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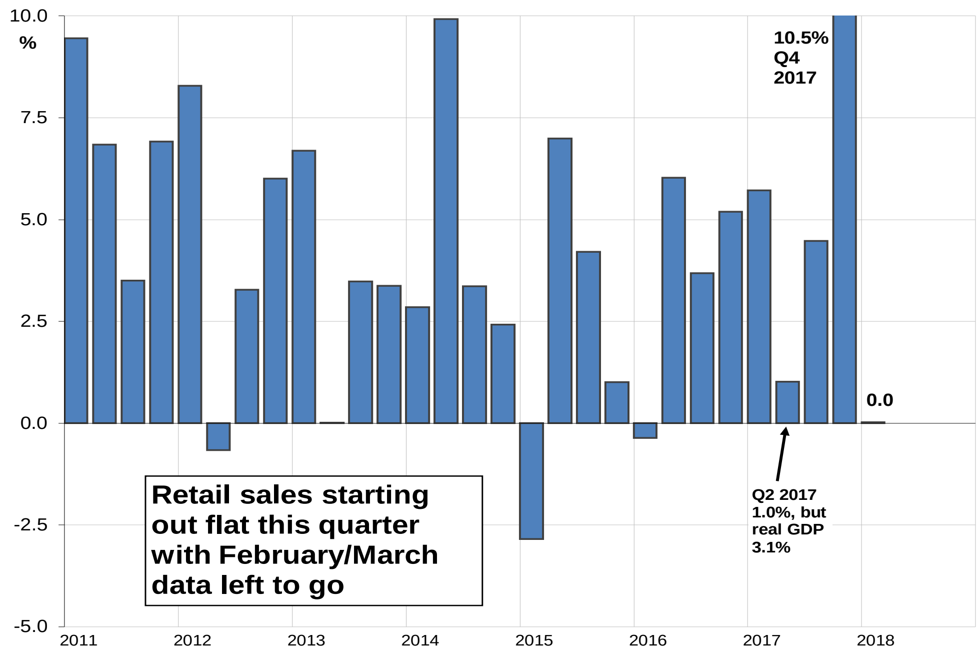
RETAIL SALES A BUST IN JANUARY, BUT AFTER A HUGE Q4 2017

The Fed said under Yellen that policy is data dependent, but that shouldn't mean the very last data point… certainly. Monetary policy should not be dependent on short-term, transitory, economic trends. Retail sales in a report on Wednesday, February 14, "consumer expenditures" more or less, the economy's main-engine for GDP growth, fell 0.3% in January and December's 0.4% increase was flat-lined to 0.0% in the revision. Doesn't sound all that great if you are still watching economic news headlines during the stock market's gyrations, but keep in mind that Q4 2017 retail spending shot-the-lights-out with a 10.5% surge, the biggest increase looking back to 2011. Maybe the consumer spent all their tax cuts early. The tax withholding levels didn't change until the second half of January 2018.

