Financial Market Weekly

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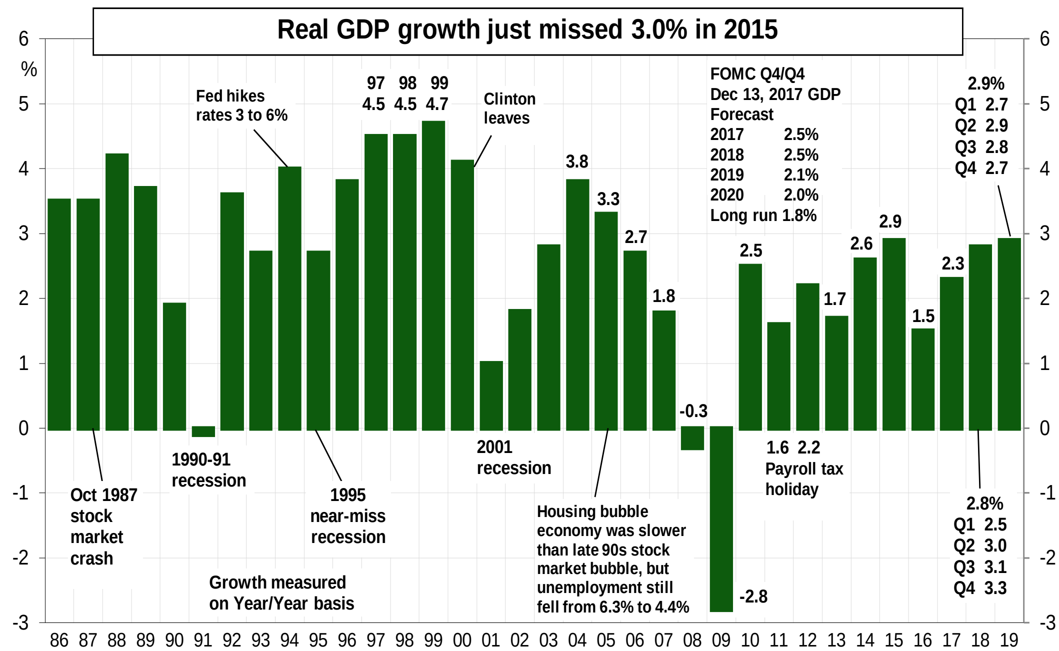
GROWTH COMES UP SHORT IN THE FINAL QUARTER, AT LEAST CONSUMERS ARE ALL IN



While we wait for the tax cuts to pay for themselves with stronger economic growth, so we don't have to sell more Treasury bonds to foreigners to pay for America First tax reform, we thought we would look at the GDP data this morning. Apparently, we are the only ones to look at the 2.6% real GDP number because the bond market sure is not. 10-yr yields left no trace on the intraday trading charts after the report as the market still struggles to find a heartbeat. At least yields closed higher at 2.66% this Friday, believing the Fed's three rate hikes story this year to 2.25%, so we shouldn't complain. Yields need to move to higher normal levels as they naturally follow the recovery in the economy from the recession.

Breaking economy news. The big beautiful waterfall of economic growth this year stopped short of the Trump administration's hopes today with real GDP in the fourth quarter rising 2.6% after 3.1% and 3.2% in the second and third quarters of 2017, respectively. The Treasury's one-pager forecast of GDP after tax reform is supposed to hit 3% starting in 2020, so the economy is not there yet.

Consumers had a blow-out quarter cleaning out the store shelves and racks with real expenditures up 3.8%, the best since 2014, not counting the 3.8% rebound in Q2 2016 from the cold winter growth slowdown to 1.8% in Q1 2016. Speaking of cold winters, we could very well see a repeat this year, and we have penciled in an increase of 2.5% for real GDP in Q1 2018 when the data are released three months from now.

Consumers are incredibly upbeat even before their after-tax paychecks go up later this month or the first of February as the tax cuts enter the economic equation. Why the 2.6% GDP number today not the 3.0% Street consensus forecast? Well to compare to Q3's 3.2% growth, inventories fell and were a 1.5 percentage drag from last quarter. Of course, consumer purchases were just the opposite adding 1.1 percentage points more to growth than in Q3 with its faster 3.2% GDP growth.

Net exports were a huge drag of 1.5 percentage points relative to the third quarter as Americans continue to splurge on imported goods. Trump's trade team better find more imports to tax other than just washing machines and solar panels, or trade is not going to contribute to growth here. America is not first when it comes to trade with the world.

