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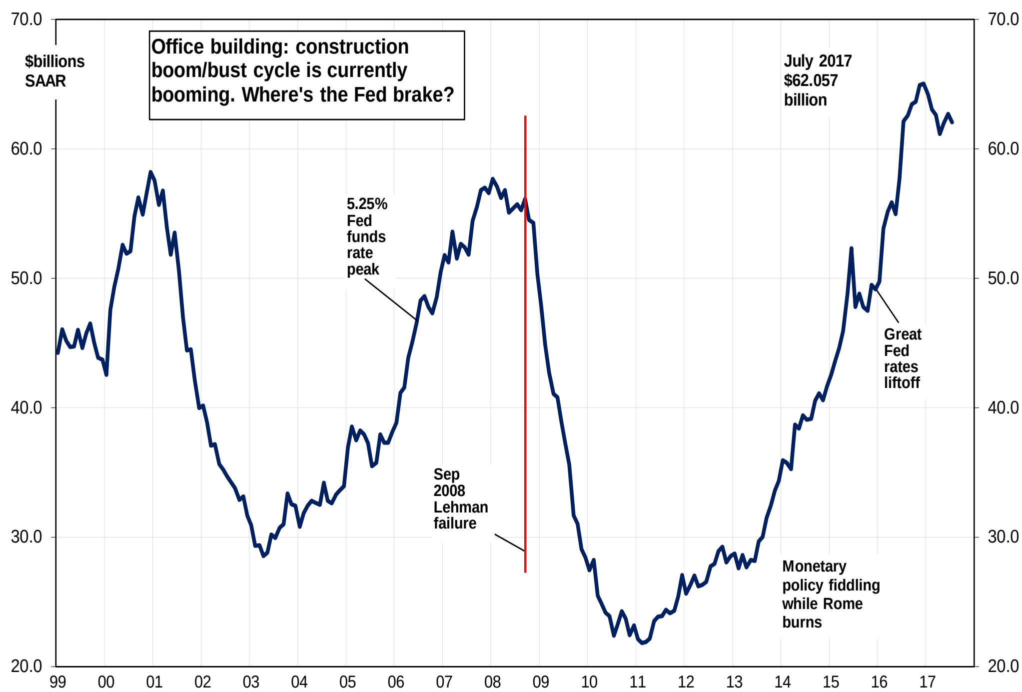
NOW STRUCTURES ARE LEVELING OFF: THEY BUILT IT ALREADY

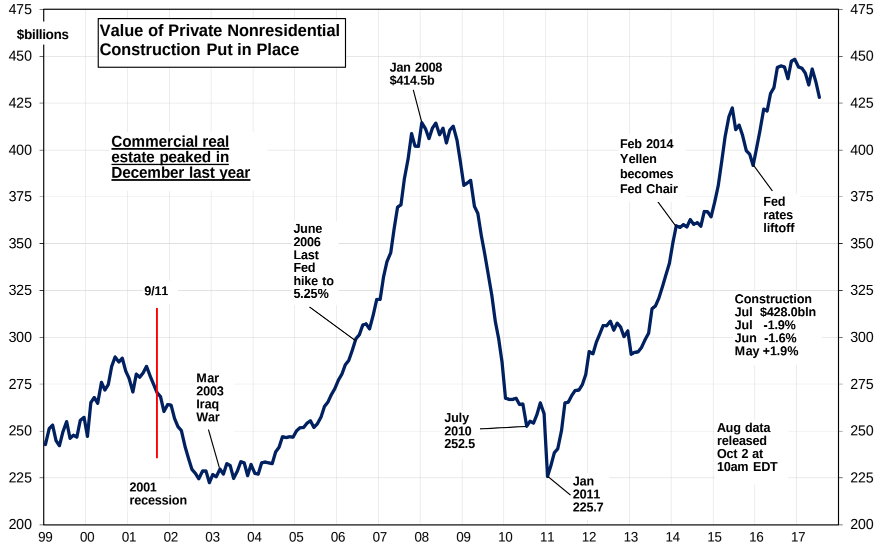
More signs of the economy's age keep showing up in this the ninth year of steady growth. Business investment in structures looks like it is leveling off. The message to Fed officials is they don't need low rates to encourage business investment in structures because they built it already this cycle. Companies have built factories, warehouses, offices, shopping centers. Did it. Been there done that.



