WEEKLY

Economic Commentary

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Millennium

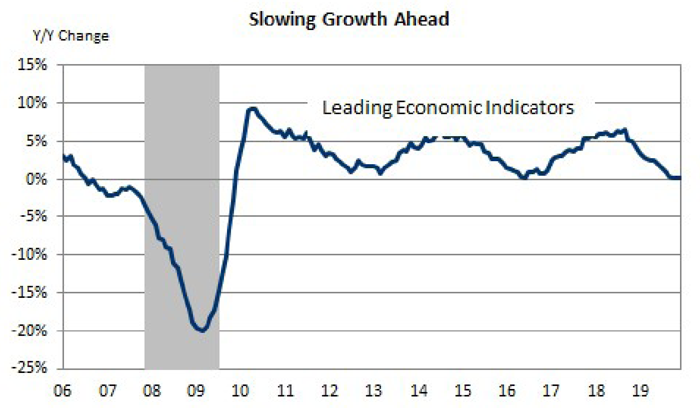
CORPORATE CREDIT UNION

There is still a week left in the month but, as was the case last January, external events are garnering more attention in the financial markets than economic data. Last year, it was the government shutdown. This year, it is all about impeachment proceedings, geopolitical disruptions in the Middle East and, more recently, the outbreak of a deadly virus in China that is spreading to other parts of the world. Unlike the initial shock last year, which saw stock prices plunge by 20 percent in December before roaring back in January, the market response this year has so far been remarkably benign. Indeed, stock prices are up by almost 2.0 percent since the start of the year amid exceptionally low volatility.

The less volatile response - at least until Friday - to external events this time is not surprising, if only because the government shutdown last year posed a more existential threat to the economy. Not only did the markets have to cope with a historic development - the shutdown was the longest on record - but it also delivered a tangible blow to the economy that incited recession fears. The after-shocks were palpable and translated into a significant slowdown in economic activity. In the first quarter, the economy's growth rate plunged to 1.1 percent from 2.9 percent in the previous quarter, and consumer confidence slumped in January foreshadowing a sharp retrenchment in personal consumption the following month.

To be sure, we have scant data on how the economy is performing this January. But few believe that it suffered negative effects from any of the aforementioned events thus far. True, the index of leading indicators, compiled by the Conference Board, posted its second decline in three months in December, suggesting that the economy lost considerable momentum heading into the new year. But two big drags on the December reading - building permits and claims for unemployment benefits - will likely be reversed in January. Meanwhile, the financial components for which current information is available are showing strength. As noted, stock prices are up and borrowing conditions have eased.

By all accounts, the economy ended 2019 on a firm footing. Consumer spirits were high, retail sales were healthy, the job market continued to hum, residential activity surged and a trade truce with China



was announced, easing - but not eliminating - a growth-dampening influence. Our estimates indicate that the economy grew modestly faster in the fourth quarter than the 2.1 percent pace recorded in the third. That said, it would be mistake to extrapolate that trend into the current quarter.

For one, a major brake is already posed to rein in the growth engine, namely the grounding of Boeing's 747 MAX aircraft, which is having knock-on effects that are stifling production and jobs at a host of ancillary industries. From our lens, that alone could shave as much as half-percent from the annual growth rate during the first quarter. What's more, on Friday the company announced that the cash squeeze caused by the grounding of the MAX is forcing it to cut back production of another of its aircraft, the Dreamliner. So the knock-on effects could turn out to be even larger.

For another, the global economy is struggling to rebound from the doldrums that enveloped it last year. A preliminary purchasing managers report for January indicates that Europe is at best bottoming out and far from gaining momentum that would jumpstart growth in the first quarter. Importantly, the ramifications to the Chinese economy from the unfolding coronavirus are still open ended. The disease is not yet as severe as the SARS epidemic that temporarily derailed the Chinese economy in 2003. But the stark travel restrictions already put in place just as the Lunar New Year gets underway threatens to stifle activity during one of the busiest times of the year for tourism and other recreational activities. China announced a travel ban that would land lock about 40 million of its citizens.

Some travel restrictions are also being taken by the U.S. and other nations to stave off the spread of the virus, which may yet become a tangible drag on certain sectors of the economy. As of Friday, more than 800 people in China have been afflicted even as cases have been confirmed in an expanding list of Asian nations, including South Korea, Japan, Thailand, and Vietnam. In the U.S. two cases have been confirmed and hospitals are gearing up for more potential patients. Aside from the human suffering involved, a budding health crisis could well seep into the economy in a number of ways.

