# Financial Market Weekly

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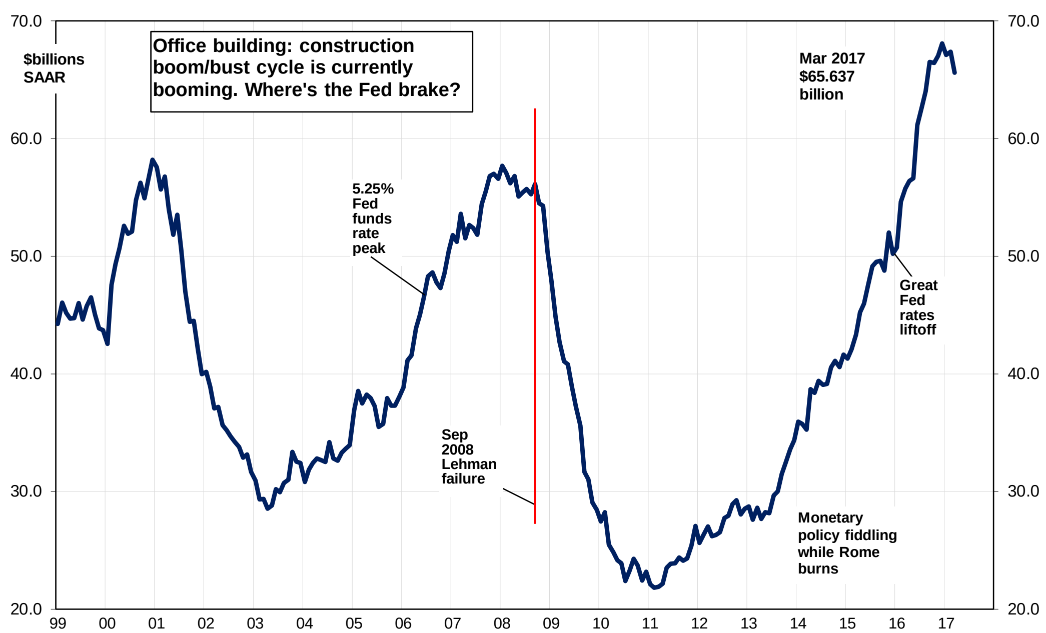
**12 MAY 2017**

