GPA GOVERNMENT PORTFOLIO ADVISORS

WEEKLY ECONOMIC COMMENTARY—WEEK OF DECEMBER 23rd, 2019

(Note—there will be no economic commentary distributed December 30th, 2019)

In less than two weeks, the economy will be entering a new decade in much better shape than it started the old one. That said, the challenges facing the economy in 2010 were straightforward and the policy prescriptions were clear. The nation was emerging from the deepest recession and harshest financial crisis since the 1930s. Drastic times required drastic measures, and there was a single-minded focus aimed at jump-starting the growth engine and repairing a broken financial system. Although there were disagreements over the extent and type of policies that should be used to accomplish these ends, no one disputed the imperative of rescuing the economy from the existential threat that still loomed large.

Not so as the curtain rises on 2020. The economy is in the eleventh year of the longest expansion on record, the labor market recovered all of the devastating 8.6 million jobs lost during the crisis even as it added at least 2 million more in every year since 2011, the financial system has been restored to health, and rapidly appreciating stock and home prices have driven household wealth to record levels. No longer facing an existential threat, the current slate of policymakers is struggling to decide whether more or less stimulus is needed to keep the expansion going.

While the decade-long expansion was the longest on record it also forged ahead more like a turtle than a hare, growing at a slower pace than all previous postwar upturns. What's more, not all segments of the population shared equally in the expansion. More of the benefits flowed to the wealthy than those on the lower echelons of the income ladder, resulting in an ever-widening gap in income and wealth – and a core issue in the political discourse now unfolding. That said, the tide did lift virtually all ships and the decade is ending with households retaining an elevated level of confidence in the economy, no doubt inspired by an unemployment rate that has tumbled to a 50-year low of 3.5 percent.

Unlike past expansions, however, the government missed a time-honored opportunity to get its fiscal house in order. Historically in the expansion phase of a business cycle, tax revenues increase faster than government outlays, narrowing a deficit that typically grows during recessions. That was not the case this time. Thanks to large tax cuts enacted in 2017 followed by increased Federal spending in 2018, the deficit ballooned towards $1 trillion in fiscal 2019 and is poised to exceed it in 2020 as well as for numerous years thereafter. With such a monumental flow of red ink, lawmakers will be in no mood to provide fiscal stimulus should the economy falter in 2020. That, of course, leaves the central bank to do the heavy lifting. But with interest rates so low, the Fed has little in the way of conventional ammunition to combat a downturn. The question is, will Washington or the Fed be needed to bail out the economy in the first year of the new decade?

That, of course, is where the rubber meets the road. From our lens, the journey should continue on the expansion trail, but at an even slower pace than the lackluster growth rate seen over the past decade. At this juncture, we do not see the economy falling off a cliff and, hence, will not need to be rescued with muscular policy efforts to keep it afloat. But we are less confident than the Fed that no help at all will be necessary. At their last policy meeting of the decade, Fed officials put the rate-cutting cycle on pause after three quarter-point reductions in 2019, believing that the

economy is in a "good place" and recession threats have receded. Indeed, most expect the next move in rates to be up, beginning in 2021, not down.

At first glance, there is little reason to dispute that decision. The economy's growth engine shifted into a steady gear in the second and third quarters, cruising at around a 2.0 percent pace and underpinned by solid job and income growth. That combination continued into the fourth quarter, sustaining growth in GDP at roughly the same pace. On Friday, the Commerce Department released its final estimate of gross domestic product for the third quarter, confirming that growth was unrevised at 2.1 percent. As was the case in the second quarter, when GDP advanced by 2.0 percent, consumers did most of the heavy lifting, although this time they also received some support from a recovering residential sector.

That pattern remains very much intact early in the fourth quarter. Following the GDP report, the Commerce Department released more information on how consumers, the economy's main growth driver, are progressing. The news was generally upbeat, indicating that the expansion still has legs to run. As has been the case throughout the expansion, consumer spending is receiving fuel from a robust job market. In November, the economy added a stellar 266 thousand jobs and households eagerly transmitted their newfound purchasing power into the spending stream. During the month, personal consumption on goods and services increased by a solid 0.4 percent, the strongest increase in five months, belying the soft gain reported last week for retail sales.

