Financial Market Weekly

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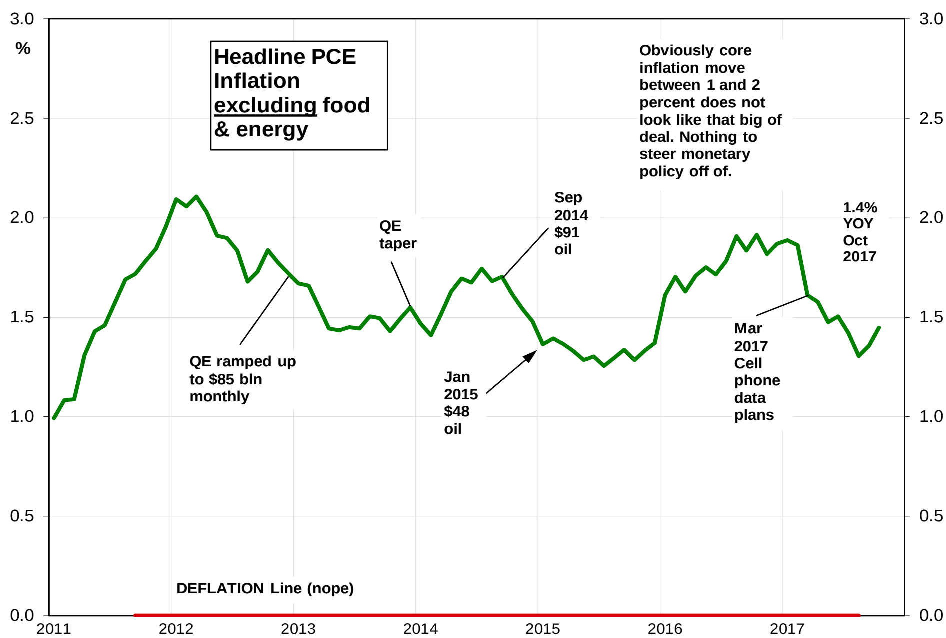
1 DECEMBER 2017

LOW 4.1% UNEMPLOYMENT, WHY NO INFLATION?

This is what Yellen was asked as a question at NYU a week ago. And Congress asked Yellen and Powell this at the hearings this week. The fact that inflation is low is nothing to stop them from returning rates to neutral, and promptly, we would even take their 2.75% vision of neutral to start. Can't people be patient for gosh sakes? No inflation. Be patient. It will pick up again. C'mon. And besides, inflation is not a measure of the economy's failure or success at this stage of the business cycle. But we digress.



On Tuesday, November 21 Yellen answered a student's question saying indeed, it is unusual historically to have a low unemployment rate and not at least be seeing signs of inflation moving higher. It has not been a mystery the last several years though this low inflation. First unemployment was very high and labor market slack depressed it, then there was a massive decline in crude oil prices that pushed down inflation for several years, and then starting in 2014 there was a huge appreciation of the dollar that pushed down import prices and held down inflation. 2014, 2015, 2016 were lower than we wanted it, but no surprise. In 2017 low inflation is a surprise. We are guessing there are some transitory factors at play in 2017. Healthcare rising less rapidly than it used to partly due to Obamacare but this will change. Unlimited data for your cellphone, pushed down inflation "statistically" even though people's phone plan bills did not change much. So we expect inflation will move back up, but we are watching inflation closely.

Well after Yellen spoke on low inflation being transitory, core PCE inflation for October was released on Thursday, November 30. Core PCE inflation has recovered from the declining trend and the overall decline looks less severe. Core PCE inflation was 1.869% in December last year and is now 1.447% or a decline of four-tenths. This is the first we have heard Yellen saying healthcare costs were rising more slowly, partly Obamacare-related, but that this was a transitory trend. PCE inflation measures healthcare differently than CPI healthcare inflation which is much higher, CPI, than PCE healthcare inflation. And one problem with PCE inflation is that healthcare has an enormous weight in core consumer purchases. In December 2016, PCE spending less food and energy was $11.660 trillion and healthcare spending $2.216 trillion or 19%. Healthcare's weight in CPI is much lower at 8.4% which partly explains why October core PCE inflation is lower at 1.4% (just missed 1.5) while core CPI inflation is 1.8%. Healthcare inflation has a larger weight in the PCE measure and it is rising less quickly.

