Weekly Market Commentary

January 7, 2019

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	FINANCIAL INDICATORS			
INTEREST RATES	January 4	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.42%	2.39%	2.39%	1.39%
6-month Treasury bill	2.51	2.48	2.54	1.58
3-month LIBOR	2.80	2.80	2.77	1.7
2-year Treasury note	2.50	2.52	2.73	1.96
5-year Treasury note	2.50	2.56	2.71	2.29
10-year Treasury note	2.67	2.72	2.86	2.48
30-year Treasury bond	3.00	3.03	3.15	2.81
30-year fixed mortgage rate	4.42	4.55	4.75	3.95
15-year fixed mortgage rate	3.99	4.01	4.21	3.38
5/1-year adjustable rate	3.98	4.00	4.07	3.45
STOCK MARKET				
Dow Jones Industrial Index	23433.16	23062.40	24388.95	25295.87
S&P 500	2531.94	2485.74	2633.08	2743.15
NASDAQ	6738.86	6584.52	6969.25	7136.56
Commodities				
Gold ($ per troy ounce)	1286.20	1283.40	1253.80	1321.4
Oil ($ per barrel) - Crude Futures (WTI)	48.30	45.12	52.34	61.55
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Purchasing Managers Index (December)	54.1	59.3	57.7	58.4
Nonfarm Payrolls (December) - 000s	312	176	274	222
Unemployment Rate (December)	3.9	3.7	3.7	4
Average Hourly Earnings, YY% (December)	3.2	3.1	3.2	3.0

What a difference a year makes. As the curtain rises on 2019, the economic and financial landscape is the mirror image of the opening week of 2018. A year ago, Trump's tax cuts and other business-friendly measures were on the books, stoking expectations of quickened growth and muscular profits, which understandably ignited a powerful stock market rally.

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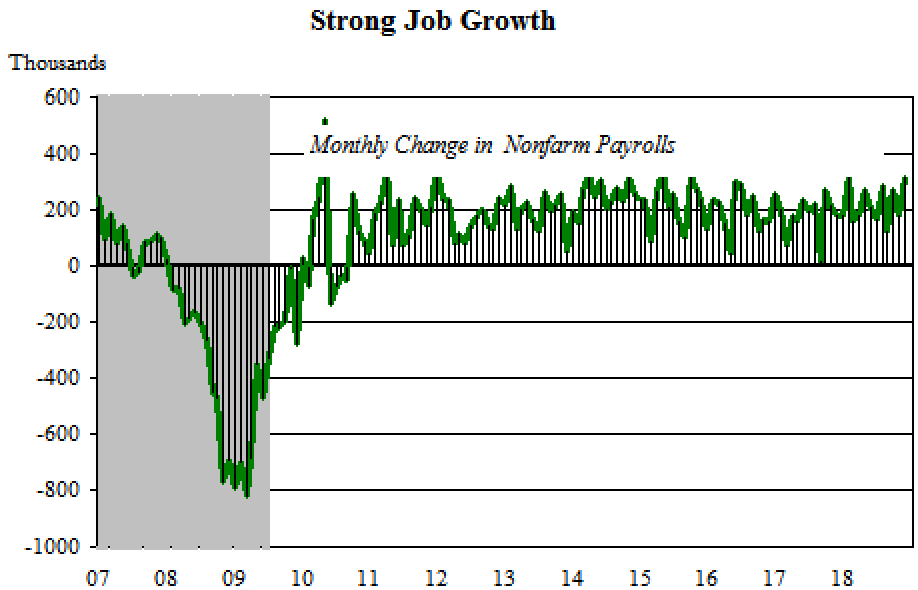
At the same time expectations of higher inflation and tighter monetary policy also took hold, sending bond yields sharply higher. For the most part, these expectations were fulfilled. The economy turned in its strongest performance in a decade, inflation picked up, corporations delivered stellar profits and the Fed, as advertised, hiked rates four times. To be sure, there were bumps in the road, but the main stumbling blocks – escalating trade tensions, a global growth slowdown and ongoing political dysfunction in the U.S. – had more of an impact on the financial markets than on the real economy. Hence, while investors were brimming with optimism at the start of 2018, the year ended in a frenzy of confusion, extreme market turbulence and plummeting stock prices, even as the economy showed few signs of the despair permeating market psychology.

In contrast to the opening week of 2018, the mindset entering this year is more grim than optimistic. Fears of a recession escalated, with nearly 50 percent of corporate CFOs expecting a downturn before the end of the year. Economists also upped their odds of a recession happening sooner rather than later, although most, including us, see a slowdown rather than an outright contraction in activity this year. While many believe that the markets' pessimism at the end of 2018 was overblown, they also feared a negative feedback loop that could spill into the real economy, bringing about a self-fulfilling prophesy of recession. Adding to the gloom and doom in the markets, the year started with a partial government shutdown, more evidence that the Chinese economy is in dire straits, and a compelling sign that trade barriers may finally be damaging U.S. prospects. On the first trading day of the new year, the Institute for Supply Management reported that its index of manufacturing activity registered its steepest monthly decline since the recession. Amidst this swirl of dispiriting events, the Fed's latest rate hike came under a harsh spotlight, not only from its biggest critic in the Oval Office, but also from investors who are now pricing in no further increases this year.

