FEBRUARY 14, 2020

THE WEEKLY REPORT

No worrisome signs at all in preliminary consumer confidence reports for the middle of the month. They surprised to the high side, with the exception of inflation expectations (likely due to lower gasoline prices). The growth trend of nominal retail sales, however, was not as rosy. Actually, "not rosy" is too polite. Chris Low labeled them lousy.

Excluding the more volatile items – and tabulating sales the way they are reported through to consumption for GDP analysis – the six-month trend is erasing gains due to job growth through the first three quarters of 2019. The four-month trend of annualized 6-month growth is now below 4%. That would suggest price-adjusted consumption could be below 2% in the critical transition period of trade wars in 2019 to expected growth in 2020.

The gray line in the background, though, shows the volatility of seasonally adjusted retail sales, even after revisions. Key to the first half of this year for the US, then, will be the next four months to see if the dip was transitory. This country's GDP performance remains the best among the global leaders. If it can meet expectations, the Fed will be slow to consider rate cuts in the middle of its long-term policy review.

Source: US Census Bureau, FHN Financial

MARKET UPDATE P. 2

Interest rates this week detached from the buoyant outlook in risk assets. Treasuries can no longer see the daylight spotted by equity and commodity investors. Amid the information shortfalls and confusion in China, the differing macro views are not surprising by themselves. For consideration as the confusion clears, however, is the bond market's insight into global conditions led i) the Fed; and ii) the stock market through most of 2019.

INFLATION LAB P. 8

January's core CPI showed its typical spike to start the year. In the context of the slowdown to end 2019, though, the overall trend is nowhere near the pace required to reach the Fed's forecast of a 1.9% increase in core PCE this year.

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MARKETS SPLIT ON LONG-TERM VIRUS OUTCOME

Global asset prices never settled on just one view of what China's Covid-19 epidemic will mean for global growth. Credit spreads, for example, barely reacted. Still, the major indicators moved in roughly the same direction starting the last two weeks of January. By the middle of February, though, interest rates have detached from the buoyant outlook in risk assets. Treasuries can no longer see the daylight spotted by equity and commodity investors.

Amid the information shortfalls and confusion in China, the differing macro views are not surprising by themselves. For consideration as the confusion clears, however, is the bond market's insight into global conditions led i) the Fed; and ii) the stock market through most of 2019. Bottom Line: The flight to quality trades ended February 7, but rates are lower on February 14. That is outside the usual "crisis" response patterns.

The long end of the Treasury curve has been particularly sensitive to negative sentiment on growth this year. In contrast to the trade war – which was political and oddly expedient rather than organic – the bond market is pricing China's internal contagion as a different threat. Consider the decline in 30-yr UST real rates plus (compressed) term premiums in the last 12 months.

1. The bounce from the trade agreement was modest
2. Current lows are under the worst panic tied to the trade war

10-Yr Real Treasury Yields + Term Premium
March 2018 to Present
Daily

Source: *FHN Financial*

The real yield has not been this low since December 2012. That is not the case with the 10-yr UST where real yields have been at or below the current level of -7bp multiple times in the last six years. The strong rally at the long end of the curve can be said to be an overreaction because no one has articulated the fundamental case behind the fears. That's why low real yields are best judged now as sentiment that flies right in the face of stock market sentiment. At this stage, the fundamentals support a decline in inflation expectations more than they do the drop in real interest rates.

The Covid-19 attack has added to declines in inflation expectations at roughly the same magnitude as the trade war. 5x5 UST breakevens are off their lows of late summer, but the decline comes off a muted response to the end of the trade war in the fourth quarter.