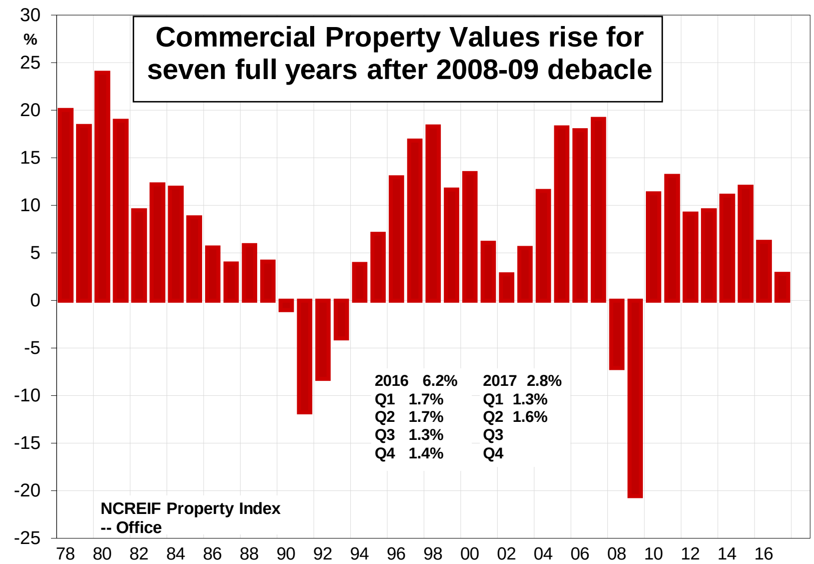
Office building construction above has more than recovered from the Great Recession and in fact has peaked for now at $65.048 billion in December 2016 apparently after the Fed's second rate hike to 0.75% on December 14, 2016. The Fed's restrictive policy is starting to bite.

Nonresidential Construction $bln	Jul 17	% Chg	2017 YTD	2016 YTD	Peak Year 2007	Peak % Chg
Total private	427.994	3.7	438.695	422.987	369.110	18.9
Lodging	26.882	7.0	27.451	25.657	27.481	-0.1
Office	62.057	12.4	62.546	55.644	53.793	16.3
Commercial	79.314	15.6	81.765	70.702	85.466	-4.3
Health Care	29.204	-1.0	29.758	30.070	35.552	-16.3
Educational	18.951	6.0	20.316	19.171	16.636	22.1
Religious	3.133	-8.4	3.232	3.528	7.523	-57.0
Amusement	13.033	10.3	12.740	11.550	10.180	25.1
Transportation	13.873	0.5	13.560	13.491	8.983	51.0
Communication	21.749	4.3	22.433	21.501	27.399	-18.1
Power (oil & gas too)	93.633	0.6	94.876	94.356	53.965	75.8
Manufacturing	65.584	-9.2	69.202	76.238	40.086	72.6

Seriously now, nonresidential construction (as in greater "investment" that Fed officials say they want to see) has declined and will be adding less to real GDP growth. Office construction in the table above was $62.057 billion in July 2017 which is 14.5% of total nonresidential construction of $427.994 billion for the month (annual rates). <u>Offices are long-lived and the economy may have built enough offices for this business cycle.</u> The definition of "office" building is broad: administration buildings, computer centers, office and professional buildings. Offices can also be for the entertainment industry, like movie/TV offices, and for financial institutions as well.



Total private construction is still up 3.7% over the first 7 months this year relative to cumulative spending in 2016, but the July data itself is lower than this year-to-date 2017 average. The "peak" year of 2007 in the table is arbitrary as it represents the last year prior to the recession even though construction spending is a lagging economic indicator and typically doesn't slow for many months into a recession.



