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Economic Research

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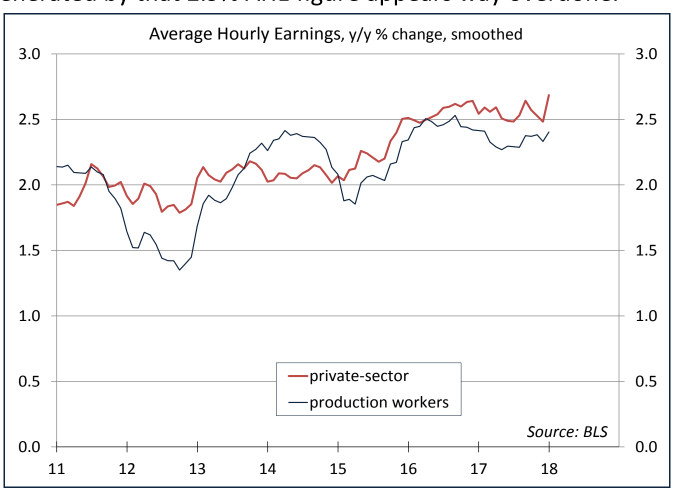
Weekly Economic Monitor

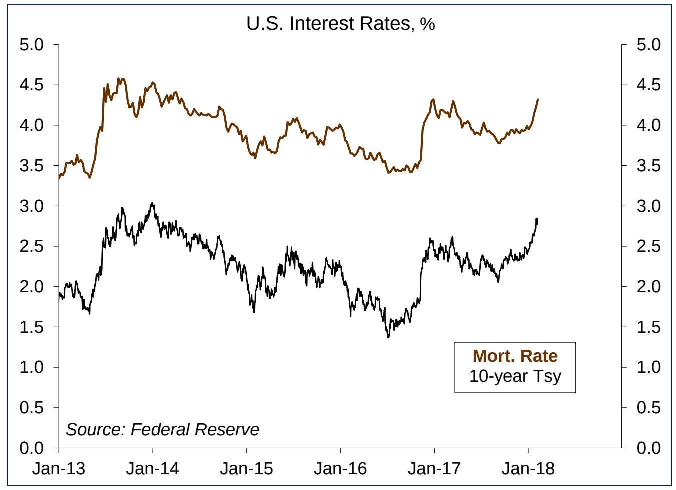
Rethinking the Fundamentals?

The recent uptick in average hourly earnings (+2.9% y/y) and the surge in the government's borrowing needs ($1 trillion plus in the current fiscal year) have had some implications for the underlying fundamentals. However, the outlook hasn't been tumultuous enough to explain multi-100-point intraday swings in the Dow. Something else is clearly going on. Past market corrections have had two key elements. One is that many participants felt that the market was overvalued to begin with. The other is that people are selling mostly because other people are selling. Looking through the day-to-day noise, the recent market action is consistent with the two economic themes for 2018: 1) solid momentum across sectors to start the year; and 2) increased uncertainty regarding the intersection of corporate tax cuts, job market constraints, increased government borrowing, and more aggressive monetary tightening.

Let's circle back and look at the average hourly earnings (AHE) data released on February 2 (recall that this report included benchmark revisions to the data, but that didn't change the picture). AHE for private-sector workers were reported up 2.9% y/y, the highest in over eight years. However, monthly figures can be erratic. If we smooth the wage figures using a three-month average, wage growth was 2.7% – and if we restrict that to production workers, the pace was 2.4% (essentially unchanged over the last two years). Granted, wage pressures should build as the job market tightens, but the anxiety generated by that 2.9% AHE figure appears way overdone.



The government borrowing outlook grew worse last week. Recall that Treasury reported a sharp rise in its borrowing need on January 29 and announced increases in the sizes of the regular monthly auctions of notes and bonds on January31. Last week, Congress approved, and the president signed, a two-year budget agreement that boosts spending for FY18 and FY19 about $300 billion over the previous spending cap. That additional spending qualifies as "fiscal stimulus," on top of the near-term stimulus of the Tax Cut and Jobs Act approved in December. However, the impact is going to be unclear given the limitations of the job market and the fact that monetary policy would likely be even tighter.



