2019 Q3 Economic Recap and Rate Outlook

After raising the overnight fed funds target rate three times in 2017 and four in 2018, Fed officials reversed course in 2019’s third quarter and cut the funds target twice. Quarter point easing moves at the July and September FOMC meetings, which brought the target down to a range of 1.75%-2.00% were fully expected ...but not entirely supported by economic data. Somewhat ironically, in the same quarter, the longest economic expansion in U.S. history entered its eleventh year. It's possible to imagine a scenario where the expansion limps along for years, and just as easy to envision a recession starting as soon as next year.

Bond yields reflected the uncertainty during the quarter with significant moves, both up and (mostly) down. On August 15th, the 30-year Treasury bond yield closed below 2.00% for the first time ever. On August 27th, the 3-month/10-year Treasury yield curve inversion which began in late May, had widened to a full 51 basis points, with the 3 month T-bill trading at 1.98% and the 10-year T-note at 1.47%. It's no secret that a 3-mo/10-yr curve inversion has historically signaled recession is on the horizon, so alarm bells were sounding. However, given the distortion of massive QE intervention by the Fed and the fact that yields are negative throughout Japan and much of Europe, history may not be the most reliable of guides. Short yields are still buoyed by stubborn Fed policy, while longer yields are sinking along with diminishing expectations of economic growth and inflation.

The Fed’s reluctance to cut rates more aggressively probably has much to do with the fact that it’s been quite successful in meeting its dual mandate, achieving both full employment and stable inflation.

Q3 Interest Rates

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</thead>
<tbody>
<tr>
<td>Last (6/30/2019)</td>
<td>2.25%-2.50%</td>
<td>2.09%</td>
<td>1.94%</td>
<td>1.76%</td>
<td>1.77%</td>
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<tr>
<td>High</td>
<td>--</td>
<td>2.25%</td>
<td>2.02%</td>
<td>1.91%</td>
<td>1.89%</td>
<td>2.14%</td>
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<tr>
<td>Low</td>
<td>--</td>
<td>1.80%</td>
<td>1.70%</td>
<td>1.43%</td>
<td>1.32%</td>
<td>1.46%</td>
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<tr>
<td>End (9/30/2019)</td>
<td>1.75%-2.00%</td>
<td>1.85%</td>
<td>1.77%</td>
<td>1.63%</td>
<td>1.55%</td>
<td>1.66%</td>
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Source: Bloomberg and HilltopSecurities.

The Fed’s reluctance to cut rates more aggressively probably has much to do with the fact that it’s been quite successful in meeting its dual mandate, achieving both full employment and stable inflation. This measure of success would normally allow Fed officials to step aside and watch policy play itself out, but the rapidly escalating trade war with China has kept them fully engaged. Monetary policy has grown even more complicated as President Trump repeatedly voices his frustration with Fed officials he believes are not in step with national interests. The President and the Fed Chairman have battled in the past, most notably Paul Volker and Ronald Reagan, but the emergence of social media has turned murmurs into shouts...and there was quite a bit of shouting going on recently.
When comparing the good economic data to the bad during the quarter, the good still held a slight advantage, mostly due to the apparent health of the labor market. As more Americans find work and make money...they spend it. Consumer spending, the biggest contributor to GDP growth, expanded at an annual rate of +4.2% in the second quarter, matching the second-best performance of the 10-year recovery cycle. Unfortunately, business investment fell -6.1%, carving 1.1 percentage points off GDP, while net exports subtracted another -0.7. When all was said and done, Q2 GDP had grown at an uninspiring annualized rate of +2.0%. The initial measure of third quarter GDP is still weeks away, but it appears the slowing trend has continued as business optimism fades.

