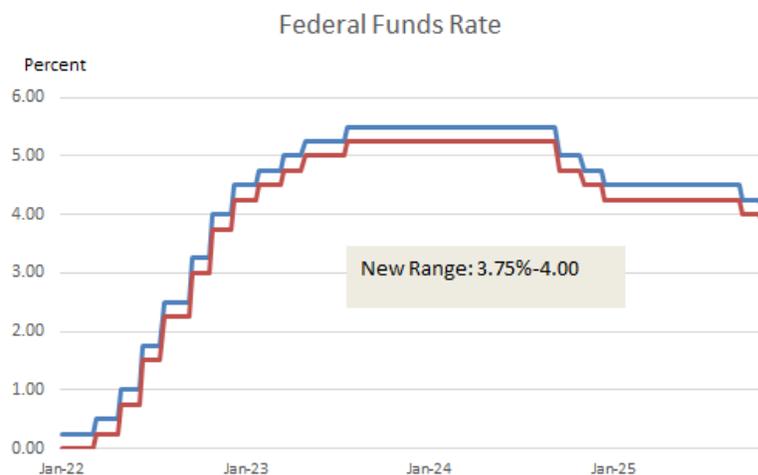


Unless rational minds take the mantle in Congress, we are inexorably barreling towards the longest government shutdown on record. By next week, the previous 35-day record of longevity set in 2018-19 would be shattered, disrupting the lives of millions of vulnerable Americans that heavily rely on government services and financial aid, not to mention the army of furloughed government workers going without a paycheck. The anxiety over what's to come has been building for some time, but the economic damage is in its early stages. Each week the shutdown lasts slices about 0.1-0.2 percent off of the annual GDP growth rate.

Importantly, the data void caused by the shutdown deepens the fog of uncertainty that policy makers must cope with. In the absence of fresh data that would illuminate how the economy is performing, the Federal Reserve is operating in a treacherous environment. Most data that guide decision making reflects activity with some lag, usually about a month or so. That's not too bad, as a \$30 trillion economic juggernaut does not shift gears on the dime, unless some unexpected external shock knocks it off course. Hence a policy error based on month-old data does not usually have catastrophic consequences. However, with the shutdown now obliterating all official data (with the exception of the September CPI report for September released last week) since August, the rear-view mirror is revealing events that are moving further and further in the background. That means the Fed is driving in an increasingly empty lane with little guidance as to which way to turn.

As a result, the central bank is sticking with its risk management approach to policy, although it recognizes that the risks are becoming greater due to the lack of information. Unsurprisingly, the rate-setting committee retained the risk-off approach adopted at the September meeting, choosing to cut interest rates for the second consecutive month. The repeat of a quarter-point reduction lowered the federal funds rate to a range of 3.75-4.00 percent, fully 1.5 percent lower than a year ago. As was the case at the previous



meeting, Fed officials continue to see a greater risk of a deteriorating job market than of escalating inflation. When government data was available in September, it depicted a marked softening in labor conditions through the summer; the Fed is taking out insurance against the possibility that the weakness might have continued.

Despite the latest rate cut, however, the meeting this week sounded a more hawkish note than expected. At the September meeting, the median forecast of Fed officials was for another rate cut in December, and the financial markets had priced in a 90 percent chance of that happening. However, at the press conference following the latest gathering, Fed chair Powell put the kibosh on that notion, asserting that a December rate cut is not a given but, as he noted, “far from it”. That comment upended expectations, and by Friday, the odds of a December rate cut had retreated to 65 percent, according to the popular CME FedWatch rate tool. Market pricing quickly followed suit. The 2-year Treasury note, which is highly sensitive to rate expectations, jumped by an unusually large 10 basis points, from 3.50 to 3.60 percent following Powell’s press conference.

Needless to say, the data blackout influenced Powell’s remarks. As he noted, when you are driving in a fog, the natural tendency is to slow down. Hence, rather than driving headfirst into what could be an inflammatory inflation situation, the Fed is looking both ways – at both the labor market and inflation. And while the latest official government jobs report is for August, the Fed has the advantage of more current inflation data, the aforementioned consumer price report for September, released specifically to calculate the COLA adjustment for Social Security benefits in 2026. As we discussed last week, the overall numbers were relatively benign as the headline and core inflation came in a tad weaker than expected. But both are further away from the Fed’s target of price stability (i.e., 2%) than its maximum employment target of roundly 4 percent. Inflation is hovering around 3 percent while the unemployment rate (at least as of August) stood at 4.3 percent.

