# Weekly Market Commentary

## *March 4, 2019*

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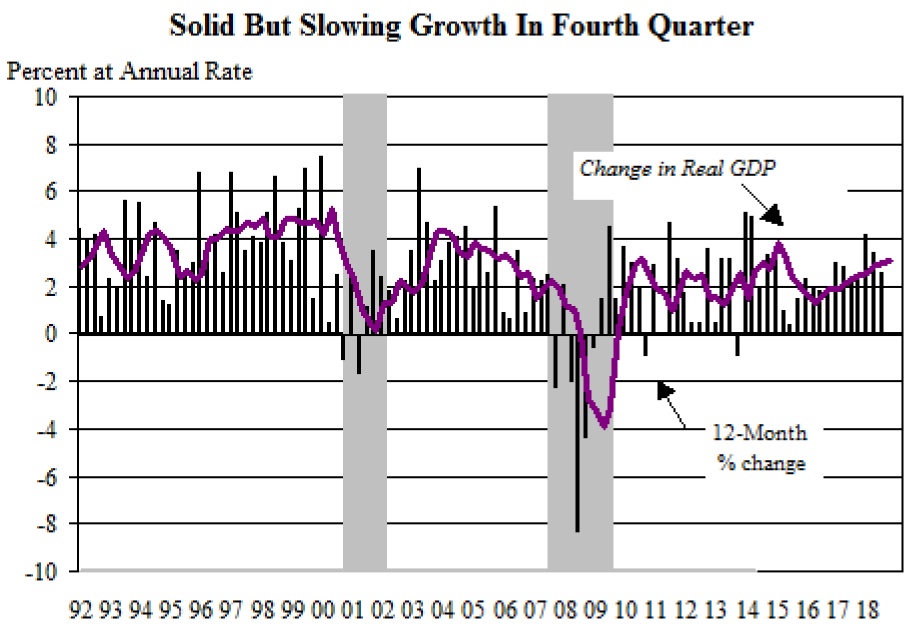
With a nod to Ol' Blue Eyes, Frank Sinatra, 2018 was indeed a "very good year." The final reviews haven't been written yet, but preliminary notices for the fourth quarter indicate that last year ended on an upbeat note. Depending on how the year's performance is graded it was either the strongest in three or in thirteen years. Comparing the calendar years, the 2.9 percent growth rate was the best since 2015. Measuring the fourth quarter against the corresponding quarter of 2017, the 3.1 percent gain outperformed every year since 2005. In either case, 2018 stands tall amidst a near-10-year recovery that saw growth averaging a lackluster 2.2 percent annual rate, the most sluggish upturn in the postwar era.




Although growth slowed in the fourth quarter to a 2.6 percent pace from the 4.3 percent and 3.4 percent annual rates in the second and third quarters, respectively, it came in above consensus expectations, which generally hovered closer to two percent. Impressively, the above-consensus pace was broadly based, with spending by households and businesses doing the heavy lifting. Housing, where activity sagged, was the one blemish in the overall picture, extending a pattern seen throughout the year. But the economy's main growth driver, personal consumption expenditures, more than held its own despite numerous headwinds that battered confidence during the period. Those included a debilitating plunge in stock prices, intensifying trade tensions, a tightening monetary policy and the threat of a government shutdown, which eventually materialized and lasted a record 35 days.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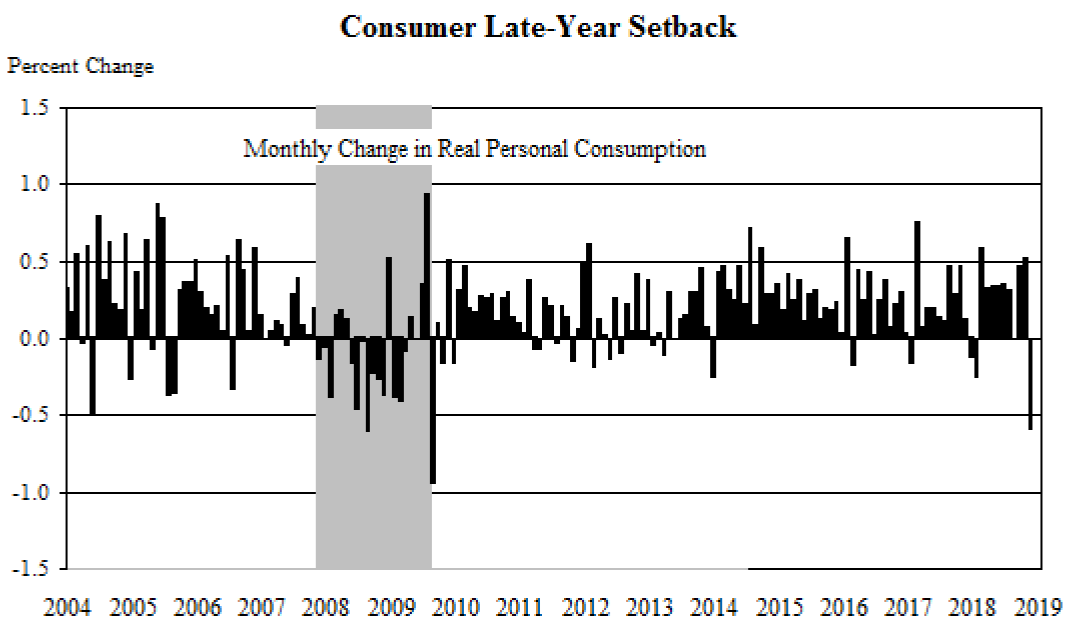
Yet consumers battled through those obstacles and posted a respectable increase in spending during the closing quarter. Real personal expenditures advanced by a 2.8 percent annual rate, slower than the previous two quarters but better than the 2.4 percent average throughout the recovery. What's noteworthy is that the respectable reading for the quarter occurred despite a sharp consumer pullback in the final month of the period, something that was telegraphed by the surprisingly weak retail sales report for December released earlier in the month. That unexpected decline was confirmed in the broader consumer spending report released on Friday revealing a sharp 0.5 percent drop in personal consumption on goods and services. Adjusted for inflation, the December nosedive was even steeper, at 0.6 percent.




