Weekly Market Commentary

February 4, 2019

Weekly Commentary

There was much joy on Wall Street this week. Stocks rallied sharply, punctuating the strongest month of January for the Dow Jones Industrial average and S&P 500 in at least three decades. As the curtain rises on February, much of the debilitating plunge in stock prices during the fourth quarter had been recovered, with the S&P standing just 9 percent below its September 20 record high and up 14 percent from the trough of late December. Meanwhile, the new year is bringing cheer to fixed income investors as well. Bond prices moved significantly higher this week, lowering the yield on the bellwether 10-year Treasury issue to 2.63 percent on Thursday before an eye-opening jobs report on Friday sent it up to just under 2.70 percent by the end of the week. Still, that's a far cry from the 3.25 percent touched less than three months ago. The decline will lead to lower mortgage rates, an encouraging omen for potential homebuyers.

Given all of the negative news hitting the headlines in recent weeks, the joyful mood on Wall Street would seem to be an aberration. Clearly, the upbeat tone is not another example of bad news being good news, which has stoked market rallies in the past. That usually occurred when the economy was thought to be overheating, or on the verge of it, raising hopes that a negative reading on some key indicator would stave off a growth-stifling turn in Fed policy towards aggressive tightening. This time, there was nothing positive about the array of bad news that preceded and, indeed, coincided with muscular run-up in stock prices last month. The record-long government shutdown was widely condemned as a bad influence on the economy, corporate earnings and consumer as well as business confidence. Likewise, no one is cheering the global growth slowdown that gained traction towards the end of last year, paced by deteriorating conditions in China and Europe and reinforced by a chaotic Brexit episode that is turning into a nail-biting affair as the deadline for a deal draws ever closer in March. Nor is there anything positive about the ongoing impasse on the trade front with China that, despite some signs of progress in current meetings, continues to underpin fears of an all-out trade war that could clobber global growth.

Moreover, it is hard to view the uplifting spirits on Wall Street as merely a defining sign of a relief rally following the reopening of the government last week. For one, the rally was well underway before the temporary deal was reached. For another, there is no guarantee that the short-term agreement will morph into a permanent spending bill that prevents another shutdown after it expires on February 15. While unlikely – given the aversion to that prospect by the majority of legislators on both sides of the aisle – it would be hazardous to predict President Trump's reaction to a bill that omits border wall funding to his satisfaction. Simply put, the wall of worries that the markets are climbing is as tall as ever, raising the question of whether investors are being set up for a major fall.

Time will tell if that turns out to be the case. But while the worriers have plenty of fuel to feast on, the optimists received a huge lift this week on both the policy and economic fronts. The first boost came courtesy of the Federal Reserve, which stunned the financial markets with a much more dovish turn in policy direction than

Fred Eisel
Chief Investment Officer
Email: feisel@vfccu.org
Phone: 800-622-7494 ext. 1610

Scott Wood
Portfolio Strategist
Email: swood@vfccu.org
Phone: 800-622-7494 ext. 1631

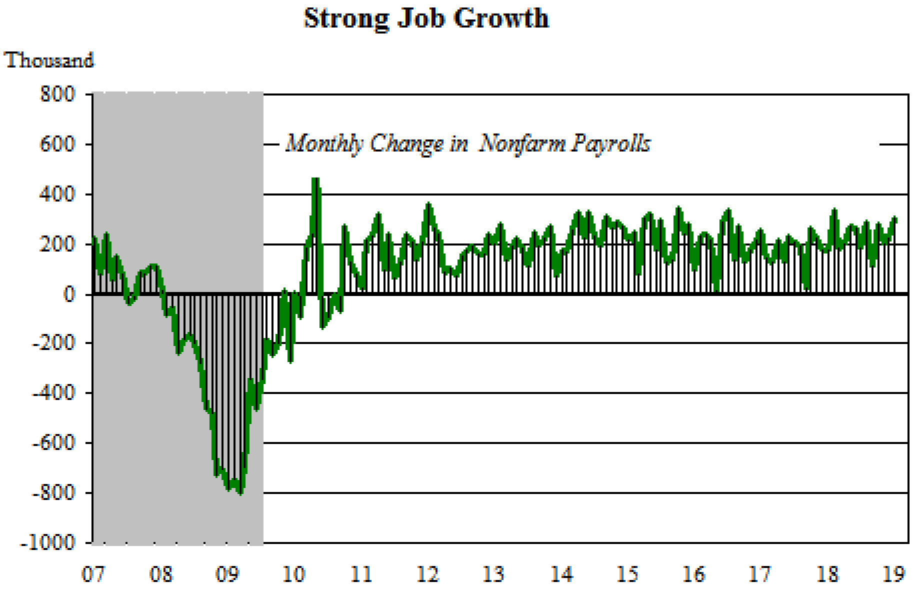
Jeffery Sengsy
Investment Analyst
Email: jsengsy@vfccu.org
Phone: 800-622-7494 ext. 1628

