Financial Market Weekly

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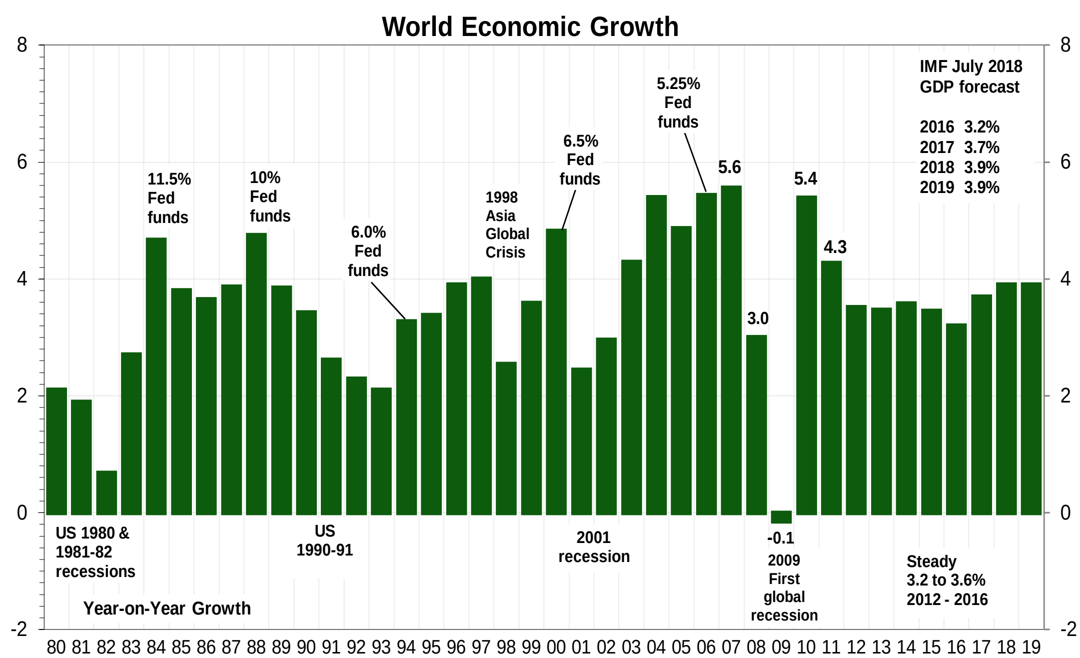
TRADE WARS NOT AFFECTING WORLD ECONOMIC GROWTH FOR NOW

For Now is the word. Estimates for second quarter U.S. real GDP growth (to be reported Friday, July 27) are around 4% in part due to the strength shown in the retail sales report for June on Monday this week. But what about the world economy with trade war storm clouds out on the horizon and even raining in places. How long can the U.S. remain an island of prosperity while the rest of the world is in turmoil as Greenspan put it famously back in the 1990s. Maybe until the massive tax cut monies are fully spent by individuals and corporations. Maybe. Meanwhile, a slowdown in China's economic growth has figured importantly in the past when the global markets got cold feet and feared the worst for the world economic outlook. We are thinking back to early 2016 and in mid-2015 when Yellen postponed a rate hike due to concerns and worries over China and what it meant for the outlook. China's currency has been falling sharply since April this year partly on concerns about what the trade war with the U.S. means for China's economic growth. On Wednesday, South Korea warned on economic growth given the escalation in trade tensions. Its economy is forecast to create fewer jobs this year, 180 thousand versus 320 thousand they forecast in December. The Finance Minister said, "The economic situation could become even more difficult, if the unrest in global trade and financial instability increase due to trade disputes between the U.S. and China, and monetary tightening, and if confidence in markets and businesses does not revive." Global worries over the trade tension risks are clearly spreading.



