Weekly Market Commentary

January 14, 2019

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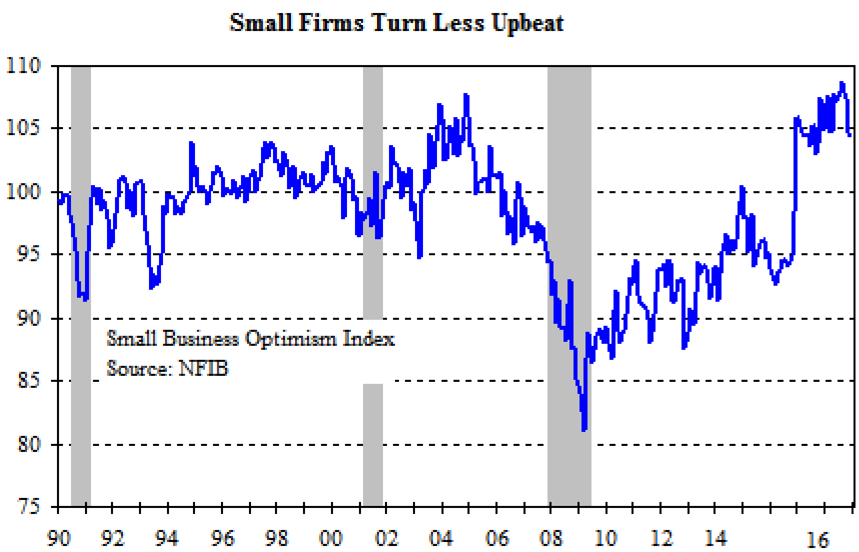
Following a vigorous rally this week, the stock market is on the cusp of leaving correction territory, clawing back nearly half of the near-20 percent drop in the S&P 500 index since September 21. Likewise, bond yields bounced back from their lows reached a week ago, with the 10-year Treasury yield moving up from 3.55 percent to 3.75 percent on Thursday before slipping back to 3.70 % at week's end. Do these moves in financial assets mean that perceptions of the economic outlook have improved? Not likely. Indeed, the latest Wall Street Journal poll of economists placed the odds of a recession over the next twelve months at 25 percent. That's up from 17.6 percent in the early-October survey, just as the stock market rout was getting underway. True, the most important barometer of the economy's health, job growth, came in much stronger than expected over the final two months of the year. If not for the blockbuster December employment report, recession fears might have been even higher in the WSJ survey, which was taken between January 4 and 8.

But the jobs data are a lagging indicator and while last Friday's employment report may have capped recession fears, investors as well as the consensus of economists still expect growth to slow this year. That outlook is supported by the weakening tendencies revealed in several forward-looking measures released just before and after the latest jobs report. The Conference Board's consumer confidence index, for example, fell in December for the second consecutive month, lowering it to last July's level. Another survey, taken by the National Federation of Independent business of its small business members, also revealed waning sentiment. The overall optimism index fell for the fifth consecutive month in December, and only 16 percent of respondents expect the economy to improve over the next six months. That's the smallest fraction since November 2016.



