Financial Market Weekly

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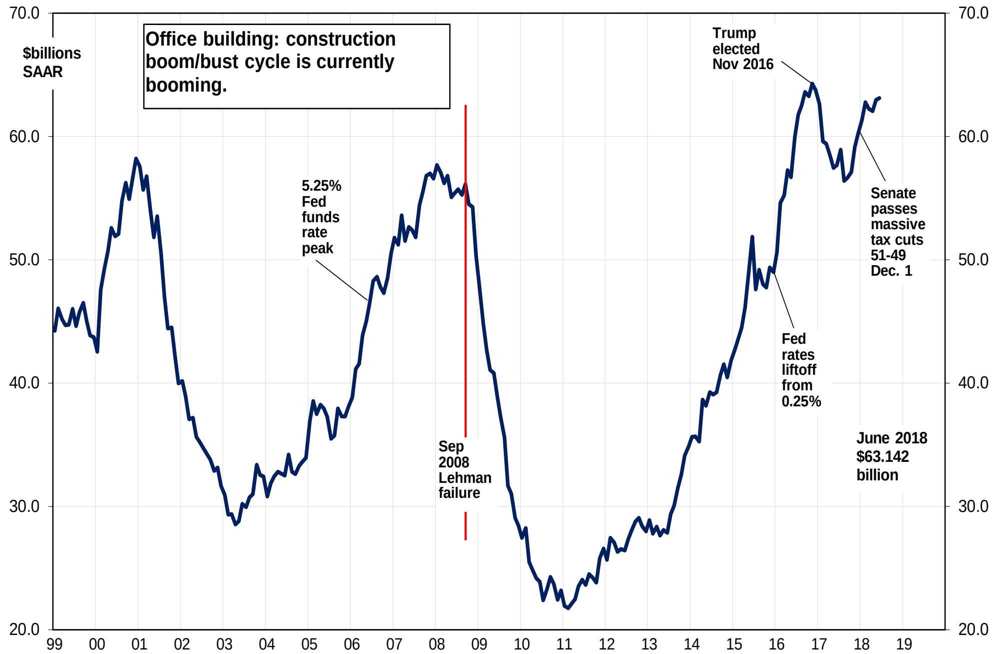
TAX CUTS NOT GOING FOR INFRASTRUCTURE, OR AT LEAST "STRUCTURES" WHICH IS PART OF GDP INVESTMENT

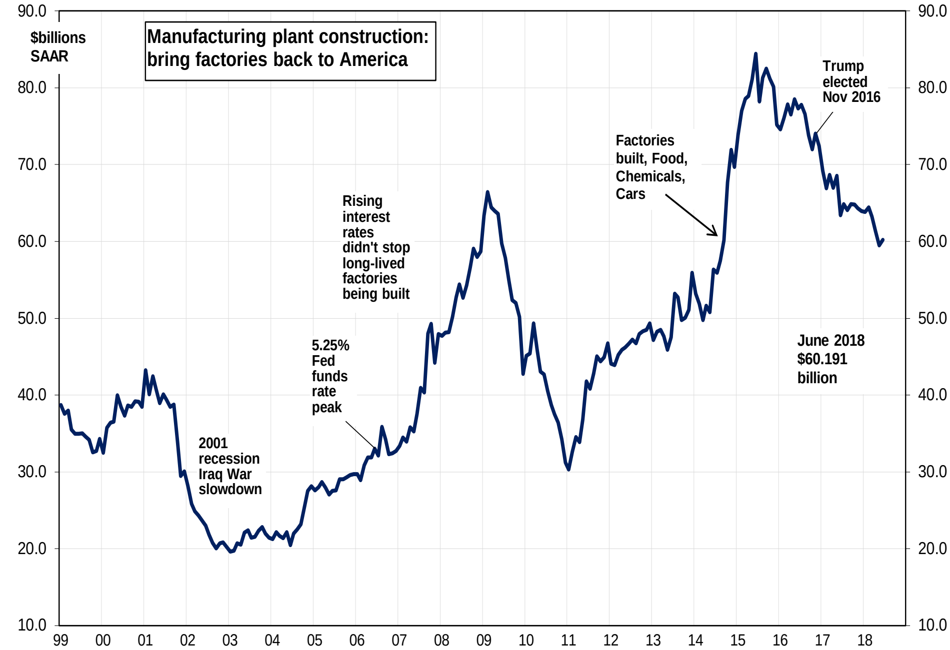


Investment in structures is an important driver of economic growth always. Increased investment spending, factories, warehouses, offices, shopping centers, has an immediate impact on GDP of course, but it also has longer-term effects on economic growth. What we are building today for a better tomorrow.

