WEEKLY
Economic Commentary

February 21, 2020

Millennium
CORPORATE CREDIT UNION

In real estate, it is said that having the best house in a deteriorating neighborhood is a losing investment. In economics, however, there are instances when your value strengthens when neighbors around you fall on hard times -- as long as their hardship is worse than yours. That observation is playing out in spades, as the global economy is taking a bigger hit from the spreading coronavirus than the U.S. -- at least so far. When economic adversity strikes, people and investors look for safe havens to park their valuables; with the U.S. holding up better than its neighbors, dollar-denominated assets look safer and have become a magnet for funds.

It comes as no surprise, therefore, that the greenback has risen to near three-year highs alongside a companion refuge for safety-seeking funds, gold, whose price has soared to the highest level in nearly seven years. Meanwhile, the risk-off trade has benefited another traditional U.S.-based safe haven, Treasury securities. Yields across the board are plummeting as investors are abandoning riskier assets, including stocks, for government issues, driving up their price. The yield on the 30-year Treasury bond has fallen to a record low of under 2.0 percent this week and the bellwether 10-year Treasury yield has slipped 12 basis points on Thursday and Friday alone, ending the week at 1.47 percent - matching the lowest closing level since the 1.36 percent hit in July 2016. The shift in asset preferences struck a severe blow to the equity market towards the end of the week, sending stock prices sharply lower.

While the safe-haven trade dominated market behavior this week, the decline in interest rates is also sending a message: the U.S. may be holding up better than its neighbors, but it is not immune to the growth-retarding threat posed by the coronavirus. Indeed, with the 2-year Treasury yield at 1.34 percent sitting well below the Federal Reserve's policy rate, currently at range of 1.50-1.75 percent, the market is also harboring growing expectations that the Fed will cut rates again to cushion the economy against the threat. Until recently, expectations of a central bank put gave solace to equity investors. But the market retreat now underway suggest investors are less confident that a rate cut would be effective in staving off a recession if the disease is not contained soon.

For its part, the Fed officially remains on standby. According to the minutes of the July 28-29 FOMC meeting released this week, most participants were cautiously optimistic about economic conditions, bolstered by recent trade agreements and a strong job market. While Fed officials were comfortable with the current stance of policy, expecting to keep interest rates unchanged for the foreseeable future, there was a palpable sense of concern over the coronavirus and the downside risks it poses to the economy. The key takeaway was that the Fed is poised to act if the negative impact on the economy is greater than expected. Interestingly, while the outbreak has intensified since the meeting, two Fed officials - regional bank presidents Bullard and Bostic - opined that the virus should deliver no more than a short-term shock to the economy. Clearly, the financial markets view that perception with a good deal of skepticism.

That said, the broader picture that depicts diverging trends among nations is holding fast. The virus is exacting the biggest economic and human toll on China, where tens of millions of people are on lockdown, stifling spending, production and overall growth. Asian neighbors whose economic fortunes depend heavily on China and are also experiencing an increase in outbreaks are struggling mightily as well. But the spillover effects extend far and wide, thanks to the interconnectedness of the global economy that links broad swaths of industries with supply chains in a multitude of different countries, with China looming among the largest of the suppliers.

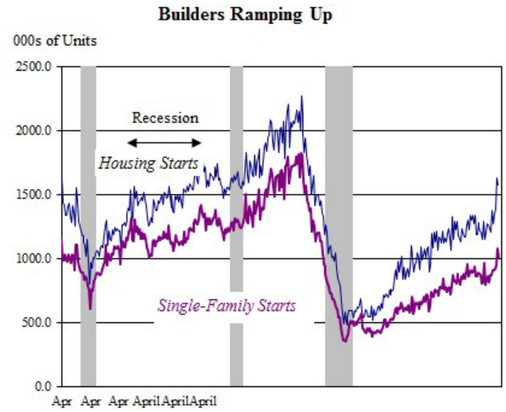
Distance matters, and while the U.S. is vulnerable to supply-chain disruptions (note the travails of Apple and other tech firms) it is less impacted by the plunge in tourism that is taking a big bite out of smaller economies, particularly in Asia. The question for the U.S. is whether the demand disruption will become more of an influence going forward. For sure, spending related to tourism has fallen sharply, hitting airlines and revenues at many leisure and hospitality establishments. To the extent that the global slowdown weakens foreign demand for American goods, exports will suffer as well and impose a further drag on an already-struggling manufacturing sector.

But the U.S. economy derives most of its strength from domestic sources, and the evidence so far is that the virus has not meaningfully impaired domestic demand. That could change, of course, if the disease morphs into a global pandemic stoking fear and uncertainty among households. Another virus-related catalyst that could send consumers into hibernation would be a severe market correction. By itself, the negative wealth effect from a sharp decline in stock prices would not derail consumption: only a small fraction of the population holds the vast majority of stocks, and an abrupt sell-off is not likely to alter the spending habits of these wealthy shareholders.

