Financial Market Weekly

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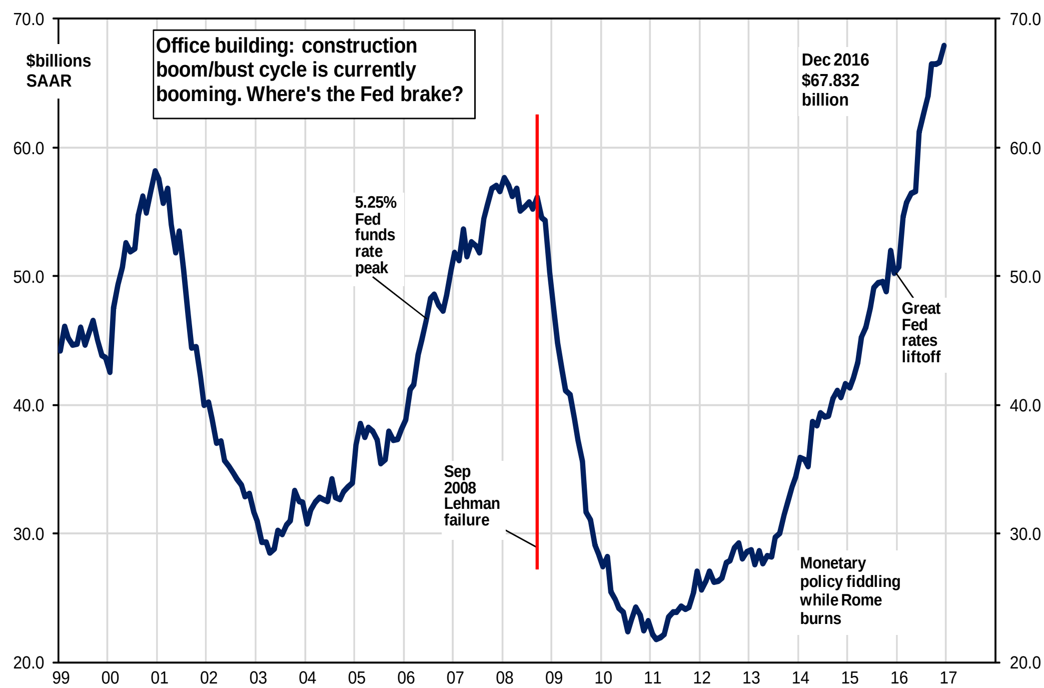
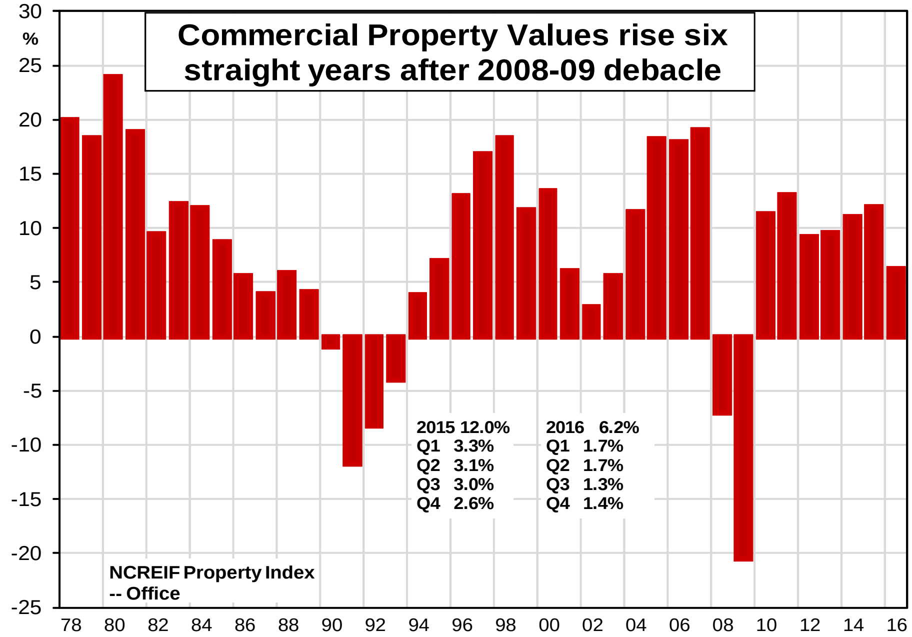
THE COMMERCIAL BUILDING BOOM CONTINUES UNCHECKED