The ISM manufacturing index, a reliable leading indicator fell, from 51.2 to 49.1 in August, indicating contraction with the first sub-50 reading in three years. This is just a survey, but the purchasing managers’ indexes have always had a tendency to lead the economy, so when ISM flashes contraction, the markets take notice. The ISM survey also includes comments from the respondents, and the most frequently mentioned concern continues to be the trade war. Purchasing managers’ indexes in China, Japan, and Germany were also below the 50 mark, as were neighbors Mexico and Canada. Here too, the most frequently mentioned concern was trade. Unfortunately, the very public mêlée between the U.S. and China only intensified during the quarter. If the added pressure of much higher tariffs on virtually all goods imported into the world’s two largest economies doesn’t fast track a deal, it’s likely to derail the global economy.

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The ISM Manufacturing Index


The derailing bet seems to be winning as global growth sputters. In response, the European Central Bank cut the bank deposit rate from -0.40% to -0.50%, while announcing a relaunch of its already massive quantitative easing campaign...with no end date. Although it isn’t clear this “QE Forever” plan will rekindle growth in Europe, it’ll definitely keep downward pressure on yields and encourage borrowing ...for better or for worse. According to the Institute of International Finance, the total debt of governments, businesses and households worldwide has increased by almost 50% since before the financial crisis to $246 trillion at the beginning of March. In a single week in September, a record $140 billion in corporate bonds

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were sold at record low yields. One company taking advantage of the cheap funding was Apple, who borrowed $7 billion, despite holding an estimated $200 billion in cash and securities.

Predictably, corporate borrowing is even cheaper across the Atlantic. German industrial company Siemens was able to issue a zero-coupon, two-year note with a yield of -0.315%. CNN Business described it as “the most negative yielding corporate bond ever to be priced in the primary market,” and reminded us that investors are actually paying Siemens for the privilege of lending them money. Normally, the combination of a recession and heavy debt spell trouble, but when debt service costs are negative…maybe not so much. In fact, nothing in modern history provides any clue to how the global economy (and by extension, the domestic economy) will navigate the next recession. The amount of stimulus is already unprecedented, and it’s not working.

Consumer Spending
The consumer has essentially kept the U.S. economy afloat since spring. A +0.4% gain in August retail sales marked the sixth straight monthly advance, and a +4.1% year-over-year sales increase was the biggest in 10 months. The question going forward is whether the consumer can continue shouldering the burden. Most of the underlying data suggests it won’t be easy. Until very recently, businesses, not consumers, have taken the brunt of the tariff battle, but in early September the trade war arrived on Main Street with a 15% tax levied on a list of $300 billion in Chinese imports, primarily targeting consumer goods. Trump abruptly decided this painful round would be gradually phased-in with scheduled tariffs on traditional holiday gift items like video games, laptops and footwear delayed until mid-December to spare the holiday buying season from ruin. JP Morgan recently calculated that once the new tariffs are in place, the annual cost to American families will rise by around $1,000, essentially negating the entire 2017 tax cut benefit for most families.

In August, the Census Bureau reported that inflation-adjusted median household income had risen from $62,200 to $63,179 last year. On the surface, this sounds great, but last years’ median income was essentially flat to inflation-adjusted income from 20 years ago. So, consumers are borrowing to make up the difference. The New York Fed’s latest quarterly report on household debt and credit shows a record $192 billion rise in the second quarter, the 20th consecutive uptick, while total household debt, at just under $14 trillion, is now $1.2 trillion above the high point from the third quarter of 2008.

