March Monthly Market Commentary

Reduced Policy Risks Defuses Recession Threat

The economy skirted another landmine on February 15 when Congress passed, and President Trump signed, a package of spending bills that funds the government for the rest of the fiscal year ending September 30. With the growth-impediment of another government shutdown out of the way, the economic expansion should remain on course to become the longest in U.S. history. While that milestone, which would be reached in July, is laudable, other records have already been broken. Most notably, the economy has celebrated the longest stretch of continuous job gains ever, reaching 100 consecutive months in January.

Despite the muscular performance on the jobs front and a stock market that got off to a flying start over the first six weeks of the year, there has been growing speculation that a recession is poised to occur sooner rather than later. Most of the speculation targets 2020 as the probable endgame of the expansion, although some see the upturn expiring as early as this year. Aside from the fact that economists – as well as policy makers – have a notoriously bad record of forecasting recessions, there's not much evidence to support the case for an imminent downturn. In fact, a better case can be made that the economy has entered a sweet spot, one that features low unemployment, tame inflation and steady growth.

But that happy perception received a nasty jolt from a belated report on consumer spending for December that revealed the sharpest drop in retail sales since the recession. Since consumers are the economy's main growth driver – accounting for more than two-thirds of total economic activity – the zipping up of their wallets and purses during the all-important holiday shopping season could be seen as a bad omen for 2019. But that would probably be a mistake. It is hard to imagine consumers going into hibernation when the job market is so robust. While hyped-up expectations for holiday shopping were probably overblown, the downbeat retail sales report was likely an aberration. The handoff to the new year may have been weaker than thought. But it supports the widely held view that last year's growth spurt was not sustainable, and the economy is reverting to a more stable, albeit slower, longer-term trend.

Higher Recession Odds

Even before the dispiriting retail sales report for December came out, economists were placing increasing odds that a recession loomed within the next year or two. The most common reason is that the economy is benefiting less and less from the fuel of fiscal stimulus and synchronized global growth that propelled it to its strongest annual growth rate in three years. The tax cuts of 2017 and the spending bill passed in early 2018 added about 0.7 percentage points to the 2018 growth rate. That positive thrust is expected to shrink to about 0.3 percent this year and disappear entirely as the curtain rises on 2020.

Meanwhile, the synchronized global growth of 2017 and early 2018, which stoked foreign demand for American exports and energized the manufacturing sector, fell apart around the middle of last year. China, the world's second largest economy, started to falter early in the year, reflecting deflating property values, excess capacity and government efforts to reign in borrowing. The slowdown was reinforced by the escalating trade war with the

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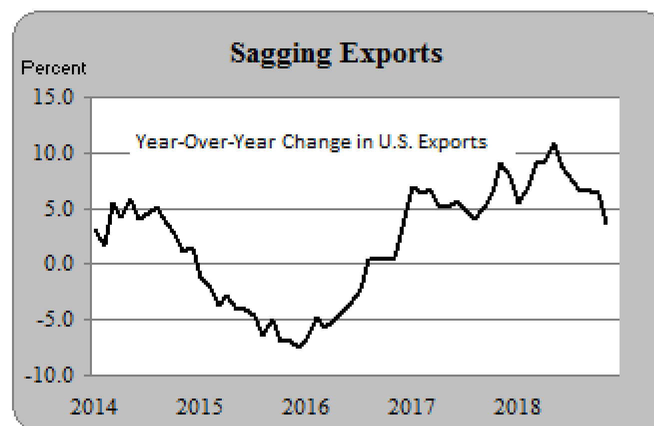
U.S., which imposed tariffs on $250 billion Chinese imports. China is the largest export market for German autos and, hence, its slowdown hit the German economy hard. The eurozone's largest economy barely escaped a recession as growth virtually stalled out over the second half of the year.

And while the U.S. is less vulnerable to global weakness than other developed countries, it is certainly not immune to it. The rebound in manufacturing activity from the energy-related slump in 2015 and 2016 benefited from growing exports to strengthening economies overseas. But the upward trend in exports peaked last May when it hit a 10.8 percent year-over-year growth rate. Since then, export growth has steadily weakened along with slowing global growth, receding to a 3.7 percent pace in November, the weakest annual growth rate in nearly two years. The softness in foreign sales has no doubt sapped some strength from the manufacturing recovery, as reflected in a sharp 0.9 plunge in factory output in January.

