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Weekly Economic Monitor

Through the Noise: More of the Same

Beyond all the twists, turns, and quirks in the economic data reports, the overall picture appears largely the same. Growth remains on a moderate track, somewhat beyond a long-term sustainable rate (as the job market continues to tighten). Ex-food and energy, we're still seeing a deflationary trend in goods and moderate inflation in services, but pipeline pressures are somewhat higher. The "soft" (survey-based) economic reports are strong. The "hard" (actual data) reports remain lackluster to moderate. The global economy is improving. In this environment, corporate earnings can continue to advance.

The monthly inflation reports were mostly in line with expectations. The headline Consumer Price Index was boosted by higher gasoline prices, reflecting the temporary impact of Hurricane Harvey. Gasoline prices are now falling, which should add to consumer purchasing power in the near term. The CPI report showed a continued deflationary trend (-1.0% y/y) in consumer goods ex-food & energy. Rising inflation in shelter costs boosted inflation in non-energy services last year, but we've seen a moderation this year. Inflation in the Producer Price Index has been more elevated than the CPI and pipeline inflationary pressures have been picking up. That's not a major threat to the inflation outlook, but it means that an important factor restraining inflation in the last few years is fading.

Financial market participants have often looked to surveys of consumer and business sentiment to gauge the underlying strength of the economy. However, since the November election, we have seen sharp divergences. The ISM Manufacturing Index hit a 13-year high in September. In mid-October, the University of Michigan's Consumer Sentiment Index rose to its highest level since early 2004. Yet, the Federal Reserve's index of manufacturing output was up a lackluster 1.6% year-over-year in September. Retail sales posted a strong gain in September, but that was fueled by inventory clearance promotions in motor vehicles, possibly a hurricane-related pickup in building materials, and higher gasoline prices. Core retail sales (which exclude autos, building materials, and gasoline) rose 0.4% (after no change in August).

Much of the divergence between the hard and soft economic reports appears to be political in nature. The UM consumer sentiment survey (among others) had shown a sharp division in perceptions by political affiliation in recent months. Republicans are optimistic, Democrats are depressed, and Independents are somewhere in between. Business owners tend to be Republican – hence, strength in business sentiment.

Does any of this matter? Probably not. The hard data are what count. Many market participants remain optimistic that we're going to see a major infrastructure spending plan and large-scale tax cuts in the months ahead. However, nine months into the current administration, we still have no infrastructure plan. Moreover, leaders in Washington are not even talking about "tax reform" any more. It's "tax cuts."

The Republicans' legislative strategy is to cut tax rates through budget reconciliation, which would require only 50 votes in the Senate, instead of the usual 60 (if done through the usual way). However, to do that, you need an actual budget, which we don't have. There is some haste to complete a budget for the current fiscal year (the current Continuing Resolution that funds the government runs through December 8), so work on tax cuts can begin, but we may see some tax cuts included in the budget negotiations. None of this will be easy, but we may see somewhat lower tax rates by the end of the year.

A key question is whether stock market participants will be disappointed by the lack of infrastructure spending, more limited reductions in tax rates (relative to earlier expectations), and a continued moderate pace of growth in the overall economy. Probably not, as perceptions appear to matter more than reality, but we shall see.

Of course, even if the Trump agenda were to be enacted in its entirety, economic growth would still be limited by demographic constraints. Now, there may be more slack in the labor market than is widely believed (that is the argument of administrative officials), but – unless you allow a lot more immigration – you will still eventually run into labor market constraints. One could make the argument that tax cuts will fuel business investment, which will boost productivity growth, offsetting the impact of slower labor force growth. However, there's nothing to prevent firms from expanding now.

