Financial Market Weekly

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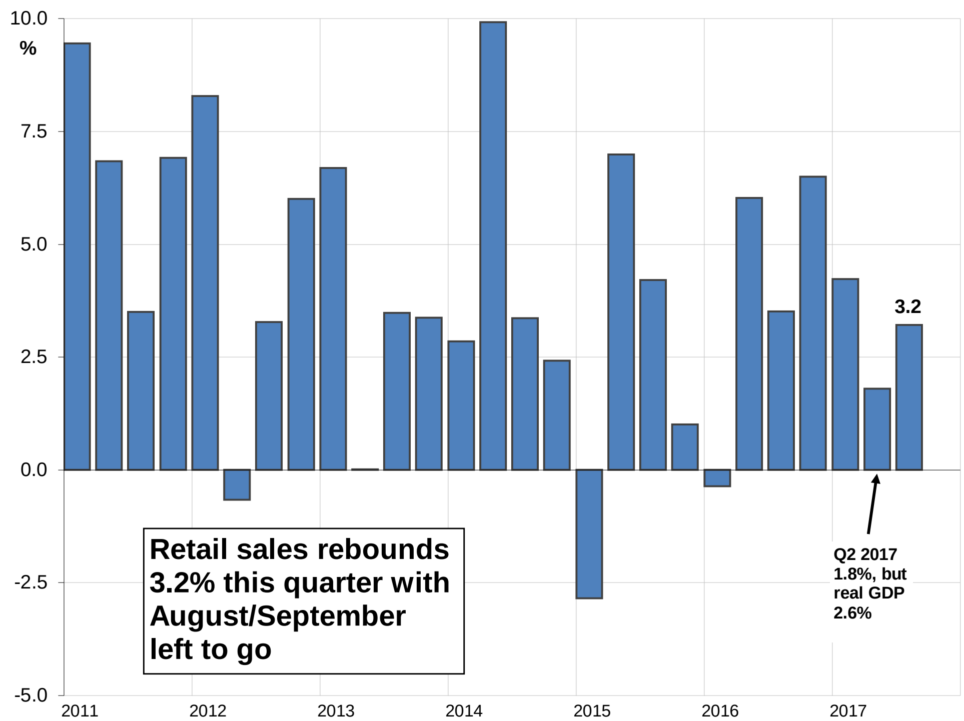
HOW'S THE CONSUMER DOING IN ALL THIS? TWO-THIRDS OF THE ECONOMY

There has been a lot of handwringing concern over economic growth from all sides. But the consumer seems to be taking it all in stride. Consumer spending has been remarkably stable the last few years, excepting some slowdown of expenditures in the first quarter of 2016 and again earlier this year that some blame on the winter weather. There are two basic indicators: one is retail sales released early in the month, and the more comprehensive measure that is part of GDP is personal consumption expenditures (PCE) which comes out later in the month after the GDP report. The market trades more on retail sales traditionally and loses interest in the consumer by the end of the month when PCE is released. Retail sales are durable and nondurable goods bought at the shops and malls, where PCE adds services spending in addition to goods. Services spending is so large that it can offset the trend in spending on consumer goods.



Retail sales were famous in earlier decades as a recession leading indicator where three consecutive monthly declines signaled a recession. Nominal retail spending was fast back in the 80s due to the higher inflation rate so a monthly decline in retail sales was a big deal back then. This year there have been a few monthly retail sales reports that looked on the weak side calling into question the outlook for the broader economy. At least in the market's mind; bond traders "think" kind of stuff.

