Financial Market Weekly

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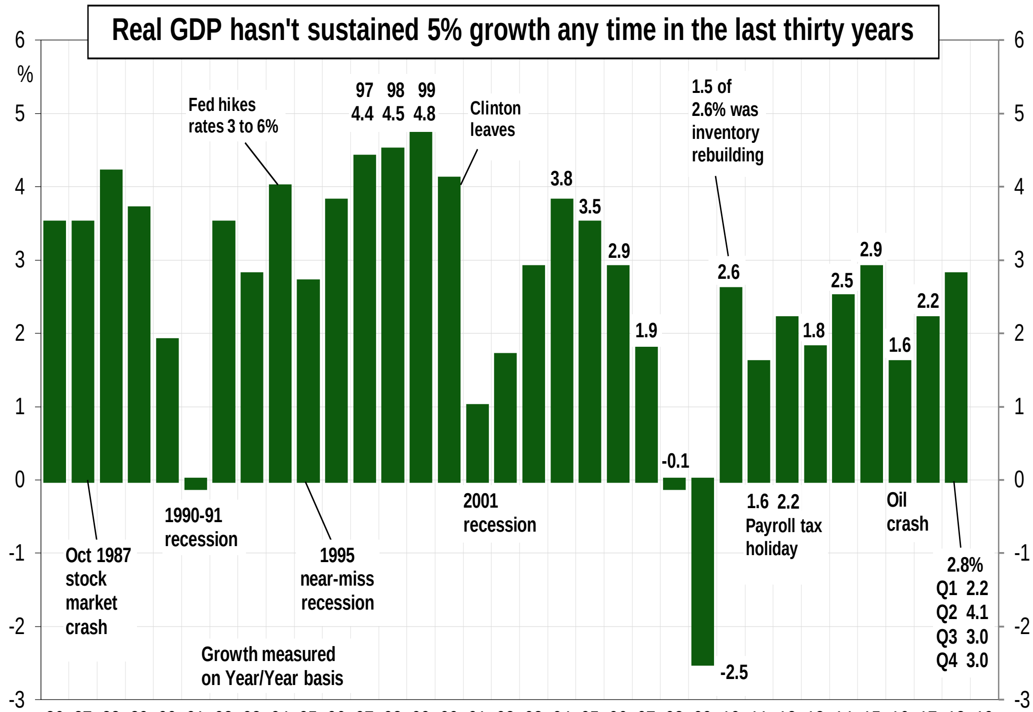
TRUMP'S 5% GDP FORECAST: WISHFUL THINKING OR NOT?

Trump was out in Bedminster, New Jersey Wednesday near where we live and we were not able to attend the dinner that night with business executives. Heard about it though. Trump said, "We anticipate this next quarter to be, this is just an estimate, but already they're saying it could be in the fives." Okay, 5 percent after 4.1% in the second quarter. We were thinking three percent growth in Q3. But Okay.



It's been a while since the economy ran near 5 percent. Last time was under Clinton in the late 90s. Those were the days. Twenty years ago. Make American Great Again. Things were different back then. The baby boom generation in 1998 was 34 to 52 years old and buying up a storm. In 2018, baby boomers are 54 to 72 years old and growing more conservative in politics and in spending alike. Saving up a storm now and retarding economic growth. Just how did the economy grow so fast in the late 90s. No, we don't mean productivity, we mean what components of GDP contributed to the faster growth? Look at the components, consumption, investment, exports, etc., and try to guess along with the President can the economy grow 5 percent again. Can tax cuts, deregulation and leveling the playing field for international trade, grow the economy stronger and faster again?

The strong years for growth in the 90s, right before the Fed pushed interest rates to 6.5% dropping the country into the 2001 recession under President Bush, were 4.5% in 1998 and 4.8% in 1999.

So, let's review the past. It's important. Those who look at the past are doomed to repeat it. So, let's go. 4.8% GDP in 1999. It's been 20 years. The growth of the economy (real GDP) in the graph on page one is annual averages. The Fed forecasts are Q4 to Q4 growth. Annual growth is steadier more reliable (easier to analyze over time). It can result in telling stories about the economy that occurred too long ago however. Still then, in regards to the economy and all this talk of 5% growth from the President, real GDP on an annual basis was 2.9% in 2015 before the oil price crash (looking at graph on page 1). Growth was 2.2% in 2017 the first year under Trump. The big difference from the Economy to Party Like 1999 table is consumer spending is not like 1999 and not adding as much to GDP on its own. 3.4 percentage points of 1999's growth was all on the backs of the consumer. There were more of them with paychecks back then with nonfarm payroll jobs rising 2.4% in 1999 versus just 1.6% in 2017. Companies upgraded computers/software constantly, and state & local governments had the money to spend on their citizens: both categories added 1.2 percentage points of 4.8% growth in 1999 and in 2017 they added 0.1 percentage point.