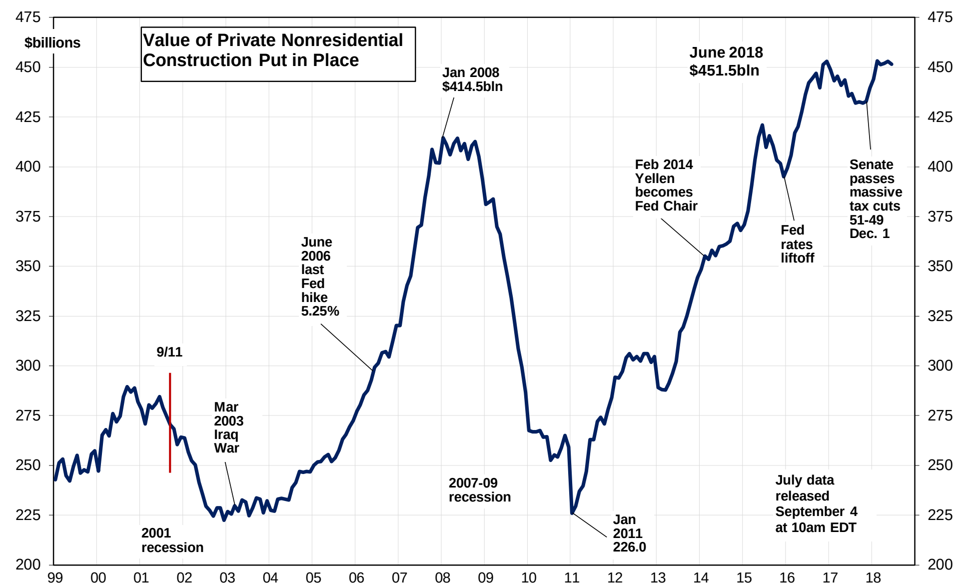
Investments made today also last for a long time. Structures are very long-lived. Just look at Trump Tower built in 1983. This expansion began its tenth year in July and is headed for the record books next summer if it breaks the ten-year expansion from the Clinton years in the 1990s. Fine. But how many structures need to be built to keep an economy running fast and strong in any given cycle. Probably less than you think. Office building is $63.142 billion in June 2018 at an annual rate. It is probably a coincidence that office construction peaked in November 2016 when Trump won the election, and in

Nonresidential Construction $bln	June 18	% Chg	2018 YTD	2017 YTD	Peak Year 2008	Peak % Chg
Total private	451.494	1.8	450.839	442.966	408.624	10.3
Lodging	30.709	8.4	30.276	27.937	35.364	-14.4
Office	63.142	5.4	62.435	59.214	55.382	12.7
Commercial	87.528	5.0	88.337	84.100	82.827	6.7
Health Care	32.880	3.2	33.233	32.195	38.381	-13.4
Educational	19.933	-0.5	20.466	20.565	18.626	9.9
Religious	3.096	-13.2	2.642	3.044	7.201	-63.3
Amusement	14.462	5.0	14.174	13.505	10.534	34.6
Transportation	17.149	19.6	16.584	13.862	9.898	67.5
Communication	24.466	3.2	25.525	24.742	26.384	-3.3
Power (oil & gas too)	97.157	-1.4	93.853	95.226	68.608	36.8
Manufacturing	60.191	-7.7	62.088	67.291	53.397	16.3

any case, $60 billion plus of office construction each year is still a lot, hopefully there is no overbuilding like that which is thought to have occurred prior to the 2007-09 recession. Companies probably didn't need an historic tax cut to encourage new construction of offices. But office building is slightly better since the Senate passed the massive tax cuts legislation by a 51-49 vote on December 1, 2017.



Part of making America great again is making goods again in factories here. We aren't building any, or better put, we aren't building even more factories. Construction of manufacturing plants was $60.191 billion in June 2018. It has trended down since Trump was elected, but the declining trend is more of a slowing one: it is really more of a return to normal after a surge of factories were built in 2014 into 2015 for food, chemicals and automakers.