Percent Changes in Real Consumer Spending

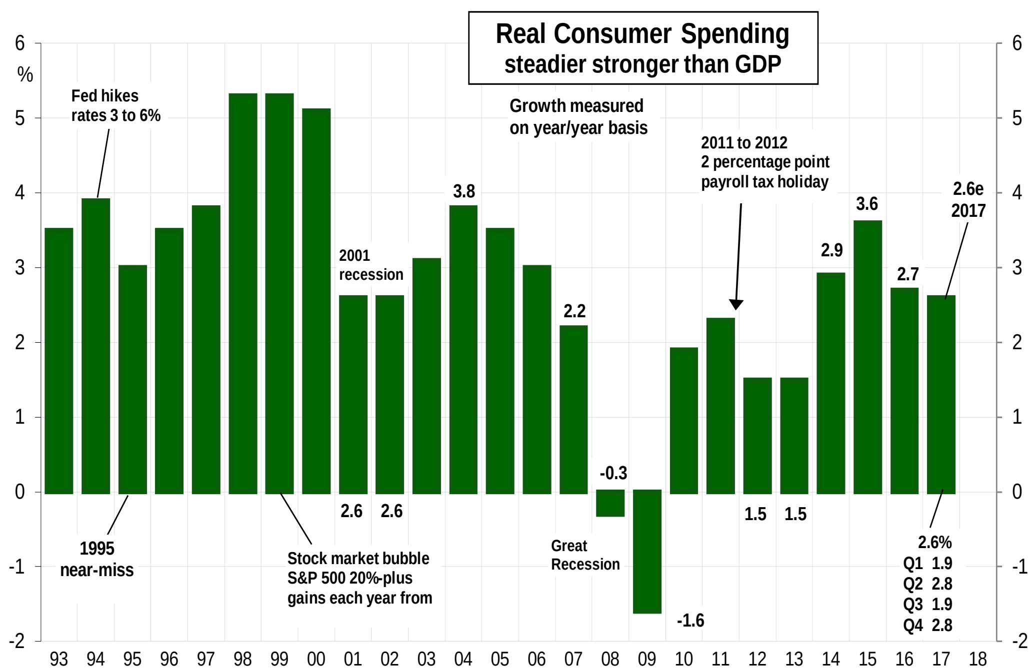
2016 % Total		Q1 16	Q2 16	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17
100.0	PCE	1.8	3.8	2.8	2.9	1.9	2.8	
32.1	PCE Goods	2.1	6.0	3.2	4.7	0.7	4.7	
11.0	Durable goods	1.0	8.5	9.4	9.2	-0.1	6.3	
21.1	Nondurable goods	2.6	4.7	0.1	2.5	1.1	3.8	
67.9	PCE Services	1.7	2.8	2.7	2.1	2.5	1.9	
	Retail sales	-0.4	5.9	3.7	6.5	4.2	1.8	3.2
	Retail sales ex-autos	-0.1	7.1	1.9	5.3	6.2	1.5	1.8
	Auto sales (mln)	17.3	17.2	17.5	17.8	17.1	16.8	16.7

SAAR-Seasonally adjusted annual rates; % Total is nominal expenditures

Weak monthly retail sales reports. Take the Good Friday holiday this year on Friday, April 14 where retail sales fell 0.2% in March, and February was revised from up 0.1% to down -0.3%. This was also the day core CPI fell 0.1%; core CPI basically never declines, although the last time was in January 2010, and the time before that don't ask. A stagnant economy and deflation, a bond trader's dream, although luckily the stock and bond markets were closed for Good Friday. Or take last month's report on Friday, July 14, where June retail sales fell 0.2% after falling 0.1% in May. 10-year Treasury yields fell from 2.33% to 2.28% on the weak economy story in the first half hour of trading following the news.

Despite these weaker retail sales reports, real PCE spending in GDP holds up pretty well on a quarterly basis. Third quarter data didn't look so promising a month ago, but with the revision to retail sales and better July data, third quarter retail sales are running 3.2% with August and September reports still to come.

