Financial Market Weekly

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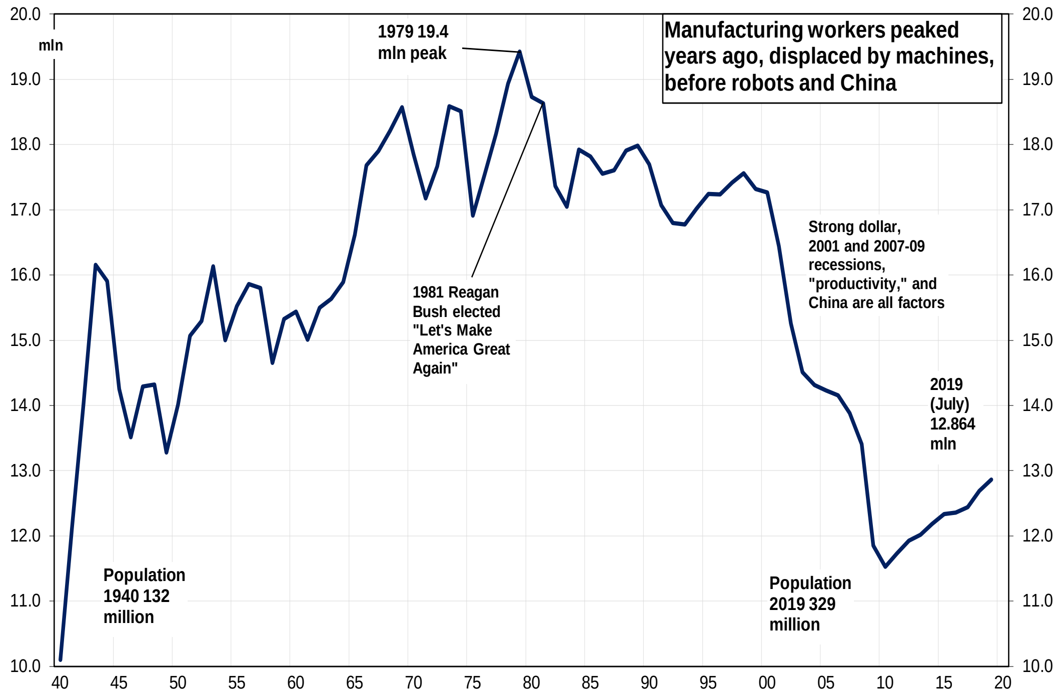
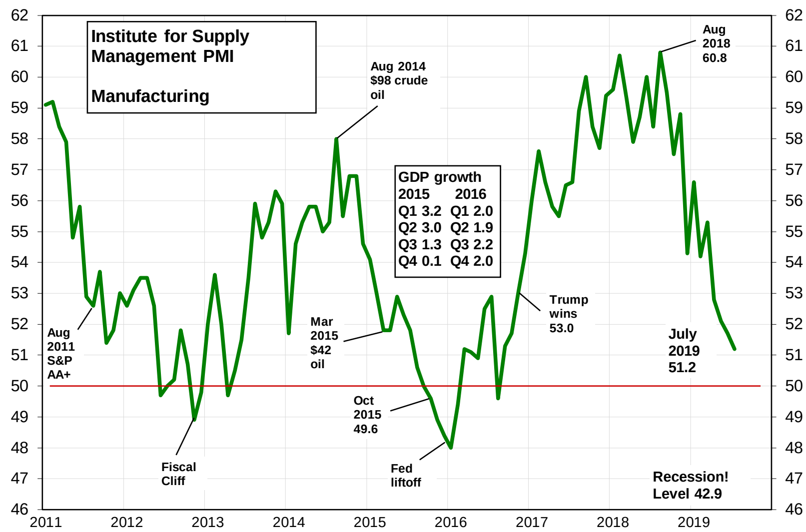
IS U.S. MANUFACTURING IN A RECESSION?



