Financial Market Weekly

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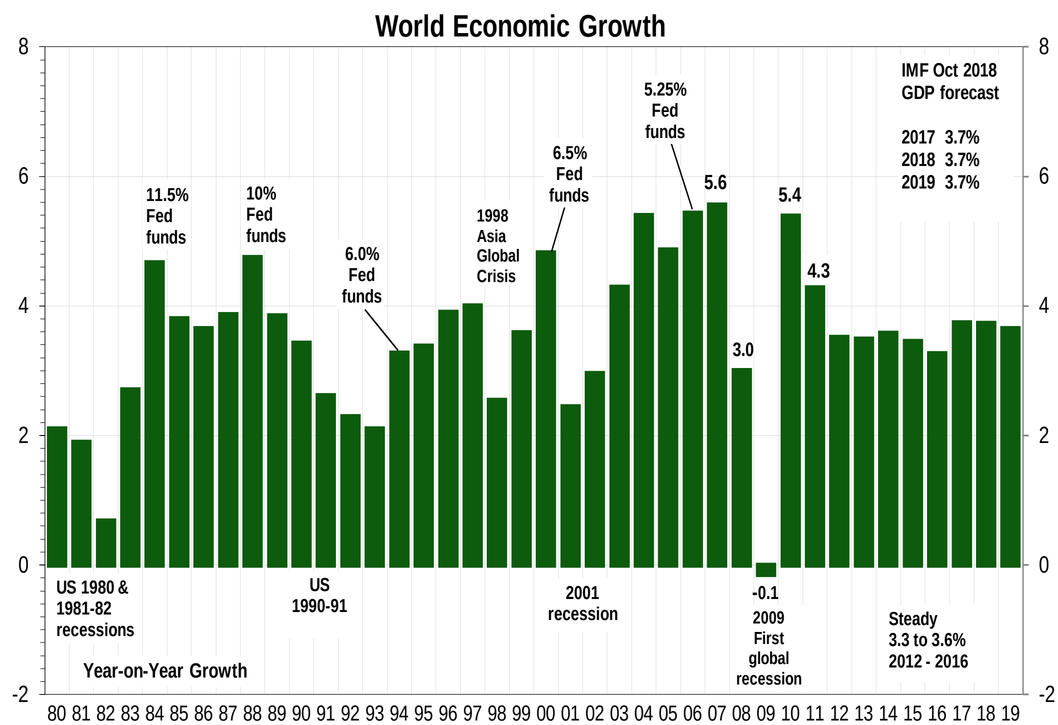
ANOTHER CHALLENGING IMF FORECAST FOR THE WORLD ECONOMY AHEAD



This week the IMF is having their fall meeting in Bali this year. As good a place as any to gain a vantage point from which to survey the damage this week in global financial markets. At one of the IMF Bali seminars they took a survey (results not yet released) asking the delegates to tick the box which best describes the reason for the October meltdown in the US stock market that spread to the rest of the world.
☐ America's trade war with China ☐ Loco Fed officials raising interest rates with no inflation
☐ Earnings boost from biggest tax cut in history is over ☐ Chill. Just a normal, healthy correction.
We will analyze the survey results when we get them.

