WEEKLY

Economic Commentary

October 11, 2019

Millennium
CORPORATE CREDIT UNION

Signs of progress on the trade front brightened the economic and financial landscape this week, sending stock prices up for the first time in four weeks. Hopes that a meeting between president Trump and the Vice Premier of China on Friday would produce a limited deal on some non-core issues, including a possible suspension of tariffs scheduled to go into effect on December 15, sparked the rally. In addition to promising developments on the home front, some positive signals regarding Brexit negotiations also fueled optimism that trade tensions would simmer down, removing major drags on the U.S. and global economies.

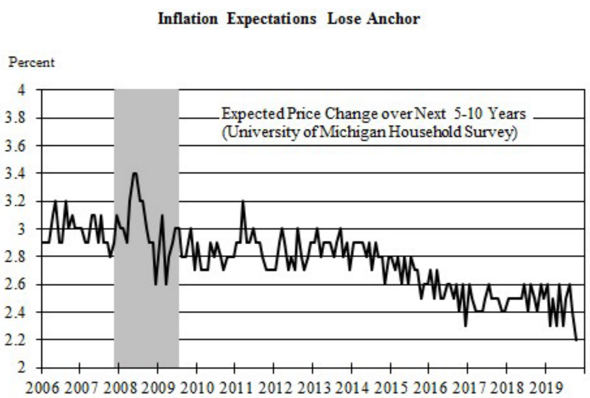
To be sure, there have been so many ups and downs in the 15-month trade war between the U.S. and China that only the most diehard optimist could believe a comprehensive solution is at hand. Likewise for the Brexit negotiations, which got a lift from an encouraging meeting between the leaders of Ireland and Britain. But here too, the best likely outcome that could be expected is another delay in the October 31 deadline for the UK to exit the European Union. That said, while these positive signals provide immediate gratification for the financial markets, they are not likely to put an end to the lingering uncertainty over trade policies that have become firmly embedded in the minds of skeptical investors. Another breakdown in negotiations, a nontrivial prospect, could well darken the mood in the markets as rapidly as this week's promising signs brightened it.

And while investors were encouraged by trade developments, they still expect the Fed to cut interest rates again at the October 29-30 policy meeting. The confidence level has diminished somewhat, as the markets on Friday priced in just over a 70 percent chance of a cut, significantly lower than the over 80 percent that prevailed just before the positive trade news surfaced. For its part, the Fed remains divided on the need, timing and scope of future reductions. That dispersion of opinion was amply revealed in the minutes from the last meeting in September, which produced the second quarter-point reduction this year, as well as remarks from policymakers over the past week. Nonetheless, all the policymakers recognize the growing risks that trade tensions and deteriorating conditions overseas pose to the economy, particularly the impact they are having on business confidence and investment spending. The Fed may be divided but it still retains an easing bias.

That bias should tilt more in the easing direction following this week's economic reports. Indeed, among the array of indicators the Fed follows, the one mainstay that has long diluted its rate-cutting propensity may be falling by the wayside. Even as the Fed shifted gears away from the 2018 tightening cycle this year, it has maintained that inflation was poised to increase towards its 2 percent target. Of course, this prediction, based on time-honored economic relationships such as wage growth and unemployment, has failed to materialize since the 2 percent target was officially established in April 2012. But even as inflation has consistently undershot its target, the Fed drew encouragement from its belief that inflation expectations were "well anchored". That perception, in turn, served as a bulwark against concerns that deflationary forces would gain traction amidst slowing economic growth.

Even as inflation expectations in the financial markets have steadily declined since last October - with the 10-year breakeven inflation rate plunging from 2.17 percent to the current 1.52 percent - they have remained relatively steady on Main Street. According to the University of Michigan consumer sentiment surveys, expected inflation over the next five to ten years hovered between 2.3 and 2.6 percent throughout the past four years. However, the latest survey results for early October, released on Friday, revealed a break in expectations through the lower threshold, dropping to 2.2 percent. Not only was this the first time it pierced the bottom of the narrow range in effect since early 2016, it marks the lowest reading on inflation expectations in the history of the survey results, dating back to 1990.

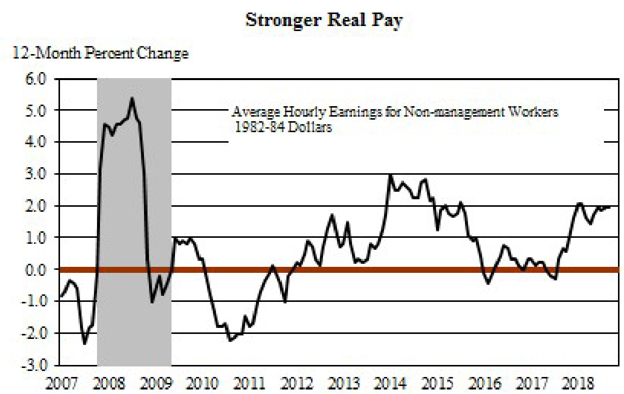
To be sure, this was a preliminary finding that could be revised upward in the final reading for the month. What's more, at 2.2 percent households are far from being pulled into a deflationary mindset that would encourage them to postpone spending in anticipation of lower prices down the road. That vicious cycle in which a delay in consumer purchases contributes to lower prices that spurs a further spending pullback is



what strikes fear in the minds of policymakers. Still, the decline in inflation expectations has to be disconcerting, particularly since it is now aligned with the trend in the financial markets. Importantly, the actual movement in inflation, revealed in the latest report on consumer prices this week, provides little reason to believe that expectations will be lifted anytime soon.