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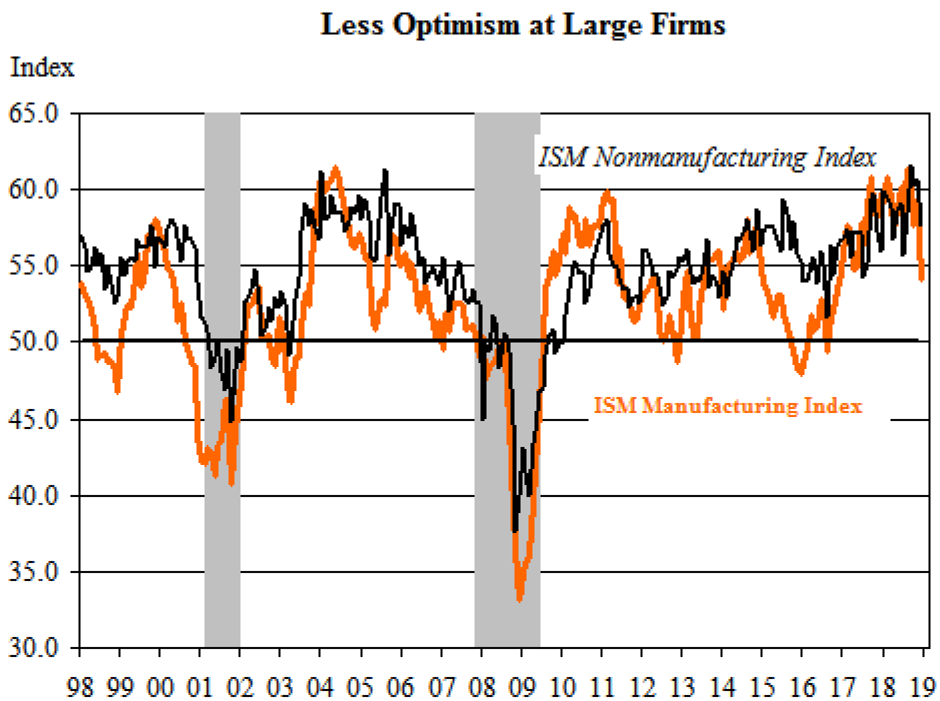
Nor do larger firms feel more optimistic than a few months ago. Last week, the Institute for Supply Management reported that its index of manufacturing activity fell by a steep 5.2 points to 54.1, which coincidentally, also brought it to the lowest level since November 2016. More ominously, the biggest drag came from new orders, the most forward-looking of the components. Non-manufacturing companies did not fare as poorly; but they too have turned less upbeat as the ISM reported that the overall index of non-manufacturing activity fell 3.1 points to 57.6 in December. To be sure, these leading indicators are not flashing recessionary signals. Except for the manufacturing index, they are only a tad below their highs of the expansion. But investors pay attention to trends, and the direction for these indicators have mostly turned to the downside.



So why the brighter mood on Wall Street? One reason is the Fed. Keep in mind that incipient recession fears gained traction when the Fed raised its benchmark short-term rate in December and indicated that two more increases were expected in 2019. While the move was fully expected by the markets, it came at a time of mounting headwinds, highlighted by more evidence of a global growth slowdown, falling oil prices, ongoing trade tensions with China and proliferating signals of distress in the financial markets, including a flattening yield curve, widening credit spreads and plummeting stock prices. Investors were hoping that if the Fed were intent on raising rates again in December, it would at least issue a more dovish statement that it did, one that suggested an extended pause before pushing through additional increases.

While that message was not conveyed to the market's satisfaction at the December 18-19 policy meeting, it has since been articulated by a litany of Fed officials, culminating with loud and clear signals from two of the most important ones over the past week. Appearing before the American Economic Association last Friday, Fed Chairman Powell firmly stated that policy was not on a preset course but that the Fed would follow the data closely and be sensitive to financial market turmoil.

Powell reiterated this more flexible policy approach at the Economic Club in Washington this week, pointedly indicating that the Fed would be patient regarding future rate increases. These dovish comments were echoed by Vice chairman Richard Clarida in a speech on Thursday, which also included a market-encouraging hint that the Fed might also slow the pace in which it reduces the size of its balance sheet.

If the chorus of positive comments by Fed officials wasn't enough, the release of the minutes of the December policy meeting also buoyed investor spirits this week. The minutes revealed a far more dovish sentiment among the committee members than was expressed at the post-meeting policy statement. Indeed, a few opposed the rate increase taken at the meeting, citing the soft inflationary readings and the market turmoil. The general impression is that the policy makers were inclined to take a wait-and-see approach next year as they assess how the economy responds to previous rate increases and how global developments affect activity in the U.S. Simply put, the past week's events have noticeably calmed fears that the Fed would move too aggressively to prevent the economy from overheating.

Hence, by the end of the week the markets had priced in much higher odds that no rate increase would be forthcoming in 2019. From our lens, that's being overly pessimistic about the economy's prospects although we recognize that the downside risks have increased in recent weeks. Global growth is slowing more than expected, leading the World Bank to cut its 2019 growth forecast by 0.1 percent compared to its prediction of six months ago. The U.S., of course, is less dependent on global developments than most other nations. Still, the total volume of trade, exports and imports combined, accounts for a nontrivial 32 percent of GDP so the potential feedback from worsening conditions overseas would be palpable. The ongoing trade conflict with China, which is contributing to the global growth slowdown, is poised to escalate as U.S. tariffs on $200 billion of Chinese imports are set to increase from 10 to 25 percent in March if the two nations do not forge an agreement on several key issues.

