WEEKLY

Economic Commentary

May 17, 2019

Millennium
CORPORATE CREDIT UNION

The data calendar filled up this week and the results were nothing to write home about (see last page of this report) – but nothing to get too concerned over. Yes, growth is poised to slow from the surprisingly robust 3.2 percent annual rate set in the first quarter. That much was established the moment the ink was dry on the preliminary GDP report, which revealed that the period's strength came mostly from unsustainable sources, notably inventories and trade. Both will be drags in the current quarter, more than offsetting an expected pickup in the economy's main growth drivers – consumer and business investment spending.

That dynamic has not changed despite mixed readings on consumers in recent months and gathering headwinds buffeting investment decisions. The wild card, as has been the case since late last year, is the unpredictable response of the financial markets as well as of the mind-set on Main Street to the steady drumbeat of nerve-racking news on the trade front. The twists and turns in the dispute with China continue to grab headlines and send the markets into fits of convulsion. Stock prices initially plunged following last week's news that negotiations broke down and the U.S. would hike tariffs on $200 billion of Chinese imports from 10 percent to 25 percent and threatened to assess levies on an additional $300 of Chinese goods. The pullback sounded a downbeat note at the start of the week, stoking fears that an all-out trade war would simultaneously stifle growth and lift inflation, resulting in the dreaded stagnation that has few, if any, acceptable policy prescriptions.

It's pure speculation to say that the administration "got the message" implied by the 617-point dive in the Dow Industrials on Monday. But soon thereafter, the White House was sounding all the right notes, postponing tariffs on auto imports scheduled to take effect on Saturday and announcing it was removing tariffs on steel and aluminum imposed on Canada and Mexico. It even signaled that talks with China could yet bear fruit at the G-20 summit in late June, when president Trump and Chairman Xi are scheduled to meet. Not surprisingly, stocks rebounded over the next three days, erasing almost the entire loss suffered on Monday. Those hopeful signs on the domestic front, however, were not reciprocated in China, as media reports there on Friday suggested that Chinese officials were in no mood to accept the demands made by the Trump administration. It takes two to tango, so market jitters once again flared up at the end of the week, sending stock prices down. This saga is far from settled.

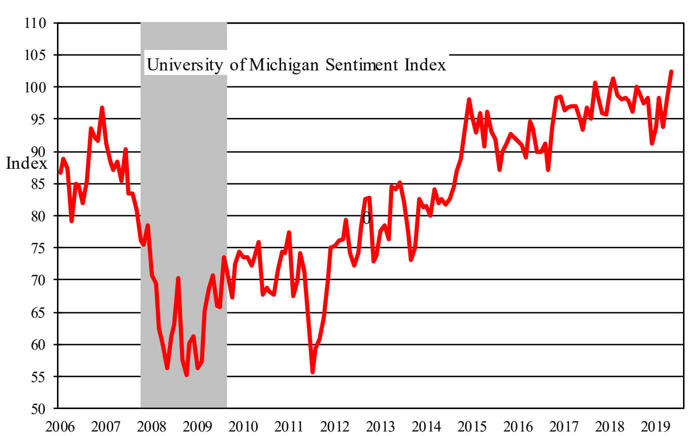
No doubt, if the gyrations on Wall Street continue unabated in coming months, Main Street will feel the tremors. The adverse, if temporary, impact that the harsh market correction late last year had on consumer spending early this year is a stark reminder of that prospect. So far, however, neither households nor businesses are showing ill effects from the markets' peripatetic response to the trade imbroglio. One reason, of course, is that investor anxiety has not put much of a damper on the stock-market rally since the start of the year. Despite the recent skid, including five consecutive weeks of declines, the main indexes are still up considerably so far this year.

What's more, growing concerns in the fixed income market over economic and inflation prospects are providing benefits for the denizens on Main Street, lowering the cost of borrowing. The bellwether 10-year Treasury yield ended the week at just under 2.40 percent, which is nearly a full percentage point below the 3.25 percent peak seen last November. Mortgage rates, which are linked to the Treasury yield, have responded accordingly, falling from 4.96 percent to the current 4.07 percent over the same period.

