Financial Market Weekly

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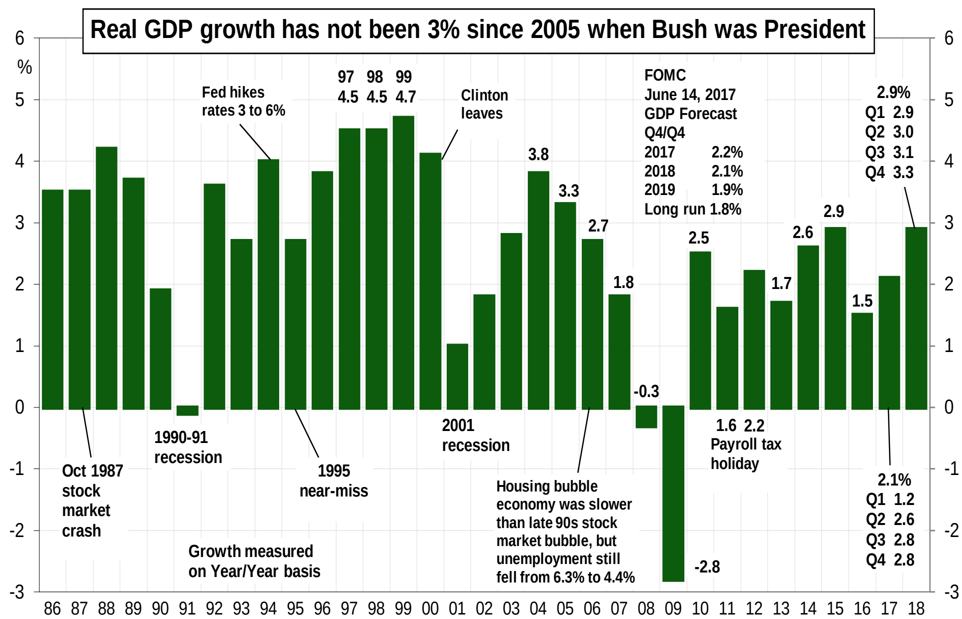
GDP SIGNIFICANTLY STRONGER IN REVISIONS TO 2014 AND 2015, AND GROWTH NOW 2.6% IN Q2 2017; EMPLOYMENT COST INDEX (WAGES) TOO

Not sure the economy is all that short of the 3% mark that Trump's economics team is shooting for. Economy is at full employment and doesn't need much fixing. The payroll tax cut in 2011 and 2012 did not push GDP that much faster, and we can't remember the last time Washington tried to give Americans a tax cut unless the economy was in recession. Nevertheless…



Breaking economy news. Data for the second quarter on GDP and the Employment Cost Index, also known as wages. People use the word "wages" almost as often as they mention the word "robot." Too many robots not enough wages.

GDP	2014	2015	2016
Was	2.4	2.6	1.6
Now	2.6	2.9	1.5

Real GDP was 2.6% in the second quarter and the first quarter is now just 1.2% down from 1.4%. They revised the data today in this once a year benchmark revision back to 2014. Not too much change here in the overall profile of spending in the economy. Economic growth was better than we thought in 2014 and 2015 before it slowed in 2016. We view the 2016 slowdown to 1.5% as due to temporary factors which in no way, shape, or form, stops the economy from challenging the ten-year expansion of the Clinton years. Year nine of the current expansion began in July.

Maybe the 2016 slowdown is the pause that refreshes. In any case, the fears that the retiring baby boom generation will take a toll on growth as they sit on the porch in increasingly rocking chairs watching the sun set is not happening. Real consumer spending was pretty good at 2.7% in 2016 so it was not responsible for the 1.5% GDP growth slowdown.

