



WEEKLY

Economic Commentary

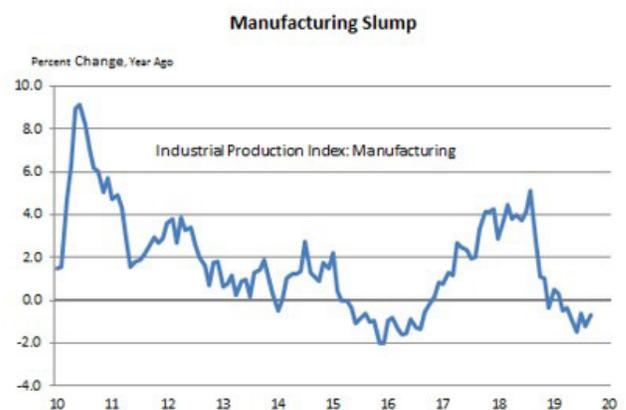
February 14, 2020

The uncertain ramifications of the intensifying coronavirus continue to cast a dark shadow over the financial markets and global economy. Just as the spread of the disease seemed to be waning China reported a surge in new cases towards the end of the week, undercutting hopes that the impact of this formidable growth-retarding headwind was easing. Even before the ominous reports from China surfaced, economists were marking down near-term growth prospects. While the human toll in the U.S. has so far been relatively contained, corporate America is suffering increasing pain. Not only are goods-producers running short of parts because of supply chain disruptions overseas, severe travel restrictions into the U.S. are dealing a severe blow to the tourist-related leisure and hospitality sector as well as to airlines.

The potential hit to U.S. growth comes on top of the haircut already baked in by the grounding of the Boeing 737 MAX aircraft, which is expected to shave about 0.5 percent from the first-quarter's GDP growth rate. Add another fraction from the virus and the economy's momentum is rapidly losing altitude. From our lens, growth in the first quarter is tracking a pace of under 0.5 percent, which would be the weakest in more than four years. But as demonstrated by previous shocks -- including the government shutdown and energy-related slump that temporarily derailed growth during this record-long expansion -- the financial markets tend to look beyond the current upheaval, expecting the economy to rebound once the shock wears off.

The relatively muted response so far in the stock market suggests that investors retain an optimistic bias this time as well. Time will tell how long they are willing to overlook the spate of negative economic data that is expected to roll out in coming months. To be sure, the market's confidence is underpinned by the economy's resilience following past shocks. But while we expect the economy to withstand the current headwinds, a V-shaped growth rebound to the above-2 percent pace seen last year is probably not in the cards. Indeed, this week's data for January, which do not reflect the impact of the coronavirus, strongly indicate that the economy has already lost a good deal of momentum.

As expected, industrial production took a major hit from the travails at Boeing, as a plunge in output at aerospace and miscellaneous transportation equipment contributed to a setback in overall manufacturing production last month. More worrisome, however, is the negative reading on activity linked to capital spending, which continues to show no sign of coming out of a year-long slump. Business equipment output has fallen in four of the past five months, and the 2.6 percent plunge in January was the steepest in more than 10 years. It's unclear how much of that falloff was in transportation equipment and, hence, related to Boeing. But there is no question that the industrial side of the economy continues to suffer the effects of weak global growth, the strong dollar, tariffs and trade uncertainty.



Those headwinds are not expected to vanish anytime soon. The phase one deal with China struck in mid-January should provide some relief on the trade front, but the potential boost to exports may well be delayed by the coronavirus that is taking a big bite out of China's growth. Meanwhile, prospects elsewhere on the global stage are hardly reassuring. The eurozone is barely skirting a recession, as the bloc eked out a slim 0.1 percent gain in the fourth quarter, with the region's powerhouse, Germany, posting no growth at all. The near-term outlook is grim owing largely to the coronavirus, which is poised to have a devastating impact on the German auto industry, the nation's main growth driver. And with the U.S. faring better than other nations, the flight to the safety of U.S. dollar-denominated assets is only getting stronger. The greenback is roaring to

the highest level in almost four years, undercutting the price competitiveness of U.S. producers on the global market.

Nor is momentum getting much of a kick on the domestic front. As noted, the capital-spending spigot remains closed, although the housing valve has reopened and is just about offsetting the drag from sagging equipment outlays. For the most part, consumers will again determine how well the economy holds up to the prevailing headwinds. Odds are, they will provide enough fuel to sustain the life of the expansion through its record eleventh year. But this important growth cylinder should be providing less torque than in the recent past. On the positive side, the job market continues to grow payrolls and support gains in incomes and confidence. Household balance sheets remain in good shape; debt-servicing burdens are low, the personal savings rate is high, and assets continue to appreciate.

But the positive thrust from each of those spending influences has limits. While overall debt burdens are low there are pockets of distress, particularly among younger borrowers and those with auto loans where delinquencies are rapidly increasing. The high personal savings rate does suggest that households have the firepower to sustain spending. But it also reflects the muted impact that the huge wealth gains in recent years is having on consumption. That, in turn, suggests that households are more inclined to view their savings as a buffer against adversity than as a catalyst for additional spending. This cautious mindset should remain intact as job and income growth tapers off over the coming year.