No matter how quickly China's viral woes can be worked through, several observations are hard to dispute when it comes to inflation:

- Big economic events – even short lived – have lasting inflationary effects. The loss of demand in the first half means lower inflation all year.
- The economic impact in China will be profound. Retailers are talking about double-digit sales declines as stores close. Travel has plummeted. Oil consumption is down 20%.
- Recovery will take longer than expected. Most commentators are using stock prices as a proxy for progress while on-the-ground reporting suggests a deepening problem.
- Emphasis on restarting Chinese production and returning life to normal will take precedent over the original agenda for 2020 – which was stimulating growth after it fell last year. China is powerful but it can't bring unlimited resources to bear rapidly. The growth agenda has to wait, if nothing else to demonstrate the ability of Beijing to reverse the damage "caused" by provincial officials.

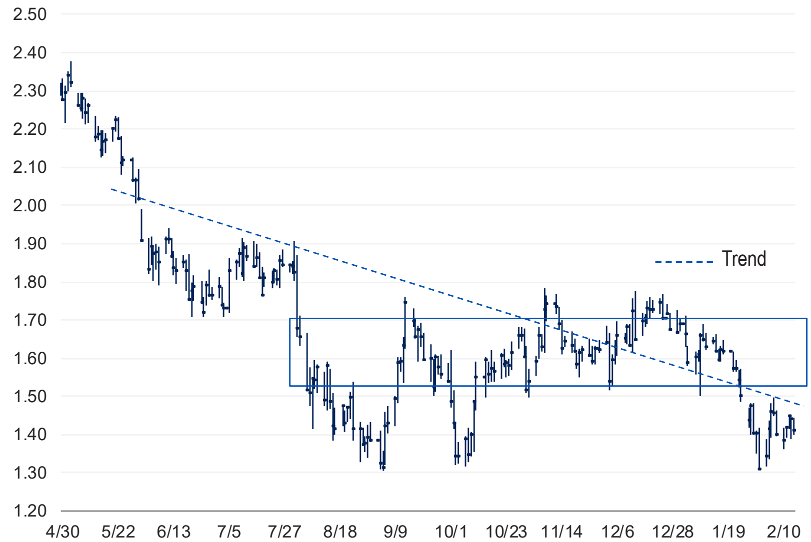
Intermediate technicals support worries about Covid-19

The long end of the curve displays max drama this month, but 5-yr technicals better capture near-term growth concerns. The chart highlights two immediate impressions:

1. Current levels remain below the bull market trend first set by the trade war.
2. The length of time 5s have stayed below the range.

- In the August-September trade war peak, 5s were below the range 19 trading sessions.
- When traders became concerned the fragile trade talks could splinter in early October and ISM surveys were worse than expected, the range break lasted six days.
- ***So far, the coronavirus break has lasted 15 days.***

5-Yr UST Yields
April 30 to Present



Source: FHN Financial

Based on bond market flows the last two weeks, the horizon for returning yields to their previous range continues to extend. Chair Powell told the Senate Banking Committee the Fed will be able to get a read on the global importance of the quarantines via economic data reports. The earliest semi-reliable indicator arrives next Friday from preliminary Markit purchasing manager surveys around the world. Those responses should incorporate almost four weeks of on-the-ground experience across the global supply chain, but perhaps not the max quarantine impact. After PMIs will come the Fed's Beige Book for on March 4. As for hard data, however, there's almost nothing on tap before the next FOMC on March 18.

The April 29 meeting will have a lot more date, but we're doubtful it's enough to get the Fed to change either rates or language. Forward money markets are roughly correct, then, in looking for any potential rate move to arrive in June at the earliest.

The broad outlook remains for the upper end of the fed funds target to be at 1.50% a year from now.

