2019 Q4 Economic Recap and Rate Outlook

As December began, there were an unusually high number of potential disruptions capable of derailing an already fragile U.S. economy. The December Fed meeting and a U.K. general election, both key events, took a backseat to impending tariff escalation and the possibility of another government shutdown. But one-by-one, all the concerns eased. The year ended with a prevailing sense of calm. Recession fears have receded. Stocks rallied unimpeded during the final month, shrugging off the House impeachment of President Donald Trump along the way, undaunted by the upcoming Senate trial or the November 2020 elections. The NASDAQ climbed a staggering 35% in 2019, while the S&P 500 and the DOW rose +29% and 22% respectively.

Bond market prices gained on the year, but fell during the fourth quarter with significant volatility...most of it early on. The 10-year Treasury yield bottomed at 1.53% on October 8th after the China trade outlook abruptly soured, but climbed to the quarter’s high point of 1.94% on November 8th when U.S. trade representatives announced significant progress and the likely postponement of December tariffs.

These off-and-on trade negotiations dominated news headlines and the Twitter-sphere during the quarter, as they had all year.

The December FOMC meeting was expected to be a non-event, and indeed it was. Fed officials voted to hold monetary policy steady following rate cuts at the three previous meetings, while signaling their intent to maintain the current 1.50% - 1.75% overnight target for all of 2020. Committee members clearly prefer to remain on the sidelines during what promises to be a contentious election year, but President Trump believes additional rate cuts are still necessary with foreign central banks providing significantly more accommodation than the Fed.

Although the European Central Bank also opted to hold key interest rates steady at its December meeting, the ECB bank deposit rate remains negative at -0.50% while QE asset purchases of 20 billion euros per month are slated to continue indefinitely. The updated ECB 2020 GDP outlook for the euro area is a sub-par +1.1% with inflation growth also expected at +1.1%. Higher U.S. interest rates and stronger relative GDP growth in the U.S. suggests a strengthening dollar, which will continue to weigh on multinational companies.

The U.K. elections produced expected results with Boris Johnson’s Conservative party claiming a majority in the British Parliament, which should open the door for the United Kingdom to leave the European Union in 2020 …with or without an agreement in place. Although Brexit has suddenly become more certain, that certainty isn’t necessarily positive. This story is far from over.

On the U.S. budget front, funding was secured early and with little drama, ensuring the Federal government will continue operating through all of 2020. Recalling the extreme damage caused by last year’s 35-day shutdown, both parties were more than willing to kick discussions out into 2021. In the meantime, the Federal budget deficit, which managed to hold just under $1 trillion in FY2019 is projected to top the trillion

Please see analyst certifications and disclosure starting on page 6.
dollar mark in FY2020 for the first time in eight years. Any attempt to rein this in will have to wait until after the November elections. Like Brexit, the swelling federal budget problem will eventually have to be addressed, but for now, it’s been relegated to the backburner.

The December game-changer came on the trade front as the administration announced “Phase 1” of a long anticipated trade deal with China just hours before new tariffs were set to kick in on $156 billion of consumer goods imported from China. Investors had apparently expected this painful escalation to be postponed, but the details of the agreement, although sketchy, were more upbeat than expected. According to Administration sources, in exchange for reduced tariffs on some imported products, China pledged to import an additional $200 billion in U.S. goods and services over the next two years, purchasing $40 billion to $50 billion of U.S. agricultural products in 2020 and 2021. China also agreed to “crack-down” on its intellectual property theft and forced technology transfer, and promised it will not intentionally devalue its currency. Chinese officials seemed to have a slightly different take on the key components of the deal, but the markets were starved for positive news and the announcement of de-escalation was welcomed relief. A week later, the Chinese Finance Minister announced his country would be lowering tariffs on 850 products to boost imports and address domestic shortages of goods including pork, avocados, asthma and diabetes medications, and semiconductors.

The deal is expected to be signed in mid-January and “Phase 2” discussions have supposedly already begun. It’s tempting to throw cold water on the trade giddiness, but both sides are heavily incentivized to follow through at this point. China, by its slowest economic growth in three decades, and the U.S. by the increasingly frustrated and heavily subsidized farmer.

It was almost an afterthought, but days earlier House Democrats signed-off on an amended version of the USMCA trade agreement, and representatives from Canada, Mexico and the United States promptly signed the deal. The Senate will likely vote to ratify in early 2020. The USMCA agreement is seen as a positive, not only as an improvement over NAFTA, but also as an indication that Republicans and Democrats are still capable of working together.

All this apparent trade success emboldened the Trump administration to reinstate tariffs on steel and aluminum from Argentina and Brazil to combat what the president believes is a “massive currency devaluation.” According to the U.S. trade representative, the U.S. will also consider raising tariffs on some European products to spark stalled progress in an ongoing dispute over airplane subsidies. Few expect trade concerns to quietly fade away in 2020.

