Capital Markets Group

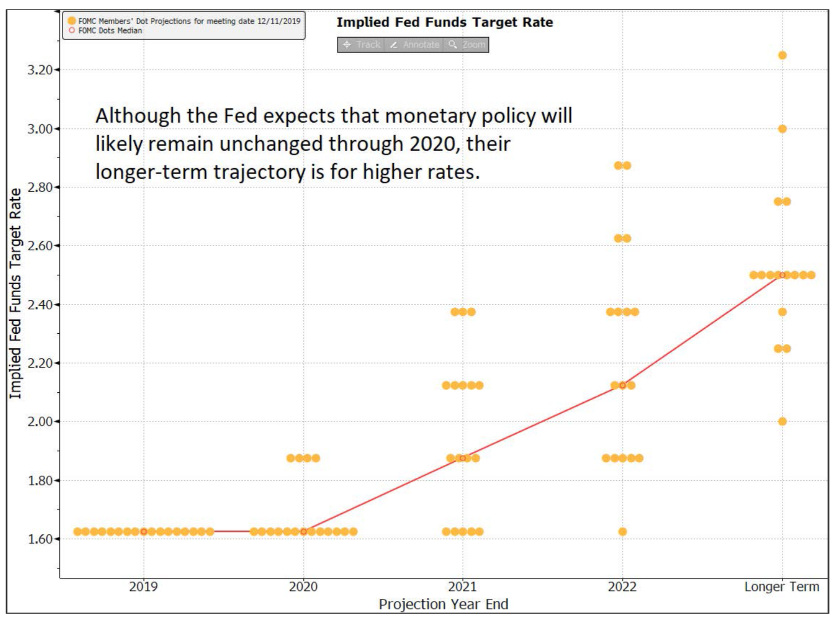
Weekly Review—December 20, 2019

As year-end fast approaches, investors look to enter 2020 in a state which I would describe as uneasy calm. The treasury yield curve is no longer inverted, equity markets continue to set record highs, U.S.-China trade talks look to be moving forward and fears of a near-term recession seem to have subsided. As for the Fed, their economic outlook "remains a favorable one." Based on their quarterly “dot plot” projections which were released last week, the central bank looks to be united in staying on the sidelines through next year. Evidenced in the below graph, thirteen officials submitted projections suggesting they would lean toward keeping rates steady, while four penciled in one 25-basis-point hike for 2020. None projected a rate cut in 2020, though the futures market is currently wagering - with a mere 53% probability - that the central bank will ease policy 25bps by the end of next year. Beyond 2020, the Fed’s median forecast reveals an upward bias as its benchmark overnight rate increases to 2.50% by year-end 2023.

While the current economic outlook looks to have stabilized, it doesn’t come without downside risks that include stubbornly low inflation, continued weakness in the manufacturing sector and slowing global growth. Over the last few days, several policy makers have reiterated that interest rates are on hold *unless there’s a material change in their economic outlook*. As I see it, the gradual slowing of economic growth combined with low & slowing inflation pose the greatest risk to their outlook. Why?

As stated in the World Economic Forum, a moderate amount of inflation is generally considered to be a sign of a healthy economy, because as the economy grows, demand for goods and services increase. This increase in demand pushes prices a little higher as suppliers try to create more of the things that consumers and businesses want to buy. Workers benefit because this economic growth drives an increase in demand for labor, and as a result, wages usually increase. Finally, these workers with higher wages go out and buy more stuff, and so this “virtuous” cycle continues. Inflation isn’t really causing all this to happen – it is merely the symptom of a healthy, growing economy. But when inflation is too low, a “vicious” cycle can take its place. Very low inflation usually signals demand for goods and services is lower than it should be, and this tends to slow economic growth and depress wages. Low demand creates a downward spiral in growth and wages – often times leading to recession.

