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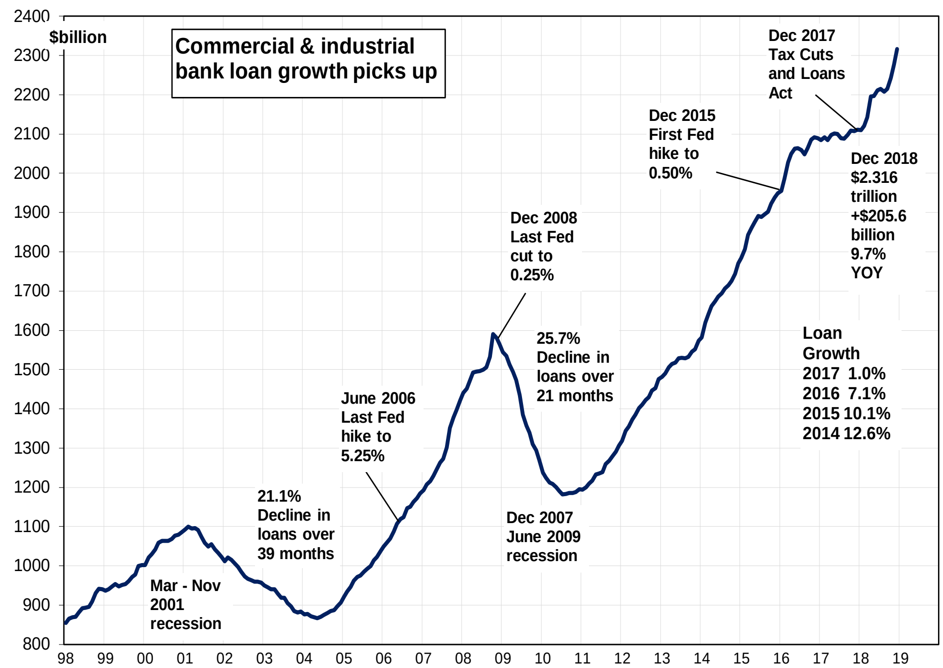
BANK LOANS TO BUSINESS TAKES OFF AFTER TAX CUTS AND JOBS ACT

You would have thought the biggest corporate tax cut in history would have been enough of a cash free-for-all for companies, but not so apparently as commercial & industrial loans made by commercial banks have surged, rising $205.6 billion the last year, an increase of 9.7%. Higher interest rates from the Federal Reserve, moving gradually from 0.50% to 2.5% over the last three years, hasn't slowed down the short-term borrowing by companies one bit.

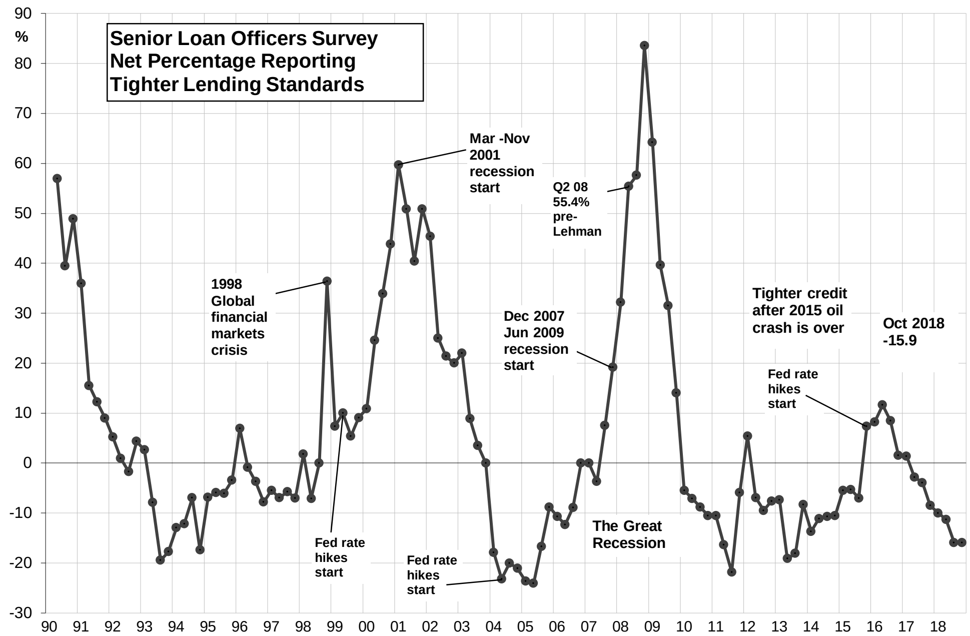


What if bank lending was the best leading indicator of recession? China always seems to open the spigot and provide more credit to help support economic growth (would hate to see China GDP slow from 6.5% down to 6.0 or 6.1 percent). Bank loans peaked in February 2001 before the March – November 2001 recession (just a short-and-sweet 8 months long, why all the worry whether another one is coming, blink and the bad times are over). Loans rose for ten months into the December 2007 – June 2009 recession. Loans jumped in October 2008 after the Lehman bankruptcy as firms drew down their

