WEEKLY ECONOMIC COMMENTARY—WEEK OF OCTOBER 28th, 2019

With a nod to an age-old proverb, the third quarter came in like a lion but ended like a lamb. The final month of the period still has some blanks to fill in, but most key indicators have clearly followed that trajectory. Recall that the quarter started on a promising note. Nonfarm payrolls increased by a solid 166 thousand in July, worker earnings rose by healthy 3.3 percent over the year, consumer confidence shot up to near the high for the expansion and households were spending lavishly; retail sales staged a solid 0.7 percent increase, nearly twice the 0.4 percent average gain over the previous three months.

No one expected a breakout quarter as the constraints that had inhibited growth over the first half of the year, most notably escalating trade tensions and slowing global growth, were still very much in place. But the general consensus was that the economy would perform at least as well as it did in the second quarter, when GDP advanced at a trend-like 2.1 percent (since revised down to 2.0). By the third week of August when all the data for July had been tabulated, the Atlanta Federal Reserve's GDPNow tracking model pegged the third-quarter's growth rate at 2.3 percent, upgraded from 1.8 percent just three weeks earlier.

But that was then. As the quarter progressed, the clouds over the economic landscape steadily darkened. Job growth slowed, slipping to 136 thousand in September, wage growth fell below 3.0 percent for the first time in twelve months, and consumers pulled in their horns; in September retail sales fell for the first time since February. Business confidence plunged to the lowest point in a decade, reflecting mounting uncertainty over trade policy, and household spirits started to wilt. The University of Michigan's Sentiment Index slipped to 93.2 in September, still relatively high but well off the nearby peak of 100 seen in May. The Atlanta Fed's GDPNow model is forecasting growth at 1.8 percent for the quarter. From our lens, that's still overly optimistic; we expect growth to come in under 1.5 percent and the risk is tilted to the downside, as the headwinds buffeting the economy show no signs of letting up.

Importantly, the global slowdown that has been a serious drag on U.S. manufacturing activity is continuing apace. The latest reports depict a eurozone that virtually stagnated in the third quarter and remained in the doldrums in early October, with Germany, the region's powerhouse, mired in an industrial recession. Like the U.S. the performance of economies overseas has been severely impacted by the trade wars. And like Germany, the main victim in the U.S. is the manufacturing sector. No doubt, plunging exports and the strong dollar have contributed mightily to the woes in manufacturing activity, underscoring the decline in production in two of the past three months. Just as important, however, is the ongoing uncertainty over trade policy that is prompting business leaders to shelve capital spending plans.

This week's report on orders for durable goods highlighted that ominous trend. Bookings for all long-lasting goods fell by 1.1 percent in September, a steeper decline than expected, dragged down by the GM strike and the ongoing woes of Boeing, whose problem-plagued 737 Max aircraft has been grounded. But while the transportation sector weighed heavily on orders and shipments for durable goods last month, this category tends to be volatile and is often a misleading barometer of investment spending trends. Orders for aircraft, for example, are usually lumpy, with a bunch of orders in one month followed by none for an extended period of time. Meanwhile, the

depressing influence of the GM strike should be followed by a snapback soon, as the UAW members appears ready to approve the contract forged between their leaders and GM.

But the readings for the less volatile core capital goods orders, which exclude defense and aircraft items, tell a more compelling story about the state of business investment spending. The main theme: companies are cutting back. Orders for core capital goods fell for the second consecutive month in September, with the latest month's drop pushing the volume 0.8 percent below the year-earlier level. That equaled the steepest year-over-year decline since November 2016. While the slump in bookings augurs for weak investment spending going forward, the current quarter is shaping up to be weaker than expected. Shipments of core capital goods, a proxy for equipment spending in the GDP accounts, declined 0.7 percent in September following no change in August and a similar 0.7 percent drop in July.

For the third quarter, core shipments fell by an eye-opening 3.3 percent annual rate, assuring that equipment spending had a negative impact on GDP during the period. We expect that such capital outlays plunged by an annual rate of 4.6 percent, which would more than erase the tepid 0.8 percent increase in the second quarter and represent the sharpest decline since the fourth quarter of 2015, when the collapse in oil prices decimated energy-related investment spending. Importantly, with the third-quarter weakness back-loaded, capital spending has little momentum heading into the final quarter of the year.

