



WEEKLY

Economic Commentary

January 31, 2020

It is hard to get overly excited about the economy's performance when plunging imports are the strongest driver of growth. Yet that's precisely what happened in the fourth quarter of last year. On the surface, the overall picture looks decent. Real GDP increased at a 2.1 percent annual rate, spot-on with the third quarter and suggesting the economic engine is cruising into 2020 on an even keel. But the steady-as-she-goes impression is superficial at best, as it masks sputtering cylinders that will guide the economy onto a slower lane over the coming year.

By far the biggest contribution to the fourth-quarter's advance came from an 8.7 percent contraction in imports, which accounted for 1.32 percentage points of the 2.1 percent overall growth rate. Since imports represent less than 20 percent of GDP, that's clearly a case of a component punching well above its weight. Conversely, consumer spending, which accounts for about two-thirds of GDP, contributed a more modest 1.20 percentage points to the fourth-quarter's tally. To be fair, the plunge in imports should not be viewed as a trend that would provide a sustained boost to growth. The setback primarily reflects the distortions from the trade war with China; some imports were pushed forward into the third quarter to avoid higher tariffs that were potentially set for September and December. With the phase one deal that derailed the threatened tariff increase, imports are poised to rebound in the first quarter.

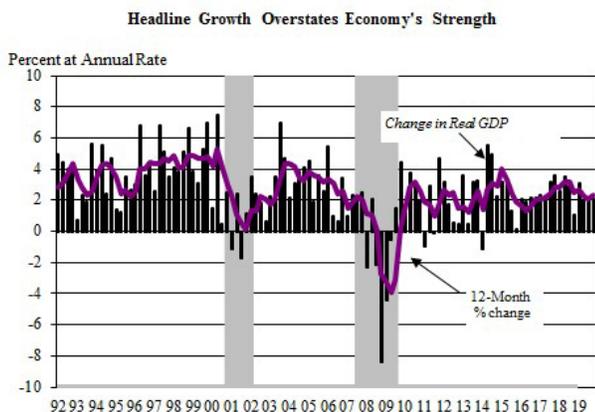
its weight. Final sales to private domestic purchasers increased at the slowest pace since 2015, rising by a timid 1.4 percent annual rate. Part of the blame rests with consumers who have been doing most of the heavy lifting since the expansion began nearly 11 years ago. In the final quarter, however, they showed some fatigue. Personal consumption advanced by 1.8 percent, down from more robust growth rates of 3.2 percent and 4.6 percent in the third and second quarters, respectively. For the year as a whole, consumer spending increased 2.6 percent, which is actually a tad higher than average for the expansion.

Still, the cynics may well ask households, what have you done for me lately? No doubt, consumers were troubled by the escalating trade wars and attention-getting reports of a global slowdown that threatened job and income prospects in the U.S. Some pullback to guard against external shocks is a time-honored response on the part of households and we suspect it had an influence in the fourth quarter. However, with the phase one deal consummated in January and fortified by the persistent strength in the job market, households entered the new year with an upbeat attitude. In January, the Conference Board's consumer confidence index increased by a stronger-than-expected 3.8 points to the highest level since August.

What's more, the survey was finalized before the phase one deal with China was signed on January 15, although its anticipation likely buoyed household spirits. That said, consumers are primarily influenced by how confident they are about finding and keeping a job. On this score, their attitude could not be more upbeat. In compiling responses, the Conference Board asks households about the ease or difficulty of finding a job, asking whether jobs are plentiful or hard to find. The difference between the two job-searching experiences is a measure of how confident households feel about the job market. Except for August, this measure reached the highest level in nearly two decades in January, going back to the dot-com boom of the late 1990s.

But take out the volatile components of trade, inventories and government spending, and you are left with a private sector that is punching well below

That said, this measure is hardly a leading indicator of the economy's performance. In each of the last three business cycles, a recession began less than a year





after confidence in the job market reached a peak. Simply put, some external shock - a dot.com bust or housing collapse that precipitated the global financial crisis - can abruptly deflate household confidence and bring the economy to its knees. In earlier cycles, confidence-shattering events included oil crises or overly restrictive monetary policies that stifled activity through higher interest rates. Most external shocks are unforeseen, but the financial markets are highly tuned to growth-retarding signals that could translate into something more ominous.

Indeed, on more than one occasion over the past two years the markets viewed the escalating trade war with China as a possible catalyst for a downturn. For a brief spell last year, the yield curve turned negative as heightened trade anxiety and a global slowdown sent bond yields plummeting below short-term rates. This historically reliable recession indicator swiftly regained a positive slope, thanks to a succession of Fed rate cuts and renewed confidence that the U.S. economy was rebounding from a sluggish performance earlier in the year. But the markets have once again found a reason to be rattled, this time by the mysterious coronavirus originating in China that is sending shock waves through the global economy.

It is far too early to assess the actual or potential economic damage of the virus. But fears are escalating along with the exponential increase in the number of afflicted victims in China and elsewhere. At least two major American airlines suspended flights to and from China, highlighting the disruption to global economic commerce that is gaining traction by the day. Stock

prices plunged on Friday, wiping out all of the gains for the year and, once again, the dreaded yield-curve inversion came to pass, with the yield on the 10-year Treasury issue falling below 3-month bills. As investors flocked to safe assets, the 10-year Treasury yield tumbled to a four-month low on Friday, hitting 1.51 percent, 4 basis points below the 3-month yield.

