



WEEKLY

Economic Commentary

February 28, 2020

With the Ides of March rapidly approaching, is the economy about to be struck with the proverbial knife in the back? That question looms larger each day the spread of the coronavirus continues unabated, threatening to deliver the death knell to the global economic expansion. Unlike Julius Caesar who didn't heed the omens, households, businesses and governments are stepping up protectionist measures to contain the outbreaks. The problem is, these measures are taking a toll on the global economy, thus amplifying the debilitating impact the disease is having on human life. The longer containment efforts remain an imperative, the more severe is the potential toll they will take on the global economy.

Thus far, only a few cases have been detected in the U.S. with no fatalities reported. But the economic impact has been more than trivial, as tourism - both in and out of the country - is slumping, undermining the travel industry, particularly airlines, the leisure and hospitality sector, and retail establishment that derive significant revenues from sales to tourists. That's the demand-side impact. On the supply side, manufacturers that depend on China, the hub of the virus, for parts and materials critical to the production process are facing shortages of these inputs that could severely curtail operations, if not shut them down entirely. That, in turn, could lead to shortened hours for workers and, in time, layoffs, which would intensify the negative impact on demand. Nor are companies in the services sector immune from the economic shock: many that get their inventory from abroad, including Walmart and Amazon, are in danger of not being able to stock their shelves with enough merchandise to meet demand. Most toys are made in China.

Importantly, fear has gripped Wall Street, sending stock prices into correction territory less than a week after they hit all-time highs and driving interest rates down to record lows. Meanwhile, the government is sending mixed messages; the CDC is urging the public to prepare for a greater outbreak in the U.S. while the White house is striving to calm nerves, issuing assurances that everything is under control. Pressure is building on the Federal Reserve to cut interest rates, but questions abound as to how effective

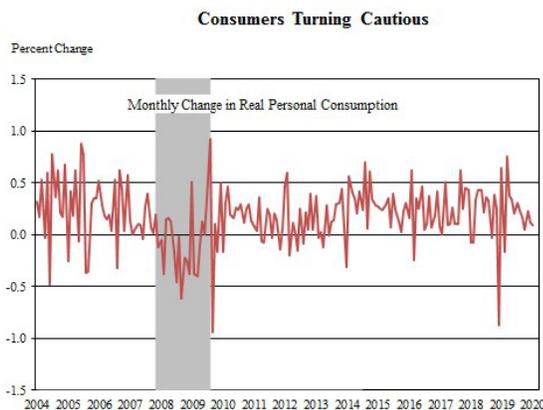
that would be against what is so far mostly a supply shock to the economy. Besides, some policy makers are wary of cutting rates now if the virus is soon contained and the economy quickly rebounds. If it turns out in coming months that the rate cut was unnecessary, the Fed might be unwilling to rescind the cut and hike rates in an election year.

From our lens, economic prospects had already indicated that one rate cut would be needed by the summer even before the coronavirus hit the fan. The economy was losing momentum, the global landscape looked bleak and the grounding of the Boeing 737 Max aircraft was putting heavy downward pressure on the first quarter's growth rate. Now the headwinds have turned fiercer, aggravated by the insidious virus-related fear factor hammering Wall Street that has vaporized more than \$4 trillion in household equity holdings. Hence a perfect storm may be brewing that could bring growth to a virtual halt in the first quarter, hastening the need for a rate cut. We thought the Fed would wait for confirming data of weakness before taking a move, but the rout in the stock market and potential liquidity squeeze that could strangle business activity will likely prompt a rate cut sooner rather than later. We now expect the Fed to act at the March 18 policy meeting and signal a second rate reduction in June, when incoming data will confirm that the economy is slowing due to both weakening demand and supply disruptions. The futures market is already pricing in a 100 percent chance of a cut at the March meeting, according to the CME pricing tool.

The unanswered questions are, how long will the outbreak last and how broadly will it spread through the economy? Only time will tell if we have to wait for a change in the weather to short-circuit the outbreak or if human managers can do the job. The outcome will determine if the economy can avoid a recession this year. Ironically, recession fears are taking hold once again even as incoming reports suggest that the economy is in fairly good shape. On Friday, the Commerce Department reported that personal incomes jumped 0.6 percent in January, the largest monthly gain in more than a year. The increase was helped by the annual cost-of-living

adjustment to social security beneficiaries as well as other government payments, such as refundable tax credits related to the Affordable Care Act. As well, the December gain was revised down from 0.2 percent to 0.1 percent and, hence, the January increase was amplified by coming off a lower base.

Still, the income gain last month carried a big punch, as most of it was due to fatter paychecks. Wages and salaries rose by a robust 0.5 percent and disposable incomes increased by 0.6 percent, also the strongest in more than a year. However, in a sign that households are turning more cautious, most of the income increase was saved, as the personal savings rate jumped from 7.5 percent to 7.9 percent. On the flip side, spending growth downshifted markedly. Real personal consumption expenditures eked out a slim 0.1 percent increase in January, matching the weakest showing since last February.