Structures ($billion)	Q1 16 531.2	Q2 16 539.7	Q3 16 555.1	Q4 16 556.7	YOY% 3.3	Q1 17 577.5	Q2 17 588.3	Q3 17 585.3	Q4 17 590.6	YOY% 6.1	Q1 18 614.9	Q2 18 641.5	% 17.2
Commercial and health care	159.7	167.2	176.8	180.6	23.0	179.7	181.1	179.9	181.6	0.6	189.2	189.8	9.0
Manufacturing	76.2	77.6	76.2	72.9	-7.5	68.3	66.2	64.5	64.2	-11.9	63.7	61.4	-8.7
Power and communication	104.5	110.6	118.9	121.0	11.9	122.4	116.3	112.7	109.8	-9.3	116.6	119.6	17.9
Mining exploration, shafts, and wells	87.3	72.4	70.0	68.0	-34.7	91.6	108.9	112.5	116.5	71.3	124.7	148.0	54.1
Other structures *	103.5	111.9	113.2	114.3	13.1	115.6	115.8	115.7	118.5	3.7	120.7	122.7	7.1
* Religious, educational, vocational, lodging, railroads, farm, and amusement and recreational structures, other												Annual rate	

We haven't discussed the oil & gas drilling effect on America's investment in structures. These come out in the GDP data that were recently revised (back to 1929 if you have the time). Structures include, Commercial (explosion of Amazon warehouses), manufacturing, power/communication, Other (Religious has plummeted the last decade, see table page one.). Oil and gas drilling was boosted during the fracking trend starting late 2011. Structures investment is up 17.2% so far this year, but if mining exploration, shafts and wells had not risen 54.1% to $148.0 billion, total structures would be up 6.6% the first six months of 2018. How far can fracking drive mining structures? It's $148.0 billion in Q2 2018, and the peak before the oil crash in 2015 was $202.2 (Q4 2014). Still room to grow.

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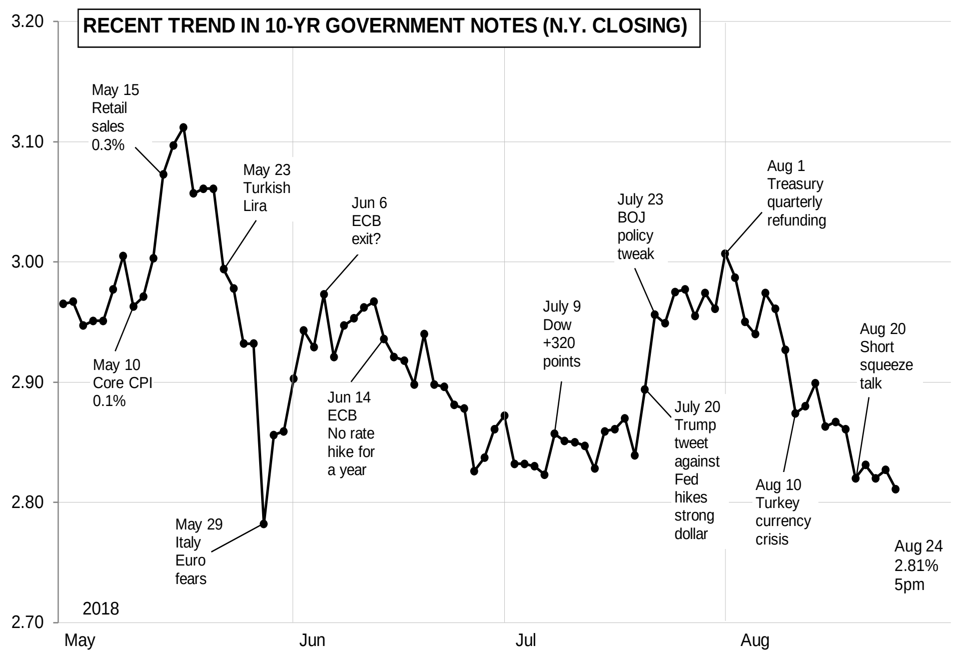
MARKETS OUTLOOK

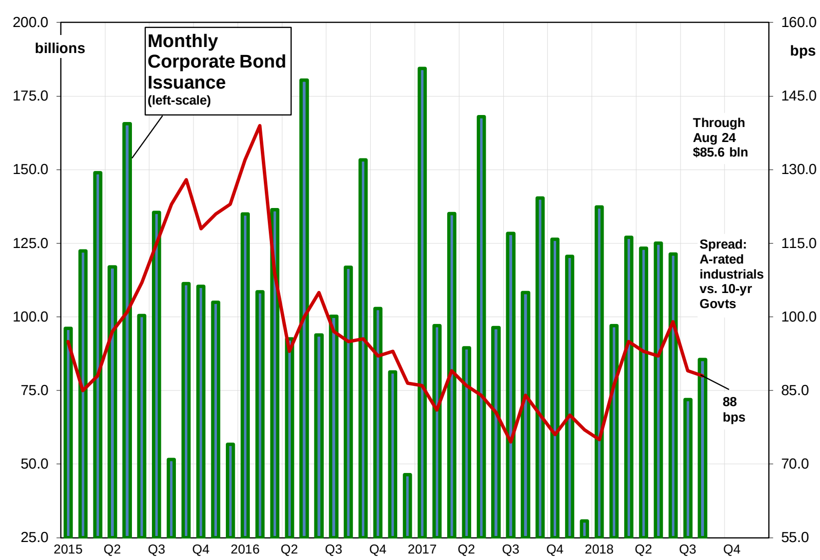
	29-Jun 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.99	3.10	3.20	3.35	3.45	3.60	3.60	3.75	3.85	3.80	3.95
10-Yr Note	2.86	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95
5-Yr Note	2.74	2.70	2.90	3.10	3.20	3.45	3.45	3.65	3.75	3.80	3.95
2-Yr Note	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)