The IMF provided its normal July update to the world economic forecast on Monday. They make two major forecasts a year in April and October and follow-up these with updates in January and July. World economic growth was left unchanged from that April 2018 World Economic Outlook (WEO) at 3.9% forecast this year and next. The trade wars are not affecting world growth now, but the risks are there if trade tensions escalate. Indeed, IMF Managing Director Christine Lagarde said this may be the high-water mark for world growth. The IMF is traditionally very risks focused in these reports, what can go wrong, etc. Many of the WEO titles from prior outlooks were quite grim in recent years, even though world economic growth stayed fairly constant ranging from 3.2 to 3.6 percent from 2012 to 2016. Faster U.S. growth is helping this year.

IMF World Economic Outlook (WEO) Titles

Jul 2018	Less Even Expansion, Rising Trade tensions
Apr 2018	Cyclical Upswing, Structural Change
Jan 2018	Brighter Prospects, Optimistic Markets, Challenges Ahead
Oct 2017	Seeking Sustainable Growth: Short-Term Recovery, Long-Term Challenges
Jul 2017	A Firming Recovery
Apr 2017	Gaining Momentum?
Jan 2017	A Shifting Global Economic Landscape
Oct 2016	Subdued Demand: Symptoms and Remedies
Jul 2016	Uncertainty in the Aftermath of the U.K. Referendum
Apr 2016	Too Slow for Too Long
Jan 2016	Subdued Demand, Diminished Prospects
Sep 2015	Adjusting to Lower Commodity Prices
Jul 2015	Slower Growth in Emerging Markets, a Gradual Pickup in Advanced Economies
Apr 2015	Uneven Growth: Short- and Long-Term Factors
Jan 2015	Cross Currents

China has figured importantly in the outlook for world growth. It is still an emerging market country even if it has one of the biggest GDP economies in the world. Yellen made a controversial decision to delay the first Fed rate hike in September 2015 a month after China devalued its currency. A weaker yuan is more supportive of China's economy as it makes its exports more attractive to the world. China's currency is falling again (like a rock Trump said) since April this year on the trade war escalation with the U.S. which diminishes their outlook for economic growth. Trump has said higher US interest rates is aiding the dollar rally although that's another story. China did not need the trade war uncertainty which will take a toll on growth. Second quarter real GDP was just released at 6.7%, but has been expected to slow. Domestic credit growth has helped push the economy forward in the past. But authorities had been attempting to rein in the over-leveraged economy, even if now it is moving to reverse some of these credit tightening steps that may have gone too far and are no longer the right policy for an economy facing trade headwinds.

The key to this financial crisis is whether it keeps escalating, and the trade tension doesn't seem to be dying down. The fully aired CNBC Trump interview let us know at 6am Friday that Trump is ready to go to $500 billion on the China import tariffs. We only imported $505 billion of goods in 2017. Late in the day, Mnuchin following up on Trump's CNY falling like a rock comment said he was monitoring the Yuan for signs of manipulation. Stay tuned.

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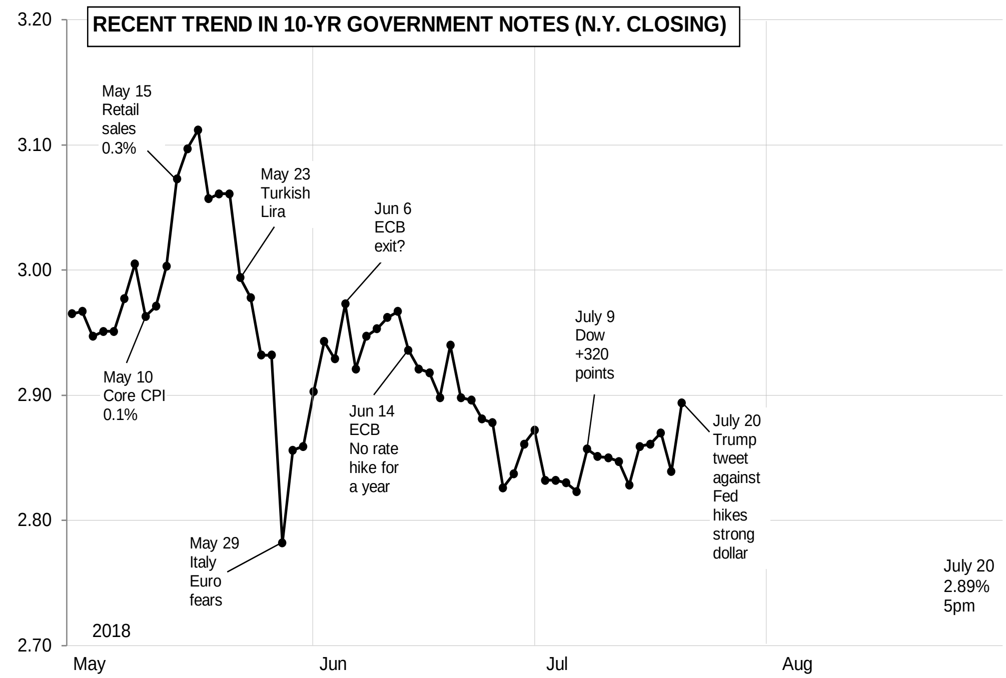
MARKETS OUTLOOK

