Economic &
Financial Digest
OCTOBER 2019

Millennium
CORPORATE CREDIT UNION

Will Trade Wars Topple the Economy?

Just as there is nothing more certain than death and taxes, the financial markets face the perpetual challenge of climbing a wall of worry. More often than not, the challenge is successfully handled as worries generate opportunities that beget rich rewards for risk-takers. By all accounts, that premise has been in full display since the end of the Great Recession. The U.S. stock market has staged an astonishing rally over the past decade despite an array of worrisome episodes ranging from a European debt crisis, three government shutdowns, an ever-escalating trade war, geopolitical flare-ups, and a severe global slow-down among other nontrivial setbacks. At the same time, the bond market has easily weathered these time-honored signs of distress. Yields have come down, reflecting a low-growth, low-inflation environment, but credit spreads have remained narrow amid low default rates; what's more, corporations have found highly receptive buyers for a copious volume of new issues in recent years.

But the wall of worry is getting steeper and the markets are getting jittery. Stock prices are no longer traveling a one-way street to higher ground that, until recently has been underpinned by complacency and low volatility. Equity prices peaked in July after a stomach-churning plunge during the spring, extending a yearlong bout of wild fluctuations. Bond yields have also experienced sharp movements, although within a declining trend, this year. Has the "wall" reached a tipping point for investors?

Clearly, the forces stoking heightened anxiety among investors this year are gaining traction. Indeed, a number of new uncertainties have joined the list of woes noted earlier. For one, recession fears have taken hold in the markets, particularly among bond investors who have driven short-term rates above long-term yields, a time honored recession indicator. For another, the potential growth-killing shocks that pessimists fear are drawing more attention. Trade tensions have escalated, the global economy continues to deteriorate and uncertainty over monetary policy is increasing. What's more, the campaign season ushering in the 2020 election is ramping up, which is sure to generate a host of conflicting and confusing legislative proposals that could undermine household and business confidence. These worries will not go away anytime soon - but they are not likely to bring the economy to its knees.

Trade Wars Escalate

If there is one lightening rod most responsible for stoking market jitters, it is the drumbeat of tariff announcements over the past 18 months. Since President Trump imposed tariffs on solar panels and washing machines in January 2018, there have been ten subsequent episodes in which the administration has either threatened, imposed, or raised tariffs on goods coming from overseas, most notably from China. Over that time span, China has threatened or retaliated with its own tariffs on U.S. goods.

Initially, the markets appeared remarkably calm about the tariffs. The early 2018 levies on solar panels and washing machines resulted in a mild 0.2 percent increase in the CBOE VIX index, the most recognized measure of stock-market volatility, the day after the announcement. Indeed, throughout most of 2018 the market reactions to trade policy decisions were muted, as seen in the accompanying table. The VIX index actually declined following every tariff announcement through last August.

However, investors lost patience following the announcement last September of a 10 percent tax on $200 billion of Chinese imports. That stirred the pot, sending the VIX index up and setting the stage for ever-more anxious responses to each subsequence tariff announcement. The worst two-day increase in volatility occurred this August 1, when the VIX index spiked by 8.5 points following the announcement of 10 percent tariffs on an additional $300 billion of Chinese imports beginning October 1, including consumer goods such as phones, laptops and clothing. Not surprisingly, equity prices, which resisted most of the tariff announcements in 2018, turned negative following each one since last September.

Why Do the Markets Care?

The ever-larger market responses from rising trade tensions reflect a series of factors. First, the China tariffs have rapidly increased in magnitude. This was most visible when the administration lifted the 10% tariffs on $200 billion of goods from China to 25% on May 5, 2019. Subsequently, the 10% tariffs on the remaining $470 billion of Chinese imports was lifted to 15%, although the scheduled start date was pushed back to December 15 from October 1 as a "good will" gesture.