Trump: Economy to Party Like It's 1999

Year-on-year growth	1998	1999	2017
REAL GDP	4.5	4.8	2.2
CONSUMPTION	3.4	3.4	1.7
Durables	1.0	1.1	0.5
Nondurables	0.6	0.8	0.3
Services	1.9	1.6	1.0
INVESTMENT	1.8	1.6	0.8
Structures	0.2	0.0	0.1
Equipment	0.9	0.9	0.4
Intellectual Property	0.4	0.5	0.2
Homes	0.4	0.3	0.1
Inventories	-0.1	0.0	0.0
EXPORTS	0.3	0.5	0.4
IMPORTS	-1.4	-1.4	-0.7
GOVERNMENT	0.4	0.6	0.0
Federal defense	-0.1	0.1	0.0
Fed nondefense	0.0	0.1	0.0
State and local	0.5	0.5	-0.1

Percentage point contributions to 2017 2.2% real GDP

To conclude, we don't want to argue with the President's 5% growth forecast for the third quarter. All Presidents are leaders who often bend the truth a little in order to encourage better outcomes for the people and the economy. He's not a professional forecaster (scroll to bottom of link for list), an economist on Wall Street (moved uptown, 4.2 miles away now, please, come visit me at Rock Center 1251 Avenue of the Americas at 50th Street), watching the Federal Reserve and markets and the economy every day. It just seems it will be difficult for economic growth to pick up and sustain the level he is suggesting is possible. We are not going to get into the more political considerations about what too-shy growth might mean for making those massive tax cuts ever pay for themselves with the faster growth in incomes and the economy that are supposed to engender even greater tax revenues.

1999 was the strongest growth seen in the last thirty years and the 4.8% real GDP took place when the baby boom generation was hitting its prime years for spending. Not easy to go back twenty years ago and Make America Great Again for many of them.

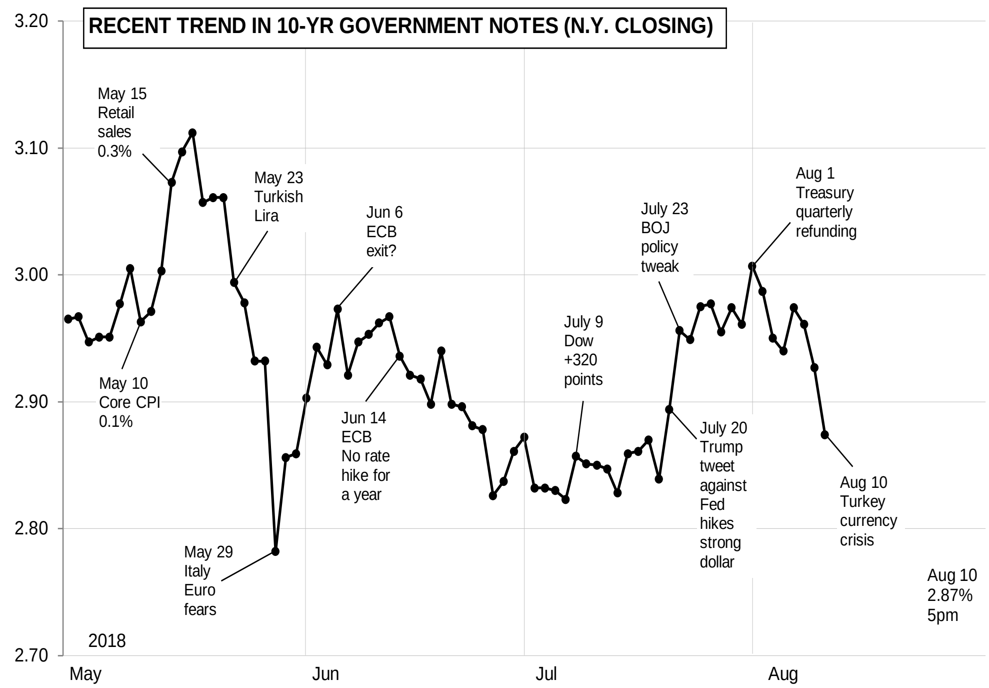
	1997	1998	1999	2000	2017
GDP Growth	4.4	4.5	4.8	4.1	2.2
Contributions to growth					
Computers/software	0.6	0.6	0.7	0.4	0.2
State & local Govt	0.4	0.5	0.5	0.3	-0.1
Car/light trucks mln	15.1	15.5	16.9	17.3	17.1
Nonfarm payroll jobs	2.6%	2.6%	2.4%	2.2%	1.6%
S&P 500 % Chg	31.0	26.7	19.5	-10.1	19.4