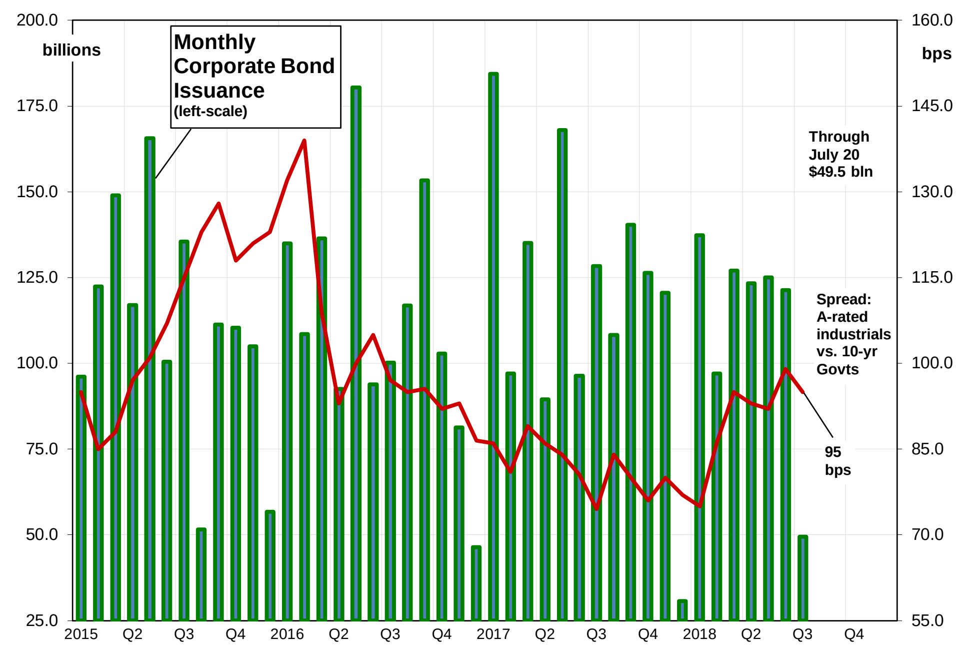
	29-Jun 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.99	3.10	3.20	3.35	3.45	3.60	3.60	3.75	3.85	3.80	3.95
10-Yr Note	2.86	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95
5-Yr Note	2.74	2.70	2.90	3.10	3.20	3.45	3.45	3.65	3.75	3.80	3.95
2-Yr Note	2.53	2.55	2.80	3.00	3.15	3.40	3.40	3.60	3.75	3.80	4.00
3-month Libor	2.34	2.55	2.80	2.95	3.20	3.45	3.45	3.70	3.95	3.95	4.20
Fed Funds Rate	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75	3.75	4.00
2s/10s spread	33	35	20	20	15	10	10	10	5	0	(5)



A lot of news this week, much of it political. 10-yr yields went out at the highs on Friday. The dollar fell on the Friday morning 843am Trump tweet and bond prices eventually followed. Fed raising rates while dollar gets stronger was the tweet (see Federal Reserve Policy section). There was also a rumor the BOJ would tweak its policy of controlling the yield curve, that would result in higher bond yields essentially, when they meet at the end of the month. This story helped push US yields higher Friday. Bonds have a downward trend of sorts, maybe next week's "4%" GDP report will help it along.