Who cares? Indeed. That was last week's abbreviated newsletter on U.S. trade with China after our refreshing two-week holiday in Europe. "Who cares?" Glad to be back. We care of course. Is manufacturing still important? Manufacturing jobs total 12.864 million out of nonfarm private payroll employment of 128.889 million or 10.0% in July 2019. We don't know whether it is a recession for manufacturing exactly. Presidential candidate Elizabeth Warren has said as much though she is running for office and pointing out economic weaknesses that she can make right and gain votes. Happens every four years and it is a miracle that economic confidence isn't affected more negatively by all the fault-finding and mud thrown the economy's way by politicians seeking the highest office in the land. Warren said on July 22, "[The country is now in a manufacturing recession]." An economic crash was coming she said. It's an odd coincidence manufacturing was weak in 2016 during the primaries and now again.

Recessions with negative economic GDP growth for a couple of quarters do not happen without job losses. Right now the weakest sector of the economy, manufacturing, that is facing those uncertain trade war headwinds, is creating new jobs over the last twelve months: manufacturing jobs are up 157K the last twelve months. ISM manufacturing purchasing managers don't think their sector of the economy or the broader economy is contracting or in recession territory ... yet, even though Fed officials sure seem concerned about the dive in the ISM manufacturing index. A lot of inexperience there of course. At the Fed. At the highest decision-making levels. The ISM manufacturing index fell with the crash in crude oil prices starting in Q4 2014. The ISM manufacturing index weakness didn't stop the Fed rates liftoff. ISM manufacturing fell to 48.6 in November 2015 prior to Fed liftoff (whoa, strap yourselves in) from 0.25 to 0.50 percent on December 16, 2015. Now some of the Fed officials think recession is on the horizon with ISM manufacturing at 51.2. Purchasing managers themselves don't even think manufacturing is declining unless the index is under 50.0, and a recession in the broader economy is not indicated unless the index falls below 42.9. Anyway at the moment, industrial production has declined about 1-1/2 percentage points since the end of last year even if the ISM manufacturing index is above 50. See our comment on the July industrial production report released on Thursday later on in this weekly. The decline in industrial production this year is why Senator Warren said manufacturing is in a recession, but you can't have a recession without job losses so this decline in output doesn't have the sting of recession as manufacturing jobs have increased 157 thousand to 12.864 million in July from year earlier levels. 12.864 million manufacturing jobs are 8.5% of total nonfarm payroll employment in July of 151.431 million.

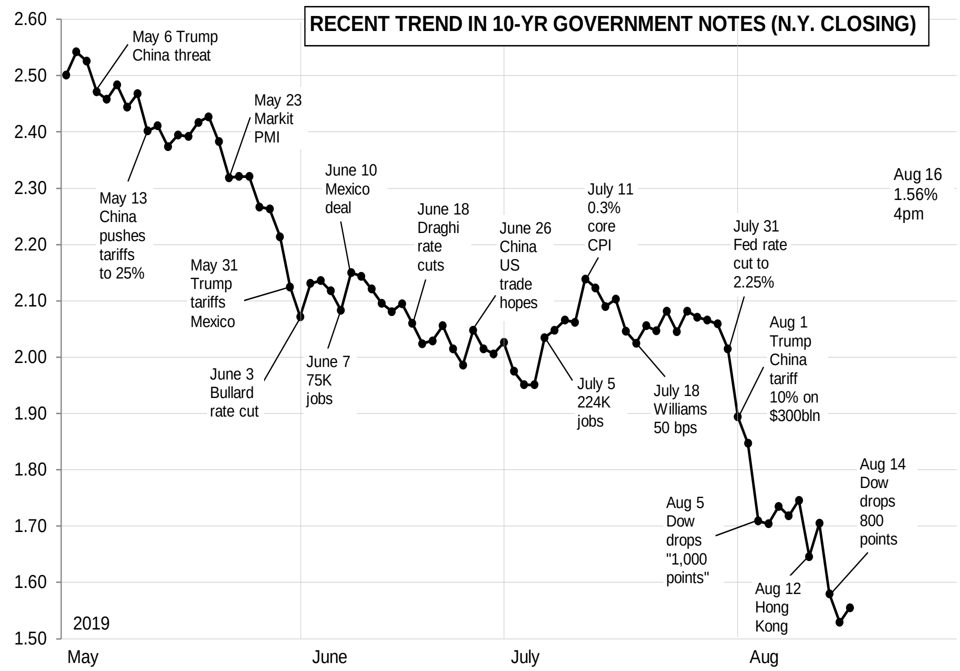


Where are all the manufacturing jobs?