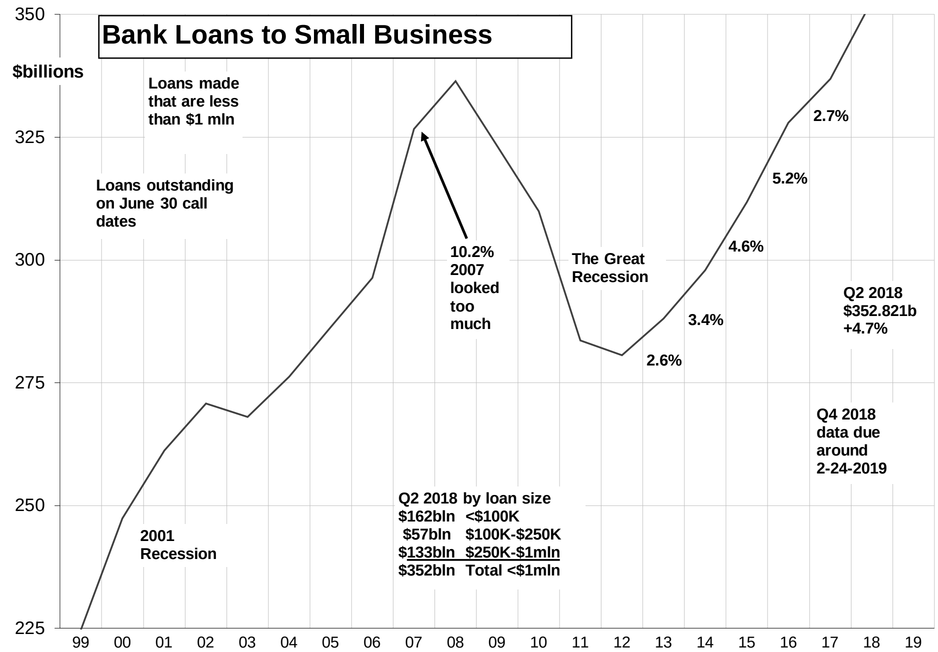
FDIC Banks and S&Ls	2018	2008	1998
Number	5,547	8,451	10,713
Employees	2.070	2.203	1.842
Deposits	13.573	8.572	4.209
5,547 banks in Sep 2018, 2.070 million employees, $13.573 trillion in deposits			

backup commercial paper credit lines when the credit markets froze. C&I loans has questionable leading indicator properties, but when loans are falling it certainly is consistent with a weakened business sector if not negative or slow economic growth.

C&I loans jumped $205.6 billion or 9.7% in 2018 after rising just 1.0% in 2017. There was a technical upward revision of about $25 billion when a bank bought a savings institution at the start of the second quarter, but much of the rest is driven by M&A activity. Credit continues to be readily available for companies.



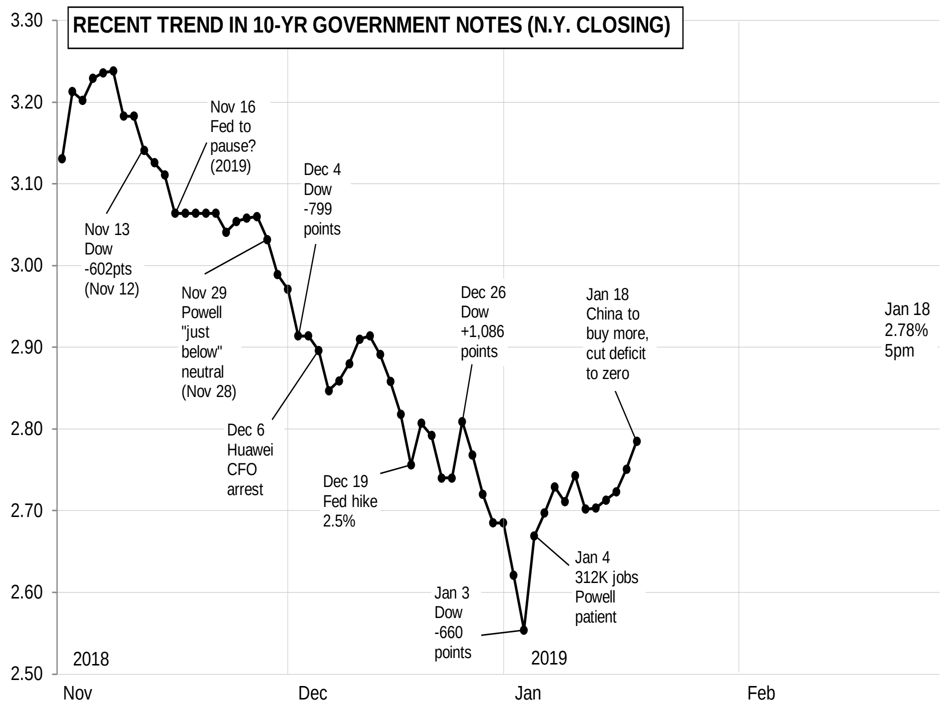
The Fed's October survey of Senior Loan Officers show banks continue to make credit as easy as possible with net credit easing 15.9 percent, the same as three months earlier. These statistics are for all banks and are the credit standards for large and middle-market firms with $50 million and up of annual sales. Out of 69 responses, 3 tightened somewhat, 52 were unchanged, 14 eased somewhat, and this equates to a net easing of 15.9 percent ((14-3)/69).



