WEEKLY
Economic Commentary

June 7, 2019

Millennium
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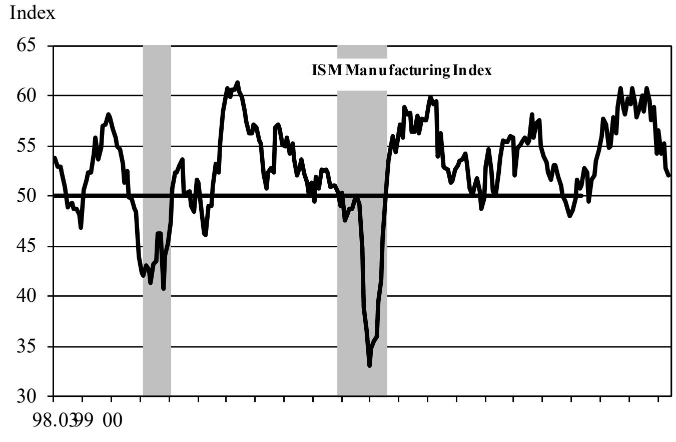
Just a few weeks ago the general perception was that the upcoming FOMC meeting on June 18-19 would be a ho-hum affair, with Fed officials retaining the wait-and-see strategy conveyed at the previous confab held in late April. Recall that the central bank was pulled in opposite directions at that meeting, as inflation was running below expectations but the economy was performing somewhat better, showing considerable momentum heading into the second quarter. That conflicting backdrop underscored the "patient" attitude adopted by the Fed, which was generally accepted by the financial markets; following the meeting, traders and investors gave about even odds that the next rate move could be either up or down.

However, the backdrop heading into the upcoming meeting has shifted noticeably – as has market sentiment. Inflation is still running below the Fed's 2 percent inflation target, and the central bank no longer believes it will rise to that threshold any time this year. But the big difference now is that the economy's momentum that seemed to be building prior to the April meeting has fizzled out. Most incoming data over the past month have been weaker than expected, putting the second quarter on a growth track that is about half the 3.1 percent pace seen in the January-March period. Importantly, amidst this dimming economic backdrop the central bank is facing a more existential threat to the economy, as the trade friction that drew its attention at the last meeting has intensified considerably.

Indeed, the rift with Mexico over border security and the administration's threat to impose stiff tariffs on Mexican imports beginning Monday may have been the last straw prodding Fed officials to the more dovish side. Chairman Powell opined this week that the Fed was closely monitoring events on the trade front and would take appropriate action to sustain the expansion. To many in the financial markets, that opened the door to a rate cut sooner rather than later, a view buttressed by comments of other Fed officials, including St. Louis Fed president Bullock who signaled this week that an imminent cut was justified. As a result, the upcoming policy meeting has been put in play by the markets, which is pricing in a nontrivial chance (over 30 percent) that a rate cut might take place. Those odds increase dramatically for the July meeting, rising to over 70 percent, pointing to multiple rate cuts in 2019.

We do not believe that the Fed will take such an abrupt move away from its patient approach, although a rate cut before the end of the year is likely. The economy is cooling, as we expected, but it is not poised for a hard landing. For sure, some sectors are feeling significant pain inflicted by trade tensions and the global slowdown now underway. The main victim is manufacturing, which has been wallowing in the doldrums for months. Investment spending and the demand for capital goods have been weakening, mirroring trends in auto sales and exports and punctuated by the persistent decline in factory production since the end of last year. More industrial companies are expanding than contracting, but the latest ISM index of manufacturing activity released this week shows that the margin is rapidly narrowing, with the activity gauge in May the closest to the dividing line of 50 since the energy-related slump in the fall of 2016.