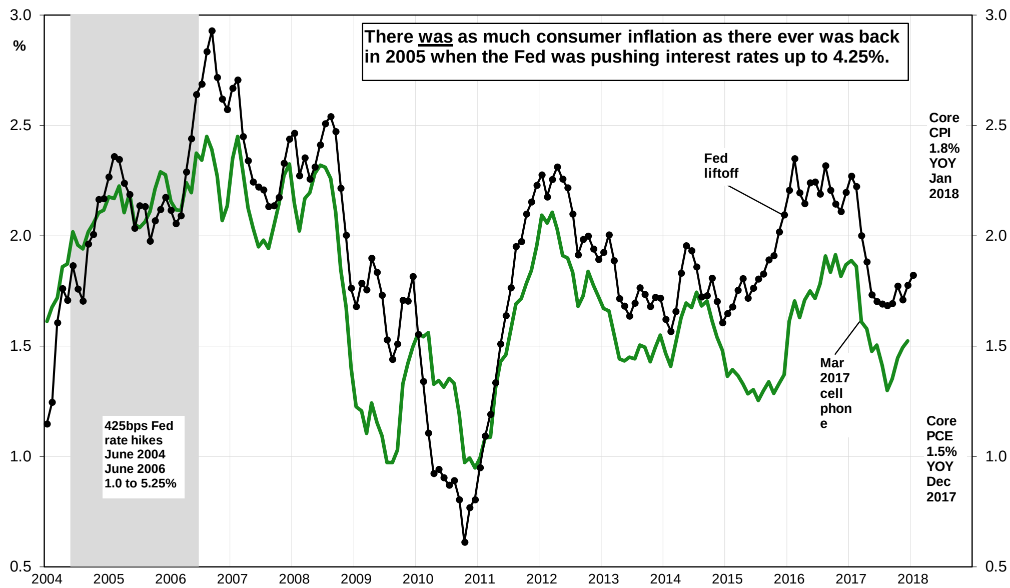


This is the third consecutive first quarter cold start to the year for consumers which makes it harder to get economic growth to the Trump administration 3.0% goal again this year. The bond market is doing its own thing when it comes to pricing yields recently when it comes to economic news, but at least for the immediate outlook for Fed policy, the odds of a March rate hike are sky-high at 94% at Friday's close. Retail sales fell in January, but core CPI inflation jumped 0.3% at the same time. The market thinks the Fed is going 25 bps to 1.75% on Wednesday, March 21 as the stock market has settled back down. Dow industrials closed Friday up 2.0% year to date, more or less out of trouble for now.

The data dependent Yellen Fed, transitioning to the Powell Fed, can ignore the decline in January sales, the market is saying, and can hike rates anyway next month. The January slowdown probably doesn't mean anything after the big increase in Q4 2017 consumer expenditures. Retail sales don't always match the trend in personal consumption expenditures (PCE) that make up two-thirds of GDP. Q2 2017 retail sales rose just 1.0%, yet real PCE spending was a strong 3.3%. Nevertheless, auto sales were just 17.1 million at an annual rate in January, which will be a drag on overall spending as it is well off the 17.7 million sold during Q4 2017. Real GDP probably won't hit 3.0% in Q1 2018 when the advance report is released Friday, April 27.

Retail sales vs. Personal Consumption Expenditures (PCE)

2016 % Total		Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17	Q1 18
100.0	Real PCE	2.8	2.9	1.9	3.3	2.2	3.8	
32.1	PCE Goods	3.2	4.7	0.7	5.4	4.5	8.2	
11.0	Durable goods	9.4	9.2	-0.1	7.6	8.6	14.2	
21.1	Nondurable goods	0.1	2.5	1.1	4.2	2.3	5.2	
67.9	PCE Services	2.7	2.1	2.5	2.3	1.1	1.8	
	Retail sales	3.7	5.2	5.7	1.0	4.5	10.5	0.0
	Retail sales ex-autos	2.0	4.2	7.4	0.8	4.4	9.8	1.8
	Auto sales (mln)	17.5	17.8	17.1	16.8	17.1	17.7	17.1
	SAAR-Seasonally adjusted annual rates; % Total is nominal expenditures							



The market got another hot inflation reading in the January CPI data this week. Headline CPI rose 0.5% to a 2.1% year/year pace. Core CPI rose 0.3% to a 1.8% year/year pace. Core PCE was 1.8% last month as well on the "annual" basis, but the bond market sees the 0.3s as more inflation and sends yields higher. There had been a 0.3% core CPI report for December as well released January 12, but the bond market did not realize that 0.3% core increase had been revised down to a 0.2% change when the annual seasonal adjustment revisions were made (this year back to 2013) on February 7. Is inflation heating up? Well, there are not all that many 0.3% monthly increases to spark an inflation outbreak that would spread like wildfire. Besides the January 2018 0.3% core CPI reading this week, the last 0.3 was January 2017 which is why the year-to-year core CPI was unchanged at 1.8% in January relative to December. There were no 0.3s in 2016, and just one in 2015, in the month of March. If inflation is heating up, it's taking its sweet time.

