WEEKLY ECONOMIC COMMENTARY—WEEK OF DECEMBER 2nd, 2019

Economic data released just ahead of the Thanksgiving holiday included all the "right fixings" to support our view that the economy is moving on to a gently slowing path. Adding to the holiday cheer, stock prices continue to set new highs, notwithstanding Friday's setback, amid growing expectations that a trade deal with China will be accomplished, albeit one that is likely to be greatly scaled down from the grand ambitions originally set out by the administration. Still, any positive movement on the trade front is a key catalyst for optimism in the financial markets, even as it lessens recession fears on Main Street.

Those fears flared up in May and early June when initial trade negotiations hit a wall and again in September when president Trump threatened to double down on raising tariffs on a broader range of Chinese imports. In both instances, stock prices plunged and bond yields fell, stoking widespread growth downgrades in the forecasting community. Some even thought that the economy was poised to fall off a cliff, a view supported by some time-honored recession signals, including an inversion of the yield curve. While trade negotiations have traveled a bumpy path in recent months, their disruptive impact on the financial markets has gradually diminished, reflecting in good part the economy's continued show of resilience as well as the cushion provided by a series of Federal Reserve interest rate cuts.

This week's data provided further confirmation that the economy is cooling but staying far from the edge of a recession cliff. For one, its performance in the third quarter was a tad better than the initial reading of a 1.9 percent growth rate. According to the Commerce Department's revised figures released this week, real GDP rose by a slightly better 2.1 percent annual rate during the period, which is actually a bit stronger than the 2.0 percent registered in the second quarter. The upward revision primarily reflected a smaller contraction in business investment spending than initially estimated as well as a bigger contribution from inventories, as companies stockpiled more merchandise than thought.

However, it would be a mistake to view the slight upward revision in the headline GDP data as a sign the economy is revving up the growth engine. For one, despite growing sequentially faster compared to the second quarter, the year-over-year pace slowed to 2.1 percent from 2.3 percent, so the gradual waning of momentum remains firmly intact. For another, the stronger contribution from inventory stockpiling may well become a drag in the fourth quarter if it turns out that businesses are carrying too much merchandise relative to sales. If so, new orders would tumble, leading to a pullback in production and weaker GDP growth. Finally, the smaller contraction in investment spending than originally reported should not disguise the fact that such spending did indeed contract – only less so. Instead of falling by 3.1 percent, it fell by 2.7 percent.

Simply put, the main takeaway from the revised GDP report is that the economy continues to run on a single engine: the consumer. The unrevised 2.9 percent growth rate in personal consumption expenditures accounted for 2.0 percent of the 2.1 percent increase in GDP. The other components were a mixed bag, with an encouraging pickup in residential outlays offsetting the drag from business investment and the trade deficit. We suspect that these offsetting influences will continue to prevail in the fourth quarter, leaving consumers once again the main growth driver.

The good news is that households seem prepared to do the heavy lifting again, although they will likely be providing less muscle to the fourth quarter's advance then in the third quarter. Indeed, the opening month of the period corroborates our view that growth momentum is gradually waning. On Wednesday, the Commerce Department reported that consumer spending increased 0.3 percent in October, a modest uptick from the 0.2 percent advance in each of the two previous months. But before getting too excited about this improvement, it should be noted that inflation wiped away 0.2 percent of the increase; real personal consumption only posted a tepid 0.1 percent increase and is now trending at 2.3 percent over the past year, the weakest annual pace in eight months.

What's more, the mix of purchases last month depicts more weakness than strength. A sizeable increase in outlays on electricity and gas accounted for most of the spending gain. Excluding these energy-related and a modest increase in food purchases, real spending was unchanged in October, the first month that hasn't posted a gain since last December. Purchases of big-ticket durable goods, such as autos, actually fell during the month. Hence, with the busy holiday shopping season is upon us, and with growth prospects squarely resting on consumers' shoulders, "the most wonderful time of the year" could well be the most critical one too. Last year, retailers recorded their weakest holiday season since the Great Recession as the record-long government shutdown, along with rising trade and Federal Reserve policy uncertainty triggered severe financial market turbulence and led consumers to abruptly retrench. Following a weak start to the season, retail sales plunged 2 percent in December – the largest drop since September 2009.

