WEEKLY ECONOMIC COMMENTARY—WEEK OF SEPTEMBER 30th, 2019

While we believe the Fed will follow up its quarter-point rate cut on September 18 with a similar reduction at its next meeting in October, we recognize that the decision will be a close call. The bias towards further easing was evident at the last meeting but only by a slim majority of Fed officials. Indeed, the lack of consensus has been on full display since the meeting as evidenced by the disparate remarks of several policymakers. This week alone, one regional Fed president opined that steeper rate reductions should have been made, another felt that the reduction taken at the last meeting was unnecessary and a third thought that the quarter-point reduction was right on the mark.

Odds are most Fed officials will be sitting on the fence right up to the October 29-30 policy meeting and, hence, their decision will be heavily influenced by incoming data. If the latter comes in on the strong side the easing bias could well be erased, or at least shunted to later in the year, while weaker-than-expected reports would have just the opposite effect. Until recently most U.S. data pointed to a modest slowing but still respectable growth rate for the current quarter, not far from the 2.0 percent posted in the second quarter. However, this week's economic reports sounded a decidedly weaker note, suggesting a more severe slowdown is underway. What's more, the prospect of political dysfunction stemming from the impeachment inquiry currently unfolding in Congress adds to the uncertainty over trade policy that has long roiled the financial markets and is buffeting confidence on Main Street.

It's too early to tell what impact the events on Capitol Hill will have on household and business confidence, much less on the markets. However, the depressing influence of ongoing trade developments is becoming ever-more evident in the business community. Last week we referenced the latest Business Roundtable survey that depicted a sharply weaker economic outlook among business leaders, a downshift primarily related to trade tensions. This week brought more evidence that the slippage in business optimism is translating into actual behavior, most notably in weaker capital spending. On Friday, the Commerce Department reported that a proxy for business equipment spending in the GDP accounts is running measurably below the second quarter average over the first two months of the third quarter.

While shipments of core capital goods (nondefense items excluding aircraft) increased 0.4 percent in August that was not enough to offset the larger 0.6 percent drop in July. Based on the depressed average reading for July and August, our tracking model points to a 2.0 percent contraction in business equipment spending in the third quarter. That would sustain the bumpy road to nowhere seen so far this year. Equipment spending rose a slim 0.8 percent in the second quarter following a 0.1 percent contraction in the first.

What's more, prospects over the near term do not look promising. Orders for these same core capital goods fell 0.2 percent last month, following no change in July. The momentum in bookings has turned decidedly weaker. New orders were down 0.3 percent in August from a year ago, the second consecutive year-over-year decline. That's the first back-to-back decline since November/December 2016, when the collapse in energy-related investment spending paced the deteriorating trend. This time, the weakness is more broadly based and is consistent with the recession readings in manufacturing activity revealed in the ISM surveys of manufacturers.

Importantly, the Federal Reserve's easing bias has been linked to the weakening trend in capital spending; hence, the latest figures on durable goods orders will only reinforce the dovish sentiment among Fed officials. By itself, that increases the likelihood the central bank will pull the rate trigger again at next month's meeting. But an even bigger push appears to be coming from a more critical source: consumer spending. Keep in mind that even as the Fed was cutting rates in both July and September it believed that the economy was still underpinned by solid fundamentals, most notably the healthy job market and strong consumer spending, the economy's main growth driver.

But that firm belief may be shaken by the latest data on consumer spending. Along with the downbeat reading on capital spending, the Commerce Department also reported on Friday that consumers sharply curtailed spending last month. Total personal expenditures eked out a slim 0.1 percent increase in August, down sharply from the robust 0.5 percent increase in July, which itself was revised down from the previous estimate of a 0.6 percent increase. Adjusted for inflation, personal outlays also rose by a slim 0.1 percent last month, about one-third of the 0.3 percent increase posted in July. Hence, after blowing through expectations in the second quarter with a 4.6 percent increase – matching the strongest quarterly pace since the fourth quarter of 2014 – real personal outlays are poised to downshift considerably in the current quarter. We are currently expecting a growth rate of 2.5 percent, underpinning a corresponding slowdown in GDP to 1.3 percent from a 2.0 percent pace in the second quarter.