There were several factors on the demand side that added to economic growth in 1999 that are not replaceable. A different time.

1) Business investment: computer and software spending added a lot to GDP 0.7% in 1999
2) Consumption expenditures strong in part due to baby boom putting more cars in driveways
3) State & local government spending added 0.5 percentage points to 4.8% real GDP
4) Baby boom powers the economy: private nonfarm payroll jobs rise 2.4%.

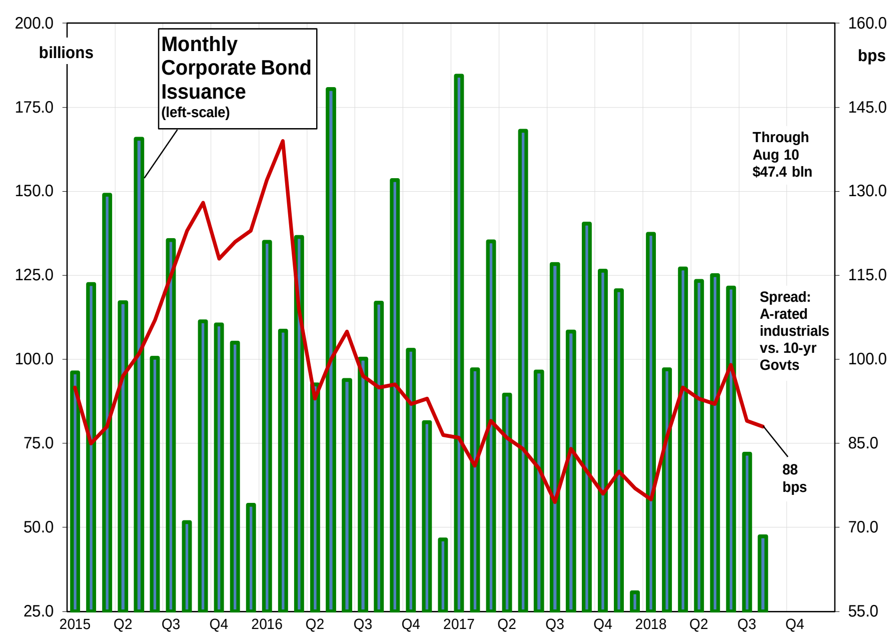
MARKETS OUTLOOK

	29-Jun 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.99	3.10	3.20	3.35	3.45	3.60	3.60	3.75	3.85	3.80	3.95
10-Yr Note	2.86	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95
5-Yr Note	2.74	2.70	2.90	3.10	3.20	3.45	3.45	3.65	3.75	3.80	3.95
2-Yr Note	2.53	2.55	2.80	3.00	3.15	3.40	3.40	3.60	3.75	3.80	4.00
3-month Libor	2.34	2.55	2.80	2.95	3.20	3.45	3.45	3.70	3.95	3.95	4.20
Fed Funds Rate	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	33	35	20	20	15	10	10	10	5	0	(5)



Before we deliver the good news (if you are long bonds), yields never really got the lift expected from the three days of Treasury quarterly refunding auctions: 3-years, 10-years, and 30-years. Supply doesn't matter at this point: markets can absorb it (wait till later this year/early 2019). This was true even before Friday's rally on the talk of contagion in emerging currency markets. When Trump tweeted that he was doubling steel and aluminum tariffs on Turkey at 847am EDT on Friday, 10-year Treasury yields were barely 2.91% and then yields fell, closing at 2.87% as U.S. stocks suffered losses. At 847am EDT Dow futures were down about 111 points at 25,382 and fell 167 points more at one point. S&P 500 still ended Friday +6.0% YTD.

