

WEEKLY ECONOMIC COMMENTARY—WEEK OF SEPTEMBER 9th, 2019

Traders and investors returned from their extended Labor Day vacations and to their dismay found the economic, financial, policy and geopolitical landscape just as confusing – if not more so – as it was before they left. Not surprisingly, their first week back was anything but tranquil; stock prices see-sawed violently, bond yields fell then rose, the 2 year/10 year yield curve inverted then reverted, commodity prices sank even as the dollar and gold prices surged. This dizzying ride echoed the crosscurrents that dominated the headlines during the week.

Grabbing most attention of course is the ongoing trade dispute with China. Market participants had to grapple with the latest tit-for-tat in the tariff battle, which escalated dramatically over the past several weeks and sent investors fleeing for cover in safe-haven assets. However, just as the conflict seemed to be approaching a boiling point, the markets were cheered by news this week that trade negotiators of the world's two largest economies were scheduled to meet next month, suggesting a possible thaw in the trade war might be in the offering. That drove stock prices and bond yields higher, highlighting once again the dominant influence this ongoing trade saga is having in the financial markets.

While president Trump continues to assert that that trade war is hurting China more than the U.S. there is little question that it is taking a toll on the U.S. economy. So far, most of the damage has been inflicted on the goods-producing sectors, particularly multinational companies with deeply-rooted foreign operations that are coping with supply chain disruptions and higher input prices on supplies from overseas, which have been bearing the brunt of the tariffs. But the pain is poised to spread more broadly in coming months. The latest round of tariffs, scheduled to begin October 1 and December 15 will be attached to consumer goods, which makes them much more visible and directly hits household wallets and purses. That prospect is seeping into the mindset of households, as consumer sentiment suffered its biggest drop in August since December 2012, when fears of the fiscal cliff were running high.

To be sure, consumers have yet to curb their actual spending. Indeed, thanks entirely to the torrid 4.7 percent growth rate in personal consumption expenditures, the economy advanced by a respectable 2.0 percent pace during the second quarter. More than anything, the sustained strength in consumer spending is keeping recession fears at bay. After all, personal consumption is the economy's main growth driver, accounting for roundly 70 percent of total output. The general perception is that as long as the engine's key cylinder continues to run at a healthy clip, the economy should remain on a positive growth path. However, it is noteworthy that the facts do not always corroborate this perception. In five of the last eight recessions, personal consumption increased during the first quarters of the downturns. Indeed, consumer spending increased in every quarter of the mild 2001 recession. Even during the harsh 1981-82 recession, consumer spending increased in five of the six quarters of the downturn.

But those episodes were heavily influenced by shocks that overwhelmed the increase in consumer spending – the dot.com and capital spending bust in 2001 and the Federal Reserve's tough inflation-fighting policy in the early 1980s that drove interest rates sky-high and decimated housing activity. No comparable shock is on the radar screen this time. The most worrisome influence, the trade war, is not potent enough to tip the economy over the edge, although its direct impact could well be amplified by the negative spillover effects on the financial markets and, in

time, consumer and business behavior. As it is, lingering uncertainty over trade policy has taken a bite out of capital spending, and business leaders continue to list trade tensions as their primary concern going forward.

Still, from our lens the direct and indirect effects from the trade conflict should at most slice 0.5 percent from the economy's growth rate next year. That would slow, but not derail, the expansion, which is likely to advance by a modest 1.6 percent in 2020. The wildcard, assuming all the tariffs and retaliatory measures by China take effect, is the impact they have on the financial markets and on consumer and business confidence. Should investors head for the hills, leading to massive wealth destruction, the hit to the economy would be palpable. If that were accompanied by an equally severe nosedive in business and consumer confidence, the odds of a recession would clearly soar.

But that worse case scenario is likely to be short-circuited by political expediency. President Trump has a vested interest in keeping the economy afloat as a challenging election year looms ahead. China is already in the grips of a marked slowdown even as it grapples with unrest in Hong Kong. Meanwhile, the Federal Reserve is poised to cut interest rates more aggressively if the global headwinds threaten to do more harm to the economy than is currently envisioned. Odds are, a comprehensive trade deal is not in the cards. But some temporary compromise that keeps hopes alive for a more permanent solution is likely to be struck before conditions deteriorate beyond repair in both nations.

Assuming the global headwinds do not escalate dramatically, consumers should continue to drive the economy forward through next year. Notwithstanding the steep drop in sentiment last month, households are still highly confident in the job market. As long as job security is solid and paychecks are growing, consumers will spend. By all accounts, those spending fundamentals remain firmly intact, although less so than in recent years. The latest monthly jobs report released on Friday was not as uniformly positive as expected, but the overall impression was more good than bad. From a policy perspective, there was little in the report that should dissuade the Fed from cutting rates by another quarter point at its upcoming meeting in mid-September.

