Weekly Market Commentary
February 25, 2019

Weekly Commentary

Aside from the persistent strength in the labor market, virtually every key economic report for December and January has come in weaker than expected. To some this confirms the notion that labor market data, particularly on payrolls, wage growth and unemployment should be viewed as lagging indicators. The sustained strength in the job market reflects earlier strength in the economy that encouraged businesses to hire more workers to generate output. What's more, given mounting labor shortages following a record 100 consecutive months of payroll increases that has driven the unemployment rate down to 50-year lows, employers are reluctant to lay off workers at the first sign of economic weakness, which may or may not be temporary.

While the history of business cycles supports the view that trends in the labor market are either coincident or lagging indicators, its relevance to the current situation is far from clear. Just as many economists take a skeptical view of incoming weak data. They view the healthy labor market as a true barometer of the economy's fundamental strength, and consider incoming soft data on retail sales, production and this week's batch of housing and capital spending reports as flawed due to the 35-day government shutdown. Adding to their conviction is that the stock market has been off to the races over the first eight weeks of the year – posting the longest stretch of consecutive weekly gains to start a year since 1964. Clearly, investor sentiment would be less bullish if they thought the economy was about to hit the skids.

They may be right. But the longer the data comes in on the weak side, the more difficult it will be for optimists to dismiss the lagging aspect of the strong labor market. To be sure, there are compelling reasons to downplay the surprisingly weak retail sales report for December released last week. That unexpected weakness flies in the face of other consumer data, such as the Johnson's Redbook Index and upbeat earnings reports of Walmart, which depicted more strength on holiday shopping than the monthly retail sales report indicates. Many on Wall Street expect that the December data will be revised up or, at the very least, be followed by a decent rebound in sales for January. No doubt, the skepticism surrounding the weak consumer spending data reflects in large part the persistent strength in the job market.

That said, the case for the economy's resilience continues to be severely tested, as some key cyclically sensitive sectors are flashing ominous signals. Most worrisome is the poor performance of the housing market, a time-honored harbinger of cyclical turning points. Unfortunately, data on new home sales and starts for December are not yet available, delayed by the government shutdown, but figures through November suggest that the housing recovery peaked last spring and has been slip-sliding ever since. Indeed, residential outlays have been a drag on GDP in each of the first three quarters of last year, and the fourth quarter is shaping up to be no different. Meanwhile, the market for previously owned homes appears to be falling off a cliff.

Data on existing home sales, which are compiled by the private industry group the National Association of Realtors are available through January and, hence, provide a fairly current reading on the housing market.

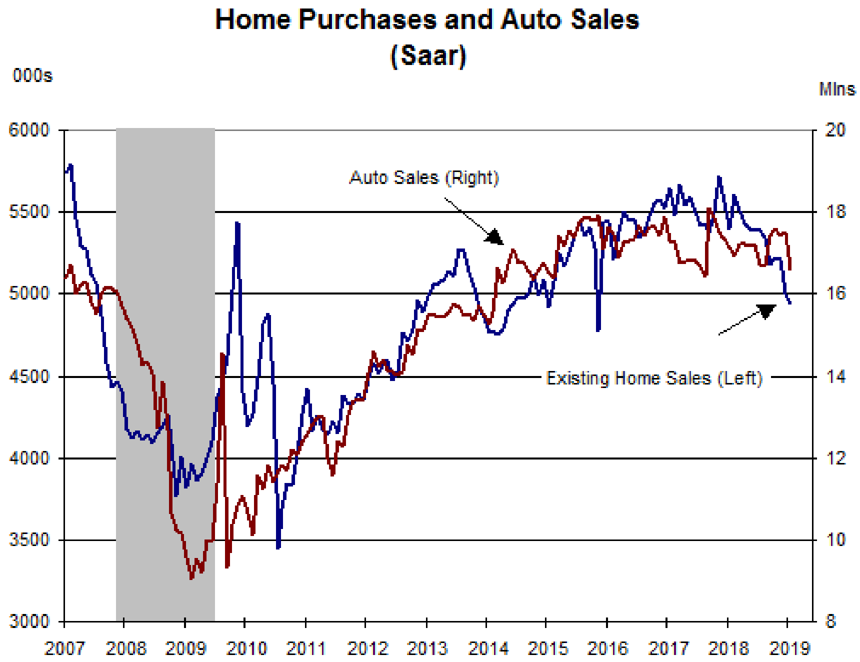
Fred Eisel
Chief Investment Officer
Email: feisel@vfccu.org
Phone: 800-622-7494 ext. 1610