anticipated at this week's policy meeting. In stark contrast to its December meeting, which left markets believing that more rate hikes were on the way in 2019, the message conveyed this week was that past increases would be enough for a while. With inflation remaining tame and an array of global uncertainties overhanging the landscape, the imperative to preemptively lean against the inflationary winds became less of an imperative in the eyes of policy makers. Instead, Fed officials will wait to see how the data plays out before making its next move, which some interpreted as a sign that we are at the end of the rate-hiking cycle. Patience is the new mantra of the Fed. The icing on the cake was the Fed's declaration that it would be flexible in reducing the size of its balance sheet while indicating it would retain a larger portfolio of securities than previously thought.

The Fed's dovish stance at its latest meeting assuaged fears that policy was moving too fast in the quest to bring rates up to normal levels, removing one key threat to the expansion. Clearly, the central bank had ample reason to put rate increases on hold heading into the meeting. All of the above-noted negative influences were front and center on the global stage. Making matters worse, the government shutdown had deprived policy makers of vital data needed to assess current conditions. The truncated data made available was hardly encouraging. Private surveys depicted weakening conditions in the housing and manufacturing sectors, consumer confidence was sagging and inflation showed no sign of picking up. Thanks to the strong dollar, the plunge in stock prices as well as rise in interest rates late last year, financial conditions were also tightening.

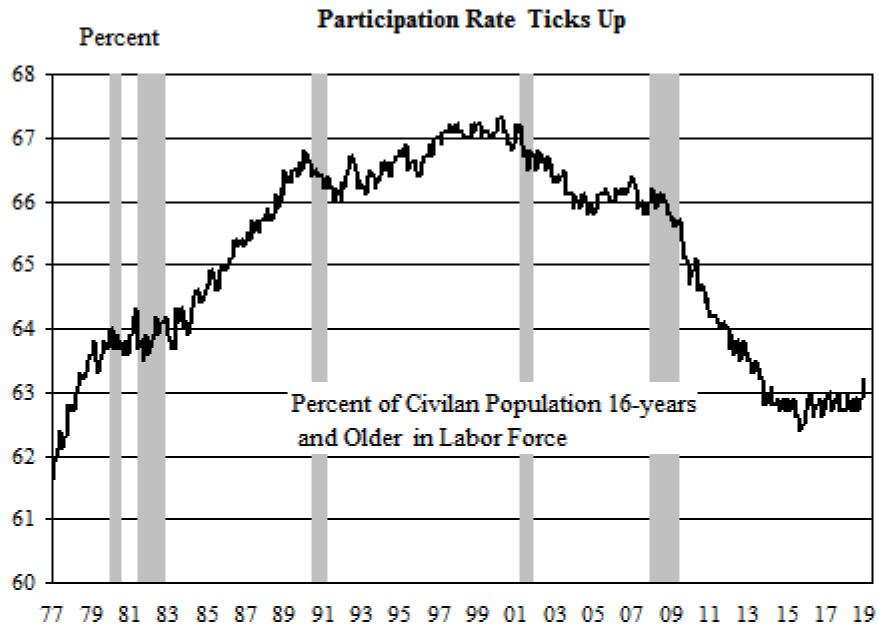
Even as these headwinds were gaining traction, the Fed was well aware that the tailwinds, which provided considerable support to the economy's growth engine last year, were set to fade. Most of the tax benefits accrued to households and businesses have already found their way into the spending stream and would not be providing as much thrust in 2019. Nor did the economy seem to have much momentum heading into the new year as the growth engine was not running on all cylinders. As noted, both housing and manufacturing activity lacked vigor and the CBO estimated that the government shutdown sliced a cumulative 0.3 percent from the GDP growth rate in the fourth and first quarters. Auto sales peaked months ago and households significantly reduced their six-month buying plans for major appliances in the latest Conference Board survey of consumer confidence, which also fell by an unseemly 16.4 points over the past two months.

But a funny thing happened on the way to a recession, which an increasing number of observers thought was coming sooner rather than later. The fatigue that gripped the economy late last year appears to have been miraculously replaced by a burst of energy to start this year. To be sure, there is scant data to support that view, as the book for January are just opening. But the first reading for the month was a boon for growth optimists. Indeed, if a recession lurks around the corner, the labor market didn't get the memo, as the economy generated an eye-opening 304 thousand net new jobs in January. That not only exceeded expectations by more than 100 thousand, it was the largest monthly gain since last February, when a 330 thousand increase was inflated by a weather-related 73 thousand surge in construction payrolls. Before that, you would have to go back to July 2016 to find a larger monthly increase.



