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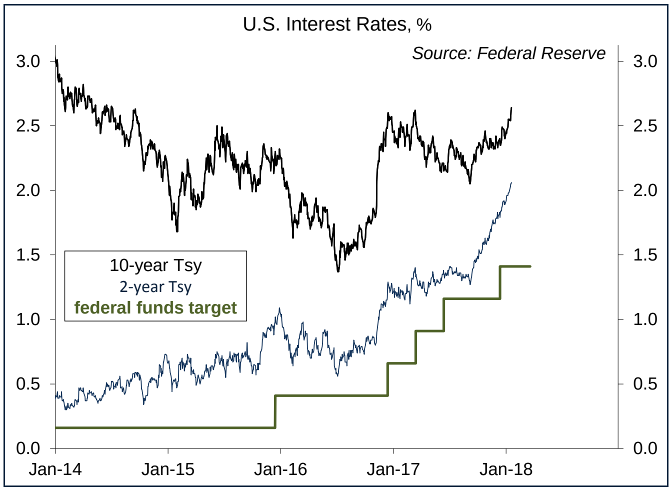
Weekly Economic Monitor

This Too Shall Pass (maybe)

The economic impact of the partial government shutdown will depend on how long it lasts. Government workers will still get paid, but those supporting government workers (food service, etc.) will not. Economic data reports and Treasury auctions may be delayed. For financial market participants, it's a sense of "been there, done that." We've been through shutdowns before and we know that the government will reopen at some point. We shouldn't expect significant market disruptions. However, stock market participants should keep an eye on the bond market, where the 10-year Treasury note yield has approached (if not breeched) a critical level.

The broad consensus among economists is that growth should be moderately strong in the near term, but limited by the further tightening in labor market conditions. Near-term risks to the outlook are weighted mostly to the upside (stronger wage growth, stronger business investment, stronger global growth), but there are some downside risks as well (higher interest rates, trade war, geopolitical shock). The long-term trend in GDP growth is seen as a little less than 2% per year (labor force growth of 0.5-0.6% plus productivity growth of around 1.1-1.3%). We may see GDP growth above that trend in the near term if the unemployment rate continues to fall. However, a sharper decline in the unemployment rate would trigger a faster tightening of monetary policy. Indeed, the financial markets have begun pricing in a more aggressive Fed in 2018.

One of the main issues with the government shutdown is the loss of confidence in the system. Setting a budget is the bare minimum requirement. All else equal, that loss of confidence implies that Treasury yields ought to be higher than they would be otherwise. The Federal Open Market Committee is widely expected to be more hawkish this year, which is also putting some upward pressure on bond yields.



The price of a stock can be thought of as a risk-adjusted discounted stream of future earnings. Hence, all else equal, higher interest rates mean a greater discounting of future earnings and lower share prices. In turn, a drop in share prices should lead to increased capital flows into the bond market, lowering yields. Large moves in the bond market will have consequences for the stock market and vice versa. The dynamics here are hard to forecast, but we're likely to see some increase in market volatility.

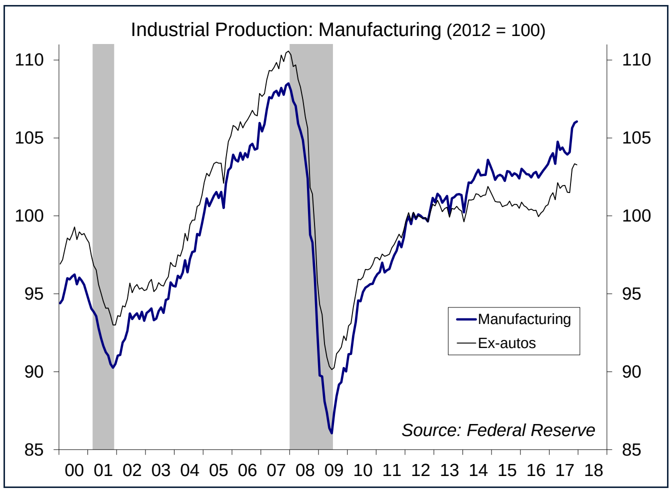
Over the last month, there has been increasing concern about the slope of the yield curve, which is the single best predictor of the business cycle. An inverted curve nearly always precedes a recession. However, it depends on why the curve inverts. Typically, that's because of increased expectations of a recession. Consumers become a little more cautious with their spending and businesses are less likely to make capital expenditures. We are a long way from that now. The yield curve is still nowhere near inverting, but it bears watching. While the near-term risks to the growth outlook are weighted to the upside, the risks for 2019 and beyond are to the downside.