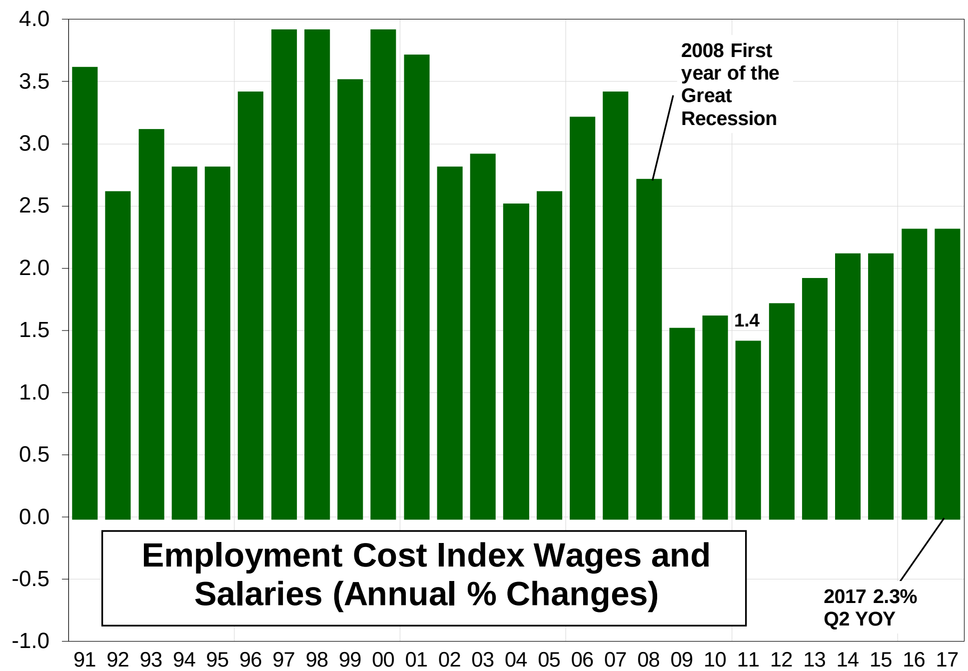
	Q2 16	Q3 16	Q4 16	Q1 17	Q2 17p
REAL GDP	2.2	2.8	1.8	1.2	2.6
REAL CONSUMPTION	3.8	2.8	2.9	1.9	2.8
CONSUMPTION	2.6	1.9	2.0	1.3	1.9
Durables	0.6	0.7	0.7	0.0	0.5
Nondurables	0.7	0.0	0.4	0.2	0.6
Services	1.3	1.2	1.0	1.2	0.9
INVESTMENT	-0.5	0.4	1.3	-0.2	0.3
Business Plant	0.0	0.4	-0.1	0.4	0.1
& Equipment and	0.0	-0.1	0.1	0.2	0.4
Intellectual Property	0.4	0.2	0.0	0.2	0.1
Homes	-0.2	-0.2	0.3	0.4	-0.3
Inventories	-0.7	0.2	1.1	-1.5	0.0
EXPORTS	0.3	0.7	-0.5	0.9	0.5
IMPORTS	0.0	-0.4	-1.1	-0.6	-0.3
GOVERNMENT	-0.2	0.1	0.0	-0.1	0.1
Federal defense	-0.1	0.1	-0.1	-0.1	0.2
Fed nondefense	0.0	0.0	0.1	0.0	-0.1
State and local	-0.1	0.0	0.1	0.1	0.0

Below line: Percentage point contributions to Q2 17 2.6% real GDP

Second estimate for Q2 is Wednesday, August 30

Wages? You want more wages? The employment cost index is out for the second quarter and total compensation is running about the same at 2.4% the last year. If Congress was voting on our paychecks this would be the skinny version. Salaries are up 2.3%, and benefits are rising 2.5%, both measured on a year-on-year basis. Time will tell whether wages march higher with the economy at full employment. We really need to wait and see what happens over the next couple of years before concluding better wages will never get doled out by tight-fisted corporations.

Net, net, the economy is running this race just as fast as it can and is doing pretty well given its age. The Trump economics team is concentrating on 3% GDP and now we see that growth was 2.9% in 2015 not 2.6%, this goal they have set for themselves looks attainable. Real economic growth slowed in 2016 largely due to weaker business investment in equipment and structures during the oil price crash that hit oil & gas drilling hard, and a one-off drag from inventories.



That's all behind us now with real economic growth up 2.6% in the second quarter of 2017 largely on the backs of consumers that continue to do all the heavy lifting. Business spending on equipment bounced this quarter, while housing starts were a drag. The economy is close to 3% growth, but may have trouble actually getting there if government spending does not pick up. Nondefense Federal spending has fallen for two straight quarters during the Trump administration and State & local spending is restrained.