They asked a couple of special questions in October. One was on FICO-based credit approvals for credit cards and auto loans. Relative to the start of the year, banks said they were less likely to approve these consumer loans with FICO scores of 620 and more likely for borrowers with FICO scores of 720. The survey also asked about the yield curve slope and its effect on lending. The change in the yield curve this year had not had an impact on lending the banks said. If the yield curve were to invert, banks would tighten credit standards or price terms in every major loan category as an inverted curve was "interpreted as a signal of a deterioration in economic conditions." Guess we were wrong, an inverted curve does signal we are doomed to some people. Stay tuned. There is caution in the wind, and this was before the stock market plummeted later in the year.

MARKETS OUTLOOK

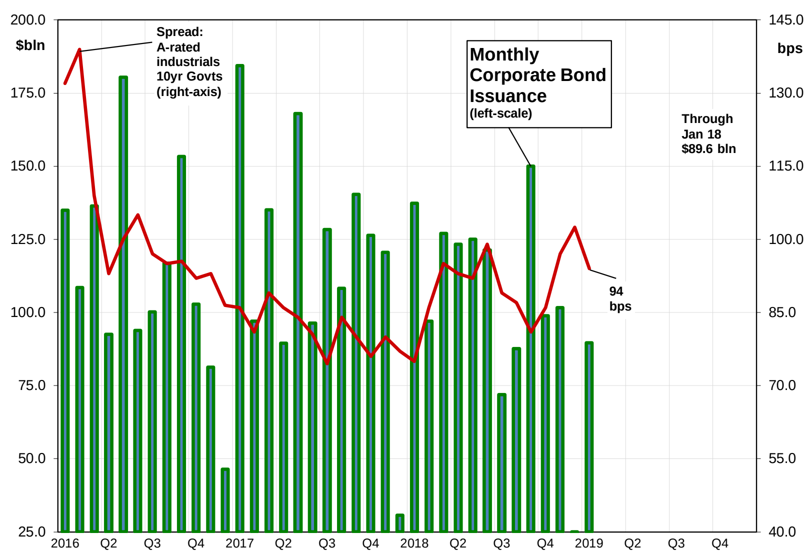
	31-Dec 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	3.02	3.20	3.30	3.35	3.45	3.45	3.50	3.60	3.70
10-Yr Note	2.68	3.00	3.10	3.20	3.30	3.30	3.40	3.50	3.60
5-Yr Note	2.51	2.85	3.00	3.10	3.20	3.25	3.35	3.45	3.60
2-Yr Note	2.49	2.80	3.00	3.10	3.20	3.20	3.35	3.45	3.60
3-month Libor	2.81	2.70	2.95	2.95	3.20	3.20	3.45	3.45	3.70
Fed Funds Rate	2.50	2.50	2.75	2.75	3.00	3.00	3.25	3.25	3.50
2s/10s spread	19	20	10	10	10	10	5	5	0



Bond yields closed the week 8 basis points higher at 2.78%. China was in the mix of news from start to finish. The 2.66% low yield on Monday was driven by weak trade statistics out of China on Sunday night. More positive news on China came out on Thursday and Friday. On Thursday, a Wall Street Journal story said the administration might drop the tariffs on China, which was quickly denied by the U.S. Treasury. Bond yields stayed higher however. Then a Bloomberg story Friday said China would buy more U.S. goods over the next six years, enough to wipe out the trade imbalance completely. Markets seem to think where there is smoke there is fire on this latest China news.

