Quarterly Economic Recap and Rate Outlook

The U.S. ended the second quarter in the midst of the longest economic expansion in history at 121 months … and counting. The current growth cycle that began in June 2009 has finally bettered the 10-year “dot-com” boom of 1991-2001. Unfortunately, the pace of the current expansion has been significantly slower: +2.3% average GDP growth compared to +3.6% for the second longest and +4.3% for the third in line. But, the story of the second quarter for fixed income investors was a remarkable plunge in bond yields and a very reluctant dovish turn in Fed thinking. The two-year Treasury shed an astonishing 50 basis points in 91 days, closing at a yield of 1.76%, while the 10-year tumbled 40 basis points to close at 2.01%. As the Wall Street Journal (WSJ) pointed out, forecasters were caught off guard by the depth of the plunge. In the WSJ’s October 2018 survey, not a single one of the 50 economists surveyed expected the 10-year yield to fall below 2.75% by June 2019. In fact, the survey’s average forecast at that time was 3.39%.

The policy-making FOMC held the top of the overnight fed funds target range at 2.50%, not yet admitting the economy was struggling enough to justify a rate cut. Indeed, with GDP growth above +3.0% in three of the last four quarters, unemployment at a five-decade low and the stock market at or near record highs, it’s been a tough argument to make. Good news was easy to find, but it was all on the surface. The underlying data was much weaker.

To combat the previous two recessions, the Fed had responded by slashing the overnight rate target by 550 and 500 basis points. That particular remedy won’t be available whenever the next recession starts. The Fed had held the bottom of its target range at 0.00% for seven long years in hopes that the historically weak pace of GDP growth would pick up, but with the exception of a few strong quarters along the way, it didn’t. The Fed finally began to ratchet rates higher in late 2015, gradually hiking by a combined 225 basis points. A case could be made that with the recent $1.4 trillion dollar tax cut on the fiscal side and 2018 proving the strongest year of the cycle, the Fed had its best chance to “normalize” monetary policy and raise the target rate to prepare for the next recession. But, the trade dispute(s) dragged on longer than imagined while the Fed remained stubbornly on task.

St. Louis Fed President James Bullard was the first FOMC member to suggest Fed officials might have tightened too much, telling Bloomberg TV in June, “We may have slightly overdone it with our December rate hike.” At the moment, the prevailing thought is the Fed will be forced to reverse course and cut rates multiple times this year, with the underlying reason being an unexpected escalation in the trade war and the resultant global economic slowdown.

In the last quarter of 2018, U.S. producers imported finished goods and raw materials in anticipation of higher tariffs. By bringing forward those purchases in Q4, they didn’t need to buy as much in the first quarter of 2019, so the trade deficit shrunk and inventory stockpiles grew. This made Q1 headline economic growth appear stronger than it was.

Please see disclosure on page 10.
and probably emboldened President Trump to get tougher on his trade stance. At the same time, Chinese President Xi Jinping may have determined his country was gradually gaining the advantage, given an improvement in Q1 GDP and a corresponding stock market rally.

On May 5, President Trump, reportedly growing impatient with the lack of progress, unexpectedly announced an end to the five-month truce with China, abruptly hiking tariffs on $200 billion of Chinese imports from 10% to 25% and threatening a 25% tariff on the remaining $325 billion. China quickly retaliated by imposing tariffs on another $60 billion of U.S. goods and stiffening its resolve. According to Bloomberg News, the trade wars had already wiped out all but $100 of the average American household’s 2017 tax cut windfall, but up to this point, the overall economic effect was relatively modest. The outlook changed dramatically with this escalation and war of words.

2-Yr T-Note Yield

Source: Bloomberg and Hilltop Securities

The Federal Reserve Bank of New York calculated the new tariffs were likely to cost the average American household $831 this year, while Bloomberg Analytics projected that a 25% tariff imposed on all Chinese imports would slash GDP by 1.5 percentage points. Bond market yields continued to sink in response to an expected slowdown in economic growth. Then, on May 30th, the administration doubled-down further on trade by declaring the U.S. would place a 5% tariff on all goods imported from Mexico. The percentage would then increase by 5% every month until reaching 25% in October, if Mexico didn’t act to stop the flow of illegal immigration into the United States. If Mexico, already teetering on the edge of recession following a -0.2% contraction in the first quarter, were to slow further, history suggests the border problem could worsen.