Millions	July 2019	Year/year Changes Thousands
12.864	Manufacturing	157.0
8.081	Durable goods	120.0
0.409	Wood products	2.5
0.415	Nonmetallic mineral products	1.6
0.379	Primary metals	1.9
1.484	Fabricated metal products	12.7
1.138	Machinery	11.8
1.086	Computer and electronic products	29.1
0.161	Computer and peripheral equipment	5.1
0.085	Communications equipment	0.6
0.379	Semiconductors, electronic components	8.0
0.426	Electronic instruments	15.1
0.033	Miscellaneous computer/electronics	0.3
0.403	Electrical equipment and appliances	3.4
1.751	Transportation equipment	47.9
1.005	Motor vehicles and parts	11.9
0.394	Furniture and related products	-0.8
0.618	Miscellaneous durable goods	9.4
4.783	Nondurable goods	37.0
1.635	Food manufacturing	13.7
0.112	Textile mills	-0.7
0.114	Textile product mills	-1.4
0.107	Apparel	-5.5
0.370	Paper and paper products	3.4
0.420	Printing and related support activities	-10.0
0.115	Petroleum and coal products	-0.4
0.859	Chemicals	22.8
0.739	Plastic and rubber products	7.6
0.307	Miscellaneous nondurable goods	7.4

MARKETS OUTLOOK

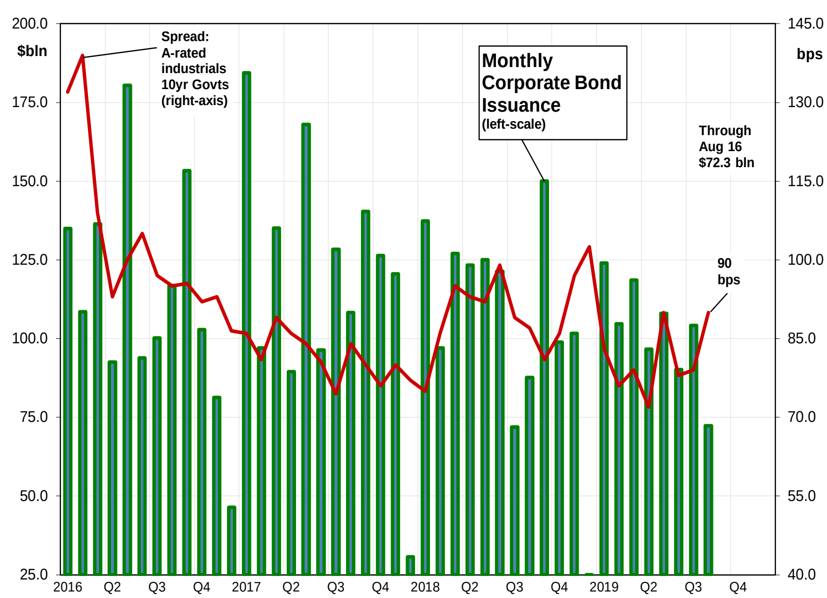
	29-Mar 2019	28-Jun 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	2.53	2.25	2.30	2.40	2.50	2.50	2.70
10-Yr Note	2.41	2.01	1.75	1.80	2.00	2.10	2.20	2.40
5-Yr Note	2.23	1.77	1.50	1.55	1.80	1.90	2.00	2.20
2-Yr Note	2.26	1.76	1.50	1.60	1.70	1.80	2.00	2.20
3-month Libor	2.60	2.32	2.00	2.00	2.00	2.00	2.00	2.00
Fed Funds Rate	2.50	2.50	2.00	2.00	2.00	2.00	2.00	2.00
2s/10s spread	15	25	25	20	30	30	20	20



10-year Treasury yields dropped to 1.50% this week and are discounting a lot of action from the Fed at 75 bps under the 2.25% Fed funds rate. We expect another rate cut at the Fed's September meeting to 2.0%, but after that, the crystal ball gets a little cloudy. There were three Fed rate cuts twice in the 1990s; some Fed officials think those were for insurance reasons. We think the 75 bps of rate cuts in the 1990s, first to 5.25%, then to 4.75%, were for we are going into a recession reasons, but maybe sitting on a trading desk (remember those?) our recollection having watched the Fed and markets in real time is a little cloudy. Hope Fed stops soon.

