Financial Market Weekly

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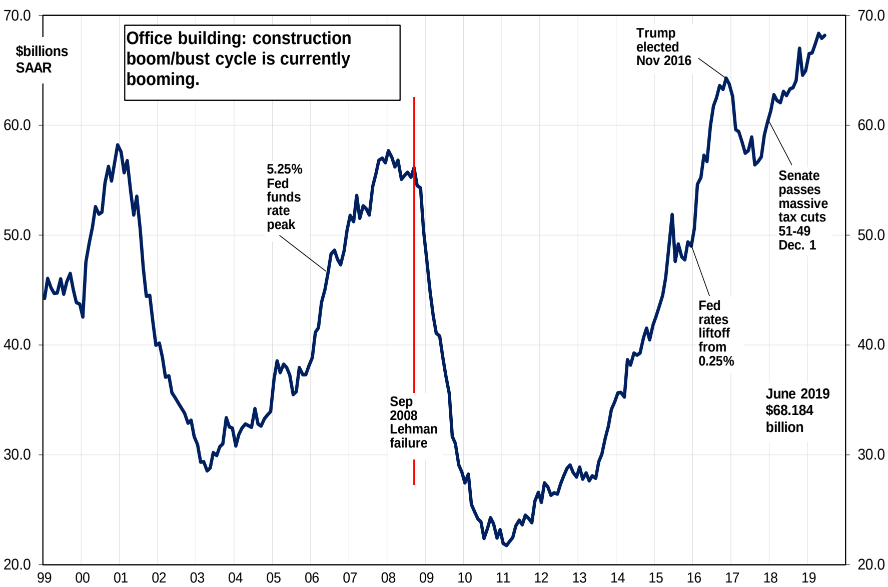
ONE REASON FOR RATE CUTS IS WEAK BUSINESS INVESTMENT

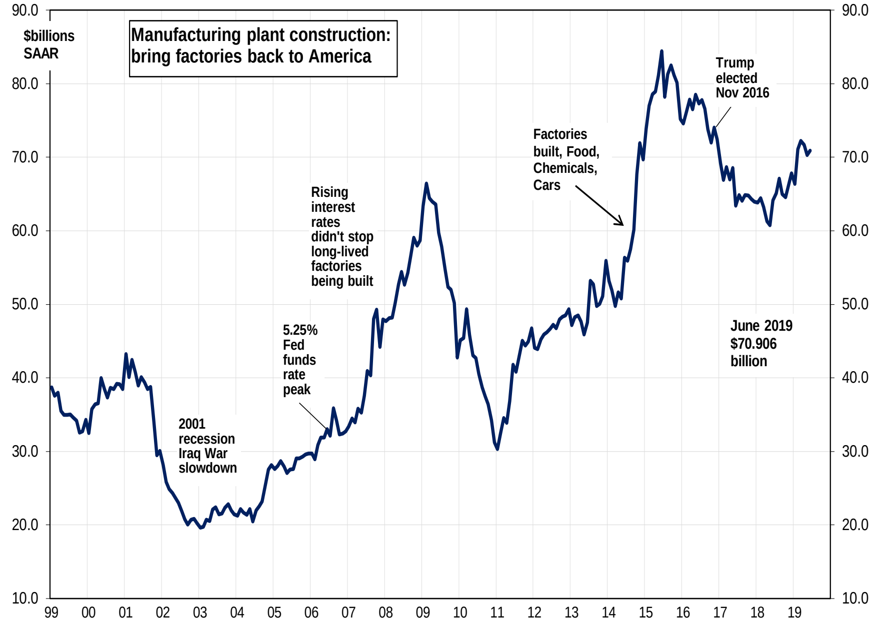


Fed officials are concerned about a slowdown in business investment. Equipment purchases are the biggest component of business investment at $1.252 trillion in Q2 2019, a drop in the bucket really against total nominal GDP of $21.337 trillion. Investment spending despite its small size is volatile and declines sharply in recessions. Intellectual property (software, R&D) is $1.006 trillion in Q2 2019. Construction spending on so-called structures rounds out business investment and is $634.5 billion in Q2 2019. Construction spending is the weakest part of investment right now although much of this is due to weakness in oil & gas drilling that is no longer flying as high and adding as much to business investment overall. Office building is quite strong up 8.2% in the first half this year from 2018, though one wonders for how long.

