GOVERNMENT PORTFOLIO ADVISORS

WEEKLY ECONOMIC COMMENTARY—WEEK OF OCTOBER 7th, 2019

With the drumbeat of data sounding a decidedly soft note this week, investors are betting that the Fed will ride to the rescue in an effort to save the economy from an unceremonious plunge into recession waters. Indeed, following a downbeat report on activity in the services sector, the markets on Thursday had priced in more than a 90 percent chance that the Fed would cut rates again at its upcoming meeting in late October. Adding to the markets' conviction, the growth-dampening trade wars received more ammunition this week from the WTO, which gave the U.S. permission to impose additional tariffs on European goods. Not one to pass up such a gift, the administration promptly announced that it would impose duties on $7.5 billion of European imports, including jetliners, cheese, French wine and Irish whisky (yikes!) and hand tools later this month.

The latest wrinkle on the trade front should have a negligible direct impact on the economy, but it suggests that trade tensions are not about to abate anytime soon. Hence, the financial markets will continue to be vulnerable to the ebb and flow of negotiations between the U.S. and its main trading partners, most notably with China. Talks between top-level officials of the world's two largest economies are set to resume next week, so the prospect of more nerve-wracking headlines should not be dismissed. Importantly, this week brought more evidence that trade developments are inflicting serious damage on the goods-producing sectors of the economy, stoking recession fears.

The most striking illustration of this impact was provided by the Institute for Supply Management, as its index of manufacturing activity fell into contraction territory for the second consecutive month in September. Not surprisingly, the biggest drag is coming from exports, as the plunge in the sub-index of export orders pulled the overall index down to the lowest level since June 2009. But while the weakness in manufacturing was greater than expected, it was not totally surprising, given the generally soft readings on the industrial side of the economy released in recent months. What did upend market expectations was the ISM's companion survey of non-manufacturing activity, which also came in much weaker than expected – hitting a three-year low – and suggests that the slump in manufacturing brought on by trade developments is spilling over into the much-larger service sector of the economy.

No doubt, there is some spillover effect; business executives of both service providers and goods producers have long expressed concerns over trade policy and the potential impact it would have on the broader economy. These concerns have already translated into cutbacks in investment spending. What's more, there are early signs that uncertainty over trade policy is making a dent in household confidence, possibly contributing to the increase in personal savings and the unexpected setback in consumer spending during August. That said, none of the recent economic reports portrays an economy that is actually contracting. Even the manufacturing recession is not deep enough to drag down the overall economy. According to the ISM, an index reading of 42.9 would be consistent with a recession; in September, the manufacturing index stood at 47.8. Meanwhile, the ISM non-manufacturing index remained in expansion territory, at 52.6, comfortably above the 48.6 level that the ISM estimates would be consistent with a recession.

Simply put, the economy is slowing, but it's not yet at death's door as the ISM readings are tracking a growth rate of about 1.5 percent. Not too long ago, that would have been considered stall speed but it is now viewed as only marginally below the economy's 1.8 percent potential growth rate. Still, the downshifting in the economy's growth engine makes it more vulnerable to external shocks. Importantly, it also raises the question of how much policy support is needed to cushion the economy against the relentless trade headwinds. As noted, following the ISM reports the markets had fully priced in a Fed rate cut at the October policy meeting, as well as a very high probability of a second reduction in December.

But those odds came down considerably on Friday, thanks to a somewhat reassuring employment report from the Labor Department. Indeed, for some time now, surveys and other "soft" data have been signaling a grimmer outlook than is showing up in the hard data. The jobs report is another example of that divide. Make no mistake; the job market is cooling, echoing the slowing growth in the broader economy. But the jobs engine is still humming at a decent pace, even though not all cylinders are firing. In September, nonfarm payrolls increased by 136 thousand, a tad under expectations, but more than enough to accommodate the increase in the working-age population. What's more, the increases for July and August were revised up by 45 thousand, bringing the average gain to 157 thousand over the past three months. That's a gentle, not dramatic, slowing from the 179 thousand average over the past twelve months.

As expected, the main misfiring cylinder is the factory sector. Manufacturers sliced 2000 workers from payrolls last month, extending the weakening trend since the trade wars escalated late last year. So far this year the monthly gains in manufacturing jobs are running about one-quarter of the pace seen in 2018. To be sure, the GM strike may have depressed the numbers somewhat, but the weakening trend in the goods-producing sector is real and enduring, reflecting the cutbacks in exports and capital spending. The strong dollar is adding to the woes of goods producers by making their products more expensive to foreign customers even as it cheapens the costs of imports and siphoning off sales of domestic companies. The strength of the dollar, in turn, is linked to the relatively high interest rates in the U.S. compared to those overseas, which bolsters the case for the Fed to cut rates.