CORPORATE BONDS: EXXON MOBIL, DAIMLER, ONEOK, SHERWIN-WILLIAMS

Corporate offerings were $23.7 billion in the August 16 week versus $41.5 billion in the August 9 week. On Tuesday, UPS sold $1.5 billion 5s/10s/30s. It priced a $400 million 2.5% 10-yr (m-w +15bp) at 85 bps (A2/A). The global package and document delivery company will use the proceeds to make early contributions to pension plans, and repay commercial paper. Corporate bond yields (10-yr Industrials rated A2) were 90 bps above 10-yr Treasuries Friday versus 86 bps last Friday.



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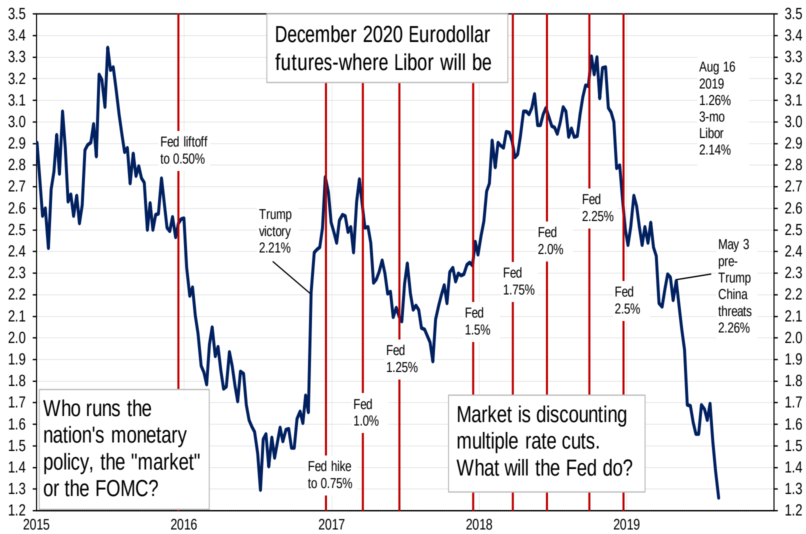
FEDERAL RESERVE POLICY

The Fed meets September 17-18 to consider its monetary policy. One rate cut is done and another to go. We have a forecast for a rate cut to 2.0% on September 18 if there is still a need for interest rate forecasts anymore. Economists' forecasts are being dragged along by the markets. 10-year Treasury yields went below 1.50% briefly on Thursday which means bond investors think the Fed funds rate will be 1.5% at some point down the line… just as the president wanted months ago. Speaking of the president, he tweeted "CRAZY INVERTED YIELD CURVE" this week in response to the 800 point stock market loss on Wednesday. The 2-yr to 10-yr Treasury curve inverted briefly starting early on Wednesday before the stock market open, inversion which forecasts a recession!! How many doggone yield curve inversions do we need to forecast a recession anyway?



The 3-mo T-bill to 10-yr yield curve has a better track record of recession forecasting and this bills-bonds curve, if you must, if you can't not look, inverted in June this year meaning a recession is 8 months away to as long as 16 months away. 16 months? Plenty of time to get your affairs in order before the economy blows up. Crazy inverted yield curve indeed. These are crazy strange economic times with some Fed officials thinking rate cuts are needed "to reverse the yield curve inversion." Don't get us started. It's not just the U.S. where central bank officials think they have something that they can do to support their economies. The ECB meets in September as well and ECB official Olli Rehn moved the market and Euro yields lower this week by saying it was "better to have a very strong package of policy measures." As strong as you can get we guess when your official policy rate is already at zero and you've got nothing. Let's hope Fed officials don't get similar ideas. The Fed has done enough.

Fed statement July 31, 2019
This action supports the Committee's view that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain. As the Committee contemplates the future path of the target range for the federal funds rate, it will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective.