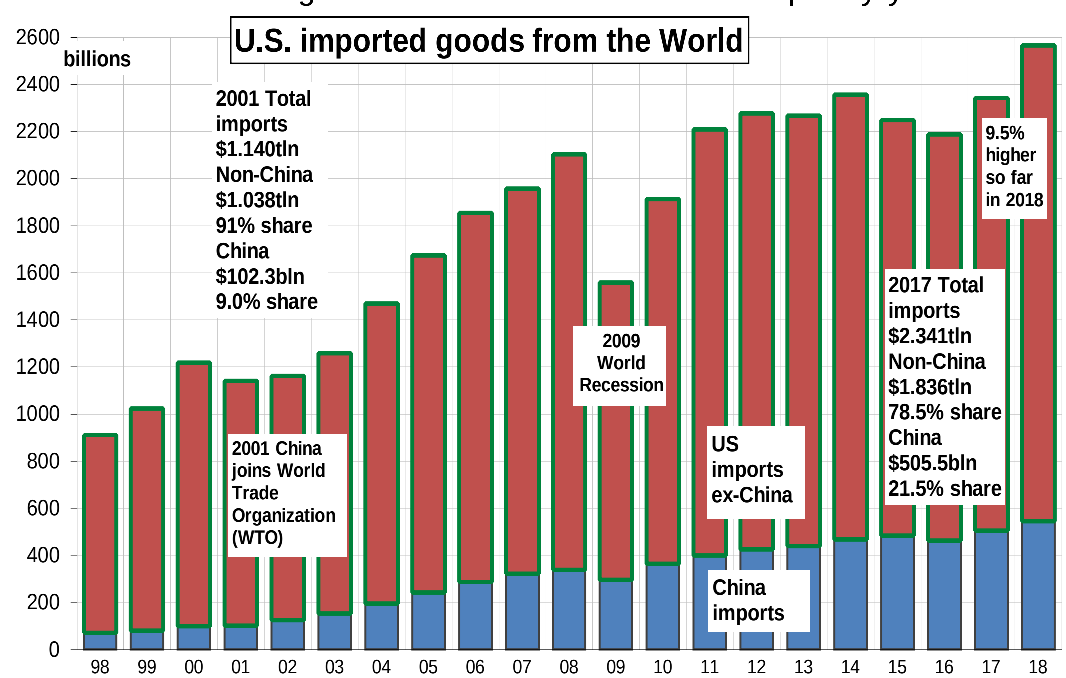
The IMF published its four times a year world economic growth forecast: in July, they still saw world growth of 3.9% in 2018 and 3.9% in 2019. On Tuesday, they said world growth would slow to 3.7% this year and next. Down a couple of tenths. Protectionist policies will hurt world trade they said. Is it just us, or is it hard for others to see the world isn't turning all that much: despite the latest downgrade, world economic growth has been remarkably steady at 3.3 to 3.6 from 2012 to 2016, and now they see it a touch higher at 3.7% the next two years. Not the end of the world, or is it?

The IMF statement at the meeting in Bali said this about the world economic outlook: “the recovery is increasingly uneven, and some of the previously identified risks have partially materialized. Overall, risks are increasingly skewed to the downside amid heightened trade tensions and ongoing geopolitical concerns, with tighter financial conditions [i.e. US rate hikes] particularly affecting many emerging market and developing countries.”

Looking at the trade picture of the U.S., the import of goods is still rising into this year’s trade war risks. Goods imports are up a sharp 9.5% in the first eight months of 2018 versus the same period in 2017, partly due to the front-running of potential tariffs and the stronger U.S. economy is a factor as well [4.2% GDP for one quarter anyway]. The overall picture of rising trade imports since the 90s is hard to characterize, the reason why other than growing with the overall economy and consumer and business demand. Imports rose after China entered the World Trade Organization in 2001, but the additional goods came in from many countries not just China. Imported goods in 2001 were $1.14 trillion with China imports 9.0% of the total. Imported goods were $2.34 trillion in 2017 and China’s share rose to 21.5% of the total.

Imports picked up after the 2001 recession (consumers don’t buy anything in a recession) and rose quickly over 2003-08 before the drop in the 2009 worldwide recession. Petroleum imports were part of the rapid rise in total imports of goods as crude oil prices soared. China imports accelerated as well rising from a 12.1% share of total imported goods to 16.0% share of total imports in 2008. Since the 2009 world recession U.S. imports after a rebound to the old highs have gone sideways until 2018.

In conclusion, there are downside risks for the world from rising trade tensions and it is too early to tell if the U.S. economy can overcome these global headwinds. President Trump may yet settle for some cents on the dollar trade agreement with China, despite the increasingly heated rhetoric, and bring this America First chapter to a close. Europe is still negotiating with the U.S. on trade and those auto tariffs are still possible in some form early in 2019, but we are hopeful the trade wars will diminish without slowing world growth appreciably.

