GALLIARD
Capital Management, Inc.
ARCHITECTS OF INVESTMENT SOLUTIONS

ECONOMIC UPDATE

FOURTH QUARTER 2019

Quarterly Key Points

- As expected, the Federal Reserve delivered another 25 bps policy rate cut in October, marking three consecutive rate cuts; however, the post-meeting message from the Fed strongly suggested that a pause in further policy accommodation might be in order, given the recent resilience in broader economic data. The Fed unanimously remained on hold at the December meeting following several months of internal dissent, setting the stage for a relatively calm policy rate forecast in 2020.
- U.S. GDP growth held steady at 2.1% in the third quarter, as unemployment remained extremely strong at 3.5%, a 50-year low, in November. Over the past year, buoyant consumer spending has more than offset flagging business activity; however, the margin of this offset is somewhat less than at mid-year.
- On the business side, manufacturing survey data slipped deeper into contractionary territory in December, suggesting a turnaround may take some time. Although growth is expected to slow further in 4Q, the lagged effects of supportive monetary policy and the potential for a trade war cease-fire have set the stage for increasing business output in the quarters ahead.
- Headline CPI has shown some signs of life, increasing sharply from 1.7% annualized in September to 2.1% in November. After steadily increasing throughout the second and third quarters, core CPI (ex-food and energy) leveled off at 2.3% in October and November.

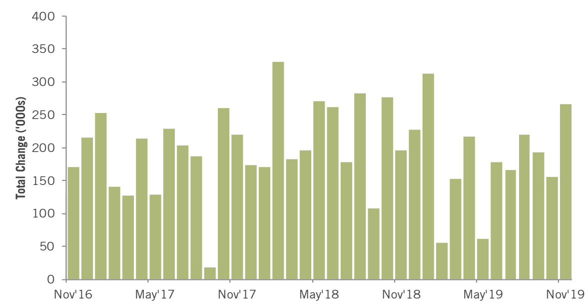
Our View

- Despite continued low unemployment, consistent wage gains, and healthy consumer spending, expectations for 4Q GDP growth are in the 1.5% - 2.0% range. Business activity will continue to be a drag, although there is optimism that a turnaround in business output is forthcoming in the back half of 2020.
- After slowing considerably in the first half of the year, job creation has resumed a healthy pace. Combined with healthy consumer spending and high levels of consumer confidence, strong job growth and continued personal income growth suggest a lower risk of reduced business activity spilling over into labor markets and consumption than previously thought.
- A trade war cease-fire between the U.S. and China (Phase I trade deal) in combination with supportive monetary policy have reduced downside risks to the broader economy. The Fed will likely be on hold for the foreseeable future; however, an easing bias exists with additional rate cuts more likely than rate increases.
- While there is optimism that downside risks have been reduced and that renewed economic activity is near, uncertainty is ever-present. Furthermore, commentary regarding the mini trade deal with China suggests it lacks substance and fails to bridge the wide gaps that exist between the two countries. We look for moderate GDP growth in the coming quarters with the potential for stronger growth in the back half of the year, absent any exogenous shocks.

4Q – DOWNSIDE RISKS HAVE BEEN REDUCED

As expected, the Federal Reserve delivered a third consecutive 25 basis point (bps) cut in October. The post-meeting message from the Fed strongly suggested that a pause in further policy accommodation was in order, given resilience in broader economic data. At the December policy meeting, the Fed unanimously voted to keep policy rates unchanged, cementing the idea that the series of "mid-cycle adjustments" had come to an end. With the economy on a firmer footing than back in August and September, the Fed has some breathing room to be patient. This is particularly important in an election year, when all incentives are aligned for a calm economic environment. The market perceives a very low probability of monetary policy action in the year ahead; however, an asymmetric easing bias exists with the hurdle for raising rates being considerably higher than for cutting rates. The Fed continues to inject liquidity into overnight markets via a reverse repo facility, prompting some discussion about the long-term efficacy of such an operation.