Fed Policy-key variables	2019	2020	2021	Long Term
Fed funds	2.4	2.1	2.4	2.5
PCE inflation	1.5	1.9	2.0	2.0
Unemployed	3.7	3.8	3.9	4.3
GDP	2.1	1.9	1.8	1.9
June 2019 median Fed forecasts				

Fed funds rate by year-end				Longer
Votes	2019 End	2020 End	2021 End	run
1	1.875	1.875	1.875	2.375
2	1.875	1.875	1.875	2.500
3	1.875	1.875	1.875	2.500
4	1.875	1.875	1.875	2.500
5	1.875	1.875	1.875	2.500
6	1.875	1.875	2.125	2.500
7	1.875	1.875	2.125	2.500
8	2.125	2.125	2.375	2.500
9	2.375	2.125	2.375	2.500
10	2.375	2.375	2.375	2.750
11	2.375	2.375	2.375	2.750
12	2.375	2.375	2.375	2.750
13	2.375	2.375	2.625	3.000
14	2.375	2.375	2.625	3.000
15	2.375	2.625	2.625	3.250
16	2.375	2.625	2.875	3.250
17	2.625	3.125	3.125	
Median	2.375	2.125	2.375	2.500
Meeting	June 19	June 19	June 19	June 19

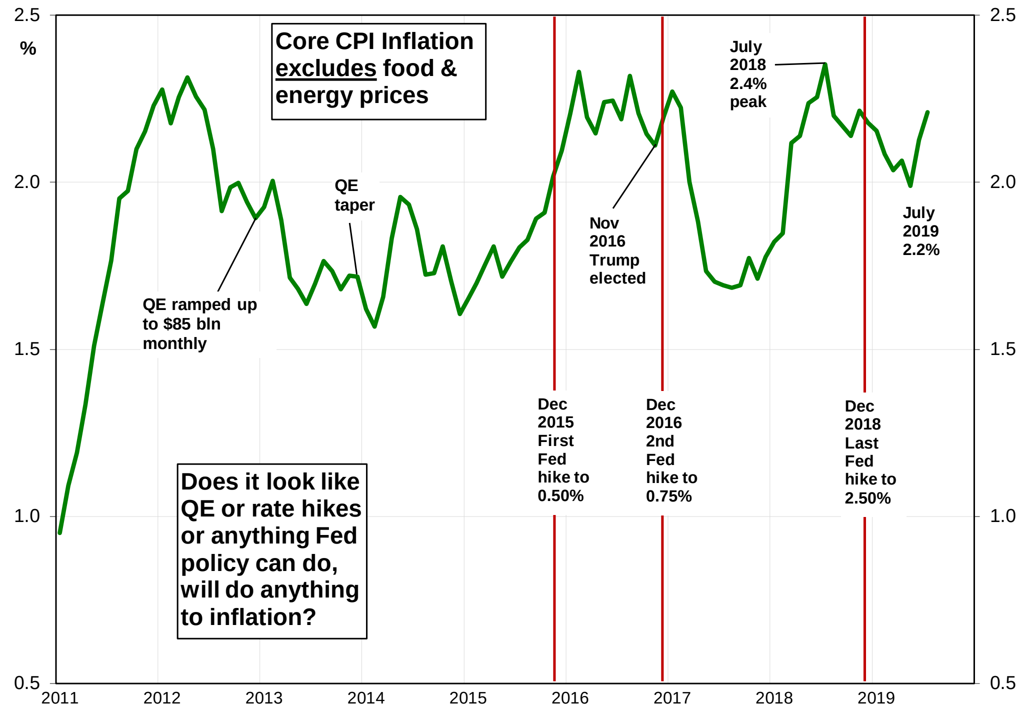
OTHER ECONOMIC NEWS THIS WEEK

2nd month of 0.3% core CPI inflation as trade war worsens (Tuesday)

Breaking economy news. CPI inflation that the Fed pretends not to see. No more. A second month of a 0.3% rise in core consumer prices in July kicks the year-on-year rate up to 2.2%. Core prices are rising and the increases are broad-based with housing costs, medical care, airline tickets, furniture, clothing and personal care products prices all registering solid increases.

Net, net, businesses are no longer having success at keeping the tariffs on China imports from hitting the consumer with full force as core consumer prices have jumped the last two months. More consumer price increases are coming with the president announcing on August 1 that he would put a 10% tariff on the remaining $300 billion of China goods imports that have escaped tariffs starting on September 1.