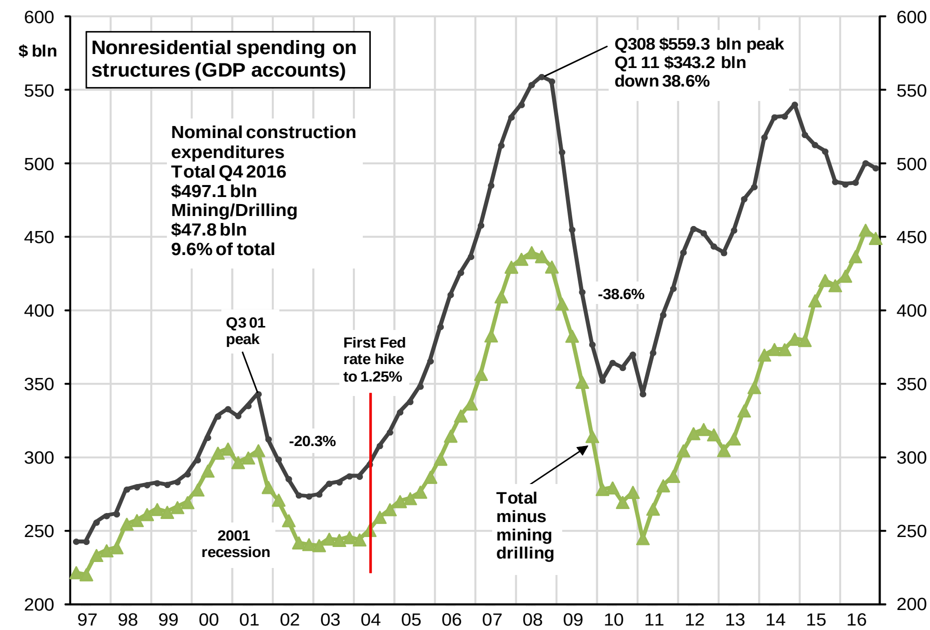


If the Fed is keeping interest rates low to help commercial real estate it isn't necessary. Office building is going literally straight up and ended last year at $67.8 billion. The level of construction of "offices" is well above the last peak of activity that was right before the 2008-09 recession. There was talk in 2007 that building activity was not sustainable at that pace. The Fed under Greenspan actually had stopped hiking rates before office construction got back to the peak reached before the 2001 recession; the Fed funds rate peaked at 5.25% in June 2006. If this office building indicator of economic activity is not on Yellen's "dashboard" it should be. Current Fed forecasts don't show the Fed funds rate reaching 3.0% until December 2019. These data are from the Census Bureau as part of private nonresidential construction that totaled $430.1 billion in December 2016. The definition of office construction is more than just some of the properties owned by the President. In general the category of offices is administration buildings, computer centers, office buildings, and professional buildings. If the office building is at a manufacturing site then it is "manufacturing." Also included in the category are motion picture, television, and radio offices, as well as banks, financial institutions, saving & loans, and credit unions. Office buildings are long lived and the economy often produces too many in economic cycles. The building in the mid-2000s was thought to be excessive. Is it now?

So zero rates encourage projects that shouldn't be built. Property values are still rising though and don't suggest an oversupply, although the price appreciation for offices slowed to a 6.2% gain in 2016.



Fed officials talk a lot about weak investment spending. Part of investment is the outlays businesses make for structures. Total nonresidential spending on structures has fallen since the end of 2014 because oil & gas drilling structures collapsed with the price of oil, although this trend has apparently bottomed for now as Yellen grudgingly admitted in testimony this week.



Spending on commercial and health care is red hot rising 9.8% in 2015 and jumping 18.7% in 2016. 18.7% as in unsustainable. Making America great again has its work cut out for it as the building of factories fell 6.6% in 2016. This was after a big 11.4% jump in 2015 though. Seriously, for all the talk of factories being shuttered and moving overseas, taking jobs in the heartland with them, nominal dollar spending on manufacturing facilities is much higher than it was prior to the 2007-08 recession, and even longer, from the time of the rising trend in China exports to the U.S. that took off starting around 2002-03. Nominal dollars spent on manufacturing structures was $72.8 billion in 2016 up 29.3% from the $56.3 billion peak spending level before the recession cancelled projects and sent manufacturing structures tumbling. More structures, fewer workers: guess it's true about all the talk of productivity gains in manufacturing.