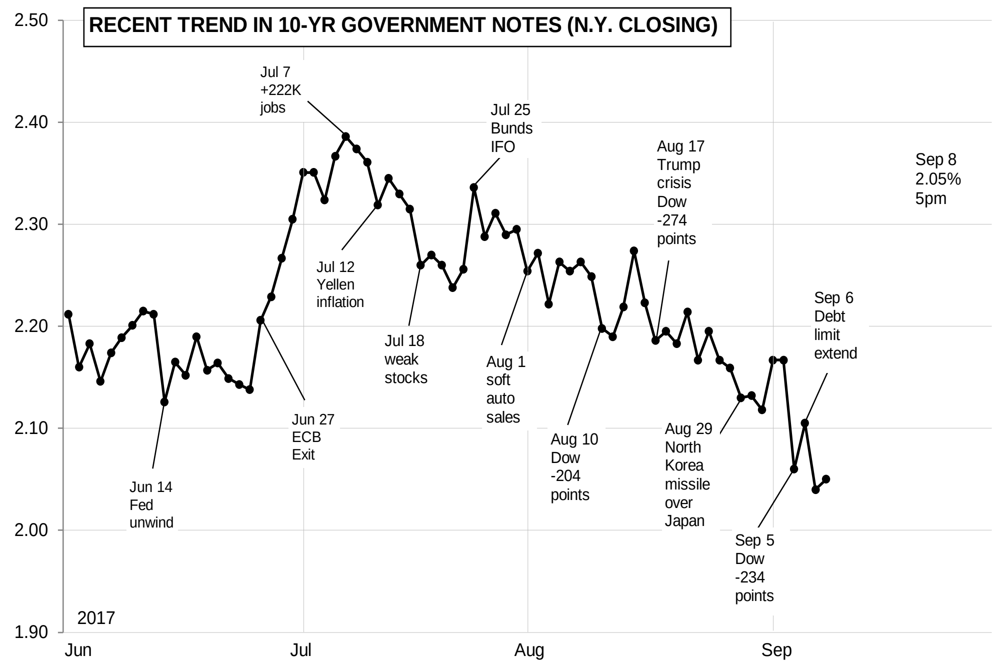
Investment spending on structures in the GDP accounts is much stronger this year at the halfway mark, rising 13.7%. The recovery is almost all in oil & gas drilling which at $102.5 billion in the second quarter of 2017 is double the low of $59.1 billion in Q4 2016. Almost all the other components are down so far in 2017 except for commercial and health care structures. Manufacturing is down 5.2% in 2017, power and communication down 11.3% and Other structures, education, lodging, railroads, recreation are declining 2.7%.

Structures ($billion)	Q1 15	Q2 15	Q3 15	Q4 15	YOY%	Q1 16	Q2 16	Q3 16	Q4 16	YOY%	Q1 17	Q2 17	%
	552.7	556.8	536.2	504.3	-9.2	504.6	508.7	525.6	525.8	4.3	548.4	561.9	13.7
Commercial and health care	136.6	145.7	144.6	146.4	7.9	155.0	161.7	172.4	177.3	21.1	178.8	180.1	3.2
Manufacturing	76.0	80.7	78.6	75.3	11.2	74.8	74.0	74.5	69.2	-8.1	69.9	67.4	-5.2
Power and communication	105.5	121.5	118.0	107.1	11.2	111.3	117.9	123.0	122.3	14.2	118.6	115.4	-11.3
Mining exploration, shafts, and wells	154.4	122.7	106.6	89.9	-48.5	74.6	60.2	59.5	59.1	-34.3	83.2	102.5	146.9
Other structures *	80.2	86.1	88.5	85.7	5.9	89.0	95.0	96.2	97.8	14.1	97.9	96.5	-2.7
* Religious, educational, vocational, lodging, railroads, farm, and amusement and recreational structures, other											Annual Rate %		

The Fed is counting on more investment, and some see the relative lack of investment as a reason why interest rates remain low, but it is looking increasingly like the economy has made enough investment in structures for now, except perhaps for some further recovery in the oil & gas sector.

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



The bond rally from "2.40%" in early July extended itself this week (as we seem to write every week). Most of the move came on Tuesday to 2.06%. Dow industrials fell 234 points on Tuesday after the long Labor Day weekend in part on North Korea having a hydrogen bomb now. 10-yr yields followed Bunds down at the ECB meeting on Thursday as Draghi said they could be patient on recalibrating those QE purchases. Yields closed Friday at 2.05%. The low for the move also on Friday was 2.01%. Where did bond yields close Tuesday, November 8 hours before the Trump election results were known? Answer: 1.85%.