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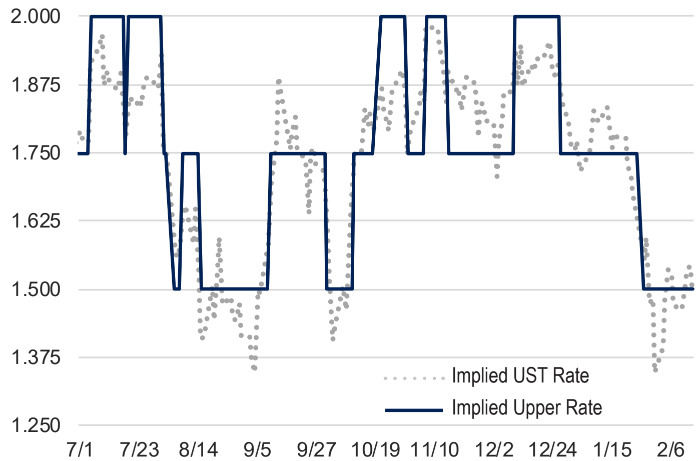
Fed funds upper target 12 Months Forward
Implied by UST Curve
July 1, 2019 to Present
Daily

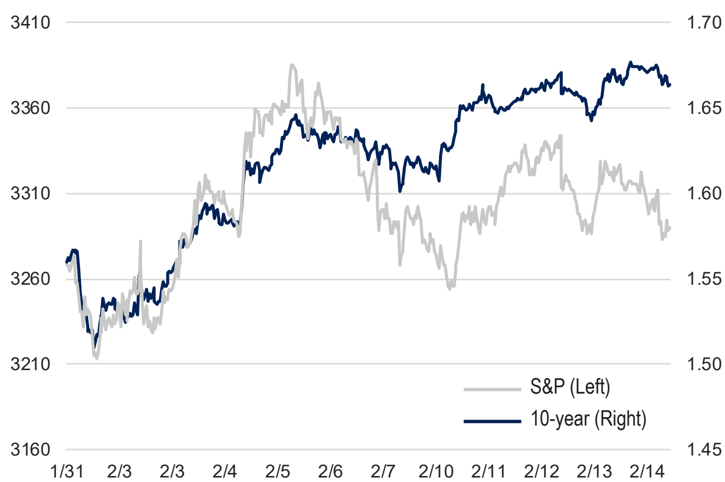


Source: FHN Financial, Bloomberg

Mapping looser trading correlations between rates and equities

This 30-minute interval chart is the easiest way to see rates detach from stocks into the long weekend. It is the backbone of FHN Financial's current virus tracking analysis.

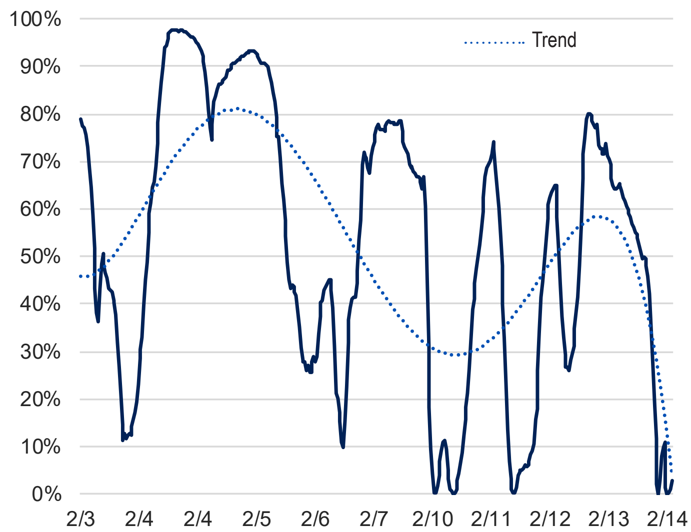
S&P 500 Futures vs 10-yr UST Yields
Jan 31 to Feb 14 (1:00 pm EST)
30-minute Intervals



Source: CME, FHN Financial, Bloomberg

To add statistical precision to the "easy" chart, the next one maps the 24-hour r-squared trends between 10-yr UST yields and S&P 500 futures. The relationship peaked in the first week of February and remained consistently high into the weekend with only one dip. This week, the stock/bond trade fell apart three times, ending the period at 0% correlation. The last time it was strong (1) was when China announced the large increase in reported cases early Thursday. (See the next section)

Relationship of Stock and Bond Prices
R-squared of previous 24 hours
30-minute intervals
February 3 to February 14 (1:00 pm EST)



Source: FHN Financial, CME, Bloomberg

Selected commodities also remain outliers from the optimism expressed by equities. Industrial metals, for example, demonstrate a shallower recovery than oil prices.