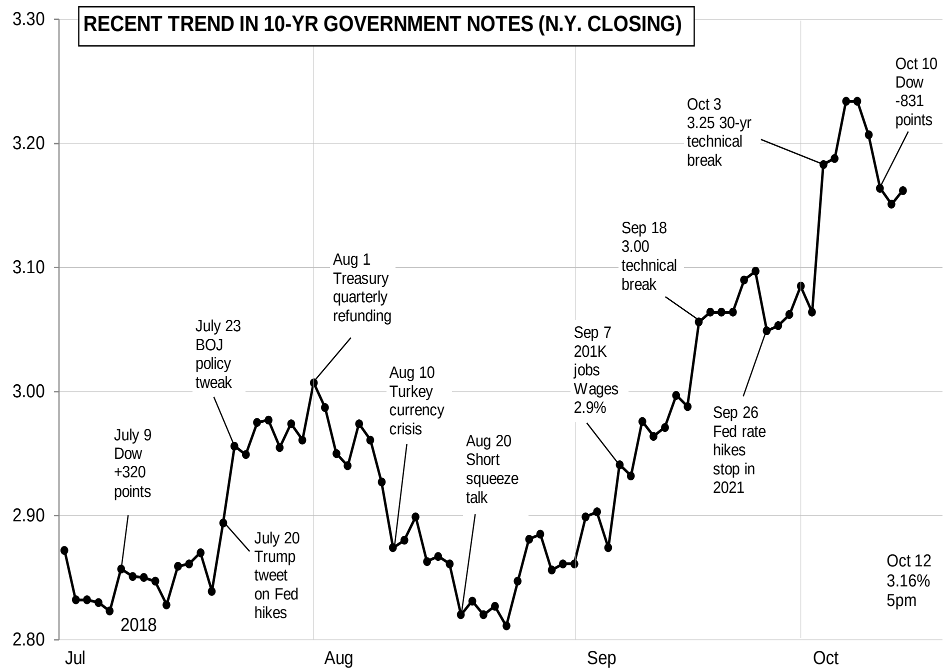


IMF OCTOBER 2018 WORLD ECONOMIC GROWTH FORECASTS

	World GDP	U.S.	Euro area	Germany	France	Italy	Spain	UK	Japan	Canada	China	Russia	India	Brazil	Mexico
2017	3.7	2.2	2.4	2.5	2.3	1.5	3.0	1.7	1.7	3.0	6.9	1.5	6.7	1.0	2.0
2018	3.7	2.9	2.0	1.9	1.6	1.2	2.7	1.4	1.1	2.1	6.6	1.7	7.3	1.4	2.2
2019	3.7	2.5	1.9	1.9	1.6	1.0	2.2	1.5	0.9	2.0	6.2	1.8	7.4	2.4	2.5

MARKETS OUTLOOK

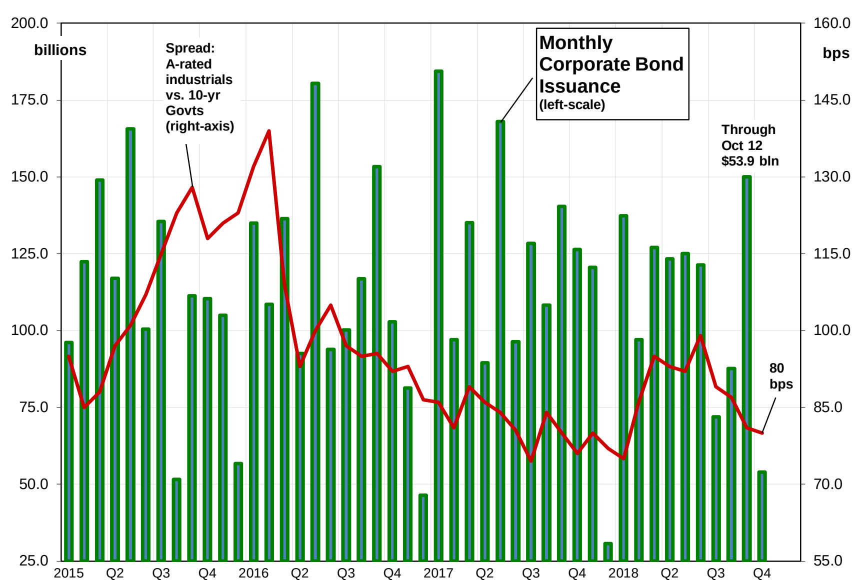
	28-Sep 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
30-Yr Treasury	3.21	3.25	3.40	3.45	3.65	3.60	3.80	3.85	3.85	3.95	3.95
10-Yr Note	3.06	3.10	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95	3.95
5-Yr Note	2.95	3.00	3.10	3.20	3.40	3.45	3.65	3.75	3.80	3.95	3.95
2-Yr Note	2.82	2.90	3.00	3.15	3.40	3.40	3.60	3.75	3.80	4.00	4.00
3-month Libor	2.40	2.70	2.95	3.20	3.45	3.45	3.70	3.90	3.90	4.20	4.15
Fed Funds Rate	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75	3.75	4.00	4.00
2s/10s spread	24	20	20	15	10	10	10	5	0	(5)	(5)
Libor/funds spd	15	20	20	20	20	20	20	15	15	20	15



Bond yields were lower this week at 3.16% versus 3.23% last Friday. The mystery we guess is why yields didn't sink even lower with the stock market collapse. Maybe markets believe a 25 bps rate hike to 2.5% in December is still on the table. Fed funds futures if they still are working and have enough liquidity to measure true market sentiment said year-end odds of a rate hike were 80% Friday versus 82% last Friday before the stock market crash. We always like how analysts and the President as well say the stock market correction was to be expected. We found it stomach-turning, and we are not alone. S&P 500 up 7.9% last Friday in 2018 year-to-date and now tonight closing out the week at up 3.5% year-to-date. Not good for sentiment.