The bottom line is that growth has rebounded from the sluggish 1.2% rate in the first quarter as the Fed expected and at 2.6% in the second quarter, the economy's wheels are running above the Fed's expectations for the entire year. This pattern of rebounding growth shows Fed officials can continue with the gradual pace of rate hikes with another rate hike forecast for this year, and three more in 2018. Whatever the signal is from the slower inflation in recent months it is not the result of stagnating growth. The Fed needs to acknowledge this stronger growth and move on. Business spending on equipment was the biggest surprise jumping 8.2% as there were concerns companies were awaiting clarification on tax rates and reforms before ordering more equipment that helps make the economy go. So far so good for the economy this year. Things are better than you think.

MARKETS OUTLOOK

	30-Jun 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
30-Yr Treasury	2.83	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10
10-Yr Note	2.30	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90
5-Yr Note	1.89	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70
2-Yr Note	1.38	1.60	1.85	2.10	2.40	2.60	2.85	3.10	3.35	3.35	3.60
3-month Libor	1.30	1.65	1.90	2.20	2.45	2.70	2.95	3.20	3.45	3.35	3.70
Fed Funds Rate	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50
2s/10s spread	92	90	85	90	80	80	65	60	45	55	30
Libor/funds spd	5	15	15	20	20	20	20	20	20	10	20

We can't say nothing happened in bond land this week as 10-yr yields lifted dramatically from the 2.24% close on Friday, July 21. Yields jumped 8 bps on Tuesday to the 2.34% highs for the week. U.S. bonds closely followed the jump in Bunds where 10-yr yields rose 6 bps higher to 0.57%, after technical levels were broken. 10-yr Treasuries fell not once but twice from the 2.30-something yield level this week. A delayed response to the Fed statement where a rate hike isn't coming until December if that is news (more likely following the dollar's response to the "Dovish" Fed statement), and coming down a little on the 2.6% GDP report and lower than expected Employment Cost Index (no wages for you) on Friday. The whisper number on GDP was above 3% after Thursday's advance trade deficit and inventories data.

FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	26-Jul	19-Jul	12-Jul	5-Jul	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2465.170	2465.145	2465.121	2465.096	479.782
Federal agency debt securities	8.097	8.097	8.097	8.097	0.000
Mortgage-backed securities	1768.999	1779.394	1770.281	1770.281	0.000
Primary credit (Discount Window)	0.013	0.051	0.001	0.001	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)	1.710	1.710	1.709	1.709	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	0.085	0.041	0.055	3.070	62.000
Federal Reserve Assets	4512.0	4523.6	4513.4	4513.8	961.7
3-month Libor %	1.31	1.31	1.30	1.30	2.82
Factors draining reserves					
Currency in circulation	1561.976	1561.884	1564.816	1565.957	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	103.311	144.731	179.172	240.029	0.000
Reserve Balances (Net Liquidity)	2293.616	2250.646	2238.951	2169.650	24.964
Treasuries within 15 days	11.794	11.794	1.278	1.278	14.955
Treasuries 16 to 90 days	32.799	32.799	44.593	44.593	31.549
Treasuries 91 days to 1 year	276.684	276.684	275.578	275.577	69.272
Treasuries over 1-yr to 5 years	1152.633	1152.629	1152.805	1152.801	170.807
Treasuries over 5-yrs to 10 years	357.353	357.347	357.263	357.258	91.863
Treasuries over 10-years	633.907	633.892	633.604	633.589	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

The Fed met July 25-26 to consider its monetary policy. They only changed a few words in the statement. The most important ones said the balance sheet unwind could take place "relatively soon." The markets are unanimous in the belief that this means the formal wind down announcement will be made at the September Fed meeting. This means there will not be a rate hike until December as the Fed cannot do two things at once. The bond market actually rallied on the press statement on Wednesday in a lagged response, possibly to the appreciation of the Euro against the dollar on the news, foreign exchange markets being smarter than the domestic U.S. fixed income market always, and possibly as it dawned on traders and investors that the next possible rate hike is not until December 13, 2017 which is 135 days away.

How many "relatively soons" do we need before they actually do it? The first relatively soon for the timing of the unwind official start came in Yellen's response to a question at the June 13-14 press conference, where she said they could put this into effect relatively soon "if the economy evolves in line with our expectations." After three months of hearing "relatively soon," September looks like the last possible month to be considered soon.

