WEEKLY
Economic Commentary

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Millennium
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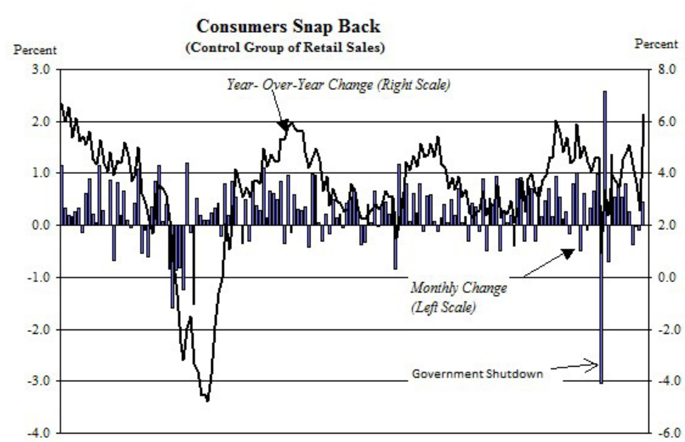
History will determine if the phase one deal between the U.S. and China will lead to peace and harmony on the trade front, vanquish investment-dampening business uncertainty, spur faster growth in 2020 and smooth the way towards a successful resolution of the upcoming phase two negotiating chapter sometime after the presidential election. We have our doubts that any of these grandiose ambitions will be accomplished, but acknowledge that the limited pact signed on January 15 will offset some of the damage the trade wars inflicted on the economy in 2019. But even that modest accomplishment is linked to the condition that the deal holds together for the duration of the year; among the terms in the 86-page document is the stipulation that the U.S. can snap back the tariff relief it agreed to if China does not live up to its side of the bargain.

That said, the financial markets rejoiced over the trade deal, upending the usual pattern of buying the rumor and selling on the news. The stock market set new records after the signing, pushing valuations further into the upper range of historical yardsticks despite mediocre profit reports rolling out for the fourth quarter. To be sure, it would be a mistake to conclude that this behavior is another sign the financial markets have become disconnected from economic developments. Along with the positive trade news this week, which also included the Senate's passage of a revised NAFTA deal, Washington provided investors with a spate of favorable economic reports that indicates the economy ended the year with considerably more momentum than thought a month or so ago.

The good news starts with consumers, the economy's main growth engine. Retail sales in December increased by a solid 0.3 percent, following an upwardly revised 0.3 percent gain in November. The December increase, which lifted the annual advance to a 16-month high of 5.8 percent, overcame a 1.3 percent slump in auto sales. And while the overall total received a hefty boost from sales at service stations, where prices at the pump rose for the third consecutive month, the December gain was broadly based. Excluding volatile big-ticket auto and price-driven gasoline sales, retail sales posted a robust 0.5 percent increase, putting the annual gain at 5.8 percent, the strongest in 20 months.

What's more, consumers did more of their late-year shopping at brick and mortar establishments. Online retailers, which have taken ever-bigger bites out of total retail sales for years, appear to have hit a temporary wall. Non-store retail sales, mostly Internet commerce, eked out a slim 0.2 percent increase in December, following three months of either no change or declining sales. You would have to go back to early 2013 to find a similar stretch of weakness in e-commerce sales. That said, don't cry for Amazon or its e-commerce brethren; their sales were still up an eye-opening 19.2 percent from a year earlier in December, and account for 15.8 percent of total non-auto sales. That share was under 10 percent less than four years ago.