There’s a lot information to sort through on the consumer side, and there’s more than enough data to support a myriad of opinions, but it appears that spending has exceeded capacity for a long time. Some retrenchment may be overdue and confidence seems to be cracking. The Conference Board’s measure of consumer confidence dipped from 134.2 to a three-month low of 125.1 in September. Although the present situation index remained near an 18-year high, the future expectations index fell to its lowest point of the year. Fading confidence doesn’t necessarily translate into lower spending, but it indicates caution is afoot.
Employment

Employment is the shining star of the economy with the official unemployment rate, at 3.7%, still hovering near a 50-year low, but on closer inspection labor conditions appear vulnerable. Nonfarm payrolls, which grew by a monthly average of +223k in 2018, have slowed to a +143k monthly pace since February. And, the Bureau of Labor Statistics quietly announced that in January 2020 it will revise average monthly payroll gains for the 12-month period ended March 2019 downward from +210k to +190k. The slowing job growth has much to do with a shortage of qualified workers. The global population is aging and family sizes are shrinking. For the first time, there are now more people in the world over the age of 65 than under the age of five. Since virtually all developed countries are facing the same demographic shift, it stands to reason that the demand for foreign workers will increase, or the pace of automation will rise. There isn’t anything the central banks can do to rewrite this story.

Inflation

In the long run, it’s hard to imagine a situation where too many dollars are chasing too few goods, so there are few worries about future inflation. However, in the short run there are signs that inflation is at or above the Fed’s target and creeping higher. This isn’t necessarily a bad thing, but it does question the idea that the Fed should be cutting rates. The core consumer price index (CPI), which excludes food and energy prices, climbed +0.3% for the third straight month in August, pushing the year-over-year core up from +2.2% to +2.4%, the highest in over 11 years. Core CPI has now been at, or above the Fed’s target rate for 18 consecutive months. Core producer prices are also a bit elevated with core PPI advancing +2.3% year-over-year. Bloomberg recently reported on a little known inflation index compiled by Gordon Haskett Research Advisors that replicated the actual habits of shoppers. This representative basket of 76 goods from Walmart and Target had risen +5.5% in June over the previous year. Since both stores stock a significant percentage of merchandise from China, this index is poised to surge later this year as the new consumer tariffs kick in. The Wall Street Journal also reported several price measures that were running hot, including the Atlanta Fed’s “sticky price CPI,” which measures a basket of goods that change price infrequently, and a San Francisco Fed measure of PCE prices more sensitive to overall economic conditions.


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The bottom line is that although price pressures aren’t getting out of hand, they aren’t abating either...not yet anyway, and the tariff increase will have an impact on prices. The Fed’s preferred inflation measure, core PCE, is still below +2.0%, but even this laggard is generally expected to move into the target range. Since the Fed appears to have achieved its inflation mandate, and future rate cuts would (all else being equal) push inflation higher, the Fed would normally be inclined to hold steady, but these are different times.

**Housing**

Residential investment hasn’t made a positive contribution to GDP growth since the fourth quarter of 2017, but it looks like the losing streak may have ended in the third quarter. Just about every bit of housing-related data showed improvement. Existing home sales for August rose +1.3%, bringing the pace of existing home sales to an 18-month high. Sales of new homes climbed +7.1% in August and are now within range of the 12-year peak. Likewise, housing starts and building permits both soared to new 12-year highs. Starts jumped +12.3% to a 1.364 million unit annual pace in August, while forward-looking permits climbed +7.7% to a 1.419 million unit annual pace. These numbers are significant. They represent real production and should have a positive impact on Q4 GDP.

Looking forward, the National Association of Home Builders/Wells Fargo Housing Market Index rose to 68 in September, the highest level in almost a year as a strong labor market, declining interest rates, and buyer demand all made positive contributions. However, in another survey by the National Association of Realtors, 36% of active homebuyers confessed they expect a recession in 2020, while 56% said they’d delay their housing purchases if the economy were to weaken significantly.