This announcement was surprising for multiple reasons. The new USMCA free trade agreement had been signed pending formal approval, and at some point this year Mexico had become the United States’ largest trade partner, skipping over both Canada and China. But the bigger concern for Wall Street analysts was that the administration didn’t seem to be following a recognizable script. An uncertainty premium had to be built into the outlook.
UBS, one of the more optimistic primary dealer firms when the year began, illustrates the sudden shift especially well. According to UBS on June 4th, “We only see the Fed cutting rates if we get a sufficient slowing in the real economy and they fear a recession. An equity sell off would accompany that slide in the economy, but by itself, it seems insufficient. Tariffs increase the probability of recession. In our baseline, we continue to assume that deals are struck before meaningful further escalation occurs.” That equity selloff didn’t ultimately materialize as stocks enjoyed their best June showing in eighty years, but the U.S. economy seemed to be weakening quickly and UBS, less than a week later, wrote that if all threatened tariffs were implemented on China and Mexico, GDP could be reduced by 150 to 250 bps and the U.S. could easily slip into recession. Several other notable firms were similarly dramatic. JPMorgan slashed its two-year Treasury-note yield forecast to 1.40% by year end. Just six months earlier, that same two-year forecast for the end of 2019 had been 3.70%.

Remember that U.S. companies pay tariffs when they import goods, and the resulting higher prices must either be passed along to consumers or get absorbed by the companies in the form of lower profits. The hope is that companies will substitute purchases from domestic producers, but even this doesn’t seem to be happening. Apple has asked its largest suppliers to consider the feasibility of shifting 15% to 30% of its output from China to Southeast Asia. China is also exploring alternate trade partners. The most noteworthy of these is Russia, which has tripled its soybean shipments to China as Presidents Putin and Xi work to strengthen their mutual alliances.

President Trump never imposed the 5% tariff on our neighbor to the south, as Mexico agreed that its newly formed National Guard would police the border. The bond market, however, didn’t relinquish the rally. With China trade talks on hold and uncertainty feeding increasingly pessimistic forecasts, hopes for a resolution fell on the G-20 summit scheduled for June 28-29th in Japan. Although no deal was struck at the summit, the world’s two largest countries did agree to freeze tariffs at current levels and resume talks. China pledged to buy more American agricultural goods and the U.S. threw Huawei Technologies a lifeline, allowing the Chinese technology giant to use U.S. microchips in its smart phones.
Equity investors were appeased, but the bond markets were unconvinced.

While trade and politics held the spotlight, the economic data was quietly building a new story line. As mentioned earlier, there was plenty of positive news during the quarter on the labor front and the stock market, but many of the lesser known data series were flashing trouble ahead. The Cass Freight Index, which tracks U.S. freight shipments announced that volume fell at annual rate of -6.0% in May, the sixth straight month of year-over-year declines and the sharpest drop since November 2009. Similarly, the Association of American Railroads (AAR) reported rail freight volume had dropped -4.1% from a year ago.

The Morgan Stanley Business Conditions Index plunged from 45 to 13 in June, reaching the lowest point since the recession. The 32-point drop was the largest monthly decline in series history. On the consumer side, the Conference Board’s measure of consumer confidence unexpectedly fell -10 points in June, the largest miss relative to expectations in nine years. The Conference Board warned continued uncertainty could fuel future declines and increase consumer fears of recession.

U.S. factory managers echoed similar concerns as the ISM manufacturing index continued on its sharp downward path, printing a 51.7 in June. A reading above 50 reflects expansion, while below 50 indicates contraction. A year earlier, this index had stood at 60. This deterioration in purchasing managers’ outlook isn’t just contained to the United States. Of the 35 nations releasing factory purchasing managers’ indexes in June, 21 posted sub-50 readings, indicating outright contractions, the highest percentage in seven years. Just five countries experienced factory sector improvement in June, while 24 experienced worsening situations.

Optimism amongst U.S. farmers is also floundering despite tens of billions in federal aid with only 65% of those surveyed by Purdue University now expecting a favorable outcome to the trade war, down from 77% in March. But it isn’t just trade hammering the farmers. The 12-month period ending in April was the wettest in U.S. history. According to the USDA, less than half the planned corn acreage had been planted by mid-May, the least since 1995, while less than 20% of the U.S. soybean crop had been planted, the worst showing in 12 years.
Pressure has mounted for a trade deal to get done with both the global and domestic economies slowing at an increasing pace. By quarter end, the bond market had priced in three to four rate cuts, and while the FOMC had voted in June to hold the fed funds target rate steady in a range from 2.25% to 2.50%, it formally opened the door to rate cuts in the near future.