## COMMERCIAL REAL ESTATE CONSTRUCTION ACTIVITY REMAINS STRONG

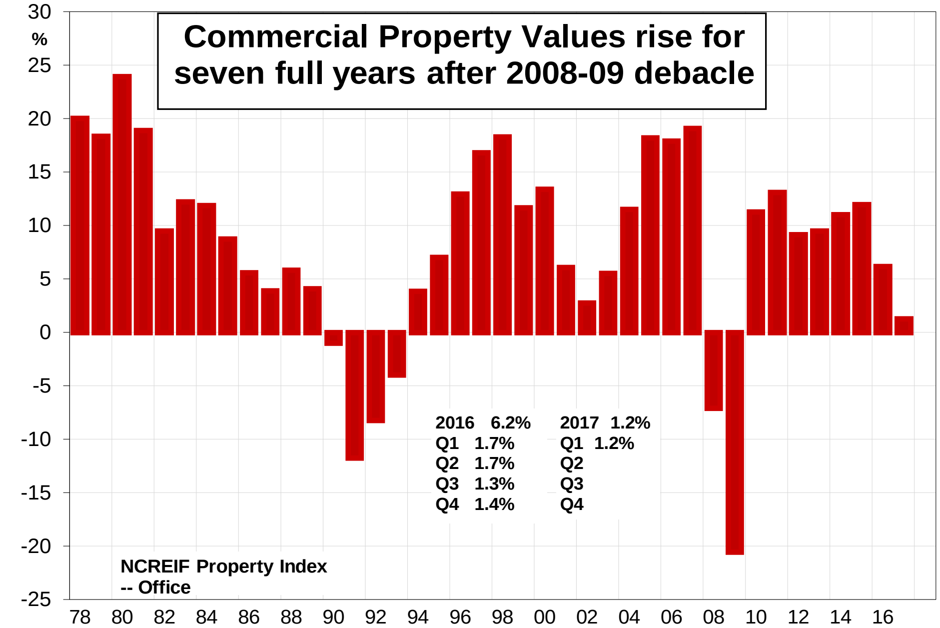


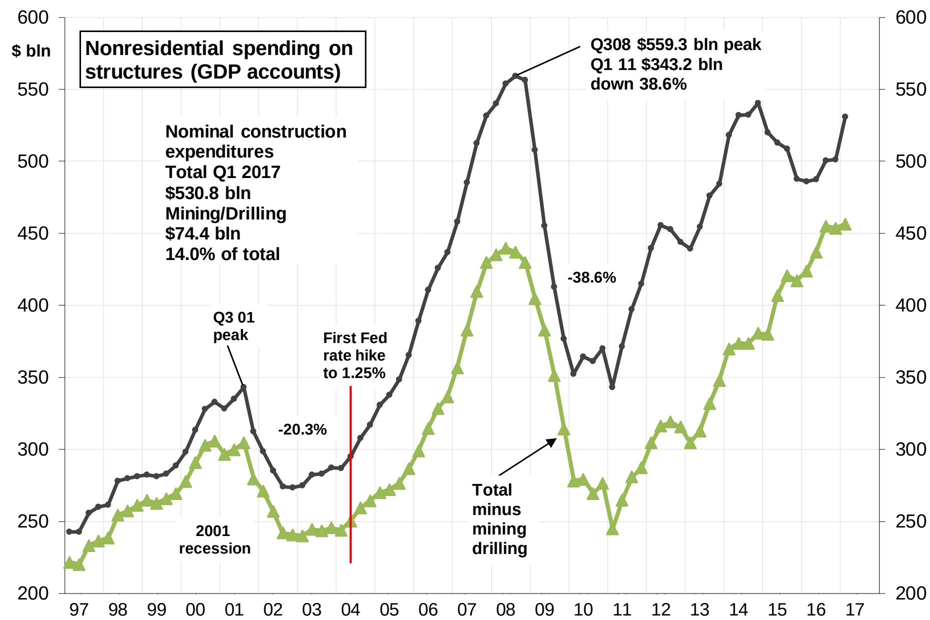

Office building continues unchecked. While office construction fell 2.6% in March, the level of $65.637 billion is 17.7% higher than it was in 2016 and higher than the prior two peak building tops before the last two recessions. There is a lot of talk from some Fed policymakers that business investment is weak, but business investment in office buildings is sure not weak. Boston Fed President Rosengren continues to warn about excessive building or better said he is wondering if building and price appreciation of properties has gone beyond the economic fundamentals. He is watching the potential risks of this commercial real estate sector closely, as it has figured prominently in many historical economic downturns, and he is one FOMC member who wants to hike rates four times this year.

| Commercial Construction $bln | Mar 17 | % Chg | 2017 YTD | 2016 YTD | Peak Year 2007 | Peak % Chg |
|---|---|---|---|---|---|---|
| Total Commercial | 77.593 | 15.0 | 78.983 | 68.686 | 85.466 | -7.6 |
| Automotive | 7.112 | 19.0 | 7.284 | 6.123 | 6.259 | 16.4 |
| Food/beverage | 7.948 | 5.4 | 7.954 | 7.550 | 7.970 | -0.2 |
| Multi-retail | 20.743 | 10.2 | 21.882 | 19.850 | 34.570 | -36.7 |
| General merchandise | 2.193 | 20.7 | 2.493 | 2.066 | 7.486 | -66.7 |
| Shopping center | 14.216 | 1.5 | 14.541 | 14.323 | 22.117 | -34.3 |
| Shopping mall | 4.102 | 63.9 | 4.487 | 2.738 | 4.004 | 12.1 |
| Other commercial | 5.493 | -6.5 | 6.103 | 6.530 | 13.505 | -54.8 |
| Warehouse | 25.578 | 37.2 | 25.002 | 18.220 | 16.882 | 48.1 |

Commercial construction is larger than office building and building here is up 15% from last year to $77.593 billion in March. Apparently you can have bricks and mortar and Amazon retail sales too.