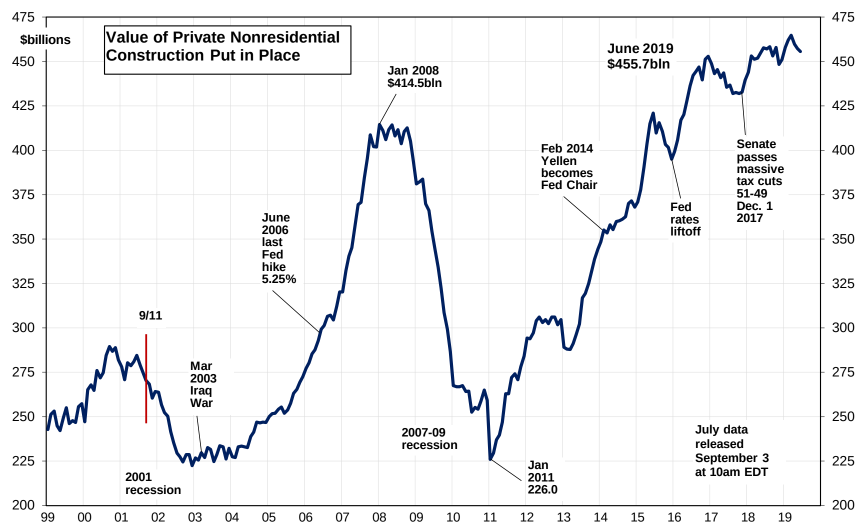
Business Investment Spending in the nominal GDP accounts			$Bln
Q2 2019 $bln	Level	% YOY	YOY
Equipment	1252.3	3.1	38.0
Intellectual Property	1006.2	8.5	78.5
Construction			
Business structures	634.5	-0.9	-5.5
Mining, shafts, wells	134.9	-5.9	-8.4
Other	499.6	0.6	2.9
Total	2893.0	4.0	111.0

Nonresidential Construction $bln	June 19	% Chg	2019 YTD	2018 YTD	Peak Year 2008	Peak % Chg
Total private	455.712	1.6	459.660	452.199	408.624	12.5
Lodging	33.188	7.8	32.606	30.255	35.364	-7.8
Office	68.184	8.2	67.498	62.384	55.382	21.9
Commercial	78.702	-9.7	80.107	88.668	82.827	-3.3
Health Care	34.300	3.9	34.390	33.112	38.381	-10.4
Educational	17.709	-5.3	19.644	20.738	18.626	5.5
Religious	2.751	-5.2	2.944	3.107	7.201	-59.1
Amusement	14.597	2.0	14.511	14.233	10.534	37.8
Transportation	18.443	11.7	18.562	16.614	9.898	87.5
Communication	23.060	-8.6	23.307	25.498	26.384	-11.7
Power (oil & gas too)	92.417	0.2	94.139	93.910	68.608	37.2
Manufacturing	70.906	11.9	70.434	62.963	53.397	31.9

Manufacturing? The president is telling companies to get their factories out of China, but since his election it doesn't look like many new factories are coming back. Factory construction is strong looking back over the last two decades. Manufacturing construction was $70.906 billion in June 2019 at an annual rate which is relatively strong however for this point of the business cycle. Over the past year, fewer factories in the areas of food and beverages, and for plastic/rubber products, have been built, but more factories have been built for computer/electronic/electrical products and for transportation equipment. Fed rate cuts that reduce financing costs marginally aren't going to spur firms to build any additional factories certainly.