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

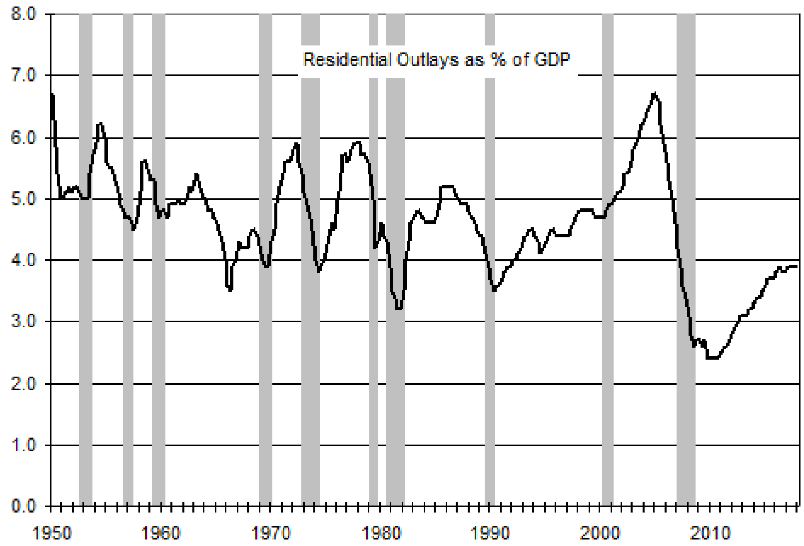
Unfortunately, that reading is anything but pleasurable. Sales of previously owned homes fell 2.8 percent during the month, marking the third consecutive month of declining sales. At an annual rate of 4.94 million, total transactions stand 8.5 percent below the year-earlier level and are the lowest since November 2015. Since these sales represent the changing ownership of an existing asset, they do not enter into the GDP calculations, except for some minor amounts attributed to broker fees and renovation outlays.

But the purchase of an existing home does have large multiplier effects on the economy, spurring outlays on furniture, appliances, moving services and home improvements that generate employment in these respective industries. Keep in mind that sales of existing homes are nearly ten times larger than that for new homes, so the impact on consumption is correspondingly larger. Importantly, the ability and willingness of households to purchase a home is correlated with their propensity to purchase other big-ticket items unrelated to home buying. Not coincidentally, the second largest big-ticket purchase made by households – a motor vehicle – is also coming off peak sales. Indeed, the 16.6 million annual rate of motor vehicle sales in January was the lowest since August 2017.



Clearly the weakness in these cyclically sensitive big-ticket purchases is not a promising omen for the economy at the start of 2019. But while it confirms our view that the peak growth for the expansion is behind us, we caution against reading too much into the recent setback in these purchases. That's particularly so with regards to the housing sector, which has been a consistent leading indicator of economic turning points. For one, the sector carries less weight in the overall economy that it has in the past. Residential outlays account for 3.9 percent of GDP, where it has remained for four consecutive quarters. That compares to an average peak share of 5.9 percent over the previous eight expansions dating back to 1950. Hence, just as the housing recovery has imparted less oomph to the overall expansion, it should be less of a drag on growth if a housing downturn is on the cusp of happening.

