Weekly Market Commentary

February 11, 2019

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It will be a while before the data calendar is back to normal, as the government shutdown prevented the Census Bureau – the government's main statistical-gathering agency – from publishing key data during the 35-month hiatus. That includes the comprehensive GDP report for the fourth quarter, which still doesn't have an official release date. Nonetheless, the paucity of information hasn't stopped economists from estimating how the economy performed in the waning months of last year; most of the growth estimates fall within a range of 2.5-3.0 percent. We expect the GDP growth rate to have come in at 2.8 percent, topping out a full year for growth that would rank among the strongest since 2005.

While 2.8 percent is a solid pace relative to the 2.2 percent average over the previous 8.5 years of the expansion it does represent a slowing trend, as it follows 3.4 percent and 4.2 percent growth rates in the third and second quarters, respectively. No doubt, the slowdown in part reflects the shutdown itself, which the CBO estimates shaved 0.1 percent from the fourth-quarter tally and is likely to slice another 0.2 percent in the current quarter as well. Hence, the slowing trend is poised to extend through the first quarter, which we currently peg at a 1.7 percent pace. Most, but not all, of that loss will be recouped in subsequent quarters, and we expect a modest rebound in the April-June period. That said, by the end of the year, the trend of slowing growth should reassert itself, with the final quarter standing about 2.0 percent above its year-earlier level.

Simply put, despite the hopeful expectations surrounding last year's growth spurt, the economy has yet to prove that it has broken out of the roundly 2.0 percent "new normal" growth path seen for more than a decade. No doubt, above-trend growth can occur for several quarters this year, as the lingering effects of the 2017 tax cuts and 2018 spending bill should provide some incremental growth thrust for a while longer. But those tailwinds are already starting to fade, and they should provide little or no support heading into 2020. By then, the economy will already be in uncharted waters, moving through the longest expansion on record even as its growth engine starts running out of fuel. Not surprisingly, economists are upping the odds that the nation falls into a recession next year.

We are not in that camp, but recognize that as the economy downshifts to a slower speed it becomes ever more vulnerable to external shocks. The latter can take many forms, from both global and domestic sources. On the global front, the threats are proliferating, starting with the growing likelihood of a hard Brexit at the end of March. The U.K is already reeling from that prospect even as the European Union is coping with an array of growth-dampening influences. Its main growth driver, Germany, is sputtering, Italy is on the cusp of recession and weakening exports to China's slowing economy is reverberating throughout the bloc. The European Commission has just revised down its 2019 growth forecast for the region from 1.9 percent to 1.3 percent. If Murphy's Law plays out, it won't be the last downgrade.

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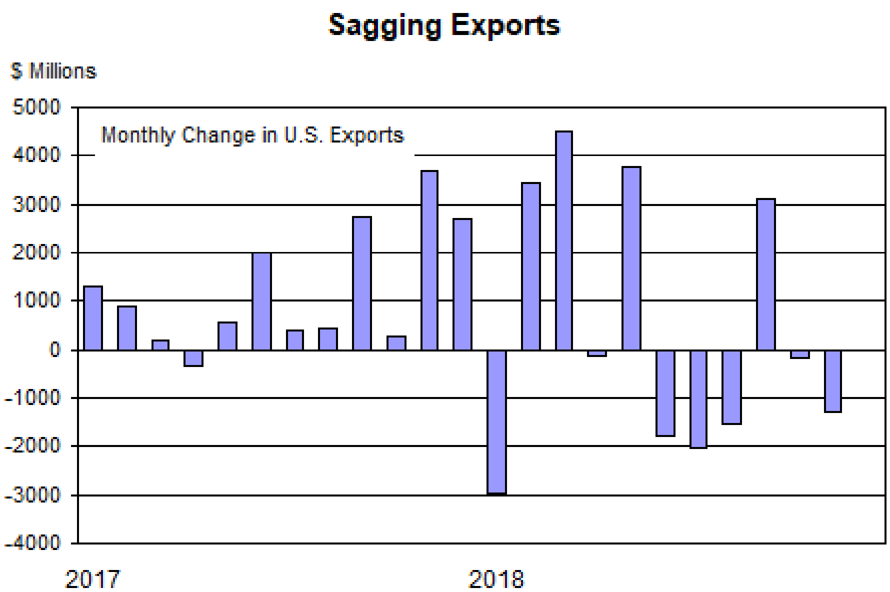
While the U.S. is relatively insulated from the troubles simmering overseas, it is certainly not immune to their effects. Slower global growth hits at the heart of manufacturing, sapping it of foreign sales. U.S. exports fell in six of the last seven months through November of last year, the longest stretch of sagging exports in three years. Nor is it just goods shipped overseas that are hitting the skids. About 45 percent of the revenues of S&P 500 companies are derived from foreign sales, so whatever ails global growth delivers pain to the bottom lines of multinational corporations. The stock market has recently been taking it on the chin in part due to lowered profit expectations. The negative feedback loop suffered by the financial markets is another channel through which adverse developments abroad can influence the U.S. economy.