Trade uncertainty isn't "slowing" business construction: investment level is maxed out



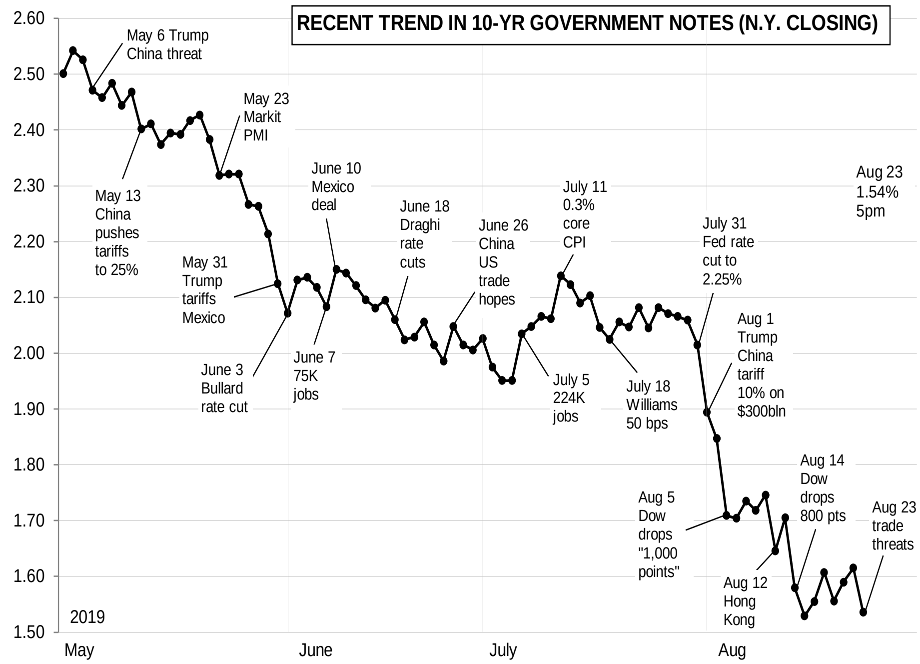
In conclusion, business investment is at a high level already and because it cannot go much higher, growth will naturally slow. One reason for Fed rate cuts is business investment. But the recent trend doesn't look like something for Fed officials to worry about in terms of the economic outlook. Business has ordered enough equipment and built enough offices for now. In any case, interest rate cuts to spur business investment, especially in the construction of new structures, is unlikely to work. The next update on business construction spending for July will be on Tuesday, September 3.

Structures ($billion)	Q1 17	Q2 17	Q3 17	Q4 17	YOY%	Q1 18	Q2 18	Q3 18	Q4 18	YOY%	Q1 19	Q2 19	SAAR
	580.2	589.0	583.7	594.4	5.0	615.9	640.0	641.7	635.2	6.9	648.5	634.5	-0.2
Commercial and health care	179.7	181.1	179.9	181.6	0.6	189.2	189.1	186.6	184.8	1.8	189.3	185.1	0.3
Manufacturing	68.2	66.2	64.5	64.3	-11.7	63.9	62.2	65.9	66.8	3.9	70.2	69.7	8.7
Power and communication	122.5	116.3	112.7	109.8	-9.3	116.7	121.4	120.1	116.3	5.9	117.7	117.7	2.4
Mining exploration, shafts, and wells	94.5	109.9	111.2	120.4	55.2	125.6	143.3	142.9	139.9	16.2	140.1	134.9	-7.1
Other structures *	115.3	115.5	115.4	118.3	3.8	120.5	123.9	126.1	127.4	7.7	128.6	127.0	-0.6

* Religious, educational, vocational, lodging, railroads, farm, and amusement and recreational structures, other