CORPORATES: HYATT, FORD, BMW, RALPH LAUREN, AMERICAN WATER



Corporate offerings were $38.4 billion in the August 10 week versus $15.5 billion in the August 3 week. On Wednesday, Starbucks sold $3.0 billion 7s/10s/30s. It priced a $750 million 4.0% 10-yr (m-w +20bp) at 105 bps (Baa1/BBB+). The company will use the proceeds to repurchase outstanding shares, business expansion, and/or paying cash dividends. Corporate bond yields (10-yr Industrials rated A2) were 88 bps above 10-yr Treasuries this week versus 87 bps last Friday.

FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	8-Aug	1-Aug	25-Jul	18-Jul	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2336.925	2336.876	2359.893	2359.766	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1709.545	1709.544	1709.528	1722.291	0.000
Primary credit (Discount Window)	0.003	0.003	0.002	0.013	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)	1.719	1.716	1.715	1.711	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	0.100	0.100	0.122	0.091	62.000
Federal Reserve Assets	4305.6	4303.0	4325.3	4339.2	961.7
3-month Libor %	2.34	2.35	2.34	2.35	2.82
Factors draining reserves					
Currency in circulation	1671.632	1669.707	1668.294	1668.409	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	1.659	0.795	0.720	6.021	0.000
Reserve Balances (Net Liquidity)	1966.103	1966.432	1947.287	1949.944	24.964
Treasuries within 15 days	23.069	23.069	30.302	30.302	14.955
Treasuries 16 to 90 days	63.772	39.939	63.008	63.008	31.549
Treasuries 91 days to 1 year	305.548	329.380	310.069	310.067	69.272
Treasuries over 1-yr to 5 years	1028.055	1028.048	1040.552	1040.534	170.807
Treasuries over 5-yrs to 10 years	296.639	296.622	296.199	296.154	91.863
Treasuries over 10-years	619.841	619.818	619.762	619.701	101.337

**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

The Fed meets September 25-26 to consider its monetary policy. Trump put fuel on the fire with a tweet about doubling tariffs on Turkey steel (to 50%) and aluminum (to 20%) exports to the US at 847am EDT on Friday which pushed the Lira down even harder. Stock markets fell, the Treasury market rallied. Fed funds futures say the odds are still high for a rate hike to 2.25% on September 26 though: odds 90% Friday, a tad lower than 94% Thursday.

Meanwhile, one of the Fed's long-standing, lonesome Doves, Chicago Fed President Evans, said this week that monetary policy may have to take the punch bowl away with the Fed funds rate being pushed higher than neutral levels for the economy. Emerging markets and President Trump are going to love that. Evans said neutral Fed funds rates of 2.5, 2.75 or 3 percent were all equally "defensible." He thought neutral was 2.75%. If inflation stays where it is "a modest amount of restrictiveness above our neutral rate might be called for in 2020," Evans said. This isn't really news, but it reinforces the higher median FOMC forecasts. The full Committee forecasts 2.5% in December, 3.25% at the end of 2019, and 3.5% at the end of 2020. On September 26 at 2pm EDT they will also provide another year's guidance—where they see the Fed funds rate at the end of 2021. You think they will forecast 4% yields for savers in 2021? Would you like to bet on it? Maybe sell some Eurodollar futures, where 3-month Libor settles in the future, they aren't even discounting 3% yet, though they might be broken, all the Libor uncertainty and all.

Year-ends for Interest Rates

Percent %	2018	2019	2020	2021
Eurodollar futures	2.59	2.935	2.93	2.92
Fed's June forecast	2.5	3.25	3.5	

