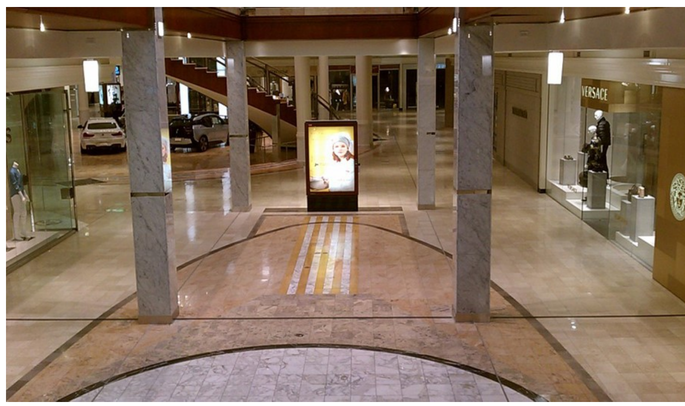
Market Update

Economic News

May 15, 2019



We take a break from trade war-related discussions to look at a first-tier economic release today in the form of April retail sales. The report was expected to be a reversion-to-the-mean after March's sales soared to such an extent it provided an unexpected spending bump to first quarter GDP. However, the April report missed on even subdued expectations. Overall sales were down -0.2% missing the +0.2% consensus and well off the 1.7% pop in March. Sales ex-autos rose just 0.1% widely missing the 0.7% forecast and well behind March's 1.3% gain. Sales ex-autos and gas were down -0.2% versus +0.3% expected and off the +1.1% March gain. Sales in the control group—a direct GDP input— were unchanged missing the +0.3% forecast and again trailing the 1.1% gain in March. In summary, with two-thirds of our economy consumption-based the monthly retail sales report is an important window into the health of the overall economy. With April retail sales missing modest expectations the miss will cause second quarter GDP estimates to be adjusted down. Bloomberg's consensus forecast is currently calling for 2.0% GDP growth while the Atlanta Fed's GDPNow model is at a 1.6% growth rate. Treasuries were already rallying on softer-than-expected Chinese numbers and the retail sales figures have added to the bid. The 10-year yield has dipped to 2.36%, the 2-year is at 2.14% and the 3mo-10yr spread is -3bps (a harbinger of a coming Fed ease). Odds of a September rate cute have risen to 57% versus 35% a week ago. All these levels are YTD lows or highs as the case may be and will put pressure on the Fed to begin acknowledging that a rate cut could be coming sooner rather than later.

Continuing the discussion of retail sales and its impact on GDP estimates, recall the first quarter 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 the lower GDP estimates, consumer spending remains an open question as to how it will fare.

While March retail sales were above expectations, the splurge still didn't offset a weak showing in January and February. Hence, consumer consumption for the quarter rose just 1.2% versus 2.5% in the fourth quarter and a high print of 3.8% in the second quarter of 2018. With April's retail sales missing modest forecasts, the second quarter consumption estimate of 2.8% appears vulnerable to a cut. Consumer spending is partially a function of incomes and confidence and if market volatility, (read stock declines) continues off the latest trade-related news the consumer may pull back further, especially on big-ticket items like autos. Thus, second quarter GDP hitting its already modest expectations could come down to the consumer remaining confident and willing to spend through the ups and downs of the market. With April's numbers were off to a very tentative start.