MARKETS OUTLOOK

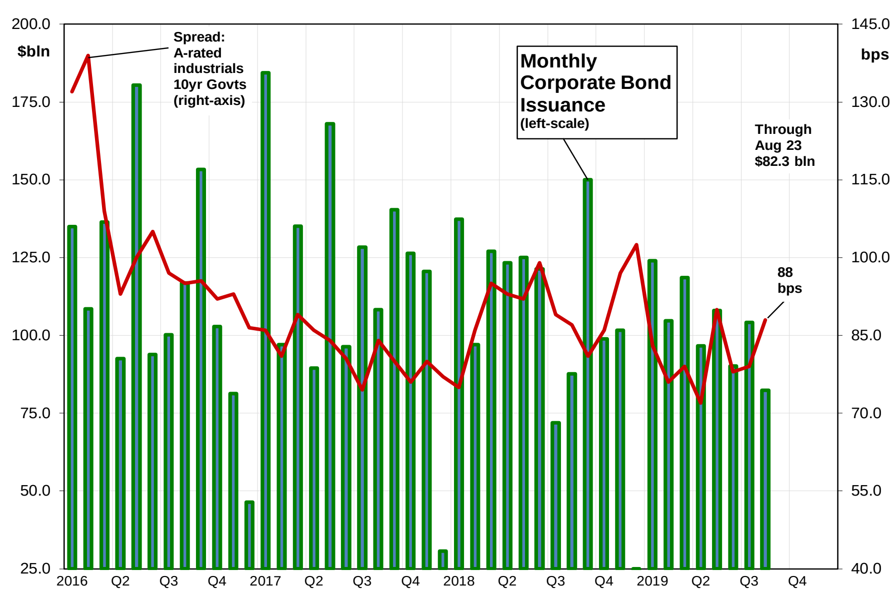
	29-Mar 2019	28-Jun 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	2.53	2.25	2.30	2.40	2.50	2.50	2.70
10-Yr Note	2.41	2.01	1.75	1.80	2.00	2.10	2.20	2.40
5-Yr Note	2.23	1.77	1.50	1.55	1.80	1.90	2.00	2.20
2-Yr Note	2.26	1.76	1.50	1.60	1.70	1.80	2.00	2.20
3-month Libor	2.60	2.32	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 had been drifting higher from last week's 2.56% close before Friday's news. China retaliated with tariffs at 8am EDT with 10-yr yields at 1.64%. Trump said he would give his response later in the day with 10-yr yields at 1.57% at 11am EDT. Bonds closed at 1.54% at 5pm EDT. Moments later Trump announced his response to China who "has been taking advantage of the United States on Trade, Intellectual Property Theft, and much more." On October 1, the $250 billion of tariffs on China will jump from 25% to 30%. And the $300 billion that was going to be taxed at 10% starting September 1 goes to 15%. Stay tuned. See you Monday.

CORPORATE BONDS: 3M, ROPER TECHNOLOGIES, BOSTON PROPERTIES

Corporate offerings were $10.0 billion in the August 23 week versus $23.7 billion in the August 16 week. On Monday, 3M Company sold $3.25 billion 3s/5s/10s/30s. It priced a $1.0 billion 2.375% 10-yr (m-w +15bp) at 90 bps (A1/AA-). The company with a diverse array of global products (Post-it notes, Scotch tape) will use the proceeds to fund its Acelity acquisition. Corporate bond yields (10-yr Industrials rated A2) were 88 bps above 10-yr Treasuries Friday versus 90 bps last Friday.



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FEDERAL RESERVE POLICY

Donald J. Trump 8-23-19 10:57AM EDT
@realDonaldTrump
….My only question is, who is our bigger enemy, Jay Powell or Chairman Xi?

The Fed meets September 17-18 to consider its monetary policy. The Fed Chair took a lot of hits from some presidential tweets on Friday. We will be more circumspect about our comments about what the Fed has in mind for the economy. Powell seems to be having a rough time of it. Not a lot changes in terms of policy's direction from [Powell's remarks] at Jackson Hole. We found it a challenging read: looking back over three eras from economic history. We prefer to rely on the July 30-31 FOMC meeting minutes released on Wednesday for laying out the reasons for additional Fed easing. We expect a 25 bps rate cut to 2.0% on September 18.

- First, while the overall outlook remained favorable, there had been signs of deceleration in economic activity in recent quarters, particularly in business fixed investment and manufacturing. A pronounced slowing in economic growth in overseas economies—perhaps related in part to developments in, and uncertainties surrounding, international trade—appeared to be an important factor in this deceleration. More generally, such developments were among those that had led most participants over recent quarters to revise down their estimates of the policy rate path that would be appropriate to promote maximum employment and stable prices.

- Second, a policy easing at this meeting would be a prudent step from a risk-management perspective. Despite some encouraging signs over the intermeeting period, many of the risks and uncertainties surrounding the economic outlook that had been a source of concern in June had remained elevated, particularly those associated with the global economic outlook and international trade. On this point, a number of participants observed that policy authorities in many foreign countries had only limited policy space to support aggregate demand should the downside risks to global economic growth be realized.

