WEEKLY ECONOMIC COMMENTARY—WEEK OF SEPTEMBER 23rd, 2019

The Federal Reserve took center stage again this week, as the rate-setting Federal Open Market Committee met on Tuesday and Wednesday. As expected, the Fed cut its short-term policy rate by a quarter-percentage point, reducing it to a range of 1.75-2.00 percent. It was the second quarter-point reduction in three months, and both were criticized as being too little as well as too late by President Trump. However, the financial markets were more tolerant, as stock prices and market yields ended the day of the announcement with barely unchanged results.

The relatively calm market reception of the news comes as no surprise. Like the Fed, investors are hardly unified as to whether the economy needs more monetary stimulus or less. Indeed, three Fed officials dissented in the vote for a quarter point cut, with two voting for no reduction and one for a larger half-point reduction. The three dissents represented the largest split in opinion under Chair Powell's leadership. What's more, this divergence extends beyond the latest decision, as policy makers are about evenly split in their rate forecasts for the rest of the year. Five are expecting further rate cuts, five are looking for a rate increase and seven see no change by year's end.

Simply put, the guessing game is about to go into full swing, setting the stage for heightened market volatility as traders and investors place bets as to what the Fed will do next. The current bet in the market is for two more rate cuts, reflecting the dovish forward guidance contained in the policy statement. While the Fed made no commitment to cut rates further, it did reiterate its intention to move promptly if necessary, to sustain the expansion. But for now, it sees little urgency to pull the rate trigger as "the labor market remains strong" … and "household spending has been rising at a strong pace". Recent data clearly back up this assessment.

That said, the Fed also recognizes that the economy has gaping weak spots and faces growing risks that could readily short-circuit the expansion. The main soft spots are business investment and exports, both of which have weakened, and the main risk is the blowback from ongoing trade disputes. These headwinds feed on each other, and the vicious circle shows no sign of ebbing. Indeed, restrictive trade policies are clearly taking a toll on business sentiment, which is putting a crimp in investment spending and hiring plans. That influence is amply captured in the latest survey compiled by the Business Roundtable, an organization of chief executives of major corporations.

The quarterly survey that began in 2002 shows how far business sentiment has fallen since the halcyon days of 2018 when the administration's tax cuts, and deregulatory measures sent business optimism sky-high. Plans for hiring, capital spending and sales expectations over the next six months have all declined sharply in the third quarter's survey released this week. The overall economic outlook index that encapsulates the three components fell by 10.3 points, the largest quarterly decline in seven years. At 79.2, the index is still in expansion territory, which is anything above 50, but the plunge from a high of 118.6 reached in the first quarter of 2018 has only been exceeded by the capitulation seen during the Great Recession in 2008. Importantly, the ebullient capital spending plans depicted during that period has never been fully realized.

Hence, unlike death and taxes, there is nothing inevitable about intentions. Just as last year's optimism failed to translate into actual behavior, so too might the plunge in hiring and capital spending plans overstate prospective developments. Keep in mind that the critical negative

influence on the mindset of executives could well turn positive in the blink of an eye. As Chair Powell noted in the post-meeting press conference, trade developments have waxed and waned since the previous policy meeting, although they have been mostly disruptive leading up to the latest confab. However, they could just as easily turn positive during the upcoming negotiations between the U.S. and China scheduled for October. Both parties have a vested interest in dialing down trade tensions before they take an even bigger toll on their respective economies.

Given the volatile pattern of trade negotiations seen over the past year, nothing should be taken for granted on this front. Odds are, uncertainty over trade policy will continue to weigh heavily on confidence for the foreseeable future. That said, there appears to be an interesting gap opening up between soft data, as reflected in confidence surveys, and hard data. Even as business sentiment, including the soft reading on manufacturing depicted in the latest Institute for Supply Management report, is taking a hit, hard data on activity is flexing some strength. The most notable example of this divergence emerged this week, as industrial production staged a surprisingly strong increase in August. The 0.6 percent increase in the collective output of mines, utilities and factories was the strongest monthly gain in a year and recovered all of the losses from the previous seven months.

But the highlight of the report is the solid 0.5 percent production increase at manufacturing firms, which is deeply at odds with the plunge in the manufacturing index depicted in the (soft) ISM manufacturing survey. Importantly, business equipment output advanced by a hefty 1.0 percent, the strongest increase in a year and the third positive reading in the last four months. If this trend holds up, capital spending should provide a modest lift to GDP in the third quarter, extending the slim 0.7 percent increase in equipment outlays seen in the second quarter. We caution though not to get overly excited by the recent rebound in manufacturing activity. At best, it is making up for lost ground, as factory output is still 0.4 percent below the level of a year ago.