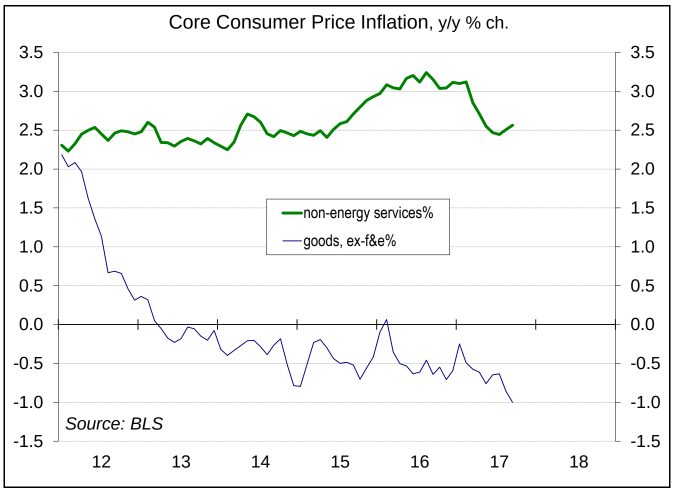
The UM's mid-October report on consumer sentiment contained a new and startling observation. That is, while consumers (regardless of political affiliation) are more optimistic about the current state of the economy and about the economy's prospects for the next six months, they appear to be increasingly resolved that the upside potential for their own personal financial situation is limited. That is, they are content with the low inflation, low unemployment rate environment and appear to be more acceptant of "the new normal" (that demographic constraints will limit the pace of economic growth). It is, according to the report, "an acceptance of lackluster growth rates in personal income and the overall economy" – a reluctant recognition of "limits on the pace of improving prospects for living standards." Wow!

A moderate growth outlook is still consistent with expanding corporate profits and the Fed is not going to slam on the brakes any time soon, but investors will still want to pay attention.

	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
9/15/17	1.05	1.17	1.30	1.39	1.53	1.81	2.20	2.77	1.196	1.358	110.84	1.218	6448.47	2500.23	22268.34
10/06/17	1.07	1.22	1.35	1.54	1.66	1.97	2.37	2.91	1.173	1.306	112.68	1.254	6590.18	2549.33	22773.67
10/13/17	1.07	1.25	1.40	1.50	1.64	1.91	2.28	2.81	1.182	1.329	111.86	1.248	6605.99	2553.19	22872.61

Recent Economic Data and Outlook

The FOMC minutes told us nothing that we didn't already know. Retail sales were boosted by a variety of factors, but core sales were moderate. Higher gasoline prices added to the Consumer Price Index, but core inflation remained low.



The **FOMC Minutes** from the September 19-20 policy meeting showed that officials expected temporary impacts on the economy from the hurricanes. Officials discussed the recent low trend in inflation, but many felt that a further increase in short-term interest rates this year *"was likely to be warranted if the medium-term outlook remained broadly unchanged."*

The **Consumer Price Index** rose 0.5% in September (+2.2% y/y), up 0.1% ex-food & energy (+1.7% y/y). Food edged up 0.1% (+1.2% y/y), continuing to reflect a divergence between food at home (0.0% m/m, +0.4% y/y) and food away from home (+0.3% m/m, +2.4% y/y). Gasoline (3.4% of the overall CPI) jumped 13.1% (+10.6% before seasonal adjustment, and +19.3% y/y). Ex-food & energy, prices of consumer goods fell 0.2% (-1.0% y/y). Non-energy services rose 0.2% (+2.6% y/y), reflecting a moderation in shelter (+0.3% m/m, +3.2% y/y).

Real Average Hourly Earnings edged down 0.1% in September (+0.7% y/y). Nominal average hourly earnings (from the employment report) were reported to have risen 0.5% (+2.9% y/y). Gasoline prices have been falling in early October, and we should see a pickup in consumer purchasing power in 4Q17.

The **Producer Price Index** rose 0.4% in September (+2.6% y/y). The old core figure, which excludes food & energy, rose a greater-than-expected 0.4% (+2.2%), but the new core (which also excludes trade services) rose 0.2% (+2.1% y/y). Trade services (up 0.8%), which include wholesaler and retailer margins, often rise with gasoline prices. Pipeline pressures have picked up. Ex-food & energy, the index for unprocessed intermediate goods rose 2.0% (+15.0% y/y), while the index for processed intermediate goods rose 0.2% (+3.2% y/y).

Retail Sales jumped 1.6% in the initial estimate for September (+4.4% y/y), led by autos (+1.0% m/m, +4.6% y/y), building materials (+2.1% m/m, +10.7% y/y), and gasoline (+5.8% m/m, +11.4% y/y). Excluding motor vehicles, building materials, and gasoline, sales rose 0.4% (+3.1% y/y), a somewhat slower trend in the third quarter (a 2.6% annual rate, vs. +3.2% in 2Q17).

Business Inventories rose 0.7% in August (+3.6% y/y). Retail inventories, the only new information in the report, rose 0.7% (+3.7% y/y), with auto inventories up 1.3% (+7.6% y/y).