I gave many economic presentations during the financial crisis. It was nothing but bad news, so to lighten the load I ended with a picture of a puppy. It was a cheesy bit, but always got a laugh and people went away feeling a little better. We welcomed Sam, a Decker rat terrier, into our household, as a companion for our deaf dog, Spartacus – and the result was that we had one dog who could not hear and one dog that would not listen. Sadly, the pest control people left the gate open last week and the dogs got out. Sam was hit by a car and died. A runner, he went out doing what he loved, and the end was mercifully quick, but as you know, losing a pet is hard. I'd like to think that Sam brought something positive during the financial crisis. He will be missed dearly.

	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
12/22/17	1.33	1.54	1.73	1.91	2.01	2.26	2.48	2.83	1.184	1.338	113.30	1.275	6959.96	2683.34	24754.06
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
1/19/18	1.44	1.62	1.79	2.06	2.20	2.45	2.64	2.91	1.222	1.386	110.76	1.249	7336.38	2810.30	26071.72

Recent Economic Data and Outlook

The economic data reports were mixed and didn't alter the overall picture. Investors were focused on the shifting odds of a government shutdown (but there is still a sense of "been there, done that"). The market odds of a March 21 Fed rate hike continued to rise (now over 80%, as implied by the April federal funds futures contract). The 2-year Treasury note yield also suggested a somewhat more aggressive Fed policy outlook. The 10-year Treasury note yield bumped up to a key resistance level.



Federal budget negotiations broke down, leading to a partial **Government Shutdown**. In a televised meeting of congressional leaders, President Trump said he would sign any budget agreement put in front of him, but White House officials later rejected the Senate's bipartisan compromise. Party leaders blamed each other for the impasse. The economic impact of the shutdown will depend on how long it lasts. The dysfunction appeared to put some upward pressure on Treasury yields.

Industrial Production rose 0.9% in December (+3.6% y/y), boosted by a 5.6% surge in the output of utilities (+1.8% y/y), reflecting cooler temperatures. Manufacturing output edged up 0.1% (+2.6% y/y), with mixed results across industries. Auto production rose 2.0% (+0.4% y/y). Ex-autos, manufacturing fell 0.1% (+2.5% y/y). Factory output rose at a 7.3% annual rate in 4Q17, but that followed a hurricane-related 1.6% rate of decline in 3Q17. Within mining, oil and gas extraction rose 1.5% (+11.3% y/y), while oil and gas well drilling rose 0.9% (following four months of decline, +40.1% y/y).

Building Permits edged down 0.1% (±1.4%) in December, to a 1.302 million seasonally adjusted annual rate (+2.8% y/y). Single-family permits, the key figure in the report, were reported to have risen 1.8% (±1.2%), up 6.1% (±2.1%) year-over-year.

Housing Starts plunged 8.2% (±7.7%), down 6.0% (±11.7%) from a year earlier. Single-family starts fell 11.8% (±6.5%), up 3.5% (±10.5%) year-over-year.

Homebuilder Sentiment (the National Association of Home Builders/Wells Fargo Housing Market Index) edged down to 72 in January, vs. 74 in December (an 18-year high) and 69 in November. Builders were apparently encouraged by the passage of the tax bill, but also noted higher construction costs and shortages of labor and lots.

The University of Michigan **Consumer Sentiment Index** fell to 94.4 in the mid-month reading for January, down from 95.9 in December and 98.5 in November. The mid-January dip was concentrated in evaluations of current conditions. Expectations were little changed, despite passage of the tax bill.

