GREENLEAF TRUST

Perspectives

MARCH 2019
VOLUME 28, ISSUE 3

Economic Commentary

William D. Johnston
Chairman, Greenleaf Trust

Sometimes it is good to remind ourselves how economic data is distributed and analyzed, and why the cycle of data releases contributes to confusion. Some recent releases are dated due to the delays caused by the government shutdown. The data in those releases doesn't necessarily reflect the current state of the economy; however, they do fill in some gaps that allow us to perhaps confirm the trend that is in place. Keep in mind the angst that is currently in play in financial markets is not so much about how our economy is currently doing, but rather the probability that economic expansion continues in the forward cycle. As the cycle of growth continues to age, the extreme focus on data increases as does the attempt at forecasting signals of impending recession. So what does the data reveal to us about the current trends in place?

> "Last month work force participation grew, as did hourly wages and hours worked. Jobless claims declined... The conditions that fuel consumer confidence seem stable."

GDP data is released in three phases. The first is labeled "advance," followed by the "initial estimate," and finally the "second estimate." Last week the initial estimate was released for 2018 Q4 GDP at +2.6% and 3.1% for the 2018 year over 2017 year period. Typically, there are more revisions between the advance release and the first estimate than occur between the first and second estimates and, thus, we can pretty much assume that the economy was growing at a pace of +2.6% through December 31. As we look at the releases of data points in February and March, we should be able to determine if the components of GDP are trending up, flat or down.

Prior to looking at those component releases of GDP, it is helpful to remind ourselves what they are. GDP is derived from personal spending, sometimes referred to as private consumption (70%), business investment (18%), government spending (17%), and net exports (exports - imports) which was -5% in 2018. The percentage attributable to each component has been very stable for many years. During recessionary times government spending may grow a bit and, not surprisingly, during strong growth years business investment may increase; however, those changes in percentage contributions are minor.

The consumer drives 70% of economic growth, so consumer confidence is critical to future spending. The Conference Board's February release showed an improvement (131.4) over January's reading (121.7). Recall that the record high of this index survey was in October 2018 at 137.9. The University of Michigan's Consumer Sentiment Index rose to 93.8 from January's reading of 91.2. Both surveys, though conducted differently, are attempting to gauge consumers' current conditions and thoughts regarding optimism about business conditions, current employment, future employment, interest rates and household income. If we trust the surveys, we should see some improvement in retail sales in the March 12 data release, which declined -1.2% in the February release. Most of the decline reported for January was due to weak auto sales. Recent information published from auto dealers reflects what might be a growing challenge. The average automobile purchaser in 2018 had a monthly payment of $580, but perhaps even more alarming was that the terms of those consumer loans increased in age to 67 months! The overall age of the automobile fleet in the United States has not decreased much; however, the duration of debt term has increased substantially. This week's employment number on Friday, March 8 will be a confirming component of future consumer confidence. Last month workforce participation grew, as did hourly wages and hours worked. Jobless claims declined to 233,000, continuing a very low trend for those applying for initial benefits. The conditions that fuel consumer confidence seem stable.

Business investment increased 6.2% for the previous quarter, and 7.2% for the year over year period. The increases were mixed and uneven across many sectors. For the current period, the ISM Manufacturing Index declined to 54.2% in February from January's strong posting of 56.6%. Recall that it is generally believed by economists that readings above 50% are positive growth cycle readings, and those below 50% illustrate recessionary declines.

The data on government spending will be a bit choppy due to the 35-day shutdown. In the end, full-time government employees will have been paid; however, independent contractors working for various agencies and suppliers will likely not catch up. All estimates of GDP impact due to the shutdown are small, at less than four tenths of a percentage point. Far more impactful on current (not future) GDP is the federal deficit spending currently in place, which helps to fuel consumer spending.

We are a country that sells product throughout the globe. We furnish goods to and feed billions of people in many countries. Our citizens buy many goods produced by other countries. We are and will always be huge exporters and importers of goods and services. The impact of net exports on GDP has been about -5% for many years. There has been a great deal of talk about trade policy and tariffs to change the balance of trade, but very little has actually occurred to alter the export/import ratio. I am not in the camp of those that think we need to or should do so, as I think it would decrease our GDP, increase unemployment and increase the cost of goods and services to our citizens. I am all in favor of examining trade components that harm American producers and consumers; however, careless punitive tariffs can quickly change industries, and therefore, people's lives. Dairy farmers in Wisconsin, and soybean growers throughout the Midwest, can provide chapter and verse of what can go wrong when public policy changes overnight. Provided we don't shoot ourselves in the foot by going down the rabbit hole of retaliatory trade wars, we shouldn't expect to see much of a change in our net export contributions to GDP. We are the strongest consumer economy in the world; it makes sense that we would have the strongest appetite for global goods and services, and therefore, be importers of those goods and services.

> "Provided we don't shoot ourselves in the foot by going down the rabbit hole of retaliatory trade wars, we shouldn't expect to see much of a change in our net export contributions to GDP."

The current condition of each of the largest components of GDP is in stable condition and reflect an economy growing at a moderate pace of 2.6% to 3.0%. Global conditions, as well as self-inflicted domestic political missteps, could impact the future health of the consumer, employment, business spending and interest rates. Though the expansion cycle is long in the tooth, there aren't any current conditions existing to sound any alarm bells. Fed Chairman Powell has signaled a slight shift in policy from one that was viewed as tightening (raising short term rates) to one that is more neutral and more patient in unwinding the Fed's position in bonds. Financial markets were growing very skittish on the impact of future rate hikes, and thus, they have reacted positively to the perceived Fed position change.