The big surprise was the jump in government spending that added 0.5 percentage points to growth. Real GDP could have been closer to 2.0% if it had not been due to a bounce in state and local government spending, and Federal defense spending is adding more as well.

Net, net, the economy fell short of the market and Trump administration hopes for faster 3% growth in the final quarter of the year. The expected rebound in the economy from tax reform and a better regulatory climate is still coming if you believe the estimates from Trump's economics team. Wait for it. 2.5% growth in 2018, 2.8% in 2019, and then 3.0% for the next ten years is their call, with the caveat that they need to be returned to office in the election in 2020 to make it happen.

	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17p
REAL GDP	1.8	1.2	3.1	3.2	2.6
REAL CONSUMPTION	2.9	1.9	3.3	2.2	3.8
CONSUMPTION	2.0	1.3	2.2	1.5	2.6
Durables	0.7	0.0	0.6	0.6	1.0
Nondurables	0.4	0.2	0.6	0.3	0.7
Services	1.0	1.2	1.1	0.5	0.8
INVESTMENT	1.3	-0.2	0.6	1.2	0.6
Business Plant	-0.1	0.4	0.2	-0.2	0.0
& Equipment and	0.1	0.2	0.5	0.6	0.6
Intellectual Property	0.0	0.2	0.2	0.2	0.2
Homes	0.3	0.4	-0.3	-0.2	0.4
Inventories	1.1	-1.5	0.1	0.8	-0.7
EXPORTS	-0.5	0.9	0.4	0.3	0.8
IMPORTS	-1.1	-0.6	-0.2	0.1	-2.0
GOVERNMENT	0.0	-0.1	0.0	0.1	0.5
Federal defense	-0.1	-0.1	0.2	0.1	0.2
Fed nondefense	0.1	0.0	-0.1	0.0	0.0
State and local	0.1	0.1	-0.2	0.0	0.3

Below line: Percentage point contributions to Q4 17 2.6% real GDP

Second estimate for Q4 is Wednesday, February 28

It was a hard GDP report to categorize today with so many pieces moving in different directions. Consumers and business investment is going gangbusters, counting residential home building as well. The big drag is from America's demand for foreign goods, even if they are produced by our own companies from factories off-shore, and a one-off inventory correction. Three percent growth is not impossible if you are a dreamer, but the 3% growth is more likely front-loaded in 2018, when the tax cuts improvement to the bottom lines of companies and workers first takes effect, rather than way out in the year 2020 according to Trump economics team guesses. Time will tell if the tax cut boost will lead to more sustainable growth forever and ever.

Fed officials will not be put off their game when it comes to the gradual path of rate hikes they foresee this year. A March rate hike still looks like a done deal and they better get the first one in early this year before the door shuts with the slowdown in growth that is likely due to the chillier winter conditions for the economy in the first quarter this year as happens often if you look back historically. Winter is coming. If you are a dreamer, don't lose heart with growth slowing to less than 3% in the final quarter of the year. Better times are coming for the economy. Bet on it.

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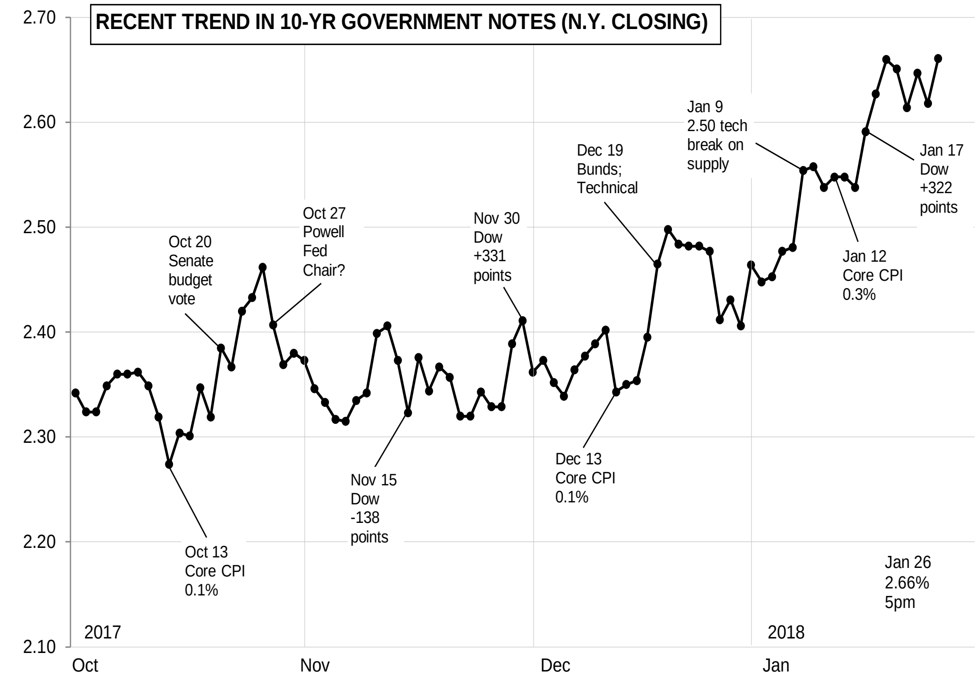
MARKETS OUTLOOK