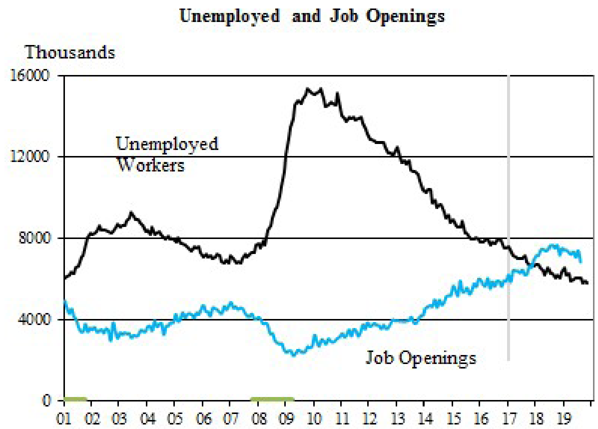
Importantly, the group of sales that serves as a proxy for consumer goods purchases in the GDP accounts posted a solid 0.5 percent increase in December and ended the year a whopping 6.3 percent higher than a year ago. That's the strongest annual gain for this so-called group in more than a decade, and a big jump from the 2.6 percent annual increase posted in November. Thanks to that burst of activity, personal consumption is likely to provide more heft to the economy in the fourth quarter than earlier thought, supporting a GDP growth rate approaching 2.5 percent.



That said, it would be a mistake to inject too much meaning into the December surge in retail sales. For one, the year-over-year comparison benefits immensely from a sharp drop in sales last December, which lowers the base against which the annual gain is calculated. For another, the December strength in sales comes in the wake of three consecutive months in which sales for the control group either declined or showed no gain. One month does not make a trend, and the December reading should probably be viewed as more of a rebound than a sign of momentum heading into the new year. From our lens, consumers will still be doing the heavy lifting driving growth in 2020, but its impact will be considerably less than last year as households are expected to increase spending at the slowest pace in seven years.

One reason: employment growth will continue to slow and curtail the increase in personal income, the lifeblood that fuels personal consumption. Indeed, the slowdown in job growth is already underway, albeit that trend is overshadowed by the lowest jobless rate in 50 years and a record 118 months of continuous job gains through December. But the monthly increases in payrolls slowed to 176 thousand in 2019 from 223 thousand in 2018 and the gains should continue tapering off in 2020. The most important influence behind this prospect is the increasing shortage of labor, as the record stretch of continuous job gains together with a wave of retirements is draining the pool of available workers to fill positions. This supply constraint is confirmed by anecdotal reports among businesses that cite the difficulty of finding qualified workers as their most pressing concern.

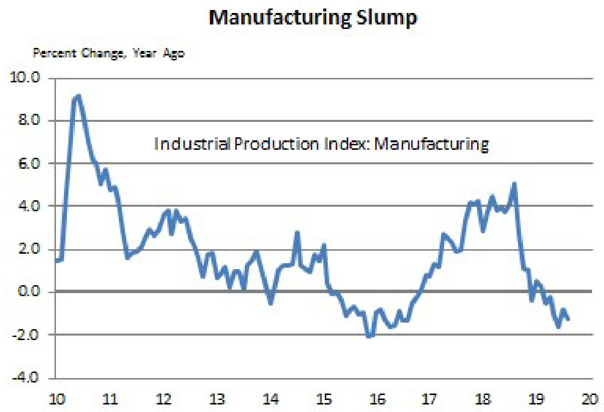
Indeed, the numbers backing up those reports can be found in the latest Job Openings and Labor Turnover Survey (the JOLTS report) for November. During that month, there were 989 thousand more job openings than unemployed workers, an excess that has persisted for 21 consecutive months. The competition for labor is spurring a high level of voluntary quits, as workers are emboldened to resign their positions either because they received a higher paying job elsewhere or are confident that they can readily find one. Hiring activity also remained strong in November. But like the still-sturdy payroll reports, signs of slowing are also appearing in the JOLTS report. For the first time since March 2019, the excess of job openings over unemployed workers fell below 1 million, as companies listed the fewest number of available jobs since February 2018. Job openings in November fell by a sizeable 561 thousand to 6.8 million.