Industrial Metal Commodity Price Index
Mid 2018 to Present

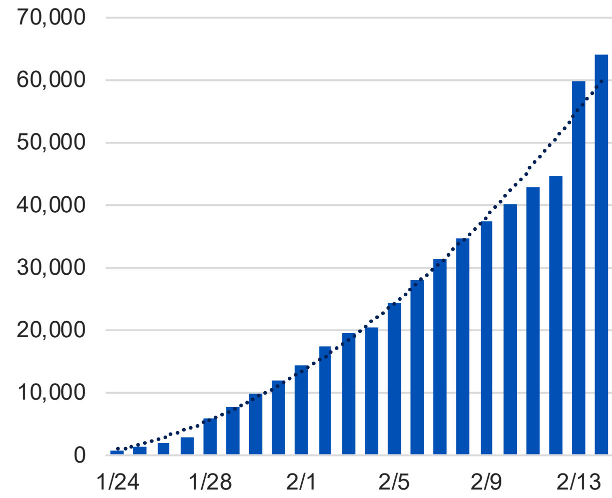
Source: Bloomberg

China Covid-19 Updates

Events on the ground appear too chaotic for investors to trust the reliability of official numbers or anecdotal news. Yet, headlines and analysts continue to emphasize daily number of new Covid-19 cases. The broad upswing is more important than the daily count, however. In the last week, the number of diagnoses, severe cases, and deaths have all more than doubled. Just because new numbers are available every morning doesn't mean the daily numbers are the most informative.

The two most recent reports completely reset the picture established by the previous daily updates.

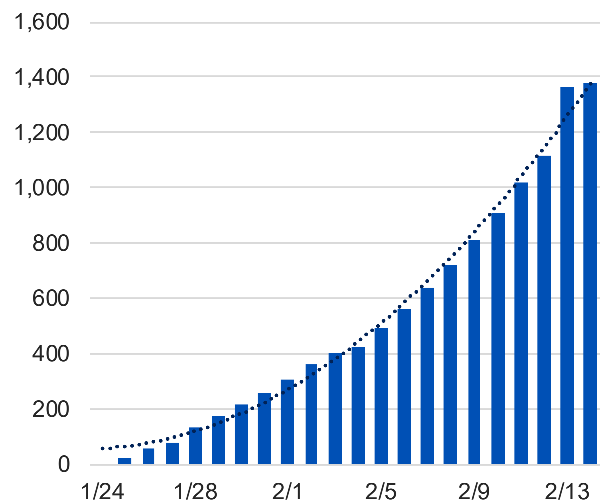
Reported Coronavirus Cases in China
January 24 to February 14
Daily



Source: National Health Commission of China

Deaths are climbing, along with the severity of the reported cases. There is still no reliable estimate of the mortality rate.

Reported Coronavirus Deaths in China
January 24 to February 14
Daily



Source: National Health Commission of China

The next question for the accuracy of Chinese case reports is the concentration of the illness in Hubei province. It accounts for more than 90% of the daily case increases and 90% of the severe cases compiled by the National Health Commission. Given the spread of the virus for those exposed outside China, that seems low.