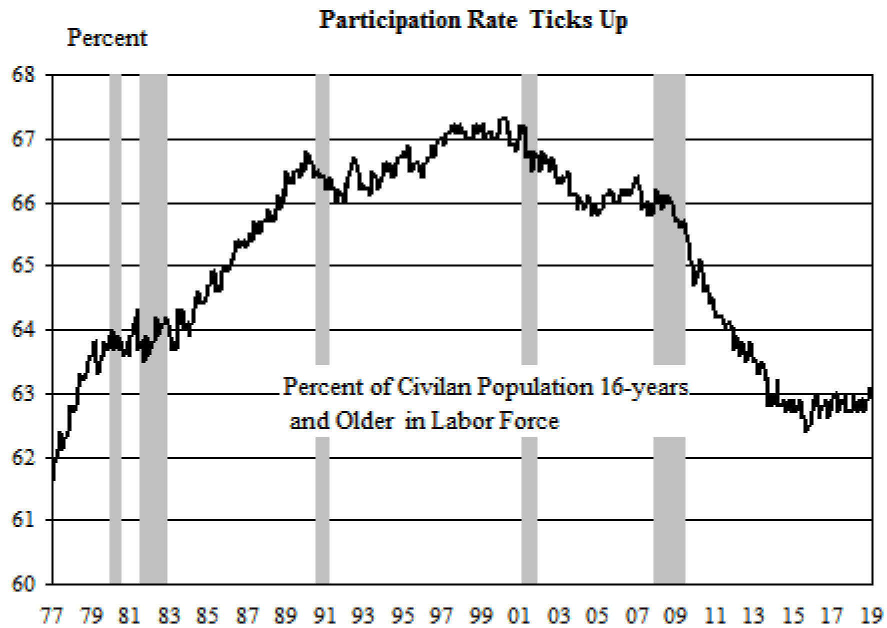
But just as the market bears and policy doves were taking center stage, the jobs market reminded us once again not to underestimate the resilience of the U.S. economy. If a recession is just around the corner, human resource managers are not paying attention. That was starkly revealed in a blockbuster employment report released on Friday, which is once again bringing about a reassessment of the economic outlook and Fed policy. Indeed, the financial markets have abruptly shifted gears. After opening the year with the worst two-day start since 2000 amidst the dispiriting news on the global and domestic fronts, the stock market recovered all of its losses and then some on Friday, with the Dow Jones industrial average surging by almost 750 points. Likewise, the doves fled the bond market in droves, replaced by hawks that drove the 10-year Treasury yield up from its 12-month low of 2.55 percent on Thursday to 2.67 percent at the close of trading on Friday. The dreaded yield curve inversion, a time-honored precursor of recessions, also took a step back, as the spread between the 10-year and 2-year yield widened.

Underscoring this astonishing turn of events, the Labor Department reported on Friday that the U.S. economy generated 312 thousand net new jobs in December, far exceeding consensus expectations of about a 180 thousand gain. This robust increase comes on top of an upward revision that added 58 thousand more jobs to the previous estimates for October and November. Hence, instead of tapering off in the fourth quarter, the job-creating engine shifted into a higher gear, generating 254 thousand net new jobs a month compared to a monthly average of 220 thousand for the year as a whole. That said, the 2.64 million jobs created in 2018 – topping the gains in 2016 and 2017 – is a remarkable achievement in itself, coming so late in an expansion when the labor pool is supposedly stretched to the limit. Keep in mind too that the latest employment report is subjected to revision, so the final count may even be stronger.