First the not-so-good news. The economy generated fewer jobs in August than the 160 thousand expected by the consensus on Wall Street. Nonfarm payrolls increased by only 130 thousand during the month. What's more a sizeable fraction of the gain, 25 thousand, consisted of temporary workers hired for the decennial 2020 Census. As well, the gains over the previous two months were revised down by 20 thousand. Overall, the pace of job growth is cooling a bit, but hardly falling off a cliff. Over the first eight months of the year, the average pace of job growth slowed to 158 thousand from 223 thousand in 2018. But it's been steady as she goes this year, as the payroll gains averaged 156 thousand over the past three months and 150 thousand over the past six months.

Simply put, the modest slowdown in job gains this year is consistent with a modest cooling in economic growth and with a labor market that is nearing full employment. Indeed, the payroll increases have been more than enough to keep unemployment at the lowest rate in nearly half a century. The jobless rate held at 3.7 percent in August and has remained under 4 percent in every month since February. With jobs easy to get, ever more workers are entering the labor market. The labor force participation rate increased to 63.2 percent last month from 63.0 percent in July and is up a half percent over the past year. This is a remarkable achievement considering the aging of the population that is fueling a wave of retirements. Importantly, adults in the prime of

their working age are filling the void. The share of workers age 25-54 rose to 80 percent in August, the highest since January 2008.

With the pace of job growth more than enough to absorb new entrants to the labor force, workers are enjoying steady pay increases. In August, average hourly earnings increased by a sturdy 0.4 percent, bringing the annual gain to 3.2 percent. That's slightly less than the 3.3 percent seen in July, but it remains firmly anchored above 3.0 percent reached last October for the first time since April 2009. It is also comfortably ahead of inflation, providing workers with the additional purchasing power to sustain spending at a healthy pace over the foreseeable future. And while earnings softened a bit last month for all workers in the private sector, the rank-and-file contingent fared better, a time-honored sign of a tightening labor market. The annual increase in average hourly earnings for production and nonsupervisory workers rose 0.1 percent to 3.5 percent in August.

As noted earlier, the Fed will find little reason in the latest jobs report to abstain from cutting rates at its upcoming policy meeting. The financial markets are fully priced for a rate cut and failure to follow through would be highly disruptive, something the Fed would like to avoid. At the same time, there is nothing in the report that would prod the Fed into making a deeper cut of 50 basis points that some, including president Trump, would like to see. That said, the trade wars and the global slowdown are dealing a damaging blow to the goods-producing sectors of the economy, particularly in manufacturing where job gains have slowed to 6 thousand a month this year from 22 thousand in 2018. The global headwinds will continue to be a drag on growth going forward and we expect the Fed to keep its foot on the monetary accelerator, following up its September rate cut with two additional quarter-point reductions in October and December.

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FINANCIAL INDICATORS

| INTEREST RATES | Sep 6 | Week Ago | Month Ago | Year Ago |
|-----------------------------|-------|----------|-----------|----------|
| 3-month Treasury bill | 1.96 | 1.99 | 2.00 | 2.15 |
| 6-month Treasury bill | 1.87 | 1.88 | 2.00 | 2.37 |
| 3-month LIBOR | 2.10 | 2.13 | 2.18 | 2.33 |
| 2-year Treasury note | 1.55 | 1.51 | 1.64 | 2.68 |
| 5-year Treasury note | 1.43 | 1.39 | 1.57 | 2.81 |
| 10-year Treasury note | 1.57 | 1.50 | 1.75 | 2.94 |
| 30-year Treasury bond | 2.03 | 1.96 | 2.26 | 3.11 |
| 30-year fixed mortgage rate | 3.49 | 3.58 | 3.60 | 4.54 |
| 15-year fixed mortgage rate | 3.00 | 3.06 | 3.05 | 3.99 |
| 5/1-year adjustable rate | 3.30 | 3.31 | 3.36 | 3.93 |

| STOCK MARKET | | | | |
|----------------------------|-----------|-----------|-----------|-----------|
| Dow Jones Industrial Index | 26,797.46 | 26,403.28 | 26,287.44 | 25,916.54 |
| S&P 500 | 2,978.71 | 2,926.46 | 2,918.65 | 2,871.68 |
| NASDAQ | 8,103.07 | 7,962.88 | 7,959.14 | 7,902.54 |

| COMMODITIES | | | | |
|---|----------|----------|----------|----------|
| Gold (\$ per troy ounce) | 1,515.30 | 1,529.20 | 1,509.50 | 1,201.80 |
| Oil (\$ per barrel) - Crude Futures (WTI) | 56.63 | 55.16 | 54.32 | 67.86 |

| ECONOMIC INDICATOR | Latest Month/Quarter | Previous Month/Quarter | Two-Months/ Qtrs Ago | Average-Past Six Months or Quarters |
|---|----------------------|------------------------|----------------------|-------------------------------------|
| ISM Manufacturing Index (August) | 49.1 | 51.2 | 51.7 | 52.0 |
| ISM Non-manufacturing Index (August) | 56.4 | 53.7 | 55.1 | 55.6 |
| Nonfarm Payrolls (August) - 000s | 130 | 159 | 178 | 150 |
| Unemployment Rate (August) - 000s | 3.7 | 3.7 | 3.7 | 3.7 |
| Average Hourly Earnings (August) - % chg. | 3.2 | 3.3 | 3.2 | 3.2 |

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