Ten-year Treasury yields were 2.81% on Friday versus 2.86% the week before. The bond rally continues, as most rallies do without the best of reasons. Fundamental reasons. The downward move was all on Monday on vague talk of a short squeeze developing in the Treasury market. Too many betting yields would move higher. The bond rally cannot go too far with the Fed hiking rates to 2.5% in December. On the other hand, the yield curve could invert earlier than we thought. We have the 2-year to 10-year curve inverting in Q4 2020. More Treasury supply next week: $36 billion 2-years Monday, $37 billion 5-years Tuesday, $31 billion 7-years on Wednesday. 2-yrs were $32 billion in April, when 5-yrs were $35 billion, 7-yrs $29 billion.

CORPORATES: FLUOR CORP, HONDA, NORTHWEST PIPELINE, TIMKEN

Corporate offerings were $6.5 billion in the August 24 week versus $30.2 billion in the August 17 week. On Wednesday, Timken priced a $400 million 4.5% 10-yr (m-w +25bp) at 170 bps (Baa3/BBB). The fabricated metals company (ball bearings) will use the proceeds to finance its acquisition of Cone Drive and Rollon. 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

Powell: we're not overheating so gradual pace continues, but for how long?

Breaking economy news. [Fed Chair Powell speech]() from the Mountain Top in Jackson Hole. The economy is not overheating is the first headline we saw and if so, there's not a good reason for Fed officials to take the punch bowl away from this long economic expansion, not a good reason for the Fed to lift interest rates above normal levels of 2.75 (four votes) to 3.0 (5 votes) percent. Uh-ho, this means they are closer to finishing up with these gradual hikes than many thought. Won't be long now for Fed rate hikes if they go twice more this year ending at 2.5% in December.

Okay calm down, maybe not so much breaking news here. The stock market is just sitting here with Dow industrials up 64 points on the day when the Jackson Hole speech headlines appeared at 10am EDT. This is just Powell's guess on the outlook for the economy and inflation and interest rates today. No overheating today, but with the unemployment rate low and the economy at full employment today, inflation pressures are building and maybe inflation moves up to levels in the next couple of years that Fed policymakers are less comfortable with.

Monetary Policy in a Changing Economy. Almost forgot the title of his speech, what on earth does he think is changing other than Wall Street economists being unable to take a deduction for state & local taxes. (Luckily, their numbers continue to decline.) Well, he noted some longer-term structural challenges that are beyond the Fed's abilities to change. Sounds like we are doomed, only that he is not an economist so wouldn't or at least shouldn't say such a thing. Real wages especially for low and medium income workers have grown quite slowly. Economic mobility has declined to a level lower than in other advanced economies. The Federal budget deficit is on an unsustainable path. Productivity has been low for a decade now and must rise if incomes are to rise over time. (Sounds like if we all worked harder we would get more money.)

"The second half of the 1990s confronted policymakers with a situation that was in some ways the flipside of that in the Great Inflation. In mid-1996, the unemployment rate was below the natural rate as perceived in real time, and many FOMC participants and others were forecasting growth above the economy's potential. Sentiment was building on the FOMC to raise the federal funds rate to head off the risk of rising inflation. But Chairman Greenspan had a hunch that the United States was experiencing the wonders of a "new economy" in which improved productivity growth would allow faster output growth and lower unemployment, without serious inflation risks. Greenspan argued that the FOMC should hold off on rate increases."

All this is to us is another example of Powell's reluctance to raise interest rates.

Greenspan had a hunch all right, holding his ground against raising interest rates from 5.25 percent. The Fed funds rate was 5.25% then against core PCE inflation of 1.9% in 1996. The latest reading of core PCE is also 1.9% and the Fed funds rate is 2.0%.

