GALLIARD Capital Management, Inc.

ARCHITECTS OF INVESTMENT SOLUTIONS

ECONOMIC UPDATE

FIRST QUARTER 2019

Quarterly Key Points

- The Federal Reserve's policy pivot at the January meeting instilled the market with much needed confidence, triggering a sizable rally in risk assets throughout the first quarter. Nevertheless, concerns about global growth continue to weigh heavily on market expectations.
- U.S. GDP slowed considerably to 2.2% annualized in the fourth quarter, clearly losing momentum after strong second and third quarter growth. Notably, personal consumption growth dropped to 2.5% in the fourth quarter from 3.5% and 3.8% growth in the third quarter and second quarter respectively. Looking back, broad measures of economic output have consistently slowed since mid-2018.
- The Consumer Price Index (headline CPI) continues to march lower, falling to 1.5% in February. Core CPI (ex-food and energy) continues to hover at 2.2%, but more importantly Core PCE, the Federal Reserve's preferred measure of inflation, remains at only 1.8%.
- The Fed did not change the policy rate during the first quarter. In stark contrast to the policy signal sent in December, the message from the Fed at the January meeting stressed "patience" going forward. Furthermore, at the policy meeting in March, the Fed announced the end of its balance sheet runoff and signaled a substantial change in policy rate expectations. This has been interpreted as a very dovish signal, and the market is now pricing in the possibility of a rate cut later this year.

Our View

- Despite low unemployment and recent wage gains, expectations for 1Q GDP growth are firmly in the 1.3% - 1.7% range.
- Business activity, while still expansionary, has slowed. Meanwhile, job creation is also showing early signs of slowing. Over the next several months, incoming data will shed light on these trends.
- The Fed will likely remain on hold with monetary policy, given tepid core inflation and slowing economic output.
- We continue to advocate for investors to be cautious in the face of a global economic cycle in the late stages of expansion.

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1Q SUMMARIZED BY MONETARY POLICY SHIFT

After a dismal market reaction to continued monetary policy tightening in 4Q, the Federal Reserve reversed course at the policy meeting in January by holding rates steady and signaling "patience" going forward. The message was well received, instilling much needed confidence in the market and triggering a rally across risk assets that continued throughout the quarter. By the end of March, the S&P 500 Index was once again flirting with all-time highs, gaining almost 15% year-to-date, and corporate credit spreads had retraced all of the widening that happened in November and December.

On the flipside, the Treasury market has not been so sanguine, rallying considerably and even inverting at several points along the curve. The Fed policy meeting in March included several changes that have been interpreted as extremely dovish. The Fed announced that starting in May, the Treasury portfolio runoff will be cut in half to $15 billion per month and then cease completely in September. Agency MBS will continue to runoff at a maximum of $20 billion per month with paydowns being reinvested in Treasury securities. In addition, the Fed's own policy rate expectations for 2019 (dot plot) shifted considerably from two rate hikes at the December meeting to zero rate hikes at the March meeting. This rapid change in messaging and ensuing rally in Treasury rates (10-year at ~2.40% at quarter-end) suggest that perhaps the economic slowdown will be more pronounced than expected. Confirming that, the forward rate markets now imply a zero probability of a rate hike and an increasing probability of a rate CUT by the end of the year.

FIGURE 1 REAL GDP GROWTH[1]

Looking backward, the U.S. economy grew at 2.2% annualized in 4Q, reflecting a downward shift in consumer spending. Personal consumption growth that charged ahead in the middle half of 2018 moved sharply in December to the lowest monthly measurement since fall 2009. The slowing trend is even more apparent when looking at quarter-over-quarter annualized personal consumption growth, which dropped to 2.5% in the fourth quarter from 3.5% and 3.8% growth in the third quarter and second quarter respectively. Business activity continues to expand albeit at a slightly slower pace. The Institute for Supply Management (ISM) Manufacturing Index has bounced around 54-56 in 1Q signaling expansion that is slower than what was implied by readings of 58-60 throughout most of 2018. Similar trends are emerging in measurements of business orders, construction spending, durable goods orders, and business sentiment. While all are still expansionary, these measures point to lower growth in economic output. As a result, market consensus is calling for 1Q GDP growth of 1.3% to 1.7%.

1 Endnote is located on reverse page

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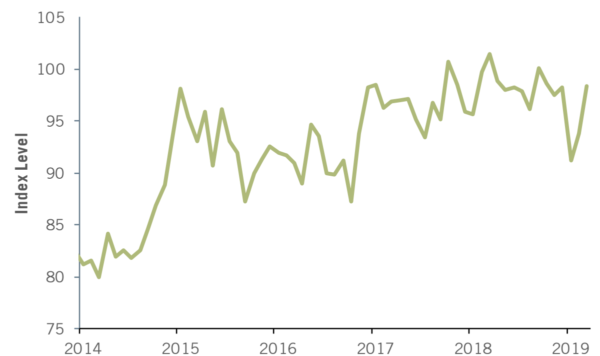
GOVERNMENT SHUTDOWN, TRADE WARS, AND WINTER WEATHER WEIGH ON GROWTH IN 1Q

FIGURE 2 UNIVERSITY OF MICHIGAN CONSUMER SENTIMENT INDEX[1]



In addition to the slowing trends in spending and business output, the economy also dealt with a number of historic events in the first quarter. Congressional impasse over border wall funding triggered the longest Government shutdown in U.S. history. Starting in late December, the shutdown lasted 35 days, impacting 800,000 government workers and millions of government contractors. Estimates of the economic impact are only around 0.1% of GDP, but the more important effects may have been psychological. The University of Michigan Consumer Sentiment Index (Figure 2) fell sharply to the lowest level in several years in January although it has since rebounded. Meanwhile, historic cold weather that started in late January and gripped the middle part of the country throughout February likely impacted consumer spending. On the trade policy front, scheduled tariff increases on $200 billion of Chinese goods have continually been delayed by the Trump administration, citing progress in talks with Chinese leaders. Still, the longer the trade dispute between the U.S. and China goes on, the more likely it weighs on the aforementioned trends in business activity and sentiment.

LOW UNEMPLOYMENT AND TEPID INFLATION REMAIN

The unemployment rate dipped down to 3.8% again in February and March after increasing to 4.0% in January. Job creation, on the other hand, stumbled in February with only 33,000 jobs added. After strong numbers of 227,000 and 312,000 jobs in December and January respectively, and a rebound to 196,000 jobs in March, the February number could be an anomaly. Leading indicators like Initial Jobless Claims and Continuing Jobless Claims have recently improved, suggesting job creation remains intact. Average Hourly Earnings increased by 3.2% to 3.4% in each month of the quarter, continuing a solid trend that started in late 2017. Should job growth remain strong and wage gains continue, consumer spending will likely follow suit.

Although hourly earnings growth has been robust, virtually all measures of inflation continue to be muted. Headline CPI inflation dropped to only 1.5% in February while the Fed's preferred measure of core inflation, the Personal Consumption Expenditures Core Price Index, stubbornly remains at approximately 1.8%. Furthermore, measures of core producer price inflation are trending lower and are now in the 2.5% range, down from 2.8% in mid-2018.

LOOKING AHEAD

Incoming data for the U.S. economy suggests GDP growth in the 1.3% to 1.7% range in 1Q. Looking ahead, slowing economic growth expectations are being met with dovish monetary policy changes. Tame inflation and lower output could foreshadow an end to monetary policy tightening for this cycle.

[1]Source: Bloomberg

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