With hurdles pushed aside in December, more of the market focus can be shifted to actual economic data. The ISM manufacturing index, a reliable leading indicator, signaled contraction for the fifth consecutive month in December. The surprising thing to note about the disappointing purchasing manager’s report was that the outlook continues to dampen despite a resolution of the 6-week GM strike in late October and the announcement of a China trade deal just weeks before the survey period. This doesn’t bode well for first quarter manufacturing.

Like Brexit, the swelling federal budget problem will eventually have to be addressed, but for now, it’s been relegated to the backburner.

Chinese officials seemed to have a slightly different take on the key components of the deal, but the markets were starved for positive news and the announcement of de-escalation was welcomed relief.

The USMCA agreement is seen as a positive, not only as an improvement over NAFTA, but also as an indication that Republicans and Democrats are still capable of working together.
Consumer Spending

In the absence of business investment, consumer spending has accounted for virtually all of GDP growth. One of the big questions going forward is whether U.S. shoppers will continue to carry the load until business spending can regain its footing.

Although the retail sales report for December hasn’t been released, the MasterCard SpendingPulse survey reported overall holiday sales were up +3.4% from a year ago. Although a respectable increase, the number falls well short of the +5.1% year-over-year advance reported for 2018. This deceleration is particularly odd when comparing this December’s +2.9% S&P 500 gain to the previous year’s -9.9% meltdown. One unusual issue consumers will face in early 2020 is a decline in the supply of products available for sale as both imports and production have dropped as a result of the trade war.

Housing

The housing market ended the year on a high note. Existing home sales began the year in a serious slump, but steadily gained momentum as mortgage lending rates fell back below 4.0%. Housing starts jumped from an annualized pace of 1,323k to 1,365k in November, the second best showing in over 12 years, while building permits (a key leading indicator) reached their highest point since June 2007, climbing from 1,461k to 1,482k. Correspondingly, the National Association of Home Builders (NAHB) housing survey revealed a spike in homebuilder confidence from 71 to 76 in December. The housing sector, which made a positive contribution to GDP in the third quarter for the first time in almost two years is poised to continue the feat.

Employment

The labor market’s biggest problem, both now and in the foreseeable future, seems to be a lack of qualified and willing workers. Company job creation was surprisingly strong in the final quarter of the year. Not only has the unemployment rate remained near a 50-year low, but nonfarm payrolls unexpectedly added +266k workers in November. When prior month revisions are added to the tally, the six-month average climbs to a quite respectable +196k. There’s little point in getting bogged down in the numbers, employment remains on solid footing. The simple fact that mostly everyone who wants to work can find a job is the foundation that promises to keep the U.S. out of recession in 2020.
Inflation

One of the most important factors determining Fed interest rate policy in 2020 will be price pressures...or the lack thereof. Before the Fed considers increasing rates, they’ll need to see core inflation above 2%. And in fact, several Fed officials have indicated that the committee could allow inflation to run modestly above 2% for a time, especially during periods of below trend growth. At the press conference following the December FOMC meeting, Fed Chairman Powell said, “We would need to see a really significant move up in inflation that’s persistent before we would even consider raising rates.” This clear statement grants the FOMC additional latitude. It also shines a giant spotlight on prices.

The consumer price index (CPI) has been running a little hot on the surface with the core rate holding steady at +2.3% for the second consecutive month in November, slightly below September’s 11-year high of +2.4%. But, the Fed’s preferred measure, core personal consumption expenditures (PCE), actually dropped from +1.7% to +1.6% in November. The Fed’s latest forecast shows core inflation averaging +1.9% in 2020 and +2.0% each of the next two years. Price pressures will be closely watched. Steady inflation would keep the Fed sidelined, but a significant drop in inflation could reopen the door to more rate cuts.

Steady inflation would keep the Fed sidelined, but a significant drop in inflation could reopen the door to more rate cuts.


Steady inflation would keep the Fed sidelined, but a significant drop in inflation could reopen the door to more rate cuts.

The consumer price index (CPI) has been running a little hot on the surface with the core rate holding steady at +2.3% for the second consecutive month in November, slightly below September’s 11-year high of +2.4%.
Economic and Interest Rate Outlook

U.S. recession risks have dissipated after three consecutive quarter-point rate cuts and an easing of trade tensions. However, the notion that negative growth is less likely in 2020 shouldn’t imply robust growth. There may be a wide range of opinion on the economic outlook over the next decade, but most economists seem to gravitate around +2.0% GDP for 2020. Similarly, a majority expect monetary policy to remain on hold all year. At the December FOMC meeting, committee members forecasted GDP growth to slow to +2.0% in 2020, followed by +1.9% in 2021 and +1.8% in 2022.