Core CPI inflation is on target



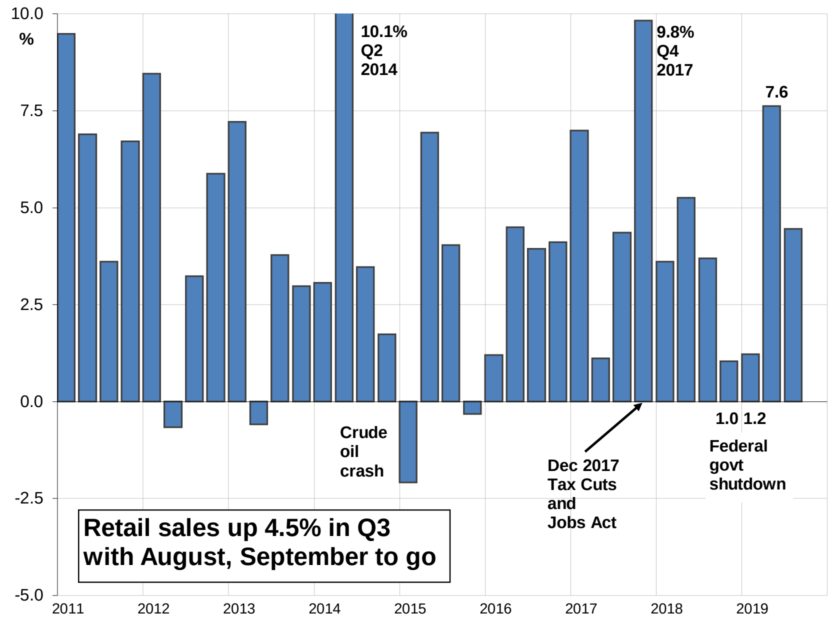
Consumer inflation is back and we will see if Federal Reserve officials remain as keen on the need to cut interest rates even further to offset slowing world economic growth and trade war uncertainty. One of the reasons the Fed has argued lower rates are needed is because inflation remains short of its 2% target. It will be harder for Fed officials to argue that inflation pressures are not building after two consecutive months of 0.3 percent monthly changes in core inflation.

The inflation genie is not out of the bottle, but Fed officials would be foolish to turn a blind eye to this jump in consumer prices with the economy still at full employment and growth continuing at a moderate pace despite the world economy's problems and the trade war uncertainty. We think this latest inflation report may add to the number of dissents by more Fed officials who are not comfortable with cutting interest rates any further.

Rate cuts in the face of greater inflation leads Fed policymakers open to criticism that they are playing politics and not adhering to their mandates on the economy and inflation that congress has given them. Stay tuned. Story developing. The inflation burst today throws a monkey wrench into the Fed's plans to cut interest rates a second time at next month's meeting. A rate cut now with inflation heating up makes them open to criticism that they are less independent and are following the playbook that the Trump administration has given them.

Wow. Consumers shoot the lights out to start the second half with strong sales (Thursday)

Damn the trade war torpedoes sowing the seeds of uncertainty, it is full speed ahead for the American consumer as they pull out all the stops to keep the economy humming as we start the second half of the year. This is not what a recession looks like. We know. We checked it. The rule of thumb for recession is three consecutive months of declining retail sales. Instead retail sales are soaring with sales jumping 0.7% in July and non-auto retail sales up 1.0%.



Retail sales were exceptional in the second quarter rising 7.6% at an annual rate after a couple of soft patch quarters. Now with July data, retail sales are up 4.5% in the third quarter with two more monthly reports left to go. This is not an economy that needs the Federal Reserve to ride to the rescue and foam the runway for an economic hard landing. Fed officials look foolish to cut interest rates with the consumer spending with abandon like a runaway train, and we cannot find another time in history when the Fed provided monetary stimulus with the consumer on fire and their confidence and spending this strong. Save your ammo for a rainy day, we don't need your help is what the consumer is telling the Federal Reserve today. The market is discounting a second Fed rate cut at the next meeting in September and the retail sales data today should put a big question mark over whether a rate cut should be made.