Some of the glow from the headline job growth last month was tarnished by a huge 90 thousand downward revision to the December count. But even with that haircut, nonfarm payrolls staged a more-than-respectable increase of 222 thousand in December, yielding a three-month average gain of 241 thousand. That's actually stronger than the 232 thousand and 234 thousand average over the past six and twelve months periods, implying a gently improving underlying trend. This defies widespread notions that the labor pool is running out of workers and supply constraints imposed by an aging population and low unemployment rate should be dragging down the monthly payroll gains. For sure, job growth averaging more than 200 thousand a month at this late stage of the business cycle is clearly not sustainable; these constraints will kick in at some point – but when?

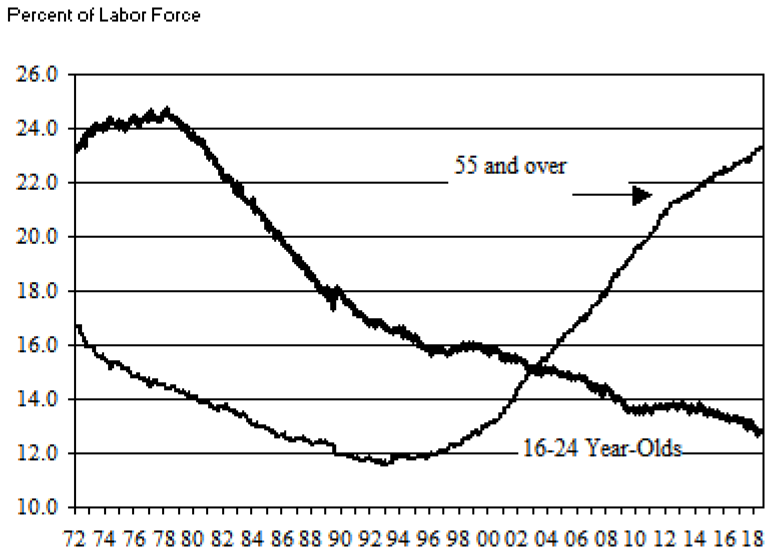
The good news is that there appears to be more room to run in the job market than thought. Simply put, the strong hiring demand is drawing workers off the sidelines who were long believed to be stalwarts remaining outside of the labor force either through retirement, disability, discouragement, family issues or for other reasons. The exodus of retiring workers due to the aging population alone should be dragging down the fraction of the population in the workforce. Instead, the labor force participation rate is steadily climbing. Last month it inched up to 63.2 percent, the highest since September 2013 and up from 62.7 percent last October. That might not seem like a huge amount, but each 0.1 percent increase out of a 200 million working-age population translates into 200 thousand jobs, so about 600 thousand workers who were out of the labor force three months ago are now drawing paychecks.



Indeed, the increase in the participation rate is the main reason the unemployment rate has not fallen further than it has. Last month's increase to 4.0 percent from 3.9 percent in December was an aberration related to the government shutdown. In previous expansions, an unemployment rate of 4.0 percent or lower would be driving up wages much faster than is currently the case, stoking inflationary pressures and prodding the Fed into an ever-more restrictive policy. Not so this time. While wage growth has picked up in recent years, it has been a gradual trend that only recently broke through the 3.0 percent year-over-year threshold. With productivity growth at 1.3 percent, a 3.0 – 3.5 percent increase in labor compensation can readily be accommodated without violating the Fed's 2.0 percent inflation target.

That said, job growth in excess of 200 thousand a month is sure to absorb the shrinking slack in the labor market at a quickened pace and exert more upward pressure on wages. The question therefore is, how low should the Fed allow the unemployment rate to fall before stepping more firmly on the monetary brakes? This is still an open debate, both within the Fed and among economists. But one issue that most economists and policy makers agree on is that the current low unemployment rate overstates the tightness in the labor market. For one, as already observed in recent months there are probably more workers than thought on the sidelines that can be lured back into the labor force to fill open positions. For another, the jobless rate itself is skewed lower by the aging of the workforce; the share of the labor force represented by workers age 55 and over has more than doubled over the past 10 years, and this group has a much lower unemployment rate than younger workers. According to the Federal Reserve Bank of Atlanta, this shift in demographics alone has lowered the unemployment rate by almost half-percent since 2000. By the same token, older workers earn more than younger ones, so the demographic shift may also be skewing the average growth rate in worker earnings higher.

Aging Labor Force



All in all, the latest jobs report validates the Fed's current stance of being patient while acknowledging the economy's ongoing strength. Growth is clearly not falling off a cliff as some had feared late last year, as the ongoing robust pace of job growth and steady improvement in wages underpin solid fundamentals for consumer spending – the economy's main growth driver. But inflation remains well contained and shows few signs of breaking out; with a host of uncertainties on the global front far from resolved, there is little urgency for Fed to step harder on the monetary brakes. From our lens, policy will likely stay on hold through mid-year, but pressures for rate hikes will build over the second half. We still expect at least one more increase later this year.