic growth. What's more, with corporate profits slipping after years of robust growth, dividend payouts should also recede, which is a common occurrence during the late stage of expansions. Meanwhile, with market interest rates well off their cycle peaks this year and the Fed poised to lower short term rates, interest receipts should have a smaller impact on income growth going forward.

But despite these restraints, consumers are still doing the heavy lifting for the economy. That's significant because other sectors are not carrying their weight. A particular underachiever is the housing market, which has been a drag on growth for most of the past three years. In the second quarter, residential outlays fell by 1.5 percent, which marked the sixth consecutive quarter of contraction. The drag from this sector is particularly remarkable in light of the positive demand-side influences that prevailed during this period, including the robust growth in jobs, steadily rising incomes and low, and still declining mortgage interest rates.

The problem here has more to do with supply than demand. True, home prices have risen much faster than incomes since the recession and pushed many would-be homebuyers out of the market. But builders are simply not keeping up with the growing population of potential homebuyers. Residential construction, in turn, has been restrained by a number of obstacles, including a shortage of workers, a lack of building lots and escalating construction costs, both for labor and materials. Some of these constraints are starting to ease, offering some hope going forward. Construction material prices –including lumber, copper, and steel – have been tumbling since last summer and home price increases are slowing. Indeed, the median price of a new home has hardly budged over the past three years and inventories in the new home market have risen to historically normal levels. We suspect that residential outlays have bottomed out, and should contribute modestly to economic growth for the rest of the year.

But a bigger concern is business investment spending, which was probably the most downbeat feature of the GDP report. Nonresidential fixed investment contracted for the first time in more than three years, falling by 0.6 percent in the second quarter. The decline was paced by a whopping 10.6 percent plunge in spending on structures – factories, office buildings as well as oil rigs. That was partially offset by a meager 0.7 percent increase in equipment spending and

another solid 4.7 percent increase in research and development and computer software. The sustained increase in R&D and software – three of the past four quarters have seen double-digit gains – is a positive long-run omen, as it points to stronger productivity growth in future years.

But the listless pace of equipment spending – the 0.7 percent gain follows a small contraction in the first quarter – bodes ominously for the near term outlook. Capital spending is a small fraction of GDP, but it tends to have an outsize influence on business cycles, frequently leading the economy into recessions. Unfortunately, prospects are mixed at best. The good news is that orders for nondefense capital goods, excluding aircraft – which is a barometer of equipment spending plans – advanced by a sturdy 1.9 percent in June, matching the strongest gain since December 2017. Even so, the June surge follows 10 months of listless activity, leaving the level only 2.0 percent higher than a year earlier.

More important, the downbeat trend in capital spending reflects broader concerns of the business community, which is highly sensitive to the persistent drumbeat of negative global developments. Not only is global growth slowing – the IMF just downgraded its growth outlook for this year – but trade tensions continue to weigh heavily on corporate sentiment. In survey after survey, corporate leaders have cited trade conflicts and their unpredictable economic consequences as the main source of uncertainty that is underpinning their more cautious behavior. Indeed, many have said that investment plans are being put on hold because of uncertainty over trade policies. The Federal Reserve has taken notice of this chilling effect in boardrooms, pointing to global developments as a key reason it is set to cut rates.

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FINANCIAL INDICATORS

INTEREST RATES	Jul 26	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.12	2.07	2.13	2.00
6-month Treasury bill	2.10	2.04	2.11	2.19
3-month LIBOR	2.26	2.28	2.32	2.34
2-year Treasury note	1.86	1.81	1.75	2.66
5-year Treasury note	1.85	1.81	1.77	2.84
10-year Treasury note	2.08	2.05	2.01	2.96
30-year Treasury bond	2.60	2.58	2.53	3.09
30-year fixed mortgage rate	3.75	3.81	3.73	4.54
15-year fixed mortgage rate	3.18	3.23	3.16	4.02
5/1-year adjustable rate	3.47	3.48	3.39	3.87
STOCK MARKET				
Dow Jones Industrial Index	27,192.49	27,154.20	26,599.96	25,451.06
S&P 500	3,025.86	2,976.61	2,941.76	2,818.82
NASDAQ	8,330.21	8,146.44	8,006.24	7,737.42
COMMODITIES				
Gold ($ per troy ounce)	1,417.70	1,425.70	1,413.10	1,232.20
Oil ($ per barrel) - Crude Futures (WTI)	56.20	56.13	57.17	68.87

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (June) -000s	646	604	658	652
Existing Home Sales (June) - 000s	5,270	5,360	5,210	5,433
Durable Goods Orders (June) - % change	2.0	-2.3	-2.8	-0.6
Real GDP (Q2) - % change, Saar	2.1	3.1	1.1	2.5

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