FEDERAL RESERVE POLICY

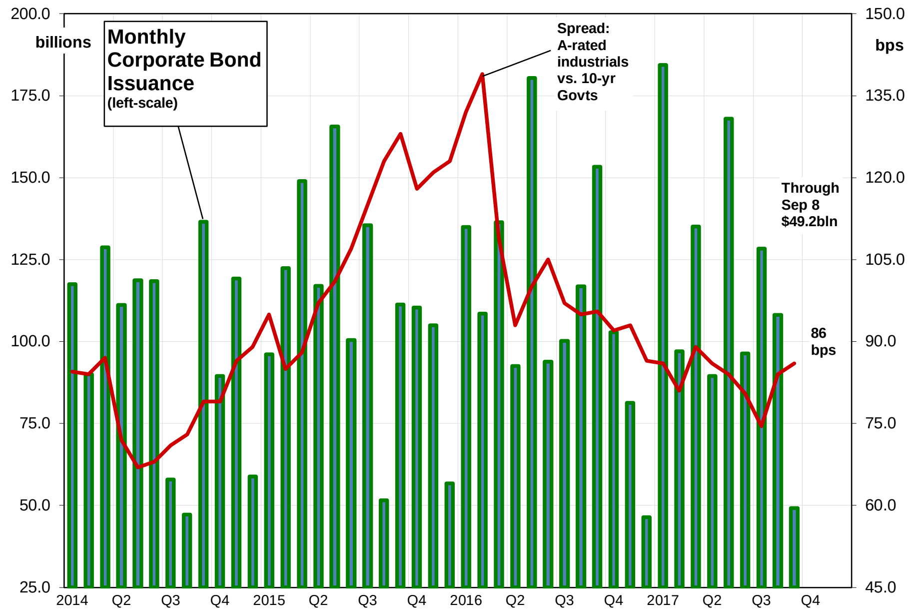
The Fed meets September 19-20 to consider its monetary policy. A rate hike doesn't seem very likely, maybe we should stop forecasting one. The market is thinking no to a rate hike in December, let alone September. It's not just low inflation stopping the rate hikes, it's the cold bathwater in the tub upstairs, two hurricanes, and a three-month extension of the uncertainty over a debt ceiling increase until December… everything but the kitchen sink. Maybe these would all be good reasons to pause if a rate hike from this level was "tightening" that could actually slow economic growth. But no one surely believes a rate hike from 1.25 to 1.50 percent could slow the economy. Do they? Anyone, anyone. Write us if you do.

Selected Fed assets and liabilities Fed H.4.1 statistical release billions, Wednesday data	6-Sep	30-Aug	23-Aug	16-Aug	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2465.289	2465.300	2465.273	2465.247	479.782
Federal agency debt securities	6.757	6.757	6.757	8.097	0.000
Mortgage-backed securities	1767.553	1767.553	1778.699	1777.975	0.000
Primary credit (Discount Window)	0.001	0.004	0.005	0.002	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	1.708	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	0.035	0.036	0.036	0.036	62.000
Federal Reserve Assets	4500.0	4498.4	4510.5	4509.8	961.7
3-month Libor %	1.32	1.32	1.32	1.32	2.82
Factors draining reserves					
Currency in circulation	1578.477	1570.551	1566.641	1566.526	834.477
Term Deposit Facility	0.000	0.000	0.000	14.733	0.000
Reverse repurchases w/others	145.128	146.086	169.793	92.840	0.000
Reserve Balances (Net Liquidity)	2357.048	2331.956	2338.169	2364.971	24.964
Treasuries within 15 days	0.000	3.197	3.197	3.197	14.955
Treasuries 16 to 90 days	38.559	30.691	30.691	19.648	31.549
Treasuries 91 days to 1 year	323.379	310.316	310.315	321.357	69.272
Treasuries over 1-yr to 5 years	1144.907	1163.518	1163.479	1163.475	170.807
Treasuries over 5-yrs to 10 years	325.239	324.365	324.394	312.184	91.863
Treasuries over 10-years	633.205	633.213	633.197	645.386	101.337

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

CORPORATE BONDS: DISCOVERY COMMUNICATIONS, APPLE, VISA, IBM

Corporate offerings were $49.0 billion in the September 8 week versus $3.3 billion in the September 1 week. On Wednesday, Eaton Corp. sold $1.0 billion 10s/30s. It priced $700 million 3.1% 10-yrs (m-w +15bp) at 100 bps (Baa1/A-). The manufacturer of electrical parts and systems for industry will use the proceeds to repay 1.5% notes due in 2017. Corporate bonds (10-yr Industrials rated A2) were 86 bps above 10-yr Treasuries on Friday versus 83 bps last Friday.