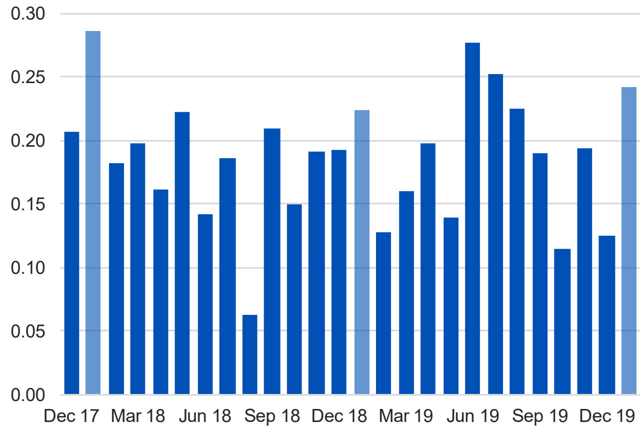
In a rough measure of the cure rate, it appears it is approaching 30%. That assumes diagnoses to cure is over a 10-day period.

In a very preliminary survey of the quarantine impact, one business conditions index showed a plunge in manufacturing activity in February. Hiring plans fell too, but service industries barely dropped. The index methodology appears more sensitive than purchasing manager data but its direction almost always matches. Preliminary Markit surveys arrive in a week.

REVISIONS SLOW RECENT PACE OF CORE CPI

January core CPI rose at the fastest monthly pace since July, a function of i) falling energy prices; ii) seasonals; and iii) downward revisions to the fourth quarter.

Monthly Change in Core CPI
December 2017 to January 2020

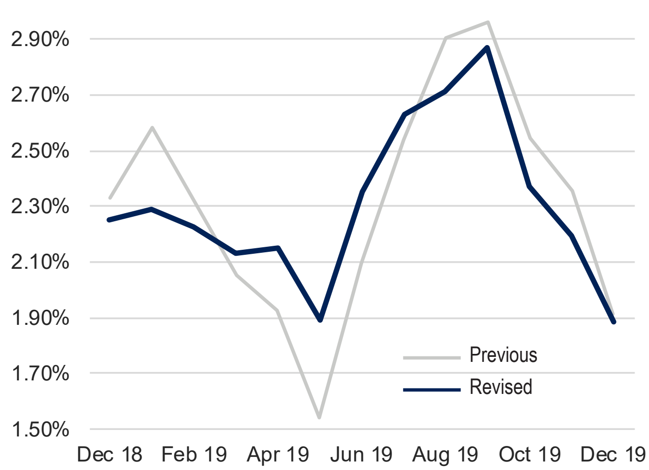


Source: Bureau of Labor Statistics

Rather than look at static months or year-over-year comparisons, the best view is the recent pace of the last several months and whether that trend is heading in the direction forecast by the Federal Reserve. And once again, it is not. The next chart trends the newly revised look at annualized inflation for the previous four months. It lays the updated price index against the older, faster numbers for 2019.

The slower revisions in the concluding months of 2019 averaged 15bp less than previously reported (annualized), a significant figure when the Fed's core PCE measure is falling 20-40bp below its forecasts.

Annualized 4-month Trend of Monthly Core CPI
2019
Monthly



Source: BLS, FHN Financial

January prices led by housing. Medical expenses cool

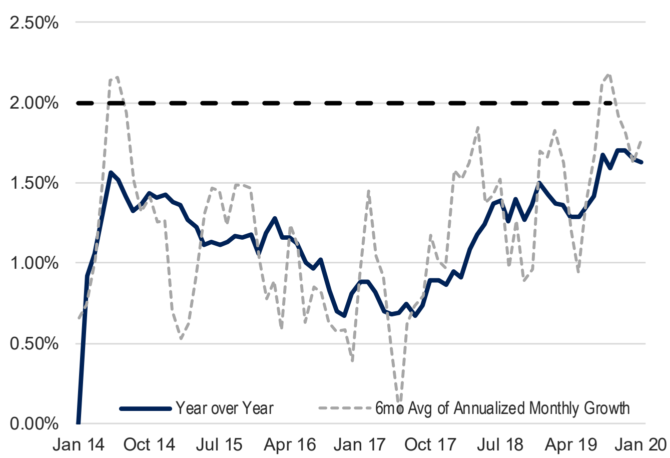
As seen in the first chart, December prices increases were second lowest last year. The big reversal into 2020 was in housing costs as they returned to their typical .3% monthly rate. Medical costs finally stopped rising at breakneck speed.

