

WEEKLY ECONOMIC COMMENTARY—WEEK OF AUGUST 5th, 2019

The Federal Reserve swung its heavy gavel this week and, to paraphrase an infamous trial, essentially proclaimed, “If the facts don’t fit, you can’t commit”. To be sure, the central bank didn’t completely exonerate the miscreant, as it took out some insurance that the economic defendant’s behavior would not go astray. Hence, it acceded to the jury’s request for a quarter-point rate cut, but refused to commit to a longer sentence of rate reductions, which most members of the financial jury had been clamoring for. From the lens of the chief judge Powell, the facts do not support such a commitment yet; but he did leave the door open should the facts change.

That may happen sooner than expected. Not surprisingly, the financial markets reacted poorly to the Fed’s decision, disappointed by the hawkish message of Fed Chair Powell in the press conference following the policy-setting meeting. Instead of indicating that the quarter-point rate cut would be the start of a lengthy policy-easing shift, he asserted that it was merely a mid-cycle correction aimed at keeping the expansion going and drawing more people into the job market. Market participants had priced in at least two more rate cuts this year heading into the FOMC meeting but scaled back those expectations following Powell’s comments, spurring a broad-based plunge in stock prices.

The market backlash eased for a while on Thursday, as investors reassessed rate-cutting prospects in light of the persistent headwinds that pose a threat to the economy and the ongoing undershoot of inflation, which remains firmly below the Fed’s 2 percent target. Meanwhile, the economy’s weak spots show no signs of reversing course. Manufacturing continues to struggle mightily, as indicated by the latest ISM purchasing managers’ report, and residential construction spending remains in the doldrums. Importantly, two of the Fed’s main concerns are the slowing global economy and uncertainty over trade policy. The latest reports from overseas only deepened the concern over global growth, as activity in the euro zone downshifted sharply in the second quarter.

But it was news on the trade front that stunned the financial markets late in the week. Just as stock prices were rebounding from its earlier backlash, President Trump ratcheted up trade tensions by threatening to impose 10 percent tariffs on an additional \$300 billion of Chinese imports beginning September 1. That’s in addition to the 25 percent tariff already on the books for \$250 billion of imports from China. The president asserted that the new tariffs are in response to China’s failing to live up to its promises of purchasing more farm products and for dragging its feet on other issues involved in the trade dispute between the world’s two largest economies. It is only a matter of time, but there should be little doubt that China will react in kind, upping the ante in the ongoing trade war that is arguably the most disruptive influence in the financial markets.

Cynics, of course, will argue that there is method to the madness behind the new tariffs. In the press conference, Powell noted that trade tensions had receded from a “boil” in June to a “simmer” in July, thus implying there is less urgency to cut rates more aggressively. President Trump was quick to express his displeasure with Powell’s timid move, tweeting that sharper and faster rate cuts should be taken. Needless to say, there is some suspicion that by ramping up trade tensions back to a boil, the president had more in mind than to punish China. If Powell

needed an extra push to act more decisively on the rate front, perhaps the amped-up trade war would do the trick.

Of course, the president might want to heed the age-old warning: Be careful what you wish for. While Trump clearly desires steeper rate cuts to bolster the economy heading into an election year, an escalation of the trade war might create more wounds than rate cuts could heal. By itself, the additional 10 percent in tariffs would not short-circuit the expansion. But Trump also warned that the levies could increase to “well beyond 25 percent” if the two sides do not reach a trade deal. That, in turn, could very well be the straw that sends the economy down a slippery slope, overwhelming the support that rate cuts could provide. What makes that ominous prospect more credible is that the negative impact of a trade war would likely be amplified by the financial market turmoil it stokes.

That said, the tariff threat is just that – a threat, not a reality. The September 1 deadline is still nearly a month away, and Trump has shown a willingness to pull back from intimidating proclamations before. We suspect that a late-minute delay in the tariffs is in the offing this time as well, particularly if the markets behave badly in coming weeks and the economy shows more signs of buckling under the headwinds it faces, heightening the odds of another rate cut in September. As it is, the futures market is still pricing in a high probability the Fed will pull the rate trigger again in September, a prospect we agree with.

But as was the case with the rate cut this week, the September reduction will not be in response to sharply deteriorating economic conditions. By all accounts, the fundamentals supporting growth remain firm. Consumers continue to supply rock-solid support, staging an impressive 4.3 percent increase in spending during the second quarter and ending the period with considerable momentum. The Commerce Department reported this week that personal consumption increased by a respectable 0.2 percent in June after adjusting for inflation. While that’s a tad slower than the increases in May and June, it left total spending a sturdy 2.5 percent ahead of a year ago. Importantly, the ingredients for future spending strength are firmly in place, thanks to substantially faster growth in disposable incomes and a savings rate that stands at a lofty 8.1 percent.