**Q4 Economic and Interest Rate Outlook**

Politics have superseded economic data in driving interest rates and the financial markets, and although economists may be able to predict economic numbers in the short run, predicting tomorrow’s tweet isn’t possible. Right now, the market tone is decidedly negative. The September Wall Street Journal survey of economists showed an average forecast of +2.2% GDP growth for 2019 and +1.8% for 2020. A month earlier, the same WSJ survey flashed a 33.6% probability of recession within a year, the highest reading in Wall Street Journal survey history. Other surveys are similarly gloomy. Economists who’d expected the trade war was “easy to win” have found out otherwise after 18 long months. Before September, the negative trade effects were seen in sagging business confidence and extreme market volatility, but U.S. consumers are certain to share the pain in coming months. Shoes and boots are on the latest tariff list, and 70% of footwear sold in the U.S. is made in China. Other goods categories likely to feel the effect of the scheduled fourth quarter tariffs are cell phones (with 80% of U.S. imports coming from China), laptop computers (95%), video game consoles (98%) and children’s toys (85%). According to the World Bank, the average tariff on U.S. imports was below 2% from 2000 through 2017, but it’s expected to approach 6% by the end of the year if scheduled tariffs take effect. Brace yourself.

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The main drivers of recent economic strength look susceptible. Job growth is slowing and the recent confidence numbers indicate concern. Prospective home buyers have acknowledged an economic downturn could postpone their planned purchases, and consumers may not be willing to borrow money at the same furious pace if the outlook gets too cloudy. Business investment has been sluggish all year, and until a trade agreement is reached, there's no expectation for this to change. Market yields have fallen across the curve and it's much easier to think of reasons why they'd continue to fall than reasons why they'd climb. A favorable trade deal with China would probably push yields higher, but we seem to be moving further and further away from an agreement. Although a spike in inflation might garner attention, both investors and the Fed would understand tariff-induced price increases can't be controlled by monetary policy, and any surge in GDP growth at this point would be suspect. In short, it's hard to imagine the case for higher yields, even in the short run. The lower-for-longer scenario is a much better bet. The economic recovery cycle is already past its expiration date and the sugar high of the tax cut is over for most Americans. Even if a trade agreement can be reached with China before the next big escalation, the European Union is queued up as the next target...and Europe is already floundering. The German economy, the fourth largest in the world and the biggest in the Eurozone, contracted in the second quarter, while a no-deal Brexit could usher a recession into the fifth largest economy early next year. Combating this global slowdown has been a challenge. In theory, zero isn't the bottom anymore. There are already an estimated $17 trillion in negative global bond yields weighing on the U.S. market, and the European Central Bank’s (ECB) recent pledge to make €20 billion in bond purchases every month for an indefinite period suggests more of the same.

Here in the U.S., impeachment, or just the prospect of impeachment adds another layer of uncertainty to a growing list. The partisan process is also likely to increase congressional gridlock and further complicate efforts to pass meaningful legislation and get control of the swelling budget deficit. The national debt is just under $23 trillion. Much of the increase is due to uncontrollable demographics changes, specifically increases in Medicare, Social Security and Federal pensions, but debt service costs had also been rising sharply as the Fed aggressively tightened monetary policy in 2017 and 2018. It may not be an official mandate, but the Fed is aware that its interest rate policy directly affects the budget. Lower interest rates mean lower debt service costs.

The last Bloomberg survey of economists, taken the second week in September, indicates the nation's top economists expect one more quarter point cut in December, while the futures market pegs the chances of that December move at 72%. On the other hand, the latest Fed “dot plot” indicates no more cuts this year...although it's close. Five committee members actually thought the September cut was unnecessary, five members expect no additional cuts this year and seven expect one more cut before the year is over. The median Fed rate projection for 2020 at 1.90% is the same as 2019, indicating Fed members expect/believe/hope they’ll be sidelined during the election year. In 2021 and 2022, the dot plot reveals a gradual drift upward, culminating with a return to a 2.50% funds rate. Take this recession-dodging outlook with a big grain of salt. Just a few months ago, none of these same FOMC members had anticipated either the July or September rate cut. Then, it seemed almost unthinkable that trade relations could get any worse. Now, 20 months after the washing machine and solar panel tariffs were announced, rather than a near-term trade agreement, our best hope is for discredited FOMC members to abandon their dual mandate and cut rates a few more times to save the day.