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TPWC Market and Economic Update

The Markets

An observer of market news could be forgiven some surprise that, for the week ending on Oct. 11, the S&P 500 stock index (SPX) was only up 0.62% to close at 2970.27. Only minutes before the market close on Friday, the SPX had risen 1.5% since its opening that morning. The market-moving news was a series of tweets from the President expressing optimism on the ongoing trade talks between the U.S. and China. Then, just before the close the index suddenly plunged 0.4% as the very limited scope of the agreement began to be seen. All in all, the market did turn in a week's gain for the first time in a month, even if it was a small one. That close puts the market about 2% below its recent high of 3028 at the end of July but up only about 1.3% from August of last year.

The near-term direction of the markets is dependent on the tangible outcome of the trade talks. If the tariffs scheduled to take effect on October 15 and those on December 15 go into effect the results will not be pretty. SPX corporate earnings for the third quarter are estimated to have declined about 4% from last year, but the market index is still up. It remains where it is based on optimism for cessation or relaxation of the trade war. If that does not happen there is nothing left to keep the optimism in place. The market is at an inflection point and all we can do is watch.

The U.S. Treasury 10-year note yield joined the stock market in muted relief, rising 4.9 basis points to 1.732% but that lack-luster rise was enough to end the inversion of the Treasury yield curve as the 90-day T-bill still was yielding 1.687%. Unfortunately, history indicates that once a yield curve has been inverted this long a drop in short-term rates is not necessarily good news. West Texas Intermediate crude oil (WTI) jumped 3.41% to close at $54.84 but most of that gain was credited to news that an Iranian tanker had been hit by missiles off the coast of Saudi Arabia. The dollar declined about half a percent but is up 3.28% for one year against a trade-weighted basket of world currencies with the WSJ Dollar Index, closing at 98.35.

The Economy

The hard data indicator for the week was the release of the September U.S. Consumer Price Index (CPI) which came in at exactly zero. That zero change puts it up 1.7% from a year ago. The big movers in the underlying data were a 4.7% decline in energy prices offset by a 2.9% increase in services. The ominous trend though has been downward, suggesting a reduction in demand over the last year. The good news is that the absence of ongoing inflation leaves the Federal Reserve cover to cut interest rates again at its next meeting.

Trucking companies cut employment by 4,200 jobs in September and manufacturers lost a net 2,000 jobs. Those losses were more than offset by hiring in health care and the business and professional services category. Thus, the pattern continues that the service sectors are adding jobs while the manufacturing and transportation sectors contract. Two-thirds of economists surveyed by the Wall Street Journal believe the manufacturing and transportation sectors are in a recession. That impression is confirmed by a 5.5% decline in railroad car-loads in the third quarter.

Economists have often wondered what level of government debt and monthly borrowing would begin to distort and disrupt the rest of the economy. That question may have been answered in the last few weeks. A couple of weeks ago, the short-term borrowing market suddenly became unstable as overnight interest rates shot to an annualized rate of

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10%. The Federal Reserve, as it is mandated to do, stepped in for several days in a row with tens of billions of dollars of emergency liquidity driving short-term interest rates down. Initially, the causative factors were announced as one-time odd events but as the weeks have gone by the Fed has had to step in daily which suggests that something fundamental has changed.

On Tuesday, Federal Reserve Chairman Jay Powell announced that the Fed would start regular purchases of short-term U.S. Treasury securities to restore liquidity to the short-term market. The apparent driver of the short-term cash deficit is the Treasury is borrowing record amounts of money, over $1 trillion in the first 11 months of this fiscal year, and most of that borrowing is in the short-term market. Our financial system is being squeezed on the short end of the yield curve by the deficit and the extra cash to cover that borrowing must be provided by the Federal Reserve. Contrary to political rhetoric, there is a limit to how much we can borrow to cover the deficit without negative side effects.

The bottom line remains the same. The economy and the markets are looking quite good but are on a knife's edge with further growth possible if the trade wars suddenly end but being dangerously close to sliding downhill if things don't turn out to be truly excellent in the near future.

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