WEEKLY
Economic Commentary

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Millennium
CORPORATE CREDIT UNION

Constructive comments on trade negotiations by government officials late in the week rescued the stock market from a potential meltdown. That said, no deal with China was struck by the end of the week, and a big hike in tariffs is on the books.

The Trump administration may be emboldened by the strong economy to make a risky bet on tariffs. Recent reports support that perception, as the economy's underpinnings remain solid. There is little sign that the job market is about to roll over; job vacancies remain high and the competition for workers intense.

Despite their stronger bargaining position, worker pay gains appear to have stalled out, perhaps reflecting concerns that trade tensions will weaken job prospects going forward. Job hopping has eased a bit in recent months. Still, worker pay is handily outstripping inflation, resulting in historically favorable increases in purchasing power.

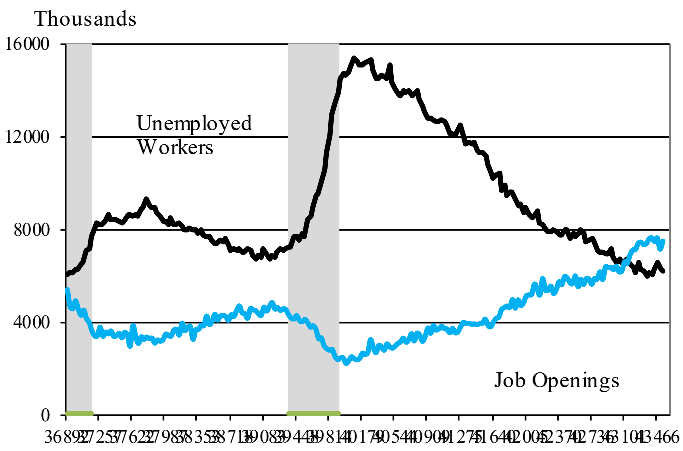
The U.S./China trade negotiations took a nasty turn this week, shattering investor complacency that an imminent deal was in the works. As speculation grew that talks were breaking down, investors ran for the hills, dumping risky assets in favor of safe havens. Stock prices suffered their worst weekly setback this year while the bellwether 10-year Treasury yield slid six basis points, ending the week at 2.47 percent. Investors woke up on Friday morning with news that their worst fears were realized; the Trump administration had followed through with its threat to hike tariffs on $200 billion of Chinese imports from 10 percent to 25 percent, effective immediately. Worse, preparations for additional levies on the remaining $325 billion of Chinese goods were being made, prompting a swift response by Beijing that appropriate retaliatory measures would be forthcoming. Simply put, we may be on the cusp of an all-out trade war.

Whether a full-fledged conflagration unfolds, which would have meaningful consequences for the U.S. as well as the global economy, remains to be seen. The tariffs are not etched in stone; if the negotiations, which resumed on Friday, bears results, they could well be rescinded and future levies, now in the planning stage, would be aborted. Indeed, a sense that a deal will be ultimately be consummated restrained the market setback. Vice President Mike Pence provided a hopeful sign on Thursday evening, opining that he and his colleagues believe that a deal is possible, and Treasury Secretary Mnuchin followed up with some encouraging remarks on Friday afternoon. Their comments put a floor under the market's slide and spurred a rally as the week's trading drew to a close. Nonetheless until ink is put on paper and negotiators shake hands across the table, investor angst will remain high, setting the stage for heightened market turmoil in coming days and weeks.

No doubt, President Trump is emboldened to take a risky bet on the trade front by the recent spate of strong economic data. The economy just recorded a deceptively solid first-quarter growth rate, the job market continues to run hot, and households have stepped up spending, keeping momentum going into the second quarter. This week's calendar was on the light side but it is poised to fill up next week with a full slate of data on retail sales housing activity and industrial production, which will shed more light on the economy's strength at the start of the spring quarter. If the blockbuster employment report for April is any indication, the demand side of the economic ledger remains firm, as the muscular job market continues to buoy household spirits.

The Labor Department's Job Openings and Labor Turnover Survey, the so-called Jolts report, released this week, confirms that strength. While the survey is for March, it covers data on the last day of the month and, hence, blends information from both the March and April employment reports whose surveys are taken around the middle of each month. While there was some ambivalence in the Jolts report – hiring eased a bit while job vacancies rebounded strongly – it corroborates the notion that the labor market continues to tighten. The key metric is the one that describes where the competition is greatest – between companies competing for workers, or between unemployed workers competing for jobs. The hands down winners are workers, as the number of job openings exceeded unemployed workers for a record thirteenth consecutive month in March.