CORPORATE BONDS: FEDEX, GM FINANCIAL, FOX CORP, SEVERAL BANKS

Corporate offerings were $31.0 billion in the January 18 week versus $47.0 billion in the January 11 week. On Wednesday, Steelcase Inc. priced a $450 million 5.125% 10-yr (m-w +40bp) at 250 bps (Baa2/BBB). The office furniture company will use the proceeds to redeem $250 million 6.375% notes due in 2021. Corporate bond yields (10-yr Industrials rated A2) were 94 bps above 10-yr Treasuries this week versus 101 bps last Friday.



FEDERAL RESERVE POLICY

The Fed meets January 29-30 to consider its monetary policy. Why bother? There is no expectation of a rate increase. The odds of a rate hike at the March 2019 meeting are only 2 percent. Can the Committee even meet with the Federal government in shut down? Google it. At least Powell will hold a press conference at the January meeting the first time despite no new forecasts (we changed our minds, we would like to see eight press conferences with Powell this year, seeing we have hardly any economic data releases to write about during the shutdown).

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	16-Jan	9-Jan	2-Jan	26-Dec	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2220.219	2222.412	2222.517	2240.717	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1632.729	1637.123	1637.123	1637.123	0.000
Primary credit (Discount Window)	0.012	0.007	0.005	0.012	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	0.000	0.000	0.000	0.000	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	
Central bank liquidity swaps	0.088	0.086	4.207	4.207	62.000
Federal Reserve Assets	4097.9	4104.3	4106.2	4123.3	961.7
3-month Libor %	2.78	2.80	2.79	2.81	2.82
Factors draining reserves					
Currency in circulation	1705.632	1711.945	1720.052	1716.129	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	1.316	2.537	19.481	1.005	0.000
Reserve Balances (Net Liquidity)	1625.501	1664.186	1607.335	1660.932	24.964
Treasuries within 15 days	14.191	2.090	2.091	18.209	14.955
Treasuries 16 to 90 days	78.611	92.622	92.622	72.334	31.549
Treasuries 91 days to 1 year	292.515	290.222	290.222	302.121	69.272
Treasuries over 1-yr to 5 years	955.556	958.045	958.061	964.817	170.807
Treasuries over 5-yrs to 10 years	260.811	260.849	260.887	264.607	91.863
Treasuries over 10-years	618.535	618.585	618.634	618.630	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

Monetary Policy. Just a week after Fed Vice Chair Clarida's remarks about easing monetary policy if crosswinds blow the economy's minivan off the highway (oh, and the economic model saying a low unemployment rate leads to greater inflation might be wrong he said), just a week after Clarida, Kansas City Fed President Esther George, the last remaining hawk on the Federal Open Market Committee (FOMC), echoed the new Fed mantra that they, "all together now" are flexible and can be patient. We have been on a lot of committee's in our career and we cannot think of many where all the members change gears so quickly and all sing the same tune so quickly too after just meeting on December 18-19 down there in Washington. Patient, flexible. But Hello, markets, the consensus forecast said two more rate hikes this year to 3.0%. We don't think the Fed is done with rate hikes this year. Even if they are flexible and can be patient, this doesn't rule out a rate hike to 2.75% in June 2019, which remains our call.

KC President George

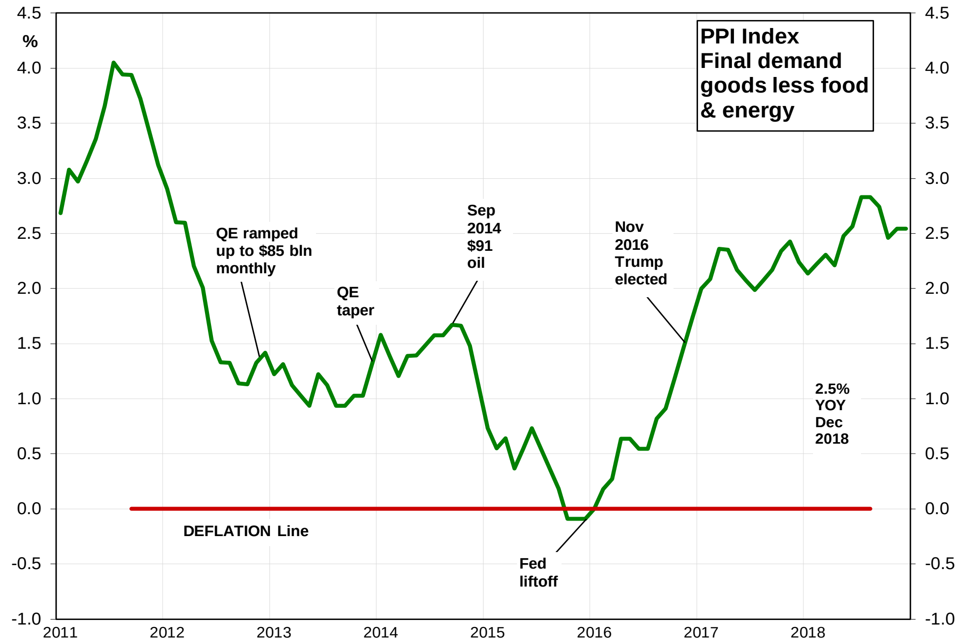
Given the cumulative 225 basis points of tightening—100 basis points of which occurred last year—we have likely not yet seen the full effect of higher rates on real economic activity or inflation. A pause in the normalization process would give us time to assess if the economy is responding as expected with a slowing of growth to a pace that is sustainable over the longer run. Failure to recognize these lags could lead to an overtightening of policy, a downturn in economic growth and an undershooting of our inflation objective.

