Weekly Market Commentary
January 22, 2019

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With the government shutdown now the longest on record – 28 days and still counting – the pain is reverberating ever more broadly throughout the economy. Unfortunately, it is difficult to quantify the extent of the damage, as the evidence is mostly anecdotal. With the shuttering of the Commerce Department – a critical source of economic data – economists are mostly in the dark in assessing the shutdown's impact. But day after day, the headlines contain numerous stories on the sacrifices being made by the 800,000 government employees either furloughed or working without pay, and how their adverse circumstances are negatively affecting their families and local businesses. As the missing paychecks pile up, these victims of government dysfunction are forced to cut back purchases, which translates into lost sales for merchants, reduced tax revenues for local governments and less business for government contractors, resulting in additional collateral layoffs. What's more, these monetary consequences are amplified by the psychological toll on government workers who find themselves adrift through no fault of their own.

From a macro perspective, there is little question that the shutdown is slicing some muscle out of the economy's heretofore-vigorous growth rate. If it lasts for another week or so, the Commerce Department's report card on the economy's fourth-quarter performance, scheduled for release on January 30, will be delayed. Past experience with government shutdowns indicates that it would take several weeks if not months after the data-collecting agencies reopen to bring the data calendar back to normal. But the data available before the shutdown began strongly suggesting that growth was already slowing in the final months of the year. The consensus estimate is that GDP expanded by a 2.6 percent annual rate during the period compared to 4.2 and 3.4 percent in the second and third quarters.

The Federal Reserve was acutely aware of the slowdown, which, along with the tame inflation readings, heightened turmoil in the financial markets and softer global activity, prompted it to adopt a more dovish stance at its December 18-19 policy meeting. Importantly, Fed officials reiterated their intention to become more data dependent rather than committed to a preset course of normalizing policy. The problem is, there is considerably less available data for the Fed to depend on than there was at the December policy meeting. Over the past two weeks alone, data on retail sales, housing, inventories and trade have all become unavailable because of the shutdown. What is available, however, should push the Fed further into the dovish side of the ledger.

In particular, data on inflation – which are compiled by the still-functioning Labor Department – reveal that the Fed has little reason to fear a breakout above its 2 percent target. Last week it was reported that consumer prices slipped 0.1 percent in December, lowering the annual rate to 1.9 percent from 2.2 the previous month, while the monthly and annual core inflation rates held steady at 0.2 percent and 2.2 percent. A similar theme emerged in this week's wholesale price report, which revealed that both headline and core producer price increases slowed from the peak rates of late last year.

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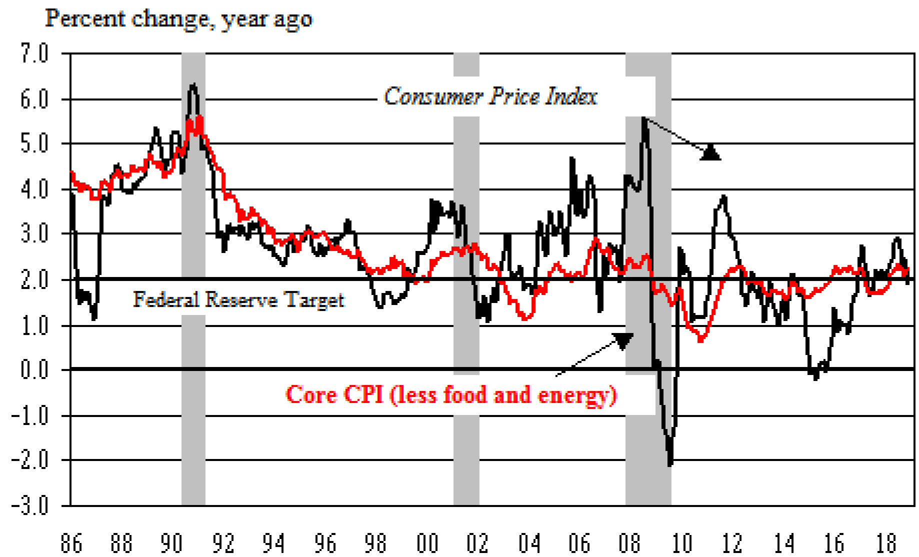
Inflation expectations also remain well contained, both on Main Street and Wall Street. The Treasury market is pricing in a five-year inflation rate of 1.64 percent, down significantly from a 2.04 percent breakeven rate seen last October.

