Recession Fears Grow, Presaging More Fed Easing and Lower Bond Yields

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While only a slim majority of Fed officials maintained an easing bias at the September 18th FOMC meeting, the upcoming gatherings, beginning with the one on October 29-30, should garner a more unified approach towards cutting interest rates. When the committee met in September, the general perception was that the economy was slowing but still in a "good place" reflecting solid household fundamentals that would support a healthy pace of consumption and sustain the expansion through the gathering headwinds of a global meltdown, weakening capital spending and escalating trade tensions. That perception is rapidly losing adherents even as the "recession watch" crowd is gaining an army of new recruits.

The notion that the Fed can withstand these headwinds with only a "mid-cycle adjustment" in policy has been shattered by incoming data since that September 18th meeting. Business investment spending is in full retreat; consumers are zipping up their wallets and purses, exports are plunging, and manufacturing is already in a recession. Meanwhile, the headwinds buffeting the economy, and financial markets are intensifying and expanding. The impeachment inquiry into President Trump is poised to reach a boiling point and add to the political dysfunction in Washington that is a time-honored catalyst of market volatility and depressed confidence on Main Street. At the very least, the probe enhances the likelihood of a government shutdown after the just enacted short-term spending resolution expires in November. A bipartisan agreement amid impeachment hearings that is driving a bigger wedge between the two parties will be difficult to achieve.

To be sure, Wall Street is known for its ability to climb a wall of worries, as evidenced by the powerful stock market rally over the past decade in the face of a litany of troublesome events, including three government shutdowns, a sovereign debt crisis, a European recession, geopolitical flare-ups and an ever-escalating trade war, among other nontrivial obstacles. But the wall of worry is getting steeper, and anxiety is building on both Wall Street and Main Street. Stock prices are no longer traveling a one-way street to higher ground that until recently has been underpinned by complacency and low volatility. Equity prices peaked in July after a stomach-churning plunge in the spring, extending a yearlong bout of wild fluctuations and growing investor pessimism that will only deepen amid deteriorating corporate profitability. The flight to safe havens that started earlier this year is gaining traction, and driving high-quality bond yields to historic lows. Business upstarts with no earnings prospects – the Ubers, Lyfts, and WeWorks – are facing a rude reception for their IPOs, leaving their public shareholders with huge losses and their private equity Sugar Daddy's holding the bag for years to come.

A World of Trouble

Thus far, overseas economies have borne the brunt of protectionist policies spreading throughout developed and emerging-market nations. The global slowdown that took hold in 2018 deepened this year, prodding virtually all central banks to ease credit conditions and drive short-term interest rates into negative territory. That policy push is continuing as the global economic landscape continues to deteriorate. Germany is on the brink of recession and dragging the rest of Europe down with it. China is suffering its slowest growth rate in three decades, inflicting hardship on its regional neighbors and trading partners. The IMF, OECD, and the ECB all lowered their global growth forecasts for 2020.

The U.S. is less vulnerable to global developments than other economies and escaped the slowing headwinds relatively unscathed in 2018. But the economy benefited from a robust tailwind, fueled by the Tax Cut and Jobs Act enacted in late 2017. That fiscal stimulus, along with the widespread perception the economy would be further energized by the business-friendly deregulatory environment espoused by the Trump administration stoked optimism and led to a temporary surge in investment spending and robust employment gains. But the glow from those halcyon days gradually dimmed as the year progressed, and trade tensions escalated, sending ever-frightening shock ways through the financial markets.

Indeed, a second look back reveals that the past was not as glowing as thought. Revised figures by the Commerce and Labor Departments shaved almost a half-percent off the 2018 growth rate and sliced a half-million workers from the year's employment gains. These downward revisions highlight the complexity of real-time policy-making, as it is doubtful that the Fed would have raised rates four times last year if these lowered growth and job figures were known. It rescinded two increases and is poised to erase the remainder, most likely before the end of the year.

The financial markets were already well aware that the Fed went too far in 2018 and began pricing in higher recession odds as soon as the calendar turned to 2019. Most notably, the yield curve flattened precipitously in the closing months of 2018, and by March, the 3-month/10-year yield inverted. The time-honored recession indicator – the 2-year/10-year inversion – followed suit later in the summer and has since fluctuated narrowly around the slope's inflection point, depending on trade talks and the strength of incoming data.

Growth is Downshifting

When the Fed met in September, the consensus among policymakers was that trade developments and soft investment spending were crimping economic activity but that growth was slowing only gradually and would settle not far from the 2.0 percent annual rate seen in the second quarter. But new data since that meeting throws that assessment into shambles. To say that business investment spending is softening is a vast understatement; business leaders have all but thrown in the towel regarding the profitability of new commitments for this cycle.