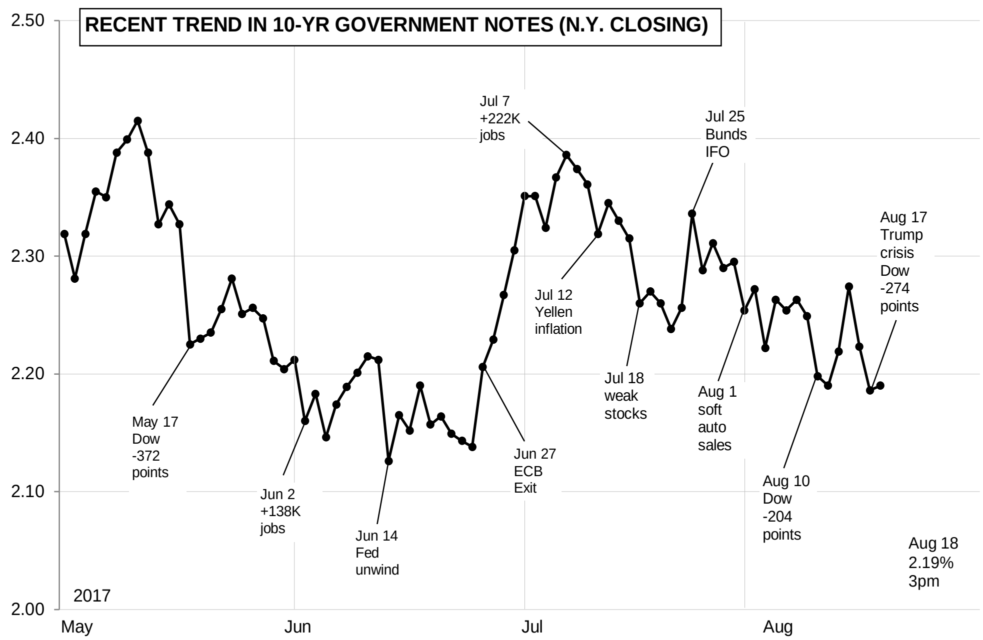
For 2017 it looks like real PCE spending is up about 2.6%, not too different than in 2016. If the consumer were the whole economy, we probably wouldn't be talking about trying to double GDP growth. Tax cuts are still on the table this year it is claimed, although we had a large tax cut, the payroll tax holiday in 2011 and in 2012 and yet real consumer spending did not increase measurably. Anyway, despite the slowdown in car & light truck sales from 17.8 million at an annual rate in Q4 2016, consumer spending overall was okay in the second quarter this year rising 2.8%. Economic conditions in the country are not as weak as Washington thinks.



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

Most of the bond rally took place on Thursday with the 274 point loss in the Dow industrials. The fallout from Charlottesville over the weekend and the disbanding of the President's two advisory councils was part of it. Rumors that Gary Cohn at the National Economic Council was leaving was part of the sell-off in stocks around 10am EDT Thursday morning. Even the Fed meeting minutes mentioned the lofty stock market valuations.



FEDERAL RESERVE POLICY

The Fed meets September 19-20 to consider its monetary policy. A rate hike doesn't seem very likely. The Fed inflation mongers are talking like they won't even vote to hike rates in December if inflation does not pick up. Let's see core PCE inflation is 1.5% and core CPI inflation is 1.7%, and the Fed is somehow trying to convey to the public that this "low inflation" is unacceptable and that business and economic conditions are not fully healed or something worse: stagnation and weak demand are causing the drop in inflation. Another reason not to return rates to normal pre-recession levels. Been so long we forgot when the recession ended.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	16-Aug	9-Aug	2-Aug	26-Jul	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2465.247	2465.221	2465.195	2465.170	479.782
Federal agency debt securities	8.097	8.097	8.097	8.097	0.000
Mortgage-backed securities	1777.975	1769.029	1769.026	1768.999	0.000
Primary credit (Discount Window)	0.002	0.001	0.003	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)	1.708	1.710	1.710	1.710	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	0.036	0.036	0.035	0.085	62.000
Federal Reserve Assets	4509.8	4515.8	4513.4	4512.0	961.7
3-month Libor %	1.32	1.31	1.31	1.31	2.82
Factors draining reserves					
Currency in circulation	1566.526	1567.095	1565.431	1561.976	834.477
Term Deposit Facility	14.733	0.000	0.000	0.000	0.000
Reverse repurchases w/others	92.840	103.950	119.334	103.311	0.000
Reserve Balances (Net Liquidity)	2364.971	2336.315	2291.576	2293.616	24.964
Treasuries within 15 days	3.197	18.655	18.655	11.794	14.955
Treasuries 16 to 90 days	19.648	22.845	22.845	32.799	31.549
Treasuries 91 days to 1 year	321.357	298.287	298.286	276.684	69.272
Treasuries over 1-yr to 5 years	1163.475	1129.964	1129.960	1152.633	170.807
Treasuries over 5-yrs to 10 years	312.184	361.534	361.528	357.353	91.863
Treasuries over 10-years	645.386	633.937	633.921	633.907	101.337

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

Here are our thoughts on the release of the July 25-26 Fed meeting minutes released at 2pm EDT on Wednesday, August 16 before the stock market sell-off on Thursday.