	29-Dec 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
30-Yr Treasury	2.74	2.90	3.00	3.10	3.30	3.40	3.50	3.60	3.70	3.80	3.80
10-Yr Note	2.41	2.50	2.70	2.80	3.00	3.20	3.30	3.40	3.50	3.70	3.70
5-Yr Note	2.21	2.20	2.40	2.60	2.80	3.00	3.15	3.30	3.40	3.60	3.60
2-Yr Note	1.89	1.95	2.20	2.45	2.65	2.85	3.10	3.30	3.40	3.60	3.80
3-month Libor	1.69	1.90	2.10	2.40	2.60	2.90	3.10	3.40	3.40	3.60	3.90
Fed Funds Rate	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75
2s/10s spread	52	55	50	35	35	35	20	10	10	10	(10)

Yields closed unchanged at 2.66% this week, but held firm at the yield highs for the year. News stories saying this is the end of a 40 year bull market in bonds seem to be supportive of the move for now. More supply is also on the way. The Federal budget deficit is running around $700 billion and may see a boost of $300 billion from tax reform over the next year. The QE wind down of Treasuries starting in October 2018 will be running at a $360 billion annual rate that the U.S. Treasury will have to replace by additional bond auctions as well.



FEDERAL RESERVE POLICY

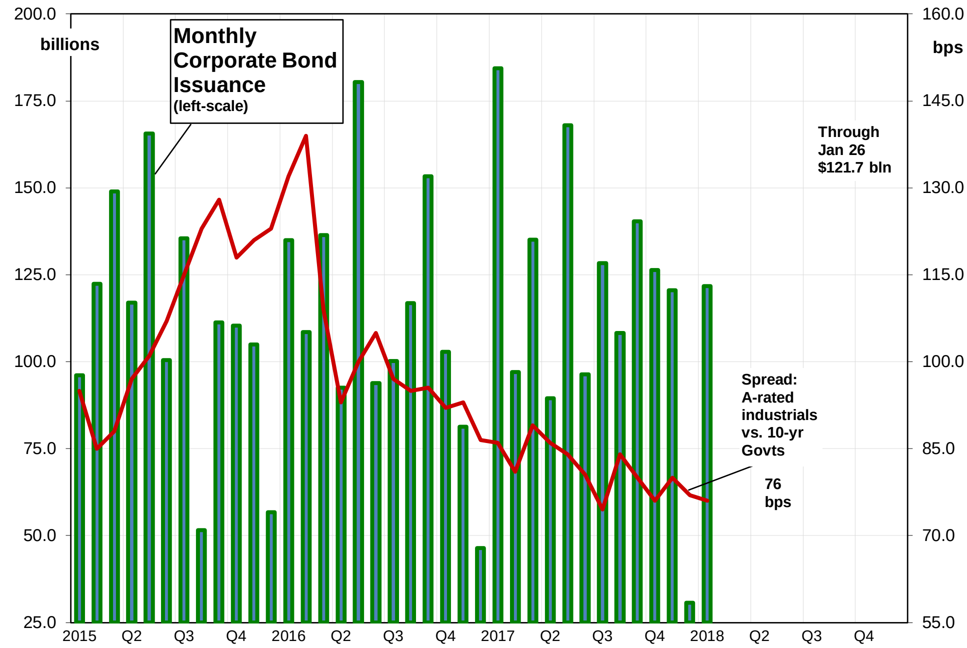
The Fed meets January 30-31 to consider its monetary policy. Yellen's last one. No press conference, no expectation of policy changes. The March 21, 2018 meeting odds of a rate hike moved up a tick from 84 to 88 percent this week.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	24-Jan	17-Jan	10-Jan	3-Jan	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2447.009	2447.009	2448.209	2448.208	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1771.054	1770.349	1764.930	1764.929	0.000
Primary credit (Discount Window)	0.048	0.096	0.107	0.038	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)	1.714	1.715	1.715	1.713	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	0.072	0.118	12.067	12.067	62.000
Federal Reserve Assets	4488.5	4486.4	4493.2	4490.9	961.7
3-month Libor %	1.75	1.74	1.71	1.70	2.82
Factors draining reserves					
Currency in circulation	1606.672	1610.257	1612.650	1618.531	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	36.371	20.548	57.954	131.622	0.000
Reserve Balances (Net Liquidity)	2182.220	2234.452	2257.894	2194.651	24.964
Treasuries within 15 days	27.847	27.847	3.098	3.098	14.955
Treasuries 16 to 90 days	80.038	80.038	107.658	107.658	31.549
Treasuries 91 days to 1 year	317.233	317.233	315.420	315.420	69.272
Treasuries over 1-yr to 5 years	1083.901	1083.901	1085.113	1085.113	170.807
Treasuries over 5-yrs to 10 years	316.716	316.716	314.035	314.035	91.863
Treasuries over 10-years	621.273	621.273	622.884	622.884	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