For all the talk of consumers making purchases from their mobile phones and shunning the shops and malls, construction of malls has picked up dramatically finally in this great and long economic expansion from the Great Recession. Shopping mall construction rose over 60% in March 2017 year-to-date from 2016 to $4.487 billion. Shopping mall construction is now greater than it was in 2007 the final year before the recession. The other standout in commercial construction is warehouses which is likely tied to companies like Amazon who need to move product closer to consumers wherever they are in the country for quicker delivery. Warehouse construction totaled $25.578 billion in March 2007 about 50% higher than the 2007 peak year on this new internet sales trend.



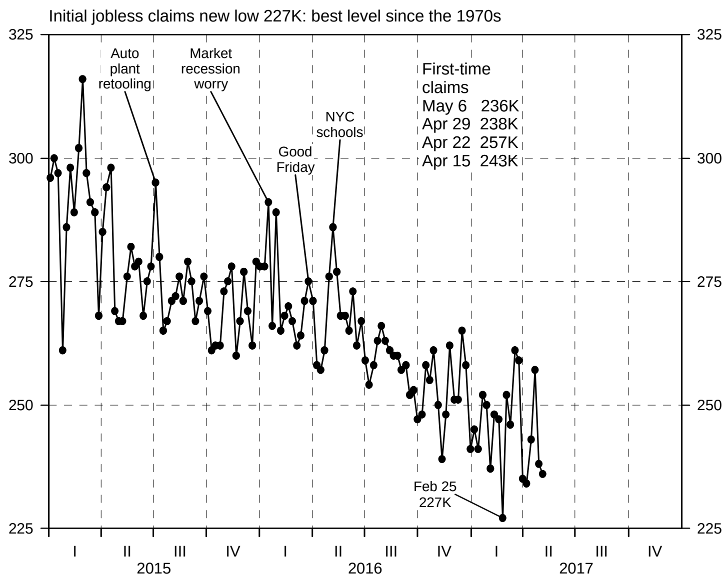

While commercial and office investment is soaring, business spending on structures that is part of "investment" had lagged overall because oil & gas drilling structures had collapsed during the oil crash. Fed officials hopefully realized business investment's weakness was closely tied to crude oil and not to overall economic demand. Business spending on structures soared in Q1 2017, adding 0.6 percentage points to the 0.7% real GDP growth, but most of this came from the resurgence in oil & gas drilling structures. Fracking is back.

