



WEEKLY

Economic Commentary

December 13, 2019

A frenzy of prospective deals brightened the economic and financial landscape this week, including one that would defuse the long-simmering China/U.S. trade dispute. Importantly, there was a surprising burst of bipartisanship in Congress that would keep the government funded through the fiscal year and finalize a revised Nafta arrangement.

The political developments overshadowed the Fed's policy-setting meeting this week. As expected, the Fed kept rates unchanged and signaled that it was moving to the sidelines for the foreseeable future, reflecting increased confidence in the economic outlook. No doubt, a series of stronger-than-expected economic reports leading up to the meeting emboldened Fed officials.

But the first key report following that meeting shows the danger of rushing to judgment. Retail sales came in much weaker than expected in November following a tepid outcome in October. With two months of lackluster consumer spending to start the fourth quarter, the economy's main growth driver may be sputtering, suggesting waning momentum heading into the new year.

Unless Lucy once again mischievously removes the football just before it is kicked, a "phase-one" deal between the U.S. and China will finally reach the goal posts. The news hit the financial markets like a bombshell on Thursday, but shared the headlines with a frenzy of other market-friendly compromises forged in recent days. These included a bipartisan congressional agreement on a spending bill that would avoid a potential government shutdown on December 20 as well as the approval by lawmakers of the revised Nafta proposal sought by the administration. To be sure, China has yet to sign off on the trade deal and unsettling reports that officials in Beijing may object to some of the terms dampened enthusiasm on Friday morning. Recall that China walked away from an agreement in May at the last minute, so Lucy may yet have her day.

Still, in a highly polarized political environment that has kept the financial markets on edge over the past three years, any semblance of cooperation in Congress strikes a positive chord with investors.

The spending deal, which is likely to be signed by the president, comes exactly a year after a rebellion over funding for a border wall led to a record-long government shutdown that battered stock prices and almost brought the economy to its knees. The make-nice moment in Congress, however, should not disguise the fact that the budget deficit is on track to balloon to over \$1 trillion and is destined to grow further as economic growth cools over the coming year. With fiscal policy hamstrung by a vast pool of red ink, it is not likely to be of much help in jump-starting the growth engine when the economy tumbles into the next recession.

Which, of course, means that the central bank is charged with the heavy lifting, a burden it has carried for the most part since the Great Recession. Prior to reports that a trade deal with China was reached, the spotlight shone on the Federal Reserve's policy-setting meeting on Tuesday and Wednesday. The committee did not generate any earth-shattering news as it left rates unchanged as expected and signaled that it was moving to the sidelines for the foreseeable future. The thrust of the message conveyed in the policy statement and the accompanying quarterly update of the committee's economic and interest-rate projections is that the three rate cuts implemented in this year marked the end of the easing cycle. No further reductions are expected in 2020, and the next move is expected to be up, with one rate hike targeted in both 2021 and 2022.

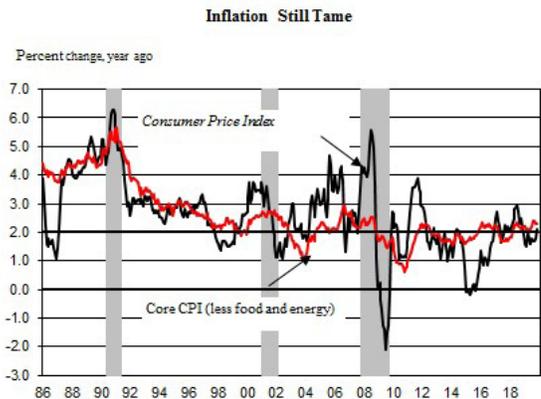
That said, the Fed is fully aware that any forecast more than a year out is an imprecise exercise at best. A little more than a year ago, Fed officials thought that 2019 would include a series of rate increases, building on the four hikes implemented in 2018. Just the opposite turned out to be the case as three of the four increases were rescinded this year. From our lens, the fourth will be taken off the board some time next year, but that's not in the Fed's plans at this juncture. Indeed, four members of the FOMC expect a rate hike next year and none of them are looking for a cut. The reason for this less dovish outlook was spelled out in the policy statement as well as by Chair Powell in the post-meeting press conference.

Essentially, the Fed is emboldened by incoming data that have mostly exceeded expectations, most notably the robust jobs report for November, as well as receding trade threats. Importantly, the policy statement removed previous references to uncertainties over the economic outlook, which the markets understandably interpreted as being less dovish than previous statements. Indeed, immediately following the meeting, the futures market priced in lower odds of a rate cut next year. But in his press conference, Chair Powell also raised the bar for a rate hike, noting that inflation remains below the Fed's 2 percent target and is not likely to reach it over the forecast horizon.

Importantly, Powell expressed little concern over the sustained strength in the job market. The Fed chief noted that the ever-declining jobless rate has not generated the kind of upward wage and price pressures that it had in the past, and signaled a willingness to let the job market run even hotter before pulling the rate-hiking trigger. Rather than being concerned over an inflation threat, the chairman is embracing the sustained strength of labor market, which is drawing workers from the sidelines that might have given up the job search. Powell recognizes that the size of this pool of shadow workers is unknown and the low 3.5 percent unemployment rate could go still lower before all the slack in the labor market is removed.

