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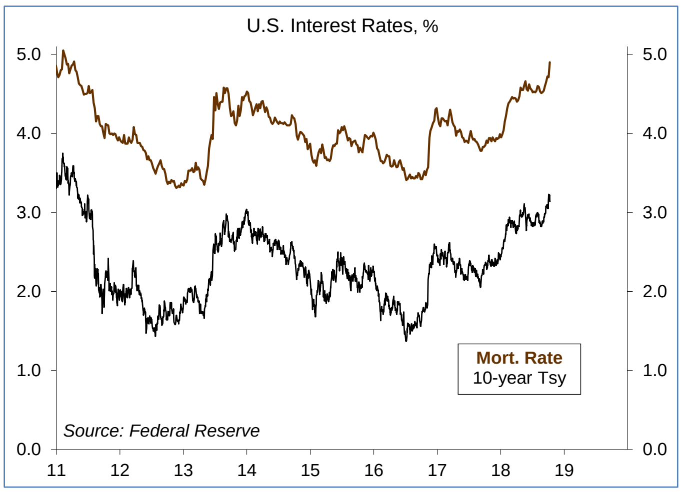
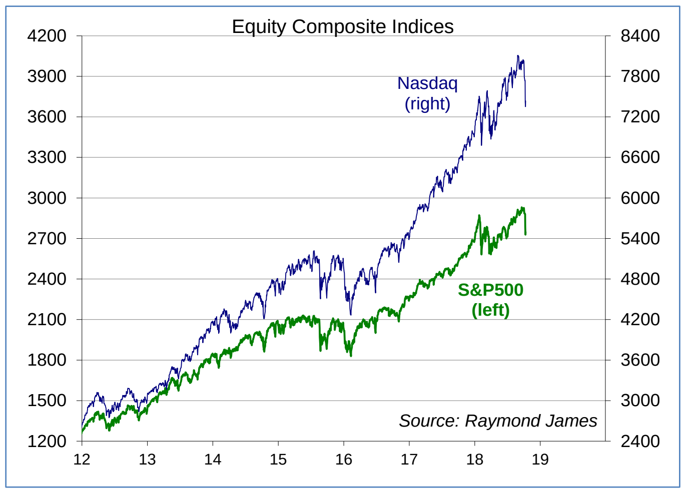
Weekly Economic Monitor

Rate Expectations – It was the best of times, it was the worst of times. Why did the stock market fall? No reason, and every reason. There doesn't need to be a catalyst. Sometimes the market is simply going to do whatever the market is going to do, but the list of worries was already there. Going forward, investors will weigh near-term optimism about the economy against fears of the future – and those fears currently appear to be overdone. Expect further volatility (upside and downside) in the near term.

The economy is in excellent shape. Growth remains strong, the job market continues to tighten, and inflation is expected to remain moderate. But there has been a long list of worries: tighter Fed policy; higher long-term interest rates; trade policy disruptions; demographic constraints; and global economic risks. In the bond market, there have been upward pressures on yields: strong economic growth; tighter monetary policy; sharply rising government borrowing; and the unwinding of the Fed's balance sheet. However, long-term interest rates abroad have remained low, limiting the increase in U.S. bond yields. Inflation, while a bit higher in 2018, is expected to remain moderate – hence, unlikely to drive yields up sharply. Until recently, bond market volatility had been extremely low (the calm before the storm), which typically results in a sharp revaluation. All else equal, higher interest rates are a negative for the stock market, but a weaker stock market is a positive for the bond market (higher bond prices, lower yields).

The strongest argument for slower economic growth is demographic constraints. Labor force growth has slowed. Slow labor force growth and moderate productivity growth imply that long-term potential GDP growth ought to be in the 1.5-2.0% range. We've exceeded that this year, boosted by fiscal policy (tax cuts and increased spending), which will continue into 2019. However, growth has been fueled by a further decline in the unemployment rate – and the unemployment rate can't fall forever.





Productivity growth could pick up. Growth in output per worker has been relatively lackluster since the recession, in part because of a slower pace of capital investment. The tighter job market could lead to a more efficient use of labor. Technology changes (robotics) have helped boost factory output per workers, but partly at the expense of jobs (it's estimated that up to half of the manufacturing job losses since 2000 have been due to technology). Foreign trade has been a significant factor in U.S. productivity growth in recent decades, as the loss of low-end jobs has been offset by the addition of higher-end jobs.

