

WEEKLY ECONOMIC COMMENTARY—WEEK OF AUGUST 19th, 2019

The recession-watch crowd gained some new recruits this week, lured by a brief inversion of the 10-year/2-year yield spread and a further deterioration in the global economy. While the inversion – a time-honored recession indicator – didn't stick, it remains to be seen if the ominous signal it sent is fully extinguished in coming days and weeks. The global backdrop still weighs heavily on investors' minds, as the German economy contracted in the second quarter, China's slowdown continues apace, geopolitical tensions are escalating, and Brexit uncertainty is intensifying as the October deadline is rapidly approaching. Meanwhile, the U.S./China trade war remains heated despite President Trump's decision to delay about half of the newly-announced tariffs on \$300 billion of Chinese imports from September 1 until December 15.

That "Christmas respite" does not remove the tariff threat but merely scales back the prospective impact it would otherwise have on consumers during the upcoming holiday-shopping season. More than \$100 billion of additional Chinese goods will still be subject to the 10 percent tariff starting in September and there is no sign that the postponed levies will be rescinded before mid-December. That means the prospect of a prolonged trade dispute remains very much intact, including retaliatory measures expected from China. As it is, the 25 percent tariffs on \$250 billion of Chinese imports already on the books are reinforcing the headwinds poised to drag down growth in the U.S. later this year and in 2020.

Not surprisingly, the global slowdown, which is nurtured by trade conflicts, is taking the biggest toll on the industrial sector. Industrial output fell 0.2 percent in July, a weaker reading than expected, and stands only 0.5 percent higher than a year ago. That's the weakest annual growth rate in more than two years. Importantly, the slowing pace in overall industrial output, which includes mines and utilities, is masking an even steeper fall-off in manufacturing activity. Manufacturing production declined by 0.4 percent last month and is now running 0.5 percent below the year-earlier level, the weakest year-over-year comparison since late 2016.

The setback in manufacturing output last month was broad-based, encompassing a wide range of sectors. But of particular concern was the 0.4 percent decline in business equipment production, marking the fourth monthly decline so far this year. The weakness in capital spending over the first half of the year has weighed heavily on the economy's performance, and the latest setback confirms the deteriorating manufacturing outlook revealed in the July survey by the Institute for Supply Management released earlier this month. Business leaders are becoming increasingly concerned over global developments and trade conflicts, and are not likely to commit to expensive investment projects amid this uncertainty. We expect the slump in manufacturing to continue and be a drag on growth heading into 2020.

While recent developments have coaxed the forecasting community to place higher odds of a recession over the next twelve months, there are still buffers that should keep the growth engine running, albeit at a slower pace than over the past 1-½ years. For one, the Federal Reserve has some leeway to pump-prime the economy. The quarter-point interest-rate cut it put into place at the end of July is likely to be the first of several reductions we expect in upcoming policy meetings, including installments in September and December. Assuming that each would also be quarter-point cuts, that would still leave the federal funds rate in a range of 1.50-1.75 percent, giving the central bank further room to cut if the economy weakens more than expected.

For another, the “wall of worry” that is weighing on the financial markets and business sentiment has so far eluded the economy’s main growth driver – consumers. If indeed a recession is looming sooner rather than later, the trigger won’t be a pullback in personal consumption – at least not in the foreseeable future. If anything, household spending is providing much more ballast to the economy than most anyone expected. Recall that personal consumption increased by a formidable 4.3 percent annual rate in the second quarter, accounting for all of the 2.1 percent growth in GDP and then some. Because that followed a tepid 1.1 percent increase in the first quarter, many viewed the consumption surge as a temporary snapback rather than a sustained pickup that would support faster growth for the economy going forward.

However, it now appears that consumer spending has considerably more heft than previously thought. While the second quarter’s 4.3 percent growth rate will not be equaled, the slowdown should be much milder than thought a month or so ago. The reason: shoppers stormed into the third quarter with far more vigor than expected. That was strikingly illustrated in this week’s retail report for July. The consensus expected that retail sales would increase by about 0.3 percent last month, modestly slower than the average monthly pace of the second quarter. Instead, total sales jumped by more than twice as much, leaping 0.7 percent. And that includes a 0.7 percent decline in auto sales, a large but volatile component. Excluding autos, sales jumped by 1.0 percent and by a still-formidable 0.9 percent without the price-driven increase in gasoline sales.