CORPORATE BONDS: TRANSCANADA PIPELINES, DEERE, EXELON, NY LIFE

Corporate offerings were $6.8 billion in the October 12 week versus $47.1 billion in the October 5 week. On Wednesday, TransCanada Pipelines sold $1.4 billion 10s/30s. It priced a $1.0 billion 5.1% 30-yr at 170 bps (A3/BBB+). The natural gas transmission and power services company will use the proceeds to repay debt. Corporate bond yields (10-yr Industrials rated A2) were 80 bps above 10-yr Treasuries this week versus 79 bps last Friday.



FEDERAL RESERVE POLICY

The Fed meets November 7-8 to consider its monetary policy. Twelve of sixteen Fed officials see a fourth rate hike this year to 2.5%. In December. This was the vote at the September 25-26 meeting which kind of spoils the forecast, our own and others, eliminates the uncertainty, for the next three months. The vote eliminated all market uncertainty unless you think the 1,107 point, 4.2% drop in the Dow industrials this week had an effect on their thinking. It had an effect on our thinking as we sold all our stock holdings. At the low this week. Anyway, the stock market losses should not be ignored. It's not just the comments of the extra Fed governor in the room, President Trump saying Fed rate hikes caused the stock market to collapse and that monetary policy was ridiculous and Fed officials were loco. We don't know, times are different, we don't have patience with these sacred "Fed independence" news stories. Can't read them. Anyway, times are different since 11-8-16. These Trump comments could just be additional evidence that rising interest rates are starting to bite. Businesses won't be as optimistic about the future and won't be committing as much to capex expenditures in the future if rates are starting to move to tightening levels. We find it hard to believe, but if interest-rate sensitive sectors of the economy, like auto sales, and home sales and construction, are starting to slow, then there could be some truth to it. Hard to believe. But then stocks are down as well in part due to 10-yr yields going to all of 3.25%. Currently, the Fed votes for neutral rates are three at 2.5%, four at 2.75%, and 6 at 3.0%. One thing is for certain, Trump will be in the room with them from now on when they vote to hike rates.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	10-Oct	3-Oct	26-Sep	19-Sep	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2294.227	2294.210	2313.208	2313.206	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1681.778	1681.775	1681.763	1695.223	0.000
Primary credit (Discount Window)	0.013	0.064	0.064	0.152	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)	0.007	0.007	0.007	0.007	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	0.090	0.151	0.090	0.100	62.000
Federal Reserve Assets	4224.6	4222.4	4240.4	4255.8	961.7
3-month Libor %	2.43	2.41	2.39	2.35	2.82
Factors draining reserves					
Currency in circulation	1692.975	1689.897	1686.023	1685.759	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	2.390	2.954	5.625	8.915	0.000
Reserve Balances (Net Liquidity)	1878.887	1837.587	1837.874	1822.718	24.964
Treasuries within 15 days	0.026	0.026	19.033	19.007	14.955
Treasuries 16 to 90 days	101.337	101.337	83.128	83.154	31.549
Treasuries 91 days to 1 year	310.595	310.595	315.819	315.819	69.272
Treasuries over 1-yr to 5 years	999.355	999.352	1010.629	1010.629	170.807
Treasuries over 5-yrs to 10 years	265.769	265.763	267.467	267.466	91.863
Treasuries over 10-years	617.146	617.137	617.133	617.132	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

On Friday, Chicago Fed President Evans said he could see the Fed pushing rates up a little beyond neutral to 3.5%. We still aren't sure if Fed officials are giving their own view or merely telling the same story as the median Fed forecast for the Fed funds rate.

