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ECONOMIC UPDATE

THIRD QUARTER 2019

Quarterly Key Points

- The Federal Reserve delivered 25 basis point policy rate cuts at both the July and September meetings. The combination of the policy signal in July and the immediately following deterioration in trade talks between the U.S. and China led to a substantial rally in interest rates in August. The 30-year Treasury rate fell below 2.00% for the first time in history and the curve briefly inverted between 2s and 10s. Despite these ominous signals, the Fed ended the quarter divided regarding the path forward as some recent economic data has surprised to the upside.
- U.S. GDP growth slowed to 2.00% in second quarter. Personal consumption growth of 4.6%, the strongest in over a year, propped up the economy as broad measures of manufacturing and business output slipped into contractionary territory. These observations highlight an economy that continues to be a tale of two cities. Forecasts are now calling for GDP in the 2% range for 3Q19.
- While the Consumer Price Index (headline CPI) continues to underwhelm, core inflation is showing some signs of life as both Core CPI and Core PCE, the Fed's preferred inflation measure, trended upward. Hints of rising core inflation support the argument that continued rate cuts are not a foregone conclusion. That said, market measures of inflation expectations, like the 5yr5yr Forward Breakeven and the 10-year Breakeven inflation rate, continue to suggest that sustained higher inflation is nowhere in sight.
- In a complete reversal from 2018, the Fed reduced its policy rate by 25 basis points twice in 3Q and ended the quantitative tightening of its balance sheet a month early. Although some measures of output have slowed, warranting continued policy easing, others have shown signs of resilience, leading to a divided Fed (non-unanimous vote) and a slightly hawkish message in September. Regardless, current expectations are for 1-2 more rate cuts between now and year-end.

Our View

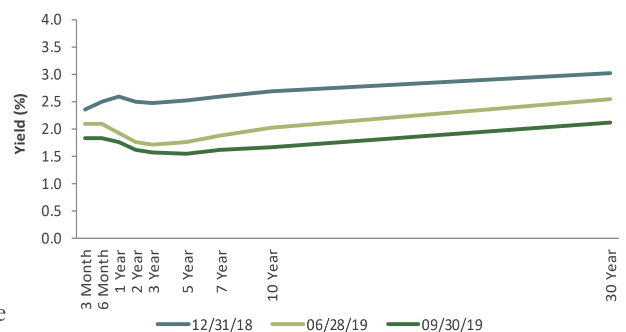
- Despite continued low unemployment, consistent wage gains and strong consumer spending, expectations for 3Q GDP growth are in the 1.8% - 2.1% range.
- Business activity continues to slow; with some output measures slipping into contractionary territory as prolonged uncertainty regarding trade and elevated geopolitical risks take their toll. With job creation showing signs of slowing, there is growing concern about lackluster business activity spilling over into labor markets, consumer confidence and ultimately consumer spending.
- Given the slowing trend in business activity and job creation, the Fed will likely continue to ease monetary policy in the last quarter of the year. As we've highlighted throughout the year, any disconnect between market expectations and what the Fed delivers has the potential to create volatility.
- We continue to advocate for investors to be cautious in the face of a global economic cycle in the late stages of expansion.

3Q SUMMARY – UNCERTAINTY PERSISTS, AS MARKET CROSSCURRENTS CONTINUE

Following through with the dovish signal of policy support in June, the Federal Reserve delivered 25 basis point cuts in both July and September. Furthermore, at the July policy meeting, the Fed announced it would end quantitative tightening (balance sheet runoff) in August rather than September, as previously communicated. Interestingly, the end of quantitative tightening came none too soon, as building liquidity stress in overnight markets reached a crescendo in September, prompting Fed intervention to add liquidity via overnight repo facilities.

No sooner did the ink dry on the Fed's July policy statement, than the Trump administration announced tariffs on an additional $300 billion of Chinese goods, triggering a new round of back-and-forth escalation between the two economic giants. While this was not entirely unexpected, the timing of the tariff announcement advanced a number of arguments regarding the chicken-and-egg relationship between Federal Reserve policy and the U.S. Government trade war. At a minimum, the trade war has muddied the signal from the Fed and made detangling underlying economic forces from the incremental effects of the trade war very difficult.

FIGURE 1 U.S. TREASURY YIELD CURVE[1]



The combination of deteriorating economic data, both at home and abroad, the dovish policy actions from the Federal Reserve, and the escalation of the trade war led to a significant Treasury market rally in August. Ten-year rates got as low at 1.45% by early September while 30-year rates dipped to 1.95%, marking the first time the long bond has ever been below 2.00%. Furthermore, the 2s/10s curve inverted briefly at the end of August while the 3M Treasury bill vs 10-year Treasury rates have consistently been inverted since May. These inversions sent a fairly ominous warning about the economic outlook over the next 12-18 months leading to a risk-off investor sentiment. A series of economic data releases in September that surprised to the upside calmed fears leading to a partial re-trace of the rate rally, an unwinding of the 2s/10s inversion, a renewed risk appetite, and counter narratives that "it's different this time."