	Q1 15	Q2 15	Q3 15	Q4 15	YOY%	Q1 16	Q2 16	Q3 16	Q4 16	YOY%
Structures ($billion)	519.8	512.9	508.5	487.8	-9.7	486.0	487.3	500.5	497.1	1.9
Commercial and health care	134.3	141.7	145.8	149.0	9.8	156.2	162.8	174.4	176.8	18.7
Manufacturing	72.8	76.5	78.9	75.5	11.4	73.3	72.2	75.1	70.5	-6.6
Power and communication	93.4	103.5	106.9	105.3	9.5	105.2	107.4	108.0	103.5	-1.7
Mining exploration, shafts, and wells	140.0	106.1	87.9	70.7	-55.8	62.4	50.4	45.6	47.8	-32.4
Other structures *	79.2	85.2	89.0	87.3	7.9	88.8	94.5	97.4	98.4	12.7

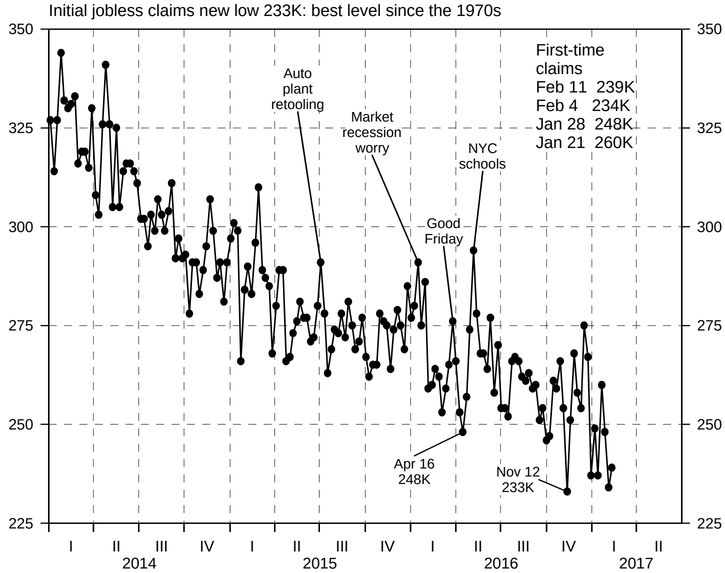
* Religious, educational, vocational, lodging, railroads, farm, and amusement and recreational structures, other

JOBLESS CLAIMS—BEST OF BEST TIMES RIGHT NOW FOR LABOR MARKET

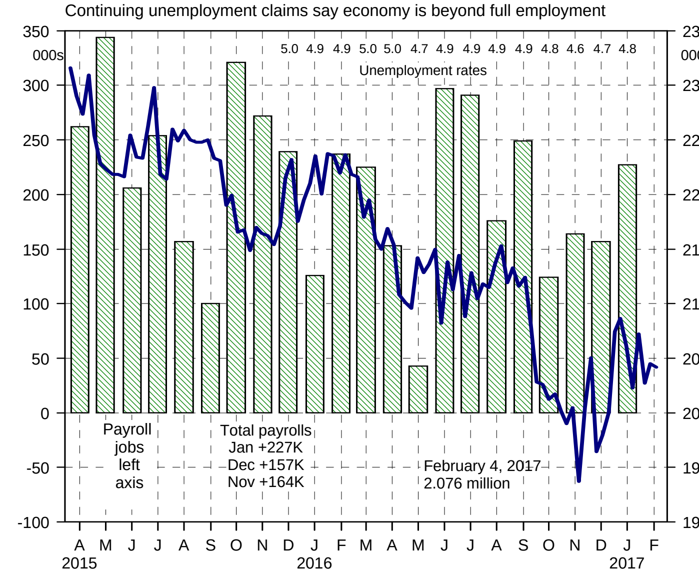
Unemployment claims near the lows for this cycle: 233K November 12 week. Jobless claims were 239K in the latest February 11 week. One thing that is certain is that the economy is at full employment as much as it is ever going to be in this cycle. If the economy is at full employment there is no pressing need for fiscal stimulus to create jobs. The timing is completely off. Historically, no other administration has done fiscal stimulus with the economy where it is today. Trump is inheriting the best economy since Bush, though with Bush the economy was just months away from recession.