Higher interest rates. Even Kansas City Fed President George is wondering whether the past Fed rate increases are weighing down the economy's interest-rate sectors, like housing and autos, more than she expected. Higher rates bad. Higher rates (2.5 percent?) made it into the Beige Book Summary of business conditions this week, that is prepared for the upcoming Fed meeting in a couple of weeks. As prepared at the Chicago Fed with President Charles Evans, the Overall Economic Activity section up top in the Beige Book Summary finished with this beauty: "Outlooks generally remained positive, but many Districts reported that contacts had become less optimistic in response to increased financial market volatility, rising short-term interest rates, falling energy prices, and elevated trade and political uncertainty." Stay tuned.

OTHER ECONOMIC NEWS THIS WEEK

PPI prices falling down, falling down (Tuesday)

Breaking economy news. PPI inflation, and look sharp, I know we already got CPI inflation last week, kind of putting the cart before the horse in terms of importance, but there's not a lot of eco news to feast on this week for the markets. Retail sales is postponed due to the Federal government shutdown, although the Fed is open and will release industrial production on Friday. Looking forward to it.



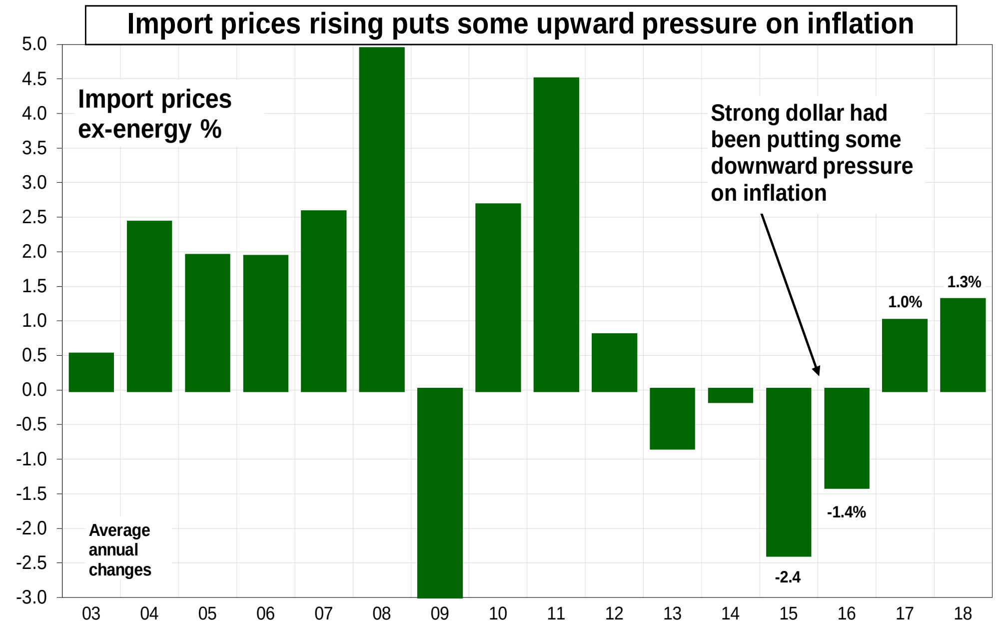
PPI final demand prices fell 0.2% in December, blame energy prices, the first monthly decline since February 2017 and the biggest one-month drop since -0.3% in August 2016.