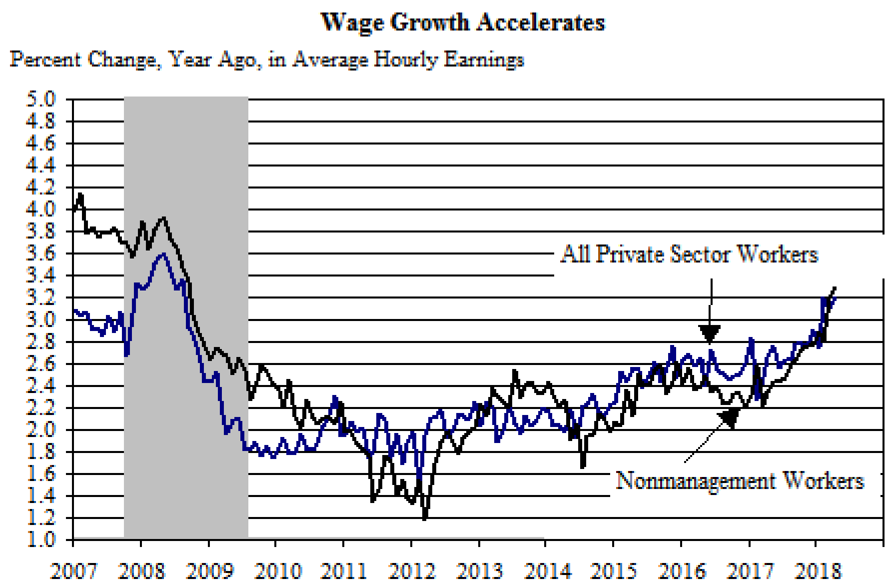


The eye-opening increase in payrolls at the end of last year sends two important messages. First, the turmoil in the financial markets, heightened trade tensions, the Fed's rate hikes and the global growth slowdown had little effect on the U.S. economy during the fourth quarter. The increase in GDP during the period is not likely to match the sturdy 4.2 percent and 3.4 percent growth rates seen in the second and third quarters, but the tapering off is now looking less severe than thought a month or so ago. Indeed, the stronger-than-expected increase in holiday shopping last month becomes less surprising given the robust increase in jobs. While the plunge in stock prices may have dented consumer confidence in December, it did little to change spending habits, which were buoyed by hefty paychecks.

For another, the outsize hiring pace in December suggests that the supply of available workers is larger than thought. The labor force participation rate increased 0.2 percent to 63.1 percent, matching the highest share since September 2013. Not all of the entrants to the labor force found jobs right away, as the unemployment rate also increased by 0.2 percent to 3.9 percent. But job leavers accounted for 13.3 percent of the unemployed in December, up from 11.6 percent in November, which suggests that more workers are voluntarily quitting their jobs, a typical sign of a tightening labor market. Put another way, the strength in the labor market is benefiting both workers with jobs and those that have left the labor force in despair of finding work. Jobholders are getting attractive offers from other firms, motivating them to quit, and those on the sidelines are being lured back to the labor force by the prospect of greater job opportunities.



For the Fed, the task of assessing the inflationary ramifications of the continued above-trend growth in jobs becomes more complicated. On the one hand, the surprising increase in the labor force participation rate indicates that there is still some slack in the job market, which argues for a less aggressive path of rate hikes to prevent an inflationary wage breakout. But the latest jobs report also shows that the Phillips Curve is not entirely dead. With companies vigorously competing for workers in a shrinking labor pool, wages are growing at a faster clip. In December, average hourly earnings increased by 0.4 percent, lifting the gain over the past year to 3.2 percent, the highest annual increase since the recession. To be sure, fully two thirds of the job gains last month occurred in higher-paying industries, which skewed the average wage gains to the upside.



The biggest gainers were in business and professional services (+43K), construction (38K), manufacturing (32K) and health care (58K). Among the low-wage sectors, the strongest increase, 55 thousand, was in leisure and hospitality, where the average pay is only $16.27 an hour, far below the $27.48 an hour for all private workers. But even among those lower earners things are looking up, as hourly earnings in the leisure and hospitality sector increased by 3.7 percent over the past year, outpacing the average gain for all workers. More important is that workers are finding jobs in a broadening swath of industries. In December, 70 percent of private industries expanded payrolls, up from 61 percent in November. Importantly, with the price of gas and other commodities holding back inflation, worker paychecks are going a longer way.

The sturdy increase in household purchasing power heading into the new year is the key takeaway from the employment report regarding near-term growth prospects, as it implies that the festive spending mood of consumers over the holidays will carry over for at least a while. True, the jobs data is a lagging indicator; what's more, the Labor Department's survey took place before the government shutdown and other distressing news became public, such as the magnitude of the slowdown in China. But the U.S. economy does not shift gears on the dime. It is hard to imagine that the growth in jobs would transition from over 300 thousand in one month to a full stop the next. By all accounts, growth over the first half of the year should receive solid support from consumer spending. Not only are job and income prospects still promising, household purchasing power will be getting an extra boost during the spring from large tax refunds stemming from the tax cuts enacted in 2017.

Encouragingly, two key fears that battered the financial markets at the end of last year were allayed on Friday. The blockbuster jobs report shattered expectations that the U.S. economy was on the cusp of a drastic slowdown or, worse, a recession. A second fear was that the Fed was ignoring the turmoil in the financial markets as well as global developments in its determined quest to normalize interest rates. Not only did many market participants feel that the December quarter-point hike was unnecessary, they became further alarmed by the Fed's prediction of two more increases in 2019. Needless to say, this gave further ammunition to skeptics – including the president – who believed the Fed was about to repeat a policy mistake that abruptly short-circuited several post-war expansions.

But comments by Fed chair Powell on Friday calmed those fears and provided another spark to the stock market rally that was already underway. Simply put, Powell disavowed the notion that the Fed was on a preset course of rate hikes, but would be flexible in response to unexpected changes in economic conditions. He was encouraged by the tame inflation readings, suggesting that the Fed would be more patient in the face of strong job growth. Just as important, he said that the Fed was listening to and sensitive to signals from the financial markets. All in all, it was a dovish message that, combined with the sterling jobs report, was just the catalyst investors needed to eradicate the doom and gloom embraced at the start of the year.