The Index of **Small Business Optimism** slipped to 103.0 in September, from 105.3 in August, still very high by historical standards. Sales expectations and the general business outlook moderated, but hiring and capital spending plans were robust.

The U of Michigan's **Consumer Sentiment Index** rose to 101.1 in the first half of October, the highest reading since early 2004. Consumers are feeling good about the current state of the economy and about the prospects for the next six months. At the same time, according to the report, consumers appear to have become acceptant of their own limited upside potential.

Economic Outlook (4Q17): 2.0-2.5% GDP growth.

Employment: Beyond hurricane distortions, the trend in private-sector job growth has remained similar to that of 2016, but is expected to slow as the job market continues to tighten.

Consumers: Recent figures suggest a sharp loss of momentum into 3Q17 (still positive). Job gains have been supportive. Inflation-adjusted wage growth has been soft recently.

Manufacturing: Orders and production have remained mixed across sectors, but moderate overall. Better global growth and the rebound in energy exploration have helped, but motor vehicle sales and production have been trending lower.

Housing/Construction: Job growth has been supportive, with some weather-related shift into the earlier part of the year. Higher home prices and rising building costs are restraints.

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 raising short-term rates gradually. Balance sheet reduction is expected to start in October, initially gradual, but picking up over the course of a year.

This Week:					*forecast*	last	last –1	comments
Sunday	10/15	9:00	**Yellen Speech**					*"Economy and Monetary Policy"*
Monday	10/16	8:30	Empire St. Manf. Index	Oct	***NF***	24.4	25.2	erratic, but likely to have remained strong
Tuesday	10/17	8:30	Import Price Index	Sep	***NF***	+0.6%	-0.1%	some pickup in oil prices
			ex-food & fuels		***NF***	+0.2%	0.0%	inflation in raw materials is picking up
		9:15	**Industrial Production**	Sep	***+0.4%***	-0.9%	+0.4%	rebounding from Harvey
			Manufacturing Output		***-0.2%***	-0.3%	0.0%	aggregate hours reports reported at -0.5%
			Capacity Utilization		***76.4%***	76.1%	76.9%	no threat to the inflation outlook
		10:00	Homebuilder Sentiment	Oct	***62***	64	67	seen a bit softer
Wednesday	10/18	8:30	**Building Permits, mln.**	Sep	***1.230***	1.272	1.230	some hurricane impact
			% change		***-3.3***	+3.4	-3.5	but mixed
			Housing Starts		***1.180***	1.180	1.190	seen about steady
			% change		***0.0***	-0.8	-2.2	but watch for revisions
		2:00	Fed Beige Book					still modest to moderate growth
Thursday	10/19	8:30	Jobless Claims, th.	10/14	***240***	243	258	hurricane impact fading
		8:30	Philadelphia Fed Index	Oct	***NF***	23.8	18.9	erratic, but likely to have remained strong
		10:00	Leading Econ Indicators	Sep	***0.0%***	+0.4%	+0.3%	temporary hurricane effects
		1:00	TIPS Auction					re-opened 30-year TIPS
Friday	10/20	10:00	Existing Home Sales, mln	Sep	***5.25***	5.35	5.44	hurricane effects
			% change		***-1.9***	-1.7	-1.3	and limited inventory of homes for sale
		7:30	**Yellen Speech**					*"Mon Policy Since the Financial Crisis"*
Next Week:								
Monday	10/23		no significant data					
Tuesday	10/24	1:00	Treasury Note Auction					2-year notes, World Series begins
Wednesday	10/25	8:30	**Durable Goods Orders**	Sep	***+1.4%***	+2.0%	-6.8%	aircraft orders improved
			ex-transportation		***+0.5%***	+0.5%	+0.8%	moderate
			nondef cap gds ex-aircraft		***+0.5%***	+1.1%	+1.3%	moderate
		10:00	New Home Sales, th.	Sep	***555***	560	580	some hurricane impact
			% change		***-0.9***	-3.4	-5.5	but watch for revisions
		10:00	BOC Policy Decision					likely to pause (following two hikes)
		11:30	FRN Auction					2-year FRNs
		1:00	Treasury Note Auction					5-year notes
Thursday	10/26	7:45	ECB Policy Decision					no change, but any QE hint?
		8:30	Jobless Claims, th.	10/21	***238***	***240***	243	likely to be noisy, but a low trend
		8:30	Advance Econ Indicators:	Sep				finishing touches for GDP estimates
			wholesale inventories		***NF***	+0.9%	+0.6%	higher in 3Q17
			retail inventories		***NF***	+0.7%	0.0%	auto inventories likely fell in Sept.
			merch. trade deficit, $bln		***NF***	-63.3	-63.8	some small hurricane effects
		10:00	Pending Home Sales Index	Sep	***-0.5%***	-2.6%	-0.8%	some hurricane effects
		1:00	Treasury Note Auction					7-year notes
Friday	10/27	8:30	**Real GDP (advance)**	3Q17	***+2.8%***	+3.1%	+1.2%	some minor drag from hurricanes
			Priv. Dom. Final Purchases		***+2.7%***	+3.3%	+3.1%	still a relatively strong trend
		10:00	UM Consumer Sentiment	Oct	***100.8***	95.1	96.8	101.1 at mid-month