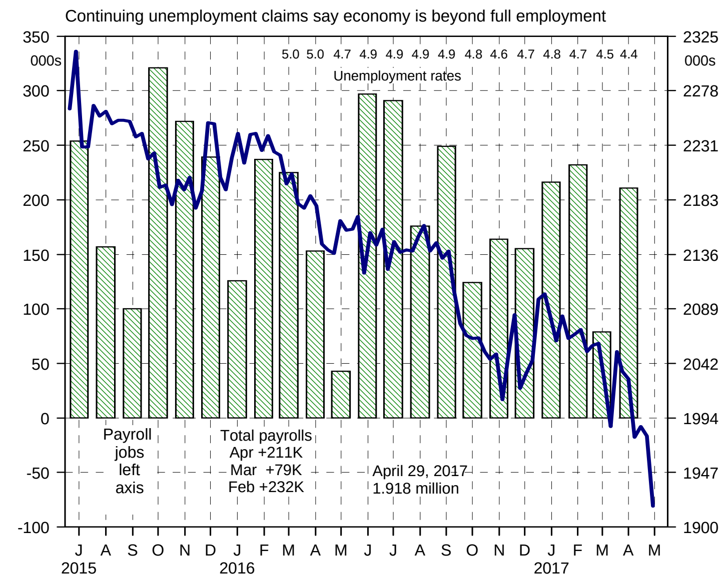
| | Q1 15 | Q2 15 | Q3 15 | Q4 15 | YOY% | Q1 16 | Q2 16 | Q3 16 | Q4 16 | YOY% | Q1 17 | % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Structures ($billion) | 519.8 | 512.9 | 508.5 | 487.8 | -9.7 | 486.0 | 487.3 | 500.5 | 501.3 | 2.8 | 530.8 | 23.5 |
| Commercial and health care | 134.3 | 141.7 | 145.8 | 149.0 | 9.8 | 156.2 | 162.8 | 174.4 | 179.4 | 20.4 | 181.1 | 3.8 |
| Manufacturing | 72.8 | 76.5 | 78.9 | 75.5 | 11.4 | 73.3 | 72.2 | 75.1 | 69.2 | -8.3 | 66.1 | -17.9 |
| Power and communication | 93.4 | 103.5 | 106.9 | 105.3 | 9.5 | 105.2 | 107.4 | 108.0 | 107.4 | 2.0 | 111.1 | 13.8 |
| 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 | 74.4 | 222.6 |
| Other structures * | 79.2 | 85.2 | 89.0 | 87.3 | 7.9 | 88.8 | 94.5 | 97.4 | 97.6 | 11.8 | 98.0 | 1.6 |
| * Religious, educational, vocational, lodging, railroads, farm, and amusement and recreational structures, other | | | | | | | | | | | Annual Rate % | |

## JOBLESS CLAIMS—BETTER THAN BEST TIMES NOW FOR LABOR MARKET

Unemployment claims stuck at the new lower level for a second week: 236K for the May 6 week, so next month's monthly payroll jobs could be another 200K-plus. The labor market continues to tighten up with the new low in the official unemployment rate to 4.4% in April and the number of people receiving unemployment benefits are also at a new low for this "recovery from the Great Recession." More Fed officials are saying the economy is at full employment even though wages are not seeing much pick up. Low unemployment argues for a June Fed meeting rate hike.