Net, net, producers are not boosting their prices due to trade war tariffs yet with today's PPI report showing inflation pressures are not brewing further down the production chain, so Fed officials do not have to worry that more consumer inflation is coming. The Fed is on hold and can remain patient for an even longer time if this latest report out of Washington is to be believed. We like to look at underlying commodity price trends, and final demand core goods prices slowed to a gain of just 0.1% in December from a 0.3% rise in November. Apparently, businesses are not able to push up their prices at a faster pace because their customers won't buy it.

Final demand goods prices less food and energy were rising 0.3% per month steadily for most of the first half of the year, but now producer inflation is more muted. Maybe the Tax Cuts and Jobs Act gave producers more pricing power for a time, but the effect of the tax act legislation appears to be fading. Stay tuned. Story developing. There is nothing in the PPI inflation report to suggest that the bond market is underpricing the threat of higher inflation. The seas are calm when it comes to any budding inflation pressures, and it will be hard for 10-yr Treasury yields to move back above the 3% line drawn in the sand if we get many more non-inflation reports like this in the future.

No retail sales in December, none; no inflation from imported goods (Wednesday)

Breaking economy news. Import prices and retail sales. No retail sales in December because the U.S. Census Bureau in the Department Commerce is closed for the government shutdown now in its 26th day. We wouldn't say there is no import price inflation, but it is not running fast enough to worry Fed officials that consumer goods inflation is heating up as it normally should in a long economic expansion nearly ten years old. It is easy to think that imported goods might reflect the tariffs that the Trump administration has put on many goods coming to our shores, but that is not the case. Import prices here exclude import duties.



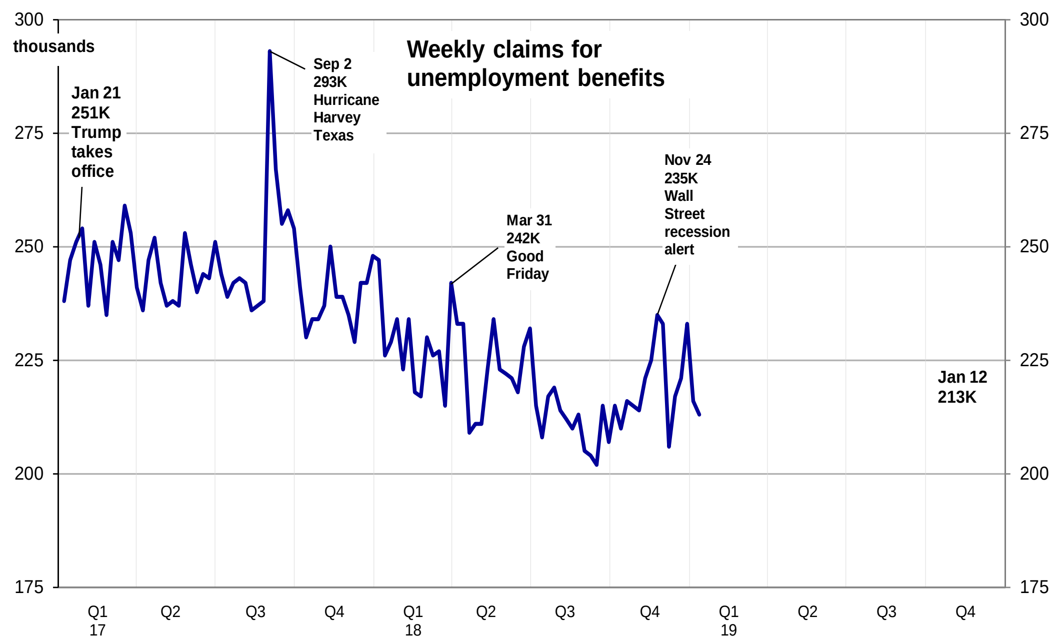
Import prices fell 1.0% in December, and ex-fuels imports were unchanged. Import prices of paper and paper stock are up the most the last year with a gain of 13.9%. For consumers, autos are up 0.3% year-on-year in December and consumer goods ex-autos increased 0.6%. Capital goods imports for companies are down 0.2% the last year. If there is an effect from globalization, bringing cheaper goods to the American market, it has been a cumulative effect occurring over many years.

Net, net, import prices tumbled 1.0% in December under the weight of falling crude oil prices, and cannot be considered deflationary or reflective of overall demand in the economy. Import prices of nonfuel goods have also slowed however since midyear as the dollar has strengthened, and this has kept imported goods relatively cheap for Americans. Imported goods less energy rose just 0.5% in December from year earlier levels, which is less than the 1.3% increase in 2017 when the dollar showed more weakness.

There is no sign that inflation is about to rear its ugly head based on imported goods prices, where the modest upward trend backs up the Fed's belief that inflation is not warming up to worrisome levels. We expect the Fed will be patient on the timing of its next interest rate move, as inflation is well-behaved and we are not importing inflation from overseas with the dollar's current trend in foreign exchange markets.

Jobless claims says the economic seas are calm and steady before the storm (Thursday)

Breaking economy news. Jobless claims fell back to 213K in the January 12 week from 216K the week before. The job layoff statistics say the economic seas are calm and steady before the storm clouds gathering out there on the horizon from the government shutdown in Washington. The economy is entering uncharted waters with the longest government shutdown in history which engenders tremendous uncertainty that grows exponentially with each new day. The Federal government shutdown at midnight December 21 is into its 27th day, but no Federal government contractors or consultants, who are not getting paid for their work, have filed for unemployment benefits as far as we can tell. Federal workers have their own separate program and are not included in the 213K new filings this week. Federal worker new claims for unemployment benefits rose to 10.454 thousand in the January 5 week from 4.760 thousand in the December 29 week.



Furloughed Federal workers means on temporary layoff, not permanent job losses, which suggests the unemployment rate is not going to soar in the January employment situation report due out on February 1. The Federal government shutdown could make the payroll jobs number a walking disaster as a million workers were not paid in the payroll period that includes January 12. Payroll employment is likely to dive, dive, dive in January with perhaps 300 or 400 thousand jobs lost after December's outsized gain of 312 thousand.

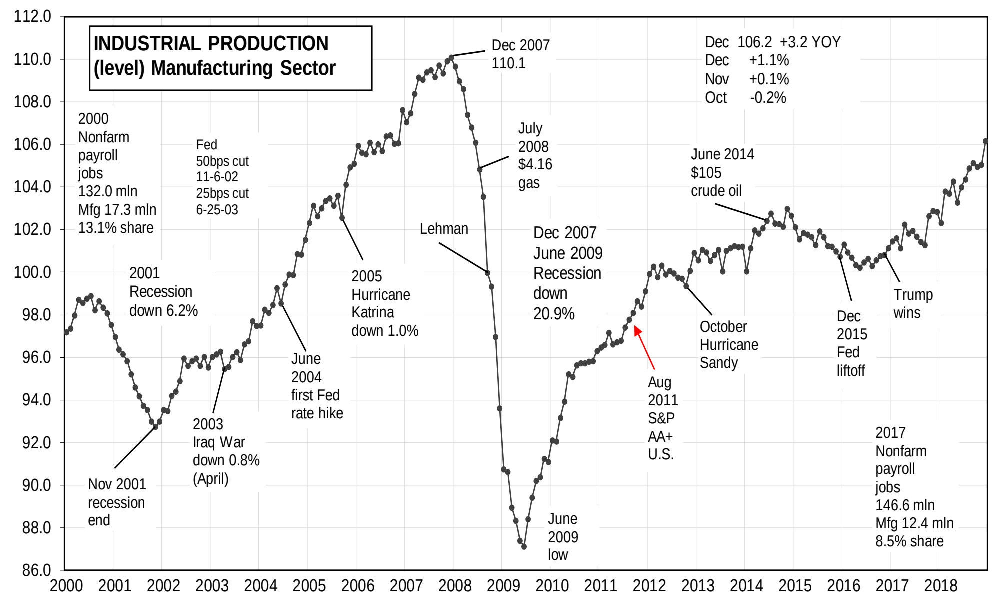
Net, net, the claims that recession is coming closer to our shores is so far just hyperbole causing needless worry because you can't have a recession without job losses and right now companies continue to hang on tight to their workers and are not letting any go. The labor pool is running on empty when it comes to potential supply and there are only so many workers sitting on the sidelines not in the labor force or working part-time and want to switch over to full-time employment.

The labor market is as tight as a drum which is good for workers who are likely to see more wages and benefits coming their way even as it is bad for companies. A profit squeeze is going to take place at some time in the near future. Business can't lift prices for their goods and services, but they have to pay more for labor. We have never had a profits-squeeze slowdown in the economy before. Maybe this will be the first. Stay tuned. Story developing.

Factory production takes off at the end of last year: no recession ahead (Friday)

Breaking economy news. December industrial production rose 0.3%, but this is a solid gain when accounting for a 6.3% drop in utility production even if it didn't seem all that much warmer than normal where we live. Mining output gained 1.5% in December for a year-to-year gain of 13.4%, but that won't continue in 2019, as oil & gas drilling firms are warning, after crude oil prices plummeted late last year.

Industrial production is soaring in the final report this year with manufacturing output in December jumping 1.1% which is the biggest gain since February. Assemblies of autos and light trucks jumped 8.0% in December to 11.87 million at an annual rate. We cannot see any supply chain disruption here whatsoever. The trade wars have not put their foot down on U.S. industrial output yet. The market could not be more wrong in trying to discount a recession later on this year. Company executives put recession at the top of their worry list of risks in 2019, but the economic data so far are proving them wrong.



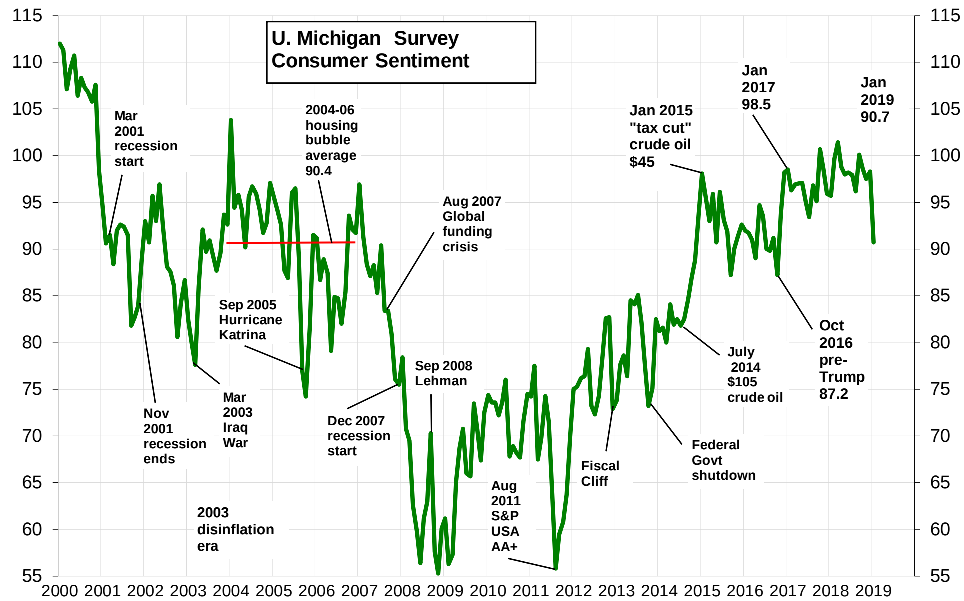
Net, net, factory production took off at the end of last year, setting the stage for continued strong economic growth in 2019. You can't have a recession or even be near one when factory run rates are going through the roof like this. Our only question is how long can the economy continue to crank up the volume on factory production if there is no one out there in the country to work on the shop floor? The growing labor shortage may yet put the kabosh on factory output later on this year.

Percent changes			Industrial Production December 2018		
Oct	Nov	Dec	YOY		Weight
0.2	0.4	0.3	4.0	Total Index	100.0
-0.2	0.1	1.1	3.2	Manufacturing	75.5
-0.2	1.1	1.5	13.4	Mining	14.1
3.3	1.3	-6.3	-4.3	Utilities	10.4
			Manufacturing payroll jobs 12.8 million +284K YOY 10.0% of Private Payroll Jobs		

Fed officials are looking for two more rate hikes this year and their own economic data are telling them to go ahead and do it, there is no need to delay the move in interest rates up a little higher to fully normal levels. This economy is screaming that conditions in the country are normal even if the chaos down in Washington makes this seem impossible to believe. The Fed has been reducing their monetary stimulus left over from the financial crisis and recession a decade ago by raising interest rates from 0.75% two years ago to 2.5% currently and these rate hikes have done nothing to slow the economy's advance. Fed officials need to keep their eyes wide open and look at the economic data and not the markets when it comes to deciding whether to move rates up higher to normal levels. The economy is better than you think. Bet on it.

Consumers losing that loving feeling about where the economy's heading (Friday)

Breaking economy news. Consumer sentiment dropped sharply in January as the Federal government shutdown and stock market losses took a toll on consumer confidence levels. There are almost a million Federal government workers who are consumers and they are not being paid so they certainly have lost all confidence in their employer. This report on consumer sentiment is the first concrete evidence that the economy is going to fall and fall hard if Washington does not end the shutdown. It is going to be hard to see real GDP growth of more than 1 to 1-1/2 percent in the first quarter if the consumer goes on a buying strike.



Net, net, Trump won the election in November 2016 and it took a while, but now the public's confidence in what is happening down in Washington has diminished. The Trump confidence boost for American consumers has largely evaporated. This is the danger that politicians worldwide often make when they make big changes to the status quo or too many changes too quickly, the country burns out, and right now consumers are saying enough is enough and they have lost much of the confidence they had after the new president took office two years ago. Stay tuned. Story developing. Factories are making more goods than ever, but that can change in a hurry if less confident consumers stop buying their goods.

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