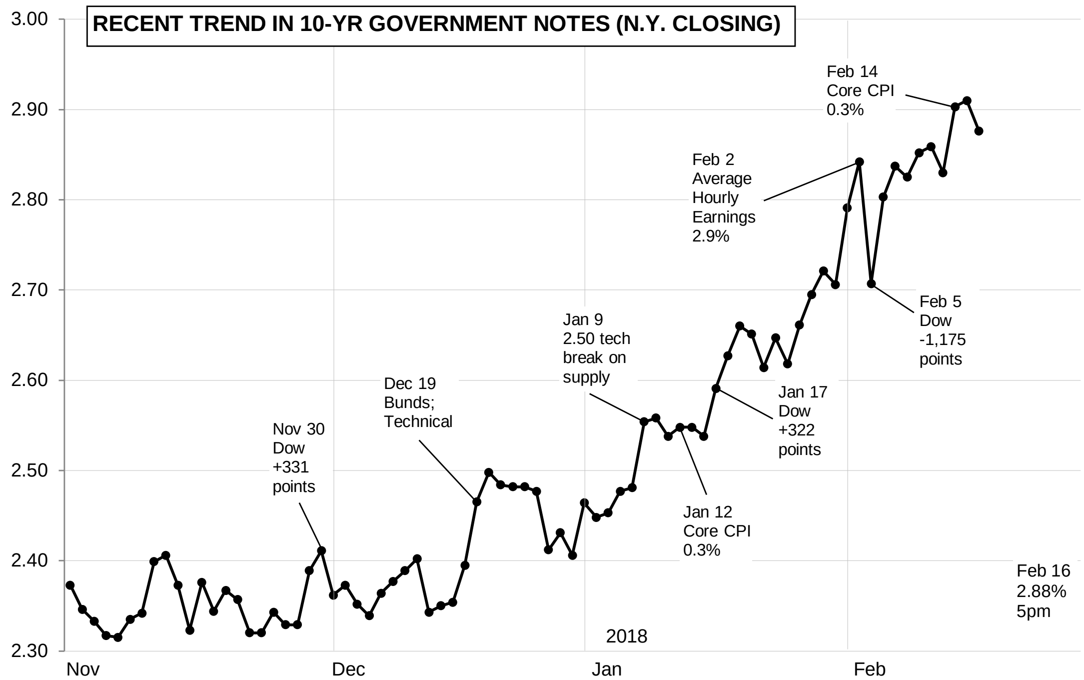
Core CPI Inflation monthly and year-on-year changes

2018	% chg	YOY	2017	% chg	YOY
Dec			Dec	0.2	1.8
Nov			Nov	0.1	1.7
Oct			Oct	0.2	1.8
Sep			Sep	0.1	1.7
Aug			Aug	0.2	1.7
Jul			Jul	0.1	1.7
Jun			Jun	0.1	1.7
May			May	0.1	1.7
Apr			Apr	0.1	1.9
Mar			Mar	-0.1	2.0
Feb			Feb	0.2	2.2
Jan	0.3	1.8	Jan	0.3	2.3

We still expect core CPI to rise to 2.0% at least when the cell phone data plan effect last March washes out of the year/year data in the report on April 11. Core CPI rarely falls in any month.

MARKETS OUTLOOK

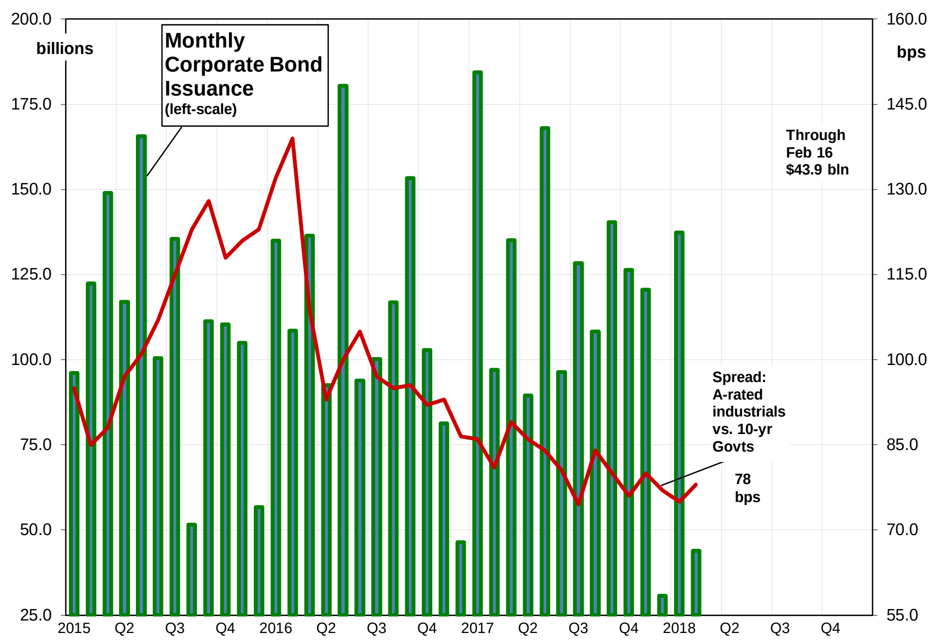
	29-Dec 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
30-Yr Treasury	2.74	2.90	3.00	3.10	3.30	3.40	3.50	3.60	3.70	3.80	3.80
10-Yr Note	2.41	2.50	2.70	2.80	3.00	3.20	3.30	3.40	3.50	3.70	3.70
5-Yr Note	2.21	2.20	2.40	2.60	2.80	3.00	3.15	3.30	3.40	3.60	3.60
2-Yr Note	1.89	1.95	2.20	2.45	2.65	2.85	3.10	3.30	3.40	3.60	3.80
3-month Libor	1.69	1.90	2.10	2.40	2.60	2.90	3.10	3.40	3.40	3.60	3.90
Fed Funds Rate	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75
2s/10s spread	52	55	50	35	35	35	20	10	10	10	(10)