Most directly, companies with supply chains in China face production bottlenecks, as 40 million Chinese people are prevented from traveling outside of their cities, which, for many, means they cannot get to their jobs. If manufacturers can't find workers, they also can't generate output. Also of note: Wuhan, the epicenter of the coronavirus, is the main transportation hub in China, as its dozens of railways, roads and expressways carries goods to Beijing and other major cities. It is often referred to as the "Chicago of China".

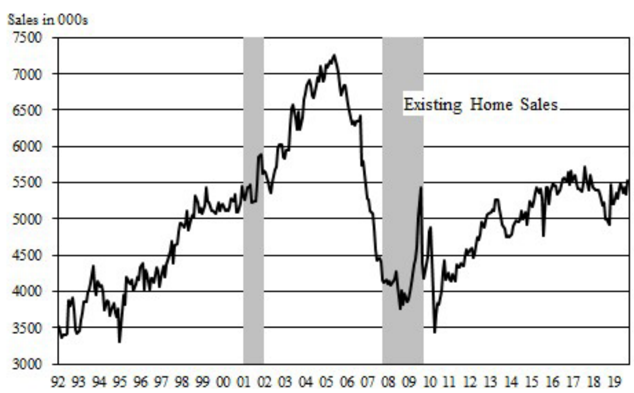
For another, as more U.S. residents are stricken with the virus, the greater is the media exposure and, hence, the more likely is household confidence vulnerable to a setback. On Friday afternoon, rumors swirled that the CDC was about to confirm a third patient with the virus. Keep in mind that social media has become a much more ubiquitous presence in the U.S. (and China) than was the case during previous epidemics, including the SARS, MERS and Ebola episodes. Hence, news travels faster, as does the fear factor.

Nor is it just Main Street that gets the message. As the week drew to a close, anxiety spread to Wall Street. Stock prices fell sharply on Friday and bond yields plunged. The 10-year Treasury yield fell to a three-month low of 1.66 percent from 1.83 percent a week earlier. The decline reflects the usual risk-off trade associated with an unforeseen shock - the coronavirus - as investors shift funds from riskier stocks to the safety of government securities. Gold also spiked on Friday. But the move also has fundamental underpinnings, as investors see the health scare as a prospective drag on growth. According to the CME group, options traders are pricing in a higher probability of a Fed rate cut than an increase at the April policy-setting meeting, although the highest odds are still for no change in the federal funds rate from the current 1.50-1.75 percent range.

Bond Yields Slide

If the late-week moves are any indication, the markets may be heading for an upsurge in volatility, following a long stretch of relative calm. For sure, the downbeat message conveyed by Friday's trading activity does not reflect any change in current economic conditions. Indeed, the market moves occurred despite the virtual absence of any economic reports this week. The sole release of any significance confirmed that the revival in housing activity is gaining traction. According to the National Association of Realtors, sales of existing homes spiked to a two-year high in December.

Home Sales Grind Higher



Clearly, low mortgage rates represent a powerful tailwind propelling home sales, reinforcing the gains in incomes that make the purchase of a home more affordable to a wider swath of the population. Assuming this week's drop in Treasury yields is not abruptly reversed in coming days, mortgage rates should move a notch lower next week, adding fuel to the home-sales revival. The major obstacle in the way of stronger sales is the lack of inventory, as the supply of homes on the market is lower than any time in at least twenty years. The bad news is that the supply constraint sets the stage for higher home prices, which will likely crimp demand going forward. The good news is that higher prices also boosts the value of equity that households retain in their homes, thus enhancing wealth with spillover effects on spending. On balance, the housing sector should be a positive influence on economic growth over the near term.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	January 24	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.53%	1.56%	1.56%	2.38%
6-month Treasury bill	1.54	1.56	1.59	2.54
3-month LIBOR	1.79	1.83	1.96	2.82
2-year Treasury note	1.49	1.58	1.58	2.63
5-year Treasury note	1.50	1.63	1.68	2.63
10-year Treasury note	1.68	1.83	1.88	2.78
30-year Treasury bond	2.13	2.29	2.32	3.03
30-year fixed mortgage rate	3.66	3.65	3.74	4.62
15-year fixed mortgage rate	3.40	3.09	3.19	4.07
5/1-year adjustable rate	3.28	3.39	3.45	3.98
STOCK MARKET				
Dow Jones Industrial Average	28989.73	29348.10	28645.26	22445.37
S&P 500	3295.47	3329.62	3240.02	2416.58
NASDAQ	9314.91	9388.94	9006.62	6332.99
Commodities				
Gold ($ per troy ounce)	1570.50	1556.70	1515.60	1258.90
Oil ($ per barrel) - Crude Futures (WTI)	54.38	58.71	61.72	45.42

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Existing Home Sales (December) - 000s	5540	5350	5440	5435

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