President takes Office		Unemployment
Clinton	Jan 1993	7.3%
Bush	Jan 2001	4.2%
Obama	Jan 2009	7.8%

Initial jobless claims new low 233K: best level since the 1970s



Continuing unemployment claims say economy is beyond full employment

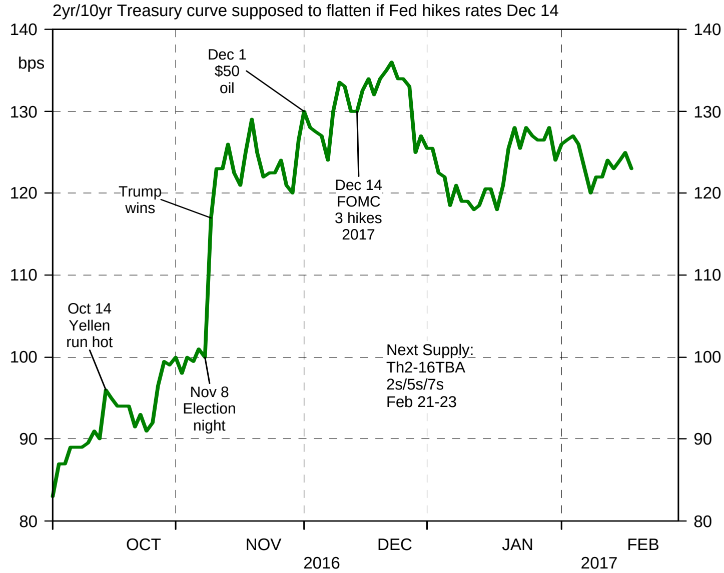


TREASURY CURVE STEEPER: TRUMP FISCAL STIMULUS MUMBO JUMBO

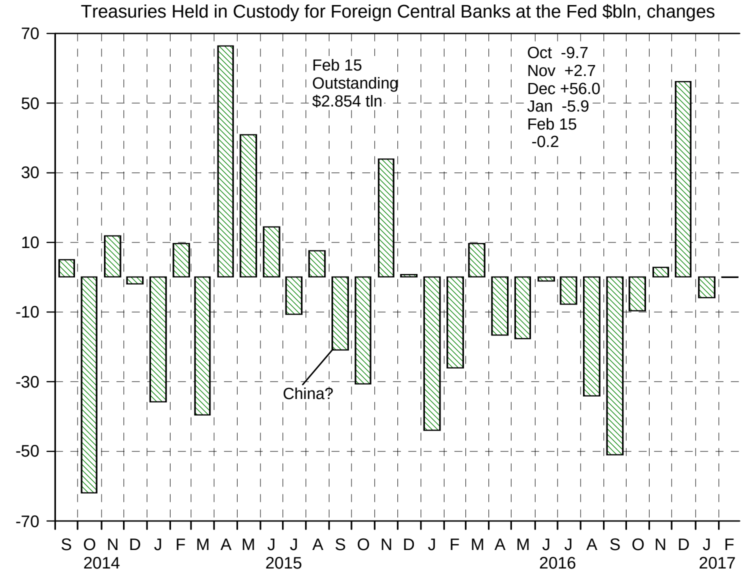
The yield curve between 2-yrs and 10-yrs was 123 bps on Friday versus 122 bps last week. 10-year Govts rose from 2.44% Tuesday on Yellen low rates "unwise" headlines, rose again Wednesday from 2.48% on 0.3% core CPI to as high as 2.52%, but fell back following Bunds on Thursday. Same story, and will be for a while. The market needs more Fed rate hikes to push 10-yr yields higher. Tax and spend policies from Washington are going to take a long time to put together.