- Third, there were concerns about the outlook for inflation. A number of participants observed that overall inflation had continued to run below the Committee's 2 percent objective, as had inflation for items other than food and energy. Several of these participants commented that the fact that wage pressures had remained only moderate despite the low unemployment rate could be a sign that the longer-run normal level of the unemployment rate is appreciably lower than often assumed. Participants discussed indicators for longer-term inflation expectations and inflation compensation. A number of them concluded that the modest increase in market-based measures of inflation compensation over the intermeeting period likely reflected market participants' expectation of more accommodative monetary policy in the near future; others observed that, while survey measures of inflation expectations were little changed from June, the level of expectations by at least some measures was low. Most participants judged that long-term inflation expectations either were already below the Committee's 2 percent goal or could decline below the level consistent with that goal should there be a continuation of the pattern of inflation coming in persistently below 2 percent.

Odds of Rate Cuts
Fed funds futures
F8-23-2019

	Fed meeting
30.5	September
64.0	December

BPS of cuts discounted at future Fed meetings

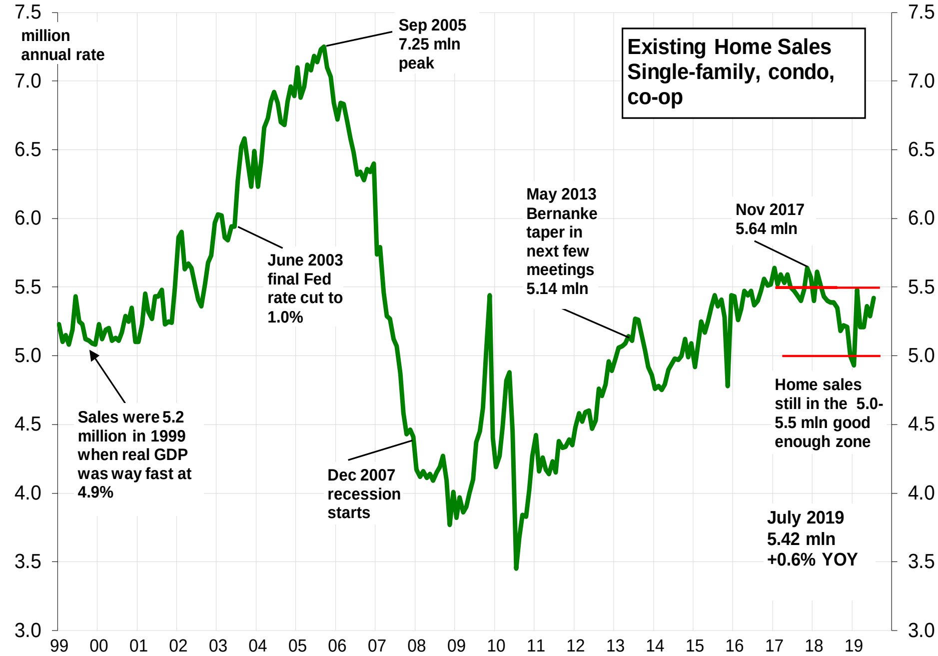
Market expectations did not change much this week. One rate cut (30.5 bps) is discounted at the September meeting. Two and a half rate cuts in total (64 bps) are discounted by the December meeting.

OTHER ECONOMIC NEWS THIS WEEK

Existing home sales weather the storm from higher mortgage rates last year (Wednesday)

Breaking economy news. It took a while, but it looks like existing homes sales have rebounded from the downturn last year triggered by the higher mortgage rates that resulted from the Fed raising interest rates too quickly last year to 2.25% in September 2018. The final downturn in existing home sales from 5.2 million to 5.0 million in December/January was the result of turbulent stock markets and the Federal government shutdown uncertainty. Existing home sales are back, and so too is a better outlook for the economy as we start the second half of the year.

July existing home sales increased 2.5% to 5.42 million from 5.29 million in June. The picture was mixed regionally where much of the gain was from the rebound out West from 1.09 million sold in June to 1.18 million in July. The biggest market down South rose from 2.27 million in June to 2.31 million in July. Sales in the Midwest increased from 1.25 to 1.27 million in July. Sales in the Northeast fell from 0.68 to 0.66 million in July.