FIGURE 1 NON-FARM PAYROLLS[1]



There is also an ongoing debate at the Federal Reserve about how best to implement inflation targeting. At present, the Fed treats inflation target undershoots as bygones that won't ever get caught up. This is different than having an "average" inflation policy that targets an average inflation rate over a period of time. A hard inflation target suggests a prompt monetary policy response when met, whereas an average inflation target implies a response that allows inflation to overshoot the stated target in order to make up for previous periods of below target inflation (thus bringing up the average). On the surface, the difference is subtle, but the implications for monetary policy may be significant. Switching to an average inflation target would allow the Federal Reserve to be patient and keep interest rates lower for longer, allowing inflation to run a little hot for a period of time in order to meet a desired average rate. Still undecided, this debate contributes to the aforementioned easing bias, even during periods of relative economic calm.

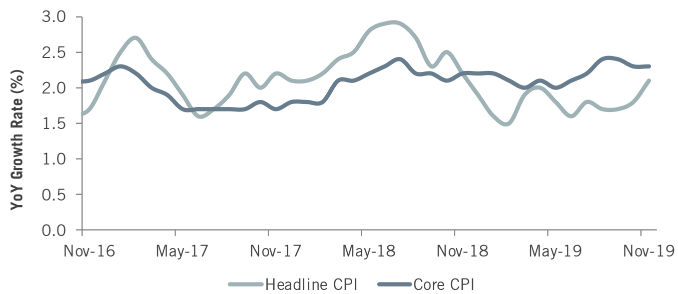
On the trade policy front, the U.S. and China have agreed to a Phase I trade deal, expected to be signed in mid-January. The deal reportedly includes a roll-back of some existing tariffs, a hold on new tariffs that were scheduled in December, and a promise of increased Chinese purchases of U.S. agricultural products over the next several years. Officials on both sides are also reporting some progress on intellectual property protections and a liberalization of Chinese financial markets. The economic significance of the tariff roll-backs is minimal, as they failed to trigger any discernable changes in aggregate consumption or inflation when implemented. More than anything, this mini-deal signals a less volatile negotiation between the two sides, at least for the time being. Without sufficient clarity around the non-tariff components, many are calling this a "cease-fire" rather than a trade deal. Nevertheless, it could have a positive impact on business sentiment.

800 LaSalle Avenue, Suite 1400
Minneapolis, MN 55402-2054
www.galliard.com 800-717-1617

1 Endnote is located on page 2

Supportive monetary policy since last summer and recent progress on the trade war with China have reduced downside risks to the broader economy. As a result, interest rates have come off their lows and both the 2s-10s and 3mo-10yr inversions reversed early in the quarter. With the Fed on hold, touting that the economy and monetary policy are in a good place, volatility expectations are relatively low going forward. Absent any exogenous shocks, the stage is set for renewed business output, perhaps by the second half of 2020.

FIGURE 2 HEADLINE CPI VS. CORE CPI[1]



AS THE DECADE COMES TO A CLOSE, LABOR MARKET STRENGTH = HEALTHY CONSUMERS

GDP came in stronger than expected at 2.1% in 3Q. Personal consumption growth of 3.2% has moderated slightly while retail sales have slowed considerably since peaking in mid-summer. Nevertheless, resilient consumers continue to be the bright spot in the economy, offsetting a continued drag from subdued business activity.

The unemployment rate remained at a 50-year low, 3.5%, in November. Despite noise from the GM strike in the fall, job creation accelerated in 4Q, easing concerns that slowness in business activity would eventually lead to problems in the labor market. The three-month rolling average change in non-farm payrolls is back over 200k in November, after monthly increases of 193k, 156k and 266k in September, October and November, respectively (Figure 1). Initial jobless claims and continuing jobless claims, net of the GM impact, remain at historically low levels, while personal incomes and average hourly earnings continue to grow at a steady year-over-year clip. Consumer confidence, as measured by the University of Michigan Consumer Sentiment Index, rebounded sharply in 4Q, reversing a rapid decline to a multi-year low at the end of the summer. Putting all of this together, it appears that consumers are entering 2020 quite healthy and ready to provide a solid base of economic growth.