That was abundantly clear in the latest Business Roundtable Survey. The quarterly survey that began in 2002 shows how far business sentiment has fallen since the halcyon days of 2018 when the administration's tax cuts and deregulatory measures sent business optimism sky-high. Plans for hiring, capital spending, and sales expectations over the next six months have all declined sharply in the third quarter's survey released a few weeks ago. The overall economic outlook index that encapsulates the three components fell by 10.3 points, the most significant quarterly decline in seven years. At 79.2, the index is still in expansion territory, which is anything above 50, but the plunge from a nearby high of 118.6 has only been exceeded by the capitulation seen during the Great Recession in 2008. Importantly, the ebullient capital spending plans depicted during that period has never been fully realized.

To be sure, intentions do not always translate into actual behavior. This time, however, the darkened mindset among businesses is playing out in real-time. The Commerce Department just provided more evidence that the slippage in business optimism is translating into actual behavior, most notably in weaker capital spending. According to its latest data, a key proxy for business equipment spending in the GDP accounts is running measurably below the second-quarter average over the first two months of the third quarter.

While shipments of core capital goods (nondefense items excluding aircraft) increased 0.4 percent in August, that was not enough to offset the more substantial 0.6 percent drop in July. Based on the depressed average reading for July and August, our tracking model points to a 2.0 percent contraction in business equipment spending in the third quarter. That would sustain the bumpy road to nowhere seen so far this year. Equipment spending rose a slim 0.8 percent in the second quarter following a 0.1 percent contraction in the first.

What's more, prospects over the near term do not look promising. Orders for these same core capital goods fell 0.2 percent last month, following no change in July. The momentum in bookings has turned decidedly weaker. New orders were down 0.3 percent in August from a year ago, the second consecutive year-over-year decline. That's the first back-to-back decline since November/December 2016, when the collapse in energy-related investment spending paced the deteriorating trend. This time, the weakness is more broadly based and is consistent with the recession readings in manufacturing activity revealed in the ISM surveys of manufacturers. On October 1, the Institute for Supply Management reported that its manufacturing index fell to 47.8, the lowest since June 2009.

Consumers Turning Cautious

Since the Federal Reserve's easing bias has been linked to the weakening trend in capital spending, the latest figures on durable goods orders will only reinforce the dovish sentiment among Fed officials. By itself, that increases the likelihood the central bank will pull the rate trigger again at the October meeting. But an even more significant incentive appears to be coming from a more critical source: consumer spending. Keep in mind that even as the Fed was cutting rates in both July and September, it believed that the economy was still underpinned by solid fundamentals, most notably the healthy job market and strong consumer spending, the economy's main growth driver.

But that firm belief may be shaken by the latest data on consumer spending. On the same day as the downbeat reading on capital spending was released, the Commerce Department also reported that consumers sharply curtailed spending last month. Total personal expenditures eked out a slim 0.1 percent increase in August, down sharply from the 0.5 percent increase in July, which itself was revised down from the previous estimate of a 0.6 percent increase. Adjusted for inflation, personal outlays also rose by a slim 0.1 percent last month, about one-third of the 0.3 percent increase posted in July. Hence, after blowing through expectations in the second quarter with a 4.6 percent increase – matching the strongest quarterly pace since the fourth quarter of 2014 – real personal outlays are poised to downshift considerably in the current quarter. We are currently expecting a growth rate of 2.5 percent for real PCE, underpinning a corresponding slowdown in GDP to 1.3 percent from a 2.0 percent pace in the second quarter.

No doubt, households appear to be in good financial shape, as wages are still rising at a 3 percent clip, and personal savings are hovering around a historically high 8 percent. As long as the job market holds up, consumers will keep their wallets open and provide enough spending support to sustain the expansion. However, consumer spending is the last thing to fall when the economy heads into a recession, and the summer pullback may be a sign that households are starting to buckle under the headwinds that are pulling down other sectors. Indeed, the New York Federal Reserve Model pegs recession odds at 84 percent over the next twelve months, the highest it has been since the Great Recession. And as downbeat as the Business Roundtable Survey is, some others are worse. In the latest Duke University/CFO Global Business Outlook survey, 53% of CFOs expect a recession before the 2020 presidential election. If households start to fear that the pullback in business investment spending is a prelude to worker layoffs, their confidence will deflate as will actual spending.

Lower Yields Ahead

In its dire forecast for the global economy, the OECD indicated that the only thing that would prevent a global recession is if governments intervene and step up fiscal stimulus. Underscoring this warning is the belief that monetary policy has reached the limits of what it can do. With central bank policy rates already at the zero bound or in negative territory, it is highly unlikely that further reductions will stimulate growth. Indeed, there is a growing body of research showing that negative rates do more harm than good, as they vaporize bank profits and choke off credit availability.

