GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—February 10th, 2020

Until Friday's correction, investors appeared to be taking the Alfred E. Neuman "what me worry?" approach to the ominous portents overhanging the economic landscape. Whether it's the coronavirus, Boeing's woes or an inverted yield curve, nothing seemed to derail the upward march in stock prices. Indeed, once the initial shock from the coronavirus that sent shares briefly tumbling wore off, the rally resumed with a vengeance and sent equity prices to new highs on Thursday. On Friday, however, the market pulled back due largely to the perception that a stronger-than-expected jobs report released during the day would prevent the Fed from cutting interest rates this year. That prospect had loomed larger in recent weeks and contributed to the buoyancy in the stock market.

But with the Labor Department reporting a robust 225 thousand increase in nonfarm payrolls in January – significantly stronger than the consensus expectation of a 160 thousand gain – the battle lines over the economy's performance were firmly drawn. No doubt, the jobs report together with the firmness of some recent data confirms the sentiment shared by most Fed officials that the economy is in a good place, undercutting the need for additional rate cuts. That assessment, which was on full display at the latest policy setting meeting, is even harder to refute when the job-creating engine – the economy's backbone – is operating in a high gear.

And for a change the devil is not in the details when parsing the numbers, as it is hard to find much to complain about in the latest jobs report. The January increase in payrolls was solidly above the 171 thousand average monthly gain posted in 2019; what's more, the pace accelerated around the turn of the year, rising to an average monthly rate of 211 thousand over the past three months. Not only was the January increase sturdy, it was also widespread, with nearly 60 percent of private industries adding workers to payrolls. Leading the way were health and education, leisure and hospitality, professional and business services and construction. Even the government stepped up, taking on 19 thousand workers during the month, a fourfold increase over the average for the previous three months.

While the demand for labor continues to outpace the increase in the working-age population that did not prevent a slight increase in the unemployment rate last month from a historically low 3.5 percent to a still-low 3.6 percent. But the increase occurred for the "right reasons", as workers continued to be drawn off the sidelines. The labor force participation rate rose to 63.4 percent, equaling the highest rate since January 2013. Simply put, workers are having an easier time landing a position, which is depleting the pool of unemployed. One barometer that highlights this trend, the so-called job-finding rate, tracks the share of unemployed workers in one month that landed a job the next month. This measure jumped to 31 percent in January, a rate not seen in nearly two decades, going back to May 2001.

To be sure, some workers were left behind. The two major blemishes in an otherwise cheerful report can be seen in the manufacturing and retail sectors where pink slips outnumbered new paychecks. Manufacturers shed 12 thousand jobs and retail payrolls contracted by 8 thousand. The mining sector also lost 11 thousand jobs last month. These three sectors are facing long-

standing headwinds that are not expected to ease anytime soon. In the case of manufacturers, weak global growth, a strong dollar and, until recently, trade conflicts have had a depressing impact over the past year. More recently, the grounding of the Boeing 737 Max reinforced these depressing influences and is expected to have a broader impact on the economy and job market in the first quarter.

For retail, the story is more of the same. Brick and mortar establishment are losing ground to online commerce, forcing them to shut down stores and lay off workers. This week's announcement by Macy's that it is closing 125 stores and laying off 2000 workers in 2020 is the latest example of a victim succumbing to this trend. Many, if not most, of these workers, however, are being picked up by the very industry that scuttled their jobs, namely the online vendors who need to fill positions in their vast network of warehouses and fulfillment centers, not to mention hard-to-get drivers required to move their products to customers. Transportation and warehousing added 28 thousand workers in January. Meanwhile, the mining sector's loss of jobs reflects the slump in energy prices, which is reducing the demand for oil riggers and other workers in the oil patch.

But the setbacks in these sectors should not detract from the resilience of the labor market, which is generating far more jobs than expected so deep into an expansion. Still, it would be a mistake to view the job market as being overheated, which would spur the Fed into rethinking its dovish stance. For one, the outsized payroll increase in January overstates the strength in hiring. To some extent, workers benefited from the milder than normal weather during the month. That seems to be particularly the case in construction, as the 44 thousand increase in payrolls towered over the 12 thousand average monthly increases in 2019. While construction activity has picked up over the past six months, it hasn't strengthened enough to warrant that much of a hiring surge. Likewise, the warm weather may have spurred local governments to hire more workers to fill potholes make road repairs and accomplish other outdoor tasks that would not be possible under normal winter conditions.