Higher interest rates should have a detrimental impact on economic growth, especially in business investment and in housing. Capital spending is unlikely to be affected much, given the cut in corporate tax rates. However, the tax changes will have significant effects on whether to finance investment through debt or equity – and it's likely to take a year or more before the IRS fine tunes its interpretation of tax law changes. Higher mortgage rates will price a lot of potential homebuyers out of the market, especially at the bottom half of the market, which has struggled to recover from the housing collapse.

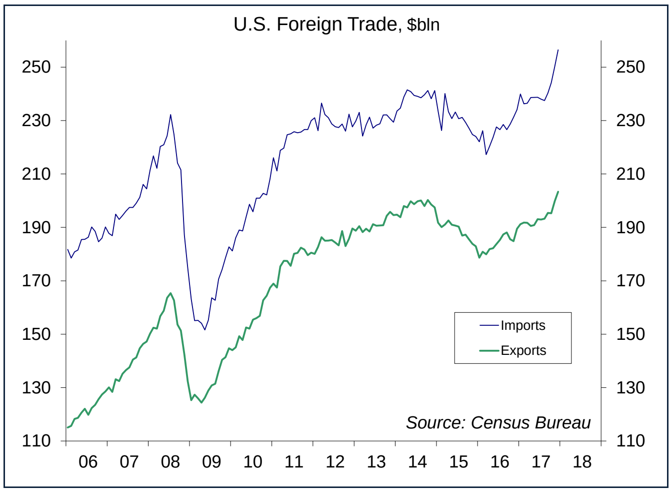
The stock market should settle down at some point, but the extreme volatility could be with us for a while. Nauseous investors are unlikely to be comforted by the notion that they are in it for the long haul, that corrections are healthy, and that the fundamentals haven't really changed all that much. Go outside. Look at the horizon. Maybe try some ginger root.

If only we had a hero. Like Clark Kent, Jay Powell is a quiet, unassuming man. The new Fed chair will present his semi-annual monetary policy testimony to the House Financial Services Committee on February 28. In his nomination hearing, Powell played it close to the vest. This time, he will have to be more explicit in his monetary policy outlook (actually not "his" alone – he's there to represent all of the Fed's decision makers). Will he step out of the phone booth and save the day? Depending on what transpires in the financial markets, he may not have the luxury of waiting. The Fed is not expected to ease policy to counter stock market weakness, but a strong, comforting statement may be needed relatively soon.

	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
1/12/18	1.43	1.59	1.78	1.99	2.12	2.35	2.55	2.85	1.213	1.369	111.23	1.252	7261.06	2786.24	25803.19
2/02/18	1.48	1.65	1.88	2.15	2.33	2.58	2.84	3.08	1.245	1.413	110.40	1.239	7240.95	2762.13	25520.96
2/09/18	1.56	1.75	1.89	2.08	2.29	2.54	2.86	3.17	1.223	1.382	108.78	1.259	6897.77	2619.55	24190.97

Recent Economic Data and Outlook

The stock market remained subject to huge intraday swings.