The **Bank of Canada** increased its target for the overnight rate by 25 basis points, to 1.25%, citing strong data, close-to-target inflation, and "an economy operating roughly at capacity." The BOE added that "uncertainty surrounding the future of the North American Free Trade Agreement (NAFTA) is clouding the economic outlook." Looking ahead, the BOE noted that "while the economic outlook is expected to warrant higher interest rates over time, some continued monetary policy accommodation will likely be needed to keep the economy operating close to potential and inflation on target."

Economic Outlook (1Q18): around 2.5% GDP growth, following 2.5-3.0% in 4Q17 (reflecting a rebound from hurricane effects, but with an expected drag from inventories and net exports).

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	1/22	9:00	IMF WEO					update on global economic outlook
Tuesday	1/23	1:00	Treasury Note Auction					$26 billion in 2-year notes
Wednesday	1/24	10:00	Existing Home Sales, mln.	Dec	***5.65***	5.81	5.50	likely lower following strong November
			% change		***-2.7***	+5.6	+2.4	trend is strong
		11:30	FRN Auction					$15 billion in 2-year FRNs
		1:00	Treasury Note Auction					$34 billion in 5- year notes
Thursday	1/25	7:45	ECB Policy Decision					looking for signs of tightening timing
		8:30	Jobless Claims, th.	1/20	***240***	220	261	noisy
		8:30	Advance Econ Indicators	Dec				inventories and merchandise trade
		10:00	New Home Sales, th.	Dec	***675***	733	624	monthly figures are erratic
			% change		***-7.9***	+17.5	-1.7	underlying trend is strong
		10:00	Leading Econ Indicators	Dec	***+0.5%***	+0.4%	+1.2%	most components higher
		1:00	Treasury Note Auction					$28 billion in 7-year notes
Friday	1/26	8:30	**Real GDP (advance est.)**	4Q17	***+2.5%***	+3.2%	+3.1%	drags from inventories and net exports
			Priv. Dom. Final Purchases		***+3.9%***	+2.2%	+3.3%	strong underlying demand
		8:30	Durable Goods Orders	Dec	***+2.0%***	+1.3%	-0.4%	aircraft orders higher
			ex-transportation		***+0.5%***	-0.1%	+1.3%	moderate
			nondef cap gds ex-aircraft		***+0.5%***	-0.1%	+0.8%	moderate
Next Week:								
Monday	1/29	8:30	Personal Income	Dec	***+0.3%***	+0.3%	+0.4%	moderate, some potential for tax shift
			Personal Spending		***+0.4%***	+0.6%	+0.2%	quarterly figures included in GDP est.
			PCE Price Index ex-f&e		***+0.2%***	+0.1%	+0.2%	core CPI rose 0.277%
			year-over-year		***+1.7%***	+1.5%	+1.4%	still below the Fed's 2% goal
Tuesday	1/30		CB Consumer Confidence	Jan	***120.0***	122.1	128.6	will miss any gov't shutdown effect
Wednesday	1/31	8:15	**ADP Payroll Estimate, th.**	Jan	***+155***	+250	+185	likely a lower trend, but noisy in Jan.
		8:30	Employment Cost Index	4Q17	***+0.6%***	+0.7%	+0.5%	some pickup in 4Q17
			year-over-year		***+2.6%***	+2.5%	+2.4%	trend still moderate
		9:45	Chicago PMI	Jan	***61.0***	67.8	63.9	seen lower, but still strong
		10:00	Pending Home Sales Index	Dec	***NF***	+0.2%	+3.5%	noisy data and Dec is not critical
		2:00	**FOMC Policy Decision**					no change, no press conference
Thursday	2/01	8:30	Jobless Claims, th.	1/27	***250***	***240***	220	still subject to seasonal noise
		10:00	Construction Spending	Dec	***NF***	+0.8%	+0.9%	uneven, but trend is higher
		10:00	**ISM Manf. Index**	Jan	***58.0***	59.7	58.2	moderately strong
		tbd	Motor Vehicle Sales, mln	Jan	***NF***	17.8	17.4	some moderation seen
			domestically built		***NF***	13.7	13.4	weaker in 2017
Friday	2/02	8:30	**Nonfarm Payrolls, th.**	Jan	***+145***	+148	+252	benchmark revisions, seasonal noise
			private-sector		***+145***	+146	+239	trend should be lower in 2018
			Unemployment Rate		***4.0%***	4.1%	4.1%	likely to trend lower in the near term
			employment/population		***60.2%***	60.1%	60.1%	seen flat or slightly higher
			Avg. Weekly Hours		***34.4***	34.5	34.4	weather was likely a factor
			Avg. Hourly Earnings		***+0.3%***	+0.3%	+0.1%	minimum wage hikes
			year-over-year		***+2.6%***	+2.5%	+2.4%	trend a bit higher, still moderate
		10:00	Factory Orders	Dec	***NF***	+1.3%	+0.4%	seen higher
		10:00	UM Consumer Sentiment	Jan	***95.0***	95.9	98.5	94.4 at mid-January