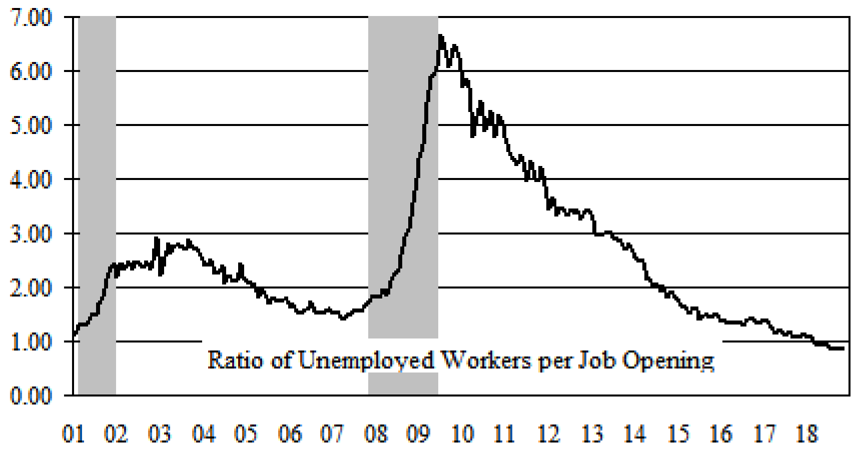
The good news, which added to the market's more buoyant mood this week, is that midlevel talks between the two nations appear to bearing fruit. China has made several concessions, lowering tariffs on U.S. imports and opening up markets for U.S. companies, and a high-ranking trade official is scheduled to come to the U.S. to continue negotiations. However, suspicions that China will not follow through on its promises run deep among U.S. officials and few observers expect a concrete resolution to the conflict anytime soon. Our base case outlook is that the tariff increase will be put into effect sometime this spring, leading to retaliatory action that will slice a fraction from the U.S. growth rate in the second quarter. If trade tensions continue to escalate, the multiplier effects on the U.S. would be amplified by heightened turmoil in the financial markets.

More immediately, the political dysfunction in Washington is getting worse, as the partial government shutdown shows no sign of ending. The president has dug in his heels about funding for the wall and Democrats have stiffened their resistance. It looks like the shutdown will last at least through the weekend, making it the longest in U.S. history. The direct effects on the U.S. economy should not be terribly harsh, given that most government functions are still up and running. Importantly, the Treasury Department said that tax refunds would not be delayed even if the shutdown continues through the start of the tax-filing season. That's important because a delay would put a dent in consumer spending, which is currently the economy's main growth driver. That said, the longer the shutdown lingers, the greater the toll it would take on the economy.

Assuming that rational minds prevail before long and the government reopens, the economy should stay on a positive, although slowing growth trajectory. For sure, upcoming data will be skewed to the downside by the shutdown. If the furloughed workers still do not have paychecks by the end of the month, the January jobs report will be ugly, possibly showing a decline in payrolls for the first time in 99 months and ending the record-long stretch of job gains. But the drop-off would be confined mostly to government workers, although some private companies hurt by lower sales to laid-off government workers would also reduce staff, if only temporarily. That said, the demand for labor remains robust and those workers will no doubt quickly find jobs, either at their old positions or at new firms.

According to the government's Job Openings and Labor Turnover Survey (the so-called JOLTS report) there continues to be more job openings than unemployed workers, an excess that appeared for the first time on record last March and which has since grown wider. The latest JOLTS report is for November but the December jobs report released last Friday suggests that the gap may have narrowed last month when the number of unemployed workers actually increased, lifting the unemployment rate from 3.7 percent to 3.9 percent. But that's actually a positive indication for the labor market because it reflects a return to the labor force of workers that have been forced to the sidelines by the lack of job opportunities. With the persistent elevated level of job openings, these job searchers are being lured back to the workforce, encouraged by greater prospects of landing a position.

Plenty Of Job Opportunities



Simply put, concerns over global growth, trade policy and political dysfunction continue to stoke volatility in the financial markets and cloud the economic outlook. Just as market pessimism in the fourth quarter was overblown, the turnabout since the start of the year reflects changing perceptions regarding Fed policy and some progress on the trade front rather than any shift in economic fundamentals. We still expect the economy to deliver above-trend, albeit slowing growth this year and the job market to continue tightening, with the unemployment rate falling to 3.5 percent by the end of the year. The uncertainties noted above will likely keep the Fed on the sidelines through at least the first quarter, but another rate increase in May is still in the cards. Our sense is that the Fed will pull the rate trigger twice in 2019, with the second coming late in the year. That's consistent with its prediction made at the December policy meeting, but the Fed will no doubt adhere to its new mantra of being patient and flexible in response to incoming data.