The Bloomberg survey of the nation’s top economists, taken in early December, showed annualized GDP growth ranging from +1.6% to +1.9% over the next two years. Presumably, post-survey trade progress will boost future forecasts a bit, but individual economists don’t seem to be sold on the idea that trade problems are behind us. The equity market is assuming significant de-escalation with little possibility of re-escalation, but if recent trade history is any indication, this might be wishful thinking. The reality is that China will have trouble meeting its $40 to $50 billion annual purchase pledge for U.S. agricultural products. According to the USDA, farm exports to China were $9.2 billion in 2018 and will likely be between $10 and $11 billion in 2019. The pre-trade war high point was just $26 billion in 2012. In recent years, China has increased its imports from other countries, most notably Brazil and Russia, to fill in supply gaps. Even if China were to sever these other relationships, and consume four-to-five times the amount of U.S. agricultural products, U.S. farmers aren’t likely to have the capability (or confidence) to gear up their production to meet significantly higher demand. China’s total commitment to import an additional $200 billion in goods and services over a two-year period may be an even bigger stretch as it struggles with the slowest pace of economic growth in 26 years. Obviously, Chinese consumers will have less money to spend, and the country’s economic struggles will be amplified if more and more goods are purchased from foreign, rather than domestic producers. For what it’s worth, Chinese trade officials have been vague on the actual commitment numbers. It’s possible that the actual agreement terms fall short of U.S. expectations. If the expected deal is signed, tariffs would remain on almost 70% of all US imports from China, and although the average tariff on Chinese imports would drop from 21% to just over 19%, it’s still well above the 3% average before the trade war began. Tariffs remain a heavy financial burden for U.S. companies. The trade war with China is far from over and Europe is next in line.

Q4 Interest Rates

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Last (9/30/2019)</td>
<td>1.75%-2.00%</td>
<td>1.83%</td>
<td>1.77%</td>
<td>1.63%</td>
<td>1.55%</td>
<td>1.67%</td>
</tr>
<tr>
<td>High</td>
<td>1.80%</td>
<td>1.73%</td>
<td>1.68%</td>
<td>1.75%</td>
<td>1.94%</td>
<td></td>
</tr>
<tr>
<td>Low</td>
<td>1.52%</td>
<td>1.51%</td>
<td>1.39%</td>
<td>1.35%</td>
<td>1.53%</td>
<td></td>
</tr>
<tr>
<td>End (12/31/2019)</td>
<td>1.50%-1.75%</td>
<td>1.55%</td>
<td>1.60%</td>
<td>1.57%</td>
<td>1.69%</td>
<td>1.92%</td>
</tr>
</tbody>
</table>

Source: Bloomberg and HilltopSecurities.

The notion that negative growth is less likely in 2020 shouldn’t imply robust growth.

The equity market is assuming significant de-escalation with little possibility of re-escalation, but if recent trade history is any indication, this might be wishful thinking.

The trade war with China is far from over and Europe is next in line.
As mentioned earlier, growth in Europe is already painfully slow, despite unprecedented stimulus. The European Central Bank has arguably run out of ammunition. Reuters reported in early December that 57%, of the $8 trillion euro bond market was still trading with negative yields…and frankly, this desperate ECB experiment may be doing more harm than good. In an extreme example of how distorted things have become, Greece actually sold 3-month bills at a negative yield in October, around the same time the entire German yield curve was negative. Europe probably can’t afford to make significant trade concessions to the United States and dodge recession at the same time.

First quarter growth in the U.S. will be further hampered by Boeing’s decision to halt production of 737 MAX planes. According to Bloomberg, this could shave as much as a half percentage point from GDP in Q1, although the shortfall should be recaptured later in the year when Boeing resumes production.

The year begins with a big dose of misplaced trade enthusiasm, record stock prices, modest growth forecasts and a content Fed, but the sense of calm that ended the year has passed. Rising tensions in the Middle East promise to increase uncertainty and market volatility. And, if these tensions were to evolve into a full-blown war (whatever that means), political tensions, both in the U.S. and abroad, could escalate quickly. With President Trump’s Senate trial looming, and the Iowa Caucus less than a month away, the political war of words is on the verge of heating up as well.

After swinging and missing wildly on forecasts last year, the Fed and the nation’s economists now share a middle-of-the-road, goldilocks’ outlook for 2020. It’s not clear that these group-think expectations are of much value. There are simply too many wildcards in play, and the number of downside risks seem to far outweigh the upside. The Fed would prefer to hold policy steady at least through the November elections, but this position could easily change as the year unfolds.