Growing chorus of Fed officials turn against Yellen's inflation bet

Breaking economy news. The minutes of the Fed's July 25-26 meeting. Reading between the lines it looks like they are mostly all in favor of: "Let the balance sheet reduction begin." We mean to say let it begin in September. The press statement said the markets should be looking for an official announcement of the balance sheet reduction "relatively soon," and today's meeting minutes certainly put another log on the fire, heating up our call for them to announce the start on September 20th. The market has no fear of a taper tantrum redux where bond yields sold off dramatically on the possibility that Fed policy would stop buying Treasuries. The balance sheet wind down will throw another $360 billion in Treasuries back to the markets each year, but the market has learned more supply doesn't necessarily mean higher yields. QE purchases of Treasuries were running $45 billion per month ($540 billion per year) before the taper announcement was finally made in December 2013.

Forget the taper or balance sheet wind down or whatever you call it, what about interest rates? Did today's minutes shed any light on the increasingly public arguments over whether a final rate hike should be shelved this year unless the Fed sees more progress on meeting its 2% inflation objective? What is the old saying? "Academic politics are so vicious precisely because the stakes are so small." This is our thought on the arguments made by some Fed officials to slow the already gradual pace of rate hikes to a snail's pace. What? Core PCE inflation is 1.5% right now, and the target is 2.0%? Doesn't look like all that much of a difference. The low-inflation worriers at the Federal Reserve never saw a rate hike they ever liked. They seem to think a rate hike will slow the economy.

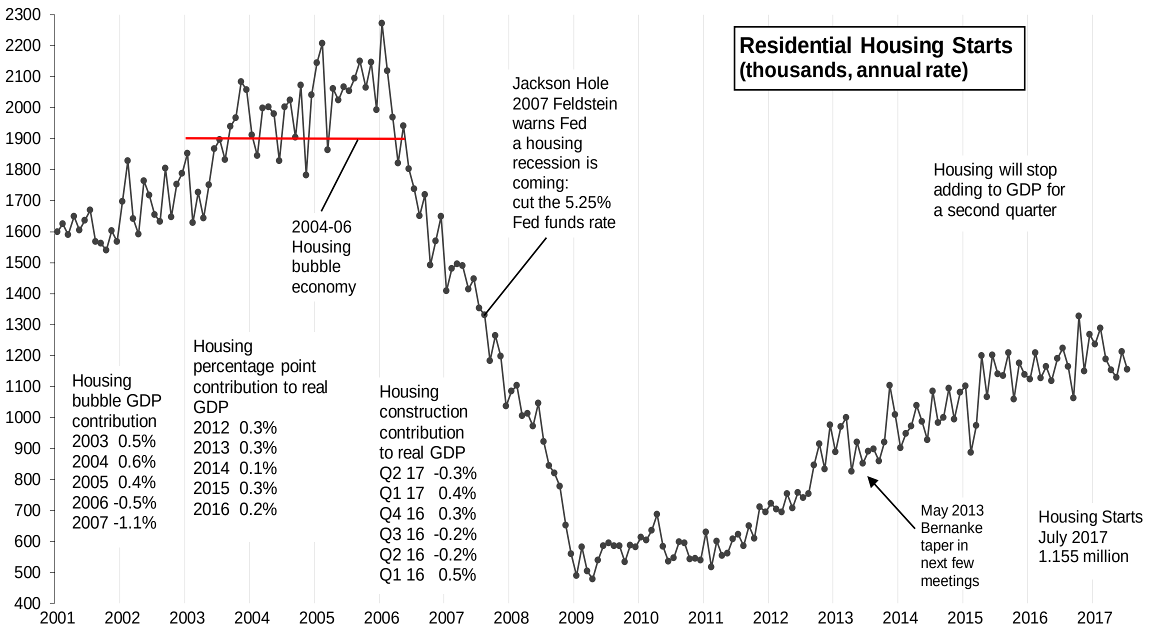
Net, net, the Fed meeting minutes give a green light to a balance sheet reduction announcement at the upcoming September meeting, but as for the decision to raise rates a third time later this year, it looks like markets and investors could find themselves stuck sitting at a red light unless inflation starts moving back closer to target and soon. Stay tuned. Many Fed officials are distrustful of the economy and the outlook for growth unless it is moving fast enough to throw off the hot sparks of more inflation. A final rate hike later this year by the cowardly lions at the Federal Reserve is not done deal. Bet on it.