As it is, consumers are showing more restraint than ebullience as the new year gets underway. Retail sales did post a 0.3 percent increase in January, about in line with expectations. But the increase follows a downwardly revised tepid gain of 0.2 percent in December and a similar 0.2 percent advance in November. Importantly, the key control group of sales, which feeds into the personal consumption calculation in the GDP data, showed no gain during the month and has increased only once in the past five months. That said, overall sales still climbed by a healthy 4.4 percent in January from a year earlier.

Even the control group of sales stood a respectable 3.3 percent higher than a year ago.

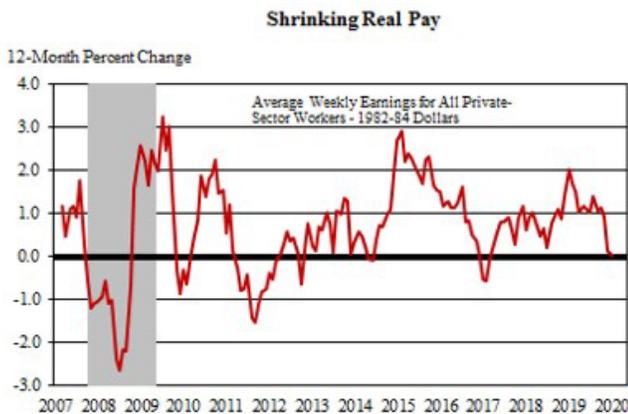


Simply put, consumers are still providing fuel to the economy’s growth engine, although the thrust is waning. The support from a still-solid pace of job growth and high level of confidence should keep wallets and purses open and enable the economy to weather the setbacks posed by Boeing’s woes and the coronavirus. But the near-term risk is that fears associated with the virus will escalate and push households into a defensive mode. If that turns out to be the case, a vicious cycle could ensue, prompting business to cut back hiring, reduce orders and spur production cutbacks. Fed Chair Powell took notice of this threat in his semiannual testimony on monetary policy before Congress this week, citing the coronavirus as a downside risk facing the economy.

Powell’s testimony confirmed our view that the Fed retains a dovish bias in its policy stance. He noted the economy’s resilience to adversity and expects it to bounce back from its projected growth slowdown in the first quarter. But the struggle to get inflation up to the 2 percent target and the desire to sustain the broadening gains seen in the labor market indicates that policy will be more sensitive to a cooler than a hotter economy. At the moment, Fed officials believe that the economy is still in a good place, neither too hot nor too cold, and are inclined to wait a few months to see how conditions evolve.

We suspect that by around mid-year, the snapback in economic activity will turn out to be less than

what the Fed expects. While inflation may well rise to the 2 percent target temporarily, reflecting comparisons with low year-earlier prices, it is likely to recede again over the second half of the year. Even so, the current inflation reading is taking a bigger bite out of household paychecks, as the growth in worker earnings has slipped markedly from its pace seen last summer. Indeed, weekly earnings adjusted for inflation has showed no growth over the past twelve months, the weakest showing in nearly three years.



Not surprisingly, the barrage of negative news on the global front combined with the still uncertain fate of the coronavirus is influencing market perceptions of Fed policy. Until recently, the consensus has been that policy would remain on the sidelines over the foreseeable future and the next move would be to raise rates. That perception has swung 180 degrees. The current expectation, based on the CME Fedwatch tool, gives greater than 50 percent odds that the Fed will cut its policy rate by July. That's in line with our expectation, as we see growth slowing to below 2 percent over the course of the year and inflation ending 2020 under the 2 percent target. The fed will need to cut rates at least one time around mid-year to guide the economy onto a soft landing and keep the expansion going into 2021.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	February 14	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.58%	1.57%	1.55%	2.42%
6-month Treasury bill	1.55	1.57	1.56	2.50
3-month LIBOR	1.69	1.73	1.83	2.69
2-year Treasury note	1.42	1.40	1.58	2.52
5-year Treasury note	1.42	1.41	1.63	2.50
10-year Treasury note	1.59	1.58	1.83	2.66
30-year Treasury bond	2.04	2.05	2.29	3.00
30-year fixed mortgage rate	3.47	3.45	3.65	4.37
15-year fixed mortgage rate	2.97	2.97	3.09	3.81
5/1-year adjustable rate	3.28	3.32	3.39	3.88
STOCK MARKET				
Dow Jones Industrial Average	29398.08	29102.51	29348.10	25883.25
S&P 500	3380.16	3327.71	3329.62	2775.60
NASDAQ	9731.18	952051	9388.94	7472.41
Commodities				
Gold (\$ per troy ounce)	1586.90	1573.90	1556.70	1324.60
Oil (\$ per barrel) - Crude Futures (WTI)	52.22	50.34	58.71	55.75

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (January) - % change	0.1	0.2	0.2	0.2
Core CPI (January) - % change	0.2	0.1	0.2	0.2
Retail Sales (January)	0.3	0.2	0.2	0.2
Industrial Production (January) - % change	-0.3	-0.4	0.9	0.0

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