Nor was the increase inflated by higher prices, as the personal consumption deflator increased by a modest 0.2 percent and the core deflator by an even tamer 0.1 percent. Hence, real personal consumption increased by a sturdy 0.3 percent, also the strongest in five months, pointing to solid momentum heading into the holiday shopping season. Indeed, the foundation for a sustained high level of spending is firmly in place. Personal incomes advanced by a healthy 0.5 percent in November, with its core component of wages and salaries gaining 0.4 percent on the back of a torrid 0.5 percent surge in October. Wages and salaries are now up 5.3 percent from a year ago, the strongest annual increase since March. With income gains outpacing spending, households have been able to build up a cushion of savings. The personal savings rate edged up from 7.8 percent to 7.9 percent, well above the 6.1 percent average over the past 25 years.

Against this backdrop, we expect consumers to continue driving the economy forward next year, which should keep the Federal Reserve on the sidelines for a while longer. But households cannot carry the load forever, and their firepower should steadily diminish as the year progresses. The remarkable strength in the job market this year surprised everyone, including the Fed, by drawing undetected workers off the sidelines and sending the labor force participation rate higher than thought possible without igniting an inflation outbreak. No one knows precisely how deep the pool of sidelined workers is, but the valve is closing and a growing shortage of labor will soon curtail job growth. As fewer workers are added to payrolls, income growth will also slow and curb the spending power of households.

To be sure, the retarding impact on incomes from slowing job growth could be offset by stronger wage gains. Some pockets of wage acceleration will likely occur, particularly in industries facing a severe labor shortage where there is fierce competition for workers. But collectively, businesses are not in a good position to accommodate higher labor costs. Profits are already being squeezed and corporate pricing power is constrained by global competition, heightened price transparency enabled by the Internet and the strong dollar, which cheapens imports. These pincers will not ease their grip anytime soon and corporate resistance to wage demands should remain high.

With profits under pressure so too is the incentive to increase investment spending. As it is, the industrial sector has been hit hard by the trade wars and slowing global growth in 2018, a double whammy that has depressed production and opened up more capacity than needed. The good news is that the phase one deal just struck with China is a hopeful sign that trade tensions will de-escalate and lower the level of uncertainty that has contributed to the pullback in investment spending. But that is more hope than reality given the volatile history of trade negotiations between China and the U.S. It is unlikely that the latest truce will vanquish trade uncertainty and embolden companies to step up investment spending in the near term.

Simply put, the economy's growth engine is heading into the new decade running mainly on one cylinder, the consumer, which is poised to provide less torque in the year ahead. As momentum gradually cools, the Fed will be brought back into play sometime during the year, particularly if inflation remains stubbornly below the 2.0 percent target and shows no sign of picking up. Not only is actual inflation still undershooting that target, inflation expectations are falling. According to the latest University of Michigan Survey, released on Friday, consumer long-term inflation expectations fell to the lowest level since the survey started including that question in the 1970s.

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FINANCIAL INDICATORS

INTEREST RATES	Dec 20	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.56	1.53	1.53	2.38
6-month Treasury bill	1.57	1.53	1.55	2.54
3-month LIBOR	1.93	1.89	1.91	2.82
2-year Treasury note	1.64	1.61	1.63	2.63
5-year Treasury note	1.73	1.66	1.63	2.63
10-year Treasury note	1.92	1.82	1.77	2.78
30-year Treasury bond	2.35	2.26	2.22	3.03
30-year fixed mortgage rate	3.73	3.73	3.66	4.62
15-year fixed mortgage rate	3.19	3.19	3.15	4.07
5/1-year adjustable rate	3.37	3.36	3.39	3.98
STOCK MARKET				
Dow Jones Industrial Index	28,455.09	28,135.28	27,875.62	22,445.37
S&P 500	3,221.22	3,168.80	3,110.29	2,416.58
NASDAQ	8,924.96	8,734.88	8,519.88	6,332.99
COMMODITIES				
Gold ($ per troy ounce)	1,482.40	1,480.00	1,462.40	1,258.90
Oil ($ per barrel) - Crude Futures (WTI)	60.36	59.79	57.95	45.42

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (November) - 000s	1,365	1,323	1,266	1,294
Building Permits (November) - 000s	1,482	1,461	1,391	1,385
Existing Home Sales (November) - mlns	5.4	5.4	5.4	5.4
Industrial Production (November) - % chg.	-0.8	-0.3	0.7	0.0
Personal Income (November) - % change	0.5	0.1	0.3	0.3
Personal Expenditures (November) - % chg.	0.4	0.3	0.2	0.4

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