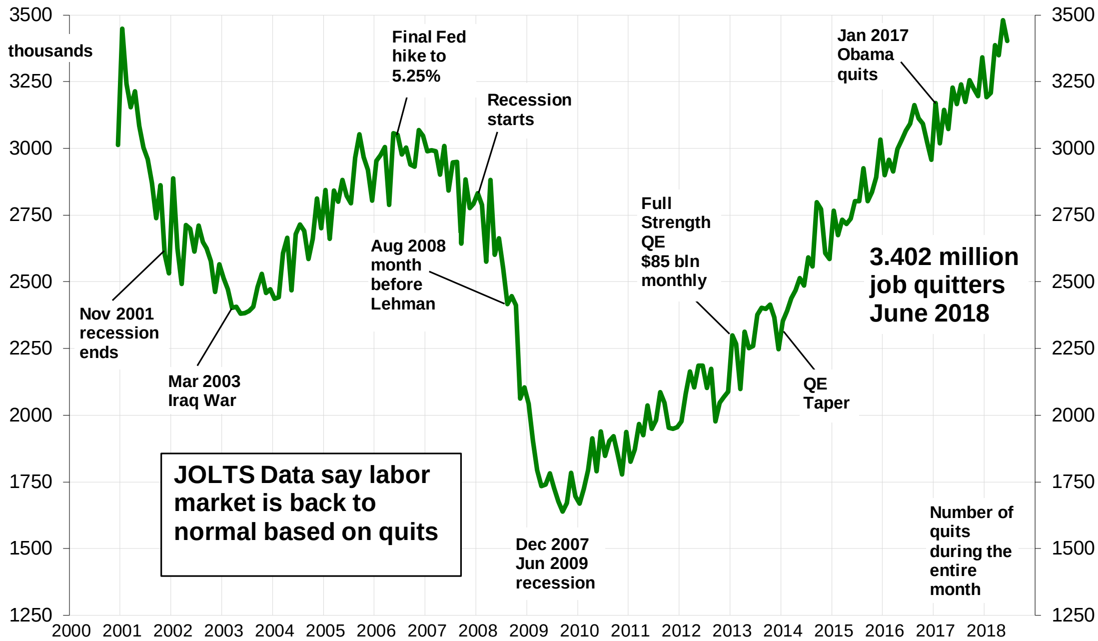
Eurodollar futures price where 3-month Libor will be in the future.
Friday, August 10, 2018 3-month Libor 2.32%

OTHER ECONOMIC NEWS THIS WEEK

Job openings second highest in history-more work for the unemployed (Tuesday)

Breaking economy news. Jolts data for June, Job Openings and Labor Turnover. The economy was strong in the second quarter with scorching growth of 4.1%, but for how long if companies just can't find enough workers to man the factories and shops and malls, and bars and restaurants. Job openings were 6.662 million in June which is the second highest in history and eclipses the 6.564 million unemployed in June behind that 4.0% unemployment rate. Something happened in March this year with openings soaring to new levels. Business is good and must be very good as companies continue to add to their headcounts so late in the long economic expansion from the recession. If you are a headhunter, your phones must be ringing off the hook. Maybe we will give you a call this afternoon.

Net, net, the labor market continues to run hot and this guarantees that more rate hikes are on the way. The Jolts data are telling us that no one has stopped hiring due to the trade war escalation with China yet. Damn the uncertainty, bring me more workers the economy is screaming. Fed officials are increasingly skeptical that this economy requires any monetary policy support whatsoever. Interest rates should be at normal, neutral levels today, and yet, the Fed's next rate hike expected at its September meeting will only put the Fed funds rate at 2.25% which is still two or three more rate hikes short of normal for the economy.



Yellen left the building a long time ago, but she was always fascinated with the labor market data showing how many people stood up at their desks and told companies they were quitting. Quitters doesn't sound very American, but a rise in the number of people who feel they can quit their jobs and get a new one is a sign of confidence in overall business conditions. Right now, the number of people quitting their jobs is the second highest since the recession at 3.402 million in June. Retail isn't dead yet as 538 thousand quit their jobs in June, hotels/motels and bars and restaurants saw 643 thousand quitting their jobs. Don't we know it. It took forever to get a hamburger and a coke at a Rock Center restaurant the other day. There is a lot of churn out there in the economy in these Jolts data with job openings and more quitters galore telling us business conditions just could not be any more perfect and the stock market knows it with the S&P 500 back near the highs of the year. Stay tuned. Story developing.