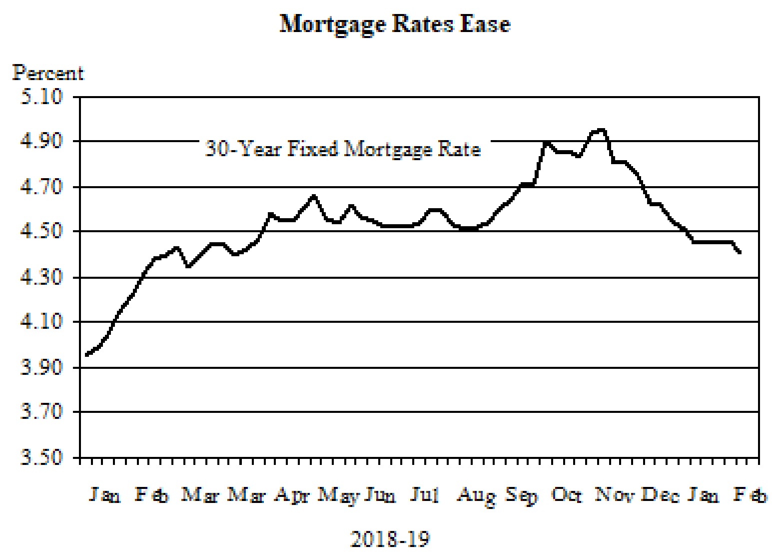


On the domestic front, the U.S. economy has been buffeted by the government shutdown, as already noted, and may still under-perform until the nontrivial prospect of another shutdown is eliminated. The committee of legislators has one more week to hammer out a deal on border-wall funding and a resolution should not be taken for granted despite a profound aversion of both Democrats and Republicans towards another shutdown. Also looming on the near-term horizon is a breakdown of trade talks with China, which has been on a roller-coaster ride of perceptions since the administration postponed lifting tariffs on $200 billion of Chinese imports in December. The temporary truce set the stage for meetings between Chinese and U.S. officials that have alternately generated rumors of hope and despair, spurring corresponding reactions in the stock market. But the temporary truce on tariffs is set to expire at the end of the month, and this week's report that President Trump will not be meeting with Chairman Xi of China next week, as hoped, had a chilling effect on the markets, contributing to declines in the major stock indexes on Thursday and Friday. The undulating prospects of trade talks with China and concomitant reactions in the markets provide a stark reminder that protectionist policies represent a major threat to the growth outlook.

Encouragingly, one time-honored domestic threat to the expansion has been diffused, at least temporarily, as the Federal Reserve took an imminent rate hike off the table. No doubt, the tightening of financial conditions over the past year has restrained growth in the U.S., hitting some sectors more than others. The four quarterly rate hikes in 2019 on top of the five more gradual increases dating back to December 2015 lifted borrowing costs for households and businesses across the board. Meanwhile, the strengthening of the dollar that has been stoked by huge inflows of foreign funds seeking higher returns in the U.S. has made American products more expensive in the global marketplace, crimping foreign demand for U.S. goods. It's unclear how much of a slowing impact the tightening of financial conditions has had on the U.S. economy, but it is also evident that some brakes were needed to prevent a government deficit-fueled growth spurt last year from getting out of control.

