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The financial markets spent the week biding time in anticipation of the G-20 summit in Japan this weekend, when President Trump and his counterpart Xi Jinping of China will hold trade talks that hopefully defuses tensions between the world's two largest economies. On a positive note, several American officials expressed optimism that the two sides were close to a deal, one that would prevent the growth-damaging tit-for-tat tariffs that have been roiling the markets for months. On the negative side, it is hard to ignore the fact that we have heard this before – many times – with nothing to show for it.

With uncertainty over the outcome of the meeting overhanging the markets, investors kept their gaze fixed on more mundane matters regarding monetary policy and the economy. But like the trade imbroglio, neither brought more clarity to the table. For the most part, expectations that the Fed was on the cusp of cutting rates as early as next month remained high. Neither Chairman Powell nor other Fed officials disabused that notion in public comments this week. Powell, in a speech before the Council on Foreign Relations, noted that risks to the outlook had increased in recent months, reflecting escalating trade tensions with China and Mexico, slowing global growth and some weakening in confidence, particularly among businesses. Importantly, he also fretted over the continued deterioration in inflation expectations as well as the persistence of actual inflation to undershoot the Fed's 2 percent target.

We suspect that the Fed will pull the rate trigger at the late-July policy meeting and again in September, but more as insurance to prevent slowing growth from gaining traction than in response to a pronounced setback in the economy. No doubt, parts of the economy are feeling the pain from slowing global growth and trade tensions, most notably the manufacturing sector. But the industrial complex is still expanding, albeit sluggishly, and does not threaten to bring the broader economy to its knees. Business leaders are growing increasingly nervous over ongoing trade disputes and tariff increases already in effect, and are holding back on investment plans. That said, they are not nixing spending plans entirely. Indeed, an encouraging sign came from this week's report on bookings for capital goods. Orders for nondefense capital goods less aircraft increased by a modest 0.4 percent in May, reversing a small portion of the deep 1.0 percent drop in April.

But it was the fourth increase in the last five months and kept the volume of orders 1.3 percent higher than a year ago. What's more, shipments increased by a more robust 0.7 percent following a 0.4 percent gain in April. These back-to-back increases suggest that equipment spending might make a positive contribution to growth in the second quarter, after falling by 1 percent in the first. However, we would feel more comfortable about investment prospects if new orders were stronger than actual shipments. Just the opposite is the case, as shipments in May exceeded bookings by a whopping $1.1 billion. Regional surveys of manufacturers in June are not encouraging, as they depict more weakness in activity than shown in the durable goods report. The national survey of manufacturing activity compiled by the Institute for Supply Management will be released next week, providing a more expansive measure of how the industrial side is holding up.

It's doubtful that lower rates engineered by the Fed would do much to directly lift the fortunes of manufacturers, as borrowing costs have not been a restraining force on industrial activity. But there would be positive indirect effects if lower rates stimulate demand for manufactured goods, particularly from credit-sensitive sectors. The most promising source for this strength is the housing industry, which has seen a remarkable fall in mortgage rates in recent months. The rate on 30-year fixed mortgages fell another nine basis points this week to 3.73 percent, down more than a full percentage points since last November and the lowest since November 2016. As expected, the decline has sparked an increase in mortgage applications, both for the purpose of purchasing a home and to refinance existing mortgages that carry higher rates. Over the first three weeks of June, refinancing applications are running more than 50 percent above the volume in May.

So far, however, the more receptive financial backdrop has had mixed results in the housing market. As noted last week, builders are only modestly breaking more ground for home construction than in the first quarter, and building permits are hardly pointing to a construction boom. But here too, as in manufacturing, the problem is not interest rates, but an array of external factors, such as a shortage of skilled workers and lots to build on as well as higher construction costs, both for labor and materials. The demand side of the housing ledger is also yielding mixed results. As reported last week, existing home sales for May turned up and the increase reflected contracts that were signed months earlier when mortgage rates were higher than they are now. That said, the response to declining mortgage rates has been uneven. New contracts signed, a measure of pending sales of existing homes, rose 1.1 percent in May, according to the National Association of Realtors, but that comes on the heels of a sharp 1.5 percent decline in April.

At best, existing home will grind higher in coming months depending on the availability of lower priced homes. A similar story prevails in the market for new homes, where sales tumbled 7.8 percent in May. But that follows two strong months of sales, including a March total that hit the highest since November 2017. Importantly, lower-priced homes are accounting for an increasing share of total sales, which presents a challenge to homebuilders as profits are higher for the more expensive units. But the wealthier segment of the market is weakening, and prices there are coming off their peaks. If home sales are to advance measurably from current levels, builders will need to find ways to profitably construct homes at lower price points.