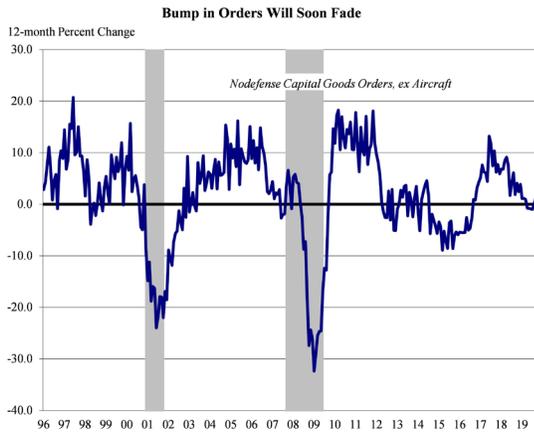
It would be an understatement to say that as goes the consumer, so goes the economy. Consumer spending has been the linchpin of the expansion in recent years, representing the only stool standing upright amidst wobbly legs of business investment spending. Given the evolving global headwinds that are menacing profits, which are already under pressure from weakening exports, a strong dollar, tariffs and rising labor costs, a turnaround is not likely in the foreseeable future. A brief sign of hope emerged with the limited trade deal with China signed in mid-January; indeed, reduced trade tensions may have contributed to a surprising 1.1 percent jump in

capital goods orders during that month.



But that upswing is likely to prove ephemeral, as whatever relief the reduced trade tensions may have provided is now being squelched by the COVID-19 virus. Given the heightened anxiety surrounding the disease, the alarming damage it is imposing on overseas economies and the potential spillover effects on the U.S. economy, the incentive to put new investment spending plans on hold will almost certainly be strong. Capital spending was a drag on growth over the last half of 2019, and it is likely to do so again for a third consecutive quarter. Keep in mind that orders can be cancelled and we suspect that purchasing managers are already on the phone rescinding or delaying bookings until the fog of uncertainty is lifted.

However, one sector continues to shine brightly on the economic landscape, the housing market. The combination of low mortgage rates, growing incomes and still-high confidence is imparting a hefty boost to home buying activity. House-seekers came out in droves in January, driving new home sales to the highest level since 2007. The 746 thousand annual pace of sales represented a 7.6 percent jump over the previous month. As has been the case in the market for existing homes, a major restraint on new home sales continues to be limited inventory, which slipped to a 5.1 monthly supply in January. The time-honored impact of an excess of demand over supply is higher prices, and this time is no different. Median home prices surged 14 percent from a year ago to a record high \$348,200 in January.



As the calendar turns to March, the behavior of households will determine if the economic expansion succumbs to the same unceremonious end that befell Caesar. At this juncture, it's impossible to tell, as virtually all hard and soft data, including surveys, were collected before the outbreak of the virus reached a critical mass and households had time to process the consequences. The good news is that the shock is hitting at a time when households have firm underpinnings, including a solid job market and healthy balance sheets that are sustaining a high level of confidence. How long those underpinnings can withstand the corrosive impact of the COVID-19 shock remains to be seen. Stay tuned.

To be sure, the home-price surge is likely to shut many homebuyers out of the market unless builders compensate by shifting more production towards lower-priced homes. Still, the damage to affordability from higher prices is being offset by the ongoing decline in mortgage rates. Last week, the 30-year fixed mortgage rate fell to 3.45 percent, just 3 basis points away from the lowest level since September 2016. That spread will be obliterated this week, as the 10-year Treasury note yield against with mortgage rates are linked plunged to a record closing low of 1.17 percent on Friday, fully 30 basis points lower than a week earlier.

Homeowners that refinanced into low-rate mortgages in recent years must reasonably have thought that rates would never get low enough again to justify another refinancing. That perception will be revised in coming weeks and months, thanks to the plunge in yields now underway. If the Fed as expected cuts its policy rate at the March meeting, the upswing in mortgage refinancing that has already taken root will certainly gain traction. The reduction in debt-servicing payments, in turn, will put more cash in the pockets of households, which hopefully will find its way into the spending stream and help cushion the economy from the recessionary-headwinds of the coronavirus. Keep in mind that the upswing in home prices is also boosting the equity values in homes. That, in turn, gives homeowners the option of cashing out some of that increased equity by refinancing into a larger mortgage, giving them even more cash to spend.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	February 28	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	1.29%	1.55%	1.56%	2.43%
6-month Treasury bill	1.13	1.52	1.54	2.51
3-month LIBOR	1.58	1.68	1.76	2.62
2-year Treasury note	0.94	1.34	1.32	2.55
5-year Treasury note	0.94	1.32	1.31	2.56
10-year Treasury note	1.17	1.47	1.50	2.76
30-year Treasury bond	1.69	1.92	2.00	3.12
30-year fixed mortgage rate	3.45	3.49	3.51	4.35
15-year fixed mortgage rate	2.95	2.99	3.00	3.77
5/1-year adjustable rate	3.20	3.25	3.24	3.84
STOCK MARKET				
Dow Jones Industrial Average	25409.36	28932.41	28256.03	26026.32
S&P 500	2954.22	3337.75	3225.52	2803.69
NASDAQ	8567.37	9576.59	9150.94	7595.35
Commodities				
Gold (\$ per troy ounce)	1580.00	1645.90	1594.00	1294.50
Oil (\$ per barrel) - Crude Futures (WTI)	45.24	53.39	51.58	55.75

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
New Home Sales (January) - 000s	764	708	692	717
Core Capital Goods Orders (January) - % change	1.1	-0.5	0.0	0.0
Personal Income (January) - % change	0.6	0.1	0.5	0.3
Personal Consumption Exp. (January) - % change	0.2	0.4	0.3	0.2
Personal Savings Rate (January) - Percent	7.9	7.5	7.8	7.7

Millennium Corporate Credit Union
8615 West Frazier Street
Wichita, Kansas 67212