Indeed, the surprisingly weak increase in personal outlays for August flies in the face of a stronger than expected increase in retail sales reported for that month two weeks ago. But the retail sales report covers mainly goods purchases, and a sizeable increase in auto purchases was largely responsible for the gain at retailers last month. Accordingly, it also made a big contribution to the increase in total outlays. But other durable goods purchases were also strong and, in fact, all big-ticket outlays increased by a solid 0.9 percent following an 0.8 percent increase in July. In addition to autos, consumers are buying furniture and recreational goods at a healthy clip. Interestingly, one expensive category is getting slammed: purchases of new foreign autos, which fell by $860 million last month and by $2 billion over the past two months, a significant 12.7 percent decline. Apparently, the stronger dollar is not giving auto imports much of a boost.

In contrast, outlays on services were soft, coming in unchanged last month. Nor was August a fluke, as services outlays were soft in both June and July as well, increasing by only 0.1 percent in each of those months. The big drag in August was the decline in energy prices, which pulled down spending on gas and electricity. Excluding energy-related items, outlays on services increased by a still soft but better 0.2 percent. However, households pulled back spending on recreational services, such as restaurants, bars and club memberships. These are discretionary purchases that could be echoing the recent slippage in consumer confidence.

Still, the solid increase in durable goods purchases suggests that consumers have not abandoned discretionary purchases. What's more, the overall downbeat reading on personal consumption last month masked a positive offset that may auger for a rebound in coming months. Even as households turned more cautious in their spending behavior, they continued to enjoy solid income gains. Personal income increased by a sturdy 0.4 percent in August, powered by a robust 0.6 percent gain in wages and salaries. Importantly, with inflation holding steady virtually the entire increase in incomes translates into improved purchasing power. Real disposable incomes increased by 0.4 percent last month, the strongest since February. Simply put, households eschewed spending in favor of building up savings, pushing the savings rate up to 8.1 percent from 7.8 percent in July.

With personal savings at historically high levels amid sturdy income gains, households have the firepower to sustain spending at a respectable pace in coming months. The question is, will they follow through or choose to keep a high level of precautionary savings to guard against adverse shocks? Recent surveys suggest that consumers are becoming more anxious over trade developments as well as the drumbeat of unsettling news from overseas. They may also start to worry about job security, fearing that the cutback in business investment spending is a prelude to reduced hiring.

We suspect that households will continue to spend at a modest but slowing pace over the coming year as the economy gradually succumbs to the headwinds of weakening global activity, the tapering off of fiscal stimulus and a slower pace of job and, hence, income growth. We also suspect that the Federal Reserve will view the prospective economic backdrop in much the same way and lean towards further rate reductions to sustain the expansion. That said, there is plenty of time between now and the next meeting on October 30, and plenty of data yet to come that could determine what the Fed’s next move will be.

GOVERNMENT PORTFOLIO ADVISORS

FINANCIAL INDICATORS

INTEREST RATES	Sep 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.80	1.91	1.99	2.20
6-month Treasury bill	1.84	1.91	1.88	2.37
3-month LIBOR	2.10	2.16	2.13	2.40
2-year Treasury note	1.64	1.68	1.51	2.80
5-year Treasury note	1.57	1.60	1.39	2.96
10-year Treasury note	1.69	1.72	1.50	3.06
30-year Treasury bond	2.13	2.16	1.96	3.21
30-year fixed mortgage rate	3.64	3.73	3.58	4.72
15-year fixed mortgage rate	3.16	3.21	3.06	4.16
5/1-year adjustable rate	3.38	3.49	3.31	3.97

STOCK MARKET				
Dow Jones Industrial Index	21,820.25	26,935.07	26,403.28	26,458.31
S&P 500	2,961.79	2,992.07	2,926.46	2,913.98
NASDAQ	7,939.63	8,117.67	7,962.88	8,046.35

COMMODITIES				
Gold ($ per troy ounce)	1,503.20	1,524.40	1,529.20	1,195.30
Oil ($ per barrel) - Crude Futures (WTI)	56.08	58.09	55.16	73.54

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (August) - 000s	713	666	729	676
Capital Goods Orders (August) - % change	-0.2	0.0	0.9	0.0
Personal Income (August) - % change	0.4	0.1	0.4	0.4
Personal Expenditures (August) - % change	0.1	0.5	0.3	0.5

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