CORPORATES: MOSTLY BANKS, SOME HEALTH CARE; MUFG $4.6 BILLION

Corporate offerings were $35.6 billion in the July 20 week versus $13.8 billion in the July 13 week. Corporate bonds (10-yr Industrials rated A2) were 95 bps above 10-yr Treasuries this week versus 96 bps last Friday.



FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	18-Jul	11-Jul	4-Jul	27-Jun	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2359.766	2360.504	2360.377	2378.250	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1722.291	1721.275	1721.272	1721.271	0.000
Primary credit (Discount Window)	0.013	0.006	0.005	0.007	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)	1.711	1.711	1.711	1.710	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	
Central bank liquidity swaps	0.091	0.096	1.091	0.090	62.000
Federal Reserve Assets	4339.2	4338.8	4337.3	4352.7	961.7
3-month Libor %	2.35	2.34	2.34	2.33	2.82
Factors draining reserves					
Currency in circulation	1668.409	1672.158	1672.170	1665.308	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	6.021	1.230	4.852	20.680	0.000
Reserve Balances (Net Liquidity)	1949.944	1980.868	1954.210	1940.916	24.964
Treasuries within 15 days	30.302	1.133	1.132	30.454	14.955
Treasuries 16 to 90 days	63.008	93.310	93.310	75.435	31.549
Treasuries 91 days to 1 year	310.067	307.881	307.879	305.421	69.272
Treasuries over 1-yr to 5 years	1040.534	1042.558	1042.539	1051.171	170.807
Treasuries over 5-yrs to 10 years	296.154	296.037	295.992	296.305	91.863
Treasuries over 10-years	619.701	619.586	619.525	619.464	101.337

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

The Fed meets July 31-August 1 to consider its monetary policy. No policy change is expected. The odds of a 25 bps rate hike to 2.25% on Wednesday, September 26 at 2pm EDT are 92%. 2.25% doesn't sound high enough to do anything to halt the economy's forward progress or slow growth down, but the President is concerned and told Powell and the world markets he was "not thrilled" about the Fed rate hikes. The news from Trump's CNBC interview became known sometime around midday Thursday, maybe 10-yr yields were around 2.85% at the time. A few in the markets may have had the news early however. We don't have much to say about whether the Fed's independence is being compromised, whether this is right or wrong. Trump's view on interest rates is important however and may make the Fed's gradual pace of rate hikes more gradual, or maybe stop the rate hikes earlier. The Fed wasn't all that eager to raise interest rates anyway. Just in case someone missed the President's views on Thursday, he sent out a couple of tweets Friday morning doubling-down on his views about higher interest rates.

We won't alter the interest rate forecast on page three showing a Fed funds rate of 3.25% at the end of 2019 and a 4% rate at the end of 2020. We would point out that no one has won a war of words with the President yet, and stories about how Trump's tweets will harden the resolve of Fed officials to keep raising rates are not believable given Fed officials are already uncertain about how high to raise interest rates and claim they don't know what the normal level should be. You can't stiffen their resolve to raise interest rates if they didn't want to raise rates that high this time around anyway. And if the yield curve inverts, a lot of Fed officials votes for continued rate hikes will disappear.

If the President overshadowed two days of Powell's congressional testimony, well, there wasn't much news there anyway. The Fed Chair under Greenspan, Bernanke, and Yellen was the nation's chief economist who could offer expert testimony. In last week's MARKETPLACE interview he said, "His natural inclination is to explain things in a way that is probably clear, I hope, intended to be clear to a general, to the general public, and people, people in general."

Trump Tweets Friday
843am China, the European Union and others have been manipulating their currencies and interest rates lower, while the U.S. is raising rates while the dollars gets stronger and stronger with each passing day - taking away our big competitive edge. As usual, not a level playing field...
851am ....The United States should not be penalized because we are doing so well. Tightening now hurts all that we have done. The U.S. should be allowed to recapture what was lost due to illegal currency manipulation and BAD Trade Deals. Debt coming due & we are raising rates - Really?