Unemployed and Job Openings



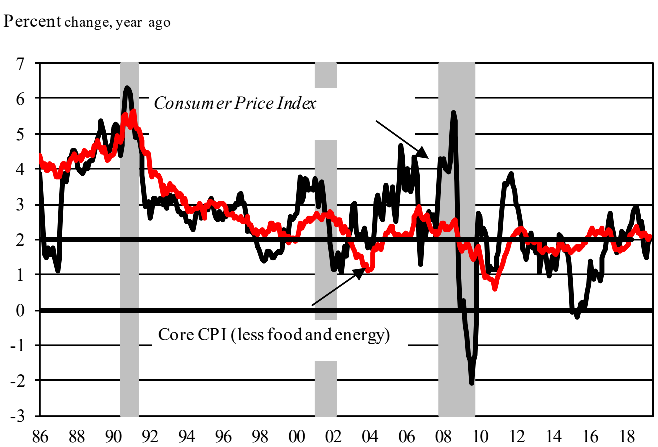
On the surface, this would indicate that workers are in a strong bargaining position to demand higher wages. But they were not as feisty in April as the imbalance between demand and supply for jobs suggests. Indeed, the annual growth rate in average hourly earnings has virtually stalled out over the past seven months, hovering around 3.2 percent again in April. This may suggest that workers are becoming somewhat less confident about job security, perhaps reflecting the steady dose of headline reports depicting the prospective economic damage associated with the U.S./China trade dispute. The Jolts report does sound a cautionary note on this score; the number of workers voluntarily quitting their jobs fell in February and March, the first back-to-back declines since late 2017.

Keep in mind too that a time-honored catalyst spurring worker pay demands is not as potent as in the past. Historically when the economy is strong, workers strive to keep up with inflation, pressuring their employers to at least compensate them for actual and expected price increases. But against the persistently weak inflation backdrop during the current cycle, that has not been as pressing an issue. Hence, while nominal pay increases during the current upswing have been slower than in past cycles, the gain in real earnings has been more than respectable. In April, the increase in average hourly earnings for all private sector workers outpaced the inflation rate, as measured by the consumer price index, by 1.2 percent. The gain in real earnings was even stronger for rank-and-file workers, clocking in at 1.4 percent.

The bad news is that the annual increases slowed from nearby peaks set in February of 1.9 percent for all workers and 2.1 percent for production and nonsupervisory workers. That said, the current increases in purchasing power compares favorably with most past expansions. Indeed, since 1964 the increase in real hourly earnings has averaged only 0.3 percent a year. What is more, inflation expectations have remained firmly contained and are even softening according to recent household surveys. There is little in the latest batch of inflation data that would reverse that sentiment.

On Friday, the Commerce Department reported that the consumer price index increased by 0.3 percent in April, less than the consensus expectation of a 0.4 percent increase. If not for the second consecutive month of hefty gasoline price increases, the increase would have been much smaller. The core CPI, which excludes volatile food and energy prices, inched up by only 0.1 percent, also weaker than the consensus forecast of a 0.2 percent increase. Over the past year, headline CPI increased by 2.1 percent and the core by 2.0 percent. Both gauges are firmly ensconced in a narrow range around 2.0 percent that has prevailed for more than a decade, with little sign of breaking out.

