Weekly Market Commentary
August 26, 2019

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With little new data to mull over this week, the financial markets had a field day trying to make sense of an assortment of statements from policy makers. Not surprisingly, the interpretations ranged all over the field and, as expected, the conflicting messages left investors scratching their collective heads. Stock prices experienced another bumpy ride, rallying early in the week but plunging on Friday, leaving the major indexes further below their levels at the start of the month. Likewise, bond investors are still probing for direction, with yields hovering tightly around their lowest levels since 2016. Importantly, the financial indicator that has received much attention in recent weeks – the 2yr/10 yr yield curve – once again briefly inverted on Thursday before ending the week essentially flat.

The recession watch lost some steam last week when a solid retail sales report for July indicated that consumers were still in an aggressive buying mood and are poised to keep the economy's growth engine humming through at least the third quarter. That upbeat news sharpened the debate that continues to swirl around monetary policy. Simply put, if the economy is doing just fine, why is there such a rush for the Federal Reserve to cut interest rates? Following its quarter-point reduction at the July 30-31 policy meeting, the markets assumed that another cut at the September meeting was virtually a done deal. But the minutes from that meeting, released this week, showed that there was more resistance among Fed officials to cutting rates than generally thought.

Indeed, three Fed officials confirmed that resistance this week with statements that questioned whether further rate reductions are needed. Kansas City Fed president Esther George captured that sentiment on Friday morning, opining that if the economy remains in its current state of health she would recommend no further cuts at the upcoming meeting on September 17-18. However, George, like her more hawkish colleagues at the central bank, recognizes the myriad threats that could well upend their upbeat assessment of the economy and alter their policy recommendation. All the doubters agree that upcoming data will be crucial, starting with the jobs report on September 6, the most important economic indicator prior to the mid-September policy meeting.

Chief among the threats, of course, is the ongoing trade conflict the U.S. is having with China. President Trump ramped up tensions early this month with the announcement of 10 percent tariffs on $300 billion of Chinese imports beginning September 1. He later postponed to December 15 the levies on about $160 billion of those imports so as not to cause havoc leading up to the holiday shopping season. As expected, China is not sitting idly by; on Friday, it announced that it is imposing tariffs on $75 billion of American goods in addition to the measures already taken in response to Trump's earlier announcement, including a freeze on purchases of American agricultural products and allowing its currency to weaken.

The heightened tensions on the trade front shared the headlines on Friday with the annual gathering of central bankers at Jackson Hole, Wyo. All eyes were on Fed Chairman Powell, the keynote speaker, for clues into his thinking regarding future rate cuts. Not surprisingly, the Fed chief was deliberately vague on that issue and

Fred Eisel
Chief Investment Officer
Email: feisel@vfccu.org
Phone: 800-622-7494 ext. 1610

Scott Wood
Portfolio Strategist
Email: swood@vfccu.org
Phone: 800-622-7494 ext. 1631

Jeffery Sengsy
Investment Analyst
Email: jsengsy@vfccu.org
Phone: 800-622-7494 ext. 1628

noted that much will hinge on how trade developments impact the economy. In a nod to the hawks, he reaffirmed the long-held view that the economy is in a good place, supported by a strong job market, rising wages and solid consumer spending. He even had a few good things to say about inflation, noting that it appears to be finally moving up towards the Fed's 2 percent target.

However, Powell refused to validate the hopes of the "one and done" crowd, those hoping that the July rate cut would be the last of the cycle. Instead, he reaffirmed the vow made at the July policy meeting that the Fed would do whatever it takes to sustain the expansion. Importantly, in Friday's speech he noted that a lot has happened since the FOMC meeting ended on July 31, which tilts the odds heavily in favor of another rate reduction, if only to reinforce the July "insurance cut" taken to cushion the blow from global headwinds. Those headwinds have clearly gained traction over the past three weeks. In addition to ramped-up tensions with China, new data showing a contraction in the German economy during the second quarter confirmed the global slowdown that is taking a toll on the U.S. manufacturing sector. Meanwhile, geopolitical disruptions are spreading, with the dissolution of the Italian government, continuing unrest in Hong Kong and the ongoing uncertainty over the looming exit of Britain from the EU without a deal.