As important as lower mortgage rates are to the housing market, their impact is greatly amplified when supported by strong household fundamentals. People buy homes when jobs are plentiful and incomes are growing, conditions that tend to also underpin a high level of confidence. The news on this front has been mostly positive lately, although consumer confidence is taking a hit from escalating trade tensions, which is causing some trepidation regarding future business conditions. The weak increase in payrolls last month may also be taking a toll on expectations, as the robust job market has been the pillar of strength driving consumer behavior this year. We will find out next Friday with the June employment report whether the weak reading for May was an aberration.

That said, the latest report on personal income and spending indicates that households are well positioned to support the economy. Recall that consumer spending was a big disappointment in the first quarter, staging a tepid growth rate of 0.9 percent. The period was notable for its spending obstacles, including the longest government shutdown on record, a stock-market rout in December, fears that monetary policy was becoming too restrictive and ongoing trade

tensions. All of these impediments, except the trade drag, were lifted as the quarter progressed, and consumers reopened their wallets and purses with a vengeance towards the end of the period. In March, they posted the strongest monthly increase in real outlays for goods and services since 2009, providing a good deal of momentum heading into the second quarter.

Impressively, the muscular spending increase that month did not presage much of a letdown over the following two months. Initially, it appeared that consumers took a breather in April, holding real outlays unchanged from March. But this week's report changed that impression, as the revised figures show that spending increased by 0.2 percent during the month. More significant is that the momentum continued into May, as real consumption posted another gain of 0.2 percent. Simply put, consumer spending is tracking a growth rate of just under 4.0 percent in the second quarter, which would rank among the strongest for a quarter in nearly five years.

The spending pickup, in turn, is being driven by a corresponding increase in household incomes. In May, personal income both before and after taxes increased by a solid 0.5 percent and most of the gain translated into real purchasing power, thanks to another tame inflation reading. Real disposable income increased by 0.3 percent during the month, lifting it a solid 2.3 percent above its year-earlier level. However, the income gain last month was not untarnished. A big boost was provided by interest receipts on assets and by proprietors' income. The bedrock income component that has the largest influence on sustainable spending – wages and salaries – showed considerably less strength, increasing by a mild 0.2 percent. That was the slowest monthly gain in six months.

The sturdy increase in consumer spending last month takes some of the pressure off of the Fed to cut rates next month, but the odds are it will follow through with its first reduction in more than a decade. The economy is facing increasing headwinds from slowing global growth and trade tensions, even as the tailwinds from the 2017 tax cuts are fading. Inflation continues to undershoot the Fed's target and inflation expectations are falling, undercutting the Fed's credibility to bring inflation up to its 2 percent target. What's more, the financial markets are fully pricing in a rate cut, and failure to follow through could stoke market turbulence and take a toll on confidence. Keep in mind also that monetary policy affects the economy with a lag and if, as we expect, growth is poised to slow over the coming year, the lower rates will be helping the economy just when they are needed the most.

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FINANCIAL INDICATORS

INTEREST RATES	Jun 28	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.13	2.13	2.36	1.93
6-month Treasury bill	2.11	2.06	2.37	2.12
3-month LIBOR	2.32	2.34	2.52	2.34
2-year Treasury note	1.75	1.75	1.94	2.53
5-year Treasury note	1.77	1.78	1.91	2.73
10-year Treasury note	2.01	2.06	2.13	2.86
30-year Treasury bond	2.53	2.56	2.57	2.99
30-year fixed mortgage rate	3.73	3.84	3.99	4.55
15-year fixed mortgage rate	3.16	3.25	3.46	4.04
5/1-year adjustable rate	3.39	3.48	3.60	3.87

STOCK MARKET				
Dow Jones Industrial Index	26,599.96	26,719.13	24,815.04	24,271.41
S&P 500	2,941.76	2,950.46	2,752.06	2,718.37
NASDAQ	8,006.24	8,031.71	7,453.15	7,510.30

COMMODITIES				
Gold ($ per troy ounce)	1,413.10	1,402.70	1,310.10	1,254.40
Oil ($ per barrel) - Crude Futures (WTI)	57.17	57.60	53.35	74.31

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (May) - 000s	626.0	679.0	705.0	648.0
Consumer Confidence Index (June)	121.5	131.3	129.2	126.6
Durable Goods Orders (June) - % change	-1.3	-2.8	1.7	-0.9
Personal Income (May) - % change	0.5	0.5	0.1	0.4
Personal Consumption (May) - % change	0.4	0.6	1.0	0.3

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