The weaker-than-expected increase in sales during the final two months of 2018 will artificially lift year-over-year holiday sales growth this year. And it underpins our above-consensus call for holiday sales (as defined by the National Retail Federation) to grow 4.8 percent relative to last year. Even if seasonally adjusted retail sales, excluding autos and gasoline, remain flat in November and December, we estimate that holiday sales growth would still advance at a 4.5 percent pace. While the increase largely reflects the statistical quirk of coming off an exceptionally weak base of a year ago, there are some fundamental tailwinds supporting consumer outlays. Among them are elevated confidence, healthy job creation, solid wage growth, a large savings buffer, moderate inflation and elevated household wealth.

While job creation has cooled appreciably from last year's brisk pace, the firm labor market will continue to bolster consumer spending in the year's final months. Over the past year, the economy has on average added a very healthy 174,000 jobs per month, and the unemployment rate in October was 3.6 percent– a level last seen in 1969. What's more, average hourly earnings of workers has remained anchored around 3 percent for 15 straight months, underpinning steady real disposable income growth. This fundamental health of the consumer sector helps explain why households remain optimistic despite lingering trade policy uncertainty.

Indeed, even while real outlays stagnated last month, wages increased by a solid 0.4 percent and are growing at a sturdy 4.9 percent over the past year, which is well ahead of inflation. Adjusted for inflation, real disposable income is growing at an annual rate of 2.8 percent. That's slower than the 3.3 percent of the previous month, but only because an outsized drop in farm income (due to a drop in farm subsidies) and in interest receipts caused personal income to remain unchanged in October. But the personal savings rate still remains at a healthy 7.8 percent despite a 0.3 percent drop last month due to the artificial weakness in personal income.

Importantly, households are enjoying muscular gains in their portfolios, including 401k plans. Notwithstanding Friday's setback, strong equity market gains in recent weeks will also help lift discretionary spending this holiday season. The S&P 500 continues to hover near record highs and is on track to register its strongest annual performance since 2013. This is in stark contrast with last year's stock market rout in the fourth quarter and represents a favorable backdrop for consumer outlays. That said, there is a lesson to be learned from last year's anemic holiday sales: A spike in policy uncertainty or a negative shift in the stock market narrative – driven by a trade war gyration, for instance – represents a key downside risk. Either can lead shoppers to think twice before opening their wallets and splurging on big-ticket items.

Overall, while holiday sales will look good compared to last year's depressed results, it's important not to lose sight of the general trend, which is reflected in the weak sequential increases in personal consumption in September and October. We suspect that growth in consumer spending as well as in GDP will be softer this quarter, and momentum will continue to fade as the calendar turns to 2020. The economy is no longer benefiting from the fiscal bump that stoked growth in 2017 and 2018 even as it faces the headwinds of slowing employment and incomes gains, weak global activity, the strong dollar and still-unresolved trade war. The economy is not falling off a cliff, but it will likely need the helping hand of another Federal Reserve rate cut next year to keep it afloat.

GOVERNMENT PORTFOLIO ADVISORS

FINANCIAL INDICATORS

INTEREST RATES	Nov 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.59	1.58	1.52	2.36
6-month Treasury bill	1.62	1.59	1.54	2.53
3-month LIBOR	1.91	1.91	1.90	2.74
2-year Treasury note	1.61	1.63	1.56	2.80
5-year Treasury note	1.63	1.63	1.54	2.83
10-year Treasury note	1.78	1.77	1.72	3.00
30-year Treasury bond	2.20	2.22	2.19	3.29
30-year fixed mortgage rate	3.68	3.66	3.78	4.81
15-year fixed mortgage rate	3.15	3.15	3.19	4.25
5/1-year adjustable rate	3.43	3.39	3.43	4.12

STOCK MARKET				
Dow Jones Industrial Index	28,051.41	27,875.62	27,347.36	25,538.46
S&P 500	3,140.98	3,110.29	3,066.91	2,760.16
NASDAQ	8,665.47	8,519.88	8,386.40	7,330.64

COMMODITIES				
Gold ($ per troy ounce)	1,462.40	1,467.60	1,507.30	1,223.40
Oil ($ per barrel) - Crude Futures (WTI)	57.95	57.83	56.62	50.39

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average- Past Six Months or Quarters
New Home Sales (October) – 000's	733	738	706	694
Durable Goods Orders (October) - % change	0.6	-1.4	0.2	0.2
Personal Income ((October) - % change	0.0	0.3	0.5	0.3
Personal Consumption Exp. (Oct) - % change	0.3	0.2	0.2	0.3
Consumer Confidence Index (November)	126.1	126.3	134.2	129.7