Smaller Housing Share



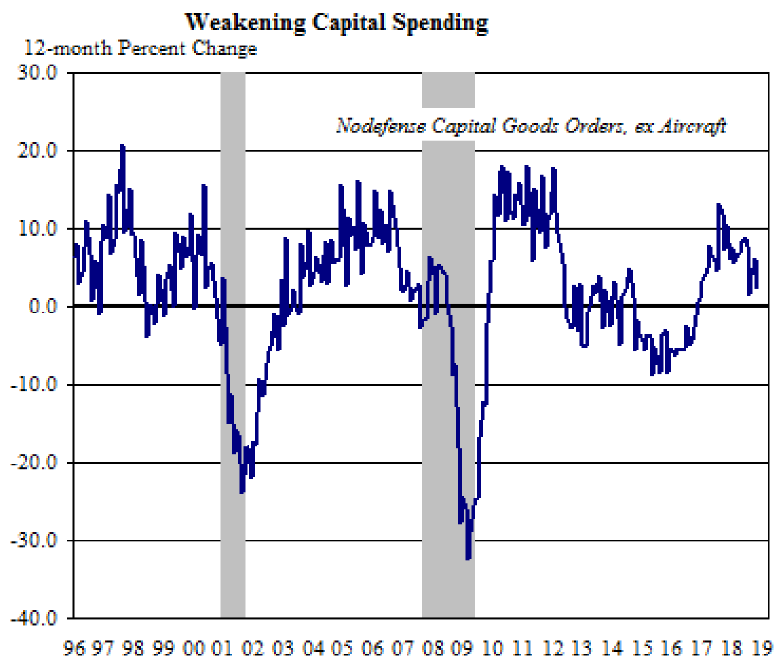
For another, while the housing recovery has been weaker than in past cyclical upturns, it has strong underpinnings in the form of favorable demographics – the expanding class of millennials are moving into the home-buying stage – and still-solid growth in jobs. True, deteriorating housing affordability remains a huge problem, as home prices have greatly outpaced the increase in wages, and mortgage rates are considerably higher than they were at their trough five years ago. What's more, the scarcity of homes on the market has been a persistent drag on sales. But all of these deterrents are easing, pointing to a modestly brighter future for the housing market.

This week, the 30-year fixed mortgage rate reported by Freddie Mac slipped to 4.35 percent, the lowest in a year and down from a 4.96 percent peak hit last November. Home price increases are slowing, with the 2.8 percent annual increase in the median price of an existing home sold in January the slowest since February 2012. As a result, the long decline in housing affordability has been arrested. The Housing Affordability Index compiled by the National Association of Realtors increased from 136.6 to 147.7 between last June and December; it likely rose further in January given the continued decline in mortgage rates and slowing home price increases. And more homes are hitting the market, with the month's supply of existing homes for sale rising from 3.7 to 3.9 in January. Compared to year-earlier levels, inventories have risen for six consecutive months.

But if the housing sector faces a brighter future, the same cannot be said with any confidence for business investment spending – another sector that has more of an influence on the business cycle than indicated by its relatively small share of GDP. Unlike housing, capital spending decisions are sensitive to global as well as domestic influences but, like housing, has been losing vigor since early last year. A broad range of events are sapping strength from the capital-spending recovery that was sparked by corporate tax cuts and elevated business confidence following the 2016 elections, robust earnings, rebounding energy prices and strong global growth.

Topping the list has been growing anxiety over trade tensions with China and other trading partners, followed by slowing global growth and weaker energy prices. Hence, after peaking at 11.5 percent in last year's first quarter, growth in real nonresidential outlays slowed to 8.7 percent in the second quarter and to 2.5 percent in the third.

By all accounts, that slowing trend continued into the final months of 2018. Worse, the forward-looking indicators point to more weakness immediately ahead. That is starkly revealed in this week's report on capital goods orders. In December, bookings for nondefense capital goods less aircraft – a proxy for business equipment spending in GDP – fell by 0.7 percent following a 1.0 percent decline in November. That was the fourth decline in the last five months, which is the weakest stretch since late 2015 when the plunge in oil prices decimated energy-related investment spending. True, momentum has not completely evaporated, as orders are still 2.5 percent higher than a year ago. But that annual increase is shrinking rapidly; a year ago, capital goods orders were running 10.5 percent higher than a year earlier.



We suspect that some capital spending decisions were put on hold late last year because of escalating trade tensions, the extreme turbulence in the financial markets and worries about rising Fed-induced interest rates. The last two deterrents have been removed, thanks to the Fed's dovish turn away from its rate-hiking campaign and the rebound in stock prices. The last shoe to fall would be a deal with China that eliminates the threat of higher tariffs scheduled to be put in place on March 2. Happily, there are promising signals emanating from current talks between the negotiators.