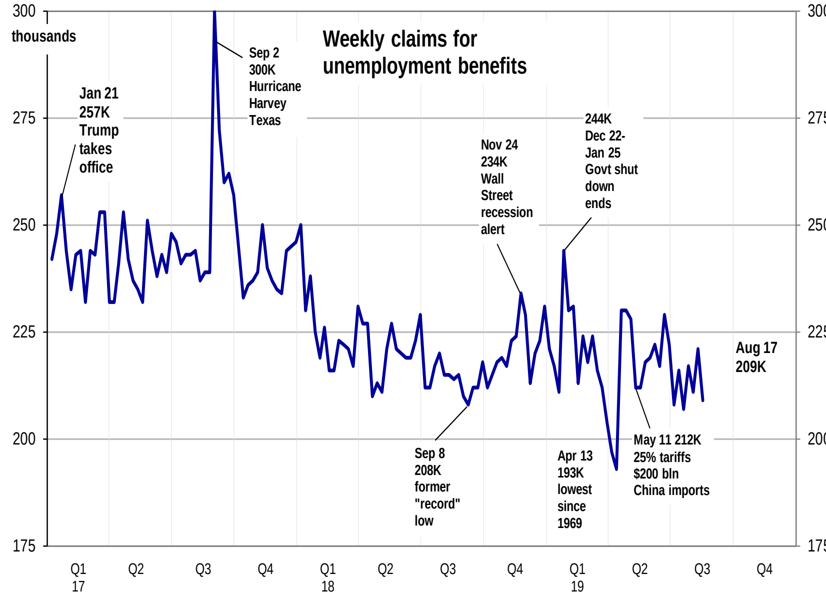


Net, net, the ball is in the Fed's court but if they are looking at existing home sales turnover as an indicator of where interest rates should be then they would cool their heels and do nothing at the upcoming September Fed meeting. Existing home sales activity has already seen a rebound, despite the uncertainty of America's trade war with China, from the shot in the arm from mortgage rates having already adjusted over 100 basis points lower after the Fed paused its rate hikes and then cut interest rates the first time since December 2008 at its July meeting.

Consumers continue to keep the faith and make the big-ticket purchases of new homes that bolster the case for continued economic expansion and keep the recession clouds from coming closer to shore. Existing home sales are a leading indicator of the economy's fortunes and right now home buyers are still purchasing a new home despite the cloud of economic uncertainty and higher home price valuations. Existing home sales have weathered the storm from higher mortgage rates last year.

Unemployment claims (Thursday)

Trade wars? Teetering on the edge of recession? Not yet. Companies often postpone new investment and new hiring as a result of rising uncertainty, but they are not firing workers. Job losses make a recession a recession and it isn't happening yet for you doubters and haters out there. Yes, initial jobless claims for those who have just been laid off remain relatively low at 209 thousand in the August 17 week. Sounds like a big number, but it's not. Heck, there are 329 million Americans out there. Anyway, companies are holding onto their workers for now.



New home sales fall from bizarre upward revision (Friday)

Breaking economic news. New home sales for July were released at 10am EDT, but we guess the world's attention was elsewhere. Jay Powell's address was released 10am EDT at Jackson Hole tailored for an elite world of past and present senior monetary officials. And nobody else. Maybe it got the reception it deserved the same as for new home sales at 10 o'clock when stocks were tumbling as the China US trade war escalated further.

New Home Sales

	Total	Northeast	Midwest	South	West
January	644	30	67	378	169
February	669	34	77	380	178
March	693	25	87	380	201
April	656	33	68	356	199
May	602	23	70	379	130
June	728	26	63	428	211
July	635	39	56	359	181
	Thousands at Seasonally Adjusted Annual Rate				

New home sales tumbled 12.8% in July to 635 thousand in July, but the June level was revised way up to 728,000 from the 646 thousand June estimate made just a month ago. New home sales were revised up sharply last month especially in the South and West. New home sales are 635K in July, but we don't have data yet showing home buyer reaction to the escalation of the trade war with China when Trump announced August 1 he would raise tariffs the first time on the remaining $300 billion of our goods imports from China to 10%.

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