ECONOMIC AND FINANCIAL DIGEST

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Buying Insurance

As this is being written, the odds that the Federal Reserve will reduce its short-term policy rate at the July 30-31 meeting are extremely high. Not only are the financial markets pricing in almost 100 percent chance that it will pull the rate trigger, but Fed Chair Powell and other Fed officials have done little to beat back investor expectations of a cut. Indeed, failure to follow through would almost certainly cause an extreme market reaction, something that the central bank is loath to see.

Yet some are questioning the logic of a rate cut at this time. After all, the economy seems to be doing just fine. The labor market continues to churn out jobs faster than the working-age population is increasing. Wage growth exceeds inflation by a comfortable margin. Consumers are spending freely, and confidence is high. There are pockets of weakness, to be sure; the housing market is struggling, and factories are barely holding their own. But the much larger services sector continues to thrive, and recent data have mostly exceeded expectations. Gross Domestic product, which a month or so ago, looked like it was slowing to a stall speed in the second quarter, now appears to be tracking close to its 2.0 percent trend rate.

So, what's the problem? Simply put, past performance, as the saying goes, is no guarantee of the future. The Fed can't just look in the rear-view mirror in deciding when or if to change interest rates. Monetary policy affects the economy with a lag and, while the central bank may be happy with current conditions, it is eying the future with more trepidation. Hence, it believes that a cut now would cushion the blow from the headwinds that threaten to crimp economic growth later this year. This would not be the first time that the Fed made an "insurance cut" to guide the economy into a soft landing; similar moves were taken several times in the recent past, which proved successful. What's more, with inflation dormant, the risk of stoking overheating conditions is very low. What are these headwinds, and how serious are they?

Global Developments

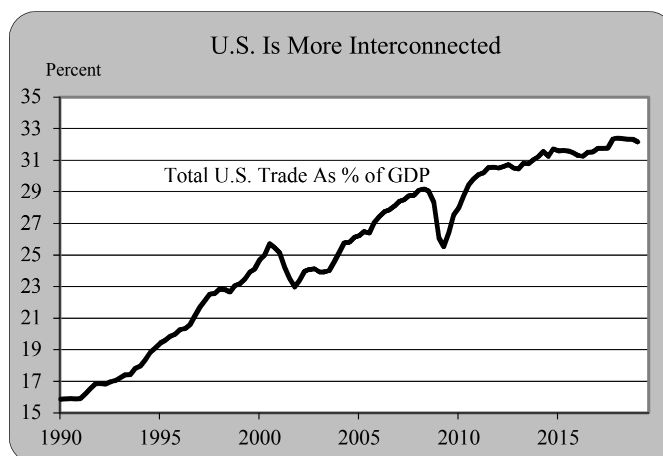
Worsening conditions overseas top the list of threats. China, the world's second largest economy that has been a major global growth driver in recent decades, is suffering the harshest slowdown in more than thirty years. Likewise, growth is slowing in Europe and Japan, where central banks are on the verge of lowering interest rates to jump-start their economies. The International Monetary Fund just released its World Economic Outlook, projecting more of a slowdown in global growth than in did in April --to 3.2 percent this year from 3.6 percent in 2018.

To be sure, the U.S. is less vulnerable to global developments than most other nations. But the tentacles of globalization have reached American shores in a big way. Companies rely heavily on foreign-sourced supply chains that have become critical to the production and distribution process in the U.S. They also derive an increasing share of revenues and profits from exports and from sales of overseas subsidiaries. Meanwhile, imports of foreign goods account for an ever-increasing share of consumer purchases.

Hence, trade in its multiple forms is playing an increasingly important role in the U.S. economy. In 1990, the sum of exports and imports accounted for about 15 percent of GDP; today it accounts for over 30 percent, a nontrivial component. Needless to say, trade policies as well as economic conditions abroad can have a deep impact on the U.S. economy. Higher tariffs, a signature tool in trade negotiations of the current administration, raise production costs for U.S. firms, even as they disrupt supply chain relationships. Importantly, protectionist trade policies invite retaliation from our trading partners, which amplifies the negative impact on global trade and, hence, growth. More directly, slower global growth translates into weaker foreign demand for U.S. products, sapping exports and crimping activity here.