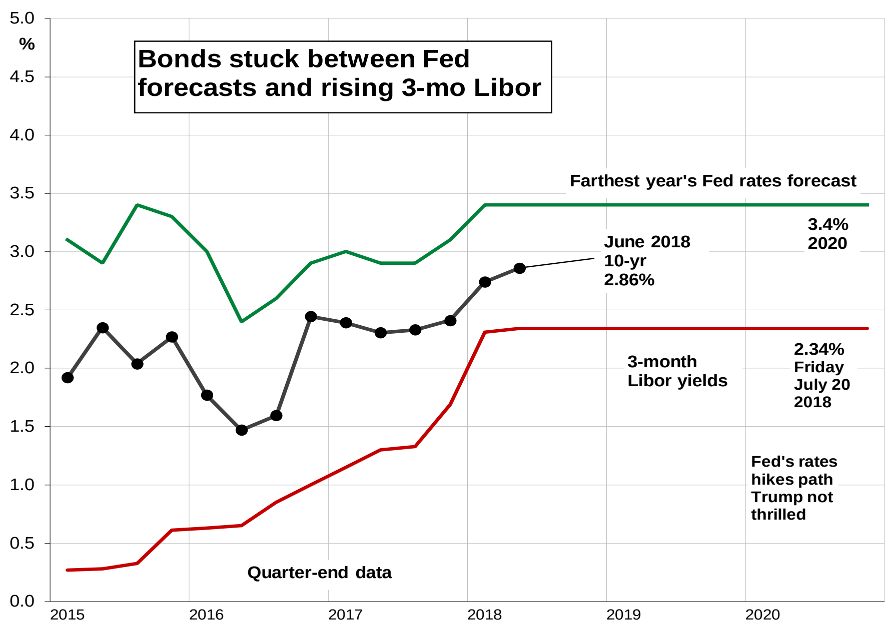
That leaves out Wall Street economists and bond traders--know it alls about monetary policy already that cannot be told anything. Powell also said, "I don't think of myself as the guy running the economy." Well, who is? The Fed Chairman for decades used to be thought of as the second most powerful person in the world next to the President of the United States. But if you aren't responsible for the economy-nevermind.

Fed Individual Forecasts				
Fed funds rate by year-end				Longer
Votes	2018 End	2019 End	2020 End	run
1	1.875	1.875	1.875	2.250
2	1.875	2.125	2.625	2.500
3	2.125	2.625	2.625	2.625
4	2.125	2.875	3.125	2.750
5	2.125	2.875	3.250	2.750
6	2.125	2.875	3.375	2.750
7	2.125	2.875	3.375	2.750
8	2.375	3.125	3.375	3.000
9	2.375	3.125	3.375	3.000
10	2.375	3.125	3.500	3.000
11	2.375	3.125	3.625	3.000
12	2.375	3.375	3.625	3.000
13	2.375	3.375	3.625	3.250
14	2.375	3.375	4.125	3.500
15	2.625	3.625	4.125	
Median	2.375	3.125	3.375	2.875
Meeting	Jun 2018	Jun 2018	Jun 2018	Jun 2018

Back to Fed Chair Powell's semiannual Monetary Policy Report testimony on Tuesday before the Senate: his statement read that gradual rate hikes was the most likely path for policy "for now." The words "for now" were taken in many commentaries and news stories as meaning the gradual pace of rate hikes could be altered at some point later on. But then again, if the President is "not thrilled with rate hikes, maybe "for now" is going to end up being a much shorter period than market had anticipated.

Perhaps "for now" just means the gradual rate hikes will continue from a 2% Fed funds rate now until the normal 3% level of interest rates is reached. They are getting closer to home. At any rate, the "for now" words were not much of a factor for trading after Powell's testimony statement was released at 10am on Tuesday. Trading in 10 year Treasuries was lackluster on the news to say the least, yields moved up, call it 1 basis point to 2.865%. And Fed funds futures odds of a September Fed meeting rate hike were little changed, moving from 92% at Monday's close to 96% at Tuesday's close. Powell's Day 1 testimony and Day 1 Q&A with the Senators did not recalibrate the market's thinking on monetary policy in the near term certainly. And we didn't learn whether that 3.5% estimate way out there at the end of 2020 will ever be hit. At the September 2018 meeting, they will issue a rate forecast for the end of 2021. Could be very important news. For our 4% [3.95%] bond yield forecast.