The spread of the coronavirus adds another drag to near-term growth prospects that are already suppressed by the woes of Boeing, whose grounding of the 737 Max aircraft has scuttled production and caused significant layoffs at several supplier companies. We estimate that the Boeing-related cutbacks could slice as much as one-half a percentage point from the first quarter's growth rate. The fallout from the coronavirus will add some fraction to that haircut. U.S. automakers as well as tech giants such as Apple rely heavily on parts produced in China, including regions where factory production is grinding to a halt because of the virus. The extent of the spillover effects on the U.S. economy depends on how quickly inventories of these parts are depleted and how soon the virus is contained in China and business returns to normal.

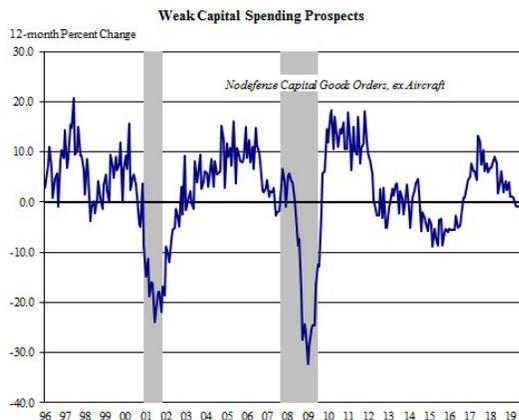
As it is, the U.S. economy has little momentum heading into the new year. The headline growth rate in the fourth quarter, as noted, overstates its actual strength as the main cylinder driving growth, consumer spending, downshifted during the period. It remains to be seen if household confidence and behavior is materially impacted by the coronavirus in coming weeks, but absent a severe negative influence consumer spending should rebound modestly from the 1.8 percent growth rate in the fourth quarter. However, with job gains poised to slow and restrain the increase in incomes, households are expected to gradually rein in purchases over the course of 2020 and provide less oomph to the economy's growth rate.

That leaves other sectors to take up the slack. Some of it should come from a revitalized housing market, which has spurred increased residential construction outlays for two consecutive quarters to end 2019, following six quarters of contraction. That revival should continue this year, fueled by low mortgage rates, improving demographics and a still-sturdy job market, though one that is less robust than in 2019.

But the positive contribution provided by the residential side of the ledger is being more than offset by the abysmal performance of the nonresidential sector, as business investment spending contracted for the third consecutive quarter in the final three months of the year. If not for higher outlays on intellectual property, primarily R&D, the drag would have been considerably worse. Equipment spending fell by 2.9 percent and outlays on structures plunged by 10.1 percent, weighed down by sagging energy-related investment.

Importantly, business investment spending is not expected to make a meaningful comeback in 2020 and jump-start the economy's engine. Manufacturing remains mired in a deep slump, reflecting sluggish global activity, lingering uncertainty over trade policy, sagging profits and a strong dollar. For sure, near-term prospects are not promising. A proxy for equipment spending, new orders for nondefense capital goods less aircraft, fell by 0.9 percent in December, leaving the level of bookings virtually unchanged from a year earlier, up only 1.0 percent. Actual shipments of capital goods fell in five of the last six months and were lower at the end of the year than at the start.

the Fed's 2 percent target. That prospect is not in the cards anytime soon, as the latest reading on the Fed's preferred inflation gauge remains well under target. If anything, the Fed conveyed a more dovish bias, as the chairman acknowledged uncertainties around the economic outlook and took note of the possible negative impact of the coronavirus at this post-meeting press conference. From our lens, recent events only confirm our view that the next move - probably around mid-year - is more likely to be a rate cut than an increase.



While it is impossible to predict what, if any, external shock will knock the economy off the rails, one that will almost certainly not is an overly restrictive monetary policy. That was solidified at this week's policy-setting meeting, in which the central bank reiterated its intention to keep short-term rates anchored at current levels until inflation shows sustainable signs of moving above

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	January 31	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	1.56%	1.53%	1.53%	2.40%
6-month Treasury bill	1.54	1.54	1.55	2.46
3-month LIBOR	1.76	1.79	1.90	2.74
2-year Treasury note	1.32	1.49	1.53	2.50
5-year Treasury note	1.31	1.50	1.59	2.50
10-year Treasury note	1.50	1.68	1.79	2.69
30-year Treasury bond	2.00	2.13	2.25	3.03
30-year fixed mortgage rate	3.51	3.60	3.72	4.46
15-year fixed mortgage rate	3.00	3.40	3.16	3.89
5/1-year adjustable rate	3.24	3.28	3.46	3.96
STOCK MARKET				
Dow Jones Industrial Average	28256.03	28989.73	28634.88	25063.89
S&P 500	3225.52	3295.47	3234.85	2706.53
NASDAQ	9150.94	9314.91	9020.77	7263.87
Commodities				
Gold (\$ per troy ounce)	1594.00	1570.50	1551.50	1322.20
Oil (\$ per barrel) - Crude Futures (WTI)	51.58	54.38	62.99	55.34

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
New Home Sales (December) - 000s	697	705	725	698
Durable Goods Orders (December) - % change	2.4	3.1	0.2	0.0
Core Durable Goods Orders (December) - % change	-0.9	0.1	1.0	-0.2
Real GDP (Q4) - % change, Saar	2.1	2.1	2.0	2.2
Personal Income (December) - % change	0.2	0.4	0.1	0.3
Personal Consumption (December) - % change	0.3	0.4	0.2	0.3

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