The key question is whether the cutback in capital outlays and the overall weakness in manufacturing will bleed into the broader economy, raising the odds of a recession sooner rather than later. The good news is that the goods-producing sector carries less weight than in earlier cycles so it would require more of a setback in production than in the past to bring the economy to its knees. Currently, for example, the gross value of goods produced in the U.S. accounts for just over 22 percent of gross domestic product. That's down from a 28 percent share just prior to the last recession and from more than 30 percent prior to each recession going back to the early 1970s, when it accounted for a 34 percent share of GDP. That's not a surprising trend amid an ever-growing advanced economy with an aging population. Such a combination generates more discretionary income to spend on things like financial services and recreational activity and has growing needs for health care services.

Hence whereas consumers devoted 51 percent of their nominal expenditures to services in 1971, that share has climbed to 70 percent this year. Nor is it just the demand side of the economy that is using more services relative to goods. On the supply side, the labor required to produce tangible goods has declined even faster. For example, jobs in manufacturing have plunged from over 26 percent of total nonfarm payrolls in 1970 to just 8.5 percent currently. That decline reflects the rise in labor productivity over the period and mirrors the shift in resources from the industrial to the services side of the economy.

Reflecting its diminished influence on the broader economy, industrial production fell for more than a year from mid-2015 through the fall of 2016 without bringing the economy to its knees. That decline – caused largely by the aforementioned slump in energy-related spending following the collapse in oil prices – was only the second time in the postwar period a year-over-year decline of more than one month in industrial output didn't coincide with a recession. The only other episode when the economy stayed afloat amid a decline in production occurred just after the Korean War when the U.S. unwound its industrial defense base built up during the conflict.

The bad news, of course, is that the source of industrial angst could well grow stronger and permeate the broader economy. That could happen if the trade wars escalate and the global slowdown intensifies. As it is, some contagion is already evident. Small businesses – most of which are service providers – are reporting cutbacks in hiring and investment plans, reflecting a sharp decline in sentiment among owners according to the latest surveys by the National Federation of Independent Businesses. If this downbeat note reverberates in a meaningful way to households, spurring an upsurge in job insecurity, the last pillar to fall in a recession, consumer spending, would be at risk of crumbling.

While recession fears have risen in recent months, it's unlikely that this dire scenario will unfold barring a sudden external shock such as an oil crisis or major geopolitical conflict. Household sentiment and spending may be flagging; but the fundamentals supporting consumption are still relatively solid and should remain so unless the job market turns abruptly weaker, something we do not expect. Importantly, a key recession buffer is firmly in place, namely a central bank that is highly tuned in to the global risks facing the economy. Unlike the late stages of previous expansions when the Federal Reserve usually waited too long to shift gears, it has already made two interest rate cuts to insulate the economy from the global headwinds. We fully expect a third to be taken at next week's policy meeting and a likely fourth cut in December, thus erasing the four increases put in place in 2018.

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FINANCIAL INDICATORS

INTEREST RATES	Oct 25	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.67	1.67	1.80	2.33
6-month Treasury bill	1.66	1.63	1.84	2.47
3-month LIBOR	1.94	1.97	2.10	2.51
2-year Treasury note	1.63	1.58	1.64	2.81
5-year Treasury note	1.63	1.56	1.57	2.91
10-year Treasury note	1.80	1.75	1.69	3.08
30-year Treasury bond	2.29	2.25	2.13	3.31
30-year fixed mortgage rate	3.75	3.69	3.64	4.86
15-year fixed mortgage rate	3.18	3.15	3.16	4.29
5/1-year adjustable rate	3.40	3.35	3.38	4.14
STOCK MARKET				
Dow Jones Industrial Index	26,958.06	26,770.20	26,820.25	24,688.31
S&P 500	3,022.55	2,986.20	2,961.79	2,658.69
NASDAQ	8,243.12	8,089.54	7,939.63	7,167.21
COMMODITIES				
Gold ($ per troy ounce)	1,507.30	1,493.90	1,503.20	1,229.70
Oil ($ per barrel) - Crude Futures (WTI)	56.62	53.71	56.08	69.38

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (Sept). 000s	701	706	665	676
Existing Home Sales (Sept.) - 000s	5,380	5,500	5,420	5,360
Durable Goods Orders (Sept.) - % change	-1.1	0.3	2.1	-0.4

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