

Monthly Market Commentary

News in recent weeks has been all about the government shutdown and the even more worrisome prospect of violating the debt ceiling sometime later this month. A debt-ceiling violation could lead to the deadly combination of higher interest rates and a slower economy. In a world where markets swoon on a 20,000-job miss in monthly employment data (on monthly job growth of about 200,000), losing 800,000 government jobs in one shot is a very big deal. Although the market has been soft lately, it seems to have hardly grasped the potential of a longer-term shutdown. We have reached this crisis point so many times recently with no negative consequences that the market seems almost numbed to the potential pain. Relatively inflexible wage rates and the propensity of most consumers to keep spending despite short-term adversity all contribute to the economy's overall stability and slow growth rate. But a month-long government shutdown would likely cut GDP growth by at least 0.5% in a world of 2.0% growth.

Employment: Another negative consequence of the shutdown is that government agencies have stopped releasing statistics; the Bureau of Labor Statistics' official employment report is missing. The ADP employment report showed more of the slow, unsatisfying growth rates seen for the last several months, with private sector jobs growing by 166,000, up from the 159,000 jobs added in August. The report was a bit of a disappointment, as the consensus estimate was for 180,000 jobs to be added.

Housing: New home sales and housing starts slowed down in the face of higher rates, while existing home sales jumped ahead as homebuyers raced to close quickly before rates moved even higher. Even before the higher rates, housing data had begun to top out as land and labor shortages slowed home construction. This has caused many analysts to scale back their housing growth rate and GDP contribution for both 2013 and 2014.

Consumer spending: Month-to-month consumption data has shown improvement, but the much more reliable year-over-year data suggests more of the same for consumption and the United States economy. Year-over-year three-month averaged consumption growth

remained stuck in its slow and unsatisfying rut of 1.9% when adjusted for inflation. That remains well ahead of income growth of just 1.1%, with the higher payroll and income tax rates subtracting close to a full percentage point off of income growth. Income data is beginning to show some improvements that might help fourth-quarter spending data, but initial reports seem to suggest a softer holiday shopping season than last year.

Quarter-end insights: While the overall U.S. economy has been quite stable, the third quarter did bring a number of real surprises, some positive and some negative. In the positive camp, Europe appeared to move from recession into recovery. The U.S., Chinese, and European manufacturing economies appeared to pick up steam in the quarter. Better auto sales and production helped the data, as did some inventory rebuilding and general improvements in consumption from more confident European consumers.

On the negative side, U.S. interest rates continued to climb throughout most of the quarter. The U.S. 10-year Treasury bond approached 3% in the middle of September before settling back a little after the Federal Reserve decided not to taper bond purchases. However, despite this decision, rates are still substantially higher than they were a quarter ago and are unlikely to approach old lows. Although tapering is off the table for another month, it will happen at some point, and the market knows it. Morningstar economists expect the 10-year Treasury bond to reach the 3% to 4% range over the next year or so, and a tapering program of some type to begin in the next three or four months. Projections for the remainder of the year include GDP growth in the 2.00% to 2.25% range, inflation at 1.60% to 1.80%, and the unemployment rate at 7.10%.