Policy Risks Abate – For Now

With the reduced tailwinds from fiscal stimulus and facing stiffer headwinds from slowing global growth, the U.S. economy is unsurprisingly losing some vigor. But the slowdown would be far worse if the Federal Reserve and



Washington were still pursuing policies that were in place late last year. Importantly, the Fed, after lifting rates from near zero in late 2015 to a range of 2.25-2.50 percent last December, took its foot off the monetary brakes in January. At the latest policy meeting that month, the central bank abandoned its plan to continue steadily increasing interest rates, stating that further rate hikes would be put on hold given the myriad global uncertainties buffeting the economy and the persistence of tame inflation.

This abrupt U-turn in monetary policy could not have been timelier, as the 2 to 3 additional rate increases planned for this year would amplify the economy's already-slowing momentum. The move to the sidelines removes a potential drag on growth of nearly half-percent this year, which clearly would bring the economy closer to the recession's edge. Another policy risk that threatened to derail the expansion was also removed when President Trump signed a spending bill that prevents another debilitating government shutdown. While Trump invoked emergency powers to secure more funding for a border wall, the legal and political kerfuffle it is likely to generate will be far less harmful to the economy than another government shutdown.

There is also welcome news on the trade front, as U.S.-China negotiators are reportedly close to a “memorandum of understanding”, which could pave the way for a trade deal to be signed later this year. At a minimum, the provisional deal should head off an increase in the tariff rate from 10% to 25% on $200 billion of Chinese imports scheduled for March 2. Clearly, the escalation of trade tensions with China and other nations has already had a negative effect on business confidence, putting some capital spending projects on hold and increasing input costs. An additional stiff penalty on China would not only punish China’s growth prospects, it would further crimp American exports and exacerbate the squeeze on manufacturers. It would also increase prices on Chinese imports, putting upward pressure on inflation.

Not Out of the Woods

That said, it would be premature to declare victory on the trade policy front. The U.S. is still considering tariffs on imports of autos and auto parts, which would inflame tensions with Europe and Japan and likely trigger retaliatory tariffs. Meanwhile, Congress has yet to ratify the administration’s Nafta-replacement pact with Canada and Mexico (the USMCA), the timetable for which has been set back by the 35-day government shutdown. And fiscal policy uncertainty will again rear its head before long, as Congress will need to approve an increase in the debt ceiling by late summer or early fall if Treasury is to meet all its obligations and forge a new budget deal by the end of September to avoid another shutdown and the return of spending caps enacted in 2011.

In a highly polarized mind-set in Washington, nothing should be taken for granted. However, given the mounting public consternation with government dysfunction, there is a reasonably good chance that rational minds will prevail, and the legislators will strive to reach a compromise on some of the more sticky issues. With the campaign season not far off, neither side wants to further antagonize voters and risk a negative reaction at the polls. Assuming therefore, that the economy is not further hampered by political headwinds, the growth slowdown now underway should culminate in a soft rather than a hard landing later this year.

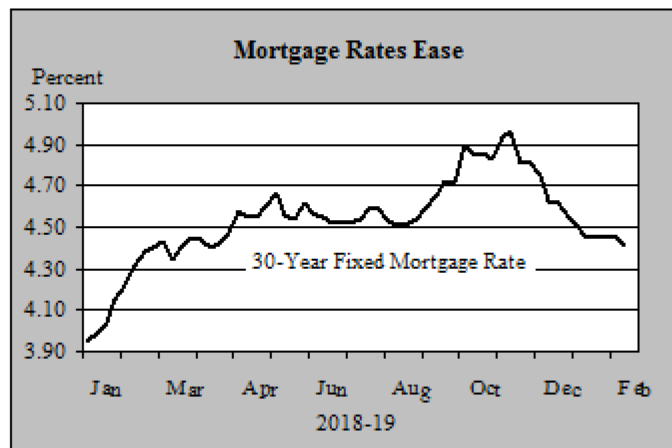
That may not seem obvious in the current quarter, which is likely to come in far weaker than any of the previous three quarters. But a number of forces should spur a modest rebound in the second quarter before the slowing trend reasserts itself over the second half of the year. For one, the Fed’s dovish U-turn has already contributed to lower interest rates, including a half-percent decline in mortgage rates, which should help rejuvenate a moribund housing market. For another, the government shutdown, which caused about 300 thousand government workers to postpone spending because of missed paychecks, has generated pent-up demand that will be unleashed in coming months.

The Jobs Growth-Sustaining Engine

Most important is the sustained strength in the job market, which, together with tame inflation, is not only pushing up wage growth but the bigger paychecks are going a longer way thanks to the low inflation environment. In January, real average hourly earnings increased 1.7 percent from a year earlier, the strongest annual increase since July 2016. Importantly, the strengthening trend in real purchasing power is trickling down to midlevel workers. Non-management workers enjoyed a purchasing power increase of 2.1 percent over the past year and their weekly paychecks are growing even faster. Over the past year, real weekly earnings of production and nonsupervisory workers have increased by 2.4 percent, the strongest since October 2015.

