WEEKLY ECONOMIC COMMENTARY—WEEK OF JUNE 3rd, 2019

- Pressure on the Fed to cut rates is intensifying. The economy is weakening more than expected, inflation remains quiescent and the financial markets are sounding a downbeat note.

- Consumer spending stagnated in April, following an outsize increase in March. Other data are also coming in below expectations, causing widespread cutbacks in second-quarter growth estimates.

- The Fed remains steadfast for now. But if trade tensions escalate and the White House follows through with its latest tariff threat against Mexico, the odds of a rate cut – and a possible recession – will increase exponentially.

The Federal Reserve's dilemma keeps growing, even as its past actions are coming under increasing criticism. With the unemployment rate at a 50-year low, wage growth accelerating, household confidence elevated and the economy coming off an above-trend growth rate in the first quarter, the case for a rate cut would seem to be weak at best. Yet the financial markets are betting that the Fed will do just that before the end of the year, pricing in a more than 90 percent chance that the federal fund rate will be lower than the current 2.40 percent average by December. Adding heft to market's bet, the 10-year Treasury yield has fallen to the lowest level since September 2017, having plunged more than a full percentage point since last November, and is currently below the rate on three month Treasury bill, an inversion that is a time-honored signal of economic weakness.

Although Fed officials recognize the myriad risks to the outlook – with a growing minority sympathetic to the markets' downbeat view – the prevailing sentiment continues to be one of patience. Most still view the risks as balanced, indicating that they believe a rate increase is just as likely as a rate cut. Underscoring this perception is the belief that mounting trade tensions and geopolitical disruptions do not yet pose an imminent threat to the economy, which is poised to moderate gently towards a trend growth rate. What's more, most policymakers expect inflation to move up towards the 2 percent target after transitory forces currently dragging the rate down run their course.

To be sure, the Fed and investors are looking at the same sets of data. One side sees the glass as half-full, the other as half-empty. From our lens, the half-full view is reflected in the rear-view mirror. The robust 3.1 percent headline growth rate in GDP during the first quarter, revised down from the initial 3.2 percent estimate, is history. Incoming data are tracking a growth rate of about half that pace in the current quarter. True, the first quarter's pace was bloated by an unsustainable buildup in inventories and a narrower trade deficit, which masked exceptional weakness in consumer and business investment spending. But neither personal consumption nor investment outlays are showing signs of a breakout rebound in the current quarter. Indeed, the latest figures on new orders indicate that capital spending will be hard-pressed to show much, if any, improvement during the period.

While consumer spending is reviving from a dismal showing in the first quarter, the recovery is hardly a barnburner. A big lift was provided in March, when real personal consumption jumped

by 0.9 percent, the strongest increase since the recession. That put the start of the second quarter at a higher level than the first quarter's average, which imparts some oomph to the current quarter's growth rate for PCE. But there was no follow-through momentum to the March gain, as Friday's personal income and spending report showed that real personal consumption flat lined in April. Thanks to a strong increase in real disposable income last month, spending should pick up in May and June, but this source of strength is looking less potent than a month or so ago.

The one redeeming feature for the half-full crowd is the job market, which by all accounts continues to run hot. That, in turn, is sustaining wage growth and underpinning a high level of confidence among households. More than anything this critical support to consumption is the primary factor keeping recession fears at bay. That said, it would be increasingly difficult for the job-creating engine to run at its current speed for much longer. There may be more slack in the labor force than the low 3.6 percent unemployment rate suggests, but the ability of companies to draw workers off the sidelines to fill positions is running dry. Indeed, a recent study by the San Francisco Fed finds that the prime-age labor force participation rate is increasing primarily because fewer workers are dropping out of the job market rather than by new workers being drawn in. The study concludes that this compositional shift has just about reached its limit.

If that's the case, the strong demand for workers against a diminished supply should sustain upward pressure on wages. While we believe that the progress made on the wage front will be retained going forward, a further acceleration of wage growth will be harder to come by. For one, the forces underpinning the strong demand for labor are waning. The fiscal impetus to growth provided by the Tax Cuts and Jobs Act in late 2017 has just about run its course. While the act injected a huge amount of cash into corporate coffers to help finance expanding payrolls as well as investment spending (although most of the proceeds were used for share buybacks and mergers and acquisitions), that spigot is closing. Indeed, after surging for five consecutive quarters, after-tax profits of nonfinancial corporations fell in the first quarter, erasing the entire gain over the second half of last year and then some.

Nor was it just the removal of tax benefits that took a bite out of earnings. Profits before taxes fared even worse, falling for two consecutive quarters. Simply put, corporations are facing headwinds that are buffeting both the top and bottom lines. With fiscal stimulus fading, so too is domestic demand for corporate output even as the pronounced global slowdown is slicing into revenues from overseas sales. The strong dollar is also hurting exports, undercutting the pricing competitiveness of American-made products. Whatever help on the price front that the administration's broadening tariff hikes might provide to domestic firms is more than offset by the growth-impeding impact of supply chain disruptions that those levies are bringing about.