Why is inflation lower in 2017?	Percent % changes Dec 2015 Dec 2016	Dec 2016 Oct 2017
Core PCE inflation YOY	1.9	1.4
Communication	-1.7	-5.0
Financial services	7.4	3.3
Prescription drugs	6.3	1.1
Other durables, jewelry, books	2.1	0.4
Hotels	3.3	1.1
Health care	1.4	1.0
Gasoline	8.9	6.1
Housing	3.6	2.7

Core PCE Inflation monthly and year-on-year changes

2016	% chg	YOY	2015	% chg	YOY
Dec			Dec	0.1	1.9
Nov			Nov	0.0	1.8
Oct	0.2	1.4	Oct	0.1	1.9
Sep	0.2	1.4	Sep	0.1	1.8
Aug	0.1	1.3	Aug	0.2	1.9
Jul	0.1	1.4	Jul	0.2	1.8
Jun	0.1	1.5	Jun	0.1	1.7
May	0.1	1.5	May	0.2	1.8
Apr	0.2	1.6	Apr	0.2	1.7
Mar	-0.2	1.6	Mar	0.1	1.6
Feb	0.2	1.9	Feb	0.2	1.7
Jan	0.3	1.9	Jan	0.3	1.6

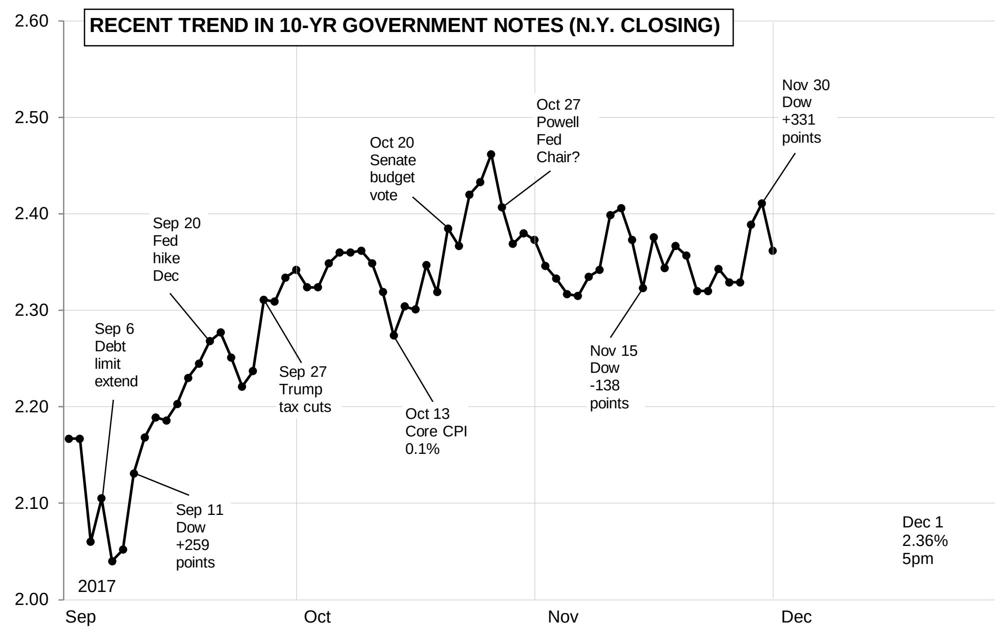
The table above looks at some of the price categories that added less to core inflation this year. (We added healthcare, gasoline, and housing just to look at the overall trend of important groups.) Communication ("free" cell phone data) is down the most this year falling 5% and that will reverse next year. Financial services inflation is slower rising just 3.3% after a 7.4% jump in 2016. This is part of the PCE problem; financial services (excluding insurance) is a 6% weight of core consumer purchases which doesn't make any sense for out of pocket costs of financial services at least at our house. Prescription drugs rising just 1.1% this year after 6.3% last year (Trump can stop tweeting about drugs). Other durables and Hotels are less this year as well. Nothing stands out as far as the relative weakness in core PCE inflation this year besides your cell phone data plan.