It's unclear how much of the decline in job openings is being driven by a softening in demand for workers or by supply constraints. Just as workers are removed from the unemployed rolls when they give up a futile job search, companies may likewise remove a job listing after a long unsuccessful period of finding a qualified applicant. Odds are, both influences are playing a part. However, in certain sectors the weakening demand for labor is clearly the dominant force. The most obvious is manufacturing, where job openings have fallen for five consecutive months, and are currently at the lowest level since December 2018.

The slowing trend, of course,echoes the ongoing weakness in the goods-producing side of the economy that has been underway for some time. Unlike consumer spending, which finished the year on a firm note, industrial activity went out like a lamb. Industrial production fell 0.3 percent in December and ended the year down 1.0 percent from a year earlier. The decline in output opened up more spare industrial capacity, as the capaciy utilization rate for all industries fell to 77.0 percent from 77.4 percent, 2.8 percentage points below its long-term average. The copious amount of excess capacity is another headwind weighing on inflation, particularly for goods, which translated into another month of tame consumer price increases in December.

Paradoxically, manufacturing output did increase by 0.2 percent in December, bucking the overall trend and offsetting a 4.3 percent drop in motor vehicle output. But the late-year uptick did little to stop the bleeding, as factory output ended the year 1.3 percent lower than at the end of 2018. What's more, some unusual influences appear to have had an outsized impact on manufacturing production late in the year. In particular, the decision of Microsoft to end support for Windows 7 juiced business demand for new computers with the Windows 10 operating system. It is no coincidence that output of computers and peripheral equipment staged a robust 3.2 percent increase in December following a 3.8 percent gain in November. Indeed, excluding high-technology industries, manufacturing output actually contracted by 1.2 percent in the fourth quarter.



We suspect that once companies replace older computers, the manufacturing sector will once again succumb to the forces that depressed it last year, most notably sluggish global growth, the impact of the trade wars, a strong dollar, lackluster capital spending and slumping oil prices that has crimped energy-related investment outlays. The phase one trade deal may well provide a temporary reprieve for the markets regarding the trade wars, but it is highly unlikely to vanquish uncertainty over trade policy in corporate boardrooms. Keep in mind that the administration has not abandoned tariffs as a lever in negotiating deals with other nations, as evidenced by the threatened levies on French wine (in response to the digital tariff imposed by the French government) and the looming prospect of tariffs on European autos.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	January 17	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.55%	1.54%	1.57%	2.40%
6-month Treasury bill	1.56	1.54	1.58	2.50
3-month LIBOR	1.83	1.85	1.93	2.78
2-year Treasury note	1.58	1.58	1.64	2.62
5-year Treasury note	1.63	1.64	1.73	2.63
10-year Treasury note	1.83	1.82	1.92	2.79
30-year Treasury bond	2.29	2.28	2.35	3.10
30-year fixed mortgage rate	3.65	3.64	3.73	4.45
15-year fixed mortgage rate	3.09	3.07	3.19	3.88
5/1-year adjustable rate	3.39	3.30	3.37	3.87
STOCK MARKET				
Dow Jones Industrial Average	29348.10	28823.27	28455.09	24706.35
S&P 500	3329.62	3265.35	3221.22	2670.71
NASDAQ	9388.94	9178.86	8924.96	7157.23
Commodities				
Gold ($ per troy ounce)	1556.70	1562.80	1482.40	1280.70
Oil ($ per barrel) - Crude Futures (WTI)	58.71	59.20	60.36	53.83

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Retail Sales (December) - % change	0.3	0.3	0.3	0.3
Core Retail Sales (December) - % change	0.5	-0.1	0.0	0.2
Consumer Price Index (December) - % chg.	0.2	0.3	0.4	0.3
Core CPI (December) - % change	0.1	0.2	0.2	0.2
Producer Price Index (Dec.) - % change	0.1	0.0	0.4	0.1
Industrial Production (Dec.) - % change	-0.3	0.8	-0.5	0.0
Capacity Utilization (Dec.) - Percent	77.0	77.4	76.9	77.3

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