Sometimes the meeting before the Fed changes rates can be a "setup" meeting, confirming market expectations, with the insertion of language hinting that policy action is imminent. The words "relatively soon," or they await "some" further evidence, have been used before to telegraph what they might do at the meeting ahead. We aren't sure a no nonsense lawyer like Powell will favor such nod-nod, wink-wink, signaling so it will be interesting to see if any heads-up language materializes in the meeting's press statement. More likely is that this meeting will really represent a changing of the guard with a complete break from how old school Fed officials may have done it.

CORPORATE BONDS: MOSTLY FINANCIALS AGAIN THIS WEEK

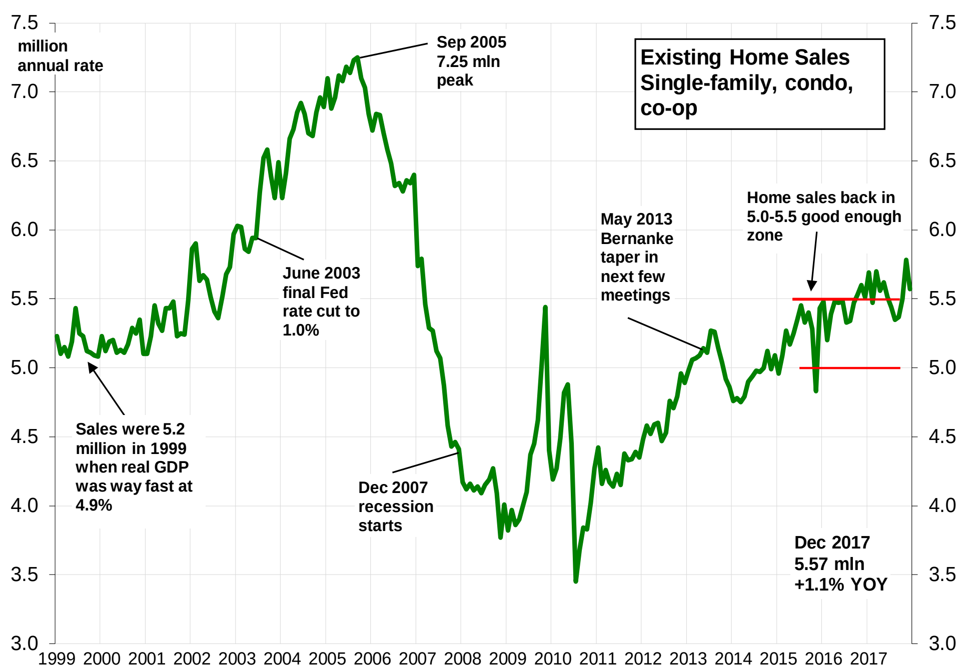
Corporate offerings were $11.3 billion in the January 26 week versus $49.5 billion in the January 19 week. On Tuesday, Owens Corning priced a $400 million 4.4% 30-yr (m-w +25bp) at 157 bps (Ba1/BBB). The world leader in composite and building materials systems will use the proceeds to finance its Paroc Acquisition. Corporate bonds (10-yr Industrials rated A2) were 76 bps above 10-yr Treasuries this week versus 74 bps last Friday.