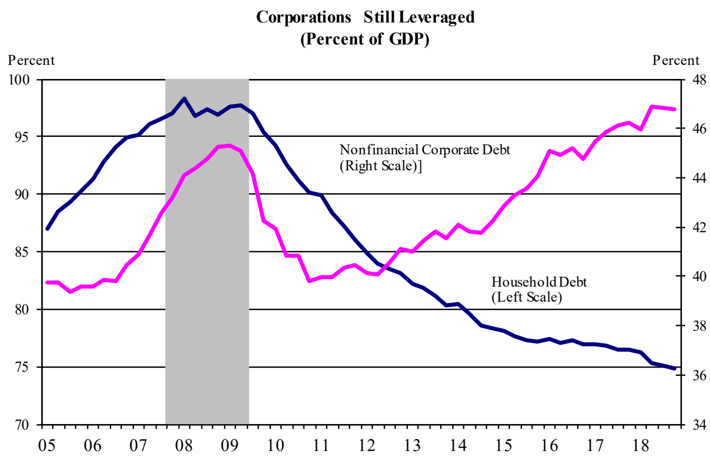
Inflation Still Tame



That's good news for consumers but a remains a source of angst for the Federal Reserve, as its preferred inflation measure has remained stubbornly below its 2.0 percent target for most of the past six years. Indeed, the increase in the core personal consumption deflator, which is the favored inflation gauge, slipped to 1.6 percent, year-over-year, in March from 2.0 percent at the end of last year. The persistence of low inflation has contributed to the Fed's decision to pull back from its rate-hiking campaign and continues to fuel market expectations that the next move will be a rate cut rather than an increase. For its part, the Fed maintains that the recent slippage in the inflation rate is due primarily to transient forces that will reverse in coming months. By retaining that perception, the Fed is keeping alive the possibility of another rate increase if the economy performs up to its expectations over the next year or two. From our lens, the final increase for the cycle was taken last December.

With policy on hold for the foreseeable future, the Fed briefly turned its attention to the health of the financial system this week, issuing its second Financial Stability Report. Like the first, issued last November, the current report finds that the financial sector remains in generally good shape. Banks and other institutions have greatly strengthened their balance sheets compared to the sorry state that prevailed prior to the financial crisis. Banks are well capitalized, broker-dealers have reduced their leverage and insurance companies have shored up their financial positions. There is no worry about a systemic meltdown that preceded the Great Recession.

But the Fed did highlight some concerns about asset valuations, which remain elevated as investors continue to pursue risky assets to obtain better returns in a low interest rate environment. It also noted the huge debt buildup on the books of corporations since the recession, in contrast to the significant deleveraging by households over the same period. From a peak of 45.3 percent of GDP in 2009, nonfinancial corporations briefly ran down their debt loads to a low of 39.8 percent of GDP in 2010. Since then, however, they have aggressively issued debt to a willing investor base, driving the debt ratio up to a record of nearly 47 percent last year. Fortunately, corporations have easily covered the interest expense of this massive borrowing, as profits and cash flow have more than kept pace. The question is whether their debt-servicing capacity will be sufficient when profits turn negative.



Households, however, have slashed debt burdens by a considerable extent since the recession, both relative to GDP and to disposable incomes. At issue here is not whether households can meet their debt obligations, which is not a concern at the moment, but whether they will retain an appetite to borrow and spend and, therefore, sustain the expansion. So far this year they have continued to take on debt, but a slower pace than in recent years. We suspect that trend will continue and contribute to a slowdown in consumer spending later this year.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	May 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.44%	2.44%	2.44%	1.92%
6-month Treasury bill	2.45	2.46	2.46	2.06
3-month LIBOR	2.54	2.57	2.60	2.36
2-year Treasury note	2.27	2.34	2.40	2.55
5-year Treasury note	2.27	2.34	2.38	2.83
10-year Treasury note	2.47	2.53	2.56	2.97
30-year Treasury bond	2.89	2.92	2.98	3.10
30-year fixed mortgage rate	4.10	4.14	4.12	4.55
15-year fixed mortgage rate	3.57	3.60	3.60	4.01
5/1-year adjustable rate	3.63	3.68	3.80	3.77
STOCK MARKET				
Dow Jones Industrial Average	25942.37	26504.95	26412.3	24831.17
S&P 500	2881.4	2945.64	2907.41	2727.72
NASDAQ	7916.94	8164.00	7984.16	7402.88
Commodities				
Gold ($ per troy ounce)	1286.80	1280.20	1294.10	1319.2
Oil ($ per barrel) - Crude Futures (WTI)	61.74	61.90	63.78	70.57

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Producer Price Index (April) - % change	0.2	0.6	0.1	0.1
Consumer Price Index (April) - % change)	0.3	0.4	0.2	0.2
Core CPI (April) - % change	0.1	0.1	0.1	0.1
Consumer Credit (March) - $blns	10.3	15.5	17.2	16.2
Trade Deficit (March) - $blns	50	49.3	51.1	52.9

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