Resilient Consumers

By itself, adverse trade developments should not derail the U.S. economy, which derives most of its strength from domestic sources. Consumer spending accounts for about 70 percent of U.S. output and by any standard, household fundamentals remain solid. The labor market is healthy, churning out far more jobs than



there are job searchers and driving the unemployment rate down to a near half-century low of 3.7 percent. Wages are rising comfortably faster than inflation, pumping up household purchasing power. Not surprisingly, consumer confidence is hovering near its highest point of the 10-year old expansion.

Against these favorable fundamentals, consumers regained the spending mojo they abandoned earlier in the year. Recall that in the first quarter personal consumption grew at a tepid pace of less than 1 percent, as several confidence-shattering incidents prompted them to zipper up their wallets and purses. Buffeted by a record long-government shutdown, households were also licking their wounds from a dispiriting late-year plunge in stock prices and becoming more anxious over the escalation of trade tensions with China.

While trade tensions are still high, the other impediments to spending have vanished. Washington resumed operations in late January and the stock market staged a vigorous rebound, recovering all the late-year losses and them some. Fueled by the rebound in wealth and ongoing strength in the job market, consumers returned to the shopping centers and malls with vigor, spurring the strongest gain in retail sales since late 2017 in the second quarter. As much as anything, the resilience of consumers and still-strong growth in jobs underscore the questioning of skeptics as to why the Fed needs to cut rates at this time.

The Drag from Tariffs

Clearly the surprising vigor of consumers complicates the Fed's decision as well as its ability to justify its policy intentions to investors and the public. But while the economy's main growth driver, consumers, is powering ahead, some other cylinders are starting to sputter. Most notably, the business sector, which has more at stake than households when it comes to trade disruptions, is turning decidedly more downbeat. The potential toll that adverse trade developments has on business fortunes can be felt on both sides of the ledger.

As noted, higher tariffs on imports raise production costs, as a large and growing share of supplies and materials that American firms use to generate output comes from overseas, including from foreign subsidiaries. The administration's goal is to induce these firms to shift purchases and production back to the U.S. as well as to punish the nations it is targeting with the tariffs. So far, however, that objective has met with limited success; some firms have stopped outsourcing production, but the vast majority are either retaining long-established supply chain relationships or looking to low-cost producers in other nations for needed supplies and materials.

Both options increase costs, which cut into profits if they cannot be passed on to consumers, something that is hard to do in the current low inflation environment. Worse, the punitive effects of higher tariffs are being felt, as spreading trade barriers are having a particularly harsh effect on countries that rely heavily on trade to support growth. Emerging market economies whose fortunes are closely linked to a slowing China are suffering greatly. But Europe, particularly Germany, has also been hit hard by the reduction in global trade. While the dispute between the U.S. and China has been put on temporary hold, no formal resolution is in sight. Meanwhile, Europe is in the cross hairs of U.S. trade hawks threatening to impose new tariffs on European autos, which is having a chilling effect on business sentiment on the Continent.

Corporate America Turns Defensive

That chilling effect has spread to the U.S. business community. While it is hard to measure the impact of trade tensions on actual behavior, corporate leaders have expressed their displeasure with the spread of protectionist policies. In survey after survey, trade tensions and their unpredictable economic consequences are cited as the main source of uncertainty that is leading to more cautious behavior. Indeed, many have said that investment plans are being put on hold because of uncertainty over trade policies.

It is no coincidence that capital spending has been a major disappointment over the past two years, despite the 2017 tax cuts that was designed mainly to stimulate business investment. Indeed, manufacturing, which is the sector most exposed to trade developments, is languishing, as factory output contracted in both the first and second quarters of this year. The dollar value of capital spending and manufacturing output is relatively small as a share of GDP; but they have an outsize influence on business cycles and frequently led the economy into recessions.

All of this by no means suggests that the economy is on the verge of a recession. But as the IMF noted in its World Outlook, the downside risks are rising, and the longer trade impediments remain so pervasive, the greater the odds that recessions will occur. The Fed is understandably sensitive to these risks. Indeed, overseas shocks have prompted Fed responses before. The Asian financial crisis and the near collapse of the Mexican Peso in the late 1990s, the European recession in 2011-2013 and the sharp slowdown in the Chinese economy in 2015-16 were all episodes that threatened to damage the U.S. economy. The Fed cut rates each time, although the U.S. economy was performing reasonably well during those periods.