This Week…

The week will be bookended by Yellen speeches (Sunday, Friday evening), but we aren't likely to learn much new from the Fed chair. The key economic data (industrial production, residential construction) have slight market-moving-potential. The stock market is expected to be driven by earnings reports and the bond market may look to the stock market for direction.

Sunday

Yellen Speech (G30 International Banking Seminar) – Fed Chair Janet Yellen will speak on "the economy and monetary policy." We have received some economic data since her last public speech (September 26), but much of it has been distorted by the hurricanes. However, her views are unlikely to have changed. Policy moves will remain data-dependent and hurricane effects (on the data) should wash out over time.

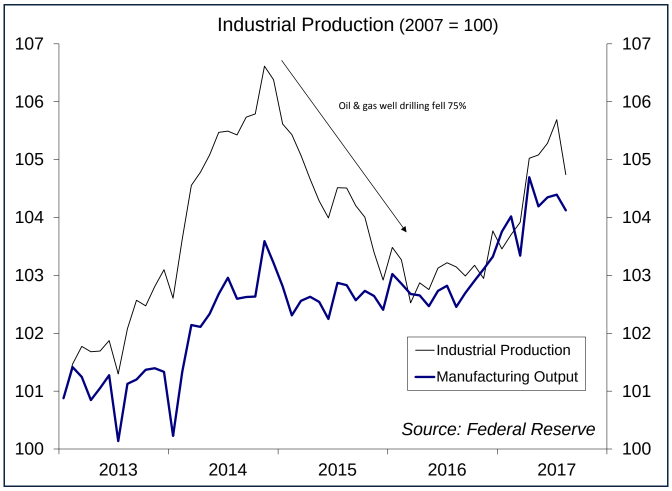
Monday

Empire State Manufacturing Index (October) – The Fed's regional survey results have grown increasingly erratic and unreliable in recent years. Market participants have stopped caring. However, the headline figure is likely to have remained strong in October, further evidence of the split between the lofty soft economic reports and the moderate hard economic data.

Tuesday

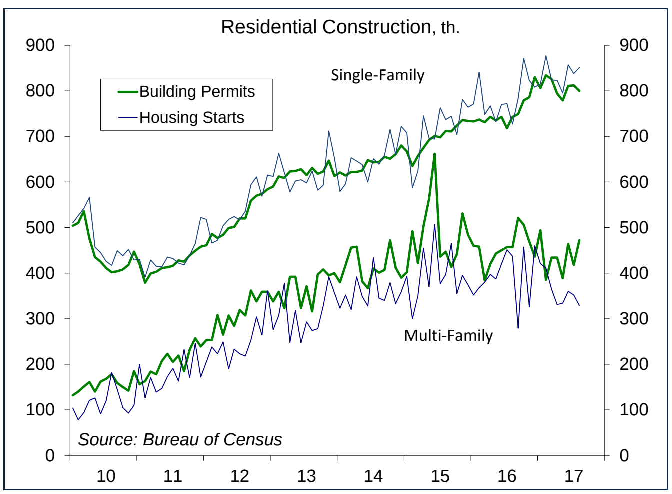
Import Prices (September) – Import prices, driven partly by a strong dollar, have been an important disinflationary force in recent years, but that has changed in 2017. Still, while upward pressures have been evident in prices of imported raw materials in recent months, there's been no inflation in imported finished goods. That ought to change over time.