Yields were higher at 2.88% this week. CPI inflation rose 0.3% at the core level, always a sign that inflation is getting ready to break out according to market thinking. Before CPI on Wednesday morning, yields were 2.82%, and eventually moved as high as 2.94% early Thursday morning before New York opened. Still talk that bond yields are going higher this year as tax cuts and $400 billion of new Government spending boosts auction amounts and the Fed balance sheet wind down kicks into high gear ($360 billion annual rate) in October.

CORPORATES: CSX, EXELON, INGERSOLL-RAND, NORFOLK SOUTHERN

Corporate offerings were $10.1 billion in the February 16 week versus $18.8 billion in the February 9 week. On Thursday, CSX Corp. sold $2.0 billion 10s/30s/50s. It priced a $800 million 3.8% 10-yr (m-w +15bp) at 90 bps (Baa1/BBB+). The railroad (Freight transportation company) will use the proceeds for stock repurchases, working capital and other uses. Corporate bonds (10-yr Industrials rated A2) were 78 bps above 10-yr Treasuries this week versus 73 bps last Friday.



FEDERAL RESERVE POLICY

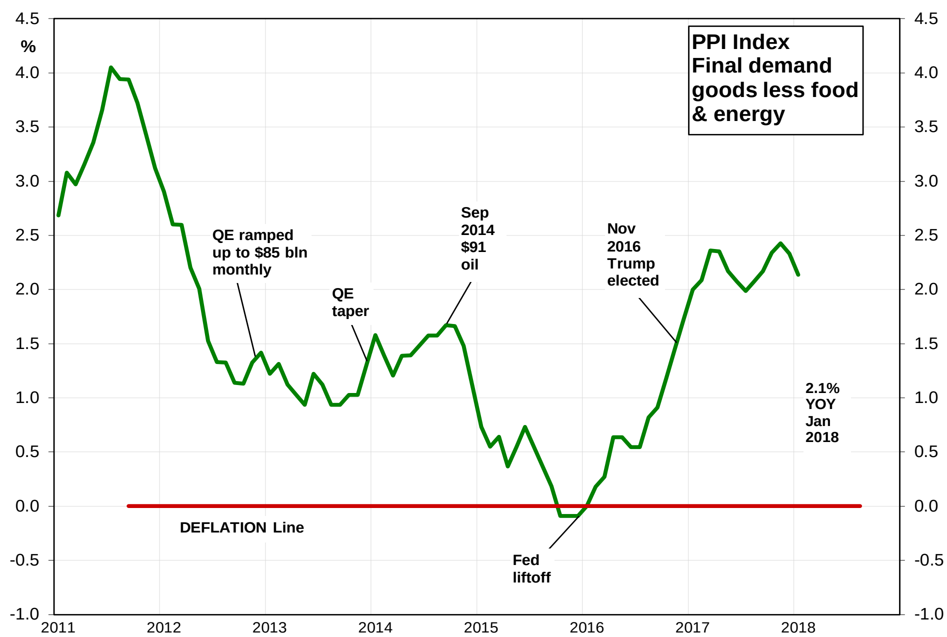
Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	14-Feb	7-Feb	31-Jan	24-Jan	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2436.173	2436.192	2436.211	2447.009	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1771.927	1760.743	1760.743	1771.054	0.000
Primary credit (Discount Window)	0.002	0.019	0.046	0.048	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)	1.715	1.715	1.715	1.714	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	0.062	0.039	0.673	0.072	62.000
Federal Reserve Assets	4482.2	4468.0	4465.6	4488.5	961.7
3-month Libor %	1.85	1.80	1.78	1.75	2.82
Factors draining reserves					
Currency in circulation	1616.273	1612.559	1607.532	1606.672	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	38.518	48.120	65.797	36.371	0.000
Reserve Balances (Net Liquidity)	2226.188	2240.014	2323.217	2182.220	24.964
Treasuries within 15 days	48.610	16.563	16.563	27.847	14.955
Treasuries 16 to 90 days	92.002	97.821	97.821	80.038	31.549
Treasuries 91 days to 1 year	270.849	297.077	297.078	317.233	69.272
Treasuries over 1-yr to 5 years	1107.777	1081.307	1081.309	1083.901	170.807
Treasuries over 5-yrs to 10 years	295.684	322.161	322.166	316.716	91.863
Treasuries over 10-years	621.252	621.263	621.274	621.273	101.337