This Week…

Investors will likely be sensitive to any progress on funding the government, even if that is only a temporary fix. The advance 4Q17 GDP report (if not delayed) is the highlight on the economic calendar. This is the initial estimate, which could easily be a full percentage point above or below the final number (investors typically place far too much emphasis on the headline figure). The details should show an unwinding of the third quarter's mixed impact of the hurricanes.

Monday

IMF World Economic Outlook Update – The International Monetary Fund's WEO is likely to reflect a more optimistic outlook for global growth.

Tuesday

No significant data.

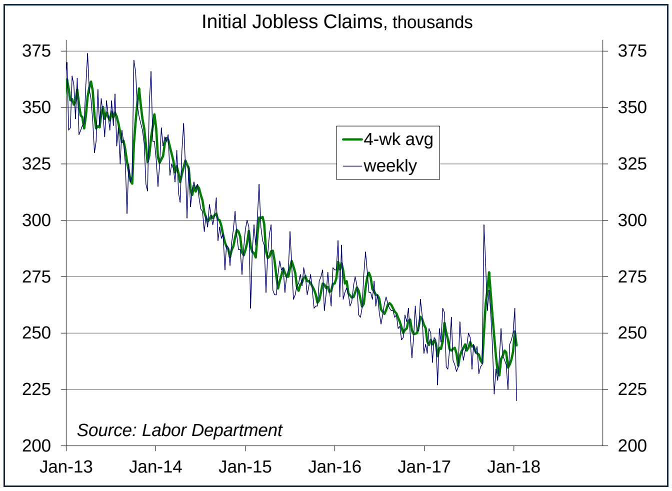
Wednesday

Existing Home Sales (December) – Sales were reported sharply higher in November. Some moderation is seen for December, but this really isn't a critical month for homes sales.

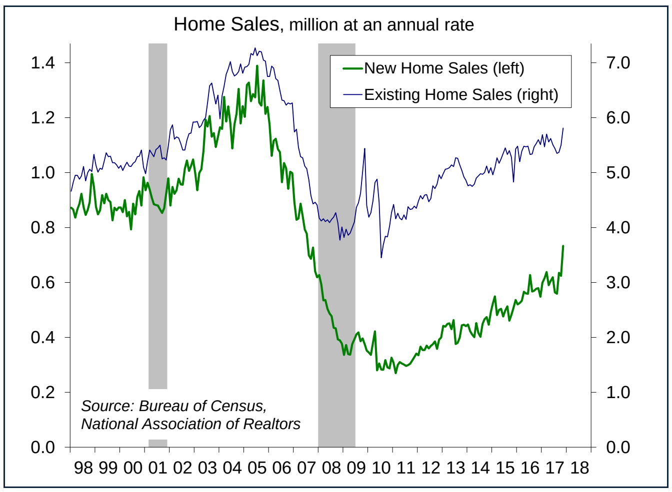
Thursday

Advance Economic Indicators (December) – This report includes December figures on merchandise trade, wholesale inventories, and retail inventories, which should help to refine economists' forecasts of 4Q17 GDP growth.