	30-Dec 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018
30-Yr Bond	3.07	3.10	3.10	3.20	3.40	3.60	3.70
10-Yr Note	2.45	2.40	2.50	2.70	3.00	3.20	3.40
5-Yr Note	1.93	2.00	2.10	2.40	2.70	3.00	3.20
2-Yr Note	1.19	1.60	1.80	2.00	2.20	2.50	2.75
3-month Libor	1.00	1.25	1.50	1.70	1.95	2.20	2.45
Federal Fund Rate	0.75	1.00	1.25	1.50	1.75	2.00	2.25
2s/10s spread	126	80	70	70	80	70	65

2yr/10yr Treasury curve supposed to flatten if Fed hikes rates Dec 14



Treasuries Held in Custody for Foreign Central Banks at the Fed $bln, changes



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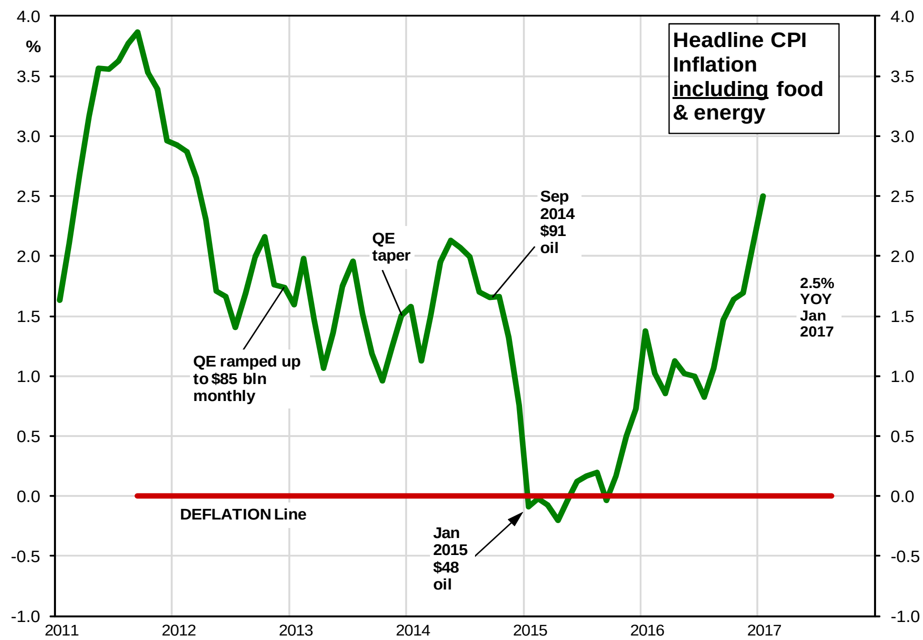
FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	15-Feb	8-Feb	1-Feb	25-Jan	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2463.446	2463.436	2463.426	2463.462	479.782
Federal agency debt securities	14.829	16.180	16.180	16.180	0.000
Mortgage-backed securities	1759.700	1744.642	1744.636	1744.594	0.000
Primary credit (Discount Window)	0.011	0.007	0.010	0.000	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)	1.705	1.705	1.705	1.707	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	0.236	0.265	0.392	0.465	62.000
Federal Reserve Assets	4500.9	4502.5	4500.1	4498.9	961.7
3-month Libor %	1.04	1.03	1.03	1.04	2.82
Factors draining reserves					
Currency in circulation	1508.844	1505.331	1500.147	1499.320	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	105.123	122.934	133.730	108.360	0.000
Reserve Balances (Net Liquidity)	2254.271	2237.460	2172.093	2137.012	24.964
Treasuries within 15 days	13.175	7.159	7.159	7.356	14.955
Treasuries 16 to 90 days	48.558	41.249	41.249	34.350	31.549
Treasuries 91 days to 1 year	163.208	167.127	167.127	153.339	69.272
Treasuries over 1-yr to 5 years	1240.508	1210.167	1210.166	1233.263	170.807
Treasuries over 5-yrs to 10 years	363.532	407.661	407.659	405.066	91.863
Treasuries over 10-years	634.466	630.073	630.067	630.088	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

The Fed meets March 14-15 to consider its monetary policy. They hiked rates in December 2015 the first time, and then a second time, a year later, in December 2016. Is it too much to ask the Committee to speed up the rates normalization process by hiking rates a third time to 1.00% is all on March 15 this year? Just 1%. Not quite four weeks from now. Let's see the Laubach-Williams (Williams her former research director at the San Francisco Fed) model of real neutral interest rates says it "should naturally be" 0.22% right now. Add to it the current PCE inflation rate (includes food & energy) of 1.7%, and the neutral Fed funds rate should be 2%. It's at 0.75% now so the Fed is 125 bps behind the curve. Yellen has been leaning on this natural rate concept as yet another argument to keep rates low, and now, lo and behold it is moving higher. They have run out of reasons to keep rates low to aid the recovery. The recovery from the recession that ended in June 2009.