Net, net, the consumer is plainly ignoring all the trade war tariffs and sanctions and are retailers ever glad of it. Consumer spending strengthened materially in July which puts the second half economic outlook on extremely solid footing. Robust retail sales like these are not what a textbook definition of a recession looks like and if additional Fed rate cuts are being contemplated to guard against a downturn, our advice would be not to bother. Cutting interest rates from 2.25 to 2.0 percent is not what the doctor ordered for this strong economic expansion. Rate cuts aren't needed to bolster consumer spending, and rate cuts will have no effect on business investment. What will have an effect on business investment spending is strong and confident consumers whose purchases will force companies to order up new investment in equipment to meet the demand for their goods and services.

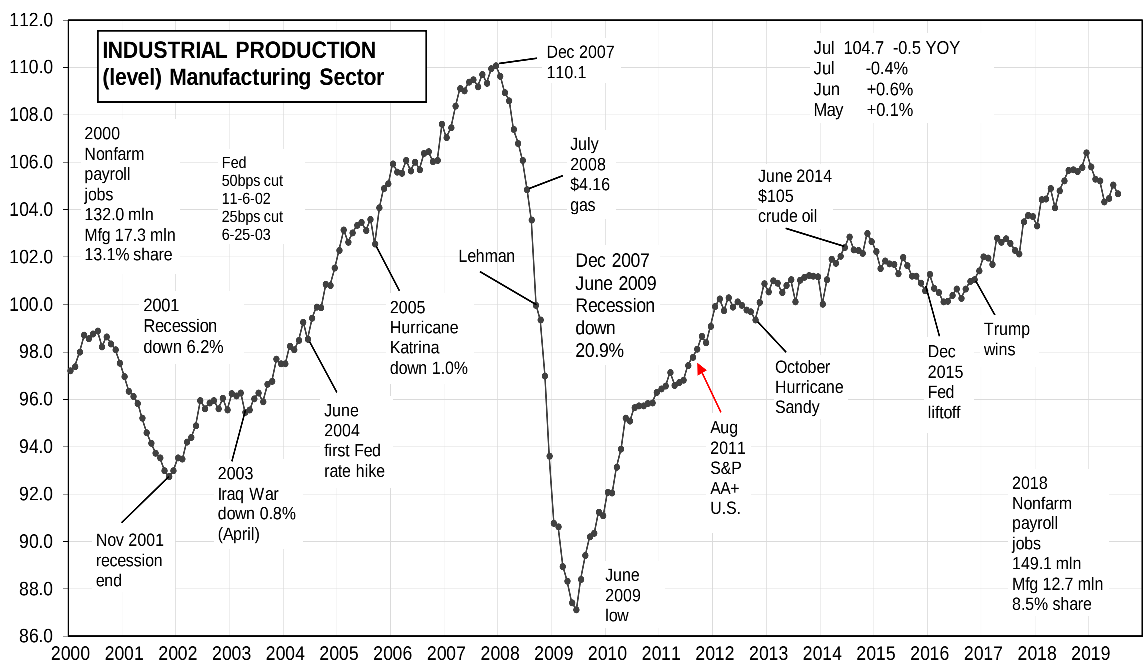
Federal Reserve officials have some explaining to do when it comes to cutting interest rates and driving down the yields on safe investments like Treasury bonds and notes to near record low levels. They don't need to explain their rate cuts to voters or to the Trump economics team, but they will have to explain themselves to the history books. The Fed's interest rate cut looks more out of line than ever given the strength of the economy. Recession? What recession? That's what we want to know.

Manufacturing activity sputters-- the economy's weakest link (Thursday)

Breaking economy news. Industrial production fell 0.2% in July and manufacturing production fell 0.4%. Factory output is not out of the woods yet in this latest soft patch caused by trade war uncertainty and slowing exports growth. Production is down but not out as the trend is largely sideways since the low for the year was made back in April.

Net, net, manufacturing output posted a large decline in July showing factories are still not out of the line of fire in this long trade war with China and the rest of the world. Much of the nation's factory production goes to producing the goods that are exported overseas, so it is natural that the reduction in world trade volumes between nations is taking a toll on manufacturing output.

Manufacturing production has fallen over 1-1/2 percent this year which marks the second time this decade that industrial output has declined outside of a recession. We still think the decline in industrial output this year does not have negative implications for the broader economy, but the health of factories is still an important driver of growth and the soft patch for production remains a factor that is keeping economic growth in the slow lane.



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