Weekly Market Commentary
January 28, 2019

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President Trump's endorsement on Friday of a truce that would reopen the government for three weeks temporarily ends an ugly chapter in American politics. The plight of the 800,000 government workers either furloughed or working without pay was exposed to the harsh glare of the media every day of the record 34-day shutdown. Not surprisingly, recriminations from both Democrats and Republicans competed for headline space, and the finger pointing will likely continue throughout the pending negotiations for a more permanent deal. The ongoing saga also brings to our attention some comments by government officials – one old and one new. The former dates back to the 1960s when Illinois Senator Everett Dirkson in response to growing Federal deficits allegedly opined "a billion here, a billion there, and pretty soon you're talking real money." While on a smaller scale, we have no doubt that the families of government workers about to miss their second paycheck feel the same way.

The second comment that elicited widespread attention came from Commerce Secretary Wilbur Ross on Thursday. In a CNBC televised interview, the secretary who ironically made his fortune dealing in distressed securities opined that he couldn't understand why so many of the furloughed government workers were distressed, noting that they could easily get a loan to tide them over until they received their back pay. The only implied downside is that they would have to pay a little bit of interest. Aside from the poor optics of his comments, a look at some Federal Reserve data indicates that the interest payment might not be so little. To be sure, some credit unions and regional banks are offering interest-friendly loans to government employees affected by the shutdown. But the fastest way an individual put in dire straits by unforeseen circumstances to get a loan is to charge purchases against his or her credit card.

If they do, they might be in for sticker shock when their statements arrive in the mail. True, it is no secret that the Federal Reserve has been lifting short-term interest rates, pushing up consumer borrowing costs in the process. But the increases since the end of 2015 have been relatively mild for a tightening cycle – 2.50 percentage points versus 4.25 and 3.50 percentage points during the previous two tightening episodes. Ordinarily, consumer borrowing costs do not rise as steeply as Fed-induced short-term rates as the economy is usually booming in the later stage of a tightening cycle, bolstering the quality of consumer loans. Not so this time. Not only has the rate that banks charge on credit cards risen in lockstep with the increase in short-term rates, they are higher than any time since 2001. But the three-month Treasury bill rate is less than half the level prevailing at the peak of the last expansion. What's more, the latest data on credit card rates are for November and, hence, do not reflect the bump following the Fed's rate hike at the December policy meeting.

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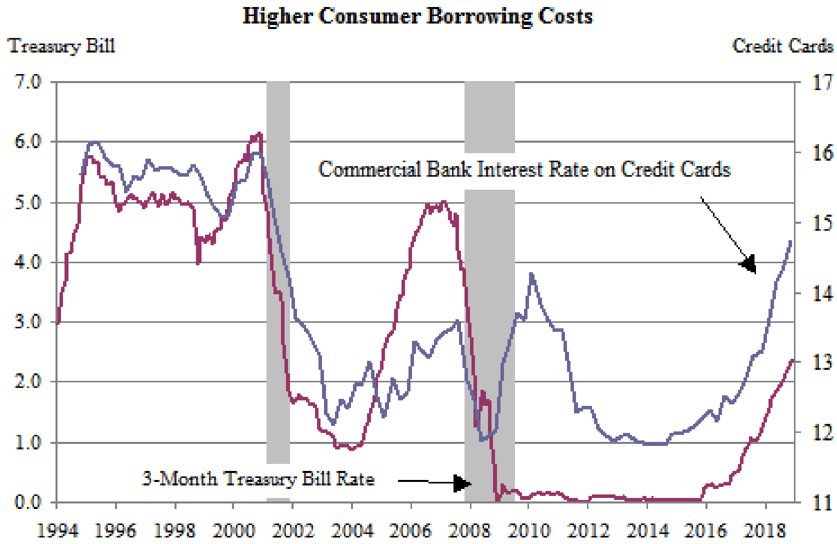