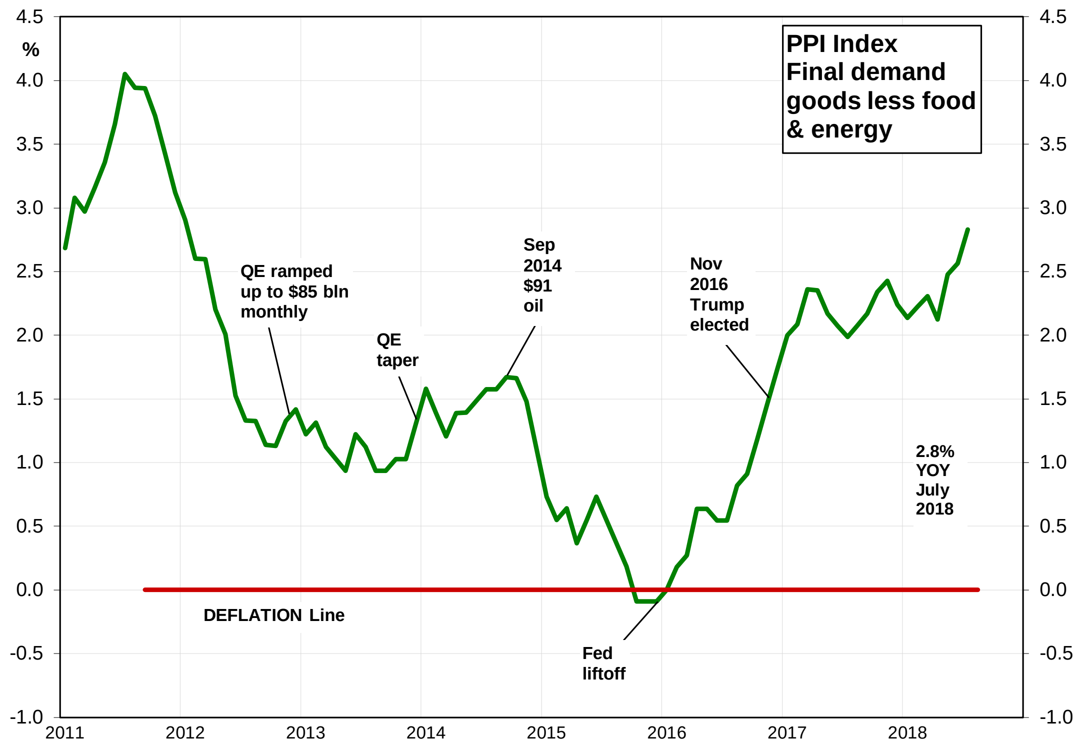
Inflation ticking time bomb still ticking, tic toc, tic toc, tic toc (Thursday)

Breaking economy news. Producer price inflation. The good old PPI data once one of the two bigliest traded economic numbers in the world back when inflation was the worry and bond market vigilantes ruled the land. Those were the days. Now the bond markets are ruled by robots executing customer transactions, most of which are strictly buy and hold and less speculative in terms of taking a view on where interest rates are heading next. And thank goodness, gives us more opportunity to follow the fake political news headlines during the trading day.

PPI final demand inflation was unchanged in July. No inflation. Nada. Those tariffs on solar panels, washing machines, steel & aluminum, and $34 billion of goods imports from China haven't pushed up final demand prices at the producer level yet. 0.0 percent this month although year-to-year, the index is up 3.3 percent... still Fed Chair Powell isn't comfortable yet with the inflation outlook and isn't quite sure whether we have won the battle with low inflation. Maybe he could query one of his economists. Yep, 3.3% and no inflation pressures. Make America great again. Bring back double-digit inflation from the 1980s. Now that was inflation!

Net, net, the reports that companies are paying more for inputs and raw materials due to the fallout from the trade war tariffs on imported goods has not reached final goods prices at the producer level yet. The inflation time bomb's fuse has been lit perhaps, but if so, it is a very long one. Inflation isn't ready to explode yet. But imported goods are roughly 12% of nominal GDP spending meaning higher priced imported goods will start to move the needle on inflation at some point.

Inflation is there, it's coming, the pressures are building. Fed officials need to stay ahead of the game and get interest rates back to more normal levels while they can. Trade war tensions in the clouds out there on the horizon may still move closer to shore later this year.



