Weekly Market Commentary

February 19, 2019

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Just as we were ruminating about how the economy has entered a sweet spot of low unemployment, solid growth and tame inflation, a nasty revelation made an abrupt appearance that turned the narrative on its head. It appears that the holiday shopping season last year was not so festive after all, as the cash registers at retailers stopped ringing in December. In one of the more shocking reports to hit the headlines this week – belatedly because of the 35-day government shutdown – retail sales tumbled in the final month of the year, staging the biggest decline since September 2009. Consumers, of course, are the economy's main growth driver – accounting for more than two-thirds of total economic activity –so the zipping up of their wallets and purses just prior to the new year is clearly not a trivial event.

For sure, some of the weakness in headline sales can be explained by the sharp 5.5 percent drop in gasoline prices in December, which depressed revenues at service stations. But consumers rebuffed a broad swath of retailers in the final month of the year, and even e-commerce sales suffered an unusual downturn. Non-store sales, the group that includes Internet vendors, plunged by 3.9 percent, which was the steepest decline since November 2008 when the economy was in the throes of the Great Recession. And while the rapid growth of online purchases has decimated sales at brick-and-mortar establishments, the latter did not benefit from the slump in e-commerce sales in December. Department stores, the traditional destination for holiday shoppers, suffered a 3.3 percent drop in sales, the steepest decline for the month of December going back to at least 1992.

The so-called control group of sales that excludes autos, gasoline, building materials and food services, which feeds directly into the calculation of personal consumption in the GDP accounts also fell by an unseemly 1.7 percent, the steepest since January 2000. Recall that month followed the Y2K scare when households thought computers would stop working on December 31, 1999 and pulled forward their purchases into December. Unsurprisingly, the weak reading on consumer spending has prompted economists and analysts to revise down estimates for economic growth in the fourth quarter. It now appears that the slowdown from the 4.2 percent and 3.4 percent growth rates in the second and third quarters will turn out to be sharper than previously thought. We shaved about half-percent from our earlier estimate, but still peg the growth rate somewhat higher than 2.0 percent. Other forecasts portray a much grimmer performance, with the Atlanta Fed's GDPNow model estimating the economy grew by a meager 1.5 percent during the period.

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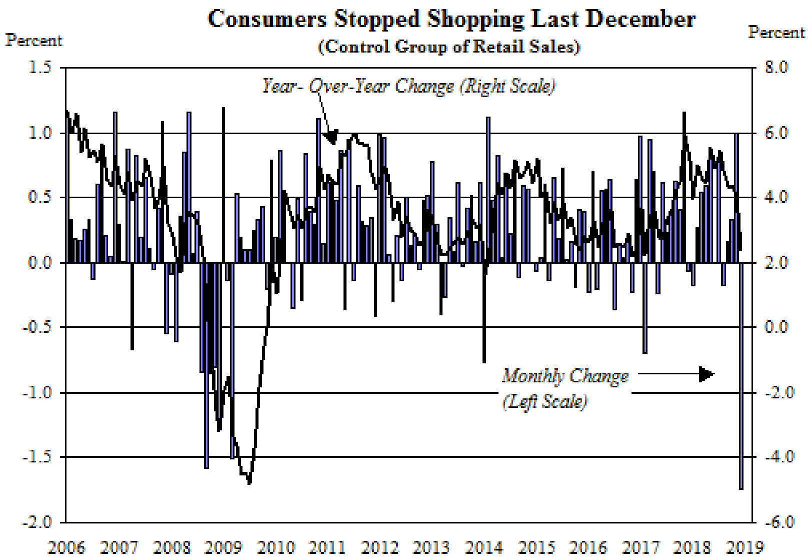