Slowing But Still Growing Manfacturing Activity

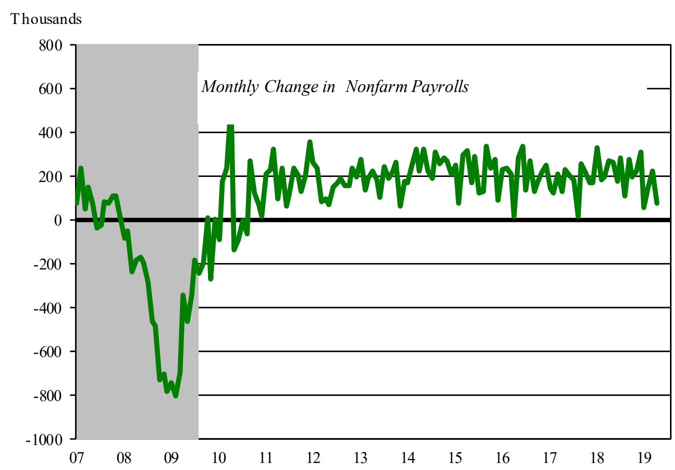


Clearly, the Fed is attuned to the ongoing weakness in industrial activity, particularly since it is so tightly linked to global developments and escalating trade tensions. However, until that weakness shows tangible signs of seeping into the broader service sector, policy makers are not likely to pull the rate trigger. So far, that has not been the case. Indeed, in contrast to the manufacturing gauge, the ISM index of non-manufacturing activity staged a notable rebound in May, reversing two months of declines. While that increase may not capture the recent escalation of trade tensions, the index, at 56.9 remains comfortably in expansion territory. That said, even the service-sector gauge is consistent with the cooling trend in overall activity, as it is measurably below the average of both the fourth quarter of last year and this year's first quarter.

Simply put, with the headwinds from trade tensions intensifying and the positive thrust from tax cuts enacted in late 2017 waning, the economy's growth engine has downshifted. The question is whether it is heading for a soft or hard landing. Clearly, if the full slate of tariffs on Mexico goes into effect, rising by 5 percent each month to 25 percent, accompanied by higher levies on all Chinese imports, the odds of a hard landing sooner than later would increase exponentially. As it is, the fixed income market is increasingly pricing in a hard landing, highlighted by plunging bond yields and an inverted yield curve. The stock market, however, is taking a different perspective, viewing bad news and good news because it enhances the odds of an imminent Fed easing that would rescue the economy from the grip of a recession. Stock prices rallied strongly this week on the back of dovish comments by Chairman Powell and other Fed officials.

From our lens, the economy is heading for a soft landing, notwithstanding a long list of weaker than expected economic reports. The latest was unveiled on Friday with the all-important jobs report for May. True to form, the Labor Department reported that the economy generated far fewer jobs than expected during the month. The consensus forecast was for a gain in nonfarm payrolls of roundly 175 thousand, but the actual increase was less than half that, coming in at 75 thousand. What's more, the increases over the previous two months were revised down by 75 thousand. Hence, over the past three months, the average growth in payrolls slipped to 151 thousand from a six-month average of 175 thousand and 196 thousand over the past twelve months.

Slowing Job Growth

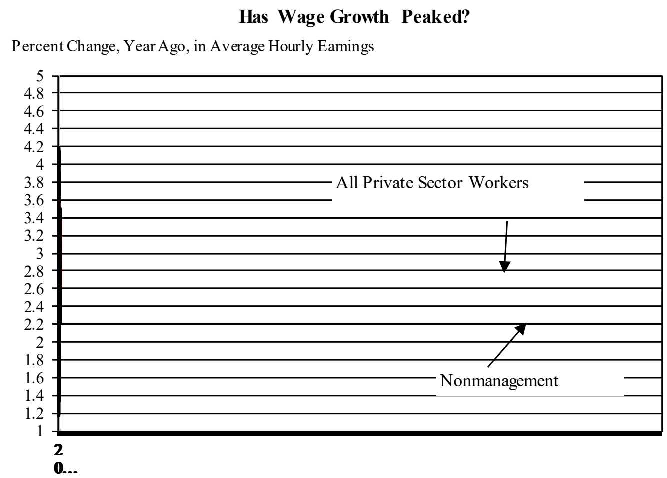


While the deceleration in job growth is clearly evident, it is not particularly ominous. Just as the initial estimate showing a blockbuster 263 thousand jobs increase in April (revised down to 224 thousand) was overblown, the much smaller 75 thousand gain last month probably reflects more noise than substance. The more interesting question is whether the modest trend softening in job growth to 151 thousand a month reflects waning demand for workers or a shrinking supply of workers available to fill positions. Most likely, the answer is both, but not of equal importance. For sure, some industries are seeing weaker demand for workers.