What's more, the slowing pace of overall job growth may actually be understating the extent of the slowdown in hiring. For example, all of the upward revisions to payrolls in July and August were in the government sectors. Private payrolls took a decided turn towards weakness, adding only 114 thousand jobs last month and an average of 119 thousand over the past three months. That's a far more dramatic decline from the 167 thousand average increase over the past twelve months than the 22 thousand drop-off for all payrolls. Last month's gain in government payrolls was mostly at the state and local level, but the Federal government's hiring of workers for the 2020 Census will have a much more distorting influence in coming months.

Generally speaking, the jobs report contained a mix of good and bad elements. As already pointed out, the economy is generating more than enough jobs to accommodate the increase in the working-age population. That excess is strikingly evident in the drop in the unemployment rate to 3.5 percent, the lowest since 1969. Other unemployment measures are also falling. The broader underemployment rate, which includes discouraged workers and those in part-time positions that would like a full time job, fell to 6.9 percent in September, the lowest since December 2000 and only 0.1 percent above the record low hit in October of that year. Indeed, the household survey from which the unemployment rates are derived shows an interesting departure from the trend in the establishment survey, which generates the payroll data.

Over the past three months the household survey reveals a robust 421 thousand average increase in jobs, much stronger than the aforementioned 157 thousand average increase in nonfarm payrolls reported in the establishment survey. Hence, while companies are showing a downshift in job growth over the past three months, the household survey is showing just the opposite, with job growth accelerating from a twelve month average of 205 thousand to 421 thousand over the past three months. Economists generally agree that the payroll data is a more reliable barometer of the job market than the data in the household survey, which is derived from a much smaller sample and is much more volatile. Still, the strength in the household survey supports the notion that the tightening labor market is drawing ever-more people into the workforce that have long been sidelined for a variety of reasons. Hence, the employment/population ratio for prime-age workers (25-54) regained virtually all of the ground lost from the Great Recession, moving to just 0.2 percent shy of the 83.3 percent pre-recession peak. This ratio never recovered the recession losses during the previous expansion.

Nonetheless, a point for the Fed to consider is that the tightening job market is still not generating upward wage pressures, which would raise inflation alarms if policy were easing too aggressively in the eyes of investors. After staying above 3 percent in twelve of the past thirteen months, the annual growth in average hourly earnings fell back to 2.9 percent in September. This may or may not indicate that the supply of labor is more abundant than thought, as suggested by the ongoing increase in the employment/population ratio. More than likely, the wage restraint reflects the absence of business pricing power amid moderating domestic demand and global competitive forces, underscored by the strong dollar. From our lens, the Fed will view the slowing pace of job creation, stagnant wage growth and other soft economic data as reasons to provide the economy with more of a buffer to withstand the headwinds from trade developments and weakening global growth. Hence, we still expect it to cut rates both at the October and December policy meetings.

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FINANCIAL INDICATORS

INTEREST RATES	Oct 4	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.71	1.80	1.96	2.23
6-month Treasury bill	1.65	1.84	1.87	2.42
3-month LIBOR	2.04	2.10	2.10	2.41
2-year Treasury note	1.40	1.64	1.55	2.89
5-year Treasury note	1.35	1.57	1.43	3.07
10-year Treasury note	1.53	1.69	1.57	3.23
30-year Treasury bond	2.02	2.13	2.03	3.41
30-year fixed mortgage rate	3.65	3.64	3.49	4.71
15-year fixed mortgage rate	3.14	3.16	3.00	4.15
5/1-year adjustable rate	3.38	3.38	3.30	4.01

STOCK MARKET				
Dow Jones Industrial Index	26,573.72	26,820.25	26,797.46	26,447.05
S&P 500	2,952.01	2,961.79	2,978.71	2,885.57
NASDAQ	7,982.47	7,939.63	8,103.07	7,788.45

COMMODITIES				
Gold ($ per troy ounce)	1,510.10	1,503.20	1,515.30	1,207.00
Oil ($ per barrel) - Crude Futures (WTI)	52.95	56.08	56.63	74.30

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (Sept)	47.8	49.1	51.2	50.8
ISM Non-Manufacturing Index (Sept)	52.6	56.4	53.7	52.6
Nonfarm Payrolls (September) - 000s	136.0	168.0	166.0	154.0
Unemployment Rate (September) - Percent	3.5	3.7	3.7	3.6
Average Hourly Earnings (Sept) - Y/Y%	2.9	3.2	3.2	3.1

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