Year-ends for Interest Rates				
Percent %	2018	2019	2020	2021
Eurodollar futures	2.675	3.19	3.22	3.18
Fed's Sept forecast	2.5	3.25	3.5	3.5
Eurodollar futures price where 3-month Libor will be in the future.				
Friday, October 12, 2018 3-month Libor 2.44 %				

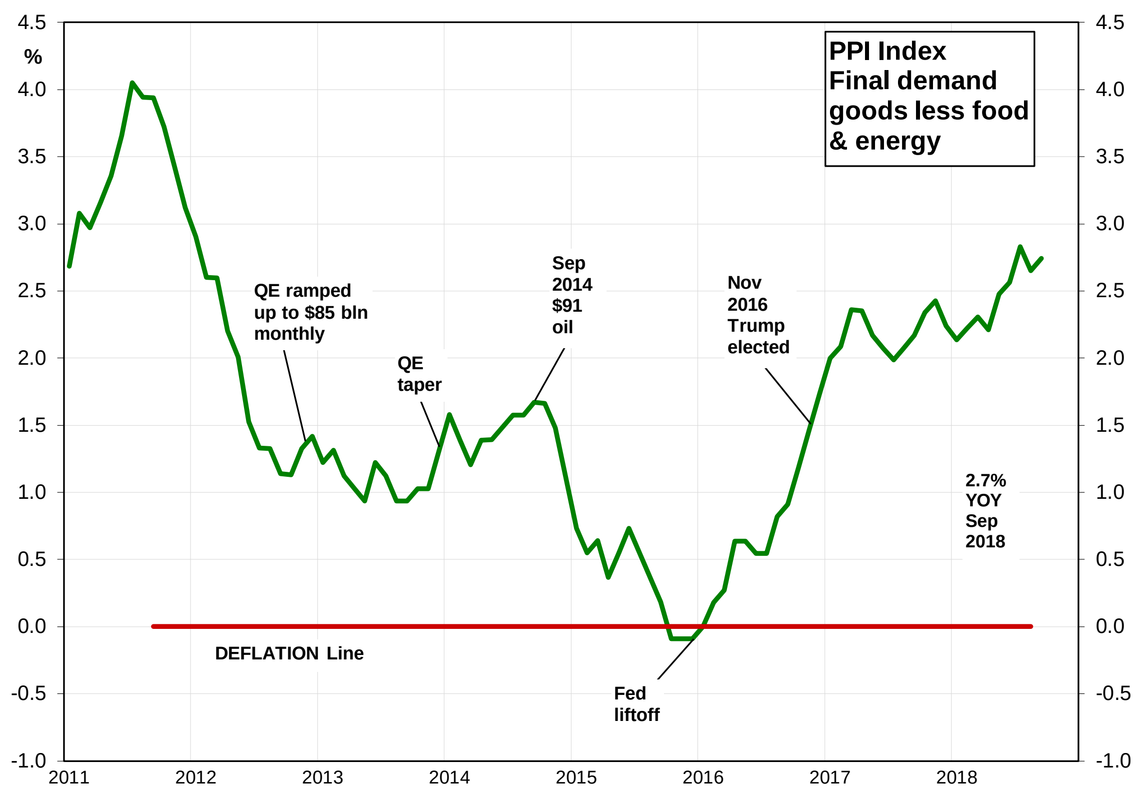
Fed Individual Forecasts					
Fed funds rate by year-end					Longer
Votes	2018 End	2019 End	2020 End	2021 End	run
1	2.125	2.125	2.125	2.125	2.500
2	2.125	2.375	2.625	2.625	2.500
3	2.125	2.625	2.875	2.875	2.500
4	2.125	2.875	3.125	2.875	2.750
5	2.375	2.875	3.125	2.875	2.750
6	2.375	2.875	3.125	3.000	2.750
7	2.375	2.875	3.125	3.125	2.750
8	2.375	3.125	3.375	3.375	3.000
9	2.375	3.125	3.375	3.375	3.000
10	2.375	3.125	3.625	3.375	3.000
11	2.375	3.125	3.625	3.375	3.000
12	2.375	3.375	3.625	3.500	3.000
13	2.375	3.375	3.625	3.625	3.000
14	2.375	3.375	3.625	3.625	3.250
15	2.375	3.375	3.625	3.875	3.500
16	2.375	3.625	3.875	4.125	
17					
Median	2.375	3.125	3.375	3.375	3.000
Meeting	Sep 2018	Sep 2018	Sep 2018	Sep 2018	Sep 2018

OTHER ECONOMIC NEWS THIS WEEK

Producer prices advance again in September after a rare drop in August (Wednesday)