After the the formal announcement expected at 2pm EDT on September 20, it will take them a year to gradually work up to the full strength unwind: letting $20 billion per month of MBS roll-off, and $30 billion per month of Treasuries. This means starting September 2018, the balance sheet will unwind at a $600 billion per year pace. How low will the $4.5 trillion balance sheet go? We expect the $2.293 trillion of Reserve Balances in the table above to come back down to where it was before they let Lehman go bankrupt: the $24.964 billion of excess reserves outstanding on September 10, 2008.

What will be the effect on the markets? Trader lore around the world has long held that the huge scale of these unprecedented quantitative easings (QE), i.e. the massive asset purchases by global central banks, has reduced yields. Hard to tell if this is true or not. The proof will be in the eating. The Fed bought an extra $2 trillion of securities that will now have to be absorbed by the markets as the balance sheet is unwound. The $360 billion of Treasuries rolling off will force the Treasury to sell $360 billion more Treasuries each year, which could lead to higher yields. The $240 billion of estimated annual MBS prepayments will have to be absorbed by the markets and could possibly lead to higher financing costs on your newly purchased or refinanced home.

What else was in the Fed statement on Wednesday? Anyone, anyone. Oh yeah, some of the squeaky wheels on the Committee don't seem to want to hike rates again unless they have proof positive, like

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Bam! right between the eyes kind of certainty, that inflation is headed back up to the Fed's 2% target. In case you weren't following this, core PCE inflation was 1.8% in January and now has slowed down to 1.4% in May... going, going the wrong way! Heaven forbid, say it ain't so. Tuesday, August 1 the June PCE data are announced.

We thought there was a chance that they might call out inflation in the Fed meeting press statement on Wednesday and say they were watching it extremely closely or something, meaning nod-nod, wink-wink, if inflation doesn't move back up in short order then they may alter the path of their gradual rate hikes that is basically 75 bps each year. But nope, little change in the wording on inflation, they just report that core inflation has declined on a 12-month basis and is running below 2%, same wording as last month. Oh, and "the Committee is monitoring inflation developments closely" just as they were last month.

***UPDATE June core PCE data are not out until Tuesday, August 1 at 830am EDT, but Friday's GDP report revealed the Q2 data which of course is the average of April, May, June. Core PCE inflation was revised up in 2016, "If only we'd known, we would have raised rates 4 times last year," and the second quarter average for 2017 is 1.5% YOY. So at least the May 1.4% core PCE inflation data didn't "worsen" any further if worsen is the word.

Core PCE inflation % Year-on-year (YOY)

	Q2 17	Q1 17	Q4 16	Q3 16	Q2 16	Q1 16
New	1.52	1.79	1.87	1.84	1.72	1.65
Old		1.70	1.72	1.69	1.61	1.61
Diff		.09	.15	.15	.11	.04

The point is there is less reason for some of the inflation hobgoblins of little minds worriers at the Fed to be so concerned. This is not an economy facing a downturn or stagnant economic conditions. Inflation is hanging in there, if that's what you're rooting for. For gosh sakes, the Dow industrials stock market averages, a leading indicator which partly discounts future economic growth, ended this week up 10.5% year-to-date, following on 2016's 13.4% gain. Looks like President Trump was correct in saying he made a lot of people a lot of money since he was elected… for now.