The steep drop in the cost of financing a home purchase is already having results; mortgage applications are running well ahead of last year, which augurs favorably for home sales this summer.

To be sure, the decline in interest rates is also a reflection of perceived economic weakness that, if realized, would more than undercut the incentive of households to take on new debt, much less step up purchases of big-ticket items. As it is, their love affair with autos has already cooled off, as sales are down meaningfully from last year's pace. But consumers are still in a buying mood and spirits are high. Indeed, the latest University of Michigan sentiment survey painted a particularly upbeat picture, with its overall index surging to the highest level in fifteen years in early May. But the survey was taken before the recent escalation of trade hostilities, which are expected to take some of the glow off of the final reading later this month.

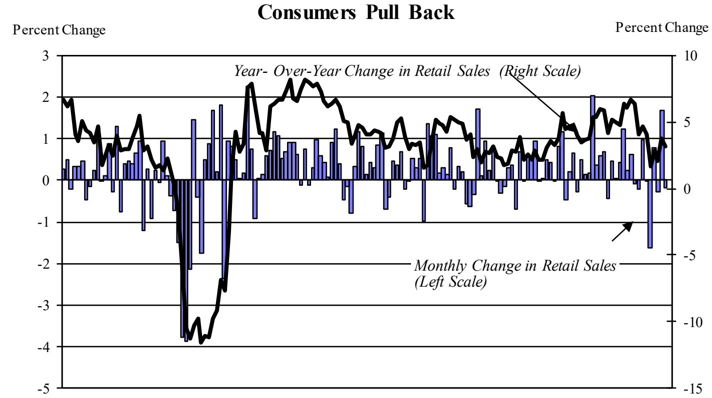
Household Confidence Jumps



Importantly, while households may be optimistic about the economy, they are not following through with their wallets. After rebounding in March, consumers took a spending breather in April, as retail sales were disappointingly soft. Total sales slipped 0.2 percent during the month, short-circuiting the momentum generated by the robust 1.7 percent advance in March. The weakness was broad based, with most major spending categories posting declining sales. Leading the way, as noted above, were auto sales, which fell by 1.1 percent during the month, the third decline in the first four months of the year. If not for the drag from autos, sales would have been up by a slim 0.1 percent last month. But even that gain is dubious, as it was inflated by the rise in receipts at service stations, which benefited from a 5.7 percent surge in gasoline prices. Strip away both autos and gasoline purchases, and you are left with the same 0.2 percent decline recorded for total retail sales.

Retail sales account for only about one-third of total personal consumption, but it provides a sense of how this key growth driver is stacking up as the second quarter gets underway. Unless spending falls off a cliff in May and June, the period should look much better than the dismal showing in the first quarter, when personal consumption advanced by a listless 1.2 percent annual rate. The reasons behind the expected improvement are both statistical and substantive. Statistically, the second quarter is starting from an elevated base, thanks to the sturdy rebound in spending in March, the final month of the first quarter. Hence, even if spending flattens out in May and June, the average for the quarter will yield a larger gain than in the first quarter.

Consumers Pull Back

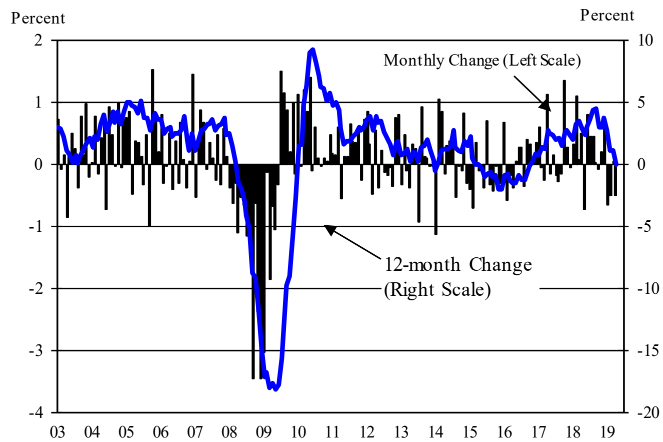


For another, consumers are in a better place than they were at the start of the year. Back then they were licking their wounds from a brutal stock market correction, a record-long government shutdown and the flare-up of trade tensions with China. The first two of those headwinds are now a memory, while the third continues to occupy headlines. But the recession fears that took hold earlier in the year have abated, as the job market has retained its remarkable strength, real wage growth has continued to strengthen and the Federal Reserve has pulled back from its rate-hiking campaign. With the stock market recovering most of the losses suffered late last year and confidence climbing, the underpinnings for a decent rebound in consumer spending are firmly in place. We expect personal consumption to stage a 2.5 percent increase in the current quarter, more than double the gain in the first.