Employment
Employment conditions were generally strong during the quarter, with the exception of an unexpectedly weak non-farm payroll report in May. The most recent Job Openings and Labor Turnover (JOLT) survey revealed the total number of workers hired in April was the highest in the 19-year history of the series, with the number of posted job openings exceeding the number of unemployed Americans for the 14th straight month in April. Total job openings totaled 7.45 million, with just 5.82 million actively seeking work, bringing the labor shortfall to a record 1.63 million. The so-called “quits rate” held steady at a recovery high of 2.3% for the 11th straight month in April. This measure has long been a reliable indication of worker confidence.

The unemployment rate remained at a five-decade low of 3.6%, but amid all the solid employment news, several cracks appeared in the May report. Most notable, company payrolls added just +75k jobs, well below forecasts, while downward revisions to the previous two months subtracted -75k, resulting in zero net job growth in May. The four-month moving average of job growth through May is now just half of what it had been in the four-month period ending in January. The labor market participation rate has been slowing all year, and has now moved back within a fraction of its 42 year low, while wage growth slowed for the third straight month on an annual basis.

Businesses are nervous. Many hiring decisions could be delayed until the trade issue clears up.

Inflation
Price pressures are low enough to allow the Fed to cut if necessary, but not so low as to force their hand. In fact, Fed officials have contended the slide in general price levels is transitory, implying they believe inflation will eventually settle in near their 2% target. The Fed’s preferred measure of inflation, core Personal Consumption Expenditures (PCE), rose +0.2% in May, pulling the year-over-year pace up from +1.5% to +1.6%. Although still below target, the May PCE report validated Fed’s transitory assertion as the three-month moving average climbed back to +2.0%. The more familiar core consumer price index (CPI) was advancing at a +2.0% year-over-year pace in May, and has been at or above the Fed’s target for the last 15 months.

None of the inflation indexes are perfect. CPI has a huge and questionable allocation to housing costs in the form of “owner’s equivalent rent,” while the biggest component of PCE is healthcare, which is largely determined by Medicare and Medicaid costs … which are actually controlled by the government. Few in the real world could truthfully admit their cost of living has been as stable over the past ten years as the government’s inflation indicators suggest.

However, with stable inflation being one of two stated mandates for the FOMC (the other being full employment), prices will be closely watched in the coming months. If the tight labor market pushes wages and prices higher, multiple rate cuts become less likely, and if prices fall, pressure on the Fed to ease rates will ratchet higher.
Consumer Spending
The March, April and May retail sales reports were among the few pleasant economic releases during the second quarter and will make a significant contribution to GDP growth. The +1.8% March gain (the biggest in 18 months) was followed by respectable +0.3% and +0.5% increases in April and May. Unfortunately, the mini spending boom was fueled not by increased wages, but by saving less and borrowing more.

According to the Federal Reserve, credit card debt and other revolving credit climbed +3.4% year-over-year to $1.0 trillion. The credit increase was a high for the first quarter, a period when consumers typically cut back after the holidays. Student loan debt rose by +4.9% year-over-year in Q1 to a new record high of $1.6 trillion. Since 2010, the total has doubled. The increase in total consumer debt over the 12-month period ending in March added almost a full percentage point to GDP, but it also added to the American consumer’s record debt load, and cracks are starting to show.

The Fed recently warned auto loans delinquent 90 days or more had reached seven million, a new record high. This seems really out of place in the midst of the longest expansion cycle in history when nearly everyone who wants a job is able to find one. Mauldin Economics likened rising auto delinquencies to a canary in the coal mine. People didn’t make their payments because they don’t have enough money.

If you suspect Americans are squandering their car payment dollars on vacations, you’d be wrong. BankRate.com published a survey in late April that indicated just 52% of Americans were planning to take a vacation this summer, with 22% undecided and 26% not planning any time off. The overwhelming reason people reported for not taking a summer vacation this year was simply … they can’t afford to.
Housing

Existing home sales, which make up about 88% of all sales, have declined on a year-over-year basis for the last 14 months. This is another one of those economic numbers that doesn’t quite fit into the robust economy mold. The pace of new home sales has also declined, slipping more than 10% in April and May and down on a year-over-year basis despite favorable mortgage rates. The average 30-year fixed rate loan fell to 3.94% at the end of June, according to Bankrate.com’s national survey of mortgage lenders.