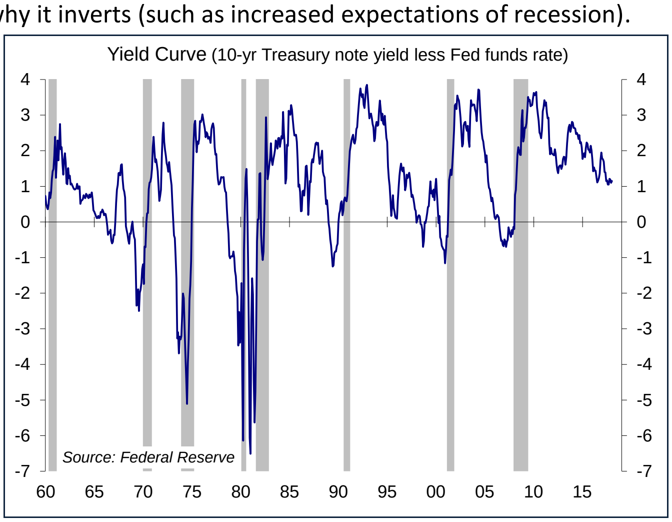
Jobless Claims (week ending January 20) – Figures will remain subject to seasonal noise. The underlying trend is low.



New Home Sales (December) – These data are reported with a huge amount of statistical uncertainty. November strength was likely weather-related. We should see a correction in December.

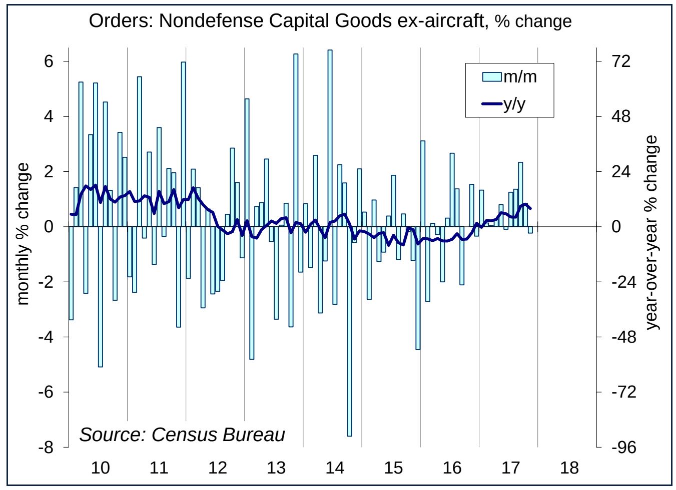


Leading Economic Indicators (December) – Most components will make positive contributions in December, the largest from ISM new orders. The yield curve is still supportive, not close to inverted. However, if and when it inverts, the important thing is why it inverts (such as increased expectations of recession).



Friday

Durable Goods Orders (December) – Boeing reported an increase in orders last month, but the government data on aircraft orders is quirky in December. Monthly figures tend to be choppy, but the underlying trend has been positive in recent months.



Real GDP (4Q17, advance estimate) – The initial estimate of quarterly GDP growth is subject to revision, but the underlying story shouldn't change much. The headline 4Q figure is likely to understate the economy's strength, just as the 3Q17 figure overstated growth. That's because a narrower trade deficit and faster inventory buildup added more than a full percentage point to 3Q GDP. This effect will likely reverse in the 4Q17 data. The best way to look at the GDP data will be to average 3Q and 4Q figures for consumer spending and business fixed investment. Still, the financial markets can be expected to focus on the headline number.

Next Week …

The Federal Open Market Committee is expected to leave the federal funds target range unchanged. There is no press conference, no revised Fed projections, and no new dot plot. The only thing we'll have to go on is the wording of the policy statement, which could point toward a March move. The data highlight is the employment report. However, payrolls will be subject to seasonal noise, weather effects, and the usual statistical uncertainty. Annual benchmark revisions to the payroll data are also due, but we probably won't see much of a change in the recent trend of job growth.

Coming Events and Data Releases

February 4	Super Bowl LII (Minneapolis)
February 16	Chinese New Year
February 19	Presidents Day Holiday (markets closed)
March 21	FOMC Policy Decision, press conf.
May 1-2	FOMC Policy Decision (no press conf.)
June 12-13	FOMC Policy Decision, press conf.
November 6	Election Day