Our bet is with Yellen's that core inflation will move back up over the next year. Then again, while her recent statements suggest low inflation from the start of the year is transitory, she sure spends a lot of time wondering if it is not. Maybe she is trying as Chair to represent all the views of the FOMC. The Committee says it is watching inflation closely, and this suggests a rate hike or two will come off the table next year if inflation doesn't make it back. The FOMC September meeting forecasts say core PCE inflation will be 1.9% in Q4 2018. Stay tuned. Story developing.

MARKETS OUTLOOK

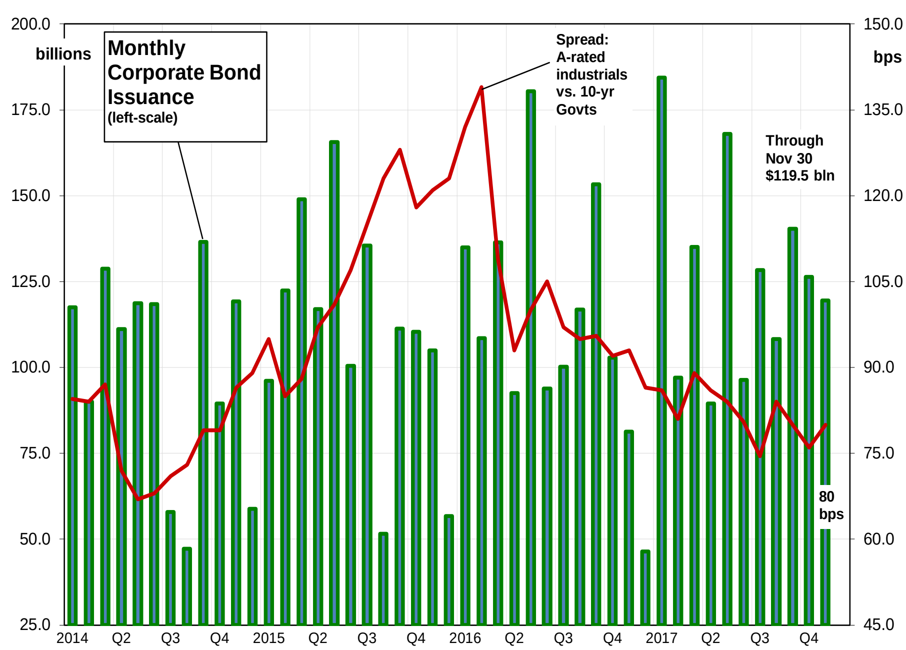
	1-Dec 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
30-Yr Treasury	2.76	2.90	3.00	3.10	3.30	3.40	3.50	3.60	3.70	3.80	3.80
10-Yr Note	2.36	2.50	2.70	2.80	3.00	3.20	3.30	3.40	3.50	3.70	3.70
5-Yr Note	2.11	2.20	2.40	2.60	2.80	3.00	3.15	3.30	3.40	3.60	3.60
2-Yr Note	1.77	1.95	2.20	2.45	2.65	2.85	3.10	3.30	3.40	3.60	3.80
3-month Libor	1.49	1.90	2.10	2.30	2.60	2.80	3.10	3.30	3.30	3.55	3.80
Fed Funds Rate	1.25	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75
2s/10s spread	59	55	50	35	35	35	20	10	10	10	(10)

10-year Treasury yields poked their head above 2.40% on Thursday for the first time in a long while. Dow industrials were up over 300 points we guess on news Senator McCain would not stand in the way of tax cuts for all instead of killing the legislation like he did for Obamacare's repeal. Last month in the quarter, time to update interest rate forecast. Four Fed rate hikes next year. Economy is ready enough. Year-end 2018 cut 10-yr from 3.4% to 3.0%. End of 2019 10-yr is down 40 bps as well to 3.5%.



CORPORATE BONDS: ALIBABA, PG&E, CATERPILLAR, SIMON PROPERTY

Corporate offerings were $28.5 billion in the December 1 week versus $7.1 billion in the November 24 week. On Tuesday, Pacific Gas & Electric sold $2.5 billion 10s/30s/FRNs. It priced $1.15 billion 3.3% 10-yrs (m-w +15bp) at 100 bps (A2/A-). The utility will use the proceeds to repay about $1 billion senior notes and FRNs, and a $250 million term loan. Corporate bonds (10-yr Industrials rated A2) were 80 bps above 10-yr Treasuries this week versus 81 bps last Friday.