So far, these headwinds have had only a modest impact on the U.S. economy. Until the key growth cylinders, most notably consumer spending and job growth, show tangible signs of sputtering, the Fed is likely to retain a wait-and-see policy stance. But escalating trade tensions and the darkening global outlook are roiling the financial markets, where the sentiment to cut rates has increased exponentially in recent weeks. Many investors believe that the Fed has already gone too far by hiking rates four times last year, particularly in light of the tame inflation backdrop. While the Fed has left rates unchanged since the last hike in December, the key inflation gauge it favors (the core personal consumption deflator) has slipped further below the 2 percent target, increasing 1.6 percent in April from a year earlier. Hence, the real funds rate has increased to the highest level in more than a decade.

The Fed acknowledges that inflation will remain below its target over the medium term owing to transitory forces that it believes will dissipate over time. However, the longer that low inflation persists, the greater will be the pressure on the Fed to cut rates. That pressure will become even more intense if incoming data continue to disappoint on the weak side. Aside from the job market, the latest batch of data have clearly fallen short of expectations, causing wide ranging cutbacks in growth estimates. We have shaved our current quarter's estimate from about 2.0 percent to 1.0-1.25 percent. The Fed has yet to formally lower its growth outlook, but recent comments by Fed officials highlight their concerns over growing downside risks. Fed Vice Chairman Richard Clarida is the latest official to voice concerns, noting this week that if the downside risks materialize, the case for a rate cut sooner than later would certainly gain traction.

Our sense is that the Fed's next move will be to cut rates, but not before early 2020. As noted, the economy is still chugging along, albeit at a slower pace, and a still robust labor market, rising wages and elevated consumer confidence should stoke the growth engine through at least the summer, when the current expansion will enter the books as the longest on record. And despite the doom and gloom surrounding most recent economic reports, the negative reaction in the bond market might actually sow the seeds for a revival in housing activity. Mortgage rates have fallen below 4.0 percent this week for the first time in over a year, which should stir demand for mortgage applications. As well, home prices are cooling off considerably, with the Case-Shiller 20-city index increasing by 2.6 percent in March, half the pace of just six months earlier. Hence, a home purchase should become more affordable to a broader swath of the population.

That said, our view that the Fed will remain patient until early next year assumes that the worst-case scenario does not come to pass. Towards the end of this week, that prospect looked ever-more precarious as the White House ramped up trade tensions, threatening to impose stiff tariffs on Mexico if that country does not comply with U.S. border security demands. The ongoing trade dispute with China has garnered most of the headlines in recent months, and if the administration follows through with its threat to impose tariffs on all Chinese imports, the spillover effect on the U.S. economy would be significant but not life-threatening.

Not so with Mexico, which is not only a more important trading partner than China, it also has deeply embedded supply chain links with American companies. If the White House follows through with its tariff threat and Mexico retaliates in kind, which is likely, the odds are that the U.S. would fall into a recession sooner rather than later. We suspect that the Fed would act preemptively if a U.S./Mexico trade war erupts and pull the rate trigger before the end of the year. The looming threat of such a prospect sounded a dire note in the financial markets at the end of the week, with stock prices posting significant losses and bond yields moving still lower.

FINANCIAL INDICATORS

INTEREST RATES	May 31	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.36	2.35	2.44	1.92
6-month Treasury bill	2.37	2.39	2.45	2.10
3-month LIBOR	2.52	2.52	2.54	2.32
2-year Treasury note	1.94	2.16	2.27	2.48
5-year Treasury note	1.91	2.12	2.27	2.75
10-year Treasury note	2.13	2.39	2.47	2.90
30-year Treasury bond	2.57	2.82	2.89	3.06
30-year fixed mortgage rate	3.99	4.06	4.10	4.56
15-year fixed mortgage rate	3.46	3.51	3.57	4.06
5/1-year adjustable rate	3.60	3.68	3.63	3.80
STOCK MARKET				
Dow Jones Industrial Index	24,815.04	25,601.32	25,942.37	24,635.21
S&P 500	2,752.06	2,829.02	2,881.40	2,734.62
NASDAQ	7,453.15	7,637.01	7,916.94	7,554.33
COMMODITIES				
Gold ($ per troy ounce)	1,310.10	1,284.20	1,286.80	1,297.40
Oil ($ per barrel) - Crude Futures (WTI)	53.35	59.06	61.74	65.70

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Confidence Index (April)	129.2	124.2	131.4	128.3
Revised GDP (Q1) - % change	3.1	2.2	3.4	2.9
Personal Income (April) - % change	0.5	0.1	0.2	0.3
Personal Consumption (April) - % change	0.3	1.1	0.0	0.3
Personal Savings Rate (April) - Percent	6.2	6.1	7.0	6.6

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