Rates Forecasts--Between a rock and a hard place.

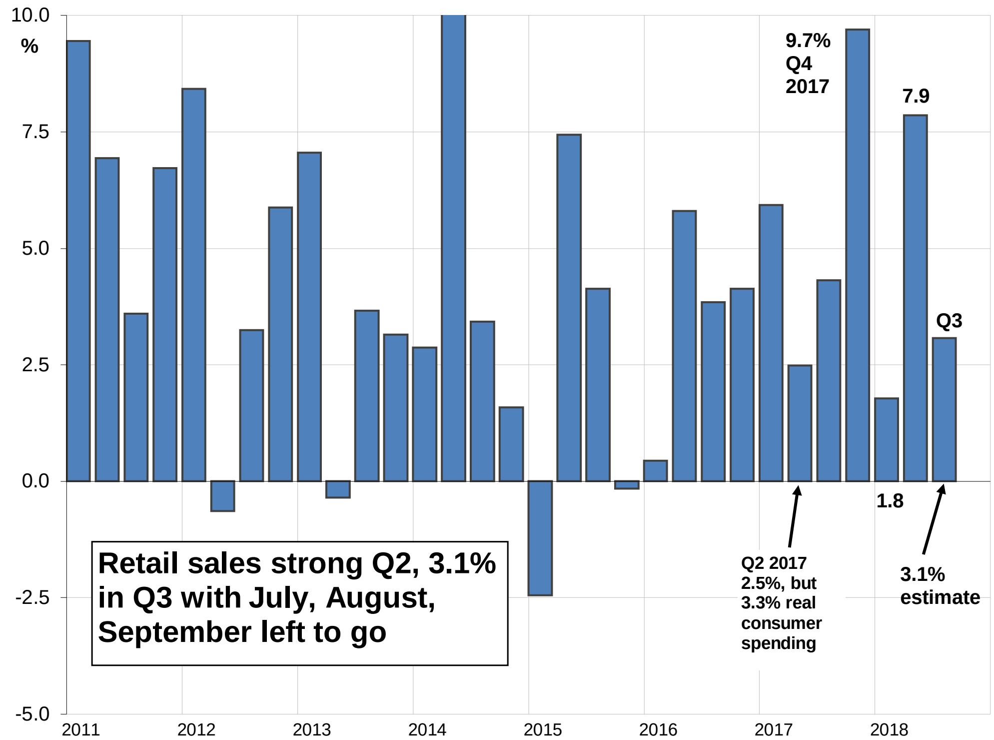


OTHER ECONOMIC NEWS THIS WEEK

Retail sales strong like bull: 4% GDP in sight (Monday)

Breaking economy news. It isn't easy to measure what 328 million Americans are up to each month. This month or even the month before apparently. Just take a look at retail sales. Retail sales in May were revised stronger from 0.8% in last month's estimate to 1.3% today, and June sales rose a further 0.5%. Retail sales less autos was revised in May from 0.9% to 1.4% and rose another 0.3% in June to close out the quarter.

Retail sales increased 7.9% in the second quarter and sales in the third quarter are already up 3.1% even if the consumer doesn't spend a dime more in July, August or September, which shows you how much forward momentum the economy has right now early in the third quarter. Economic growth is hot, hot, hot this summer. Trade sanctions be damned. U.S. consumers don't even know where China is if today's data are to be believed. (Wait till they have to pay higher prices for those tariffed consumer goods.)