FEDERAL RESERVE POLICY

The Fed meets December 12-13 to consider its monetary policy. Fed funds futures odds of a rate hike to 1.5% are 92%, they are going.

We heard from Yellen and her apprentice this week. We always get a shiver when we read in Yellen's prepared remarks (Wednesday, before Joint Economic Committee), "the neutral rate currently appears to be quite low by historical standards, implying that the federal funds rate would not have to rise that much further to get to a neutral policy stance." That can't be right. They don't know that for a fact. Economics isn't a science. She also mentioned the Committee's latest longer run Fed funds rate forecast is 2.75%.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	29-Nov	22-Nov	15-Nov	8-Nov	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2456.959	2456.822	2456.641	2459.985	479.782
Federal agency debt securities	4.391	4.391	6.757	6.757	0.000
Mortgage-backed securities	1767.095	1778.683	1775.854	1770.630	0.000
Primary credit (Discount Window)	0.024	0.010	0.003	0.004	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)	1.709	1.710	1.710	1.712	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	0.035	0.035	0.037	62.000
Federal Reserve Assets	4484.5	4497.5	4495.3	4505.4	961.7
3-month Libor %	1.48	1.46	1.42	1.41	2.82
Factors draining reserves					
Currency in circulation	1599.963	1598.883	1593.044	1591.737	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	67.019	51.634	35.038	74.546	0.000
Reserve Balances (Net Liquidity)	2271.171	2329.834	2357.806	2317.610	24.964
Treasuries within 15 days	7.869	7.869	7.869	11.043	14.955
Treasuries 16 to 90 days	65.013	65.010	48.442	56.307	31.549
Treasuries 91 days to 1 year	335.543	335.542	352.103	317.797	69.272
Treasuries over 1-yr to 5 years	1117.114	1117.078	1117.050	1111.537	170.807
Treasuries over 5-yrs to 10 years	308.302	308.286	292.840	329.680	91.863
Treasuries over 10-years	623.118	623.038	638.336	633.622	101.337

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

Don't blink or you'll miss it: the great balance sheet unwind has begun. The Fed's Treasury security holdings dropped $8.8 billion from $2.465 trillion on October 25, 2017.

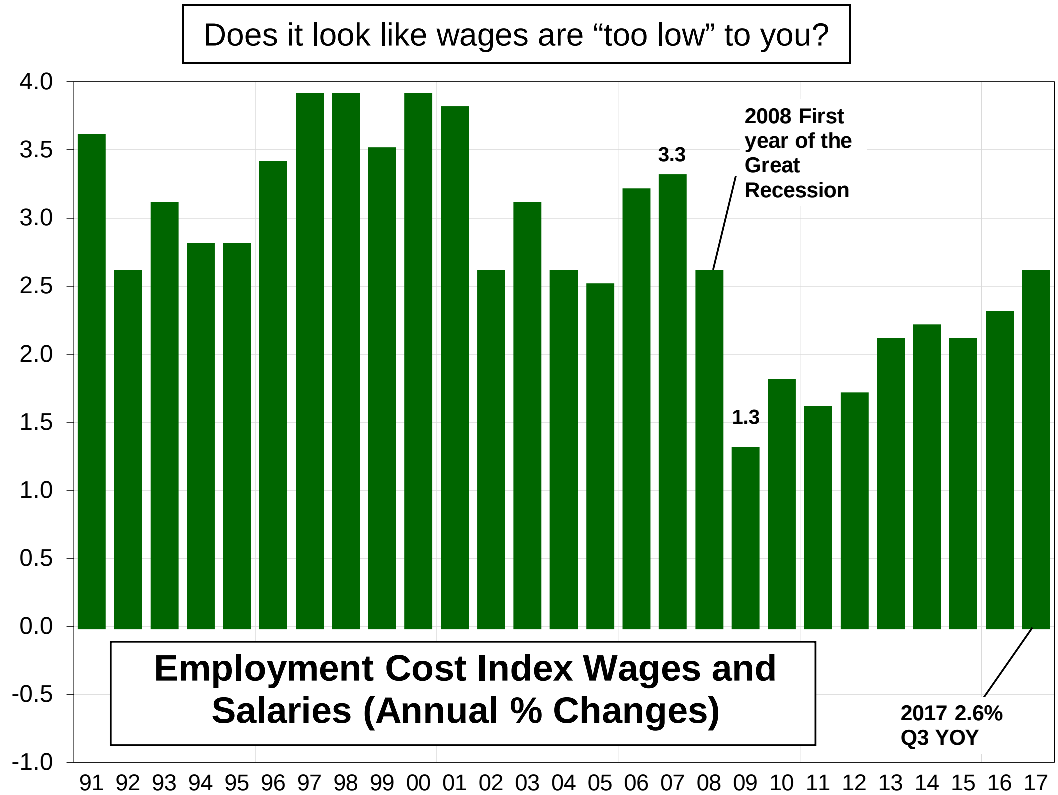
Powell's nomination hearing at the Senate was Tuesday. Yellen has obviously taught Powell well that the labor market remains unsatisfactory so never raise interest rates again. We can only hope that what was taught there can be untaught. The Fed's rules of engagement with the economy and markets have drifted since Greenspan left the building in 2006. Basically, they won't stop tinkering with the economy. Maybe Trump's naming of one of four new Fed Governors this week will be the start of returning to the good old days when the market set interest rates and Fed officials were hard-money advocates, hard money like Bitcoin where there is stable value.