And while the latest spending and income figures are for June, prospects at the start of the third quarter are not too shabby. The biggest influence on consumer behavior comes from the job market. On Friday the Labor Department released its monthly jobs report, and the outcome was mostly positive. Nonfarm payrolls increased by an as-expected 164 thousand in July, following monthly gains of 193 and 62 thousand in June and May respectively. The monthly increases so far this year have been lumpy, ranging from a high of 312 thousand in January and a low of 62 thousand in May. A better sense of the underlying trend can be gleaned by smoothing out these monthly gyrations, which yields an average of 165 thousand over the first seven months of the year. That compares to an average monthly increase in payrolls of 223 thousand in 2018.

While that seems like an abrupt downshift, it is more than enough to accommodate the increase in the working-age population. Indeed, the unemployment rate held steady at a near 50-year low of 3.7 percent during the month. The employment gains were widespread, with nearly 60 percent of all industries expanding payrolls, the broadest swath of increases this year. Companies in the health care, social services and education lead the way, adding an outside 116 million jobs last month. Surprisingly, manufacturing jobs increased by a respectable 15 thousand, despite the headwinds from slowing global growth, tariffs and slumping industrial

output. But that increase comes with an important caveat, as manufacturers cut worker hours significantly. The 0.3 percent reduction slashed the average workweek to 40.4 hours, the lowest in nine years.

The good news is that the steady employment gains are reducing slack in the labor force and putting upward pressure on wages. Average hourly earnings rose by 3.2 percent in July from a year ago, a slight uptick from the 3.1 percent increase the previous month. The bad news is that the increases peaked in February, when annual pay gains reached 3.4 percent. However, it is unclear why wage growth has tapered off. Is it because more people are joining the labor force and boosting supply (the labor force participation rate ticked up to 63.0 percent from 62.9 percent)? Or is it because lesser skilled workers, who command a lower salary, are being lured into the workforce, thus depressing average wage gains? It is noteworthy that the employment-population ratio for younger workers without a high-school diploma scored the biggest jump last month, from 43.0 to 44.7 percent.

Simply put, growth is slowing, as the tailwind from the administration's tax cuts and increased spending is fading and the economy is drifting towards its lowered growth potential of just under 2 percent. That slowing trend is neither surprising nor indicative of an expansion that is poised to run out of gas. But given the ongoing global headwinds and heightened trade uncertainty that is depressing business confidence and investment spending, the Fed will likely give the economy a booster shot in September to reinforce the support provided by the latest quarter-point reduction. Whether that will be the second installment of a lengthier cycle of rate cuts remains to be seen. A lot will depend on how trade tensions play out and how global developments evolve.

FINANCIAL INDICATORS

INTEREST RATES	Aug 2	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.06	2.12	2.23	2.02
6-month Treasury bill	2.01	2.10	2.13	2.23
3-month LIBOR	2.29	2.26	2.30	2.34
2-year Treasury note	1.71	1.86	1.87	2.65
5-year Treasury note	1.66	1.85	1.83	2.82
10-year Treasury note	1.84	2.08	2.04	2.95
30-year Treasury bond	2.38	2.60	2.54	3.09
30-year fixed mortgage rate	3.75	3.75	3.75	4.60
15-year fixed mortgage rate	3.20	3.18	3.18	4.08
5/1-year adjustable rate	3.46	3.47	3.45	3.93

STOCK MARKET				
Dow Jones Industrial Index	26,485.01	27,192.49	26,922.12	25,462.58
S&P 500	2,932.05	3,025.86	2,990.41	2,840.35
NASDAQ	8,004.07	8,330.21	8,161.79	7,812.01

COMMODITIES				
Gold (\$ per troy ounce)	1,453.50	1,417.70	1,403.10	1,221.90
Oil (\$ per barrel) - Crude Futures (WTI)	55.20	56.20	57.54	68.65

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (July)	51	52	52	53
Nonfarm Payrolls (July) - 000s	164	193	62	141
Unemployment Rate (July) - Percent	3.7	3.7	3.6	3.7
Average Hourly Earnings (July) - % chg	0.3	0.3	0.3	0.3
Personal Income (June) - % change	0.4	0.4	0.4	0.4
Personal Consumption Exp.(July) - % chg	0.3	0.5	0.6	0.5

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