**Meanwhile, Fed Chair Yellen will speak in Jackson Hole at 10am New York time on Friday, August 25 on the topic of financial stability whatever that is. The 2017 Economic Policy Symposium is on “Fostering a Dynamic Global Economy.” Draghi will attend. Last year Yellen told this conference that the case for a (second) rate hike to 0.75% was strengthening, but the Committee did not vote for a rate hike at the September 2016 meeting even with 9 out of 12 Federal Reserve Presidents in favor of a move. They eventually hiked rates 25 bps at the December 2016 meeting.

OTHER ECONOMIC NEWS THIS WEEK

Housing starts one step forward, one step back and back and back

Breaking economy news. Housing starts one step forward, one step back and back and back. The Fed lifted off interest rates back in December 2015; housing starts are well down the runway, but have not lifted off yet for this recovery, the longest takeoff of any sector of the economy since the recession ended.



As for the devil's details, housing starts fell 4.8% in July to 1.155 million at an annual rate. Housing permits fell 4.1% to 1.223 million in July, so there is hope actual starts will rise somewhat once the paperwork homebuilders have filed hurdles the regulatory process.

Most of the weakness was in multifamily housing starts, but single-unit housing construction of 856K in July remains under the record month of building for this recovery of 877K back in February this year. Geographically most of weakness was in the Northeast and Midwest this month with little change in overall starts in the South and in the West.

Net, net, residential housing construction remains down in the dumps for this long economic expansion which explains why investment in the economy fails to shine. Weak demand in investment is one of the major factors explaining why in the minds of many Fed officials interest rates are so low along with the glut of savings out there. Subdued housing construction activity is likely to make the Fed Doves cautious on the need to raise rates at a gradual pace, with a third rate hike later this year in doubt in the minds of many.

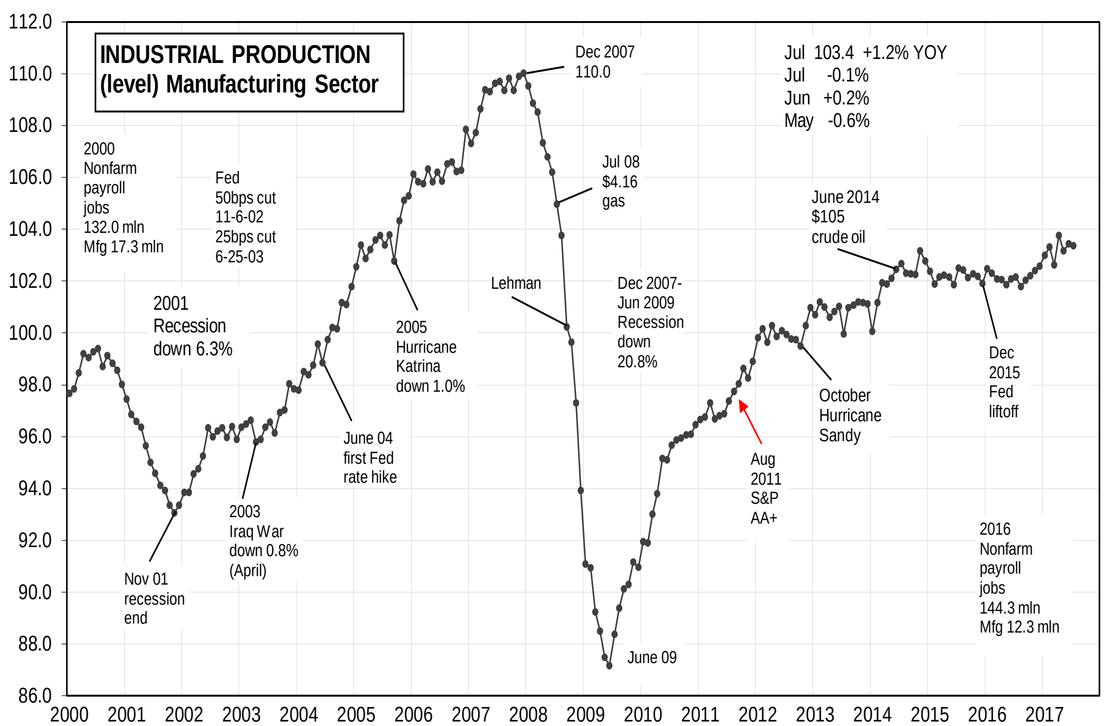
Simply put, no oomph in investment means little chance that investment demand will strengthen economic growth. The decline in residential construction throws a monkey wrench into the Trump economics team's effort to produce faster 3% economic growth that will lift all the boats and better the lives of all who participate in the American economy. Better jobs and more wages was the rallying cry for all the candidates running the gauntlet of the Presidential election last year. It's one of the reasons why the public thinks the economy still isn't okay after one of the longest economic expansions in history.