Net, net, it was a very long speech for those sitting in the room on folding chairs. There is nothing in the Fed Chair remarks other than his summarizing the latest consensus position of policymakers that interest rates need to continue moving up at a gradual pace. We knew that already and the market odds of a September rate hike are over 90% and the odds of a rate hike in December are over 60%. After 2.5% who knows

Year-ends for Interest Rates

Percent %	2018	2019	2020	2021
Eurodollar futures	2.605	2.95	2.93	2.905
Fed's June forecast	2.5	3.25	3.5	

Eurodollar futures price where 3-month Libor will be in the future.
Friday, August 24, 2018 3-month Libor 2.31%

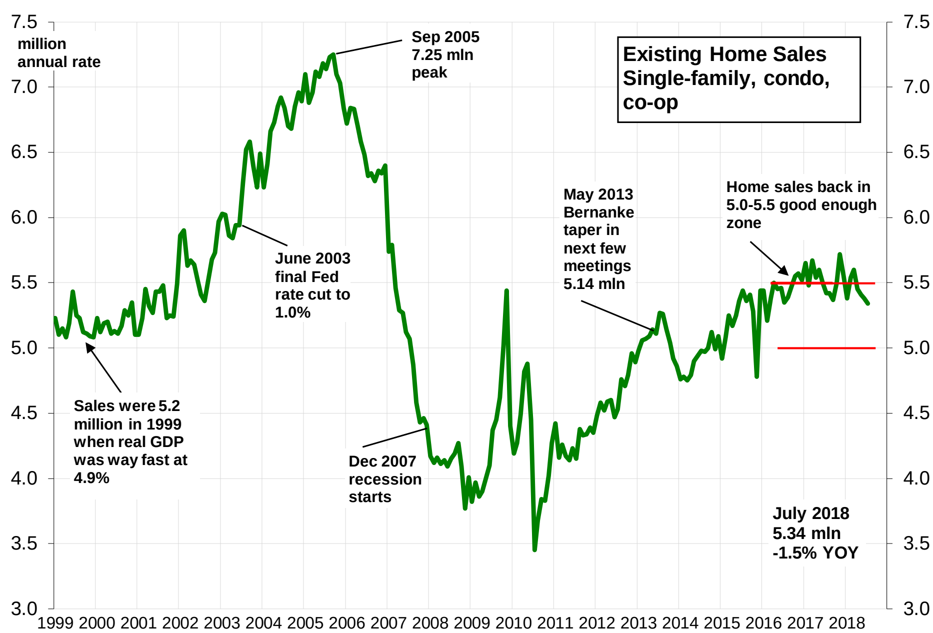
however, further rate hikes depend on whether the economy is overheating, and that means whether inflation is moving higher and expected to move even higher than that. Core PCE inflation is 1.9% year-on-year, and our guess is the Fed won't become alarmed unless it moves close to 2.5%. Without more inflation, the odds of many more Fed rate hikes above 3% becomes hard to imagine. Stay tuned. Story developing. Their forecast is that rates will be 3.5% at the end of 2020, and on September 26 they will announce where they think rates will be at the end of 2021. It's more important than you think. 2021. Bet on it.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	22-Aug	15-Aug	8-Aug	1-Aug	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2324.540	2324.391	2336.925	2336.876	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1706.731	1708.187	1709.545	1709.544	0.000
Primary credit (Discount Window)	0.010	0.007	0.003	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)	1.720	1.719	1.719	1.716	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	0.068	0.106	0.100	0.100	62.000
Federal Reserve Assets	4276.5	4276.5	4305.6	4303.0	961.7
3-month Libor %	2.31	2.31	2.34	2.35	2.82
Factors draining reserves					
Currency in circulation	1675.101	1673.616	1671.632	1669.707	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	1.126	0.315	1.659	0.795	0.000
Reserve Balances (Net Liquidity)	1902.785	1918.744	1966.103	1966.432	24.964
Treasuries within 15 days	20.932	0.000	23.069	23.069	14.955
Treasuries 16 to 90 days	77.244	63.772	63.772	39.939	31.549
Treasuries 91 days to 1 year	326.060	360.363	305.548	329.380	69.272
Treasuries over 1-yr to 5 years	1016.033	1016.026	1028.055	1028.048	170.807
Treasuries over 5-yrs to 10 years	267.171	258.449	296.639	296.622	91.863
Treasuries over 10-years	617.099	625.780	619.841	619.818	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