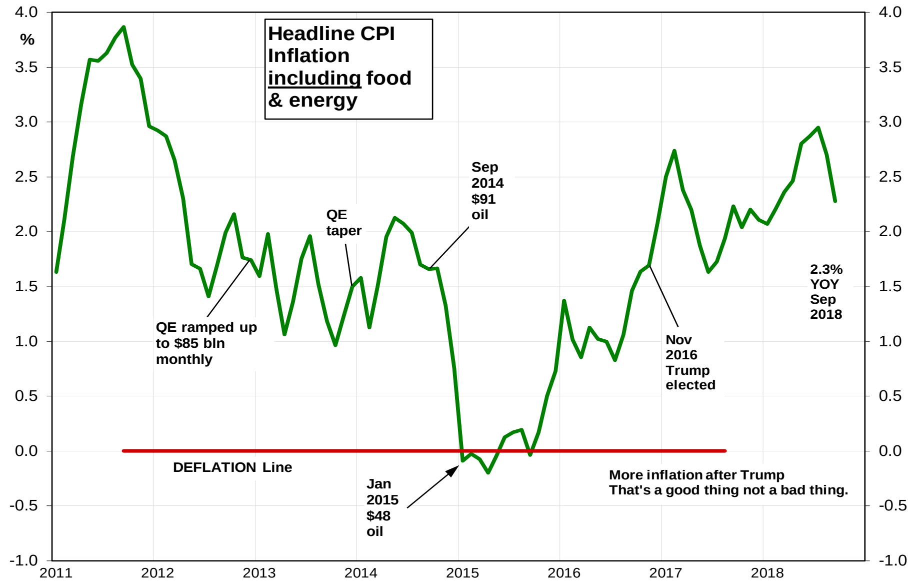
Breaking economy news. Producer prices rose 0.2% in September after declining 0.1% in August. The last time prices declined was in February 2017. Stripping away the noise from the BLS attempts to measure service prices at the producer level, final demand goods prices less food and energy rose 0.2% in September after an unchanged reading in August. Light motor trucks prices jumped 0.8% which may show the effect of US tariffs put on to fight the world on trade. The PPI index for final demand goods less food and energy held at a 2.7% year-on-year rate of inflation in September, same as the August reading, and down from 2.8% in July which was the most inflation seen since the start of 2012. Inflation is still coming and the Fed needs to remain vigilant. Fed officials will certainly bring interest rates up further into the neutral zone of 2.5 to 3.0 percent over the next year.

Net, net, price pressures are still forming at the lowest level of the production chain and with the strengthening economic winds and tariffs coming on imported goods, inflation will become a worry for consumer pocketbooks sooner or later. The Fed needs to stay on top of these incipient inflation pressures and continue to move interest rates up in a gradual way to ensure that inflation does not make it to hurricane strength, endangering the economy's forward progress and increasing the risks for another recession. Stay tuned. Story developing. CPI inflation is out tomorrow. Ahoy for the bond markets. Shelter in place if you haven't already moved to higher ground.



0.1 core CPI, two in a row, no, no, no, what happened to inflation? (Thursday)

Breaking economy news if you can take your eyes for a moment off of the plunging stock market. CPI inflation is out, even if the Fed does not consider it the preferred measure of consumer inflation. PCE inflation, that's dead as a door nail, is their official inflation measure that they forecast. It never moves higher. Ever. Maybe Fed officials have gone loco when it comes to predicting inflation that never materializes. It's simple. No inflation then no Fed rate hikes above 3% neutral, Fed officials aren't that crazy despite the Presidents tweets and squeaks to the contrary.



Core CPI inflation rose 0.1% in September to maintain its 2.2% year-on-year rate. Used cars and trucks dropped 3.0% which explains a lot of this month's core CPI 0.1% monthly change. But shelter prices rose just 0.2% where the trend had been call it 0.3 percent. Shelter or housing inflation carries a gigantic weight in core consumer purchases of 42% (doesn't leave a lot of room for groceries). And those of you worried about the baby boom generation destroying the nation's finances with Medicare and Medicaid in retirement can rest a little easier as medical care services and commodities aren't rising at the same rate as they used to a decade or more ago. Medical care services are up 2.0% the last year, and medical care commodities (grandpa's meds) are up just 0.7% on a year-to-year basis.