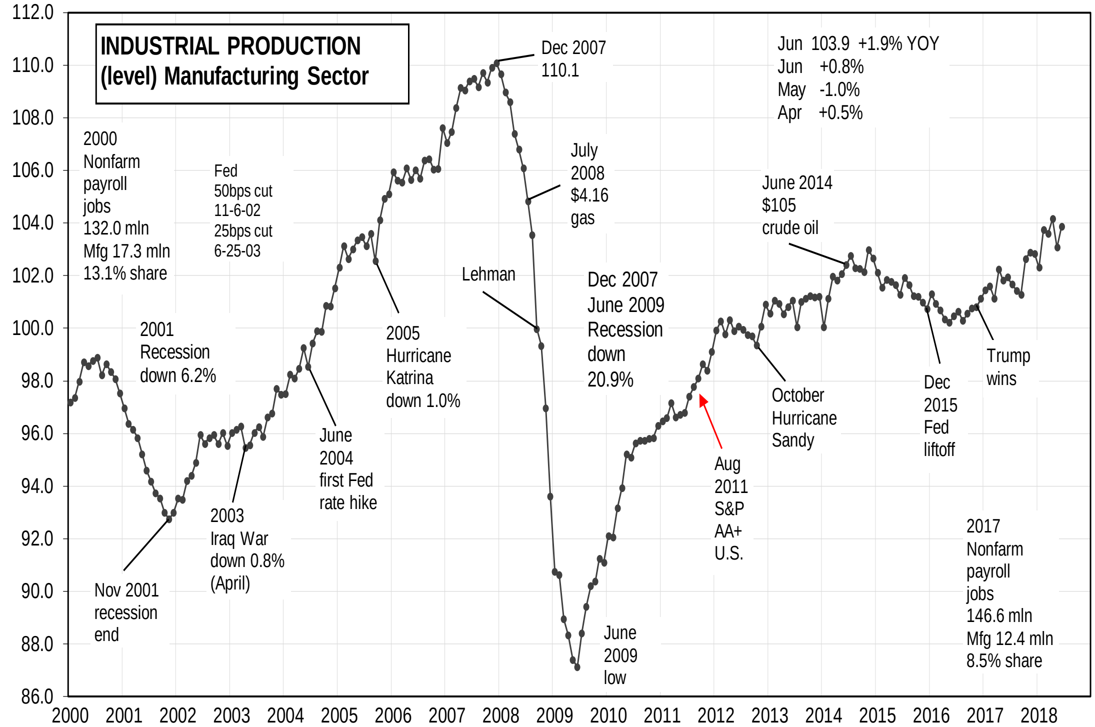


Net, net, Americans are out shopping till they drop this quarter making the dream of 4% economic growth closer to becoming a reality. This isn't just another truthless Trump administration boast that the economy is strengthening, this is real data and it shows no trade war hesitation on the part of the American consumer whatsoever. Consumers aren't buying electronics, food and beverages, sporting goods, or clothing, but everything else was cleared off the store shelves in June which puts the economy in a very, very good position as it starts its tenth year of forward movement in July.

This strengthening economy gives the Federal Reserve the green light to raise rates a third time this year at their September meeting. Retail sales are over the top when it comes to beating expectations and this means interest rates below normal levels which stimulate economic growth are no longer necessary. Those trade war clouds on the horizon may scatter in the wind without ever taking a toll on US economic growth so the Federal Reserve is on the right course to continue on their path of gradual rate hikes. The economy is stronger than you think. And this morning we really mean it.

Manufacturing jobs not coming back if production does not (Tuesday)

Breaking economy news. Industrial production in June rose 0.6% in a rebound from May's revised 0.5% decline. Total production which includes manufacturing, mining and utilities output is up 3.8% over the last year.



Manufacturing is the key focus given the presidential campaign with its fiery rhetoric promising to bring factories and jobs lost to countries overseas back to the USA. Manufacturing production rose 0.8% in June after a downward revised 1.0% decline in May.

Net, net, factory output hit a pothole in the road last month and now has made up for that loss in manufacturing production that was technically based due to problems at a supplier. Truck assemblies fell hard in May due to a big fire at a parts distributor. The fire is out and manufacturing production lifted back in June. Suppliers are very much the focus now given the heat from the trade wars where foreign imports of intermediate goods used in production are being hit by tariffs. Time will tell if this disruption in foreign trade will slow the overall US economy because manufacturers cannot get what they need to produce goods here for domestic consumption and for exports. The world is flat, but goods won't move between countries if trade barriers go up.