Egged on by the financial press (the cover of the Economist magazine asks "The next recession – How bad will it be?"), investors have begun to focus ahead to the eventual downturn. There are no signs that the U.S. economy will enter a recession anytime soon. Most of the concern is for later in 2019 and in 2020. In looking at past recessions, the table is set by misallocation of capital fueled by excessive leverage. Global shocks or sharply higher oil prices could be a trigger. The Fed could overdo it, raising short-term interest rates too much (or by raising them too slowly, and then having to raise them more rapidly later on).

While the odds of a recession in the next two years have increased, they remain relatively limited. However, the bigger fear is the limited policy options to deal with a downturn. In a typical recession, the Fed lowers short-term interest rates by 500 basis points – there's less than half of that room to maneuver currently. The Fed does not want to embark on another round of large-scale asset purchases (quantitative easing). With trillion dollar federal budget deficits as far as the eye can see, stimulative fiscal policy is likely to be out of the question. Factor in a shakier global financial system, and you really have something to worry about.

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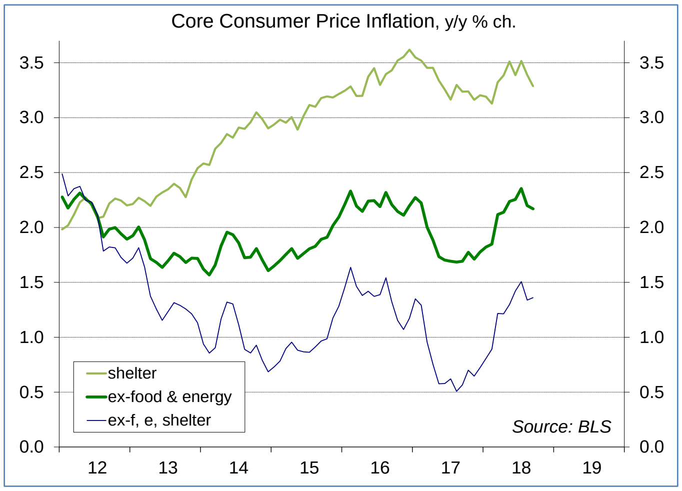
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
9/14/18	2.16	2.33	2.56	2.78	2.85	2.90	2.99	3.13	1.166	1.308	112.09	1.303	8010.04	2904.98	26154.67
10/05/18	2.23	2.41	2.64	2.88	2.99	3.07	3.23	3.40	1.150	1.310	113.56	1.295	7788.45	2885.57	26447.05
10/12/18	2.27	2.44	2.65	2.86	2.94	3.01	3.16	3.34	1.156	1.315	112.22	1.303	7499.90	2767.13	25339.99

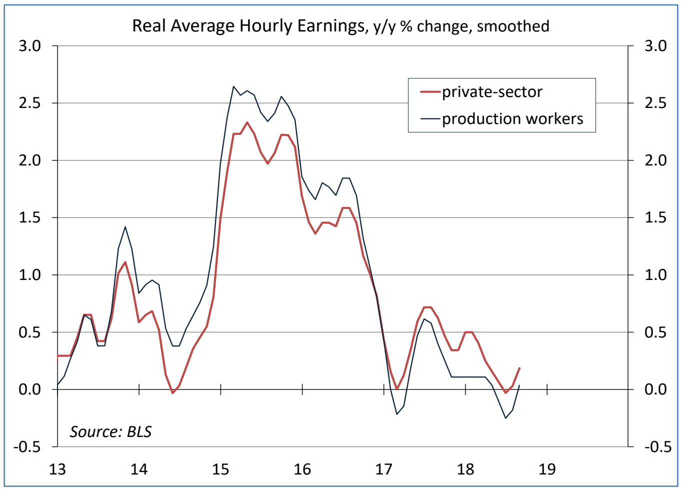
Data Recap – The economic data calendar was relatively thin. Consumer price data surprised to the downside, but largely due to a sharp drop in the price index for used motor vehicles. Bond yields moved higher, prompting a sharp decline in the stock market (which, in turn, helped to push bond yields back down).