	Weight	Jan	Dec
OER	24.07	0.344	0.242
Housing less OER & Energy	14.66	0.315	-0.096
Food & Beverages	13.23	0.207	0.161
Transportation less Motor Fuel	12.48	-0.251	-0.347
Medical	8.74	0.176	0.568
Energy	7.58	-0.710	1.424
Education & Communication	6.52	0.264	0.058
Recreation	5.61	0.250	0.149
	92.87		
Other	3.19	0.641	-0.126
Apparel	2.97	0.659	0.405
Alcohol	0.96	0.298	0.123
	7.13		

Source: FHN Financial, BLS

Without housing and energy prices, the consumer inflation rate continues to hover in the 1.70% area in the comparison with 2019.

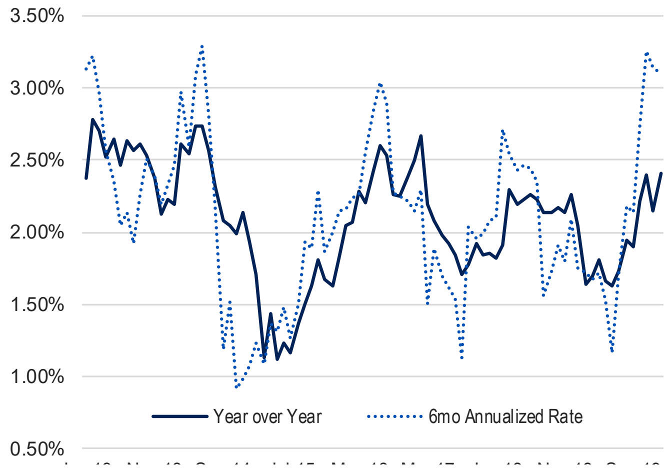
CPI excluding Housing and Energy
2014 to January 2020
Monthly



Source: BLS, FHN Financial

Service costs, less rent, continue their elevatation from in the bounce from the mid-2019 slump.

Changes in Service Costs, ex Rent
January 2013 to January 2020

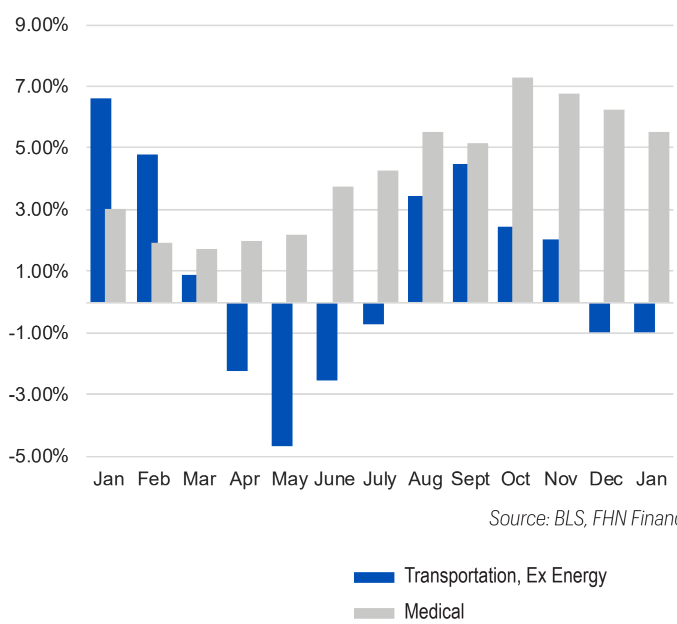


Source: BLS, FHN Financial

Transportation costs (ex-energy) ease further

The 4-month pace of transportation costs – at 12.5% of the CPI – continues to be negative. They are paired here with the smaller-weighted medical component where the pace of change is heading in the right direction…with a long way to go to reduce cost pressures and get out of the political limelight.

