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Outlook and Market Review - First Quarter 2019

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Summary:

The economy grew at a 3.1% rate in the first quarter despite headwinds from the government shutdown, weak consumer spending, delays in tax refunds, and a stock market slump. Growth exceeded analyst forecasts by a wide margin. Some of the second quarter's growth may have bled into the first quarter. Even so, the economy appears to be stronger than expected going into 2019. The economy has generally closed the output gap that persisted throughout the decade long "expansion." Growth is now back on a track matching trend growth of about 3%. Nevertheless, serious obstacles stand in the way of healthy growth going forward as global trade issues may come to a climax in the second and third quarters. The manufacturing sector continues to slide and wealth linked to the stock market and housing is not likely to grow as fast as in 2018. The 10-year Treasury yield continues to fall and is barely above 2%. Many economists believe it will go lower as the Fed uses preemptive cuts to keep the economy growing without fear of rising inflation.

The labor market remains tight with a 50-year low unemployment rate of 3.6%. The preliminary announcement of only 75,000 new jobs in May was unexpected following the robust reports of 263,000 jobs in April and 189,000 in March. May's report offers good news for the equity markets in that it most certainly keeps the Fed from raising rates anytime soon. The three-month average job growth of over 175,000 jobs a month is very healthy. As a frame of reference, monthly job gains of about 103,000 provides a match to the expansion of the work force. The labor force participation rate of 62.8% is in line with recent averages. Even with a tight labor market, wage growth remains slow. Wages grew 3.2% on a year-ago basis in April. Productivity blipped up in April but the average over the past five years is only 1.3%. Ultimately, sustained growth depends on healthy increases in both the workforce and workforce productivity.

Inflation is non-existent with the Fed's preferred PCE measure increasing only 1.5% on a year-ago basis in April. Fed Chairman Powell is clearly signaling a "stand pat" position on interest rates with a possibility of reversing field to lower rates if the economy falters later in the year. The strong value of the U. S. dollar and low rates on foreign bonds continue to drive a strong U.S. bond market. If investor confidence rebounds from worries over tariffs, low rates could help stimulate investment spending and growth. Long term fixed mortgage rates dipped below 4%, which may help stimulate the housing market.

For the next few quarters the labor market is likely to remain tight and inflation should remain below the Fed's target of 2%. Continued trade deficits, low inflation, and the strong dollar will all combine to keep long term interest rates low. Uncertainties about trade relations will weigh on investor confidence and may translate to lower consumer confidence and spending. The second quarter GDP growth is likely to fall back below 2% as tax cut stimulation wanes and uncertainty about the impact of trade issues remain. If the economy falters, the Fed is likely to ease credit conditions but the effectiveness of expansionary monetary policy in a downturn under current conditions is questionable.

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