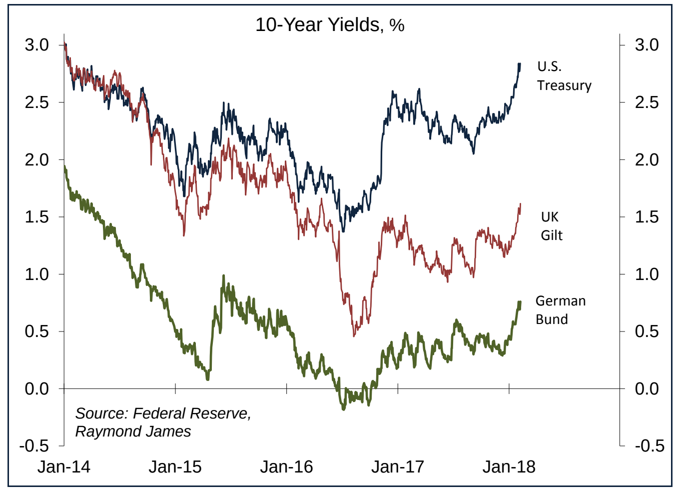


The Senate reached a two-year **Budget Agreement**, boosting spending by about $300 billion over the proposed budget caps for FY18 and FY19. The deal includes $90 billion in disaster relief and $20 billion for infrastructure. It increases the federal debt limit through March 1, 2019.

The **ISM Non-Manufacturing Index** rose to 59.9 in January (median forecast: 56.5), vs. 56.0 in December and 57.3 in November. Growth in business activity and new orders picked up. Job growth improved. Input price pressures remained elevated. Comments from supply managers were mixed.

The U.S. **Trade Deficit** widened to $53.1 billion in December, a bit higher than expected, but not far from what was assumed in the advance GDP report (implying, all else equal, little revision to the 4Q17 growth estimate). Exports rose 5.5% in 2017, while imports increased by 6.7%. The non-petroleum deficit ($734.3 billion) was the highest on record. Imports of food, feeds, and beverages ($137.8 billion); capital goods ($640.6 billion); automotive vehicles, parts, and engines ($359.0 billion); and consumer goods ($602.2 billion) were at record highs. The trade deficit with China ($375.2 billion) was a record high. The U.S. had record exports to 29 countries in 2017, led by Mexico, China, and the U.K. We also had record imports from 47 countries, led by China, Mexico, and Italy.

The Philadelphia Fed's **Survey of Professional Forecasters** showed a jump in projections of GDP growth for 2018 (to 2.8%, from November's 2.5%) and 2019 (to 2.5%, from 2.1%), with only a small decrease in the unemployment rate (what's wrong with this picture?). Inflation forecasts were little changed.



The **Bank of England**'s Monetary Policy Committee voted unanimously to keep the Bank Rate at 0.5% and to leave the asset purchase program unchanged. In its policy statement, the MPC noted that "the global economy is growing at its fastest pace in seven years," with the expansion "becoming increasingly broad-based and investment driven." The MPC repeated that "Any future increases in Bank Rate are expected to be at a gradual pace and to a limited extent." But also indicated that "were the economy to evolve broadly in line with the February Inflation Report projections, monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November Report."

Economic Outlook (1Q18): around 2.5% GDP growth.

Employment: Job growth has remained strong, but the pace should decline as the job market continues to tighten.

Consumers: Job and wage growth remain moderately supportive. Fourth quarter improvement partly reflects a rebound from the third quarter's hurricane effects.

Manufacturing: Sentiment surveys remain strong and orders have been improving. Factory output is rebounding from a soft 3Q. An improving global outlook has supported export growth.

Housing/Construction: Job growth has been supportive. Monthly figures are often erratic and supply constraints remain, but the underlying trends are relatively strong.

Prices: Core inflation has continued to trend below the Fed's 2% target, partly reflecting a "one-off" plunge in wireless telecom services. Wage pressures are moderate.

Interest Rates: The Fed remains in tightening mode, and is expected to continue gradually raising short-term rates, but personnel changes add uncertainty. Balance sheet reduction has begun and should not be disruptive for the markets.