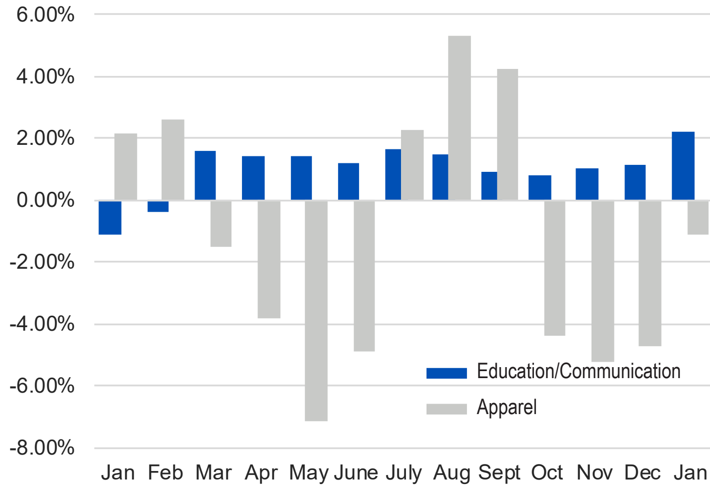
Transportation and Medical Costs
Annualized 4-Month Changes
2018 - January 2020



Source: BLS, FHN Financial

Apparel costs rose for the second month in a row, slowly winding down the savings generated by lower prices last year. The outsized bump in the annual pace of education/communication is the first in more than two years.

Communication and Apparel Costs
Annualized 4-Month Changes
2018 - January 2020



Source: BLS, FHN Financial

Flexible inflation trends fall sharply

On every lookback period, the rate of volatile inflation was in negative territory to start the year. The chart reflects the simple, year-over-year trends and those are near a record low for the last 8 years. Contact FHN Financial for other charts with 1-month or 3-month annualized rates of decline in the fastest moving components of the CPI.

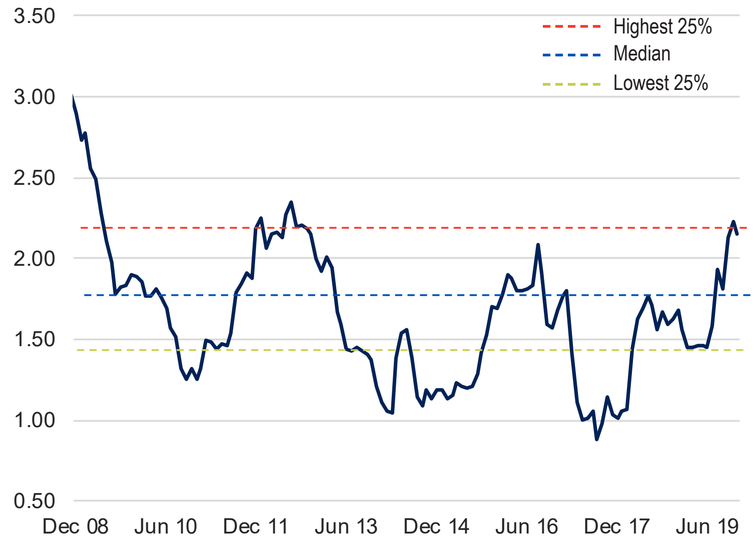
Flexible Components of Core CPI
12-month % Change
2012-January 2020
Monthly

Source: Federal Reserve Bank of Atlanta, FHN Financial

Those flexible components offset the higher trend in the slow-moving changes in consumer prices, excluding the housing component. They remain at the highest 25th percentile of the last 11 years.

Sticky Core Inflation, Ex-Housing

Year over Year
2009-January 2020
Monthly



Source: Federal Reserve Bank of Atlanta, FHN Financial