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

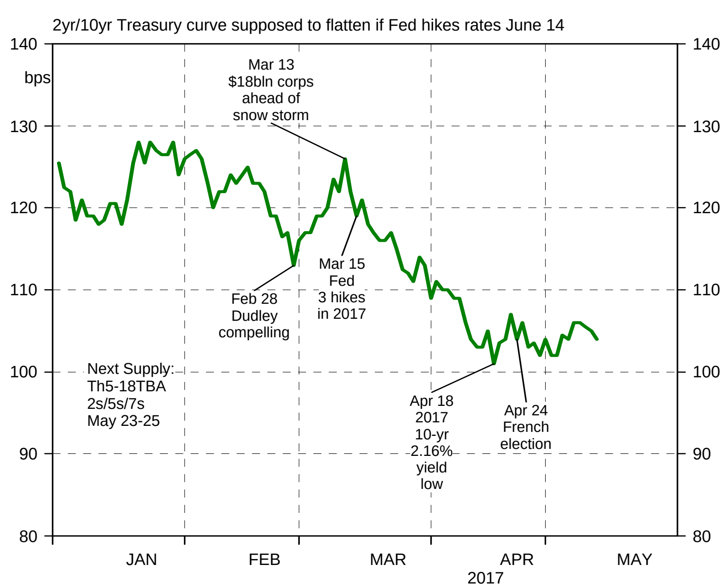


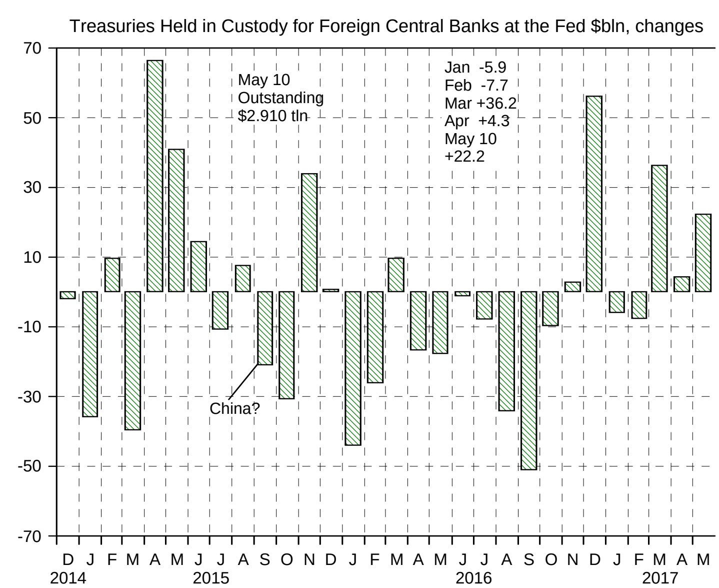




## TREASURY CURVE FLATTENING STOPS AT 100 BPS, WAITING ON FED HIKES

The yield curve between 2-yrs and 10-yrs was 104 bps on Friday versus 104 bps last week. 10-yr yields moved a little higher from supply perhaps during the Treasury quarterly refunding auctions of 3-yrs, 10-yrs, and 30-yrs. The closing high was Wednesday after the 10-yr auction at 2.41%. The rally on Friday was dramatic following 0.1% core CPI and 0.4% retail sales "missing" 0.6% expectations; bonds rallied to 2.33% as the market thought a Fed rate hike on June 14 was somewhat less probable.

| | 31-Mar 2017 | Q2 2017 | Q3 2017 | Q4 2017 | Q1 2018 | Q2 2018 | Q3 2018 |
|---|---|---|---|---|---|---|---|
| 30-Yr Bond | 3.03 | 3.10 | 3.20 | 3.40 | 3.60 | 3.70 | 3.80 |
| 10-Yr Note | 2.40 | 2.50 | 2.70 | 3.00 | 3.20 | 3.40 | 3.50 |
| 5-Yr Note | 1.93 | 2.10 | 2.40 | 2.70 | 3.00 | 3.20 | 3.30 |
| 2-Yr Note | 1.25 | 1.50 | 1.75 | 2.00 | 2.25 | 2.50 | 2.75 |
| 3-month Libor | 1.15 | 1.50 | 1.70 | 1.95 | 2.20 | 2.45 | 2.70 |
| Federal Fund Rate | 1.00 | 1.25 | 1.50 | 1.75 | 2.00 | 2.25 | 2.50 |
| 2s/10s spread | 115 | 100 | 95 | 100 | 95 | 90 | 75 |



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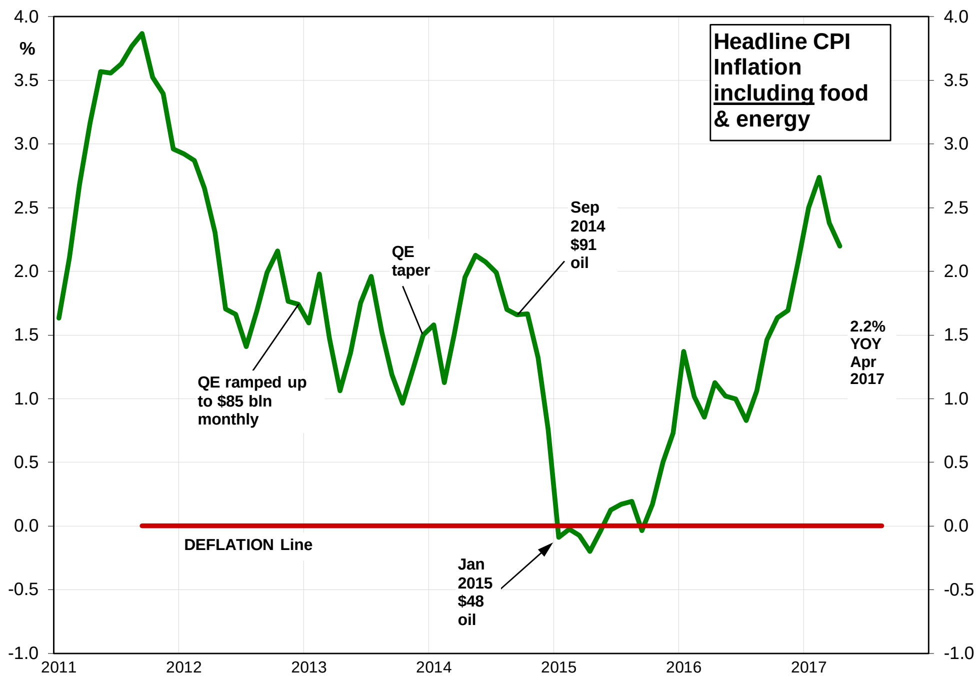
# FEDERAL RESERVE POLICY