This Week:					forecast	last	last –1	comments
Monday	2/12	2:00	Treasury Budget, $bln	Jan	***51.0***	51.3	55.2	about the same as last year
Tuesday	2/13	6:00	Small Business Optimism	Jan	***NF***	104.9	107.5	still elevated
Wednesday	2/14	8:30	**Consumer Price Index**	Jan	***+0.4%***	+0.2%	+0.3%	seasonals add to gasoline rise
			year-over-year		***+2.0%***	+2.1%	+2.2%	moderate
			ex-food & energy		***+0.2%***	+0.3%	+0.1%	potential for an upside surprise
			year-over-year		***+1.7%***	+1.8%	+1.7%	roughly steady
		8:30	Real Hourly Earnings	Jan	***-0.1%***	+0.2%	-0.3%	nominal earnings rose 0.3%
		8:30	**Retail Sales**	Jan	***+0.4%***	+0.4%	+1.3%	unit auto sales reported lower
			ex-autos		***+0.5%***	+0.2%	-1.0%	higher gasoline prices should add
			ex-autos, bld mat, gasoline		***+0.4%***	+0.4%	+1.2%	moderate core sales
		10:00	Business Inventories	Dec	***+0.4%***	+0.4%	0.0%	assumed up about 0.4% in GDP estimate
Thursday	2/15	8:30	Jobless Claims, th.	2/10	***235***	221	230	still subject to seasonal noise
		8:30	**Producer Price Index**	Jan	***+0.5%***	-0.1%	+0.4%	seasonals add to gasoline price rise
			ex-food & energy		***+0.2%***	-0.1%	+0.3%	moderate old core
			ex-f, e, trade services		***+0.2%***	+0.1%	+0.4%	some pipeline pressures showing
		9:15	**Industrial Production**	Jan	***+0.4%***	+0.9%	-0.1%	utility output likely to remain high
			Manufacturing Output		***+0.4%***	+0.1%	+0.3%	aggregate hours 0.2%
			Capacity Utilization		***78.2%***	77.9%	77.2%	trending a bit higher
		10:00	Homebuilder Sentiment	Jan	***73***	72	74	still elevated
		1:00	TIPS Auction					$7 billion in 30-year TIPS
Friday	2/16	8:30	Import Prices	Jan	***NF***	+0.1%	+0.8%	little impact from soft dollar
			ex-food & fuels		***NF***	-0.1%	+0.2%	higher raw materials, flat finished goods
		8:30	**Building Permits, mln.**	Jan	***1.310***	1.300	1.303	weather and seasonal adjustment noise
			% change		***+0.8***	-0.2	-1.0	but a moderately strong underlying trend
			Housing Starts		***1.250***	1.192	1.299	erratic in recent months
			% change		***+4.9***	-8.2	+3.0	watch for revisions
		10:00	UM Consumer Sentiment	m-Feb	***97.0***	95.7	95.9	seen a bit higher
Next Week:								
Monday	2/19		President's Day					markets closed
Tuesday	2/20	1:00	Treasury Note Auction					2-year notes
Wednesday	2/21	10:00	Existing Home Sales, mln.	Jan	***5.50***	5.57	5.78	January figures aren't meaningful
			% change		***-1.3***	-3.6	+5.1	strong, but with supply constraints
		11:30	FRN Auction					2-year FRNs
		1:00	Treasury Note Auction					5-year notes
		2:00	**FOMC Minutes**	1/31				any clues on the future pace?
Thursday	2/22	8:30	Jobless Claims, th.	2/17	***235***	***235***	230	still subject to seasonal noise
		10:00	Leading Econ Indicators	Jan	***+0.7%***	+0.7%	+0.4%	ISM new orders, stock market, yield curve
		1:00	Treasury Note Auction					7-year notes
Friday	2/23		no significant data					winter Olympics end

This Week…

Lots of economic data, but will it matter? Investors are likely to focus on the inflation figures, which can be fluky at the start of the year. Other data (retail sales, industrial production, and residential construction) will also be subject to seasonal noise.