OTHER ECONOMIC NEWS THIS WEEK

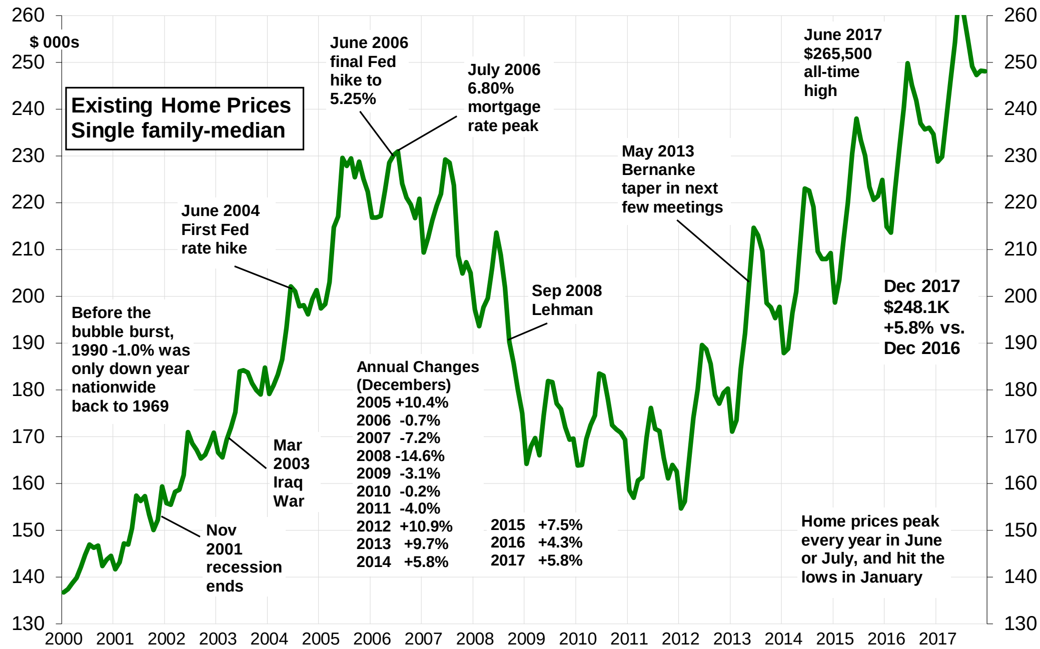
Wild ride for existing home sales this year (Wednesday)

Breaking economy news. Existing home sales fell 3.6% in December to 5.57 million at an annual rate. It was a struggle to come up with a reason why the sales turnover was way up at 5.78 million in November in the first place, so it's just as well sales fell back to earth. 5.5 million is probably fair value for this stage of the economic expansion, but who knows what lies ahead if workers put their massive tax cuts to work. We get to see how much is withheld from our paycheck at the end of this month, though it remains to be seen if this is the proper amount that should be withheld to meet our tax obligation due in April 2019. Regionally, sales were down everywhere, though the declines in the South and the West were less than 2%. Sales in the Northeast fell 7.5% and there was a 6.3% decline in the Midwest as home buyers knew winter was coming perhaps. It does every year.



Net, net, existing home sales have shown greater volatility over the second half of 2017 which could reflect the struggle of Congress to get the tax reform through to the President's desk for signature. As is usual existing home sales cover activity recorded when the sales contract is closed which means the sale took place at least 30 days earlier than today's "December" data.

Existing home sales are running about 5.5 million right now which is below the 2005 housing bubble sales of over 7.0 million for a time when Americans were flipping homes like hot cakes.



Existing home prices for single-family residences were $248,100 in December which is well off the June 2017 peak of $265,500. Prices are still on their way down seasonally to the low reached each year in January or February each year due to the winter weather. Prices are still rising however by 5.8% the last year which stokes the fires of confidence for consumers who are wealthier at least on paper. Declining home prices are bad for confidence so at least home values remain supportive of this long economic expansion which starts year ten in July.

Existing home sales are down today but this does not reflect homebuyers diminished expectations of the overall business and economic climate. Fed officials will not view today's data with concern and the odds of a rate hike at Powell's first meeting in March remain over 80% so we anticipate a move up in the Fed funds rate to 1.75%. You have to be pretty confident in your income and the future to make the biggest big-ticket purchase of your life, and homebuyers remain confident. We will see what happens to sales activity once the data reflect the tax cuts that workers are just starting to see now in their paychecks. Home sales could see a boost after the tax cuts, although lack of supply remains a constraint. Many Americans just aren't moving and putting their homes up for sale. Demographics is part of the reason as the baby boom generation doesn't know where to go after retiring, and seems to be delaying retirement as well. Stay tuned. Story developing.