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

The Fed meets March 20-21 to consider its monetary policy. Fed Chair Powell gave some remarks at the ceremonial swearing in on February 13. Powell said they would stick with the policy under Yellen that gradually normalizes interest rates and the balance sheet. They will "remain alert to any developing risks to financial stability." Somehow the market took this as a signal Powell would raise rates in March despite the stock market's volatility. Fed funds futures odds for a March rate hike were 94% on Friday. The swearing in was Tuesday and by Friday Dow industrials closed up 2.0% year-to-date so the worst of this financial market crisis is over for now. Powell also said he would listen to feedback in case they get something wrong: "There is great value in having thoughtful, well-informed critics." We will try our best. Be more optimistic, less risks-focused. Stop talking down the economy saying it isn't strong enough for rate hikes given how low inflation is. That would be a start.

OTHER ECONOMIC NEWS THIS WEEK

PPI inflation up, factory output down (Thursday)



The economy continues to grow hotter this year in this long nine year expansion heading for the record books with the labor markets pushing up against the wall of full employment. Inflation pressures are no longer on the back burner and are very much on the minds of Fed officials weighing additional rate hikes this year. The labor markets are tight and this is just the time that inflation pressures emerge. If the Trump administration is going to continue with its Buy American, Hire American mantra as a campaign slogan, they are going to miss on the Hire American part of the pledge. There are no Americans to hire. The unemployment rate is at decades lows of 4.1% which means everyone has been put back to work already. It is a myth that there are significant numbers of Americans on the fringe of society