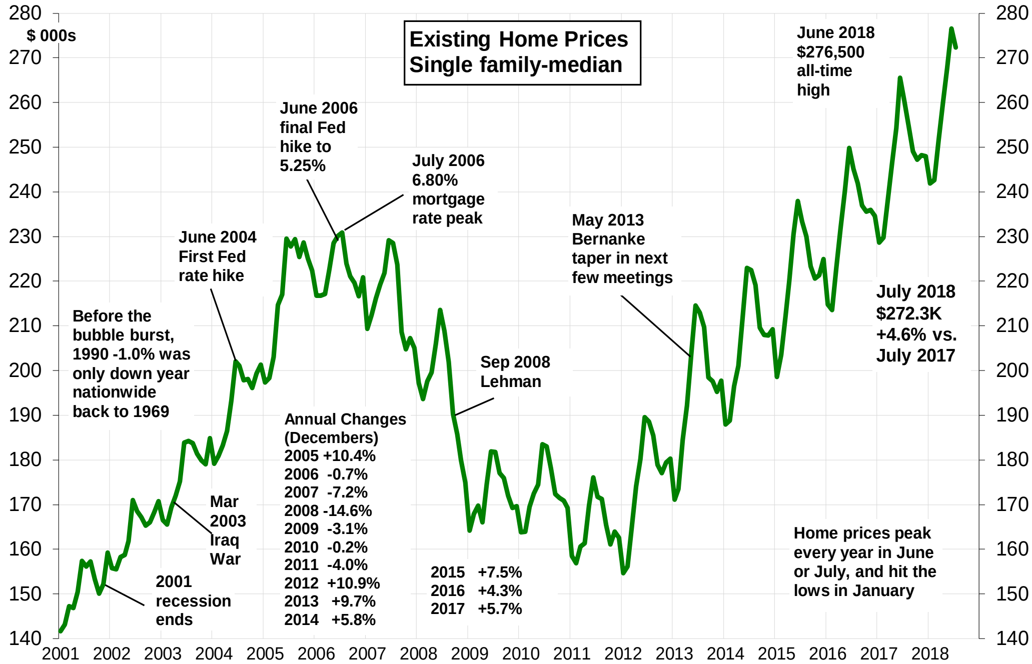
OTHER ECONOMIC NEWS THIS WEEK

Existing home sales can't rev up to mid-2000s bubble levels (Wednesday)

Breaking economy news. Existing home sales fell if that's the word 0.7% in July to a 5.34 million annual rate of turnover. Home sales are drifting lower and are now the lowest since February 2016. Americans seem to be content with their tax cuts largesse to stay at home and remodel rather than moving on up to the Eastside or anywhere actually. A lot of this seems to be driven by the new trend of retiring baby boomers to stay put for now rather than move elsewhere or downsize in preparation for their golden years. Additionally, there is so much work available that workers are unwilling to sell and relocate for better opportunities. Only sales in the West bucked the trend this month, up 4.4%, with modest declines in the South and Midwest, and a bigger 8.3% drop in the Northeast.



It is cheaper to buy an existing single-family home if you graph home prices and get out a magnifying glass. You in your golden years need a magnifying glass anyway most likely. Single family homes cost $272,300 in July, off four thousand two hundred bucks from record all-time highs of $276,500 in June. What a deal. Existing home prices peak every year in June during the height of the summer selling season and then trend down to the lows in January during the winter. Listen to your realtor next time, will ya? Existing home prices fell last July by 2.0% even more than the 1.5% drop in July 2018 reported today. Home prices are still up 4.6% from year ago levels which is greater than any measure out there of worker wages, and may help answer the question why sales turnover is the weakest in a couple of years. Not enough pay in worker paychecks to make the down payment on a new home.



Net, net, if existing home sales don't pick up the pace then we cannot be as confident that the economic expansion will break the record for longevity set during the Clinton years a couple of decades ago. A lot of money gets spent on these money pit new and existing homes after purchase, and consumer spending on furnishings, appliances, and other sundry decorations may languish if existing home sales activity continues to slide.