The current average is the lowest since November 2016, and 116 basis points below the 52-week high of 5.10%, which means the refi window has reopened for many borrowers.

The *volume* of existing home sales has declined for 15 months in row on an annualized basis according to the Wall Street Journal. The sluggish pace of home sales has helped drive demand for rental apartments to a five-year high. The number of apartment move-ins rose 11% in the second quarter from a year earlier, bringing the national occupancy rate to 95.8% and pushing prices up 3% annually nationwide. Builders have responded to the lack of supply by constructing new units at the briskest pace in 30 years, but the majority of new supply added is at the high end of the price range. This has only compounded affordability problems on the low end of the price scale.

On a related note, according to CoreLogic and the WSJ, the percentage of U.S. home purchases by investors rose above 11% in 2018, a record high and twice the level experienced before the 2008 financial crisis. Housing experts had expected the number of investor purchases to moderate once the bubble-era excess inventory cleared, but those purchases have actually accelerated. The WSJ suggested internet marketing has made the process easier and more appealing, and people nearing retirement have increasingly diversified their savings into real estate. However, these investors have primarily focused on the bottom-third of the price range, making up 20% of all purchases. This excess demand has resulted in higher percentage price increases on the low end as prospective first-time buyers are forced to compete with investors.

Stocks

Stocks shook off a terrible trade-tainted showing in May with a tremendous rebound in June, fueled by hopes for Fed rate cuts. The Dow soared +7.2% in the final month of the quarter, the best June performance by the Dow in more than 80 years, with the S&P 500 gaining +6.9% and the NASDAQ +7.4%. This late surge brought the quarter into positive territory and moved all three major indexes within a percentage point of record highs. At just above 20, the PE ratio for the S&P 500 is more than two percentage points below a year ago, and doesn’t appear overvalued by recent historical standards. And, with an estimated 20% of the world’s government debt trading at negative yields, the risk/reward trade-off to stocks grows increasingly more palatable.

Unfortunately, the stock market shares the concerns of the broad economy, so there’s no reason to expect the stomach-churning volatility will disappear anytime soon. So far, the effects of trade on equities have been negligible, but further escalation would likely chip away at corporate profits and rewrite the forecast. According to USA Today, about 44% of sales in the S&P 500 come from foreign markets, where the negative impact of trade has been much more pronounced.
**Equity Indexes**

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**Interest Rates**

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<tr>
<td>End 6/30/19</td>
<td>2.25%-2.50%</td>
<td>2.09%</td>
<td>1.94%</td>
<td>1.76%</td>
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**Economic and Interest Rate Outlook**

Yet again, the economic outlook hinges largely on trade, and despite recent escalation and signs that both the U.S. and China are digging in, there’s prevailing optimism that a deal will emerge soon. In the meantime, business investment is in a virtual holding pattern, consumer spending has been stretched, hiring has slowed and confidence is sagging. The most visible indicators (record stock market highs and historically low unemployment) are still overwhelmingly positive on the surface, and this has allowed investors to overlook the vast amount of weaker and less visible data.

As mentioned many times, it’s become increasingly difficult to separate the economy from politics. In the simplest of terms, a favorable trade resolution with China in the coming weeks would boost spending, optimism, and GDP growth. But, the closer we get to the election, the more leverage shifts toward China, which seems to understand that no American president since Calvin Coolidge in 1924 has been reelected while the country was in recession.

A weakening global economy has become collateral damage in the trade war. There’s no official definition of a global recession, but in the past the IMF has argued that annual GDP growth of +3.0% or less was one of several factors considered. In its semiannual growth forecast, the World Bank slashed its global outlook for 2019 from +2.9% to +2.6% with downside risks. The report cited darkened economic prospects, tightening financial conditions, moderating industrial production ... and elevated trade tensions.

The Organization for Economic Co-operation and Development (OECD) indicated in its...
June Interim Economic Outlook that the global economy continues to slow and major risks persist. The OECD points to significant weakness in China and Europe as well as diminished global trade as the main anchors on growth, and warns that additional trade restrictions and policy uncertainty could amplify the problem. OECD Chief Economist Laurence Boone reported, “The global economy is facing increasingly serious headwinds, and a sharper slowdown in any of the major regions could derail activity worldwide, especially if it spills over to financial markets.”