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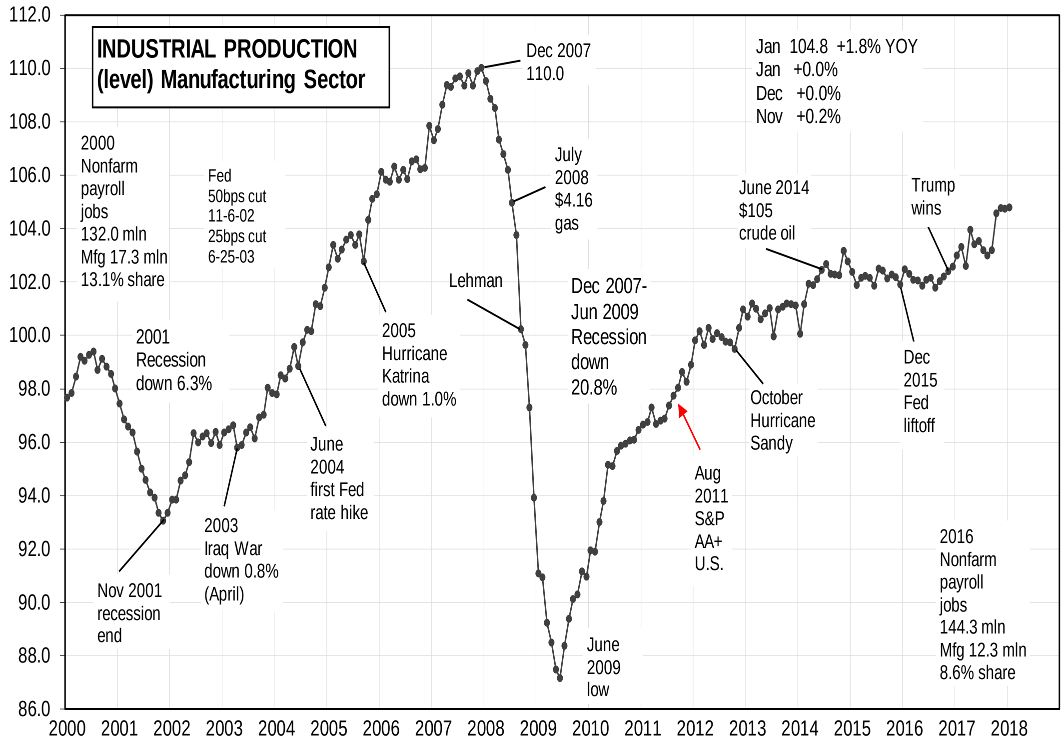
that can somehow be brought into the workforce. The labor pool is empty. Companies increasingly cannot find the help they need to grow their businesses and serve up their goods and services to customers. No workers no growth no matter how many tax cuts you throw out and how much regulatory red-tape you untangle.

CPI inflation jumped 0.5% in January in yesterday's report, and today, inflation at the producer level is up 0.4% in January. Inflation is starting off the year with a bang for both producers and consumers, and Fed officials are probably just itching to get another rate hike in there next month if the stock market would just settle down. The stock market has called nine of the last five recessions and maybe the loss this year is one of the nine and not one of the five, in other words, there is no recession signal in the stock market's plunge, so Fed officials can stay the course with their gradual pace of rate hikes this year.

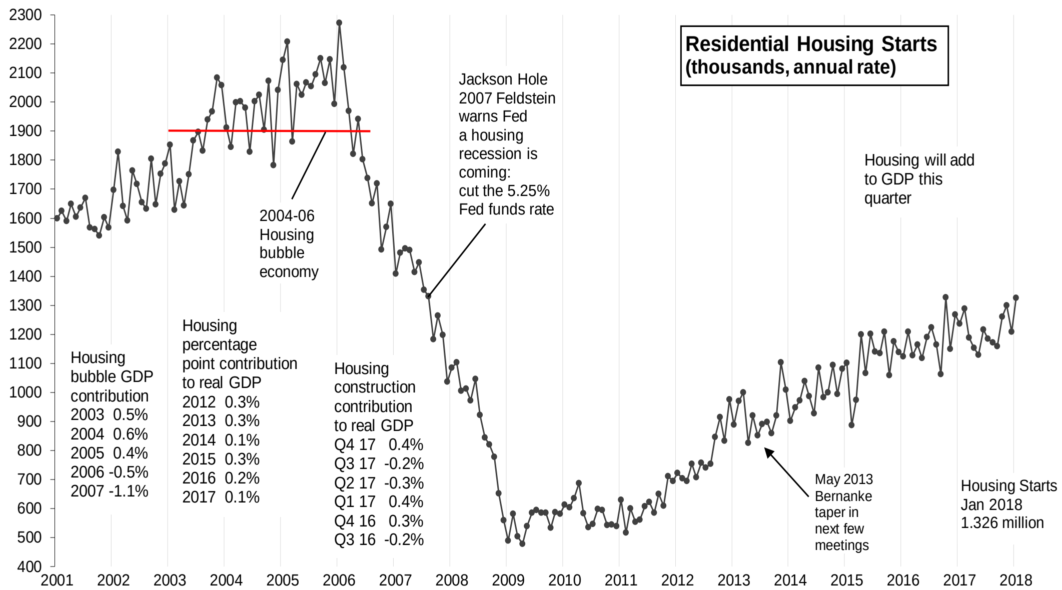


Meanwhile, factory output came off from its recent string of gains and fell 0.1% in January, the first decline since August. Manufacturing production was unchanged and utilities added a little so most of the decline came in mining production. No worries yet for factories with consumer goods production up a strong 2.8% the last year, business equipment up 4.8%, and materials production up 4.7%. The underlying foundation is strong for manufacturing, and we expect further gains later in 2018 after this hiccup to start the year, possibly due to unseasonably cold, winter weather conditions. Stay tuned. Story developing.