The Fed is currently selling the idea that monetary policy is appropriately positioned to foster continued economic growth within the context of stable prices. Looking at current data, 3rd quarter GDP of 2.1% remains below its 5-year quarterly average of 2.3% and well under its 3.5% high. Fourth quarter GDP is projected to decline to 1.7%. As for 2020 and 2021, economic growth is projected to have 1% handles. Inflation, as measured by the core PCE deflator, registered a 0.1% gain in November, in-line with expectations. Unrounded, it rose by 0.138%. At 1.6%, the year-over-year inflation rate was down from October’s 1.7% and below the Fed’s 2% inflation target. Since the end of the Great Recession, the Fed’s preferred measure of inflation – Core PCE deflator YoY% – has been below their symmetrical target of 2% eighty-nine percent of the time.



At this point in the business cycle, one would think that unless inflation picks up from its somewhat anemic level, the next move by the Fed will be down - which runs counter to their dot plot forecast.

As a heads-up, the next CMG Weekly Commentary will be published January 3. Enjoy the holidays!

Your comments/questions are encouraged.

Dennis Zimmerman Jr. |Sr. Vice President | Asset/Liability Services Manager | 800-548-2663 | dennis.zimmerman@commercebank.com

NEW ISSUE MUNICIPAL CALENDAR			
Date	Amount ($)	Description	Maturity
12/25/2019		Merry Christmas!	

ECONOMIC CALENDAR				
Monday 12/23	Tuesday 12/24	Wednesday 12/25	Thursday 12/26	Friday 12/27
New Home Sales Durable Goods Orders	MBA Mortgage Applications		Initial Jobless Claims	

KEY INDICES			
	Current	Last Month	One Year Ago
Prime Rate	4.75	4.75	5.50
Discount Rate	2.25	2.25	2.75
Fed Funds Rate	1.55	1.55	2.20
IOER	1.55	1.55	2.40
1-Month Libor	1.79	1.72	2.48
11th Dist COFI	1.10	1.13	1.06
1-Yr. CMT	1.52	1.54	2.62
Dow	28,455.09	27,821.09	22,859.60
NASDAQ	8,924.96	8,526.73	6,528.41
S&P 500	3,221.16	3,108.46	2,467.42
Bond Buyer	2.74	2.85	4.11

MUNI AA—BQ	
3 Mo.	1.02
6 Mo.	1.05
1-Year	1.07
2-Year	1.10
3-Year	1.11
5-Year	1.19
7-Year	1.34
10-Year	1.59
30-Year	2.29

Treasuries & New Issue Agencies *(Spread to Treasuries)*					
	Treasuries	Bullets	NC-6 Mo.	NC-1 Year	NC- 2 Year
3 Mo. Bill	1.56				
6 Mo. Bill	1.55				
1-Year Bill	1.51				
2-Year Note	1.63	2	11	2	
3-Year Note	1.67	2	20	12	
5-Year Note	1.74	5	39	30	15
7-Year Note	1.85	15	44	36	21
10-Year Note	1.92	23	61	52	39
30-Year Bond	2.36				

CMO Spreads to Treasuries		
	PAC	Vanilla
1-Year	N/A	+43
2-Year	48	60
3-Year	60	72
5-Year	72	83

MBS Current Coupon Yields	
GNMA 30 Yr.	2.45%
FNMA 30 Yr.	2.75%
GNMA 15 Yr.	2.15%
FNMA 15 Yr.	2.31%

About the Author, Dennis Zimmerman

In 2015, Dennis joined Commerce Bank's Capital Markets Group as Manager of Asset/Liability Services. With his leadership, the Capital Market's ALM team provides asset/liability management consulting services to community banks.

Prior to joining Commerce, he was employed for nearly 26 years at one of the largest privately-held banks in Kansas. In addition to managing a $775 million bond portfolio, his Asset/Liability Chairman responsibilities included managing margin, interest rate risk, liquidity and capital. Prior to becoming the bank's Finance Treasury Officer, he was a Registered Investment Representative and Supervising Principal in the bank's Capital Markets division.

As a seasoned professional, Mr. Zimmerman offers a comprehensive understanding of bank finance treasury, fixed income, complex financial analysis as well as regulatory and operational awareness. As a banker, he understands the challenge of balancing shareholder expectations within appropriate levels of risk.