Inflation Still Tame

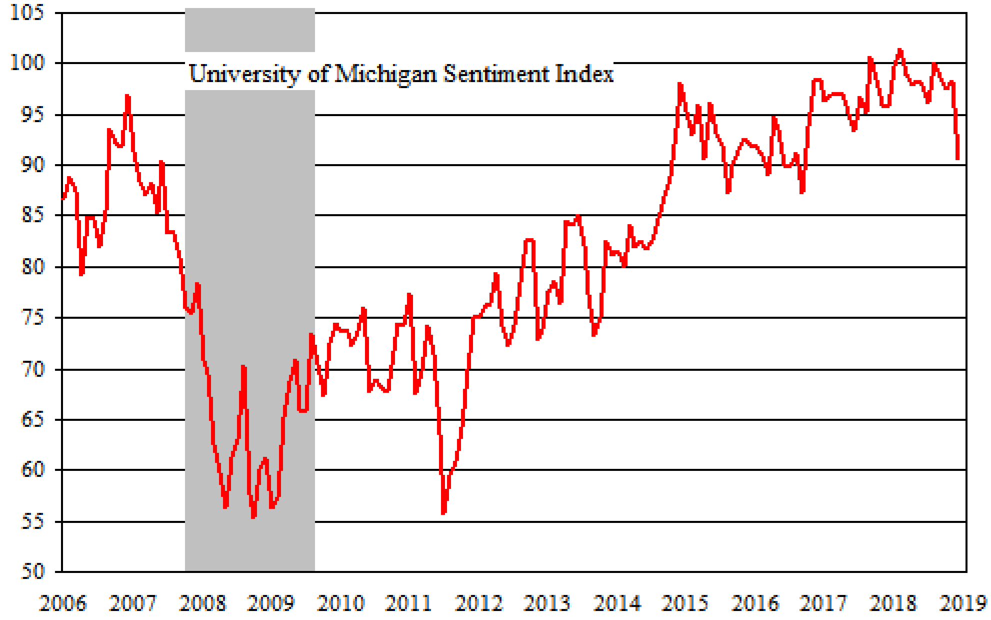


Not surprising, expectations of future Fed rate increases have also receded. While the latest median prediction of Fed officials is for two rate hikes in 2019, the markets are pricing in at most one increase, and many expect the Fed to stand pat for the entire year. Despite the median prediction, Chairman Powell and several of his colleagues have repeatedly said that the Fed would be patient in its rate-hiking strategy, with the latest calming missive coming on Friday from New York Fed President John Williams in a speech before the New Jersey Bankers Association. We are still in the camp that expects two rate increases this year but believe that the first hike will not come until May when, hopefully, the shutdown will be well over and incoming data will provide a clearer picture of how the economy is performing.

No doubt, the tailwinds that last year propelled the economy to its strongest growth rate since 2005 will be fading over the coming year. These include the positive thrust provided by fiscal stimulus, strong consumer spending, solid global growth, relatively low albeit rising interest rates, and elevated business and consumer confidence. As the calendar turned to 2019, these tailwinds were already losing traction even as the economy faced strengthening headwinds. Global growth slowed dramatically, led by a slumping China mired in a trade dispute with the U.S. and a faltering Europe coping with the still-unresolved issue of Britain's pending exit from the EU. The business tax incentives designed to spur a capital-spending boom petered out after an initial spurt of investment outlays. In the waning months of the year, business surveys and forward-looking indicators, such as new orders, pointed to a slower pace of capital spending this year.

Importantly, cracks in the once-solid level of consumer and business confidence are appearing. On Friday, the University of Michigan reported that its consumer sentiment index plunged 7.6 points in early January to the lowest level since October 2016, erasing all of the gains since Trump's election. Households cited an array of downbeat influences, including the government shutdown, tariffs, financial market turbulence, slowing global growth and uncertainty over monetary policy. The collective toll these influences are having on the outlook is palpable, as consumers view prospects for the economy over the next year to be the worst since mid-2014. To be sure, consumers do not always behave as they feel, and the loss of confidence may not translate into reduced spending. But if diminished perceptions of the economy continue and prompt households to build up precautionary savings, that would indeed result in a consumption pullback.