Monday

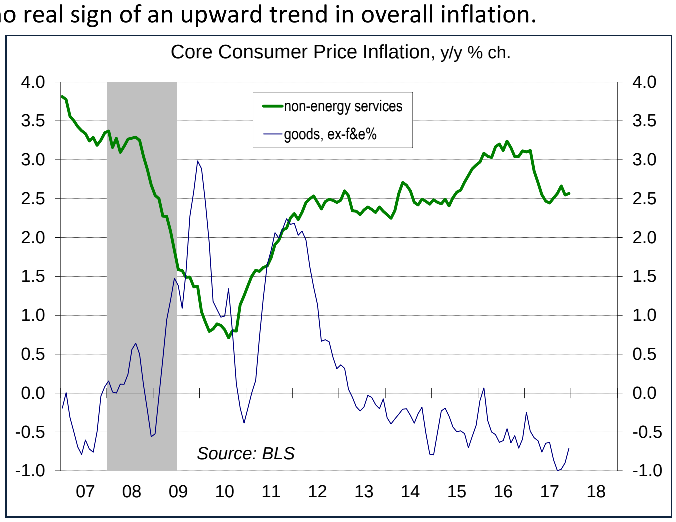
Treasury Budget (January) – January is a surplus month for Treasury (revenues greater than outlays) and this year's surplus is expected to be roughly the same as a year ago (receipts up 5.2% y/y, outlays up 6.2% y/y). The bigger concern is the expected increase in the deficit over the next several years.

Tuesday

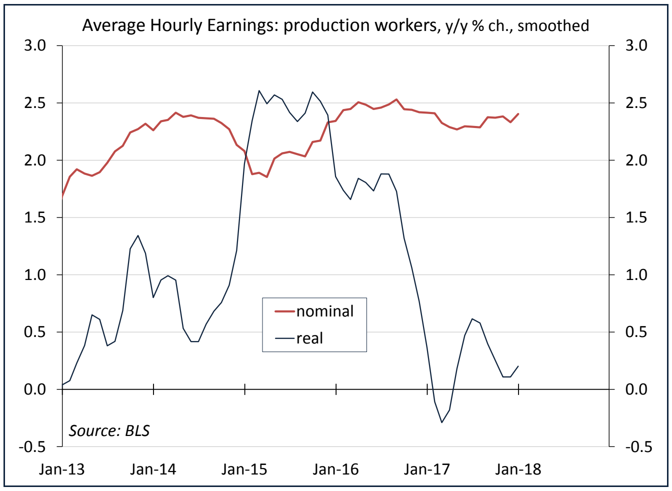
Small Business Optimism (January) – The survey results are likely to remain relatively strong by historical standards.

Wednesday

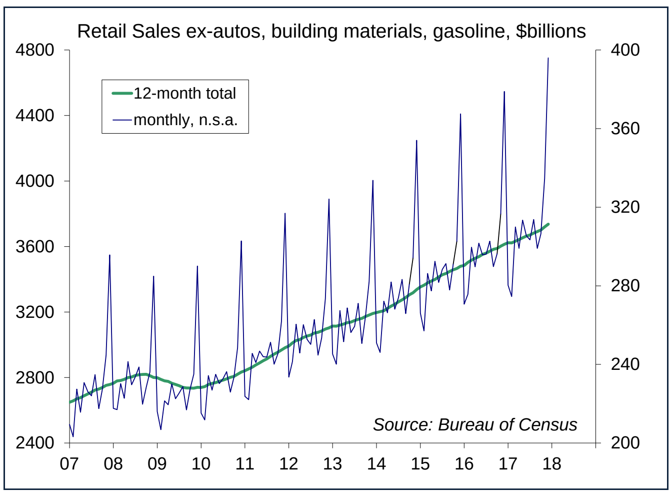
Consumer Price Index (January) – Higher gasoline prices should boost the headline figure in January. Many firms will try to raise prices at the start of the year to see if they stick. There's been an ongoing split between inflation in goods and in services, but no real sign of an upward trend in overall inflation.



Real Hourly Earnings (January) – Nominal average hourly earnings growth for production workers has been moderate, but has barely kept up with inflation over the last year. That implies little growth in the ability to spend for the typical worker.