Meanwhile, data releases also continue to highlight a flagging business sector, particularly manufacturing. For example, the December Institute for Supply Management (ISM) Manufacturing Index reading slipped further into contractionary territory to 47.2, another post-crisis low point. Similarly, all three of the ISM Manufacturing Report on Business Orders indices (new orders, import orders, and export orders) have remained contractionary since mid-2019. Other measures of business activity, including construction spending, durable goods orders, and non-manufacturing activity have been on a subtle downward trend since mid-2018. Notably, though, the ISM Non-Manufacturing Index and the ISM Composite Index have remained expansionary, further highlighting the considerable weakness in manufacturing.

LOW MORTGAGE RATES SPUR HOUSING ACTIVITY

Primary 30-year mortgage rates ended the year at ~3.70%; 120 bps lower than November 2018. Lower mortgage rates have driven a flurry of robust housing activity since the middle of the third quarter. Year-over-year, new housing starts and new home sales have been extremely strong, increasing at double-digit paces. While some of this is base effect related (comparing to extremely weak numbers from a year ago), the economic impact of renewed housing activity is a positive. The Case-Shiller U.S. Home Price Index has settled into a series of ~2% year-over-year growth figures over the last six months. This type of home price appreciation, that tracks real income growth, is expected going forward.

[1]Source: Bloomberg

INFLATION PRESSURES AT BAY

Headline inflation turned sharply higher in November, increasing to 2.1% annualized from 1.7% in September. Core CPI (ex-food and energy) followed a similar trend, rising to 2.4% in 3Q before leveling off at 2.3% in October and November. Do these measures indicate that inflation pressures are building? Not exactly. The rapid increase in headline CPI over the last several months was primarily driven by a rise in gasoline prices, which are taken out of the core CPI numbers. Although core CPI has also risen on a year-over-year basis, the trend appears to have peaked in 3Q (Figure 2). The three-month annualized change in the Core CPI Index has dropped back to 2.1%; evidence that core inflation is far from overheating. Meanwhile, the Fed's preferred measure of core inflation, the Personal Consumption Expenditures Core Price Index, fell to 1.6% in November from a high of 1.8% in August. Core producer price inflation is on a similar path, decelerating from 2.3% annualized in August to only 1.3% in November.

Market measures of expected inflation, including the 10-year break-even inflation rate and the 5y5y forward breakeven rate, ended the quarter slightly higher at 1.79% and 1.84% respectively. Meanwhile, consumer expectations for inflation over the next five years, a measured component of the University of Michigan Consumer Sentiment report, sank to 2.2% in December, the lowest on record. Forward markets are pricing a very low probability of monetary policy changes in 2020. Benign inflation measures and subdued inflation expectations give the Fed ample room to patiently keep rates low for the foreseeable future.

LOOKING AHEAD

Incoming data for the U.S. economy suggests GDP growth in the 1.5% to 2.0% range in 4Q. Business activity remains muted, particularly in the manufacturing sector, although there is optimism that things will slowly turn around over the next several quarters as the lagged effects of monetary policy easing take hold. Tempering these hopes are the Boeing 737 Max production halt, which by some measures could negatively impact GDP by as much as 0.5% (annualized). The Fed is firmly on hold, with an eye towards reducing rates should the economy falter. On the flipside, inflation is of no immediate concern, suggesting rate increases are unlikely. Consumers are healthy, supported by robust job growth, consistent wage gains, and favorable mortgage rates. For the moment, monetary policy and the trade war cease-fire have reduced downside risks to the economy. Nevertheless, geopolitical risks are ever-present (e.g. Iran/Iraq) and the presidential election will undoubtedly be contentious, impeachment hearings aside. We look for moderate GDP growth in the coming quarters with the potential for stronger growth in the back half of the year, absent any exogenous shocks.