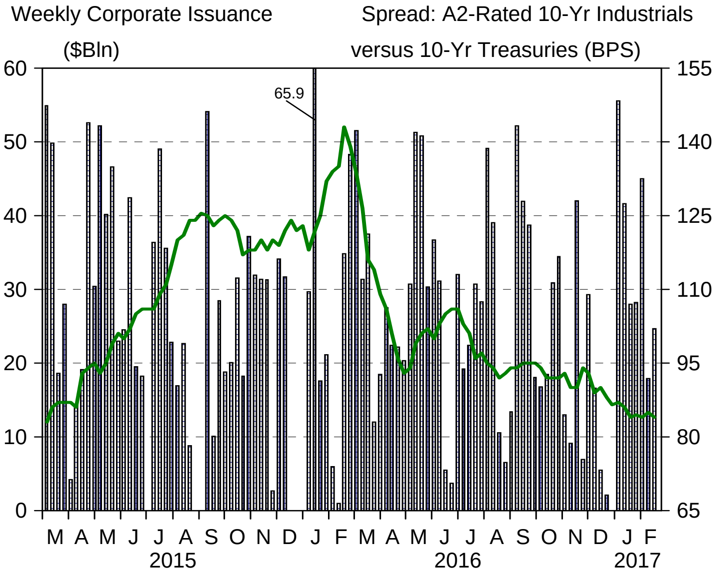


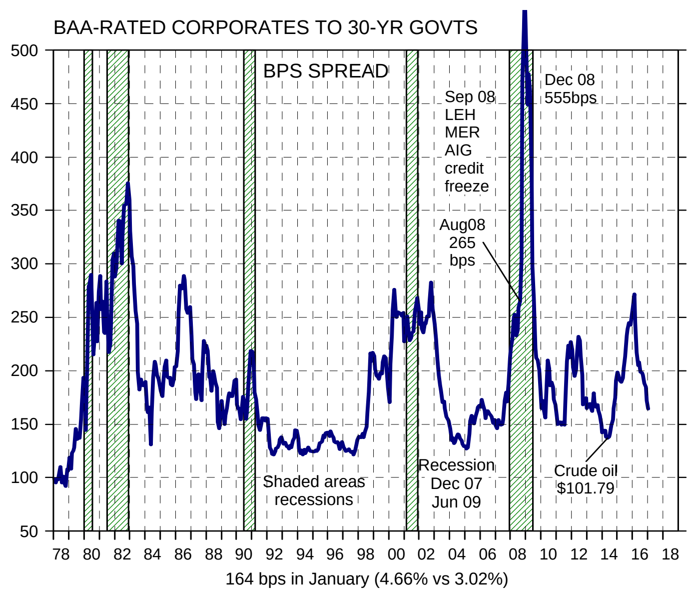
The change coming to Washington from Team Trump has not come to the Federal Reserve yet. Vice Chair Fischer this week reiterated Yellen's and the Committee's go-slow and cautious "median" forecast for interest rates in saying "if they reach the level of previous years it will be a matter of years." With the White House talking about big changes to longstanding programs like the Corporation for Public Broadcasting "Big Bird," the Legal Services Corporation, and the National Endowments for the Arts and Humanities, for the Federal Reserve, it doesn't look like the Fed's current way of doing things will last for more than another year. Yellen's four-year term ends February 3, 2018. We expect interest rates to go up above "real" CPI inflation (2.5% Jan 2017) more quickly once change in management and style comes to the Federal Reserve. Wait for it.

Yellen gave her penultimate semiannual monetary policy report testimony to Congress this week. Tuesday at the Senate and Wednesday at the House. Bond yields went up on the news headlines at 10am Tuesday: maybe something about waiting too long to raise rates would be unwise. It's too long right now for gosh sakes. The word "unwise" caught our eye, sounded important; we forgot she said it was "unwise" back on January 19, slightly different context: "allowing the economy to run markedly and persistently "hot" would be risky and unwise." On and on the story goes.