Housing demand is investment demand that the starved economy needs for growth, and the lack of growth is one reason that inflation remains short of the Fed's objective. Without a little more inflation it will be hard for Yellen to convince those on her left that the economy is strong enough to weather another rate hike. It has never been more true, so goes the housing sector, so goes economic growth and the nation's fortunes. Stay tuned. Story developing.

Second best reading for jobless claims this year; production slow, steady

Breaking economy news. Weekly jobless claims and the Fed's own manufactured statistic, industrial production. The Federal Reserve must have its second team in the game this August along with the NFL as it released the industrial production data early around 850am where the standard release time is 915am. If you are a bond trader, please return to your desks to trade the news. Just kidding. The bond market died months ago as Fed policy became as certain as the night that follows the day.

Second lowest meaning second best reading on the labor market this year. Weekly jobless claims fell 12K to 232K in the August 12 week. The only lower, better reading for job layoffs in 2017 was 227K in the February 25 week. The labor market can't get any tighter than it is right now. The Fed Doves keep waiting on inflation, or rather keep asking where is it? But this is not the right question to ask, and the lack of inflation currently, in their minds at least, is not a reason to postpone a single rate hike, either later this year, or the three forecast for 2018, or the three more penciled in for 2019. Inflation will eventually move up and rates need to move up to normal levels at the same time. The rates path right now is as gradual as it gets anyway: 1.5% Fed funds rate later this year, 2.25% at the end of 2018, and 3.0% at the end of 2019. The path forward for Fed policy could not be any more cautious.



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As far as the Fed's industrial production data, not exactly a beehive of activity, so it's just as well that the President's advisory council, the Manufacturing Jobs Initiative, has been disbanded. Industrial production rose 0.2% in July, which is an increase of 2.2% since last year, anchoring expectations that the economy's growth potential is also 2%, short of All The President's Men's ambitions. Most of the activity is in Mining, where the rebound in crude oil prices, allowed for a 10.2% jump in mining production, oil & gas drilling to you. Manufacturing production actually fell back a tenth in July and is up a little less at 1.2% year-on-year. Auto output fell sharply although other industries saw an increase in production keeping the manufacturing production decline modest at just 0.1% in July.

Net, net, if the economy were a river its forward progress would be hard to see and growth remains less than Trump's economics team is driving for. Those factories built overseas remain overseas for now with little sign that the U.S. will once again become the manufacturing wonder of the world.

Even if factories were brought back to U.S. shores using carrot or stick incentives, there would be no labor pool for companies to draw on. Nine years after the recession ended, most Americans have found work. Companies continue to hoard labor which keeps the weekly job layoff statistics at rock-bottom lows. Job openings are at record highs as the need for workers is much greater than the available pool of candidates from which to choose from. The Fed has never faced this situation before where interest rates never got put back to normal before the labor market reached full employment. Sad. The Fed's leadership is ignoring history and is instead listening to the voices of a few who are concerned there is not enough inflation. Stay tuned. The economy continues to advance at a moderate 2% pace. For now.

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