| Selected Fed assets and liabilities | | | | | Sep 10 |
|---|---|---|---|---|---|
| Fed H.4.1 statistical release | | | | | 2008** |
| billions, Wednesday data | 10-May | 3-May | 26-Apr | 19-Apr | pre-LEH |
| **Factors adding reserves** | | | | | |
| U.S. Treasury securities | 2464.815 | 2464.792 | 2464.730 | 2464.638 | 479.782 |
| Federal agency debt securities | 11.829 | 11.829 | 11.829 | 11.829 | 0.000 |
| Mortgage-backed securities | 1769.016 | 1769.015 | 1769.013 | 1776.917 | 0.000 |
| Primary credit (Discount Window) | 0.000 | 0.024 | 0.011 | 0.043 | 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) | 1.709 | 1.709 | 1.709 | 1.708 | 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 | 0.035 | 0.035 | 0.080 | 0.035 | 62.000 |
| Federal Reserve Assets | 4520.0 | 4517.6 | 4516.5 | 4525.6 | 961.7 |
| 3-month Libor % | 1.18 | 1.17 | 1.17 | 1.16 | 2.82 |
| **Factors draining reserves** | | | | | |
| Currency in circulation | 1548.378 | 1546.200 | 1542.724 | 1541.322 | 834.477 |
| Term Deposit Facility | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| Reverse repurchases w/others | 187.269 | 186.667 | 122.323 | 116.567 | 0.000 |
| **Reserve Balances (Net Liquidity)** | 2219.918 | 2200.821 | 2200.670 | 2256.670 | 24.964 |
| Treasuries within 15 days | 20.483 | 20.483 | 14.058 | 14.058 | 14.955 |
| Treasuries 16 to 90 days | 37.862 | 37.862 | 46.551 | 46.550 | 31.549 |
| Treasuries 91 days to 1 year | 223.204 | 223.203 | 200.650 | 200.648 | 69.272 |
| Treasuries over 1-yr to 5 years | 1170.574 | 1170.570 | 1194.564 | 1194.549 | 170.807 |
| Treasuries over 5-yrs to 10 years | 384.944 | 384.939 | 381.211 | 381.191 | 91.863 |
| Treasuries over 10-years | 627.747 | 627.733 | 627.696 | 627.642 | 101.337 |