Simply put, the central bank is not cutting rates in response to current conditions, which are holding up quite well thanks to a vibrant consumer supported by a solid job market. But the Fed is taking out insurance against the risk that deteriorating global developments will travel to American shores and undercut the expansion. Rather than wait for that prospect, which would require even steeper rate cuts than the Fed is able to provide, a preemptive move now is a low-risk option. It may turn out that a rate cut is not needed. But buying protection for a worst-case outcome is precisely what insurance is all about.

KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	June	May	April	March	February	January	December	12-Month Range High	12-Month Range Low
Prime Rate	5.50	5.50	5.50	5.50	5.50	5.50	5.35	5.50	5.00
3-Month Treasury Bill Rate	2.17	2.35	2.38	2.40	2.39	2.37	2.37	2.40	1.96
5-Year Treasury Note Rate	1.83	2.19	2.33	2.37	2.49	2.54	2.68	3.00	1.83
10-Year Treasury Note Rate	2.07	2.40	2.53	2.57	2.68	2.71	2.83	3.15	2.07
30-Year Treasury Bond Rate	2.57	2.82	2.94	2.98	3.02	3.04	3.10	3.36	2.57
Tax-Exempt Bond Yield	3.50	3.57	3.82	3.96	4.22	4.21	4.13	4.32	3.50
Corporate Bond Yield (AAA)	3.42	3.67	3.69	3.77	3.79	3.93	4.02	4.22	3.42
Conventional 30-Year Mortgage Rate	3.80	4.07	4.14	4.27	4.37	4.46	4.64	4.87	3.80
Dow Jones Industrial average	26160	25745	26402	25723	25606	24158	23806	26402	23806
S&P 500 Index	2890	2855	2904	2804	2755	2607	2567	2904	2567
Dividend Yield (S&P)	1.96	2.10	1.95	2.01	2.04	2.08	2.22	2.22	1.87
P/E Ratio (S&P)	19.3	18.0	19.3	18.7	18.3	17.8	16.6	21.0	16.6
Dollar Exchange Rate (vs. Major Currencies)	91.6	92.6	92.3	91.9	91.4	91.8	92.1	92.6	90.0

** Monthly Averages*

ECONOMIC INDICATORS

	June	May	April	March	February	January	December	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1253.0	1265	1270	1199	1149	1291	1142	1291	1142
New Home Sales (Thousands of Units)		626	679	705	669	644	564	705	557
New Home Prices (Thousands of Dollars)		308	335	310	321	305	330	335	305
Retail Sales (% Change Year Ago)	3	2.9	3.8	3.8	1.9	2.6	1.4	6.6	1.4
Industrial Production (% Change Year Ago)	1.3	2.1	0.9	2.3	2.8	3.6	3.8	5.4	0.9
Operating Rate (% of Capacity)	77.9	78.1	77.9	78.4	78.4	79.0	79.5	79.6	77.9
Inventory Sales Ratio (Months)		1.39	1.39	1.38	1.40	1.39	1.37	1.40	1.33
Real Gross Domestic Product (Annual % Change)				3.1			2.2	4.2	2.2
Unemployment Rate (Percent)	3.7	3.6	3.6	3.8	3.8	4.0	3.9	4.0	3.6
Payroll Employment (Change in Thousands)	224	72	216	153	56	312	227	312	56
Hourly Earnings (% Change Year Ago)	3.1	3.1	3.2	3.2	3.4	3.2	3.3	3.4	2.9
Personal Income (% Change Year Ago)		4.1	3.9	3.5	3.9	4.0	4.6	4.6	3.5
Savings Rate (Percent of Disposable Income)		6.1	6.1	6.2	7.1	6.8	7.4	7.4	6.1
Consumer Credit (Change in Blns. Of Dollars)		17.1	17.5	11.0	15.5	17.0	12.0	25.1	8.8
Consumer Prices (% Change Year Ago)	1.6	1.8	2.0	1.9	1.5	1.6	1.9	2.9	1.5
CPI Less Food & Energy (% Change Year Ago)	2.0	2.0	2.1	2.0	2.1	2.2	2.2	2.4	2.0
Wholesale Prices (% Change Year Ago)	1.7	1.8	2.2	2.2	1.8	2.0	2.5	3.4	1.7