Housing construction roars, imported goods inflation surges (Friday)

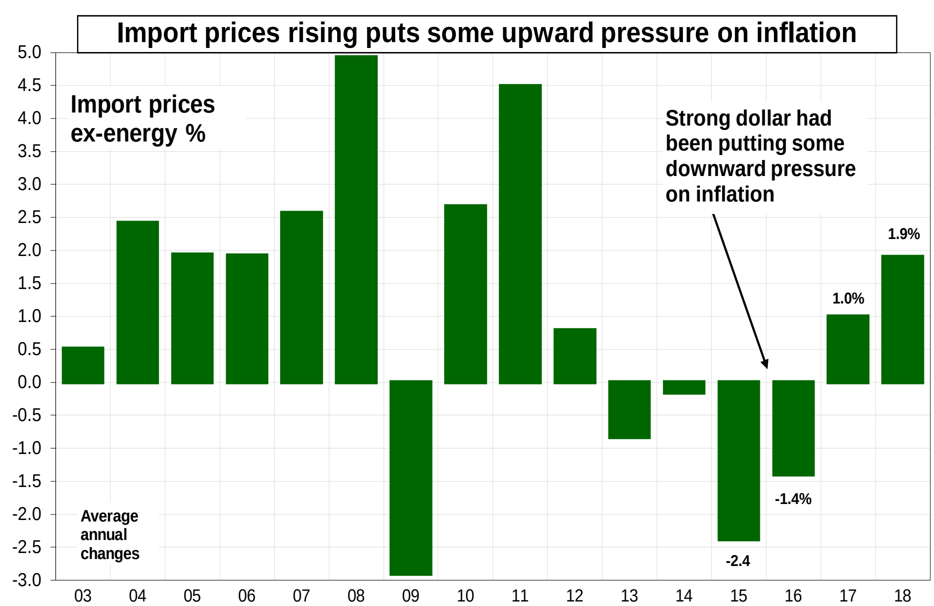
Housing starts made a 9.7% leap to 1.326 million in January backed up by housing permits rising even higher with a 7.4% surge to 1.396 million. These are the best levels seen for the nine-year recovery from the housing bubble collapse of building and home prices. Housing is back. Big time. Bet on it. Multifamily home construction recovered from the housing bust long ago as cash-poor Millennials hobbled with student loan debts favor renting smaller living spaces in multifamily buildings.

It is single-family home building that has lagged. We would have thought the January cold winter weather would have kept builders from climbing roofs and pounding nails on the East Coast, but North East single-family home starts jumped 34.7% in January. January gains were made in the nationwide single family home building count with the biggest region of the country in the South rising 4.5% and offsetting losses in the Midwest -4.0% and in the West -0.4%.



Inflation, inflation anyone? The cost of nonfuel imported goods went up a sharp 0.4% in January, reversing December's -0.1% decline, and import prices have increased 1.9% the last twelve months and are doing their part to help the Federal Reserve to meet its 2 percent inflation goal. The Fed can uncheck that box on their list of worries about the economy.

Net, net, the consumer may have stumbled in January, but housing construction activity surges. Fed officials are likely to be happy that inflation is on track to meet their 2 percent goal, if the 0.4% jump in import prices are to be believed. The economy is back on a winning path for stronger growth even if it is not firing on all cylinders with all sectors participating. Even with the January weakness in retail spending, the risks to the outlook are that the unprecedented fiscal stimulus smorgasbord of tax cuts and spending at this late stage of the cycle will light the fuse that sparks the stronger economic growth that the Trump economics team is banking on to reach its goal of 3% growth. We don't know if 3 percent is sustainable in future years, but this year is likely to see at least a few quarters of a 3% pop in GDP growth.



Today's data along with the decline in stock market volatility will keep the new Federal Reserve under Chair Powell on the path of gradual rate hikes this year with a rate hike seen on March 21.

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