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

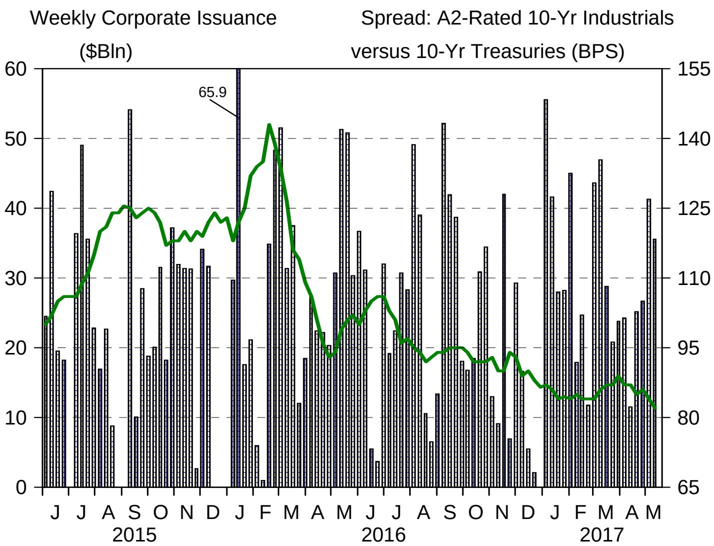
The Fed meets June 13-14 to consider its monetary policy. It is a press conference meeting where we expect great things to happen. Even uber-Dove Chicago Fed President Evans came out saying this week that the market underestimates the path of interest rates over the next few years: 1.0% today, 1.5% end of 2017, 2.25% end of 2018, and the finish line 3.0% at the end of 2019. Meanwhile, the market in its wisdom judged the data on Friday made a June rate hike less probable. The economic slowdown in the first quarter wasn't as transitory as the Fed May meeting statement said at least for the market's liking. Retail sales rose just 0.4% in April where a 0.6% gain was expected, nevermind that March's original 0.2% decline was revised to +0.1%. We think it is really core CPI that is the biggest problem for the market in terms of its Fed expectations where after falling 0.1% last month, core CPI bounced back by just 0.1% in April. This means that core PCE inflation for April released on May 30, the last inflation report before the June Fed decision, could fall back to just 1.4% year-on-year, falling further away from the Fed's 2.0% objective.

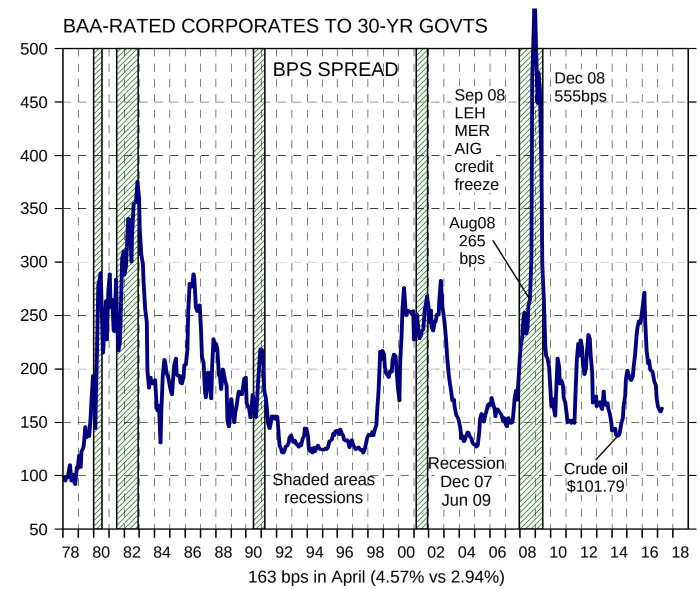



Anyway, the market based odds of a June meeting rate hike (July Fed funds futures) fell back to 68% on Friday after retail sales and CPI from 78% Thursday night, still flashing the green-go light, but not quite as brightly. Fed policy needs to look ahead always so inflation running short of target may not be the relevant driver of monetary policy. Fed officials may put greater emphasis on the low 4.4% unemployment rate: with the economy at full employment inflation pressures start to build it is just a matter of time. Besides the Fed funds rate is still way too low and accommodative at just 1%. We think they will raise rates on June 14, but we always think they will or should raise rates at a bare minimum at every press conference meeting each year all four of them until they get rates up to normal. Stay tuned. Story developing.