The good news is that the resilience shown in recent industrial production figures confirms the limited impact that trade developments have had on the U.S. economy. The bad news is that the headwinds from trade tensions and slowing global growth are gaining traction. It is hard to see manufacturing activity picking up steam if exports continue to weaken and higher tariff-related input costs crimps profits. We expect that momentum will be stalled by a combination of slowing global activity, trade uncertainty and the strong dollar, which makes American products more expensive to foreign buyers. One tailwind for mining activity, however, at least for the short run, is the boost to oil production due to the disruptions caused by Hurricane Barry in July. That uplift is getting a second leg from this week's attack on Saudi oilfields, which temporarily erased 5 percent of the world's oil output.

It is unlikely that the unexpected strength in industrial production had affected the Fed's decision at this week's meeting. A failure to cut rates would have clearly gone against market expectations and proved to be highly disruptive. From our lens, the Fed's bias is leaning towards further cuts, reflecting the growth-dampening risks that global developments still pose to the economy. What's more, inflation is still running below the Fed's 2 percent target, at least as measured by its preferred inflation gauge, and market-based inflation expectations have actually declined following the latest rate cut. Hence, the risk of stoking inflation by cutting too much is low, which gives the Fed leeway to err on the side of ease.

That said, some argue that lowering rates would do little to help the economy and in fact may even be stifling growth. A fuller examination of that argument is best left for another day, but one

sector that is benefiting from lower borrowing costs is the credit-sensitive housing sector. To be sure, the benefits have been long in coming and it is unclear whether they are having more clout than other factors, particularly the strong job market and rising incomes. But the combination of cheaper loans and fatter paychecks is making homes more affordable to a growing swath of the population, and that's showing up in the sales market. In August, sales of existing homes jumped by a stronger-than-expected 1.3 percent to the highest level since March 2018.

For the year to date, sales are still trailing last year's pace. But sales in August exceeded the year-earlier level for the second consecutive month, which is the first time that has happened in two years. Sales of previously owned homes, which is essentially a transfer of assets, only have a negligible impact on GDP, mainly through the fees they generate for brokers. But stronger sales deplete the housing supply and spur new construction, which does have more than a trivial impact on GDP. And builders are taking notice. Housing starts surged by 12.3 percent in August, and building permits for future construction jumped by 7.7 percent. The increases pushed both starts and permits to levels not seen since before the housing bust and Great Recession in 2007.

The long-struggling housing sector appears to be finally coming to life, giving the Fed another incentive to maintain a favorable financial backdrop. To be sure, mortgage rates are influenced more by the movement of long-term rates than by the Fed, which has more direct control over short-term rates. But bond investors are keeping rates low, reflecting their expectation that the economy will remain in a low inflation, low growth environment. We expect that assessment will also guide the Fed towards more rate cuts over the balance of the year.

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FINANCIAL INDICATORS

INTEREST RATES	Sep 20	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.91	1.96	1.96	2.17
6-month Treasury bill	1.91	1.92	1.86	2.37
3-month LIBOR	2.16	2.12	2.13	2.37
2-year Treasury note	1.68	1.80	1.54	2.81
5-year Treasury note	1.60	1.76	1.42	2.96
10-year Treasury note	1.72	1.90	1.54	3.06
30-year Treasury bond	2.16	2.38	2.02	3.20
30-year fixed mortgage rate	3.73	3.56	3.55	4.65
15-year fixed mortgage rate	3.21	3.09	3.03	4.11
5/1-year adjustable rate	3.49	3.36	3.32	3.92

STOCK MARKET				
Dow Jones Industrial Index	26,935.07	27,219.52	25,628.90	26,743.50
S&P 500	2,992.07	3,007.39	2,847.11	2,929.67
NASDAQ	8,117.67	8,176.71	7,751.77	7,986.96

COMMODITIES				
Gold ($ per troy ounce)	1,524.40	1,496.20	1,535.60	1,203.50
Oil ($ per barrel) - Crude Futures (WTI)	58.09	54.90	53.88	70.83

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Industrial Production (August) - % change	0.6	-0.1	0.1	0.1
Capacity Utilization (August) - Percent	77.9	77.5	77.8	77.9
Housing Starts (August) - 000s	1,364	1,215	1,233	1,258
Building Permits (August) - 000s	1,419	1,317	1,232	1,308
Existing Home Sales (August) - 000s	5,490	5,420	5,290	5,330

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