LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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MAIN STREET SENTIMENT AT 7-YEAR LOW

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KEY TAKEAWAYS

Our Beige Book Barometer has dropped to its lowest level since the 2011 European debt crisis.

The lower BBB reading is due more to a low level of strong words than a high level of weak words.

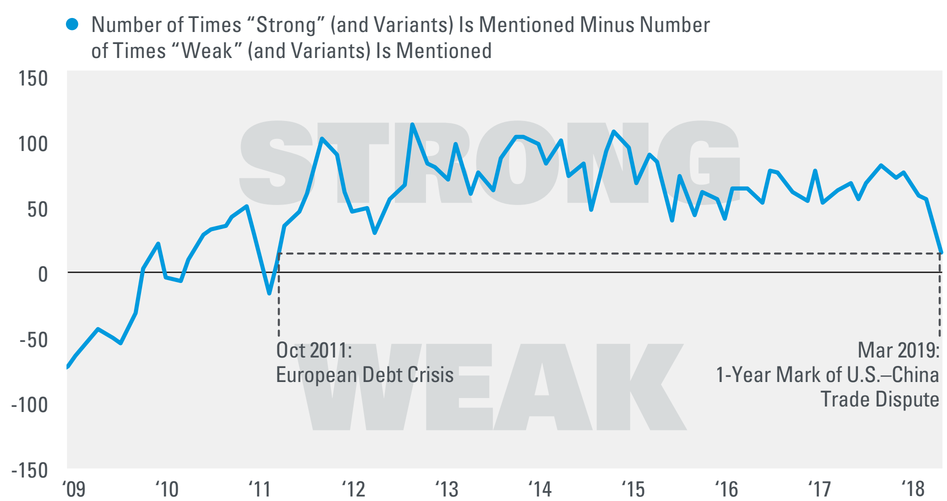
Mentions of uncertainty reached a new high amid global headwinds.

Pessimism has rapidly infiltrated Main Street's outlook, according to the Federal Reserve's (Fed) latest edition of the Beige Book. By our measure, sentiment in the March 6 Beige Book, a qualitative assessment of the domestic economy and each of the 12 Fed districts, fell to its lowest point in seven years [Figure 1]. On the surface, the Beige Book's negative tone is striking compared to recent versions, but context around key words is especially important in this edition.

TRADE-RELATED WEAKNESS

Economic reports are important for clues on economic health and macro trends, but the Beige Book provides a window into Main Street's perspective, offering valuable color on how larger trends are affecting U.S. businesses. In the Beige Book, the Fed presents qualitative observations made by community bankers and business owners about economic (housing, labor market, manufacturing, nonresidential construction, prices, tourism, wages) and banking (lending conditions, loan demand, loan quality) conditions. The latest Beige Book, which is produced eight times a year, was compiled in the weeks before February 25 and published March 6.

1 BEIGE BOOK BAROMETER FALLS TO SEVEN-YEAR LOW



Source: LPL Research, Federal Reserve 03/06/19

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At LPL Research, we maintain a straightforward but informative indicator called the Beige Book Barometer (BBB), which helps us gauge Main Street's sentiment by looking at how frequently key words and phrases appear in the Beige Book. The overall BBB measures the difference between the number of times the word "strong" or its variants appears in each Beige Book, and the number of times the word "weak" or its variants appears. When the BBB is declining, it suggests the economy may be deteriorating; when it's advancing, it suggests the economy is likely improving.

The BBB has fallen to 15 in March, the lowest level since October 2011 (the peak of the European debt crisis). Strong words fell by 20, while weak words climbed by 21, resulting in the biggest drop for our BBB since March 2016. In the January edition, we noted that oil districts heavily contributed to a lower BBB reading, but that wasn't the case this time. Excluding the oil districts, the BBB dropped to 15 in March from 48 in January. Sentiment declined in 10 of 14 Fed districts, with New York, Boston, and Richmond posting the worst declines.

A broad-based decline in sentiment is of some concern, however, about half of the 34 references to weakness were concerns about trade-related subjects: global demand, agriculture, manufacturing, and port activity. These concerns are legitimate and have been reflected in economic and market data for a few months now amid the U.S.-China trade dispute. Gauges of U.S. manufacturing health fell to multiyear lows in February, the U.S. trade gap has widened notably, and agriculture prices have dropped about 20% since the first tariffs were implemented a year ago. Trade-related repercussions are clearly bleeding into Main Street's operations, but we expect these impacts to subside once the United States and China reach an agreement. We've seen positive momentum on the trade front recently and resolution may come soon.

The BBB reading was also unusually low because of the low number of strong words, not because of the high number of weak words. Strong words have declined by 44 since the BBB reached a 2.5-year high in July 2018, while weak words have increased by 22 over the same period. Since 2005, the average BBB reading has been 55 when there have been 30 to 40 mentions of weakness.

INCREASING UNCERTAINTY

Main Street is also increasingly uncertain about the economic outlook. Total strong and weak words have hovered around the lowest level since 2005, while mentions of uncertainty have climbed to the highest levels in data going back to 2015. Beige Book respondents are finding it more difficult to characterize current economic conditions and set expectations, so they're just increasingly citing uncertainty.

To us, this is a reflection of the multiple headwinds weighing on U.S. businesses, including one that has already been resolved: the most recent government shutdown. The survey period captured the second half (and the aftermath) of a historic 35-day government shutdown, which clearly dampened sentiment. The word "shutdown" appeared 22 times in the latest Beige Book, compared to the two times it showed up in the previous Beige Book. About half of the Fed districts cited the government shutdown for slowing economic activity, and Richmond, which includes D.C.-area businesses, had one of the biggest declines in sentiment among Fed districts.

Overall, we see Main Street struggling with uncertainty more than definitive signs of sustained weakness, which leads us to think this dip in sentiment is temporary. The last time the BBB reached these levels was when the U.S. economy was weathering fallout from the European debt crisis. In that period, the BBB briefly dipped below zero (in September 2011) before climbing back to a multiyear high in April 2012.

CONCLUSION

We're in the midst of a complicated economic environment. U.S. businesses and consumers have to contend with conflicting trade and political headlines, and many recent economic reports have missed consensus estimates, some by unusually wide margins. Still, the bulk of economic data we've seen recently has been sound, business and consumer sentiment have started to recover, and leading indicators we track still indicate low odds of a recession. Because of this, we see lower Beige Book sentiment as a consequence of lingering uncertainty more than definitive weakness. Based on recent signals, we wouldn't be surprised to see softer-than-expected growth at the beginning of this year, followed by a solid rebound in economic activity once trade risk is removed. ■