



WEEKLY

Economic Commentary

October 18, 2019

It was not a good week on the economic front, although some positive earnings surprises and mildly encouraging news on the trade front supported a modest gain in stock prices until a late-day setback took hold on Friday. Nothing is written in stone yet, but a limited trade deal with China may be close at hand, and Brexit negotiations may be near a fruitful conclusion if the British Parliament approves the deal Boris Johnson struck with the EU leaders in Brussels. Anything that dials down trade and geopolitical friction strikes a positive chord with investors who have been buffeted by tumultuous crosscurrents for more than a year.

That said, it is important to note that a pending trade deal with China only affects new tariffs, including those scheduled to take effect on December 15 involving \$160 billion of mostly consumer goods. Nothing visible in the current negotiations indicates that existing tariffs on the more than \$350 billion of Chinese imports will be rolled back. Hence, the disruptions to global supply chains remain very much an ongoing process, and the higher costs on imported goods from existing tariffs continue to raise production costs, which will either squeeze profits or result in higher prices for consumers. Meanwhile, new tariffs on \$7.5 billion of imports from Europe took effect this week, and there's the real possibility that the U.S. will attach levies on auto imports next year.

Simply put, trade uncertainty that has been a dark cloud overhanging the economic and financial landscape for some time is not going away anytime soon. To date, its impact on the U.S. economy has not been severe, but it remains a significant concern to policy makers, including the Federal Reserve, and poses a major threat to global growth according to the I.M.F. and other international institutions. Indeed, the I.M.F. just sliced 0.3 percentage points from its April global growth forecast for 2019 to 3.0 percent, which would be the weakest performance since the global financial crisis a decade ago. While the I.M.F. expects a rebound next year driven by a growth pickup in emerging markets, it still forecast even slower growth in the U.S. from an estimated 2.4 percent this year to 2.1 percent in 2020.

From our lens, even that is an overly optimistic assessment of U.S. prospects. The I.M.F. correctly identifies one headwind that will impede growth next

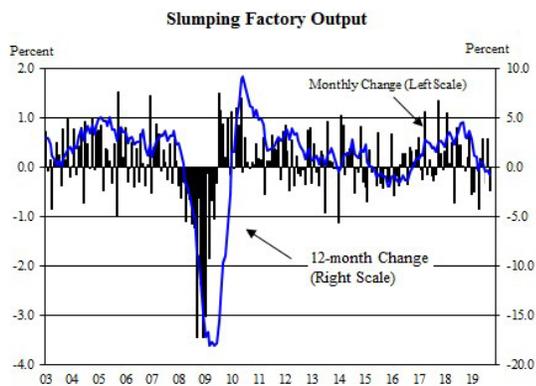
year, the fading of fiscal stimulus from the 2017 tax cuts that imparted a brief but strong boost to business and consumer spending. But the stimulus has not had as lasting an effect on growth as the administration anticipated, in large part because of the confidence-shattering impact that escalating trade tensions has had on business confidence, underpinning a pullback in investment outlays and reinforcing deteriorating conditions in the industrial sector. Manufacturing activity has been buffeted by an array of shocks in recent years, including a recession in the oil patch and a plunge in exports stemming from weakening global growth as well as the tariff wars that have decimated trade flows.

One outcome is that manufacturing activity has still not recovered the ground lost during the Great Recession in 2008-2009. Since records began in 1972, it has never taken this long during an expansion for factories to recoup the production losses from the previous recession. Admittedly, it would be a mistake to blame the manufacturing shortfall entirely on external shocks, as offshoring and other secular forces have impeded the recovery in industrial activity. That said, the trend is moving in the wrong direction, making the uphill climb to recoup the 1.8 percent shortfall from the prerecession peak in output that much steeper.



In September, manufacturing output fell 0.5 percent, driving it deeper into recession territory. Compared to a year ago, factory production has contracted by 0.8 percent, the steepest negative reading since the summer of 2016, the tail-end of the energy-related slump. True, the latest setback was heavily

influenced by a plunge in auto output, as plants were shuttered by the GM strike. But the weakness extended well beyond the auto sector, as the collective output of nonauto manufacturers fell by 0.2 percent. Most disconcerting is the ongoing weakness in business equipment output, which fell by a hefty 0.7 percent last month, leaving it 0.8 percent below the year-earlier level. That's the steepest annual contraction in business equipment since January 2017, highlighting the ongoing weakness in investment spending.



Odds are, auto output will rebound this month if union members approve the deal its leaders struck with GM management this week. However, we see little momentum that would lift overall industrial output out of the doldrums in the foreseeable future. Export orders are plunging and investment spending remains constrained by sluggish global growth and trade uncertainty. A key objective of President Trump in the trade wars was to bring production and jobs back to the U.S., but the results have so far not lived up to this lofty goal. Instead of re-starting operations in the U.S. many firms are considering shifting their supply chains and imports from China to other low-cost nations, such as Vietnam, which are not subject to tariffs. Meanwhile, payroll growth at factories has averaged a mere 4.6 thousand a month this year, a far cry from the 22 thousand monthly average in 2018.