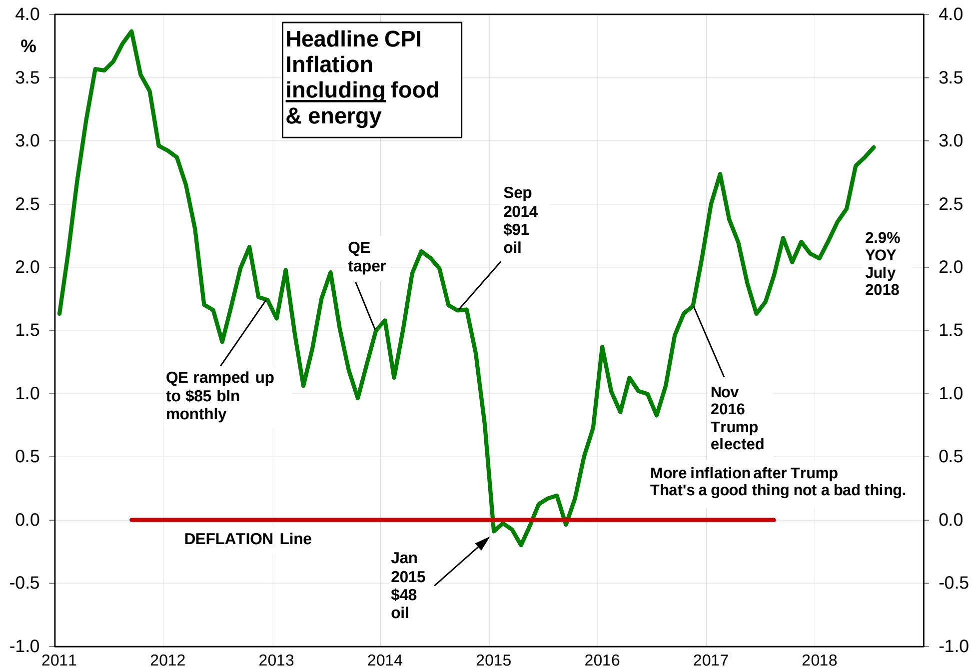
Inflation pressures building? We focus on Final demand goods prices less food and energy in the report, and these prices rose 0.3% in July, the same amount of monthly inflation seen in May and June as well. In fact, core producer goods prices have risen 0.3% every month this year except in April and are up 2.8% year-on-year, the strongest rate of price increases seen in six and a half years. 2.8% is not not inflation. The Fed better get going and soon as their 2% interest rate has no reason to be set less than 2.8% inflation, no matter what the President might have to say on it. Be bold. Do it. Raise interest rates. Stay tuned. Inflation story developing.

Inflation heats up this summer, argues for Fed to take punch bowl away (Friday)

Breaking economy news. CPI inflation fires rage unchecked this morning in July's report with both core and headline CPI rising 0.2% for the month to 2.4% for core CPI inflation and 2.9% for headline inflation, both year-on-year increases. The year-on-year core inflation pressures have been moving up as core inflation was quiet last year with a string of slower 0.1% monthly changes.

Housing costs are rising sharply and are doing the heavy lifting on the overall price level. Energy prices as well are up, gasoline prices at the pump up over 25% the last year and this causing some pass through to other prices. Medical services and commodities and clothing are all down, and yet core consumer inflation is still rising faster.

Net, net, the economy turned it up a notch this summer with spectacular growth and now the heat is starting to warm up inflation. CPI inflation is higher and it is only a matter of time before the Fed's preferred PCE inflation measure heats up too. Core CPI inflation is 2.4% in July this year versus just 1.7% this time a year ago in 2017 when Fed officials were worried about too low inflation, largely due to the free cell phone data effect last March.



The reports of inflation's death are simply not true, and with the kettle on the boil from stronger economic growth, inflation pressures will continue to build as the economy moves through full employment. There is really the making of a perfect storm here for a full outbreak of inflation spreading like wildfire when you throw the tariffs on imported goods into the forecast mix as higher import prices give many merchants and producers the excuse to regain long dormant pricing power and push up prices of all kinds of goods and services of every stripe and color.

Fed officials will not be able to turn their backs on this latest evidence that inflation is rising again. Inflation has definitely moved back to the front burner of Fed worries and concerns. Monetary policy stimulus is no longer necessary at this late stage of the business cycle and policy needs to be recalibrated in a hurry. They are behind the curve with 2% interest rates that are as much as 100 basis points and four rate hikes away from normal levels. Incredibly, policy won't even start to take the punch bowl away for another year based on the Fed's own forecasts of interest rates which shows the markets and the world how the Fed has been caught napping here. The danger now is that Fed officials have to hurry the pace of interest rate hikes that could put a bigger dent in the economy's future than they want.

Inflation is heating up this summer and argues strongly for Fed officials to take the punch bowl away. Rate hikes are coming lots of them. Emerging markets beware.

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