Similarly, we expect a modest pick-up in business investment spending this quarter. Corporations are flush with funds, reflecting robust profits growth and copious borrowing at low rates, and energy-related outlays should get a boost from strengthening oil prices. As well, rising labor costs and worker shortages should spur companies to step up spending on productivity-enhancing equipment and software. New orders for capital goods have increased in each of the first three months of the year. For the most part, business leaders are optimistic despite misgivings over tariffs and slowing global growth. The latest Business Roundtable outlook index, measuring sentiment among the CEOs of the nation's largest corporations, remains at historically high levels, albeit it has softened in recent surveys.

That said, businesses are more closely attuned to global developments than are consumers, and the headwinds from mounting trade barriers and weakening global growth are having a nontrivial impact on activity. Industrial production fell 0.5 percent in April, pulled down by a 0.5 percent slide in manufacturing output. The setback at factories was the third in the last four months and erased all of the gains over the past year. In April, manufacturing output stood even with the level of a year-earlier, the weakest year-over-year reading since October 2016. Declining auto production has played a big role, reflecting the aforementioned slippage in auto sales. When production is brought into better balance with auto sales, that source of weakness should ease.

Setback in Manufacturing Output



But more concerning is the 2.1 percent decline in business equipment output, which is linked to capital spending. That decline matches the steepest monthly fall-off since the Great Recession and could be a sign that global developments are starting to take a bigger bite out of corporate spending plans. However, this is a volatile series, and the April setback follows a 0.7 percent increase in March. Encouragingly, more recent regional surveys of manufacturing activity, including the New York and Philly surveys, reveal some snapback in activity during May. If trade tensions ease and final demand holds up, as we expect, investment spending should make a stronger contribution to growth this quarter than in the first.

As noted at the outset, the latest reports are neither a glowing testament on the economy nor a reason to worry about the near-term outlook. We expect that the headline growth in GDP will slow from the first-quarter's pace, but the underlying fundamentals will look stronger in the second quarter, thanks to a pick up in both consumer and business spending. But the economy is not off to the races and it could readily stumble if an all-out trade war with China erupts. That disturbing prospect along with persistence of low inflation heightens the odds that the Federal Reserve will lend the economy a helping hand later this year, reversing course with its first rate cut since the recession.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	May 3	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.39%	2.44%	2.42%	1.90%
6-month Treasury bill	2.42	2.45	2.47	2.10
3-month LIBOR	2.52	2.54	2.58	2.33
2-year Treasury note	2.20	2.27	2.39	2.54
5-year Treasury note	2.18	2.27	2.37	2.89
10-year Treasury note	2.39	2.47	2.56	3.06
30-year Treasury bond	2.82	2.89	2.96	3.20
30-year fixed mortgage rate	4.07	4.10	4.17	4.61
15-year fixed mortgage rate	3.53	3.57	3.62	4.08
5/1-year adjustable rate	3.66	3.63	3.78	3.82
STOCK MARKET				
Dow Jones Industrial Index	25764	25942.37	26559.54	24715.89
S&P 500	2859.53	2881.4	2905.03	2712.97
NASDAQ	7816.28	7916.94	7998.06	7354.34
Commodities				
Gold ($ per troy ounce)	1277.60	1286.80	1277.90	1291.8
Oil ($ per barrel) - Crude Futures (WTI)	62.68	61.74	64	71.36

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Retail Sales (April) - % change	-0.2	1.7	-0.3	0.1
Industrial Production (April) - % change	-0.5	0.2	-0.5	-0.1
Capacity Utilization (April) - Percent	77.9	78.5	78.5	78.8
Housing Starts (April) - 000s of units	1235	1168	1149	1198
Building Permits (April) 000s of units	1296	1288	1291	1307

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