Retail Sales (January) – Unadjusted sales spike in December, but then fall sharply when the holiday shopping season comes to an end. Unit auto sales were reported lower in January (on a seasonally adjusted basis). Higher gasoline prices ought to add a little to the total. The trend in core sales has been moderate.

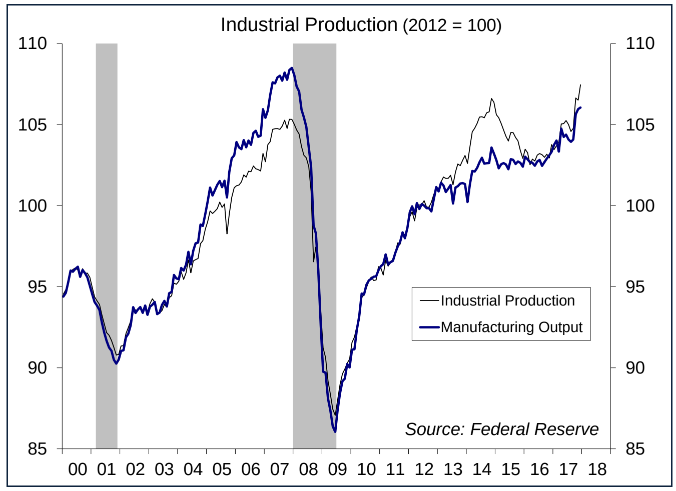


Thursday

Jobless Claims (week ending February 10) – The seasonal spike in unadjusted claims was somewhat smaller this year, consistent with a further tightening in overall labor market conditions. Weekly figures will still be subject to seasonal noise, but the underlying trend in claims is expected to remain low over the next several weeks. Nonfarm payrolls are a coincident economic indicator. Claims are a leading indicator.

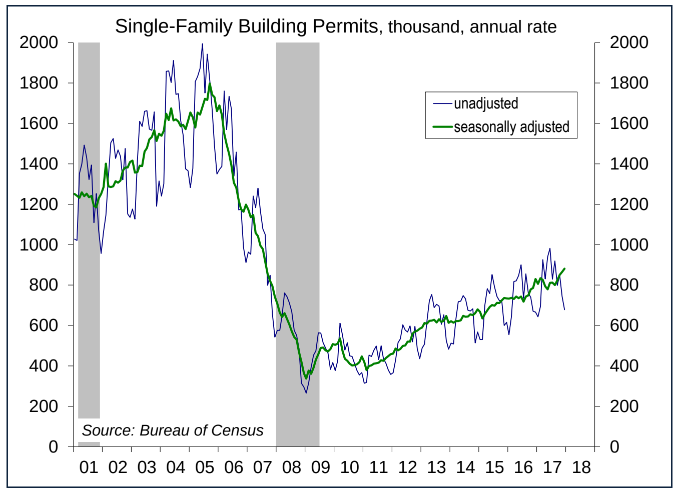
Producer Price Index (January) – The headline figure is expected to be boosted by higher energy costs. Core inflation should remain moderate. Pipeline pressures had been picking up in 2017, but softened somewhat at the end of the year.

Industrial Production (January) – Cold temperatures should keep the output of utilities at an elevated level. Factory output should be up moderately, but January figures are quirky.



Friday

Building Permits, Housing Starts (January) – Residential homebuilding is subject to a strong seasonal pattern.



Next Week …

Monday's a holiday. The economic calendar is thin. Market participants will look ahead to Fed Chair Powell's first monetary policy testimony to Congress (February 28).

Coming Events and Data Releases

February 27	Durable Goods Orders (January) Consumer Confidence (February)
February 28	Real GDP (4Q17, 2nd estimate) Powell Monetary Policy Testimony
March 1	ISM Manufacturing Index (February)
March 9	Employment Report (February)
March 21	FOMC Policy Decision, press conf.
March 30	Good Friday Holiday (markets closed)
May 2	FOMC Policy Decision (no press conf.)
June 13	FOMC Policy Decision, press conf.
November 6	Election Day