That said, as the impetus from fiscal stimulus started to wane late in the year, concerns that the Fed was applying the brakes too aggressively understandably increased. After all, inflation hardly reared its ugly head, undermining one of the two key mandates that drive monetary policy – keeping inflation in check. Indeed, the core inflation measure closely monitored by the Fed actually receded below its 2.0 percent target late last year. But the previous rate hikes as well as the increase in long-term rates had already taken a toll on some interest-rate sensitive sectors of the economy, most notably the housing market. While housing activity had been coming under downward pressure from noncredit related forces, such as a lack of supply, increasing labor and other construction costs, and rapidly rising home prices, higher mortgage rates contributed importantly to deteriorating affordability for a widening swath of prospective home buyers. By mid-November, the rate on 30-year fixed mortgages climbed to just under 5.0 percent, a full percentage point higher than at the start of the year.

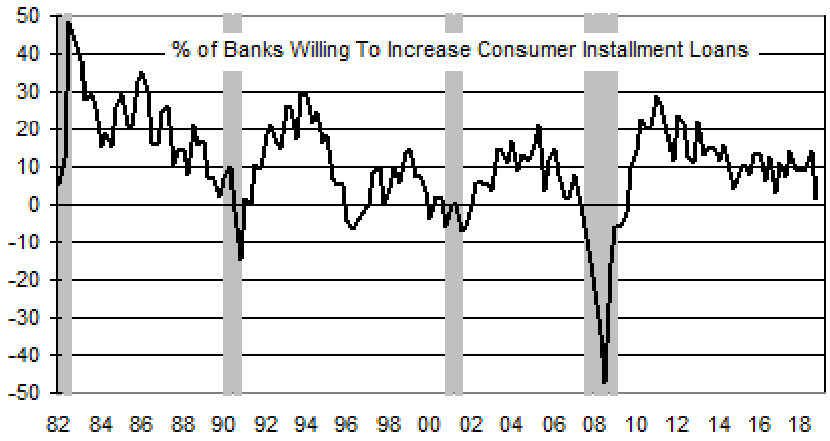
But amid a brutal stock market collapse in December that sent investors fleeing to the safety of risk-free Treasury securities, mortgage rates followed Treasury yields down. That trend briefly stalled in January, as the market recovered strongly during the month and the smattering of data as well as some business surveys revealed a still-solid economy, easing recession fears. But the Fed breathed new life into the downtrend, taking a remarkable U-turn away from its rate-hiking stance at its late-January policy meeting. The Fed's shift together with mounting global concerns once again fueled demand for Treasury securities, sending bond yields lower and pulling mortgage rates down. This week, the 30-year mortgage rate fell five basis points to 4.41 percent, which is just a tad above where it stood a year ago. What's more, the 10-year Treasury yield slipped another seven basis points this week, pointing to still lower mortgage rates ahead.



Whether the easing of financial conditions in the mortgage market revitalizes housing activity remains to be seen. For sure, the housing market has some positive influences going for it, including a robust job market, rising incomes and favorable demographics. But home prices have outpaced income growth for some time and the supply of entry-level homes remains woefully inadequate to accommodate a burgeoning millennial group of homebuyers. There are signs that builders are adjusting construction efforts to include more lower-priced homes in their plans, thanks in part to an oversupply of luxury homes on the market that is seeing major profit-crimping price cuts. We expect that the combination of slower price increases and improving demand fundamentals will reverse the drag that residential outlays had on GDP in 2018, leading to a modest positive contribution from housing activity this year.

Even if the housing market just stabilizes at current levels, households are in good shape to sustain spending on home-related big-ticket items, either as part of renovation projects or for moving-in purposes. The question is whether those outlays will be realized. Consumer confidence has wavered in recent months, dragged down by lowered expectations of future economic prospects. Meanwhile, even as some borrowing costs are easing, consumers may be facing a less favorable financing environment. In its latest survey of bank lending officers, the Fed reported a somewhat lessened willingness of banks to extend credit to consumers, particularly for credit card loans. Banks are becoming more concerned about possible deteriorating loan performance, reflecting a slight uptick in consumer loan delinquencies last year, although they remain at historically low levels.

Banks Turn Wary Towards Consumers



In coming weeks, the Census Bureau will be belatedly rolling out key data for December, including the important retail sales report. That will provide us with a better understanding of how consumers behaved at the end of last year, and how much momentum carried over into this year. Importantly, the forecasting community will finally be getting some hard data that will provide it with firmer evidence on the economy's performance, rather than relying on anecdotal evidence, surveys and market perceptions.