Household Confidence Sags

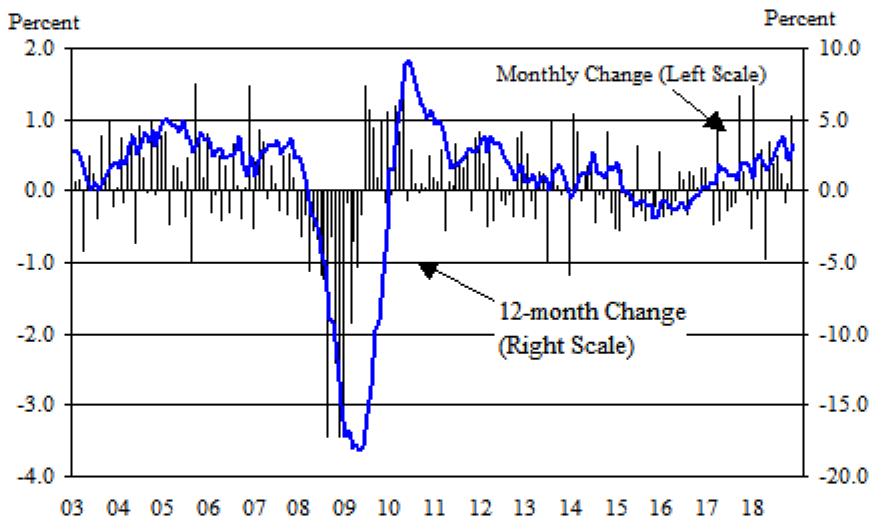


Meanwhile, business confidence is also waning, although not to the extent revealed in the Michigan survey of households. Like households, business leaders of both large and small companies are increasingly concerned over the trade war with China, higher tariffs in general and, most recently, the government shutdown. The latter is a new addition to the list of woes expressed by businesses, but it may have a more lasting influence than the others. Even if the shutdown ends quickly – a not very promising prospect – the ongoing dysfunction in Washington is likely to intensify following the mid-term elections that elevated Democrats to a majority in the House. That, in turn, raises the likelihood that future shutdowns might be a more common feature than in the past. In addition to the impasse over funding for the border wall, other potential battles loom on the horizon, including the lifting of the debt ceiling as well as temporary caps on government spending. The more businesses expect growth-retarding government shutdowns to repeat themselves, the greater is the likelihood that they will curtail investment spending and hiring.

That said, the gloom and doom surrounding the government shutdown by no means signals the end of the expansion. While the majority of economists, including us, see slowing activity ahead, most still expect the economy to remain on a positive growth path next year. With the job market chugging along at a torrid pace, lifting real wages, consumer spending should remain supportive of growth this year. Households will also be receiving an influx of cash from enlarged tax refunds starting next month, imparting some extra oomph to spending in the first and early second quarters. One byproduct of reduced growth and inflation expectations has been lower bond yields since late last year, resulting in lower mortgage rates as well. That, in turn, could give a much-needed boost to the ailing housing sector, which has been hit hard by weakening sales and construction activity.

And despite the headwinds conspiring against manufacturers and mining companies – slowing global growth and weaker oil prices – they are not yet putting the kibosh on industrial activity. Indeed, industrial production showed more strength than expected at the end of last year. According to the Federal Reserve – which remains open for business and compiles some important economic data – the nation's factories, mines and utilities increased output by a formidable 0.3 percent in December and only a weather-related 6.3 percent drop in utility output kept the overall index from staging a more vigorous increase. Manufacturing output jumped by 1.1 percent, the strongest gain since February, while mining output advanced by 1.5 percent.

Robust Manufacturing Output



The surprising strength in industrial output flies in the face of regional and national surveys that generally depict growing weakness in the industrial sector. True, the December jump in production was skewed somewhat by a 4.7 percent surge in motor vehicle output, something that is not sustainable amidst flattening auto sales. But to be fair, the IP increase was spread broadly among key components, including business equipment, which rose by 0.5 percent, suggesting that the slowdown in capital spending last quarter may not have been as severe as thought. Unfortunately, monthly data on new orders and shipments are released by the now-shuttered Commerce Department, so incoming information that would confirm or invalidate the strength in business equipment output is not available.

Paradoxically, the government shutdown that has so dominated the headlines and invoked a wave of potential dire consequences has failed to dampen spirits in the financial markets. The stock market is in the midst of staging one of its strongest January rallies in decades, the bellwether 10-year Treasury yield has increased by about a quarter-percent over the past two weeks and the dollar has regained some of its 2018 mojo, after a month of sliding into the doldrums. What’s more, the week ended on an upbeat note, fueled by rumors of easing trade tensions with China. The good news is that the powerful rally in the stock market removes the threat of a negative wealth effect on the economy that the deep slide in stock prices posed in December. The potential bad news is that the improving fortunes in the financial markets might embolden president Trump – who equates the market’s performance with his approval ratings – to keep the government shut down longer in his quest for border wall.