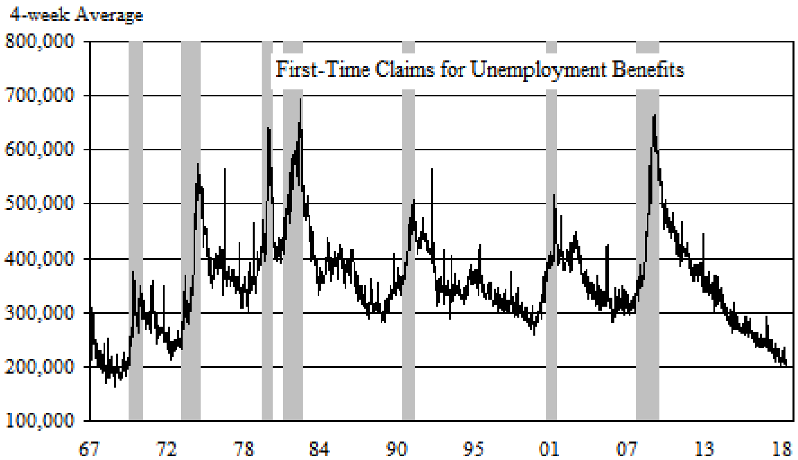
Meanwhile, the shutdown's effects on the broader economy are becoming ever more palpable. Consumer confidence has taken a nosedive over the last two months, regional manufacturing surveys for January are revealing deteriorating conditions and business leaders, already concerned about trade tensions, slowing global growth and rising short-term interest rates, are now operating in an environment of heightened political uncertainty. Friday's deal that would reopen the government by three weeks does little to assuage this uncertainty. By kicking the can down the road, it would further cement the perception that government dysfunction has become a way of life in Washington, increasing the likelihood of further shutdowns in a highly polarized political environment. That, in itself, is a growth-retarding influence as it firmly embeds a layer of uncertainty into the mindset of businesses, which is a time-honored restraint on investment decisions.

Kevin Hassett, head of the Council of Economic Advisors, estimated that each week of the shutdown slices 0.1 percent from the quarterly GDP growth rate, which would translate into a 0.5 percent haircut for the first quarter. Hassett also indicated that the economy could actually come to a full stop during the period had the shutdown continued for much longer, something that would no doubt bring recession talk to the forefront. The short-term deal puts the kibosh on that prospect, but if Congress fails to come up with a more permanent agreement by the February 15 deadline the drag from political dysfunction would linger and further erode business and consumer confidence. On the positive side, the political shenanigans have had little effect on Wall Street, as investors remain upbeat. The stock market continued to rally this week, extending one of the strongest months for a January in decades.

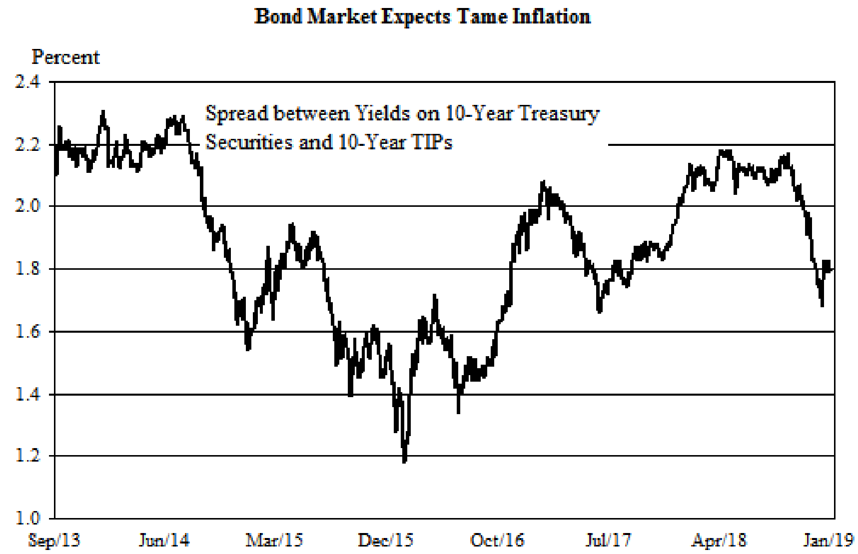
Underscoring the positive tone in the financial markets, there are few signs that the government shutdown or global concerns have yet to short-circuit the economy's key pillars of strength, namely the job market and corporate profits, both of which appear to be holding up well. Moreover, the markets were encouraged on Friday by reports that the Federal Reserve would not be shrinking its balance sheet as much as expected. We will be getting more insights into the Fed's intentions as well as some hard data on the job market next week, when the FOMC meeting takes place and the Labor Department releases its monthly employment report for January. The latter, which always takes center stage when it is released, will receive extra attention this time as it is one of the few government reports available until the data calendar returns to normal, something that will take weeks if not months to happen.