In September, the consumer price index was unchanged from the previous month, thanks mainly to a decline in energy prices, while the core CPI, which excludes volatile food and energy items, inched up by 0.1 percent. Both readings came in below expectations, with the most dramatic pullback seen in the core CPI, which had advanced by a robust 0.3 percent in each of the previous three months. The Fed's preferred inflation gauge, the personal consumption deflator, will be released later this month for September, but the CPI report strongly indicates that both the overall PCE deflator and the core deflator will come in well below the 2 percent target.

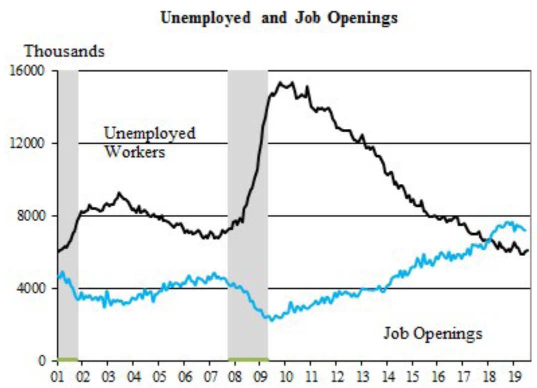
The good news is that the muted inflation trend is enhancing the purchasing power of households, a modest plus for the spending outlook. Hence, despite a disappointingly weak increase in hourly earnings last month, as revealed in the September jobs report, worker paychecks will go a longer way. That's particularly the case for non-management workers, which comprise more than 80 percent of the workforce. Their hourly earnings increased by 1.9 percent adjusted for inflation over the past year, which is firmly in the upper half of the range for real pay gains since the mid-1960s when records began for this measure. As long as the job market remains in a healthy state, households are in a good position to keep their wallets open and power the economy forward over the foreseeable future.



Of course, that's where the rubber meets the road. If the job market weakens and stokes an increase in worker insecurity, all bets are off. Then the elevated cushion of savings - the personal savings rate rose to over 8.0 percent in August - becomes not a source of spending firepower but a safety net to guard against adversity. At this juncture, the job market is flashing mixed signals. As confirmed by the September employment report, job growth has been slowing this year, but it is unclear how much of the slowdown is due to weaker demand for labor or a shortage of workers available to fill position. Both sides of the issue have supporting evidence.

The most dramatic evidence of worker shortages is the drop in the unemployment rate to a near 50-year low of 3.5 percent in September. While most agree that this low rate overstates the degree of tightness in the labor market, there is little question that a wide swath of businesses are finding it ever harder to find qualified workers to fill position. Even at the slower rate of job growth this year, the increases in payrolls are exceeding the growth in the working-age population. In the latest Job Openings and Labor Turnover Survey compiled by the Labor Department, there were 1.1 million more job openings than job seekers.

Yet there is plenty of evidence that indicates the demand for workers is starting to ebb. In that same so-called JOLTS report, the number of job openings retreated for the third consecutive month in August, slipping to 7.05 million; that's almost 1/2 million below the level at the start of the year. Hiring also ticked lower during the month and the quit rate, a measure of worker confidence in finding another job, likewise slipped from an 18-year high in July. Other private surveys depict weakening trends in labor demand. The National Federation of Independent Businesses reports that their small business members are scaling back hiring as well as planned wage increases for their workers. The latter may reflect a profits squeeze caused by a lack of pricing power, but it is unlikely that businesses would trim pay raises if they desperately needed to hire more workers.



Simply put, the economic and inflation data since the September policy meeting should tilt the Fed towards another rate cut at the upcoming meeting later this month. Ironically, a key negative influence behind many of the weaker than expected economic reports is the escalation of trade tensions that may well be dialed down if the positive tweets by President Trump following Friday's meeting with Chinese negotiators leads to a more comprehensive and constructive deal than anticipated. If that turns out to be the case, the economy would likely benefit from a powerful stock market rally and upsurge in household confidence that could weaken the case for the more aggressive rate cuts that Trump is urging on the Fed.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	October 11	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.68%	1.71%	1.96%	2.23%
6-month Treasury bill	1.68	1.65	1.92	2.42
3-month LIBOR	1.99	2.04	2.12	2.41
2-year Treasury note	1.59	1.40	1.80	2.89
5-year Treasury note	1.56	1.35	1.76	3.07
10-year Treasury note	1.73	1.53	1.90	3.23
30-year Treasury bond	2.20	2.02	2.38	3.41
30-year fixed mortgage rate	3.57	3.65	3.56	4.71
15-year fixed mortgage rate	3.05	3.14	3.09	4.15
5/1-year adjustable rate	3.35	3.38	3.36	4.01
STOCK MARKET				
Dow Jones Industrial Average	26816.59	26573.72	27219.52	26447.05
S&P 500	2970.27	2952.01	3007.39	2885.57
NASDAQ	8057.04	7982.47	8176.71	7788.45
Commodities				
Gold ($ per troy ounce)	1492.42	1510.10	1496.20	1207.00
Oil ($ per barrel) - Crude Futures (WTI)	54.86	52.95	54.90	74.30

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (Sept) - % change	0.0	0.1	0.3	0.2
Core CPI (September) - % change	0.1	0.3	0.3	0.2
Producer Price Index (Sept) - % change	-0.3	0.1	0.2	0.1
Consumer Credit (August) - $blns	17.9	23.0	13.3	16.3
Small Business Optimism Index (Sept)	101.8	103.1	104.7	103.6

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