The latest European Central Bank forecast for GDP growth is +1.2% for 2019, with lackluster +1.4% growth projections for 2020 and 2021. In June, ECB President Mario Draghi assured the markets, “Further cuts in policy interest rates ... remain part of our tools. And the asset purchase program still has considerable headroom.” After years of quantitative easing, the ECB balance sheet is already nearing 40% of the European Union’s total GDP output, more than twice that of the United States. The idea of additional asset purchases reeks of desperation, but with a possible global recession lurking, the ECB has responded and is now expected to cut its key bank deposit rate as soon as July. The widely-expected 10 basis point move would bring the interest rate banks “earn” on excess reserves held with the ECB from -0.40% to -0.50%. This negative rate means European banks lose money when holding excess reserves at the Central Bank.

The realization that even more stimulus will be required to keep Europe from slipping toward recession has pulled global market yields even lower. By the end of June, an estimated $13 trillion in global bonds were trading at negative yields, with 10-year German government bonds offered at -0.33% and 10-year French bonds at -0.01%. Painfully low yields on global bonds will continue to exert downward pressure on U.S. bond yields.

In May, Fed officials had contended the economic data was failing to make a strong case for moving in either direction. They characterized the U.S. economy as “strong,” inflation as “muted” and told the markets they’d adhere to a wait-and-see approach. The markets didn’t agree with this assessment and neither did the President, who called on Chairman Powell to help offset damages caused by the tariffs by matching the stimulus measures taken by the Chinese. In June, Trump tweeted that interest rates were too high and the Fed didn’t have a clue. This public jawboning has further complicated policy as the Fed is forced to assert its independence. Former Fed Vice Chairman Stanley Fischer hammered this point home in June, telling Bloomberg News, “There was a good chance the Fed wouldn’t have raised borrowing costs in December if Trump had been less vocal.”

Setting monetary policy is a delicate balance, and the Fed doesn’t always get it right. History has repeatedly shown that accommodative policy eventually produces bubbles, and the latest seems to be corporate debt, which has grown more than 70% since the recession ended, and is now at a record high of $11 trillion. If all this borrowed money had funded growth and new business it wouldn’t raise concerns, but instead it’s been used primarily for acquisitions and stock buybacks. This leverage could potentially compound the effects of the next recession, limiting a company’s ability to borrow. Another quiet concern is that more than 50% of the investment-grade corporate bond market is rated BBB, just one notch above junk. When the recovery began, this percentage was closer to 32%. If the Fed were to concede to the President and the markets with a series of rate cuts, they’d risk making the debt bubble worse.

Despite that, the financial phrase of choice right now seems to be “insurance cut.” The economic data may not support an ease yet, but the growth path seems to be downward. Plus, the markets have made up their mind and the President is relentless in shaming the Fed. The bond market has already priced in between three and four cuts, and the yield curve is inverted out to 20 years. At quarter end, the Fed was paying approximately 35 basis points above the one-year Treasury bill on excess bank reserves and 25 basis points more than the 10-year note yield. Banks have responded by adding to their reserve...
positions which effectively drains loanable funds from the banking system. This is a recipe for failure. So, it's not so much a question of if Fed officials cut the overnight funds target, but rather when … and by how much.

In the monthly Wall Street Journal poll of 60 of the nation’s top economists, taken in early June, 39% expected the Fed to announce the first rate cut since 2008 on July 31st, while 30% expect the first cut on September 18th. Interestingly, the survey doesn't show any clear consensus for a second move. When asked when the next recession is likely to start, 49% of respondents guessed 2020 while 37% thought 2021.

The June Bloomberg survey originally showed very similar results, but in an unusual move the survey was redone after the FOMC meeting, and the new results showed a majority of economists now expect rate cuts at both the September and December meetings.

The Fed’s “dot plot” unveiled at the June FOMC meeting showed committee members were, on-the-whole, still clinging to the notion that continued patience was the best policy for the time-being … but it was a close call with members split down the middle. Nine of 17 were in favor of holding the target rate unchanged at the current level for the remainder of 2019, while one member called for a single 25 basis point cut and seven called for total cuts of 50 basis points before year end. In the end, the median forecast for the overnight target at the end of 2019 held at 2.40%, identical to the March meeting.

Admittedly, it’s a tough spot for policy-makers who rely on economic data to drive rate decisions. But, trade has hijacked the narrative and the data is less reliable. It changes too fast. It’s too volatile.

So, we wait to see who flinches first in a game of chicken being played out by the two largest economies in the world. Of course, what makes this particularly unnerving is the obvious idea that it could all end with a single 140 character tweet.