SCOTT ANDERSON, Ph.D. | Chief Economist | 415.765.8020 | bankofthewest.com

June 15, 2018

Time EST	Indicator	For		Actual*	Estimate**	Consensus***	Previous Period****
08:30 AM	Empire Manufacturing	June	↑	25.0	18.0	18.8	20.1
09:15 AM	Industrial Production MoM	May	↓	-0.1%	0.3%	0.2%	0.9% R↑
09:15 AM	Capacity Utilization	May	↓	77.9	78.1%	78.1%	78.1% R↑
10:00 AM	U. of Mich Sentiment	Jun P	↑	99.3	98.2	98.5	98.0

* ↑ indicates stronger than Consensus estimated, ↑ indicates weaker than Consensus estimated, - indicates in-line with Consensus Estimated

**Estimate from Bank of the West Economics

***Consensus from Bloomberg

****↑*means prior reading revised up*, ↓ means prior reading revised down

U.S.-China Trade War Looms, U.S. Economic Data Mostly Positive Today

President Trump plans to impose a 25% tariff on up to $50 billion of Chinese goods in response to alleged intellectual property theft and other unfair trade practices. Beijing responded by saying they will immediately introduce taxation measures of the same scale and strength. The U.S. Trade Representative said the U.S. will initially place tariffs on 818 items worth about $34 billion on July 6. Separate measures impacting 284 products worth about $16 billion could take affect after a review and public comment process.

The tariffs announced today will only add to the inflationary pressures U.S. consumers are already feeling this year. The 25% import tax on today's list of mostly industrial type products will be passed along to U.S. buyers as higher prices, and those higher prices will eventually find their way into the general consumer price level. If the President expands the list to another $100B in Chinese imports, or adds similar tariffs on U.S. auto imports, the inflationary impacts become more serious. Consumers will end up buying less and real economic growth will slow. Assuming China retaliates with tariffs of its own, U.S. sales of agricultural products, motor vehicles and parts, and other exports to China could decline significantly adding to the economic slowdown both here in the United States and globally.

An expanding trade war also puts the Federal Reserve in a difficult position as it tries to gradually normalize interest rates with the U.S. economy already at full-employment. The Fed may have to choose between accelerating interest rate hikes to head off future inflation, or pausing their gradual rate hikes prematurely to guard against an economic slowdown. If they accelerate rate hikes to head-off future inflation, it could trigger a premature recession down the road. If they hit the pause button on rate hikes to support the economy, inflationary pressures will likely continue building.

For now, the impact of the $50B tariff tit-for-tat with China appears manageable for the U.S. economy. Our models project only a modest increase in overall consumer inflation, and a small hit to U.S. GDP growth. However, I suspect the magnitude of the impacts could be somewhat greater if economic uncertainty begins to hold back business investment and financial markets start to swoon. The U.S. tariff action against China today is a big near-term risk to the economic outlook today.

For now, U.S. economic data continues to look solid. The Empire State Manufacturing Index rose 4.9 points to 25.0 in June, well above the expected reading of 18.0 and the highest level since October. There were solid gains for both new orders (up 5.3 points) and shipments (up 4.4 points), and the employment index jumped 10.3 points to a reading of 19. Though down slightly on the month, the prices paid index was still high at 52.7.

Industrial production disappointed, however, slipping 0.1% in May from an upwardly revised reading of 0.9% in April. The consensus expected a reading of 0.2%. May's decline was driven by a 0.7% fall in manufacturing, the largest monthly decline since January 2014. The largest drops occurred in motor vehicles and parts (-6.5%) and primary metals and apparel (-2.0%). However, auto production was held back last month by a fire in a trucking parts supplier, so production could bounce back in June.

Finally, the preliminary June reading on consumer sentiment was 99.3, up 1.3 points from May and above the consensus estimate of 98.5. The June reading is the highest level in three months. The current economic conditions component drove sentiment higher, increasing 6.1 points from May. The consumer expectations component declined 1.7 points, from 89.1 in May to 87.4 in June. Inflation expectations for the year ahead also edged up to 2.9% from 2.8% in May and the 5-year outlook for inflation also increased to 2.6% from 2.5%. The survey data on inflation is consistent with recent economic data that shows consumer inflation moving higher.

Treasury yields are down across the board this morning in a flight to safety with a possible trade war. The 10-Year Treasury yield is 2.897, down 3.8 basis points from yesterday. The 2-10 Treasury spread narrowed to 35.5, a new expansion low, and down 2.0 basis points from yesterday as the Treasury yield curve continues to flatten. The futures market probability of another Fed funds rate hike in September is 73.2% this morning, down from 75.5% at yesterday’s close.

U.S. stock indexes are sharply lower this morning due to trade war concerns. The Dow and the S&P 500 are down 0.86% and 0.57%, while the NASDAQ is down 0.37%. Losses in the S&P 500 today are led by energy, materials and industrial stocks.

The U.S. dollar is up slightly against the major currencies today. The Bloomberg dollar spot index is up 0.02% from yesterday. The U.S. dollar is increasing the most against the Canadian dollar, Korean won and Australian dollar today.