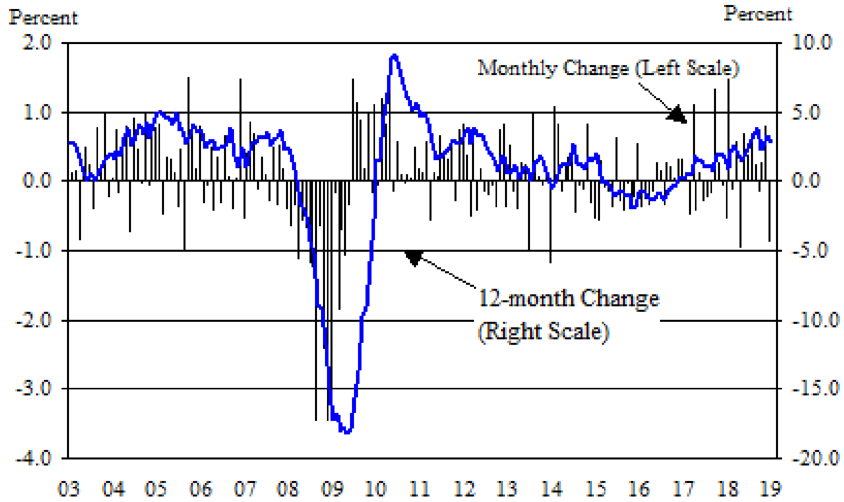
In any event, it is clear that the economy had considerably less momentum heading into the new year than thought prior to the dismal retail sales report. But if the economy is slipping and sliding and setting the stage for an earnings recession, the stock market did not get the memo. Extending the powerful rally in January, stock prices continue to move higher this month, punctuated by a sizzling 444- point surge in the Dow Industrial Average on Friday. To be sure, the market's recent strength likely reflects external events more than any constructive shift in the economic and earnings outlook. Most important is the spark provided by the passage of spending bills that avoids another government shutdown and promising signs emanating from ongoing trade negotiations with China. Progress on these two fronts lifts a dark cloud that weighed heavily on consumer and investor confidence in recent months.

But the economy still faces some stiff headwinds that should temper the recent burst of optimism. For one, the China trade negotiation is hardly a done deal. As of this writing, the increase in tariffs on $200 billion of Chinese goods scheduled to take place on March 2 has not been postponed, much less removed. For another, the growth slowdown has been far worse overseas than in the U.S., particularly in Europe where Germany – the growth powerhouse in the eurozone – is stumbling badly. The German economy contracted in the fourth quarter, according to figures released this week, following a near stagnant performance in the third quarter. To a large extent, this weakening trend is linked to slowing growth in China, which is a key export market for German goods, particularly autos. Needless to say, the trade conflict with China, including higher tariffs already on the books, has been a contributing factor, and any breakdown of ongoing talks would only exacerbate a worsening situation.

And while the U.S. is less vulnerable to global weakness than other developed countries, it is certainly not immune to it. The rebound in manufacturing activity from the energy-related slump in 2015 and 2016 benefited from growing exports to strengthening economies overseas. But the upward trend in exports peaked last May when it hit a 10.8 percent year-over-year growth rate and has since steadily weakened along with slowing global growth; in November, exports stood only 3.7 percent higher than a year earlier, the weakest annual growth rate in nearly two years. The softness in foreign sales has no doubt sapped some strength from the manufacturing recovery, as reflected in this week's industrial production report.

In January, total output of the nation's factories, mines and utilities slipped 0.6 percent, far weaker than the consensus forecast of a 0.1 percent gain. But the attention-getting story behind the headline decline is the eye-opening 0.9 percent plunge in manufacturing output, more than reversing a downwardly revised 0.8 percent increase in December. A major contributor to this swing was an abrupt downshifting in auto output, which swung from an unsustainable 4.3 percent increase in December to an even starker 8.8 percent plunge in January. More disconcerting, however, is the 1.5 percent decline in business equipment output, which is more directly linked to global growth and may point to softer capital spending going forward. But this setback follows seven consecutive months of solid gains, so there is a danger of placing too much credibility in a single month's move.

