2Q19 Economic Summary

Trade uncertainty came to a head during the second quarter of 2019 after the White House reported that China was reneging on essential parts of the trade deal. In response, the US increased tariffs on Chinese goods, and China retaliated with more tariffs of its own. A steady stream of threats and provocations continued throughout May, resulting in a sell-off in equities and a rally in Treasuries as investor demand for safe-haven assets rose. As if one trade war wasn't enough, the US also threatened to raise tariffs on Mexican imports if Mexico did not do more to stop the swarm of immigrants flowing across its borders into the US. Although an agreement with Mexico was reached within a few days and the tariffs were never imposed, business confidence was rattled nonetheless. At the end of June, the US and China came to a temporary truce after a meeting between Presidents Trump and Xi at the G20 Summit in Japan. Although the countries agreed to restart talks, a quick fix to the trade deal is unlikely. Against this backdrop of uncertainty, the Federal Reserve began to signal its willingness to cut interest rates if needed to keep the US expansion on track. Markets quickly embraced the Fed's more accommodative stance. By the end of the quarter, equities were back near record highs, and Treasury yields continued to grind lower across the curve.

While US GDP growth surprised to the upside at 3.1% for the first quarter, the repercussions of trade uncertainty and slowing global growth began to show in some second quarter data releases. Both manufacturing and service sectors cooled during the quarter as new orders slipped in response to softer demand both here and abroad. Manufacturing was hit particularly hard as tariffs forced some domestic producers to examine alternative supply chains and delay spending decisions. Business sentiment continued to sink as the trade war escalated, resulting in further pullback in fixed investment. However, labor demand remained strong, and businesses continued to hire at a robust pace. Job gains averaged 171,000 per month during the second quarter, and the unemployment rate remained low at 3.7%. Job openings continued to outnumber the unemployed, thus supporting solid wage gains. Job security and rising incomes kept consumer sentiment upbeat despite the ongoing trade rhetoric, resulting in a strong bump in personal consumption during the quarter. Housing was a mixed bag, however, as lower financing costs were positive for home demand, but housing starts and permits lagged on weak home builder sentiment. Overall, second quarter GDP growth is expected to be solid but slower than last quarter's robust pace.

The US was not alone in feeling the drag from rising trade tensions. China reported that second quarter GDP growth slowed to a 27 year low as the trade war took its toll on exports. However, the impact of trade disputes was not limited solely to the US and China. Widespread weakness in manufacturing was reported from Europe to Asia as trade uncertainty weighed on business sentiment around the globe. In the Eurozone, manufacturers across all regions except for France reported falling output. Meanwhile the UK's manufacturing slowdown was compounded by Brexit-related uncertainty. Japan's manufacturers also suffered from softer overseas demand, particularly from China. As a result of the widespread uncertainty surrounding trade, the IMF recently cut its global growth forecast again, warning that recent trade policy actions are weighing on global trade flow, eroding confidence and disrupting investment.

The uncertainty surrounding global trade and growth was one of the primary reasons the Fed began to shift to a more accommodative stance at the June FOMC meeting. In addition, participants cited the continued shortfall in inflation below the Fed's 2% target as reason for a near-term rate cut. While the Fed left rates unchanged at the meeting, they signaled that an ease was likely on the way. The Fed dropped "patient" from the June FOMC statement, saying instead that they "will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion." The dot plot sealed the deal on the Fed's dovish lean with 8 FOMC members forecasting at least one rate cut by year-end. In his post-meeting press conference, Fed Chair Jerome Powell noted that while "some participants wrote down policy cuts (in the dot plot) and others did not, our deliberations made clear that a number of those who wrote down a flat rate path agree that the case for additional accommodation has strengthened since our May meeting." There was one dissent at the meeting. James Bullard voted against leaving rates unchanged. He believed a rate cut would help re-center inflation expectations and provide "some insurance against unexpected developments that could slow US economic growth." After the meeting, futures markets began pricing in a 100% probability of at least a 25 basis point cut at the July 31 FOMC meeting.

US economic releases since the June meeting have been solid. However, given the fully baked-in market expectations for a cut, the positive data is unlikely to sway the Fed from an ease in July. The question now is will one cut be enough "insurance" or are we embarking on a new easing cycle? Stay tuned…

Any opinions herein, including forecasts, reflect our judgment as of this date and are subject to change.

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