## CORPORATE BONDS: INTEL, AMGEN, VERIZON, NISOURCE, UPS, PPL CORP

Corporate offerings were $35.6 billion in the May 12 week versus $41.3 billion in the May 5 week. On Tuesday, Costco sold $3.8 billion 4s/5s/7s/10s. It priced $1 billion 3.0% 10-yrs (m-w +15bp) at 70 bps (A1/A+). The mass retailer will use the proceeds for its $7 per share special dividend. Corporate bonds (10-yr Industrials rated A2) were 82 bps above 10-yr Treasuries on Friday versus 84 bps last Friday.




## TREASURY MARKET OUTLOOK

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

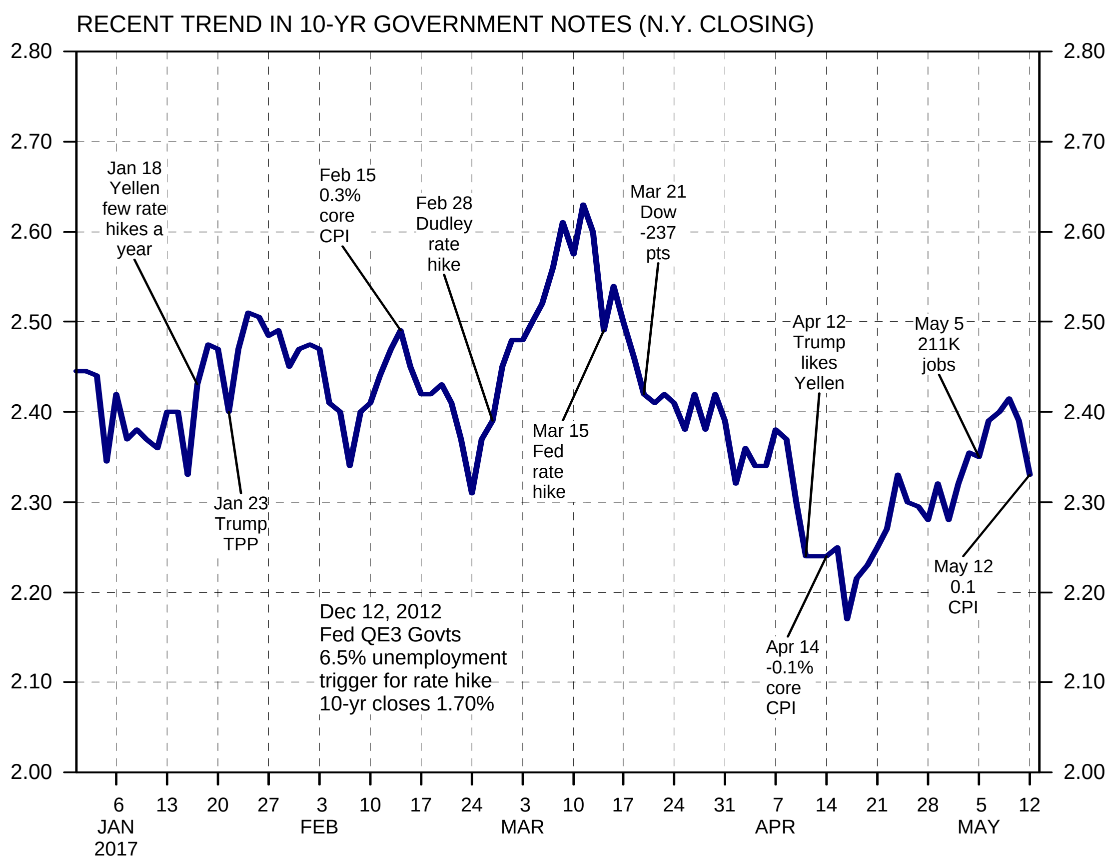
Week's 10-YR Range

**HIGH 100-15+ 2.32%**

Friday, May 12, retail sales 0.4%, core CPI 0.1%

**LOW 99-19 2.42%**

Thursday, May 11, PPI inflation 0.5% April after -0.1% March



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