Industrial Production (September) – The effects of Hurricane Harvey faded, but Irma will likely have some influence on the September figures. We should see a rebound in oil and gas well drilling. The employment report showed a 0.5% decline in aggregate hours for manufacturing in September. Note that there is usually seasonal adjustment noise in July and August, and some of that may have carried into September.



Wednesday

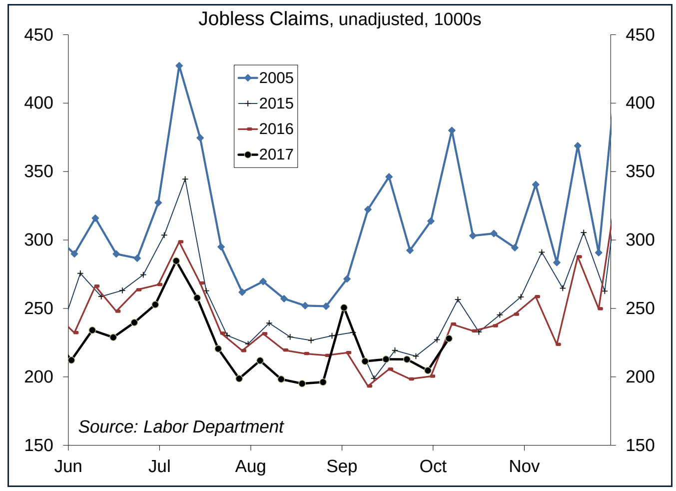
Building Permits, Housing Starts (September) – The figures on residential construction activity are quirky in the best of times, but the hurricanes will likely add another layer of uncertainty. Monthly figures have been choppy in recent months, but the year-over-year trends in single-family have remained strong.



Fed Beige Book – Let me guess: "modest to moderate" economic growth across the 12 Federal Reserve districts? Policymakers pay a lot of attention to anecdotal information, with a clear focus on the job market and inflationary pressures.

Thursday

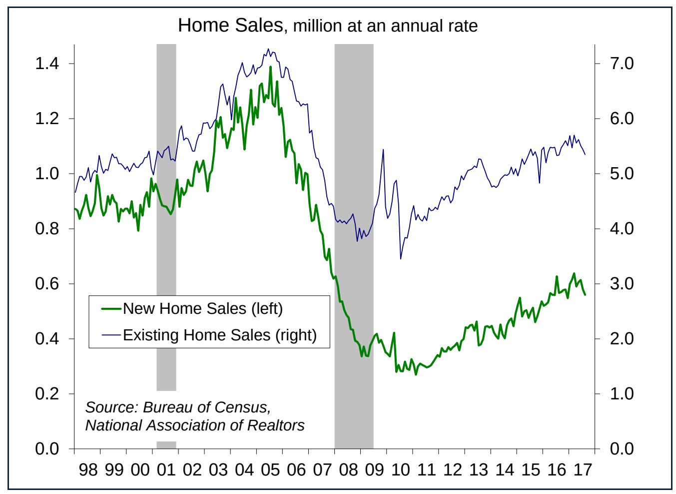
Jobless Claims (week ending October 14) – The impacts of hurricanes Harvey and Irma have faded quickly, a contrast to the lingering impact that we saw with Hurricane Katrina (which dampened commerce along the Mississippi River) in 2005. Note that unadjusted claims are choppier in the final months of the year, so we should see some noise in the adjusted claims data.



Leading Economic Indicators (September) – Components were mixed, reflecting temporary hurricane effects.

Friday

Existing Home Sales (September) – Possible hurricane effects.



Yellen Speech (National Economists Club) – Yellen will focus on the monetary policy response to the financial crisis. This may be seen as a victory lap of sorts, if she's not re-nominated.

Next Week ...

The advance estimate of real GDP growth always has its quirks, but market participants will be braced for any surprises.

Coming Events and Data Releases

October 31	CB Consumer Confidence (October)
November 1	ISM Manufacturing Index (October) FOMC Policy Decision (no press conf.) Unit Auto Sales (October)
November 3	Employment Report (November)
November 23	Thanksgiving (markets closed)
December 13	FOMC Policy Decision, Yellen press conf.
January 31	FOMC Policy Decision (no press conf.)
March 21	FOMC Policy Decision, press conf.