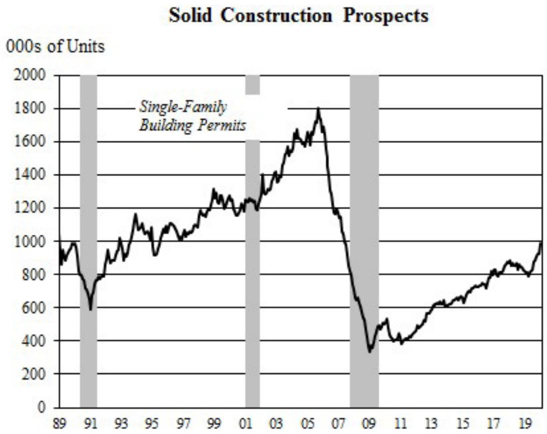
But a broad swath of households views the stock market as a barometer of the economy's health. Hence, a severe market correction could well unleash a damaging blow to consumer confidence, particularly if it is sustained and undercuts job security. Keep in mind that corporate leaders are highly sensitive to their company's stock prices, and they could well put budgets on hold in response to a sharp market sell-off that appears to be more than a temporary correction. By many measures - and in the eyes of many analysts - the stock market is already overvalued, so it may not take much to trigger a downward spiral in prices.

It is not unusual for external shocks like the one currently roiling the financial markets to generate doomsday scenarios. More often than not perceptions outrun reality, causing markets to overreact to evolving reports. We suspect that a similar situation is unfolding unless the coronavirus goes unchecked and accelerates much beyond previous outbreaks, such as the SARs, Mers and Ebola episodes over the past two decades. By all accounts, the fundamentals underpinning the U.S. economy are still supportive of continued growth. The labor market remains healthy, consumers are still spending, albeit at a slower pace, and even the beleaguered manufacturing sector showed signs of stabilizing prior to the onset of the virus.

What's more, the housing sector has become a pleasant wild card in the economic landscape, providing more of a growth boost than expected a few months ago. Home construction surged to a 13-year high in December and hardly gave back any ground in January, according to this week's report by the Commerce Department. Housing starts in January did slip from December's eye-opening 1.63 million annual rate to a still formidable 1.57 million pace. But the setback was smaller than expected and starts exceeded expectations. Last month, the volatile multifamily sector showed more strength than the much-larger single-family sector. But single-family home construction - which has more of an impact on economic activity - is poised to lead the way in coming months.



Building permits for single-family homes surged 9.2 percent in January to the highest level in more than 20 years. Nor was January a fluke, as these permits have now increased for nine consecutive months - the longest stretch of continuous gains since 1974. To be sure, unseasonably warm weather gave an outsized boost to housing starts in both December and January. But permit-issuing activity is not sensitive to weather conditions, which points to sustained strength in construction activity over the coming months. We expect residential outlays to make a positive contribution to GDP in the first quarter, marking the third consecutive quarter to do so following six quarters of being a drag on growth.



Importantly, the demand for homes remains strong, a sign that households have the wherewithal and resources to commit to big-ticket purchases. That may not be reflected in the latest sales data for existing homes, which slipped 1.3 percent to 5.46 million units in January. But the fall-off was less than expected and transactions in January still stood almost 1 percent higher than the sales pace in the fourth quarter of last year. Importantly, sales would likely be even stronger if more homes were on the market. Inventories remain scarce, as the supply of homes for sale was the lowest for any January on record. The shortage of homes for sale is blunting the positive impact that low mortgage rates would otherwise have on demand. But low rates are spurring more refinancing activity, and the cash that households save through debt-servicing payments should find its way into the spending stream, giving the economy another source of support against the shock from the coronavirus.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	February 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.55%	1.58%	1.53%	2.46%
6-month Treasury bill	1.52	1.55	1.54	2.52
3-month LIBOR	1.68	1.69	1.79	2.65
2-year Treasury note	1.34	1.42	1.49	2.50
5-year Treasury note	1.32	1.42	1.50	2.47
10-year Treasury note	1.47	1.59	1.68	2.65
30-year Treasury bond	1.92	2.04	2.13	3.02
30-year fixed mortgage rate	3.49	3.47	3.60	4.35
15-year fixed mortgage rate	2.99	2.97	3.40	3.78
5/1-year adjustable rate	3.25	3.28	3.28	3.84
STOCK MARKET				
Dow Jones Industrial Average	28932.41	29398.08	28989.73	26031.81
S&P 500	7337.75	3380.16	3295.47	2792.67
NASDAQ	9576.59	9731.18	9314.91	7257.54
Commodities				
Gold ($ per troy ounce)	1645.90	1586.90	1570.50	1330.01
Oil ($ per barrel) - Crude Futures (WTI)	53.39	52.22	54.38	57.16

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Housing Starts (January) - 000s	1567	1626	1381	1426
Building Permits (January) - 000s	1551	1420	1474	1454
Producer Price Index (January) - % change	0.5	0.2	-0.1	0.1

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