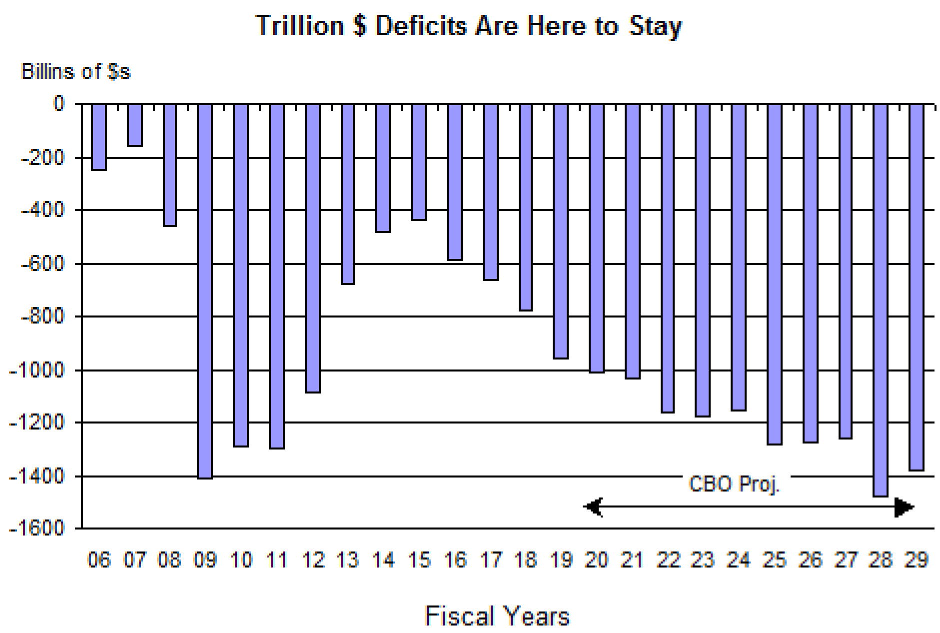
Powell noted in his Jackson Hole speech that the Fed has plenty of experience dealing with time-honored macroeconomic developments, such as too-high inflation and too-low employment with its traditional policy tools. However, it has little knowledge as to how to guard against trade uncertainty, which is the wild card in the economic outlook. Does it wait until global developments deliver a serious blow to the U.S, economy or respond now to the growing signs of distress showing up in corporate boardrooms and in weakened capital spending but have not yet threatened to derail the expansion? That conundrum was addressed in Powell's Jackson Hole speech. "*Because the most important effects of monetary policy are felt with uncertain lags of a year or more, the Committee must attempt to look through* ***what may be passing developments*** *and focus on things that seem likely to affect the outlook over time or that pose a material risk of doing so*."

On the other hand, Powell also noted that, "… *anything that affects the outlook for employment and inflation could also affect the appropriate stance of monetary policy, and that could include uncertainty about trade policy*." Further along, he notes, … "*As the year has progressed, we have been monitoring three factors that are weighing on this favorable outlook: slowing global growth, trade policy uncertainty, and muted inflation. The global growth outlook has been deteriorating since the middle of last year. Trade policy uncertainty seems to be playing a role in the global slowdown and in weak manufacturing and capital spending in the United States. Inflation fell below our objective at the start of the year. It appears to be moving back up closer to our symmetric 2 percent objective, but there are concerns about a more prolonged shortfall*".