Importantly, inflation risks have risen, thanks to tariffs and a still resilient economy driven by strong demand of wealthier households. True, the tariff effect will presumably fade after



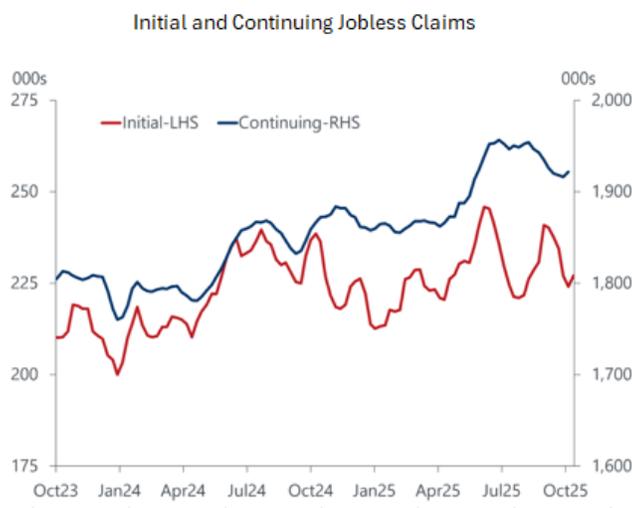
causing a one-time jump in the price level, something the Fed is counting as it cut rates last week. Excluding the tariff effect, inflation would be running closer to 2.5 percent instead of 3 percent. But that stripped-down version is not receding and an important component – the non-housing core services – is

actually accelerating. This so-called supercore inflation segment has risen at a 4 ¾ percent annual rate over the past three months and has been trending higher since the summer.

The items in this group consist mainly of discretionary purchases, highlighting the heavy influence that wealthier households are having. As long as this cohort continues to spend, the longer will service prices remain sticky and prevent overall inflation from retreating towards the 2 percent target. And since much of the purchasing power from this group derives from stock holdings, which have been on a tear over the past three years, it also means that the economy's performance is more tightly linked to the wealth-generating power of the stock market. Conversely, the economy is just as vulnerable to a severe market setback that would undercut the wealth effect powering consumption. The cautionary adage that the stock market is not the economy is true, but the two have clearly forged a closer relationship in recent years.

The Fed, of course, has repeatedly said that it does not pay much attention to asset prices, something that Powell reiterated at his latest post-meeting press conference. But the ramifications of strong demand linked to burgeoning wealth clearly influenced its decision to slow down the rate-cutting campaign indicated at this week's meeting. For sure, if there was more evidence of a collapsing job market, the Fed would be less inclined to move to the sidelines at the December meeting. But neither anecdotal nor the sparse available hard data suggest that is the case. From what he can gather, Powell noted that things are evolving more or less the same as before the government shutdown. Job growth is cooling, but only as gradually as before and much of it is due to reduced labor force participation and the crackdown on immigration that is reducing labor supply. In other words, the low hiring, low firing trend in place before the shutdown continues to be firmly in place.

The low firing side of the ledger can be confirmed by state data on weekly unemployment claims. This series is usually released by the Labor Department, which applies seasonal adjustment factors to the raw data obtained from state unemployment offices. Although the Labor Department is shut down, the raw state data are available, and seasonal factors can readily be calculated. Following this exercise, we can confirm that companies in the aggregate are not firing workers in droves, notwithstanding some recent headlines from high-profile firms. Indeed, in the week ending October 25, initial claims for unemployment benefits actually declined by 12000. That followed an upward revision the previous week, but smoothing out the data over four-week periods shows that the trend has fluctuated but has



not been moving up. Repeat, or continuing claims, have fallen from their recent peak. To be sure, there is a lag between announced layoffs and actual job losses, and if latter catches up to the former by the time of the December Fed meeting, the odds of another rate cut would clearly increase.

## FINANCIAL INDICATORS

INTEREST RATES	October 31	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.82	3.86	3.95	4.41
6-month Treasury bill	3.82	3.76	3.83	4.30
2-year Treasury note	3.60	3.49	3.58	4.21
5-year Treasury note	3.71	3.61	3.72	4.22
10-year Treasury note	4.10	3.99	4.12	4.37
30-year Treasury bond	4.67	4.59	4.71	4.57
30-year fixed mortgage rate	6.17	6.19	6.34	6.72
15-year fixed mortgage rate	5.41	5.44	5.55	5.99

STOCK MARKET				
Dow Jones Industrial Index	47,562.87	47,207.12	46,758.28	42,052.09
S&P 500	6,840.20	6,791.69	6,715.79	5,728.80
NASDAQ	23,724.96	23,204.87	22,780.51	18,239.92

COMMODITIES				
Gold (\$ per troy ounce)	4,009.40	4,118.6	3,911.8	2,746.2
Oil (\$ per barrel) - Crude Futures (WTI)	60.87	61.50	60.64	69.33

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
No Government Data				

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