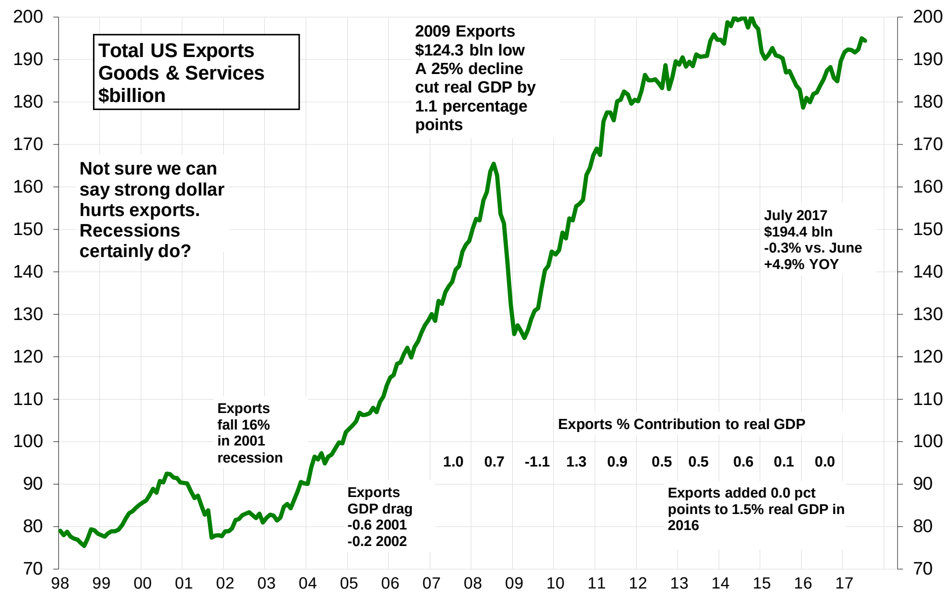


OTHER ECONOMIC NEWS THIS WEEK

US exports and imports back to normal if Trump team doesn't trade it away

Breaking economy news. US exports and imports with the world are getting back to normal if Trump's economics team doesn't trade it away. Ripping up long-standing trade agreements risks what current trade advantages we have.

America's monthly deficit with its trade partners widened slightly to $43.7 billion in July from $43.5 billion in June. It was supposed to be worse after the advance data released last week. Same story. America dominates the world in terms of the services we export. The July services surplus is $21.6 billion, but the goods deficit is $65.3 billion. It is the goods deficit that most concerns the Trump Administration.



To correct the goods deficit Washington can either try to slow the $193.9 billion goods imports coming in this month, or it can find something to sell the world to boost the $128.6 billion of exports in July. The exports record is $138.1 billion in August 2014 at the time crude oil was up around $100 a barrel. Petroleum and petroleum products are counted as goods exports, so the exports results are partly a result of the level of the price of crude oil. Exports fell to $116.7 billion in January 2016 before recovering. January 2016 is when the trade-weighted dollar rally peaked and stopped pricing American goods out of world markets.

Net, net, the trade picture continues to improve in the aftermath of the commodity price collapse a couple of years ago. Let's hope the Trump economics team doesn't gum up the works with their overreach negotiations to get a better deal. When you negotiate with countries keep in mind you are really going up against some of the biggest corporations in America who moved their operations overseas years ago. This deficit concern is somewhat misguided as it is largely a trade war with ourselves. These jobs are not coming back to America's heartland. If you built a factory in a corn field in the Midwest they wouldn't come. You couldn't get the skilled help needed to man the shop floors and produce these goods. The economy is at full employment which means what it says. Everyone has a job, there is no one left to employ.

For the Fed, it can take some comfort that the rest of the world is doing better this year as this means American exports will continue to move higher and support the growth outlook here. Fed officials can continue on the course they have set to mop up the monetary stimulus that remains years now after the recession ended. We expect the balance sheet wind down announcement in September and the final rate hike this year at the December meeting. Low inflation isn't a headwind for the economy. Fed officials need to move interest rates promptly to normal levels. The economy is stronger, more resilient, than they think. Bet on it.

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