4Q19 Economic Summary

US-China trade relations continued to dominate headlines during the fourth quarter. After many fits and starts, progress was finally made in December when the US announced a Phase One trade deal with China. The deal, which was signed January 15, suspended planned tariff escalations and lowered tariffs on some products. It also secured commitments from China to boost purchases of US goods and services and to provide better protections for intellectual property and trade secrets. Equity markets rejoiced on the positive trade news and the yield curve steepened, reflecting expectations for stronger growth and potentially higher inflation. When all was said and done, the year ended with stock markets near record highs and the Treasury curve steeper but lower than where the year began.

The US economy closed out the year on solid footing despite continued weakness in manufacturing activity. The US purchasing managers index from the Institute of Supply Management remained in contraction territory during the fourth quarter as factories were plagued by softer global demand and pullbacks in business investment brought on by the trade war. However, steady growth in the services sector helped to offset the manufacturing malaise. Consumer spending remained resilient, buoyed by strong labor market conditions. The US added an average of 184,000 jobs per month during the quarter, while the unemployment rate held steady at a half-century low of 3.5%. Job security kept confidence high and allowed consumers to shrug off trade uncertainty and ongoing impeachment rhetoric during the quarter. Activity in the housing market continued to pick up steam as financially secure Americans caught the home buying bug. While existing home sales were constrained by lean inventories, solid demand boosted new home sales and housing starts. Overall, it was another solid quarter of growth for the US despite the headwinds created by the trade war.

While the US economy continued to roll, global growth remained lackluster in the fourth quarter. China's economy languished as the trade dispute took its toll on exports, and domestic demand stayed sluggish. Fourth quarter GDP growth remained at a near 30-year low of 6.0%; however, manufacturing and business confidence began to pick up as trade tensions eased toward the end of the year. Economic growth stalled in Europe too, led by a slump in German manufacturing. The UK also continued to flounder under Brexit uncertainty and political turmoil. Japan did not fare any better as weakness in manufacturing and exports, particularly to China, continued to hinder growth despite significant government support to prop up the economy. The International Monetary Fund (IMF) recently revised down its global growth forecast for 2019 to 2.9%; however, the institution expects a modest rebound in growth in 2020 as the de-escalation of tensions between the US and China leads to a recovery in trade and investment. In addition, the IMF expects central banks to keep supporting their respective economies, which should help to further stabilize growth and buoy financial conditions.

The Federal Reserve continued to do its part to support growth in the US during the fourth quarter. As expected, the Fed cut rates by 25 basis points at the October FOMC meeting, resulting in a target fed funds range of 1.50-1.75%. This was the third cut in a row in what the Fed deemed as a "mid-cycle adjustment" to monetary policy. They cited slowing business investment and weak exports as justification for the ease. Kansas City Fed President Esther George and Boston Fed President Eric Rosengren again dissented from the vote, believing that the additional rate cut was unnecessary given the solid US economy. The Fed did signal that they were going to take a break in the easing cycle, stating that the current stance of monetary policy was likely to remain appropriate. Markets reacted favorably to the news as Fed Chair Powell did a good job effectively communicating the pause while emphasizing that the Fed stands ready to act if the economic outlook deteriorates. Following this guidance, the Fed held rates steady at the December FOMC meeting, and the dot plot forecast showed that a majority of Fed members expected rates to remain unchanged throughout 2020.

While the Fed may be taking a pause in cutting rates, they have not fully taken their foot off the accelerator. The Fed resumed balance sheet expansion in October in response to a demand for bank reserves. Short-term borrowing rates surged at the end of the third quarter due to a liquidity crunch in overnight repurchase markets. In order to avoid another such episode, the Fed began conducting a series of repo operations to ensure that funding for overnight loans stayed within the fed funds target range. In addition, the Committee announced on October 11 that the Fed would begin purchasing Treasury bills at a pace of $60 billion per month to ensure ample reserves. The purchases are expected to continue through the second quarter of 2020 as the Fed tries to calibrate the appropriate level of reserves that banks require to function properly. While Fed Chair Powell reiterated that these purchases were not another round of quantitative easing, markets viewed the additional liquidity as a sign of further stimulus.

The thawing of trade tensions is expected to feed through to the broader US economy in 2020 as trade uncertainty becomes less of a drag on growth. With the US economy on solid footing, most believe that the Fed will remain on hold at least through the election, allowing time for past monetary policy action to take hold while avoiding any appearance of political bias. However, many potential headwinds remain as we start the new year, including continued trade negotiations with China and the EU, military action in the Middle East, impeachment actions against President Trump, US elections, Brexit, and ongoing issues with the Boeing 737 Max, just to name a few. So, while the Fed may be on hold, there will be plenty of market moving events to talk about in 2020.

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