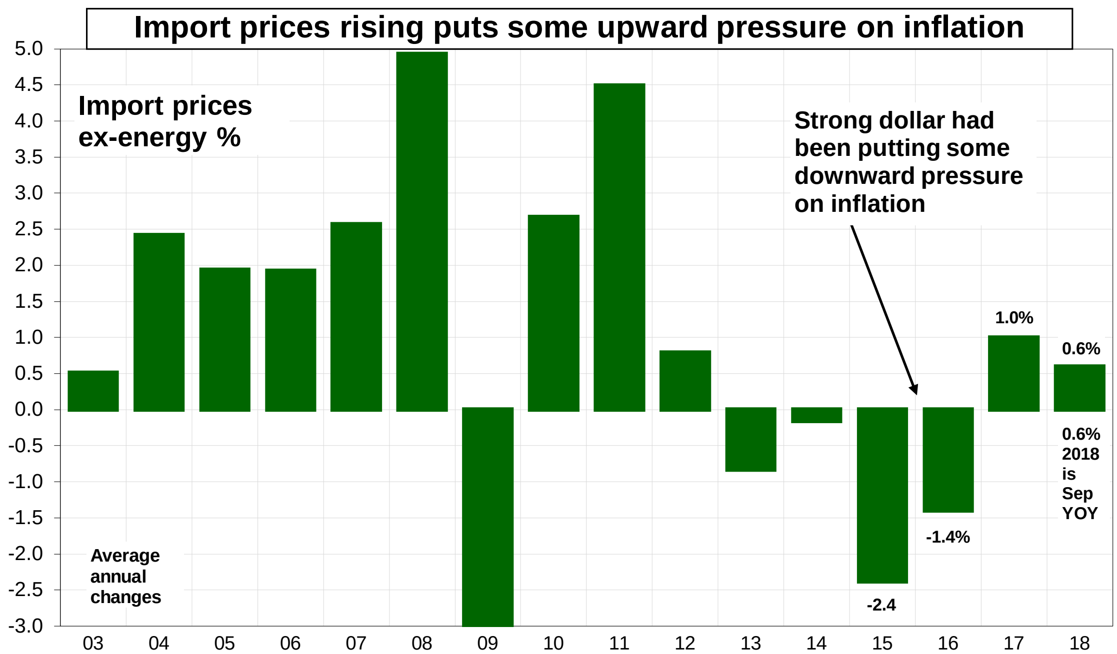
What is inflation? When does it ring the Fed's alarm bells? Well, we want to see some big monthly changes of 0.3% for one thing and as it stands right now, there were no 0.3s in 2016, one in January 2017, and one other one in January 2018 and that's it. Inflation is not breaking out as they say, and the two consecutive months of 0.1% inflation in August and now September 2018 this morning show the economic seas are calm when it comes to inflation despite the hurricane of selling hitting the world stock markets.

Net, net, the economy may be running hot, but it isn't fast enough to kick up inflation pressures and calls into question the need for Fed policymakers to move interest rates to higher levels. Tightening? What on earth for? Maybe plunging stock markets and President Trump have this one right. Maybe neutral rates are lower than many at the Federal Reserve think if inflation stays this low for this late in the business cycle. The inflation data, President Trump, and the cratering stock markets are all screaming at Fed officials what is your hurry.

This could well go down in economic history as one of the biggest conundrums of all time. The economy is strong in one of the longest expansions in history and yet inflation is just giving off a little smoke with no real fire to speak of. Higher energy prices and import tariffs on goods from China may yet upset the apple cart on any rosy forecast for inflation remaining benign, but at the moment, inflation is a puzzling no-show. Stay tuned in 2019. Story developing.

Ship ahoy! Import prices coming ashore show deflation ahead, not inflation (Friday)

Breaking economy news. Import and export prices for September. Nonfuel import prices were unchanged in September. Prices of imports from consumer goods, industrial supplies and materials are actually falling, but higher prices for food, feeds and beverages rose and kept the index unchanged in September. After jumping at the start of the year with the dollar tumbling, 0.5% in January and 0.4% in February, nonfuel import prices have fallen 0.3% in June, 0.2% in July, 0.2% in August, and were 0.0% in September reported today. Nonfuel import prices are rising just 0.6% the last year ending August 2018 versus 1.3% the year before that.