The aforementioned manufacturing sector is a prime example, as job growth at factories has virtually flatlined this year. Over the first five months, manufacturers have added a mere 6 thousand workers a month to payrolls, including 3 thousand in May, compared to an average of 22 thousand a month over the same period last year. Likewise, the beleaguered retail sector is coping with less foot traffic than last year owing to weaker consumer spending and the ongoing stiffer competition from online shopping. Retailers have actually been cutting payrolls, shedding an average of 8 thousand workers a month this year in contrast to the 10 thousand a month they hired over the same period last year.

But with the unemployment rate holding at a near 50-year low of 3.6 percent and companies aggressively luring marginal and sidelined workers back to the labor force (the broader U-6 unemployment rate fell to 7.1 percent, the lowest since December 2000) there is little question that the pool of available workers is shrinking, holding back employment gains. Indeed, the curbs on job growth from reduced slack in the labor market is confirmed by several sources, including the record number of job openings reported by small businesses as well as in the broader Jobs Openings and Labor Turnover Survey (the Jolts report) compiled by the Labor Department. The expansion is getting long in the tooth, and the economy has generated positive job growth for a record 104 consecutive months. It is only natural that finding qualified workers has become increasingly difficult.

But despite the ever-tightening labor market, there is no sign that it is on the verge of overheating. If that were the case, workers would be in a strong bargaining position, demanding – and getting – accelerating wage increases. But they are not. In fact, after reaching a cycle high of 3.4 percent in February, the annual increase in average hourly earnings has actually been slipping, falling to 3.1 percent in May. More recently, the deterioration has gotten worse. Over the past three months, the annual growth rate in earnings has slipped to 2.5 percent, the weakest since December 2017. On the positive side, middle-wage earners are faring relatively better, as hourly earnings of production and nonsupervisory workers have increased by an annual rate of 3.7 percent over the past three months. But even that metric has slowed from the pace at the start of the year, when it was advancing at a 4.0 percent annual rate.



The jobs report is not the last key economic indicator that the Fed will have in hand at its upcoming meeting on June 18-19. But unless data on retail sales, housing and industrial production that are scheduled prior to the meeting completely fall off the cliff, the economic backdrop should not push the Fed into a swift rate-cutting mode. However, the May jobs report is based on the Labor Department's survey taken in the week ending May 18, before the recent escalation of trade tensions with Mexico took hold. It's possible that some companies may curtail hiring until this issue is resolved, which would show up in the June employment report, released on July 5. If that results in another weak reading on the jobs front and the financial markets send a strong signal for the Fed to act, the odds of a rate cut at the July meeting would no doubt surge.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	**May 3**	**Week Ago**	**Month Ago**	**Year Ago**
3-month Treasury bill	2.28%	2.36%	2.44%	1.91%
6-month Treasury bill	2.16	2.37	2.45	2.11
3-month LIBOR	2.45	2.52	2.54	2.33
2-year Treasury note	1.86	1.94	2.27	2.49
5-year Treasury note	1.85	1.91	2.27	2.78
10-year Treasury note	2.08	2.13	2.47	2.95
30-year Treasury bond	2.57	2.57	2.89	3.09
30-year fixed mortgage rate	3.82	3.99	4.10	4.54
15-year fixed mortgage rate	3.28	3.46	3.57	4.01
5/1-year adjustable rate	3.52	3.60	3.63	3.74
STOCK MARKET				
Dow Jones Industrial Index	25983.94	24815.04	25942.37	25316.53
S&P 500	2877.34	2752.06	2881.4	2779.03
NASDAQ	7742.10	7453.15	7916.94	7645.51
Commodities				
Gold ($ per troy ounce)	1345.20	1310.10	1286.80	1303.1
Oil ($ per barrel) - Crude Futures (WTI)	54.10	53.35	61.74	65.64

ECONOMIC INDICATORS

	Latest Month/Quarter	**Previous Month/Quarter**	**Two-Months/ Quarters Ago**	**Average-Past 6 Months or Quarters**
ISM Manufacturing Index (May)	52.1	52.8	88.3	54.2
ISM Non-manufacturing Index (May)	56.9	55.5	56.1	57.2
Nonfarm Payrolls (May) - 000s	75.0	224.0	153.0	175.0
Unemployment Rate (May) - Percent	3.6	3.6	3.8	3.8
Average Hourly Earnings (May) - % change	3.1	3.2	3.2	3.3

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