CORPORATE BONDS: RYDER SYSTEM, BOEING CO, SNAP-ON TOOLS INC.

Corporate bond offerings were $24.7 billion in the February 17 week versus $17.9 billion in the February 10 week. On Monday, Hexcel Corporation priced $400 million 3.95% 10-yrs (m-w +25bp) at 157 bps (Baa3/BBB-). The aerospace and defense company (composite materials, engineered products) will use the proceeds to reduce amounts outstanding under its revolving credit facility, but without a reduction in commitment, and thereafter for possible share repurchases. Corporate bonds (10-yr Industrials rated A2) were 84 bps above 10-yr Treasuries on Friday versus 85 bps last Friday.





TREASURY MARKET OUTLOOK

EXPECTED 10-YR 2-3 WEEK TRADING RANGE 2.00% to 2.75%

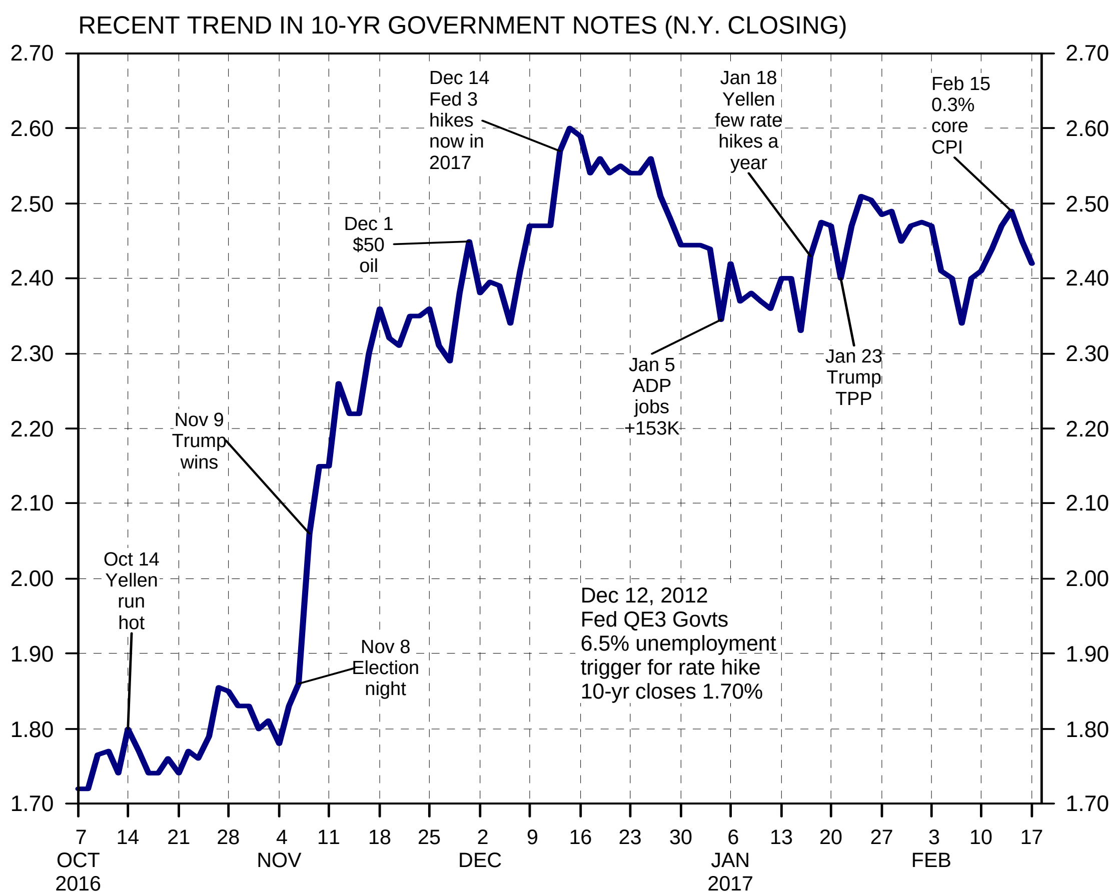
Week's 10-YR Range

HIGH 98-22 2.40%

Friday, February 17, gains overnight, Bunds, French politics, weak U.K. retail sales

LOW 97-19+ 2.52%

Wednesday, February 15, 0.3% core CPI



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