Powell's answer to one of one of his first questions at his nomination hearing about just what was "maximum employment" was most telling. He said maximum employment was an "imprecise thing." A couple of years back he said rates needed to stay low to let the economy heal and his response is in keeping with that sentiment. The sentiment where they need to take care in lifting interest rates. The economy would have healed even if they had lifted rates earlier by the way.

After a nine year economic expansion the economy has certainly reached the nirvana of full employment. This is as good as it is going to get for "business conditions." Not so apparently in the eyes of the future Fed Chair. Essentially, he answered the full employment, maximum employment, question by throwing out three economic indicators: and he said two out of three said the economy wasn't at full employment or wasn't strong enough to support higher interest rates which is the same thing. At one time, we were hopeful Powell might have his own views and strike out in a new direction from his predecessor, but it isn't looking good. Someone in the building, maybe one of the new Fed governors, will have to educate him on the need for higher rates at a faster pace.

The three key indicators of the labor market he said were the unemployment rate, the participation rate, and wages. Unemployment of 4.1% has reached the target, that is one datapoint. For the second datapoint he wandered off on a long explanation of the participation rate. There have been some dropouts among prime age males and he even pointed to their opioid use. Low participation meant some slack remains in that these dropouts can be brought back into the workforce. In further questioning he said labor force participation has been declining for over 60 years. Thank you. That means it is a long term trend and no reason not to raise rates.

For his third datapoint, he brought up wages. If wages were faster he would be more convinced they had reached their maximum employment mandate. Perhaps this could be better said that there is no sign the labor market is overheating, otherwise wages would be rising more quickly, so there is no urgency to raise rates more quickly.



Unemployment rate is okay; participation rate and wages not okay. Two out of three are against normalizing interest rates very quickly. We think they have reached maximum employment. The participation rate? We aren't going to touch that one; Powell said it is in a 60 year downward trend which means for us that it is a meaningless indicator of what is right or wrong with the labor market. Wages look good enough for us, rising fast enough to allow interest rates to move up more quickly. The employment cost index of wages and salaries won't be rising all that much faster in the years to come.