With that decline, consumer spending will be climbing off of a lower base to start the year, which just about guarantees a slower growth rate for personal consumption in the first quarter. Indeed, we are unlikely to see much of a rebound, if any, in January, thanks to the government shutdown that idled hundreds of thousands of government workers who undoubtedly put off some purchases until receiving their back pay. We expect the increase in real PCE to come in at about a one percent annual rate in the first quarter. Since consumer spending accounts for more than two-thirds of total economic activity, that tepid increase alone points to a weaker GDP print for the period, extending the slowing trend in overall growth for a third consecutive quarter.

But the first-quarter drag from personal consumption should not spill over into the second. A key reason is that household purchasing power has solid underpinnings, reflecting a robust job market that is fattening paychecks even as lagging inflation is allowing those paychecks to go a longer way. The income side of household balance sheet strikingly illustrates this point. Even as spending slowed in the fourth quarter, real disposable income accelerated, with the 4.2 percent increase nearly doubling the average gain over the previous two quarters. Significantly, the strongest increase occurred in December just as households pulled back spending; in fact, the 1.0 percent increase in real disposable income that month was the steepest in six years. The combination of weak spending and strong income growth left households flush with funds at the end the year, as the personal savings rate shot up to 7.6 percent from 6.1 percent.

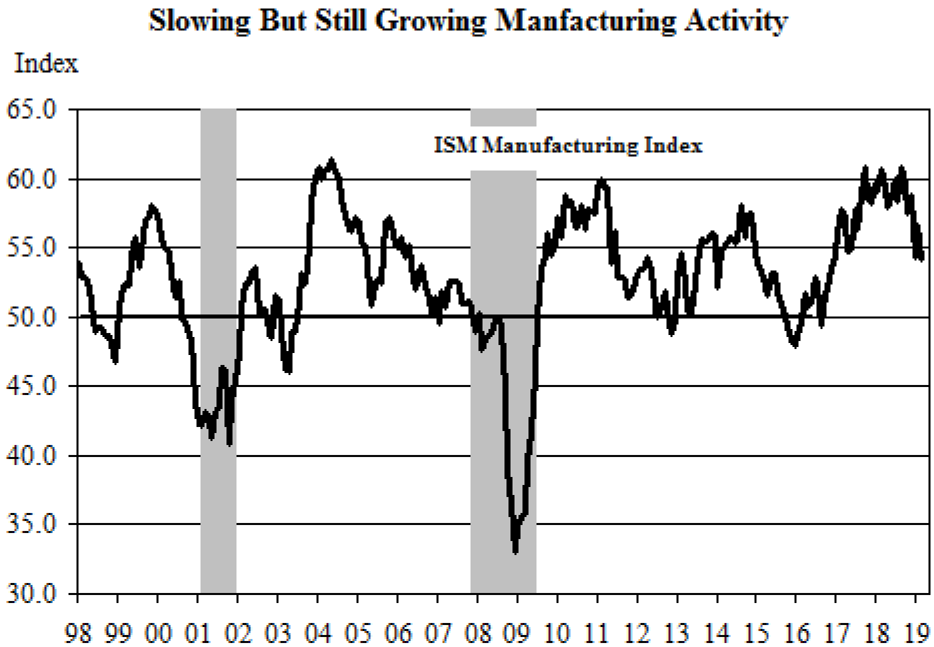
To be sure, the remarkable income increase in December was skewed higher by an aberrational surge in dividend payouts and in farm incomes. Both of these income components fell back in January, which pulled down overall personal incomes by 0.1 percent in the opening month of the year (the government could only release income, not spending figures for January due to the shutdown). But the bedrock fuel for spending – wages and salaries – showed healthy increases in both months, 0.5 percent in December followed by a decent 0.3 percent increase in January. Keep in mind that balance sheets were also bolstered by a powerful stock market rally during the month, reinforcing the bloated cash cushion provided by the increased savings rate. We suspect that pent-up demands generated by the spending restraint in December and, probably, January will be unleashed in coming months, resulting in a modest rebound in consumption in the second quarter.