In the U.S., there is some way to go before the zero bound is reached, but the path to the ZLB is being greased by the economic and inflation backdrop.

Having recognized overseas that monetary policy is virtually powerless to jump-start growth or lift inflation to the ECB's 2.0 percent target (the annual Eurozone inflation rate fell to 0.8 percent in September), there is a growing movement, borne of desperation, to leverage central bank efforts with helicopter money, i.e., having the central bank print money to finance additional fiscal stimulus. Even the German conservative diehard, Wolfgang Schäuble, seems to be embracing that notion.

With trillion-dollar Federal deficits as far as the eye can see, there is little support for another dose of fiscal stimulus in the U.S. That said, the Federal Reserve will be financing a sizeable fraction of Treasury borrowing in coming years. The accelerated Fed purchases of Treasuries stems, in part, from the astonishing failure of the New York Fed to correctly assess the volume reserves demanded by banks, which briefly sent the fed funds rate spiraling above 10 percent. Having poured over $150 billion of liquidity into the banking system over the past two weeks to correct the shortfall and bring the funds rate down to targeted levels, the Fed is about to embark on a permanent course of additions to its balance sheets to keep up with the rising demand for reserves. What's more, the Fed will be reinvesting the proceeds of maturing mortgage-backed securities into Treasuries. We calculate that the Fed will be buying $480 billion of Treasuries over the next two years to satisfy the demand for reserves, or $20 billion per month, and a roughly equal volume of MBS reinvestments. Hence, over the next two years, Treasury holdings will have increased by $910 billion, with monthly net Treasury purchases averaging just under $38 billion. These purchases are equivalent to about 40% of the new cash we estimate the Treasury will need to raise over the next two years.

While the Fed is not orchestrating quantitative easing, the large purchases will feel like QE to Treasury investors and impart a further downward bias to interest rates. That, in turn, is reinforcing the deteriorating global economic and deflationary influences that are underpinning the demand for safe havens and poised to send quality yields to ever-lower levels for the foreseeable future.

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Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	9/30/2018	6/30/2019	9/30/2019	Last Quarter	Last Year
6-Mo. Bill	2.37	2.05	1.82	0.61	2.64
2-Yr. Note	2.82	1.74	1.62	0.52	4.21
5-Yr. Note	2.95	1.76	1.55	1.33	9.09
10-Yr. Note	3.06	2.00	1.67	3.19	15.15
30-Yr. Note	3.20	2.53	2.12	9.21	27.43

Municipal Bonds	Yields (%)			Total Return (%)	
	9/30/2018	6/30/2019	9/30/2019	Last Quarter	Last Year
Barclays GO Bond Index	2.75	1.87	1.73	1.47	8.37
Barclays State GO Bond Index	2.68	1.79	1.66	1.20	7.71
Barclays Local GO Bond Index	2.84	1.97	1.80	1.76	9.08
Barclays Revenue Bond Index	2.97	2.13	1.94	1.70	8.97

Equities	Levels			US $ Terms (%)	
	9/30/2018	6/30/2019	9/30/2019	Last Quarter	Last Year
S&P 500	2519.36	2941.76	2976.74	1.70	4.25
DJIA	22405.09	26599.96	26916.83	1.83	4.21
NIKKEI (Tokyo)	20356.28	21275.92	21755.84	2.72	-3.35

Commodities	US $			Percent Change (%)	
	9/30/2018	6/30/2019	9/30/2019	Last Quarter	Last Year
COMEX Gold Active Monthly	1280.15	1413	1465.7	3.73	14.49
CRB Future Com. Pr. Index*	183.0882	181.0378	173.9399	-3.92	-5.00
West Texas Intermediate Crude ($ per bbl.)	51.67	58.47	54.07	-7.53	4.64

Currencies	Levels			Percent Change (%)	
	9/30/2018	6/30/2019	9/30/2019	Last Quarter	Last Year
Yen	112.51	107.85	108.08	-0.21	3.94
Sterling	1.3398	1.2696	1.2289	-3.21	-8.28
Euro	1.1814	1.1373	1.0899	-4.17	-7.75

Global Bond Markets**	Levels			US Dollar Terms (%)	
	9/30/2018	6/30/2019	9/30/2019	Last Quarter	Last Year
German 10-Yr.Bond	0.32	-0.44	-0.66	1.74	8.55
Japanese 10-Yr.+ Bond	0.07	-0.22	-0.32	0.81	3.46
UK 10-Yr.+ Bond	1.43	0.76	0.35	3.44	10.32
Emerging Market (USD)	5.83	4.88	5.00	1.28	10.6

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices