Financial Market Weekly

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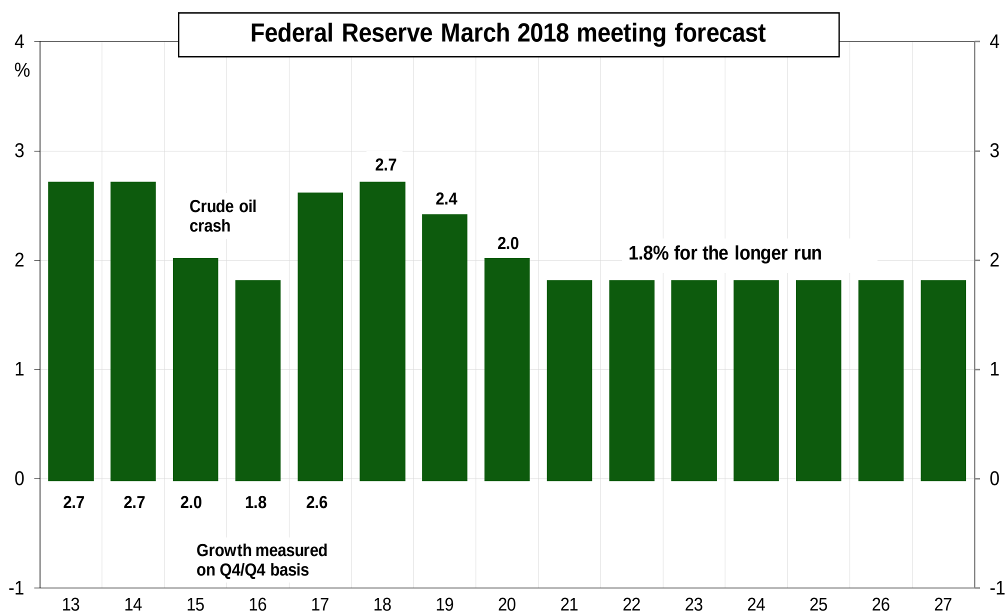
GROWTH PICKS UP, MORE EXPECTED, NO INFLATION YET… IT'S EARLY THOUGH, ONLY FEBRUARY 2018 DATA SO FAR

This week real GDP growth in Q4 2017 was revised up four-tenths from 2.5% to a faster 2.9% pace nearer to the Trump goal of 3% growth. Inventories and the consumer were the reasons . The strengthening economy numbers last quarter nudged up Q4/Q4 GDP growth a tenth higher in 2017 to 2.6% now. Growth has recovered from that downturn in investment spending caused by the crude oil price shock. Growth was 2.7% in 2013 and 2014 before investment spending cooled the economy's growth rate down to about 2% for a couple of years. We expect growth would have rebounded in 2017 regardless of who won the election. Growth is coming back… a little earlier than those original estimates provided in that famous one-page economic analysis from Treasury Secretary Mnuchin's Office of Tax Policy that was released back in early December. The tax cuts would pay for themselves by producing sustainable 3% GDP growth starting in the year 2020. The Fed revised up their forecasts to 2.7% in 2018 due to the fiscal stimulus which doesn't look like much heat given growth was 2.6% in 2017. What's an extra one-tenth between friends anyway. The Fed sees 1.8% growth only for the longer run, call it 2021 to 2027, where Trump's economics team sees 3.0%. We wonder who will be right in their forecast? Frankly, one looks too hot and one looks too cold, making the middle ground just right.



Powell in his no nonsense, noneconomist matter-of-fact way said more inflation is coming. His March 21 press conference said the deflation effect from the cell phone data freebie last year drops out of year-to-year PCE inflation data in March. March PCE data is due out on Monday, April 30. In today's report for February, headline PCE inflation (including food & energy) moved up to 1.8% from 1.7% last month, and more importantly, "sustainable" core PCE inflation bumped up from 1.5% to 1.6%.

While we wait for next month's 0.2 to 0.3 reversal of the cell phone free data effect to come through we thought we would look again at the core PCE inflation components to see if any of the moving parts imply anything for the trend of inflation in the future.

	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17p	Q1 17r	Q4 17f
REAL GDP	1.8	1.2	3.1	3.2	2.6	2.5	2.9
REAL CONSUMPTION	2.9	1.9	3.3	2.2	3.8	3.8	4.0
CONSUMPTION	2.0	1.3	2.2	1.5	2.6	2.6	2.8
Durables	0.7	0.0	0.6	0.6	1.0	1.0	1.0
Nondurables	0.4	0.2	0.6	0.3	0.7	0.6	0.7
Services	1.0	1.2	1.1	0.5	0.8	1.0	1.1
INVESTMENT	1.3	-0.2	0.6	1.2	0.6	0.6	0.8
Business Plant	-0.1	0.4	0.2	-0.2	0.0	0.1	0.2
& Equipment and	0.1	0.2	0.5	0.6	0.6	0.6	0.6
Intellectual Property	0.0	0.2	0.2	0.2	0.2	0.1	0.0
Homes	0.3	0.4	-0.3	-0.2	0.4	0.5	0.5
Inventories	1.1	-1.5	0.1	0.8	-0.7	-0.7	-0.5
EXPORTS	-0.5	0.9	0.4	0.3	0.8	0.8	0.8
IMPORTS	-1.1	-0.6	-0.2	0.1	-2.0	-2.0	-2.0
GOVERNMENT	0.0	-0.1	0.0	0.1	0.5	0.5	0.5
Federal defense	-0.1	-0.1	0.2	0.1	0.2	0.2	0.2
Fed nondefense	0.1	0.0	-0.1	0.0	0.0	0.0	0.0
State and local	0.1	0.1	-0.2	0.0	0.3	0.3	0.3
Below line: Percentage point contributions to Q4 17 2.9% real GDP							
First estimate for Q1 is Friday, April 27							

The table here shows the weights of the various core inflation prices from the biggest, 18.9% weight of healthcare in consumers' budgets, to the lowest which is the 2.5% weight of communication. The price categories here cover about 80% of all core inflation. The 2018 year just has data through February. Core PCE inflation rose from 1.3% in 2015 to 1.8% in 2016. It is hard to really see what caused inflation to move up in 2016. Healthcare rose 1.2% up from 0.6% in 2015. Financial services and insurance added more in 2016. Car prices actually fell 1.1%. Nothing stands out here, and the bond market did not know core PCE inflation went up so high to 1.8% until the benchmark revision a year later.

2017	Inflation	2015	2016	2017	2018
Weight	Core PCE	1.3	1.8	1.5	1.6
18.9	Healthcare services	0.6	1.2	1.4	2.0
13.0	Home prices	2.9	3.3	3.3	3.2
6.3	Food services	2.7	2.6	2.3	2.5
5.7	Financial services	4.8	7.4	4.1	6.4
4.6	Rent	3.4	3.6	3.7	3.6
4.3	Recreation services	1.6	2.4	2.7	2.3
4.2	Cars	0.0	-1.1	-1.1	-1.7
3.8	Prescription drugs	4.6	4.8	3.4	2.1
3.4	Transportation services	0.4	1.1	1.7	0.8
3.4	Clothing	-1.3	-0.3	-0.5	-0.4
3.4	Recreation goods	-4.3	-5.1	-4.2	-3.7
3.1	Insurance	1.4	2.8	3.1	2.5
2.8	Furnishings	-2.0	-2.1	-2.7	-3.4
2.5	Education services	3.2	2.6	2.4	2.1
2.5	Communication	-1.6	-0.3	-4.8	-4.8

Why did inflation slow from 1.8% in 2016 to 1.5% in 2017? Communication prices which includes cell phone data plans fell 4.8%. Financial services with a large weight slowed to 4.1% in 2017 from 7.4% in 2016. Despite some concerns in newspaper stories and from some Fed officials, the year 2017 does not look very "deflationary." Some of the stories said weak inflation might mean the economy was weak and needed help.

Where is core PCE inflation going in 2018? Financial services are back. Healthcare prices are rising 2.0% and maybe some of the Obamacare restraints on pricing is going away. At the same time prescription drugs have slowed to just 2.1% in 2018 after rising 4%-plus in 2015-16, maybe in response to the President's tweets? And of course, communication prices won't fall 4.8% again in 2018. Adding up the pluses and minuses, core PCE inflation could return to 1.8% for the full year, last seen in 2016. But the Fed's 2% goal doesn't look especially achievable, this year anyway.

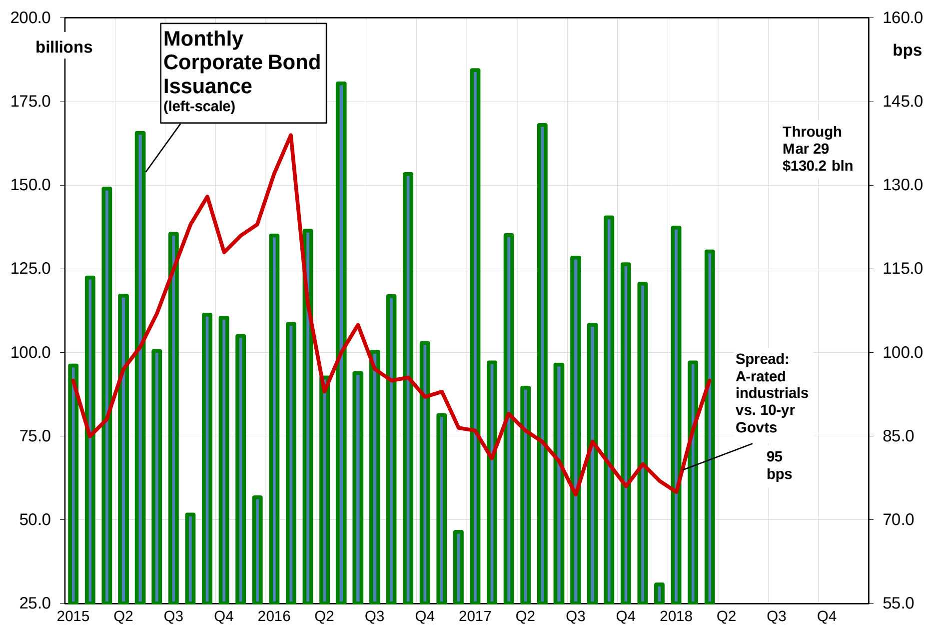
MARKETS OUTLOOK

	29-Mar 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.97	3.10	3.10	3.20	3.35	3.45	3.60	3.55	3.75	3.75	3.90	4.00
10-Yr Note	2.74	2.80	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.70	3.90	4.00
5-Yr Note	2.56	2.60	2.70	2.80	3.05	3.15	3.40	3.45	3.65	3.65	3.90	4.00
2-Yr Note	2.27	2.40	2.55	2.80	3.00	3.15	3.40	3.40	3.60	3.80	4.00	4.20
3-month Libor	2.31	2.30	2.55	2.80	3.05	3.30	3.55	3.55	3.70	3.95	3.95	4.20
Fed Funds Rate	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75	3.75	4.00
2s/10s spread	47	40	35	20	20	15	10	10	10	(10)	(10)	(20)

The bond market rallied through 2.80% yield resistance on Tuesday as Dow industrials fell 344 points. The yield rally has stalled for now, perhaps too far ahead of itself on the trillion dollar Federal budget deficit story that doesn't start until October 1 this year. Bond yields can't fall too far however, if the Fed funds rate will be 2.25% at the end of 2018, as the Fed's median forecasts predict. We changed the bond market forecast above given the start of a new quarter, just pushing out the lift in yields a little. 10-yr yields are still expected to end 3.0% this year, 3.5% in 2019, and 2020… well it's there, but Powell said he wouldn't put much stock in any 2020 forecast.

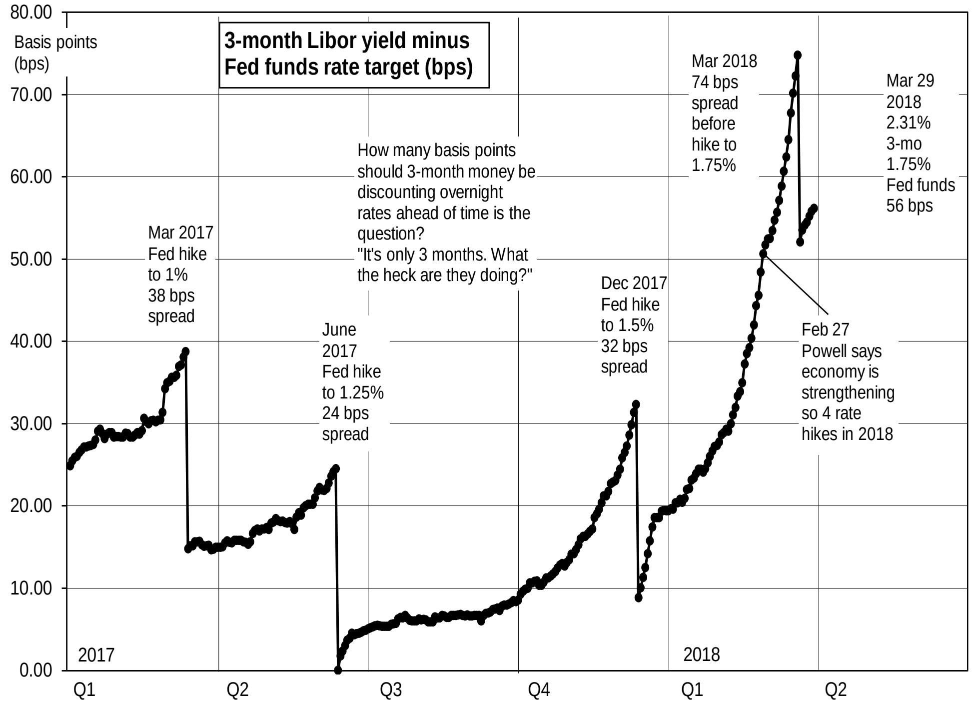
CORPORATES: ALLSTATE, COLONIAL PIPELINE, AMERICAN TOWER, ABB FIN

Corporate offerings were $12.4 billion in the March 30 week versus $29.6 billion in the March 23 week. On Wednesday, Mylan Inc. sold $1.5 billion 10s/30s. It priced a $750 million 4.55% 10-yr (m-w +30bp) at 180 bps (Baa3/BBB-). The global generic and specialty pharmaceuticals company will use the proceeds to refinance debt coming due this year and next. Corporate bonds (10-yr Industrials rated A2) were 95 bps above 10-yr Treasuries this week versus 94 bps last Friday.



FEDERAL RESERVE POLICY

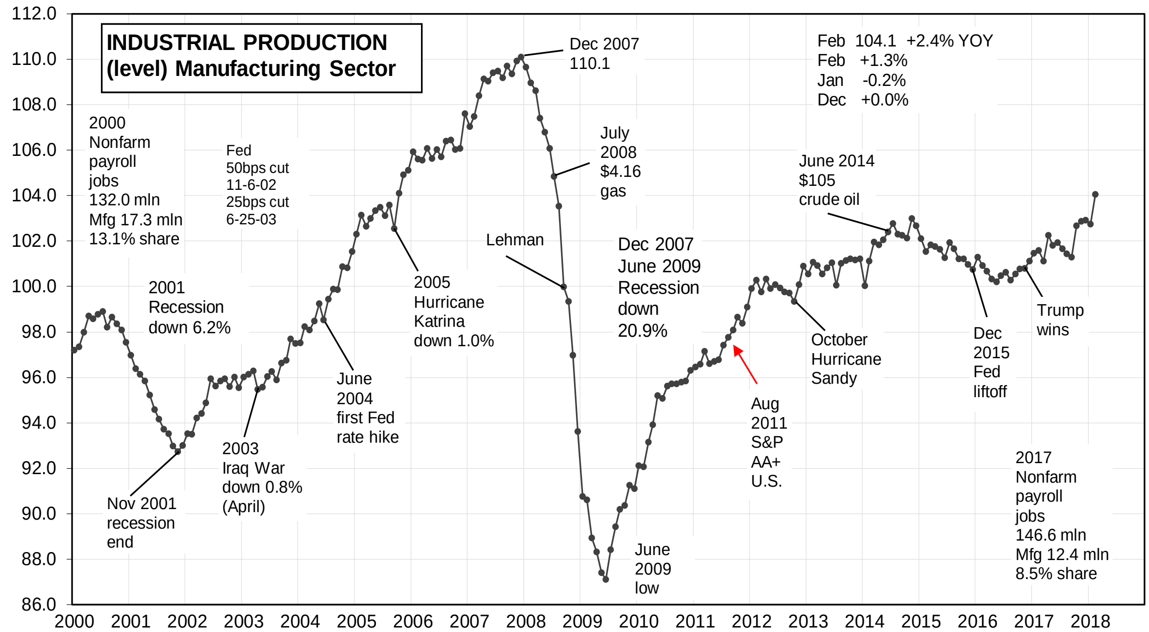
The Fed meets May 1-2 to consider its monetary policy. There is no press conference and no chance of anything happening. Two more rate hikes this year according to the median Fed forecast (7 of 15 say 3 more hikes this year), which meetings will they choose, June, September, or December? For the June 12-13 meeting, the rate hike odds are 76%. Three-month Libor is 2.31%, 56 bps above the 1.75% Fed funds rate, and already discounting a 25 bps Fed rate hike on June 13. We can't explain it, we are just reporting it.



Meanwhile, Fed Chair Powell is giving a speech on the economic outlook in Chicago of all places on Friday, April 6. He is also visiting mHub in Chicago, an organization which seeks to foster product innovation and manufacturing in the Chicago area. Innovation that creates manufacturing jobs. Maybe it's in our imagination, but this sounds similar to Yellen's first set-the-tone speech also in Chicago right after taking office that came to define her goals besides the Federal Reserve's other duties: monetary policy, bank regulation, safety and soundness of the financial system and all that. Her speech four years ago on March 31, 2014, What the Federal Reserve is Doing to Promote a Stronger Job Market, came to define her as someone who was concerned about the plight of the unemployed. And would keep interest rates down lower for longer to help them. This was the famous speech where she called out to three unemployed persons in the audience, only that two of the three had criminal records that could have kept them from getting a job rather than the slow economic recovery from the recession. Unemployment was still 6.7% back then versus 4.1% today.

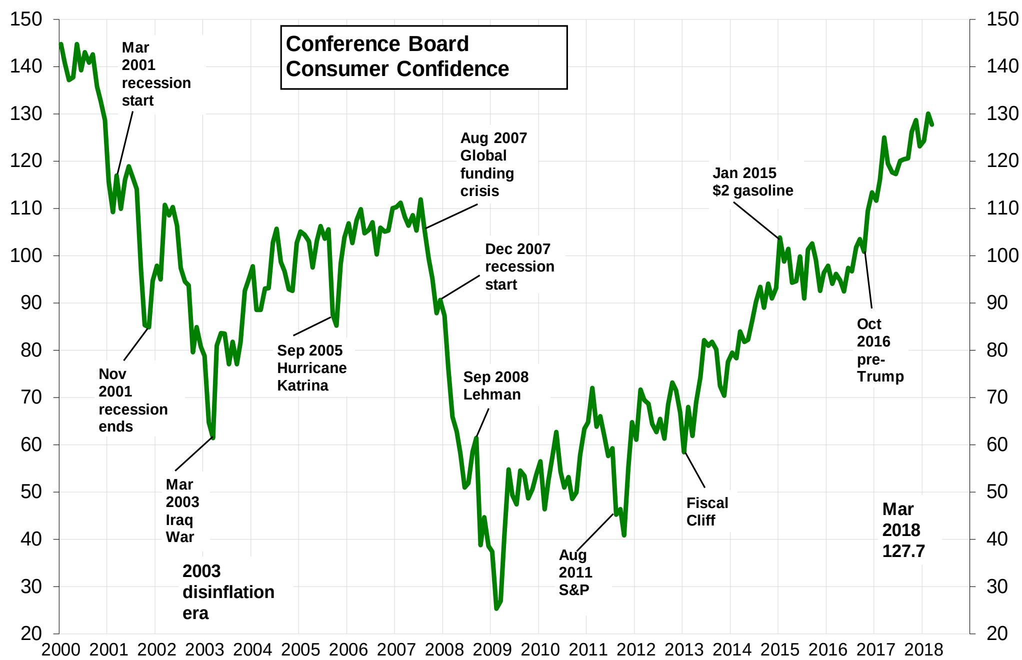
Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	28-Mar	21-Mar	14-Mar	7-Mar	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2424.883	2424.723	2424.562	2424.402	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1754.368	1763.171	1768.588	1759.991	0.000
Primary credit (Discount Window)	0.002	0.000	0.004	0.003	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)	1.709	1.708	1.708	1.708	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	0.000
Central bank liquidity swaps	0.079	0.077	0.064	0.065	62.000
Federal Reserve Assets	4439.3	4448.7	4454.6	4443.1	961.7
3-month Libor %	2.30	2.27	2.15	2.06	2.82
Factors draining reserves					
Currency in circulation	1636.934	1634.754	1634.992	1633.084	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	17.898	20.586	4.970	14.295	0.000
Reserve Balances (Net Liquidity)	2119.605	2135.068	2190.143	2261.352	24.964
Treasuries within 15 days	31.201	31.201	0.000	0.000	14.955
Treasuries 16 to 90 days	89.281	89.280	120.481	120.481	31.549
Treasuries 91 days to 1 year	298.438	298.434	298.430	298.426	69.272
Treasuries over 1-yr to 5 years	1081.513	1081.492	1081.470	1081.448	170.807
Treasuries over 5-yrs to 10 years	298.012	297.970	297.929	297.887	91.863
Treasuries over 10-years	626.439	626.346	626.253	626.160	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

Perhaps Powell will be laying down a marker here on what he wants his term(s) in office to be about or known for. It sounds a little close too close to politics though: "making America great again" and bringing back factories and manufacturing jobs to the U.S., one of the themes from the campaign that Trump ran on. On the other hand, maybe he thinks he has something to offer here. His knowledge of manufacturing and how to make companies grow or at least prosper. Powell was a partner at Carlyle Group from 1997 to 2005 where he headed the North American Industrial Buyout Group so he also knows about manufacturing jobs creation too. Manufacturing production has certainly picked up in the country already since Trump was elected. His timing was good, getting elected as manufacturing rebounded from the crude oil price crash which also sent the dollar higher and hurt exporters. Here is the latest data, including the annual benchmark revision released a week ago.



OTHER ECONOMIC NEWS THIS WEEK

Confidence takes a hit on stocks and Washington uncertainty (Tuesday)

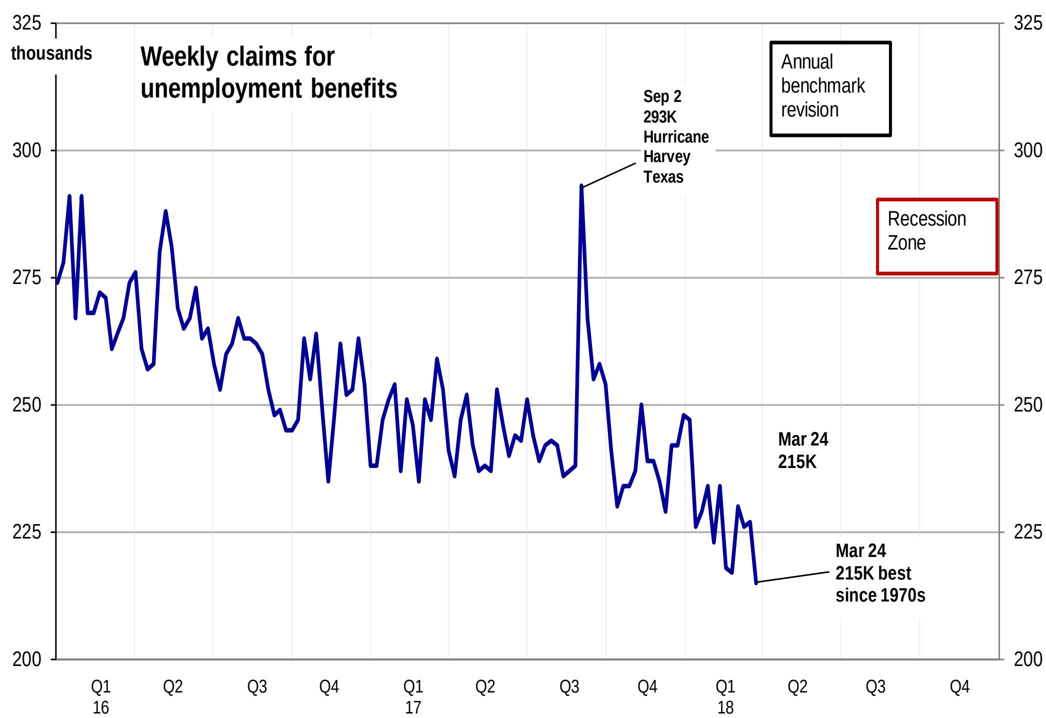


Breaking economy news. The Conference Board measure of consumer confidence took a hit as more Americans may be taking a dislike to the negative news that keeps coming out of Washington as well as the recent volatility in the stock market. Change is good but constant change is bad and the 24-hour unrelenting cycle of bad news from Washington is likely proving to be too much for most consumers. Retail sales have had slight declines for three consecutive months, so it stands to reason that confidence has deflated somewhat to better match the tepid spending trend. Consumer confidence was at the highest level of this nine year economic expansion a month ago at 130.8 in February. That was revised down today to 130.0 and March confidence fell 2.3 points further to 127.7. If consumers are so happy, then why are they not out spending one of the biggest tax cuts in history?

Net, net confidence cooled in March for consumers coming in like a lion and going out like a lamb just like the weather. The stock market has been volatile and consumers don't like market volatility. The Washington news cycle has been volatile as well and is likely to be the source of some concern for the public. Confidence just made a record high in February, so the pullback in confidence is not a concern for the economic outlook this year. Still, we wonder if the decline in confidence means that the economy may have seen some of its best days already for this cycle. Jobs are plentiful the survey said, but jobs with good wages may not be as plentiful, even if the survey does not ask this of consumers. Employment is likely to remain plentiful for some time with the unemployment rate at rock-bottom lows and companies having difficulty finding the people they need in what is likely to be an increasing shortage of workers going forward. Stay tuned. Story developing. The economy starts its tenth year of expansion from the recession in July and we hope that this period of growth can still be one for the record books.

Unemployment claims at the lowest level in fifty years after annual benchmark revision this week (Thursday)

Breaking economy news. The number of people getting fired this week and applying for unemployment benefits was at half a century lows this week after the annual benchmark revision. Fed Chair Powell will have to ask his economists on staff for an update on whether the economy, growing for nine consecutive years, whether the economy is at full employment. Seems like labor market conditions are pretty tight if companies are not laying many workers off.



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