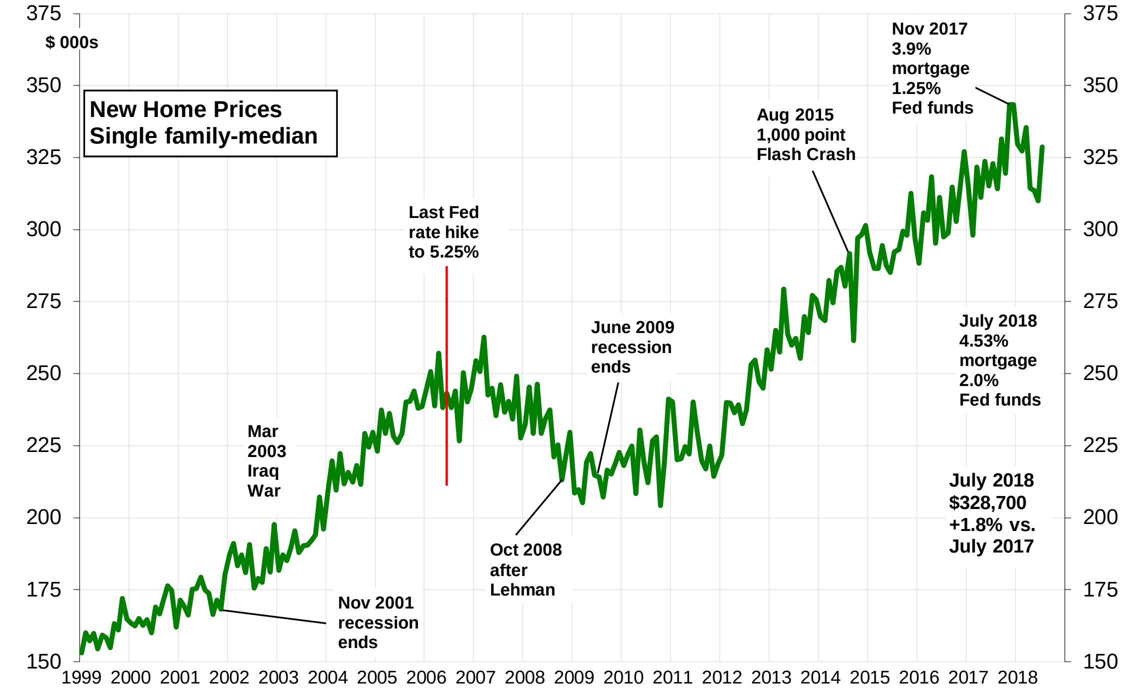
The break or downturn in sales isn't sharp enough to identify a reason behind the slide in sales activity, the soft data may be just another sign that many have already bought a new home already. There is a business cycle for consumers as well. They postpone buying homes in recessions then slowly resume purchases as the economy improves. But at a certain point, everyone has already made their move for now. Stay tuned. Existing home sales are strong enough to keep wind in the economy's sales, but growth won't be any faster than trend if purchases of appliances and furniture start to slow.

New home sales slip as tax cuts being spent elsewhere (Thursday)

Breaking economy news. New home sales decline marginally to new lows for the year. Sales activity is slowing with a whimper not with a bang, so the trade war uncertainty which poses risks to the economic outlook doesn't seem to be having a worrisome effect on new home buyers yet. The tire has a slow leak, no chance for a blowout.

It is just that new home sales have no get-up and go as a leading economic indicator and sales are certainly not consistent with the Trump administration forecasts of sustainable 3% GDP growth. It is a mystery why the consumer is gun shy on putting those tax cuts dollars to work on big ticket purchases like new homes or a new car or SUV this summer. July car sales and new home sales are weak, and there is no question that this will make a repeat of the second quarter's 4.1% growth rate virtually impossible. There is no demand out there from the consumer for taking a risk on the future and plunking down the money to buy a new home which makes us worry a little over the economic outlook in the second half of the year.

Regionally the story is more complicated with a 23K drop in the Northeast offset by at 17K rise in the West and 7K increase in the Midwest. But then again, the biggest market down South fell 12K. A mixed bag regionally. There is a solid uptrend in the South at least, despite declines the last two months, although every area of the country has sales that are nowhere near the extremes seen during the housing bubble a decade ago. We still wonder about what that means. Maybe Fed officials will discuss this at Jackson Hole, the symposium this year is "Changing Market Structure and Implications for Monetary Policy." Although maybe they don't mean change in the housing market.