President Trump criticized the Federal Reserve as “gone crazy,” “loco,” “out of control,” and “making a mistake.”

In its revised **World Economic Outlook**, the IMF expects global growth to remain steady in 2019 and 2020 (at 3.7%), although “its pace is less vigorous than projected in April and it has become less balanced.”

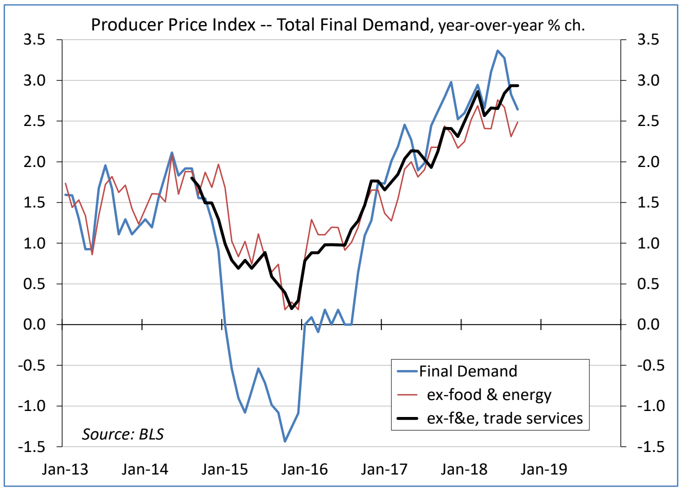
The **Consumer Price Index** edged up 0.1% in September (+2.3% y/y), up 0.1% ex-food & energy (+2.2% y/y). Prices of used cars and trucks fell 3.0% (-1.5% y/y) – otherwise, the figures would have been in line with expectations.

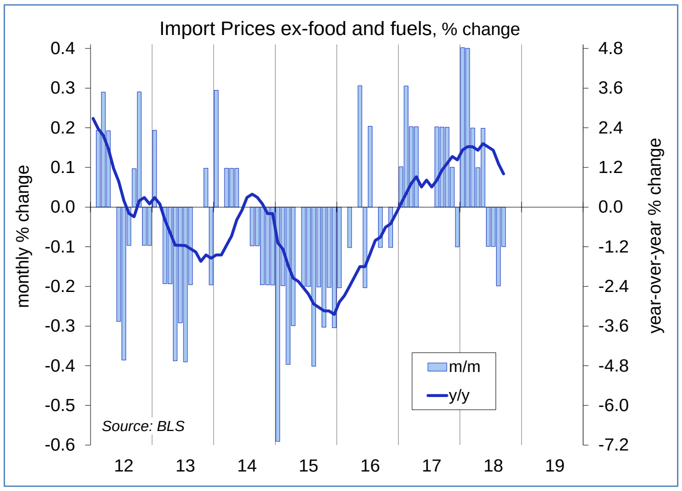




Real Average Hourly Earnings rose 0.3% (+0.5% y/y), up 0.2% for production workers (+0.4% y/y).

The **Producer Price Index** rose 0.2% in September (+2.6% y/y), up 0.4% ex-food, energy, and trade services (+2.9%). Transportation and warehousing services jumped 1.8% (+5.9% y/y). Airline passenger services rose 5.5% (+4.9% y/y).





Import Prices rose 0.5% in September (+3.5% y/y), boosted by a 4.1% rise in petroleum (+32.1% y/y). Ex-food & fuels import prices slipped 0.1% (+1.0% y/y). Prices of imported raw materials have slipped in recent months, after picking up in the first half of the year. Prices of imports capital equipment, motor vehicles, and consumer goods remain flat or modest on a year-over-year basis. Retaliation against U.S. tariffs has hit prices of agricultural exports.

This Week – With earnings season underway, the economic data reports are likely to be less relevant for the stock market, but figures will help to fill in the 3Q18 picture. The retail sales figures are expected to be the highlight. FOMC minutes arrive on Wednesday. Fed Vice Chair of Supervision Randal Quarles will speak on the economic outlook on Thursday.

Unit motor vehicle sales improved last month, although the correlation between the unit sales figures (reported by the various automakers) and the retail auto dealership data is far from perfect. Note that retail employment fell by 20,000 in September, not a good sign, and there may be some impact from Hurricane Florence. The September figure matters less to quarterly growth, but watch for possible revisions to July and August. Retail sales account for about a quarter of consumer spending, and consumer spending accounts for 68% of GDP (advance estimate for 3Q18 due October 26).