For another, an overheated job market would normally stoke the embers of wage inflation. That's hardly the case now. Yes, average hourly earnings rose back above the 3.0 percent annual growth rate last month, edging up to 3.1 percent from 3.0 percent in December and 2.9 percent in November. But that's not a barn-burning event, as earnings growth hit 3.5 percent six months ago; if anything, the pace has settled around 3.0 percent, neither accelerating nor cooling. A similar trend can be seen for middle-income earners, the 80 percent of the workforce in nonmanagement positions. Indeed, given the multitude of states that have raised the minimum wage in January, it is surprising that this cohort did not see any bump in pay during the month. Average hourly earnings for production and nonsupervisory workers only increased by 0.1 percent over December, matching the smallest monthly gain in a year.

From the perspective of the Federal Reserve, the latest jobs report is as close to a Goldilocks scenario as you can get and a justification for staying pat for a while. The robust increase in payrolls indicates that the economy is not likely to run out of fuel anytime soon, as more paychecks translates into more household purchasing power and, by extension, sustained personal consumption. That, in turn, takes pressure off the Fed to lower rates to stimulate borrowing and spending. Indeed, the muscular jobs report comes on the heels of other encouraging data on housing activity and manufacturing that suggest the economy entered 2020 on a solid footing.

But the lackluster pay increases also means that businesses are not facing strong labor costs pressures that would spur them to increase prices, something that might prove difficult in the current highly competitive global market. Indeed, the absence of accelerating wage growth combined with the limited pricing power of businesses further confirms our view that inflation will remain below the Fed's 2.0 percent target this year. Hence, even as there is no near-term pressure to lower rates, there is also little pressure to raise them. If anything, the surprising increase in the labor force participation rate combined with still muted bargaining power of labor gives the Fed every reason to let the job market run hotter than it ordinarily would. The time-honored link between unemployment and wage growth may not be broken, but it clearly is not as strong as it was in past expansions.

Interestingly, even as the stock market sold off on Friday following the stronger-than-expected jobs report, yields in the bond market declined. The 10-year Treasury yield slipped about 5 basis points during the day and remains a full 30 basis points below the level at the start of the year. It's unclear how much of the stock-market setback reflected reduced expectations of a rate cut or heightened fears associated with the coronavirus and its potential growth-retarding impact. But the behavior of the bond market is clearly dovish, reflecting ongoing perceptions of a sluggish economy and low inflation.

From our lens, the latest jobs report gives the Fed more time to stay on the sidelines, but pressures for another rate cut around mid-year should be greater. The economy is poised to hit a significant soft patch in the first quarter, thanks to the blow from the Boeing travails and the spreading impact of the coronavirus. For the job market to continue generating the kind of payroll gains seen in recent months, growth would have to rebound strongly in the spring and summer months and stoke higher inflation expectations. Neither appears to be in the cards; while we do not expect a recession anytime soon, there are more downside than upside risks over the second half of the year.

FINANCIAL INDICATORS

INTEREST RATES	Feb 7	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.57	1.56	1.54	2.43
6-month Treasury bill	1.57	1.54	1.54	2.50
3-month LIBOR	1.73	1.76	1.85	2.70
2-year Treasury note	1.40	1.32	1.58	2.47
5-year Treasury note	1.41	1.31	1.64	2.45
10-year Treasury note	1.58	1.50	1.82	2.63
30-year Treasury bond	2.05	2.00	2.28	2.97
30-year fixed mortgage rate	3.45	3.51	3.64	4.41
15-year fixed mortgage rate	2.97	3.00	3.07	3.84
5/1-year adjustable rate	3.32	3.24	3.30	3.91
STOCK MARKET				
Dow Jones Industrial Index	29,102.51	28,256.03	28,823.27	25,106.33
S&P 500	3,327.71	3,225.52	3,265.35	2,707.88
NASDAQ	9,520.51	9,150.94	9,178.86	7,298.20
COMMODITIES				
Gold ($ per troy ounce)	1,573.90	1,594.00	1,562.80	1,318.00
Oil ($ per barrel) - Crude Futures (WTI)	50.34	51.58	59.20	52.72

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (January)	50.9	47.8	48.4	48.7
ISM Non-manufacturing Index (January)	55.5	54.9	53.9	54.7
Nonfarm Payrolls (January) - 000s	225	147	261	206
Unemployment Rate (January) - Percent	3.6	3.5	3.5	3.6
Average Hourly Earnings (Jan.) - y/y % Chg.	3.1	3.0	3.3	3.2

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