OTHER ECONOMIC NEWS THIS WEEK

American's confidence remains high and points to a better tomorrow

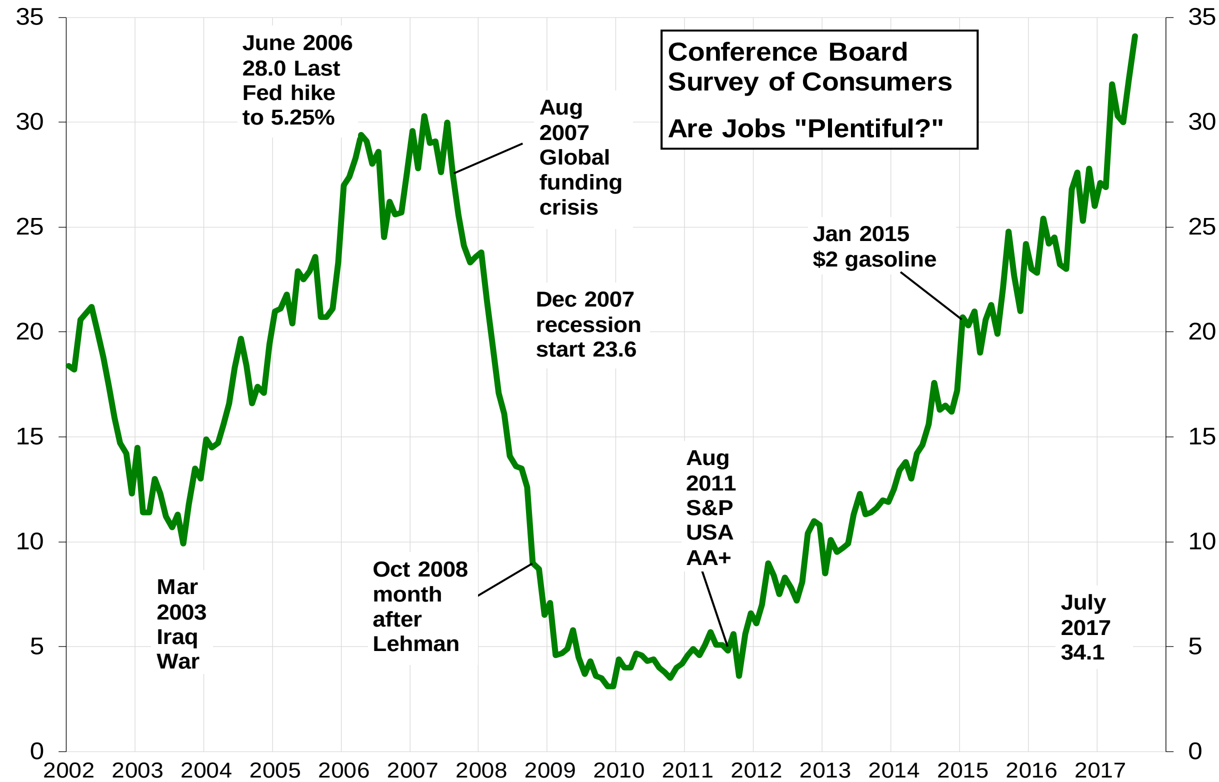
Breaking economy news. American's confidence remains high and points to a better tomorrow for growth. The confidence survey index rose almost 4 points to 121.1 in July from 117.3 in June. The labor market is on fire and boy does the consumer ever know it as those saying jobs are plentiful jumped to a new high of 34.1 in July for this economic cycle. We will have to wait until next week's payroll jobs report to see if businesses indeed stepped up their hiring plans in July.

How's the labor market doing?
Conference Board asks the consumer.

Confidence Index	Jul 17	Jun 17	May 17	Apr 17	Mar 17	Feb 17	Jan 17
	121.1	117.3	117.6	119.4	124.9	116.1	111.6
Jobs are:	Jul 17	Jun 17	May 17	Apr 17	Mar 17	Feb 17	Jan 17
Plentiful	34.1	32.0	30.0	30.3	31.8	26.9	27.1
Not so	47.9	49.6	51.7	50.3	49.2	53.2	51.8
Hard to get	18.0	18.4	18.3	19.4	19.0	19.9	21.1

Obamacare, Washington swamp, Federal government shutdown, nothing but nothing seems to get the consumer down. Retail sales fell in May and June so we will eagerly wait to see if consumers match their sky-high confidence by taking additional trips to the mall in July.

Net, net the consumer is back and full of confidence which brightens the outlook for the economy as we enter the second half of the year. One thing for certain is the consumer is not concerned at all about the too-low inflation worry that some Fed officials are talking about. The economy entered its ninth year of expansion in July and instead of focusing on the economy's old age the consumer is confident that this long-lived expansion can keep on going. The labor market is tight and jobs are there for the taking the consumer reports, so higher wages from a fully employed economy must be on the way. We expect Federal Reserve officials will continue with their gradual pace of rate hikes secure in the knowledge that a confident consumer means that more spending is on the way. The economy is better than you think the consumer is saying. Bet on it.



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