This Week:					*forecast*	last	last –1	comments
Monday	10/15	8:30	**Retail Sales**	Sep	***+0.5%***	+0.1%	+0.7%	unit auto sales rose
			ex-autos		***+0.3%***	+0.3%	+0.9%	gasoline prices little changed
			ex-autos, bld mat, gasoline		***+0.3%***	+0.2%	+1.0%	some hurricane impact
		10:00	Business Inventories	Aug	***+0.5%***	+0.7%	+0.1%	faster in 3Q18
Tuesday	10/16	9:15	**Industrial Production**	Sep	***+0.4%***	+0.4%	+0.4%	a moderate gain
			Manufacturing Output		***+0.3%***	+0.3%	+0.4%	aggregate hours slipped 0.1%
			Capacity Utilization		***78.3%***	78.1%	77.9%	trending higher
		10:00	Homebuilder Sentiment	Oct	***67***	67	67	still strong
Wednesday	10/17	8:30	**Building Permits, mln.**	Sep	***1.280***	1.249	1.303	likely to have rebounded
			% change		***+2.5***	-4.1	+0.9	still strong on a y/y basis
			Housing Starts		***1.250***	1.282	1.174	choppy
			% change		***-2.5***	+9.2	-0.3	watch for revisions
		2:00	**FOMC Minutes**	9/26				policy seen as still accommodative
Thursday	10/18	8:30	Jobless Claims, th.	10/13	***210***	214	207	a low trend
		10:00	Leading Econ Indicators	Sep	***+0.5%***	+0.4%	+0.7%	most components higher
		12:15	Fed VC Quarles speaks					"The Economic Outlook"
		1:00	TIPS Auction					$5 billion in re-opened 30-year TIPS
Friday	10/19	10:00	Existing Home Sales, mln	Sep	***5.34***	5.34	5.34	trending about flat
			% change		***0.0***	0.0	-0.7	affordability and supply issues remain
Next Week:								
Monday	10/22		no significant data					
Tuesday	10/23	1:00	Treasury Note Auction					2-year notes
Wednesday	10/24	10:00	New Home Sales, th.	Sep	***620***	629	608	these data are erratic
			% change		***-1.4***	+3.5	-1.6	choppy, watch for revisions
		10:00	BOC Policy Decision					gradually following the Fed higher
		11:30	FRN Auction					2-year FRNs
		1:00	Treasury Note Auction					5-year notes
		2:00	**Fed Beige Book**					moderate growth, tighter job market
Thursday	10/25	7:45	ECB Policy Decision					no change
		8:30	Jobless Claims, th.	10/20	***215***	***210***	214	some hurricane impact
		8:30	**Durable Goods Orders**	Sep	***-2.8%***	+4.4%	-1.2%	aircraft orders spiked in August
			ex-transportation		***+0.2%***	-0.0%	+0.2%	mixed, but a lackluster short-term trend
			nondef cap gds ex-aircraft		***+0.2%***	-0.9%	+1.5%	choppy
		8:30	Advance Econ Indicators	Sep				inventories and merchandise trade
		10:00	Pending Home Sales Index	Sep	***NF***	-1.8%	-0.8%	a soft trend in recent months
		1:00	Treasury Note Auction					7-year notes
Friday	10/26	8:30	**Real GDP (advance est.)**	3Q18	***+3.4%***	+4.2%	+2.2%	still strong
			Priv Dom Final Purchases		***+3.6%***	+4.3%	+2.0%	led by consumer spending growth
		10:00	UM Consumer Sentiment		***98.2***	100.1	96.2	99.0 at mid-month

Coming Events and Data Releases

October 29	Personal Income, Spending (September)
October 30	CB Consumer Confidence (October)
October 31	Employment Cost Index (3Q18)
November 2	Employment Report (October)
November 6	Election Day
November 8	FOMC Policy Decision (no press conf.)
November 12	Veteran's Day (bond market closed)
December 19	FOMC Policy Decision, press conf.
January 30	FOMC Policy Decision, press conf.
March 20	FOMC Policy Decision, press conf.