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With the ECB ramping up monetary stimulus to jump-start the ailing European economy, the Trump administration is putting more pressure on the Federal Reserve to follow suit. No doubt, the Fed will cut interest rates at its upcoming policy meeting next week, but the expected quarter-point reduction to a range of 1.75-2.00 percent is far less than what the president would like to see. As expressed in recent tweets, his preference is for the Fed to slash the federal funds rate to zero or even less and to resurrect the bond purchase program it abandoned five years ago. That would match the efforts being pursued by the ECB, which pushed its policy rate further into negative territory this week and announced a new round of bond purchases totaling $22 billion a month.

No one expects the Fed to follow such an aggressive policy for a variety of reasons. For one, the Fed's independence from political pressure is essential to maintaining its credibility in the financial markets, which would be severely undermined if it caved into the president's urgings. For another, the facts hardly justify more forceful action that the Fed is likely to take– at least not yet. True, the American economy is slowing from the sturdy growth rate it enjoyed in 2018 and early this year. But it is far from the dire straits seen overseas, where Europe's economic powerhouse, Germany, is teetering on the cusp of a recession and dragging down the rest of the region. What's more, the heightened uncertainty surrounding a possible messy exit of Britain from the EU without a deal next month reinforces the adverse influences that are retarding growth on the Continent.

Importantly, while global developments are taking a toll on the U.S. economy, the impact has been contained and has yet to pose a serious threat to the expansion. To be sure, manufacturing, which is most exposed to global influences, has been hit hard; indeed, activity in the industrial sector has been contracting for most of the year. But the far more important services sectors of the economy have been resilient, thriving on the strength that is still coming from domestic sources. The latest survey by the Institute for Supply Management strikingly reveals the diverging trends between the goods producing and service-providing sectors of the economy. Echoing the hard data on industrial production, the index of manufacturing activity has moved into negative territory, i.e., slipping below 50, for the first time since 2016. But that slippage in August contrasts with a solid gain in the non-manufacturing index, which remains firmly in expansion territory.

In contrast to the ever-darkening outlook overseas, sentiment in the U.S. is holding up. The University of Michigan reported on Friday that households turned more optimistic in early September, partially reversing a sharp drop in August when the escalation of trade tensions hammered confidence. Granted, households are significantly less confident than they were in 2017 and 2018 before the trade wars short-circuited the good feelings associated with tax cuts, robust job growth, a strong stock market and an economy that was expanding above its potential. But their more guarded perception of conditions is not translating into more cautious behavior. Instead, households are still spending freely, buoyed by some of the critical influences, most notably a strong job market, that lifted confidence in recent years.

The resilience of consumers is amply revealed in the latest retail sales data. On Friday, the Commerce Department reported that retail sales increased by a stronger-than-expected 0.4 percent in August, building on an upwardly revised blockbuster gain of 0.8 percent in July. Total sales are now running a spirited 4.1 percent ahead of a year ago, the strongest annual increase

since last October. Auto sales paced the gains, surging by 1.8 percent, which marks the second strong increase in the last three months. Nor does the gain reflect higher prices on motor vehicles; in the latest CPI report, prices on new vehicles actually declined by 0.1 percent during August. Next to housing, a car or SUV is the biggest expense a household makes, so the strength in auto sales is an encouraging sign that consumers are willing and able to take on a big-ticket discretionary purchase.

Not all merchants fared as well as auto dealers. Sales at food and restaurants fell 1.2 percent last month, but that followed eight consecutive months of mostly solid gains. As well, service stations suffered a drop in revenues, but that primarily reflected a decline in prices at the pump. Continuing a long-term trend, consumers are doing ever more of their shopping on the Internet, as nonstore sales advanced by 1.6 percent and are up 16 percent from a year ago. Not surprisingly, brick and mortar establishments are feeling the pain; department store sales fell by a sizeable 1.1 percent and are down 5.5 percent from a year ago. Nonstore sales, mostly Internet shopping, now account for nearly 13 percent of all retail sales (and more than 16 percent of nonauto sales) and their share is increasing at a rate of 1-1/2 percent a year.

In the context of the broader economy, it looks like consumers will be providing another quarter of solid support to GDP. The so-called control group of sales, which feeds directly into the calculation of personal consumption expenditures, increased by a decent 0.3 percent, building on a torrid 0.9 percent increase in July. Compared to a year ago, the control group of sales is up by a sizzling 5.3 percent. Retail sales account for about a third of total personal expenditures, so assuming households are not cutting back on haircuts, health care, housing and other services, the retail reports for July and August should bump up estimates for third-quarter consumption. We now expect real consumer spending to increase at an annual rate of 3.3 percent during the period, up 0.3 percent from our earlier estimate. That would be slower than the eye-opening 4.7 percent increase in the second quarter, but stronger than the pace seen throughout the 10-year expansion.