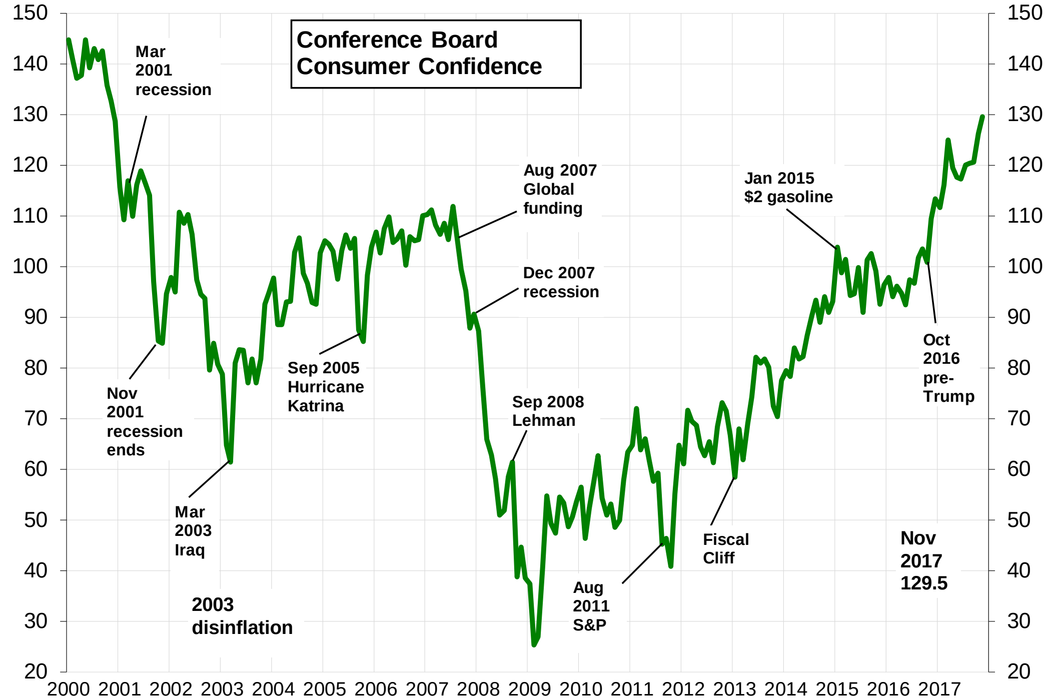
It's early yet, but it looks as if Powell will be a carbon copy of Yellen in the next couple of years. He does not sound like he would be in favor of raising rates any more quickly than the Yellen Fed. Time will tell whether he will seek to guide the committee in a new direction. The economic seas are calm at the moment. Not much for the Fed to do except move interest rates back up to normal. Maybe the first battle, if that is the word, will be over what are normal rates. Yellen is sticking with presenting the committee's 2.75% view of normal which is the September 2017 FOMC meeting median forecast of all Fed officials. That's the median, but the Fed is split, kind of like Congress. Out of 15 forecasts for the longer run Fed funds rate, only four are actually at 2.75%, five say 3.0%, four say 2.25%, with a couple of nutty forecasts higher and lower than these, and one individual who declined to say (what are we paying you for?).

OTHER ECONOMIC NEWS THIS WEEK

Nothing fazes the consumer whose confidence knows no bounds

Breaking economy news. Another new high for consumer confidence where you have to go back before the last two recessions to find them this assured of what the future holds in store for their lives. There are always lot of risks and shocks and danger zones ahead when it comes to the outlook, but this time is different the consumer is saying as their confidence levels move up and up and up. Jobs markets, stock markets, tax cuts, the consumer loves it all. The consumer confidence index in October rising 3.3 more points today to 129.5 after the big jump last month of 5.6 points. This is one of the longest economic expansions in almost twenty years and if it is showing any signs of tiring or going off the rails the consumer just doesn't see it.

Before Trump was elected the confidence index was 100.8 and now it is almost thirty points higher at 129.5 a move that defies gravity and lacks an easy explanation, so we aren't even going to try. Maybe this is what an economic bubble looks like where Americans are blind to the risks that tend to build late in the economic cycle.