By itself, the weakening trend in manufacturing would not bring the economy to its knees. The goods-producing sectors carry less weight today

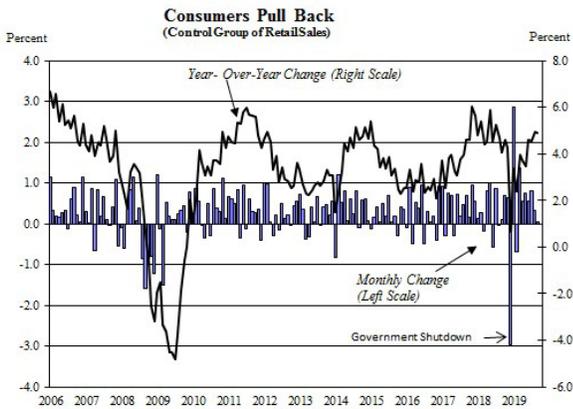
than it did in earlier decades, as service providers account for an increasing share of the nation's output. Likewise, manufacturing jobs account for only 8 percent of total nonfarm payrolls, about half the share in the mid-1990s. Nonetheless, except for the energy-related slump in 2015 through the middle of 2016, every extended setback in industrial output during the postwar period has coincided with a recession, reflecting the outsize cyclical influence that industrial activity has on the overall economy. That said, it would require a deeper contraction in industrial activity than in the past to short-circuit the expansion this time, something that we do not expect.

The key to the expansion's future rests heavily with consumers, the economy's main growth driver. For the most part their behavior has been a bright spot this year, supported by the positive fundamentals of a solid job market, low interest rates, expanding incomes and an elevated level of confidence. Against this positive backdrop consumers flexed their spending muscles aggressively in the second quarter, staging an eye-opening 4.6 percent increase in personal consumption, matching the strongest increase since the fourth quarter of 2014. That surge in spending more than offset the drag from declining investment outlays and exports to support a modest 2.0 percent growth rate in GDP during the period.

But don't expect that level of support in the third quarter. While the fundamental backdrop remains mostly intact, cracks are starting to show. Job growth is slowing, wage increases have stagnated and confidence levels are well off their peaks. Not surprisingly, consumers are turning more cautious, shoring up savings and spending less freely. The pullback was strikingly evident in September, as reported by the Commerce Department this week. During the month retail sales fell 0.3 percent, snapping six consecutive months of solid gains. Importantly, the weakness was broadly based. While a surprisingly sharp fall in auto sales and an expected decline in gasoline sales were the biggest drags, receipts were down at virtually all other retailers except pharmacies and health stores.

Hence, excluding volatile auto and price-driven

gasoline sales, which were pulled down by falling prices at the pump, sales were unchanged last month. Even the relentless increase in online sales was arrested, as nonstore receipts fell for the first time this year. Importantly, the combination of sales that feed directly into person consumption in the GDP accounts, the so-called control group, was flat for the month. Hence, while consumers still did the heavy lifting in the third quarter, they provided considerably less oomph to overall growth than in the second quarter. We estimate that personal consumption increased by a much more modest 2.3 percent pace, about half the increase in the second quarter, and its reduced contribution will result in a sluggish GDP growth rate of less than 1.5 percent.



But despite the reduced momentum, the economy should remain on a positive footing heading into the final quarter of the year. A one-month slump in consumer spending does not constitute a trend, and there is little reason to expect further cutbacks in coming months. Indeed, retail sales may have been temporarily hurt by the GM strike, which idled nearly 50 thousand workers that resulted in an estimated \$850 million in lost wages. Those workers should reopen their wallets when their paychecks start coming in again and replenish depleted bank balances. On the whole, households are still in good financial shape thanks to rising asset values, a high level of savings and, importantly, growing incomes supported by a solid, if slowing, pace of job growth.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	October 18	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	1.67%	1.68%	1.91%	2.30%
6-month Treasury bill	1.63	1.68	1.91	2.47
3-month LIBOR	1.97	1.99	2.16	2.47
2-year Treasury note	1.58	1.59	1.68	2.89
5-year Treasury note	1.56	1.56	1.60	3.04
10-year Treasury note	1.75	1.73	1.72	3.19
30-year Treasury bond	2.25	2.20	2.16	3.38
30-year fixed mortgage rate	3.69	3.57	3.73	4.85
15-year fixed mortgage rate	3.15	3.05	3.21	4.26
5/1-year adjustable rate	3.35	3.35	3.49	4.10
STOCK MARKET				
Dow Jones Industrial Average	26770.20	26816.59	26935.07	25444.34
S&P 500	2986.20	2970.27	2992.07	2767.78
NASDAQ	8089.54	8057.04	8117.67	7449.03
Commodities				
Gold (\$ per troy ounce)	1493.90	1492.42	1524.40	1229.70
Oil (\$ per barrel) - Crude Futures (WTI)	53.71	54.86	58.09	69.38

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Retail Sales (September) - % change	0.3	0.6	0.7	0.4
Industrial Production (September) - % chg.	-0.4	0.8	-0.2	0.0
Capacity Utilization (September) - Percent	77.5	77.9	77.4	77.7
Housing Starts (September) - 000s	1256	1386	1204	1269
Building Permits (September) - 000s	918	915	871	847

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