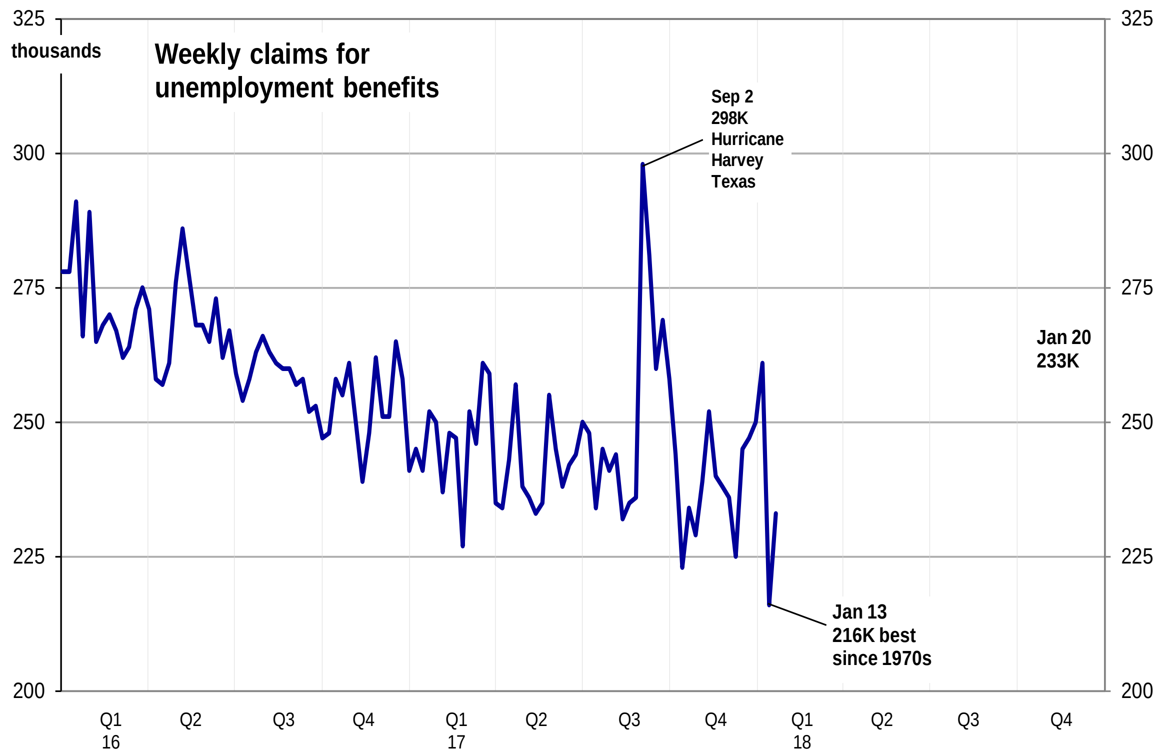
Jobs market on fire despite small rise in jobless this holiday week (Thursday)

Breaking economy news. Weekly jobless claims say there are no jobless left in America. The number of new people applying for benefits after being sacked this week rose to 233K in the January 20 week from a downward revised 216K the week before. 216K is the lowest level for this long recovery and the best reading since the 1970s.

Jobless claims may have risen a little this week from generational lows, but the only reason seems to be that people took off for the Martin Luther King Day holiday.

Net, net, the President has a lot to crow about at Davos this year with the labor market running so hot that companies are having to call back workers who had dropped out and were sitting on the sidelines. Can you work a machine press? No worries we will teach you. This is the strongest economy in decades if weekly jobless claims are the key metric of good fortune and success. The Fed may have to pick up its game this year and raise rates four times not just the three they have already forecast. A 2.5% Fed funds rate sounds about right for an economy that starts its tenth year of steady forward movement in July.

The Trump administration will have to find a new mantra besides saying they are focused on jobs, jobs, jobs as America is rapidly running out of new workers to hire. This may be the first cycle to turn not because the the Fed takes the punch bowl away, the economy may actually slow down dramatically because labor is in such short supply. The economic wheels cannot keep spinning if there is no one to put in the driver's seat. Best jobless claims data since the 1970s. The economy is better than you think. Bet on it.



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