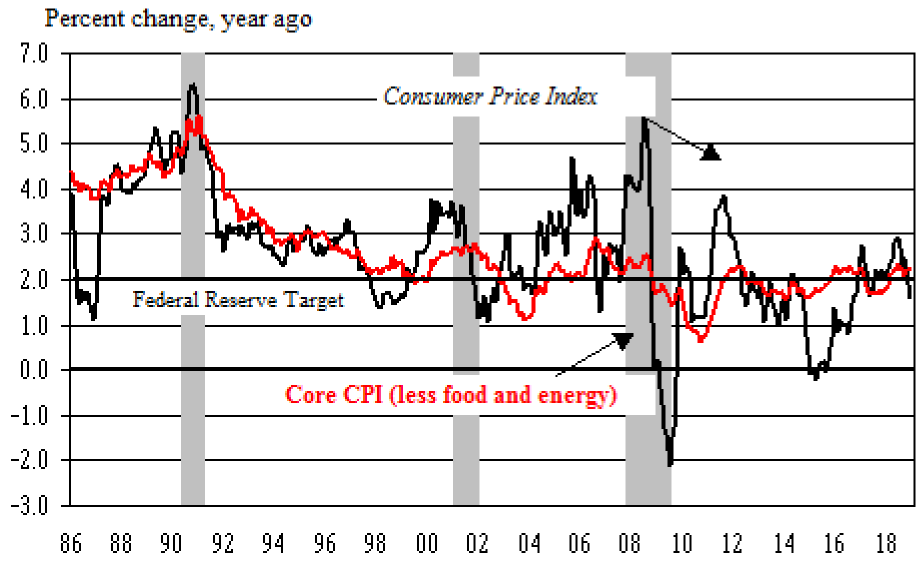
Setback in Manufacturing Output



The weak reading on consumer spending and production validates the Federal Reserve's decision to hold off on further rate hikes. Not only does the economy have less momentum than thought heading into 2019, there is little sign that inflationary pressures are gaining traction. Indeed, the headline consumer price index depicts just the opposite condition as the overall index showed no increase in January for the third consecutive month. That monthly stretch of no inflation dragged the year-over-year increase in the CPI down to 1.6 percent from 1.9 percent in December.

While falling energy prices was primarily responsible for pulling down the overall index, prices of most other items in the basket of goods and services that consumers purchase showed little or no sign of rising at a faster pace. The core CPI, which excludes volatile food and energy prices, increased 0.2 percent in January for the fourth consecutive month. That in turn, underpinned a remarkable stretch of stability in the annual inflation rate, with the year-over-year increase in the core CPI holding steady at 2.2 percent in six of the past seven months. Simply put, there is little pressure for the Fed to lean against the inflationary winds by keeping its foot on the monetary brakes. Not only does it have the luxury of patience provided by the hard data on inflation, its move to the sidelines is also supported by tame inflationary expectations. According to the University of Michigan's latest survey of consumer sentiment, household expectations for inflation over the long term fell to the lowest level on record in early February.

Inflation Still Tame



No doubt, falling energy prices have a big influence on household inflationary expectations. We suspect that as prices at the pump resume their upward climb, which they will at some point, so too will consumer inflation expectations. That said, the tame inflation environment underpins an important pillar of support for consumer spending that is being overshadowed by the surprisingly weak retail sales report for December. Thanks to steady inflation, wage increases are going a longer way. In January, real average hourly earnings increased 1.7 percent from a year earlier, the strongest annual increase since July 2016. Importantly, the strengthening trend in real purchasing power is trickling down to midlevel workers. Non-management workers are enjoying a purchasing power increase of 2.1 percent over the past year; over the past three months, their real average hourly earnings have increased at a 2.4 percent annual rate, the strongest since June 2015.

Indeed, as long as the labor market continues to generate solid job and wage gains, it is hard to believe that consumers are going into hibernation. The surprising weakness in retail sales in December was probably related to the myriad external shocks that buffeted consumer confidence towards the end of the year, most notably the government shutdown and heightened turbulence in the financial markets, rather than to deteriorating fundamentals. The government shutdown lasted through January, so the direct and indirect effects of that confidence-suppressing event may well have depressed activity last month as well. However, the job market continued to forge ahead in January, generating a blockbuster 304 thousand new payrolls, keeping spending fundamentals on solid ground.

Odds are, the spending hiatus in December that may have extended into January, has stoked a lot of pent-up demand that is about to be unleashed. Indeed, the reopening of the government at the end of January has already spurred an improvement in household spirits, as the aforementioned University of Michigan sentiment index jumped 4.3 points in early February, led by an even stronger 6.3 point gain in expectations; importantly, the share of respondents expecting increases in real incomes was the largest in 15 years. We suspect that the stock market is putting less credence in a soft retail report that depicts spending behavior two months ago and more on brighter future prospects, aided by encouraging developments on the trade and political fronts.