CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

June 14, 2019

After the docile May CPI report last Wednesday, today's retail sales numbers for May are the last of the first-tier pieces of data the Fed will see before meeting next week. Overall sales were up 0.5% which missed the robust 0.6% consensus but an improvement off April's upwardly revised 0.3% increase (initially reported as a –0.2% decline). Taking out some of the more volatile components, sales ex-autos and gas were up 0.5% versus 0.4% expected and better than the 0.3% increase in April (also revised upward from –0.2%). Sales in the control group—a direct GDP input— were up 0.5% beating the 0.4% forecast and ahead of the 0.4%result in April (revised up from an initially reported 0.0%). In summary, May retail sales met most expectations and beat April results that were revised up after the initial somewhat disappointing release. The Fed is still likely to move to an easing posture at next week's meeting because of the moribund May inflation readings, and ongoing geopolitical issues, but those looking for a surprise cut will probably be disappointed. Odds of a July rate cute remain very high sitting at 84%, while a surprise cut at next week's meeting carries only 21% odds. We explore possible Fed reactions next week and the retails sales numbers in more detail below.

Continuing the discussion of retail sales, and layering in its impact on GDP estimates, recall first quarter GDP surprised to the upside based on three factors: (1) continued increase in inventories which were partially due to front-running trade tariffs; (2) better-than-expected contribution from net exports, as again, exporters attempted to get ahead of tariffs by accelerating shipments; and (3) consumer spending rose more than expected off the extraordinarily strong March spending numbers. While the first two factors are expected to reverse during this quarter, and contribute to lower GDP estimates, consumer spending remains an open question as to how it will fare and contribute to GDP.

After March's robust retail sales results, April's initial numbers were disappointing but the revisions today reflect a solid performance by the consumer in the first two months of the second quarter. As for GDP, recall that the cycle-high 4.2% GDP print in the second quarter of 2018 was driven by a stout 3.8% increase in consumer spending. That rate has trended lower in the quarters that followed with the first quarter logging a modest 1.3%, the lowest since March of 2018. With the upward revision to April's initially disappointing retail sales, and solid May results, second quarter consumption estimates of 2.7% seem pretty safe and that could lead to an upward revision to Bloomberg's current second quarter GDP estimate of 1.9%. By the way, the Atlanta Fed's GDPNow model, which has had a good track record of late, sees second quarter GDP at a lower 1.4%, but that will be adjusted higher after today's report.

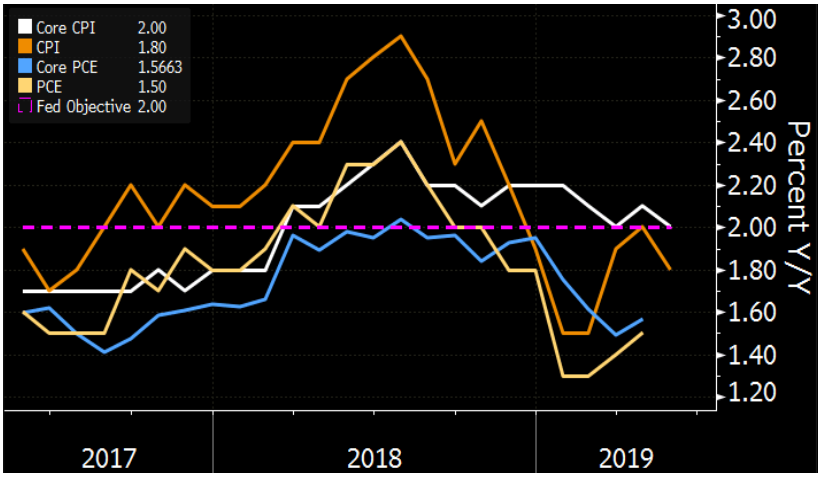
Given the expected give-back in inventories and net exports that aided first quarter GDP, consumer spending will be relied upon to generate the lion-share of this quarter's GDP growth. With May retail sales results meeting expectations, and April's adjusted higher, the consumer seems up to the task of carrying the load. In addition, the recent drop in interest rates to yearly lows should lead to continued increases in sales activity in housing and autos and that could drive a decent June and hence a second quarter GDP that manages to meet or beat expectations.

Moving on to the Fed meeting next week and what to expect with retail sales meeting expectations, second quarter GDP estimates are likely to remain near or just above the 1.9% Bloomberg consensus with a bump higher to the Atlanta Fed's current 1.4% estimate. With today's report, the Fed will feel less pressure to surprise with a rate cut next week and instead begin prepping the market for a future cut, perhaps in July.

The nagging concern for the Fed will be the trend in inflation. The "transitory" label for the downward drift becomes harder to justify after the May CPI numbers. Thus, expect more concern to be expressed about inflation missing the 2% target than recent statements have noted. In addition, moving to a more overt easing posture will require some adjustment to the economic and rate forecasts versus what they had in March. First, the fed funds dot plots will more than likely see the 2020 rate hike removed and the long-run 2.75% estimate adjusted down to 2.50%. Also, moving to an easing posture seems to require a downward adjustment to GDP and an upward adjustment to the unemployment rate. The March forecast had 2019 GDP at 2.1% and unemployment at 3.7%.

Most Fed officials have expressed confidence in the economy so any adjustments in their forecasts will most likely be modest and that is why the market may be setting itself up for some disappointment. The Fed has been more dovish than expected at every meeting this year, but it seems they'll be hard-pressed to pull that trick this time. Thus, we see the short-end selling off given the Fed's reluctance to get on with easing, while the longer-end rallies on the perception that the Fed is adjusting too slowly in light of overseas slowing and the downward inflation trend. All that being said, because of today's report, we don't expect a surprise rate cut next week. The consumer still seems to be in a good place and that will be enough for a decent second quarter GDP number. Instead, expect the prepping for a July cut to begin.

Inflation Measures Continue Trending Lower



The Fed has stuck to its characterization of the recent downward trend in inflation as "transitory" and even mentioned a couple categories as (apparel and used cars) as being particularly prime culprits and likely to reverse in the months ahead. While the May inflation numbers did see some reversals in those categories other's took their place and hence the downtrend remains. The persistence of inflation remaining under the 2% target, and in some measures trending even lower, will likely warrant a more forceful level of concern at next week's Fed meeting and could be a prime motivator in shifting to an easing posture.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	2.18%	-0.07%	1 Mo LIBOR	2.40%	-0.02%	FF Target Rate	2.25%-2.50%	3 Year	1.815%
6 Month	2.18%	+0.04%	3 Mo LIBOR	2.43%	-0.04%	Prime Rate	5.50%	5 Year	1.837%
2 Year	1.86%	+0.05%	6 Mo LIBOR	2.34%	-0.07%	IOER	2.35%	10 Year	2.045%
10 Year	2.10%	+0.03%	12 Mo LIBOR	2.33%	-0.05%	SOFR	2.35%		