WHERE DOES THAT LEAVE US TODAY?

Broadly speaking, data releases continue to highlight an economy that is a tale of two cities; business activity continues to slow while unemployment and consumer spending are robust. For example, the U.S. economy grew at a slightly slower, yet still healthy, 2.0% in 2Q19 on the strongest personal consumption growth in over a year. Continued strength in retail sales confirms a healthy consumer, at least for the time being. On the flipside, business activity indicators like the Institute for Supply Management (ISM) manufacturing

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1 Endnote is located on reverse page

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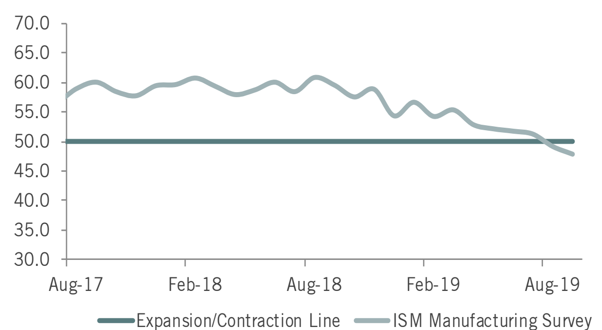
index have moved into contractionary territory, with the most recent ISM reading of 47.8 marking a post-crisis low point. As we've consistently highlighted, similar trends are emerging in measurements of business orders, construction spending, durable goods orders and business sentiment since mid-2018.

FIGURE 2 ISM MANUFACTURING INDEX[1]



DO CONSUMERS HAVE STAYING POWER?

Although the unemployment rate fell to 3.5% in September, the lowest level in 50 years, job creation moved along at a slower pace in 3Q, driving concerns that the aforementioned slowness in business activity has started to spill over into the labor market. With non-farm payroll growth of 166k, 168k and 136k in July, August and September respectively, the three-month rolling average now stands at 157k; certainly not unhealthy, but notably 50k – 75k lower than throughout most of 2018. Worryingly, consumer confidence measures have also started to slip, evidenced by the sharp drop in the University of Michigan Consumer Sentiment Index in August to the lowest level since 2016. Meanwhile, Initial Jobless Claims and Continuing Jobless Claims remain at historically low levels, bolstering the case that labor market strength remains intact. Further supporting that thesis is a solid streak of roughly 3.0% YoY average hourly earnings growth. Over the next several months, the market will focus on consumer related data including non-farm payrolls, initial unemployment claims, average hours worked and consumer confidence for any sign of cracks in consumer spending.

EMERGING INFLATION?

While headline inflation remained weak throughout the quarter, core inflation is showing some signs of life. For example, the Consumer Price Index (CPI) measured an underwhelming 1.8% and 1.7% in July and August respectively whereas Core CPI (ex-food and energy) steadily increased to 2.4%. Meanwhile, the Fed's preferred measure of core inflation, the Personal Consumption Expenditures Core Price Index, has also steadily increased from 1.5% in May to 1.8% in August. Furthermore, Core Producer Price Inflation appears to have bottomed out at 2.1% in July before drifting back up to 2.3% in August. Importantly, none of these measures suggest runaway inflation is on the horizon. It is noteworthy, however, that several have crept closer to the Fed's stated target of 2.0%.

When considered alongside continued labor market strength, hints of rising core inflation briefly led to arguments that continued rate cuts are not a foregone conclusion. Notably, the September post-meeting message from the Fed was slightly hawkish and evidence from the meeting, including the non-unanimous vote and dot plot projections, indicate that the Fed is becoming more divided regarding the path of the economy and appropriate policy. Still, and perhaps more importantly, market measures of expected inflation, including the 10-year Break-even inflation rate and the 5yr5yr Forward Break-even rate, ended the quarter at 1.52% and 1.70% respectively, suggesting that investors believe any increases in inflation are transitory. Furthermore, forward markets continue to price in 1-2 additional rate cuts before year end.

LOOKING AHEAD

Incoming data for the U.S. economy suggests GDP growth in the 1.8% to 2.1% range in 3Q. Business activity continues to slow while the consumer side of the equation is holding up, for the time being. Some measures of inflation have inched higher, but overall, the market believes inflation is tame, and despite some division at the Fed, easing monetary policy will likely continue in the near term. Data releases during the first week of October strongly support this thesis. Looking forward, the interplay between market expectations, monetary policy, the trade war, geopolitical tensions, and the looming 2020 election could be a source of volatility for risk assets.

[1]Source: Bloomberg

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