While the jobs data will be distorted by the shutdown, one thing is clear: companies are not laying off workers despite the turmoil in Washington and global growth concerns. First-time claims for unemployment benefits fell below 200,000 in the week ending January 19 for the first time since November 1969. Keep in mind that the labor force back then was half the size it is now, so those claims were proportionately larger relative to the working-age population. More ominously, November 1969 marked the endpoint of the long expansion of the 1960s, presaging a 12-month recession that began the following month and drove the unemployment rate up from under 4.0 percent to over six percent. Then, as now, the Fed was in the midst of a tightening cycle, which propelled the fed funds rate up by more than six percentage points to a growth-stifling level of over 9.0 percent.

Companies Holding On To Workers



Of course, the backdrop of the late 1960s was quite different than now. The Vietnam conflict was still raging and the administration's "guns and butter" fiscal policy fueled an inflation rate that soared from 1.5 percent to over six percent in a few short years. The Federal Reserve spent the next three decades striving to recover its inflation-fighting credibility, which was undermined by its unpredictable stop-go policies in the late 1960s and 1970s. By the late 1990s that credibility was finally restored as inflation and inflationary expectations had been tamed. Indeed, since the turn of the century, fears of deflation rather than inflation have been more of an issue. Only recently has inflation risen to the Fed's long-standing two percent target while market-based inflation expectations over the next five and 10 years are still comfortably below that level.



The tame inflation backdrop is the primary reason the Fed can be more patient before raising rates again in the face of a tightening labor market. There is virtually no chance that any change will occur at the upcoming policy meeting that ends January 30, and we expect a more dovish statement compared to the post-meeting statement in December. Recall that the stock market reacted violently to that statement, which indicated that two more rate increases were in the cards for 2019. In the weeks since, Fed officials have forcefully walked back that guidance, with several suggesting that rates could be on hold for the rest of the year unless data on growth and inflation justify another hike.

That clearly won't be the case for a while. Not only were signs of slowing growth in the first quarter already appearing, the government shutdown imposed another drag that was not anticipated at the December policy meeting. It is hard to imagine the Fed justifying an additional increase with GDP tracking a 1.5-2.0 percent growth rate in the first quarter and inflation under wraps. With the data calendar poised to slowly return to normal over the next several weeks, the central bank will need to wait longer for more statistical evidence before it feels comfortable pulling the rate-hiking trigger again. From our lens, that probably won't be the case until at least May.

By the same token, it would be premature to assume that future rate increases have been taken off the table. For one, the data available prior to the government shutdown do not justify that conclusion. Yes, there were some weak readings, particularly regarding housing activity and surveys showing that manufacturing conditions were deteriorating. But those surveys were overshadowed later on by hard data on industrial production, revealing a much stronger increase in manufacturing output in December than thought. Even more damaging to the dovish camp's argument was the December jobs report featuring the eye-opening 312,000 increase in non-farm payrolls as well as the sturdy increase in wage growth.

Assuming the government stays open and functions normally for the rest of the year, we suspect that the economy will rebound in the second quarter, fueled by a snapback of postponed purchases during the shutdown, enlarged tax refunds and sustained strength in the job market. As inflation readings firm up around the Fed's two percent target and wage growth is sustained at its current solid pace, the Fed should have enough justification to hike rates at least one more time before the end of the year.