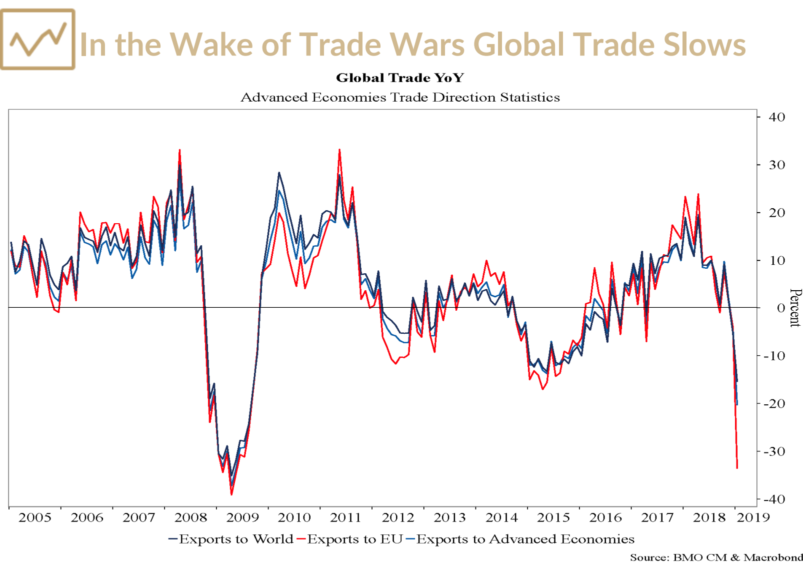
Meanwhile, moving to the trade war and tariff-related fallout there has been some discussion, particularly from Boston Fed President John Williams, that one outcome of the tariffs will be higher inflation. While higher costs due to tariffs certainly have inflationary aspects there's a lot more going on for that to happen. First, for tariff-related costs to filter into CPI and PCE producers would have to pass those costs along. That was not the case in the first round of tariffs last year, with PCE falling during the summer as producers swallowed a large portion of the cost increases thereby squeezing profit margins.

Another element to consider is that dollar strength continues to be the story in foreign currencies and China particularly has seen a decline in the yuan offsetting to a large extent the increased costs created by tariffs. Also, if costs are successfully passed through the marginal buyer may be reluctant to purchase which would slow demand and probably lead to a reversal in that cost increase. In summary, the experience we've seen to date with tariffs is a combination of producers absorbing some of the cost with a strengthening dollar absorbing another part of the higher cost.

And as if right on cue import prices in April were released yesterday and were universally weaker-than-anticipated. The headline figure disappointed at +0.2% versus +0.7% expected and +0.6% in March. Within the details, the ex-petroleum import price change was -0.6% in April which ties January as the lowest since early 2015. If anything, the data contributes another arrow to the quiver of those looking for a preventive Fed ease sooner rather than later.

As we discussed above, the decrease in import prices in April were largely attributable to dollar appreciation. The broad trade-weighted dollar was up 8% year-on-year through April and it strengthened 7% relative to the Chinese yuan over the same period. The April import price data show the tariffs of 2018 being largely offset by the strong dollar -- a pattern that has prevailed for several months. This illustrates the buffer currency markets have provided in the early rounds of tariffs, and helps explain why consumers have largely been oblivious to any increased costs stemming from tariffs.

In the Wake of Trade Wars Global Trade Slows



To offer context for the broader global trade issues, the graph charts YoY changes in global trade as measured by the IMF's Direction of Trade Statistics. Exports are broken down into three categories: 1) Exports to the world (weakest since 2009), 2) Exports to advanced economies (lowest since 2009), and 3) Exports to the EU (near 2009 lows). As estimates of the fallout from renewed trade tensions begin to reflect growing apprehension in a variety of markets, the extent of the drop in exports is unmistakable and could cause analysts to begin lowering GDP estimates.

Agency Indications— FNMA/FHLMC Callable

Maturity (yrs)	2 Year	3 Year	4 Year	5 Year	10 Year	15 Year
0.25	2.51	2.60	2.69	2.77	3.09	3.31
0.50	2.45	2.53	2.61	2.69	3.04	3.22
1.00	2.32	2.40	2.49	2.58	2.92	3.14
2.00	-	2.17	2.27	2.36	2.80	2.97
3.00	-	-	-	-	2.68	2.88
4.00	-	-	-	-	2.58	2.81
5.00	-	-	-	-	2.49	2.75
10.00	-	-	-	-	-	NA