Date	Event	Volatility Index (2-day)
1/22/2018	Solar Panel Tariffs Imposed	0.2
3/1/2018	steel and aluminum tariff threat	-1.12
4/3/2018	25% on $50bn Chinese Import threat	-4.68
7/6/2018	25% on $34bln imposed	-2.33
7/10/2018	10% on $200bln Chinese Import threat	-0.11
8/1/2018	Escalation to 25% tariff threat	-1.19
8/23/2018	25% on $16 imposed	-0.09
9/24/2018	10% on $200bln imposed	1.21
5/5/2019	Escalation to 25% on $200 bln	4.9
8/1/2019	10% on $300blns threat	8.47
8/23/2019	China hits $75 bln, Trump raises tariffs	3.63

Second, the newly announced tariffs will increasingly affect consumer goods. This is important because, unlike the previous tariffs on intermediate goods which are absorbed mostly by businesses, the levies on consumer goods will be passed on directly to households in the form of higher prices. Hence, the tariffs will boost inflation, which will complicate Fed policy and disrupt market expectations.

Third, even as the scope of tariffs has increased, the economic landscape has deteriorated both domestically and globally over the past year. This means that there is a thinner buffer against the negative effects from rising trade tensions. With global growth set to cool to the slowest pace since the Great Recession and the U.S. coming off a fiscally-stimulated economic bounce in 2018, business, consumers and investors and increasingly taking fright at the potential ramifications of the bilateral trade war. Indeed, as the trade war between China and the U.S. rages on, increasingly severe market responses and more pronounced confidence shocks should be expected. This means that on top of the direct impact of tariffs - which are generally relatively small for the U.S. economy we must consider indirect confidence and financial market spillovers.

The Economic Impact

As noted, the trade war has so far taken the biggest toll on businesses, as it has increased the cost of imported supplies and materials and disrupted supply chains that U.S. firms rely on in the production process. Moreover, it has contributed significantly to the global slowdown currently underway. China's economy has downshifted considerably, which has been extremely damaging to its trading partners. Perhaps the biggest blow has been felt by Germany where the loss of auto sales to China, its largest export market, has had a crippling effect. The German economy is on the brink of a recession, dragging down the rest of Europe.

While the global slowdown is not fatal to the U.S. economy, its effects are palpable. U.S. exports have cooled significantly since 2017, with real merchandise exports down 0.7 percent through July, following a 1.4 percent decline in 2018. Over the past year, slower export growth has sliced 0.9 percent from the economy's growth rate. Importantly, conditions overseas are getting worse. All the institutions that monitor these conditions, including the IMF, OECD and the ECB have recently lowered their global growth forecasts.

In the U.S. in addition to the direct hit to exports, corporations have scaled back investment outlays. After a temporary burst in 2018, fueled by tax cuts, capital spending has ground to a halt this year, increasing by a slim 0.7 percent in the second quarter following an outright decline in the January-March period. The outlook is not looking promising. According to the Business Roundtable - an organization of chief executives of major corporations - capital spending plans have been cut back significantly over the next six months. The primary reason for the planned cutbacks, not surprisingly, is uncertainty over trade policy.

Reasons to Worry But Not Panic

Clearly, these trade-related depressants create downside risks for an economy that is already in uncharted waters as the longest expansion on record. But expansions don't die of old age; they are always toppled by some external shock, such as an oil spike or military conflict, or by a policy mistake, such as an overly restrictive monetary policy. The growth-dampening trade tensions now underway are not yet powerful enough to do the job.

Yes, exports and manufacturing activity are in the doldrums. But combined, they account for less than 20 percent of total economic output and the drag from both is not deep enough to bring the economy to its knees. Manufacturing was in even worse shape in 2015-2016 when oil prices collapsed and vaporized energy-related spending; yet while unemployment was higher than now and the economy was in a more fragile state, it overcame the manufacturing slump and continued to grow.

Meanwhile, the consumer sector - the main engine of US economic growth - remains in healthy shape as consumer expenditures continue to top expectations. In fact, the 4.7 percent surge in consumer outlays in the second quarter was the biggest since late-2014 and spending continued to outperform expectations in July and August. The strength in personal consumption spending appears well supported by income growth, itself driven by a balanced combination of steady employment gains and solid wage increases of more than 3 percent a year. With the personal saving rate approaching 8%, household leverage historically low and confidence remaining generally elevated, the fundamentals point to a resilient recession buffer from US households.