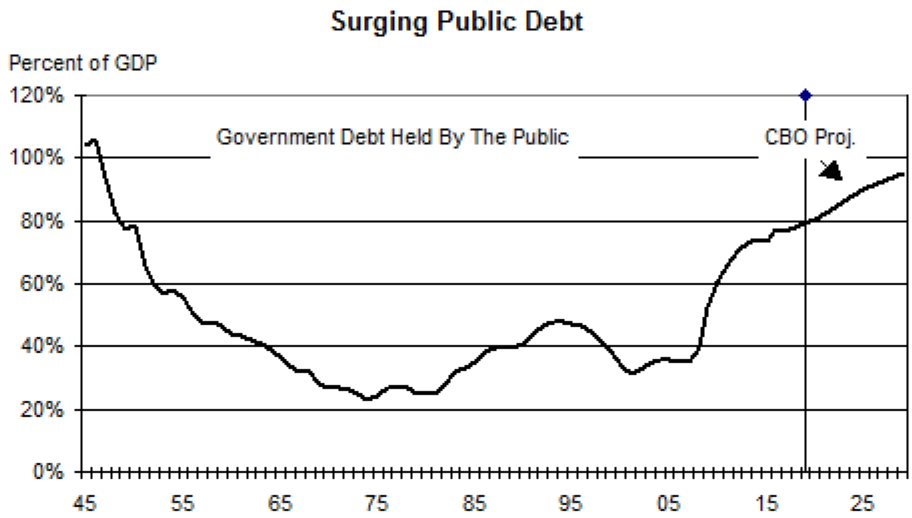
From our lens, this certainly suggests that Powell is leaning towards a rate cut at the upcoming policy meeting. We concur with that prospect, particularly following China's retaliatory measures announced on Friday and the likely harsh response from Trump; in an early-afternoon tweet the president "hereby ordered" American companies to start looking for an alternative to China. These exchanges only heighten the trade uncertainty that is pulling the Fed in a more dovish direction. That said, we also caution that the verbal exchanges between leaders of the world's two largest economies tend to be fickle, and some backtracking on the harsher comments should not be ruled out in coming days. The president is particularly sensitive to moves in the stock market, and the plunge in prices on Friday will not go unnoticed.

Interestingly, with the forecasting community giving ever-higher odds of a recession over the next twelve months, there is growing speculation regarding the ability of policy makers to combat the next downturn, whenever it sets in. The Fed's toolbox has come under scrutiny for some time, as the scope for further rate reductions is much narrower than in past cycles. To lift the economy out of the last six recessions, for example, the Fed needed to cut its policy rate by at least five percentage points. That amount of ammunition is not available this time with the funds rate currently in a range of 2-2 ¼ percent – and that's while the economy is still growing. There are always unconventional tools at the Fed's disposal, including asset purchases aimed at driving down long-term rates that the Fed relied on after the funds rate hit the zero lower bound in 2008. But its potency is the subject of considerable debate, particularly since bond yields are already more than two percentage points lower now than they were at the start of the Great Recession.

Hence, more attention is given to the fiscal side of the ledger, which has traditionally reinforced the countercyclical measures of the central bank with deficit-boosting tax and spending actions. However, here too, the toolbox has been extremely compromised by the burgeoning deficits stoked by the tax cuts enacted in 2017 and the bipartisan boost to government spending last year. Hence, after falling from a recession high of $1.4 trillion in 2009 to a cycle low of $438 billion in fiscal 2015, the budget deficit has since more than doubled, hitting an estimated $960 billion in the current fiscal year according to the Congressional Budget Office. Under current tax and spending policies, the CBO forecasts that the red ink would grow to over $1 trillion next year and remain above that threshold in every year through 2029. It's questionable that lawmakers would have the appetite to push through more deficit-boosting measures to stimulate the economy unless forced to by extremely dire circumstances.



True, some respected economists advocate additional fiscal stimulus on the grounds that the deficit can be easily financed in an exceptionally low interest rate environment that now prevails. But there is no guarantee that interest rates would remain at rock-bottom levels as the public debt accumulates and needs to be refinanced in years to come. Regardless of the debt-servicing burden that may loom ahead, the amount to be serviced is eye opening. According to the CBO, the amount of government debt held by the public is expected to surge to over 90 percent as a share of GDP by 2026, a level not seen since just after World War ll.



The good news is that the U.S. economy is not on the precipice of a recession, which would require heroic measures that are seemingly out of reach of policy makers. While the Fed may err in its upcoming decisions, it will likely be on the side of ease rather than tightness, which preceded most post-war recessions. Whether the July rate cut and the likely reduction next month are “mid-cycle adjustments”, as claimed by Fed Chair Powell, or the initial installments of a prolonged easing cycle, they should go a long ways towards guiding the economy to a soft landing rather than a hard crash. That said, an ounce of prevention could be an effective buffer against a hard landing as long as it is not overwhelmed by a pound of external shocks. It remains to be seen if the latest flare-up in trade tensions amounts to more noise than substance, but there is much at stake if the latter is the case.