As the November jobs report confirmed last week, wage pressures remain well contained, even as the jobless rate slipped back to a 50-year low of 3.5 percent. This week, the Labor Department provided further confirmation that inflation is under control, reporting mild price increases on both the consumer and producer levels last month. True, a spike in energy prices lifted the headline consumer price index by 0.3 percent, a tad above the 0.2 percent expected increase. But the core CPI, which excludes volatile energy and food prices, came in at a modest 0.2 percent, leaving the annual core inflation rate at 2.3 percent. The inflation gauge that the Fed monitors, the personal consumption deflator, is expected to post a similar 0.2 percent increase when it is reported later this month.

But the PCE deflators have been much weaker than



the CPI and are running well below the Fed's 2 percent target. The overall PCE increased 1.3 percent in October from a year earlier, and the core PCE advanced by 1.6 percent. Even in the unlikely event the 2 percent target is hit next year, the deflators have been undershooting the mark for so long that the Fed would tolerate - even welcome - an above-2 percent inflation rate for a time. Since the 2 percent target was established in 2012, the annual increases in the core PCE deflator has averaged 1.6 percent. The Fed also closely monitors inflation expectations, and both households and the financial markets expect inflation to remain tame over the foreseeable future.

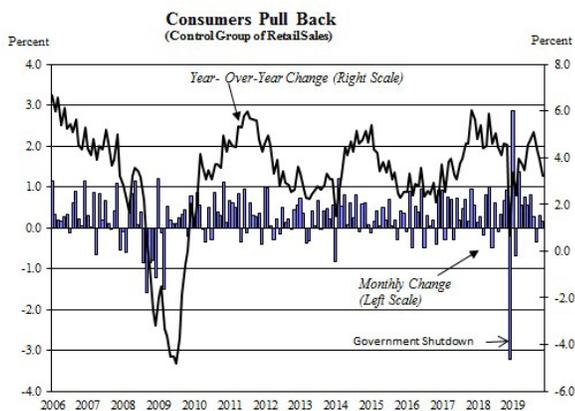
Simply put, the Fed may be feeling more confident about current economic conditions, but it would take compelling evidence that growth and inflation were poised to accelerate before it hikes rates. And while last week's jobs report supported the case for stronger growth, this week's key retail sales report did just the opposite. Indeed, there was every reason to believe that households were about to go on a shopping binge. Not only did the blockbuster increase in job creation last month fuel expectations of a robust holiday season for retailers, the attention-getting surge in Black Friday and Cyber-Monday sales seemed to validate that outcome. But the retail sales report for November hardly lived up to those joyous expectations.

Instead of signaling the start of a buoyant holiday season, retail sales turned in a Grinch-like performance in November. Total sales rose by a disappointing 0.2 percent, well under the expected 0.5 percent increase. True, the increase for October was revised up from 0.3 percent to 0.4 percent, but that merely reversed a 0.4

percent decline in September. So over the past three months, sales averaged a tepid 0.1 percent gain, which is the weakest three-month stretch since February. If not for the price-driven 0.7 percent increase at gasoline stations and a 0.5 percent gain in volatile auto sales, retail sales would have been unchanged during the month. Ominously, households cut back on discretionary purchases, reducing spending at food and restaurants and for recreational goods.

Looking at the broader picture, the so-called control group of sales that corresponds with personal consumption expenditures in the GDP accounts increased by a tepid 0.1 percent in November, dragging the annual gain down to 3.2 percent from 4.0 percent in October and 5.1 percent in August. This portends another weak month for real PCE in November, following virtually no increase in October, and points to a marked slowdown in the PCE growth rate for the fourth quarter from the 2.9 percent increase registered in the third. To be sure, the November weakness may have been affected by special factors. The late Thanksgiving holiday, for example, pushed Cyber-Monday sales into December and may have disrupted the seasonal factors the Commerce Department uses to adjust sales for the month. The retail industry remains optimistic that sales will show a marked improvement in December.

news. Indeed, bond yields, which spiked on news of a trade deal on Thursday, fell back sharply on Friday, leaving the 10-year Treasury yield virtually unchanged at 1.82 percent from the previous week. There may still be a Santa rally in the cards for the stock market, but the government statisticians will have to provide a more festive basket of goods than they did this week to lift investor spirits.



That said, the disappointing retail sales report throws some cold water on the more ebullient forecasts for the fourth quarter. It may also have restrained the enthusiasm in the stock market that might otherwise have been displayed following the promising trade

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	December 13	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	1.57%	1.52%	1.57%	2.43%
6-month Treasury bill	1.56	1.55	1.58	2.55
3-month LIBOR	1.89	1.89	1.90	2.79
2-year Treasury note	1.61	1.63	1.61	2.74
5-year Treasury note	1.66	1.67	1.66	2.74
10-year Treasury note	1.82	1.84	1.84	2.90
30-year Treasury bond	2.26	2.28	2.31	3.15
30-year fixed mortgage rate	3.73	3.68	3.75	4.63
15-year fixed mortgage rate	3.19	3.14	3.20	4.07
5/1-year adjustable rate	3.36	3.39	3.44	4.04
STOCK MARKET				
Dow Jones Industrial Average	28135.28	28015.06	28004.89	24100.51
S&P 500	3168.80	3145.91	3120.46	2599.95
NASDAQ	8734.88	8656.53	8540.93	6910.66
Commodities				
Gold (\$ per troy ounce)	1480.00	1464.60	1467.60	1242.10
Oil (\$ per barrel) - Crude Futures (WTI)	59.79	59.13	57.83	51.14

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (November) - % chg.	0.3	0.4	0.0	0.2
Core CPI (November) - % change	0.2	0.2	0.1	0.3
Producer Price Index (November) - % chg.	0.0	0.4	-0.3	0.0
Retail Sales (November) - % change	0.2	0.4	-0.4	0.3

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