In a mirror image of the weakness in industrial production, virtually all categories of retail sales posted increases. The key exception was auto sales, which as noted are highly volatile but nonetheless are tracking a slowing trend. Outside of autos, solid gains were registered for all but 2 of the remaining 12 major categories tracked by the Commerce Department. The standout performer, as usual, were non-store retailers, mostly Internet-related purchases, where sales rose by a stunning 2.8 percent, following solid increases of 1.9 percent and 2.3 percent in June and May, respectively. The strength in Internet sales got a big boost from Amazon’s Prime Day and lifted their share of total retail sales to another new record of 12.8 percent. These sales are growing at an annual pace of 16 percent, more than four times faster than the 3.4 percent annual increase in overall sales.

But the rapid growth in Internet sales did not detract from a better showing of brick and mortar establishments. Indeed, department store sales increased by 1.2 percent last month, although that rebound made but a small dent into the long downward slide in this sector. Compared to a year ago, department store sales are down by 4.7 percent, a trend that is destined to continue. On the bright side, households continue to show that they have ample discretionary funds to spend. Hence, food and restaurants enjoyed another solid 1.1 percent increase in sales, following increases of 0.7 percent and 1.1 percent in the previous two months. The 1.0 percent average increase over the past three months is nearly double the 0.6 percent average over the previous three-month span.

Importantly, the control group of sales that feed directly into the GDP calculation indicates that personal consumption is providing a significant lift to the economy’s growth rate at the start of the third quarter. These core sales topped the headline

Increase of 0.7 percent, advancing by a sturdy 1.0 percent in July. What’s more, they are gaining momentum, as the year-over-year increase moved up to 4.9 percent from 4.7 percent in June and 3.4 percent in May. Simply put, households are in good shape, bolstered by steady employment

gains, rising incomes and low inflation, notwithstanding an upward blip in the inflation rate reported for July.

The sustained vigor in consumer spending does not lessen the prospect of another Federal Reserve rate cut at its September policy meeting; but the strong retail report did arrest the growing perception in the financial markets that the economy was going to hell in the handbasket. Indeed, the upbeat report provided a much-needed spark for equity prices, which rallied strongly on Thursday and Friday, erasing much of the dispiriting plunge linked to trade tensions earlier in the week. It also was the spark that sent the 10-year yield slightly above the 2-year yield again, although the gap stood at a slim and fragile 3 basis points at the end of the week. While solid consumer fundamentals underpin expectations held by most, including us, that the expansion still has legs, the deteriorating global environment and continued trade tensions erode some confidence in those expectations. Indeed, there are early warning signs that households are not immune from downbeat news on the global front, as the University of Michigan reported on Friday that consumer sentiment took a big hit in early August, falling to the lowest level since January. If consumer spirits continue to sink and translate into weaker spending behavior, the odds of a recession sooner than later would clearly increase.

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FINANCIAL INDICATORS

INTEREST RATES	Aug 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.87	2.00	2.07	2.04
6-month Treasury bill	1.86	2.00	2.04	2.23
3-month LIBOR	2.12	2.18	2.28	2.32
2-year Treasury note	1.48	1.64	1.81	2.62
5-year Treasury note	1.43	1.57	1.81	2.75
10-year Treasury note	1.57	1.75	2.05	2.86
30-year Treasury bond	2.05	2.26	2.58	3.02
30-year fixed mortgage rate	3.60	3.60	3.81	4.53
15-year fixed mortgage rate	3.07	3.05	3.23	4.01
5/1-year adjustable rate	3.35	3.36	3.48	3.87

STOCK MARKET				
Dow Jones Industrial Index	28,886.01	26,287.44	27,154.20	25,669.32
S&P 500	2,888.68	2,918.65	2,976.61	2,850.13
NASDAQ	7,895.99	7,959.14	8,146.44	7,816.33

COMMODITIES				
Gold (\$ per troy ounce)	1,522.60	1,509.50	1,425.70	1,191.80
Oil (\$ per barrel) - Crude Futures (WTI)	54.86	54.32	56.13	65.92

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (July) - % change	0.3	0.1	0.1	0.2
Core CPI (July) - % change	0.3	0.3	0.1	0.2
Retail Sales (July) - % change	0.7	0.3	0.5	0.5
Industrial Production (July) - % change	-0.2	0.2	0.2	-0.1
Capacity Utilization (July) - Percent	77.5	77.8	77.8	77.9

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