That said, it is highly unlikely that the economy will enjoy another "very good year" in 2019. The growth surge last year benefited immensely from the 2017 tax cuts and the $300 billion spending bill Congress passed in early 2018. The "sugar high" from the massive fiscal stimulus is already fading and its effects will steadily diminish as the year wears on. Consumers will keep their wallets and purses open, thanks to the strong labor market that shows every indication of remaining in a healthy state. But even here some slowing in job growth is inevitable, if only because the pool of available workers for hire is shrinking. Meanwhile, the resurgence in factory jobs last year – the 264 thousand increase in manufacturing payrolls was the strongest in 20 years – is poised to lose a key source of support, as export orders along with global growth are slowing. The prospect of stiffer trade impediments, including higher tariffs, would only reinforce that slowing trend and have spillover effects on the U.S. economy.

Should manufacturing activity hit the skids, business investment outlays would take a hit. Surprisingly, these outlays were considerably stronger than expected in the fourth quarter, buoyed by a sturdy increase in R&D spending. That's a promising development as it portends a possible increase in productivity and, hence, the longer-term growth prospects for the economy. But mid-level workers derive more near-term benefits from investment outlays on the tangible tools of production – machinery and equipment as well as office and plant construction. These outlays received passing grades in the fourth quarter but nothing to write home about. Indeed, outlays on structures fell by 4.2 percent, following a 3.4 percent decline in the third quarter. With the manufacturing operating rate about 2.5 percent below its long-term average, there would seem to be little incentive to commit funds to capacity-expanding building projects.

Business spending on equipment, however, did come in on the stronger side in the fourth quarter, advancing by 6.7 percent, nearly double the 3.4 percent gain in the third quarter. This is consistent with the pickup in nondefense capital goods shipments observed in the monthly durable goods reports. But those same reports showed a steady deterioration in new orders, which points to weaker equipment spending over the next three to six months. To be sure, some of that deterioration reflects increasing concerns by business leaders over escalating trade tensions that would further impede global growth. Should trade policy take a turn for the better –either through breakthrough deals with China and Europe or an easing in protectionist sentiment that is spreading among developed and emerging market nations – those concerns would likewise abate and improve the investment climate.

But the recent slippage in new orders is generally corroborated by regional and national surveys of purchasing managers. The latest, released on Friday by the Institute for Supply Management, underscores the weakening trend. After a promising – and surprising – 2.3 point rebound in January, the ISM index reversed all of that gain in February and then some, falling 2.4 points to the lowest level since November 2016. At 54.3, the index is still in growth territory, above the 50 threshold that separates contraction from an expanding manufacturing sector; but the growth cushion is narrowing as the ISM index was just under 61 in the middle of last year. In addition to the headwinds from slowing global growth and trade tensions, manufacturers are also contending with a stronger dollar, which has increased by about 8.5 percent over the past year. The greenback's strength puts American producers at a disadvantage as it makes their goods more expensive on the global marketplace.




Still, the U.S. economy is less vulnerable to global developments that most other developed nations. Even the most sensitive sector, manufacturing, derives most of its strength from domestic sources. The question is whether the domestic backdrop will remain resilient and keep the expansion going. Another six months of growth would turn the expansion into the longest in U.S. history. For sure, economists as well as policy makers have a notoriously bad record of forecasting recessions, but the odds that a downturn will set in before the expansion hits the record book are long. A $21 trillion economy does not shift gears on the dime, and there is little sign that it is about to go into reverse anytime soon.

The financial markets would be the first to sniff out recessionary signals, and their behavior this year is anything but downbeat. The S&P 500 posted another solid gain on Friday, driving the index up about 12 percent over the first two months of the year, one of the strongest early-year advances in decades. Likewise, the bond market is shaking off recession fears that gripped it late last year. The bellwether 10-year Treasury yield increased 10 basis points this week to 2.75 percent and after coming perilously close to inverting late last year is now sporting a 21 basis point cushion over the two-year yield. Significantly, the yield action is occurring alongside more tame inflation readings – including a decline to a 15-year low in household inflationary expectations – that suggests stronger growth expectations among bond investors. Simply put, the expansion still has legs although thanks to weaker tailwinds and stiffer headwinds, it will be advancing at a slower pace than last year.