As long as the labor market continues to generate solid job and wage gains, it is hard to believe that consumers are going into hibernation, as suggested by the dismal retail sales report for December. No doubt, job growth will slow this year, if only because the pool of available workers is shrinking. But even that may not be as much of a constraint as thought, as companies are drawing more workers from the sidelines than believed possible a few months ago, reflecting in large part the lure of higher wages.

Simply put, the tailwinds propelling the economy forward last year are waning, putting it on a slower growth path this year. But the growth engine continues to receive fuel from a healthy job market, which shows no sign of abruptly downshifting. At last count, job openings were at record levels, comfortably outstripping unemployed workers. This pillar of strength along with reduced policy risks should enable the economy to withstand the stiffening headwinds and extend the expansion through at least the end of the year***.***



Key Economic and Financial Indicators

	January	December	November	October	September	August	July	12-Month Range High	Low
Prime Rate	5.50	5.35	5.25	5.25	5.03	5	5	5.50	4.50
3-Month Treasury Bill Rate	2.37	2.37	2.33	2.25	2.13	2.03	1.96	2.37	1.57
5-Year Treasury Note Rate	2.54	2.68	2.95	3.00	2.89	2.77	2.78	3.00	2.54
10-Year Treasury Note Rate	2.71	2.83	3.12	3.15	3.00	2.89	2.89	3.15	2.71
30-Year Treasury Bond Rate	3.04	3.10	3.36	3.34	3.15	3.04	3.01	3.36	3.01
Tax-Exempt Bond Yield		4.13	4.30	4.32	4.12	3.96	3.88	4.32	3.82
Corporate Bond Yield (AAA)	3.93	4.02	4.22	4.14	3.98	3.88	3.87	4.22	3.82
Conventional 30-Year Mortgage Rate	4.46	4.64	4.87	4.83	4.63	4.55	4.53	4.87	4.33
Dow Jones Industrial average	24158	23806	25252	25569	26233	25630	24978	26233	23806
S&P 500 Index	2607	2567	2723	2785	2902	2858	2794	2902	2567
Dividend Yield (S&P)	2.08	2.22	1.99	2.02	1.88	1.87	1.92	2.22	1.87
P/E Ratio (S&P)	18.0	16.6	18.9	18.7	20.1	21.0	20.5	22.8	16.6
Dollar Exchange Rate (vs. Major Currencies)	91.8	92.1	91.7	90.8	90.0	90.4	90.0	92.1	85.7

* Monthly Averages

	January	December	November	October	September	August	July	12-Month Range High	Low
Housing Starts (In Thousands)			1256	1217	1237	1280	1184	1334	1184
New Home Sales (Thousands of Units)			657	562	613	601	606	672	562
New Home Prices (Thousands of Dollars)			302	325	330	321	328	340	321
Retail Sales (% Change Year Ago)		2.7	4	4.7	4.2	6.4	6.6	6.6	2.7
Industrial Production (% Change Year Ago)		4.0	4.1	4.2	5.6	5.4	4.1	5.6	3.0
Operating Rate (% of Capacity)		78.7	78.6	78.4	78.4	78.5	78.0	78.7	77.2
Inventory Sales Ratio (Months)			1.35	1.35	1.35	1.34	1.34	1.36	1.33
Real Gross Domestic Product (Annual % Change)						3.4			4.2
Unemployment Rate (Percent)	4.0	3.9	3.7	3.7	3.7	3.9	3.9	4.1	3.7
Payroll Employment (Change in Thousands)	304	222	196	277	108	282	178	304	33
Hourly Earnings (% Change Year Ago)	3.2	3.3	3.3	3.3	3.0	3.2	2.9	3.3	2.6
Personal Income (% Change Year Ago)			4.2	4.3	4.2	4.5	4.6	4.6	4.2
Savings Rate (Percent of Disposable Income)			6.2	6.3	6.3	6.3	6.3	7.4	6.2
Consumer Credit (Change in Mil. Of Dollars)		16.5	22.4	26	13	23.4	17.5	26	1
Consumer Prices (% Change Year Ago)	1.9	2.2	2.5	2.3	2.7	2.9	2.8	2.9	1.9
CPI Less Food & Energy (% Change Year Ago)	2.2	2.2	2.1	2.2	2.2	2.4	2.2	2.4	1.8
Wholesale Prices (% Change Year Ago)	2.5	2.5	2.9	2.7	2.8	3.2	3.3	3.3	2.5