With the economy's main growth driver, consumers, still powering ahead the case for a steeper rate cut by the Fed is far from compelling. What's more, unlike in Europe where inflation and inflationary expectations are falling, the opposite is unfolding in the U.S. Along with the stronger-than-expected consumer spending data, the hawkish members of the Fed will be armed with fresh figures at next week's policy meeting showing that inflation is picking up. While falling gasoline prices held back the rise in overall consumer prices in August, the core consumer price index, which excludes volatile food and energy items, increased by 0.3 percent during the month.

As was the case with retail sales, this was clearly an upside surprise. Indeed, it was the third consecutive month that core prices rose by 0.3 percent. You would have to go back to 1993 to find a longer stretch of consecutive price gains that strong. The latest increase lifted the year-over-year increase in core prices to 2.4 percent, which equals the strongest annual rate of the expansion. Importantly, the latest surge in prices has little to do with higher tariffs being passed on to consumers. The biggest increases came from services, particularly the cost of medical care, which jumped by an unsightly 0.9 percent during the month. That said, tariff-related price increases remain a smoking gun going forward, as the levies scheduled to go into effect later this year will apply mostly to consumer goods.

Not surprisingly, the latest data on retail sales and consumer prices have altered perceptions in the financial markets regarding the Fed's upcoming policy moves. A few weeks ago, bond

investors had a very dim view of economic prospects, as the escalating trade wars fueled recession fears. The 10-year Treasury yield had fallen precariously close to its all-time low of 1.36 percent hit in mid-2016, falling to 1.47 percent in late August. Although expectations of a 50 basis point cut at the upcoming September meeting were still relatively low, the markets were looking for steeper reductions over time than the Fed was projecting.

But that sentiment has changed dramatically this week. Not only have the odds of a half-point cut next week been slashed significantly, the markets are pricing in much shallower rate cuts over the next year than was the case a few weeks ago. Importantly, bond yields have turned up sharply. The 10-year Treasury yield ended the week at 1.90 percent, up 35 basis points from a week ago, a significant move. It also stands more than 10 basis points above the 2-year yield, a marked shift from the inverted relationship that prevailed a month ago, which also stoked inflation fears.

That said, it would be a mistake to attribute the sharp move in bond yields entirely to changing perceptions of the economy. President Trump’s decision this week to delay the tariff increase on Chinese goods from October 1 to October 15 as a “good will gesture” offered hope that upcoming negotiations with China would lead to a thaw in relations between the two countries and mitigate the tariff war that is the biggest threat to the economic outlook. Also, there were reports that Germany was considering some fiscal stimulus to jump-start its economy, which contributed to a significant pickup in the German 10-year bond. Indeed, the U.S. Treasury yield rose in virtual lockstep with the German 10-year yield over the past week.

From our lens, the earlier plunge in bond yields reflected overblown recession fears that are now rightly dissipating The economy retains some solid fundamentals that should cushion it from global headwinds. However, those headwinds will take a toll on activity even as domestic tailwinds from the tax cuts are steadily diminishing and policy uncertainty continues to weigh on growth. We expect the Fed to monitor these events closely and respond by gradually lowering rates in quarterly increments at each of the next three policy meetings.

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FINANCIAL INDICATORS

INTEREST RATES	Sep 13	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.96	1.96	1.87	2.15
6-month Treasury bill	1.92	1.87	1.86	2.33
3-month LIBOR	2.12	2.10	2.12	2.33
2-year Treasury note	1.80	1.55	1.48	2.78
5-year Treasury note	1.76	1.43	1.43	2.91
10-year Treasury note	1.90	1.57	1.57	3.00
30-year Treasury bond	2.38	2.03	2.05	3.13
30-year fixed mortgage rate	3.56	3.49	3.60	4.60
15-year fixed mortgage rate	3.09	3.00	3.07	4.06
5/1-year adjustable rate	3.36	3.30	3.35	3.93
STOCK MARKET				
Dow Jones Industrial Index	27,219.52	26,797.46	25,886.01	26,154.67
S&P 500	3,007.39	2,978.71	2,888.68	2,904.98
NASDAQ	8,176.71	8,103.07	7,895.99	8,010.04
COMMODITIES				
Gold ($ per troy ounce)	1,496.20	1,515.30	1,522.60	1,198.50
Oil ($ per barrel) - Crude Futures (WTI)	54.90	56.63	54.86	69.00

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average- Past Six Months or Quarters
Consumer Price Index (August) - % change	0.1	0.3	0.1	0.2
Core CPI (August) - % change	0.3	0.3	0.3	0.2
Producer Price Index (August) - % change	0.1	0.2	0.1	0.2
Retail Sales (August) - % change	0.4	0.8	0.4	0.7
Consumer Credit (July) - $blns	23.3	13.8	16.8	16.0

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