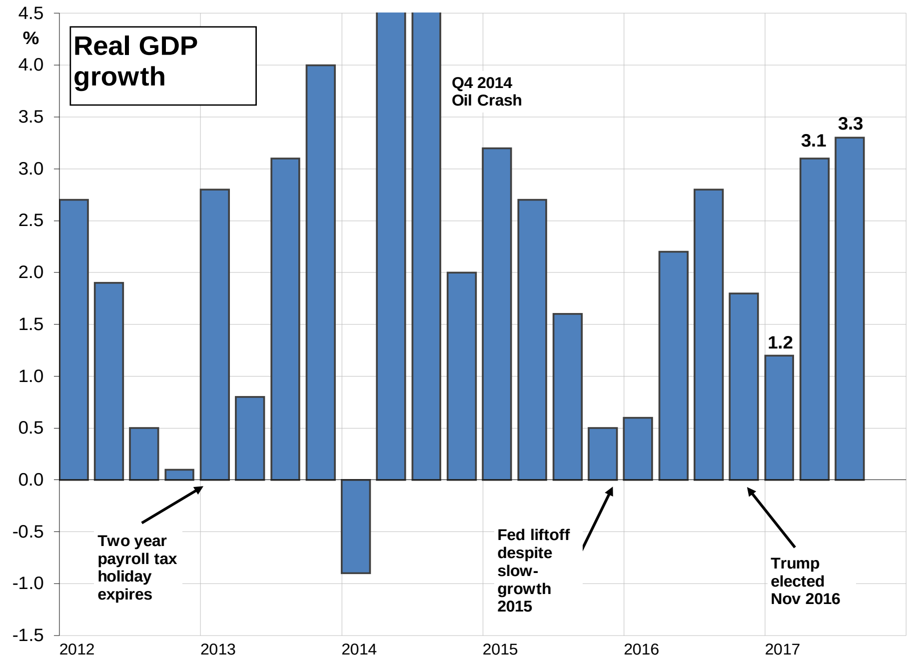
Or maybe confidence is relative and just means how old you are and how long a future you have? Not really this month anyway with those under 35 seeing confidence jumping from 127.2 to 139.8. Darn kids don't know how bad it can be out there, they haven't even been in a recession yet. Those in the middle ages 35-54 are getting squeezed with responsibilities and the hard work that comes with it during the prime years of their lives. Their confidence fell from 135.0 in October to 125.7 in November. These middle Americans need a tax cut to cheer them up.

And the baby boomers apparently have no fear of retirement though as their confidence jumped, apparently believing that TV commercial where the nice gray haired lady says she is looking forward to a "nice long life ahead of me." Too much rock and roll or something for that generation facing the sunset years and oblivious to the realities of aging. Baby boomers’ confidence, those 55 years and older jumped like the Millennials from 116.1 in October to 129.8 in November.

Net, net, this economy has really got some legs if this confidence of consumers is to be believed. A new high for how good the labor markets are with 37 percent saying jobs are plentiful. The economy is better than you think. Bet on it.

3.3% GDP growth is no longer disappointing

Breaking economy news. Real GDP tops the Trump administration's 3% hopes and is revised to 3.3% now in the third quarter from the initial estimate of 3.0% a month ago. Outgoing Fed Chair Yellen said in her testimony before the JEC today that GDP growth had been disappointing, but we think she must be referring to the year 2016 because the economy is growing gangbusters this quarter. She said that Congress might consider policies that encourage business investment where companies certainly do not need any more encouragement as they continue to spend away. Pre-tax corporate profits are up 5.4% in the third quarter so companies clearly have the monies to spend on additional investment if needed and they certainly do not need tax cuts from Washington to spur them onward. We don't know what they are going to do with the corporate tax cuts largesse, but the cash isn't necessary to push the economy any faster. Don't ask when the economy will run 3% again and make America great because the economy has reached that goal already today.



Net, net, the economy kicked it up a notch with growth hitting 3.3% this quarter. The massive rally in stocks this year seems to sprinkled some kind of magic fairy dust over the economy that makes corporate America want to buy, buy, buy. One of the economy's engines, the American consumer, was slower at 2.3% this quarter, but business fixed investment hit it out of the park again as corporations are not waiting for their tax cuts, they are buying up a storm of equipment and software right now. Business equipment purchases up 10.4% in Q3 after 8.8% in Q2. Spending on intellectual property including software rising 5.8% this quarter. Growth is solid which ticks off one of the Fed's boxes when it comes to a decision to raise rates again in a couple of weeks. Economic growth is solid so the Fed can continue with its policy of gradually raising rates to normal levels. The economy is stronger than you think. Bet on it.

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