Finally, despite criticism from the Trump administration that the Federal Reserve is moving too slowly, the central bank has decisively shifted gears from 2018 when it raised interest rates four times. So far, it has rescinded two of those increases by cutting rates by a quarter-point in both July and September, and stands poised to pull the rate trigger at least one more time before the year's end. True, there is a wide disparity of opinion among Fed officials as to how aggressively rates should be reduced, if at all. This, along with trade developments, is stoking uncertainty in the financial markets, contributing to the volatility seen in recent months. But the Fed stands unified in its quest to sustain the expansion if the trade headwinds show visible signs of stifling growth. With inflation low and the economy cooling from the 2018 pace, the Fed clearly has the leeway to err on the side of easing. Whether lower rates can stave off a recession is a question for another day, but policy is clearly supporting growth, which should go a long way towards offsetting the trade headwinds.

FINANCIAL INDICATORS*

	August	July	June	May	April	March	February	12-Month Range High	12-Month Range Low
Prime Rate	5.25	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.03
3-Month Treasury Bill Rate	1.95	2.10	2.17	2.35	2.38	2.40	2.39	2.40	1.95
5-Year Treasury Note Rate	1.49	1.83	1.83	2.19	2.33	2.37	2.49	3.00	1.49
10-Year Treasury Note Rate	1.63	2.06	2.07	2.40	2.53	2.57	2.68	3.15	1.63
30-Year Treasury Bond Rate	2.12	2.57	2.57	2.82	2.94	2.98	3.02	3.36	2.12
Tax-Exempt Bond Yield	3.09	3.45	3.50	3.57	3.82	3.96	4.22	4.32	3.09
Corporate Bond Yield (AAA)	2.98	3.29	3.42	3.67	3.69	3.77	3.79	4.22	2.98
Conventional 30-Year Mortgage Rate	3.62	3.77	3.80	4.07	4.14	4.27	4.37	4.87	3.62
Dow Jones Industrial Average	26058	27089	26160	25745	26402	25723	25606	27089	23806
S&P 500 Index	2898	2996	2890	2855	2904	2804	2755	2996	2567
Dividend Yield (S&P)	2.00	1.96	1.96	2.10	1.95	2.01	2.04	2.22	1.88
P/E Ratio (S&P)	19.2	19.4	19.2	18.0	19.3	18.7	18.3	20.1	16.6
Dollar Exchange Rate (vs. Major Currencies)	92.3	91.7	91.6	92.6	92.3	91.9	91.4	92.6	90.0

***Monthly Averages**

ECONOMIC INDICATORS

	August	July	June	May	April	March	February	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1364	1215	1233	1264	1270	1199	1149	1364	1142
New Home Sales (Thousands of Units)		635	728	602	656	693	669	728	557
New Home Prices (Thousands of Dollars)		313	306	311	339	310	321	339	305
Retail Sales (% Change Year Ago)	4.1	3.6	3.3	3.0	3.8	3.8	1.9	4.8	1.4
Industrial Production (% Change Year Ago)	0.4	0.5	1.1	1.8	0.7	2.3	2.7	5.4	0.4
Operating Rate (% of Capacity)	77.9	77.5	77.8	77.8	77.8	78.4	78.5	79.6	77.5
Inventory Sales Ratio (Months)		1.40	1.40	1.40	1.39	1.38	1.40	1.40	1.34
Real Gross Domestic Product (Annual % Change)			2.0			3.1		3.1	2.2
Unemployment Rate (Percent)	3.7	3.7	3.7	3.6	3.6	3.8	3.8	4.0	3.6
Payroll Employment (Change in Thousands)	130	159	178	62	216	153	56	312	56
Hourly Earnings (% Change Year Ago)	3.2	3.3	3.2	3.1	3.2	3.2	3.4	3.4	3.0
Personal Income (% Change Year Ago)		4.6	5.0	4.9	4.9	4.7	4.7	6.1	4.5
Savings Rate (Percent of Disposable Income)		7.7	8	8.0	8.1	8.4	8.8	8.8	7.2
Consumer Credit (Change in Blns. Of Dollars)		23.3	13.8	16.8	16.5	10.0	15.7	23.3	10.0
Consumer Prices (% Change Year Ago)	1.7	1.8	1.6	1.8	2.0	1.9	1.5	2.5	1.5
CPI Less Food & Energy (% Change Year Ago)	2.4	2.2	2.0	2.0	2.1	2.0	2.1	2.4	2.0
Wholesale Prices (% Change Year Ago)	1.8	1.7	1.7	1.8	2.2	2.2	1.8	3.2	1.7

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