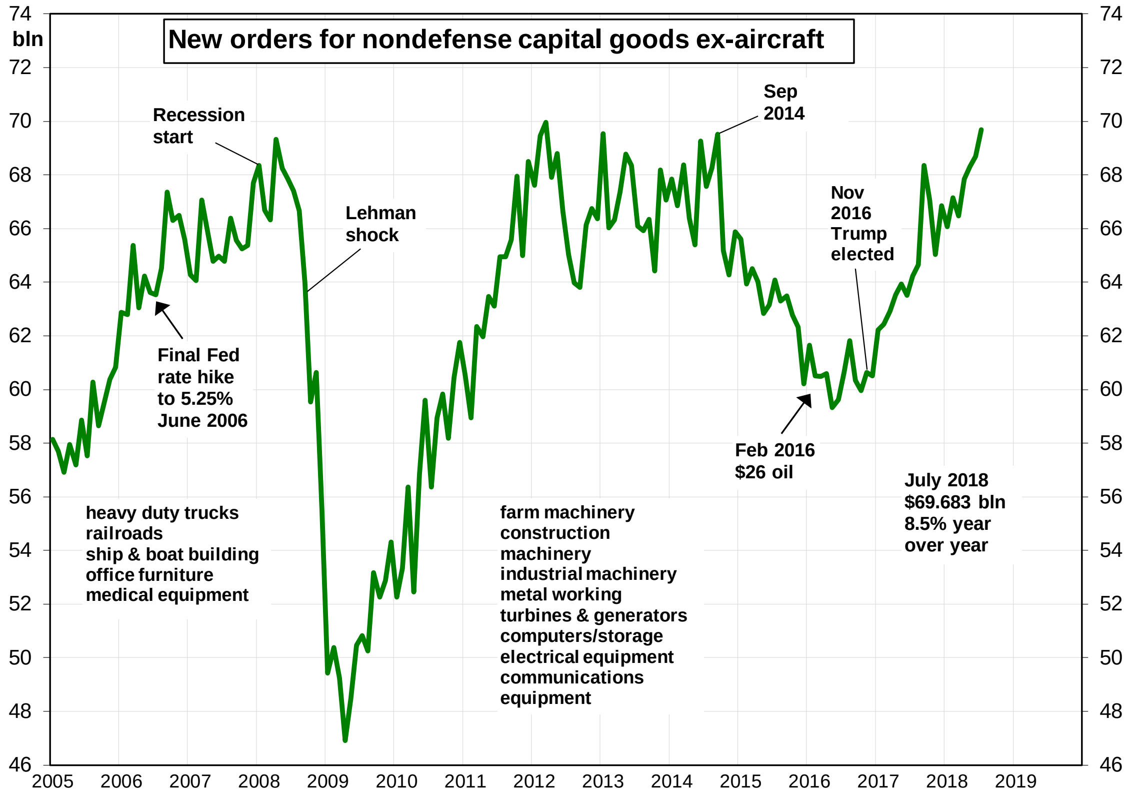


Net, net, new home sales cooled in July as consumers are spending their tax cut monies elsewhere. Cooling new home sales are not weak enough to cause Fed policymakers to rethink their gradual course of rate hikes where another rate hike is expected soon at the September meeting. The economy has seen changes and these will be discussed at Jackson Hole this week. Housing was one of the risks detailed in the Fed meeting minutes released yesterday. Indeed, new home sales are slowing, nothing scary, no need to skip a rate hike in September, but maybe Fed Chair Powell is a little more cautious on the outlook at Jackson Hole, less certain of the need to continue on the gradual path laid out at the June meeting. Stay tuned. Story developing. Maybe one of those six rate hikes the Fed has penciled in the next two years comes off the table.

Business order books building in the third quarter (Friday)

Breaking economy news. It's early out here in Jackson Hole, yawn, but we will try and write this report up. Durable goods orders fell, 1.7% in July, but who cares, because our proxy for business investment spending on equipment jumped, not rose or increased, it jumped 1.4% in July (annualize it) and was revised up in June. Nondefense capital goods orders ex-aircraft are 1.8% higher, stronger, better than we knew before this morning's report. No uncertainty or hesitation over the economic outlook posed by rising trade risks. The order books are solid over the last year with primary metals up 16.8%, fabricated metal products up 11.0%, machinery 6.5%, computers 7.7%, communications equipment 8.1%, and robots up 113%, that's right 113%. Solid as a rock. Bet on it.

Net, net, business has taken some of that historic tax cut money and put it to work with the purchase of brand new equipment, and this should keep the economy's engines purring for the rest of 2018. More investment from companies signals they are bullish on the economy and CEOs are certain that the demand for the goods and services they produce will remain firm. The Fed is right to continue its gradual pace of rate hikes, and today's report suggests that they would be wise to follow September's rate hike with another one in December to 2.5%. 2.5% is the lower bound of so-called neutral rates, the range being 2.5 to 3.0 percent, and the economy is not overheating certainly, so there is not a strong argument to be made for raising interest rates above neutral levels for the economy. Not if it's going to garner some boos and tweets from the White House, so these rate hikes might be less frequent in the years to come. What did Kansas City Fed President George say last night? The former hawk saying she didn't even know if the Fed funds rate would get to 3 percent. Wow. Times are changing indeed.



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