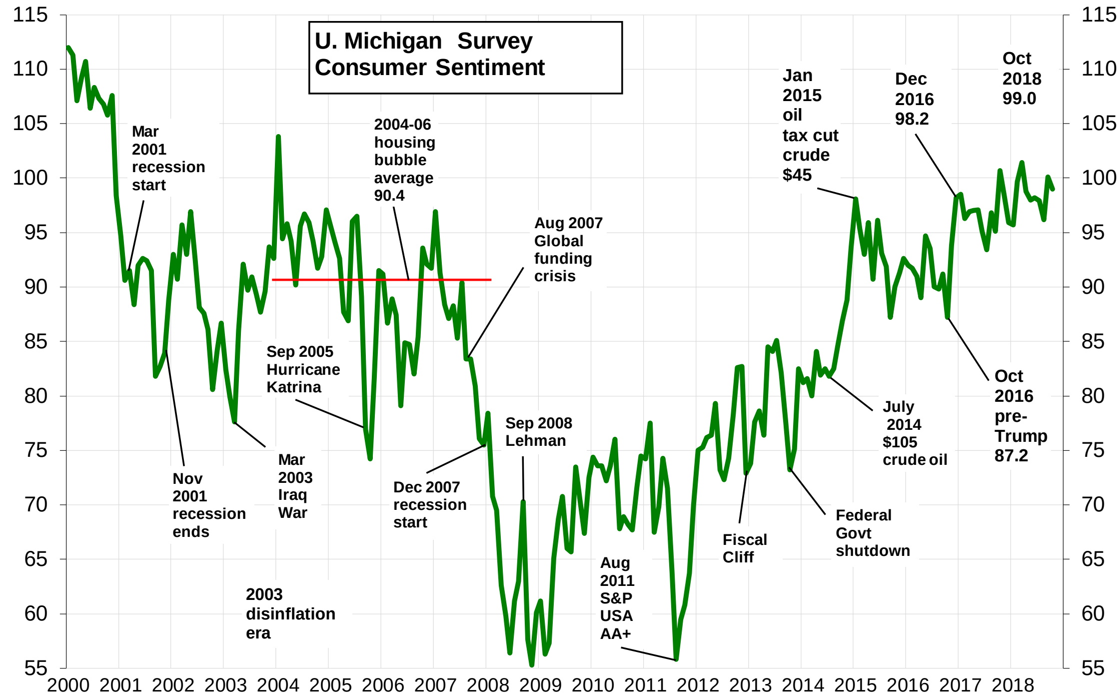
Net, net, imported goods inflation is nowhere to be seen since May as the dollar rally kicks up a storm in world foreign exchange markets. We thought there might be some tariff effect on import prices even if tariffs are specifically excluded from the Bureau of Labor Statistics measure on the price of imports coming ashore in the USA, USA, USA. Nope nada, nothing. Yellen always explained away the lack of inflation pressures as partly the result of falling import prices, and import prices are back on the decline, holding incipient inflation pressures at bay.

The tariffs slapped on during the trade war may still lift consumer prices, but the effect will be seen directly in the personal consumption expenditures (PCE) deflator and the CPI index. Today is another number that suggests inflation pressures remain manageable despite the strong economy and that Fed officials are right to chart a gradual pace of rate hikes over the next year or so. There's no inflation today, but no one has blown the whistle yet saying it is safe to jump back in the pool because the labor market is tightening with the falling unemployment rate which will make even the Fed doves wish for interest rates to move a little above neutral levels, dare we say tightening, in the years to come. Stay tuned. Story developing.

Good as it gets for the economy: consumer agrees (Friday)

Breaking economy news. Michigan consumer sentiment is out. Don't rush for your favorite news feed. The market doesn't care. The index fell to 99.0 in October from 100.1 in September. How did they used to call it down at the Fed? Mixed reading on consumer confidence. By this we mean the Conference Board survey of confidence soared to new heights in August and September, but the Michigan Sentiment survey says no dice. Looking at the graph below, consumer sentiment or confidence jumped from October 2016 prior to Trump's election to 98.2 in December 2016 and has stayed at this level. Not sure you should say confidence at this level means "high." The changes up and down are more important than levels when it comes to predicting where the economy goes next.

Net, net, consumer sentiment remains at levels that bode well for the economic outlook if they follow-up with actually spending their wages on the goods and services that companies provide. One wonders how long the good times can last for consumer confidence if the stock market doesn't lift back closer to record highs after this week's panic sell-off. You can have money in your wallet, but if the stock market is not giving you money in the bank, then it is doubtful you will remain confident in the future for long. The stock market trumps consumer confidence when it comes to forecasting the economy ahead. Stocks have forecast 9 of the last 5 recessions, while confidence levels lag until the economy actually declines. (Check it out, you doubters.)



Confidence got a lift after Trump was elected in November 2016, but consumer sentiment readings have moved sideways since then and could be a cautionary tale for economic forecasters in the next couple of years. We are worried that the American public misunderstands how strong the economy is as far as potential economic growth going forward. The last data point is 4.2% growth in the second quarter, but there is no way that is going to last. The Tax Cuts and Jobs Act is a one-year show, and once the money is gone, then growth is going to slow. Bet on it. The Fed is. They see real GDP growth slowing from 3.1% this year to 2.0% in the year 2020 which is maybe one reason they only see the need to raise rates one time in all of 2020. Stay tuned story developing. Winter is coming. Get ready for it.

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