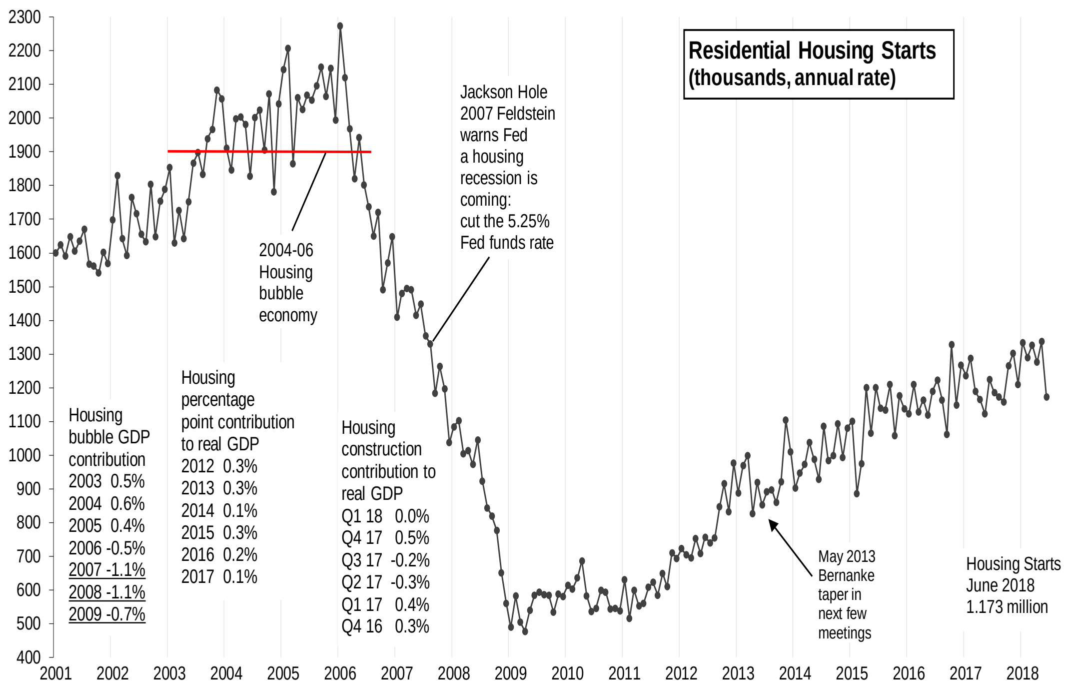
We judge that this latest news on factory production is not too hot and not too cold for the tastes of Fed officials as they guide rates on their return to more normal levels. The Fed funds rate is 2% now, some 100 bps below normal levels for the economy, so today's factory output data certainly is consistent with more interest rate hikes later on this year. Stay tuned. Story developing.

Housing starts tumble as trade talks stumble (Wednesday)

Breaking economy news. Housing starts tumbled today as the trade talks stumble raising the risk that the uncertainty caused by the trade wars is starting to postpone investment in one of the key sectors of the economy.

Housing starts tumble 12.3% in June to 1.173 million at an annual rate. The risks from the trade wars may be evident most in the 35.8 percent collapse in Midwest housing construction as this area of the country, especially its farmers, are being hit hard by tariffs which have virtually stopped the export of agricultural products in their tracks, harming relationships and markets that farmers have developed over the past twenty years. It's not just the Midwest of course, housing starts fell 6.8% in the Northeast, 9.1% in the South, and 3.0% in the West. This is clearly a troubling report for the Nation and the economic outlook.

Net, net, residential housing construction took a dive in June which interrupts for now the last several economic reports painting a picture of almost perfect economic growth in the second quarter. Housing starts are the weakest this year. The weakness in housing starts may inject some caution in those Fed officials who are already questioning the need to raise rates four times this year. The vote was split already with 8 saying four or more rate hikes in 2018 and 7 saying three or less rate hikes in 2018. Stay tuned. Story developing.



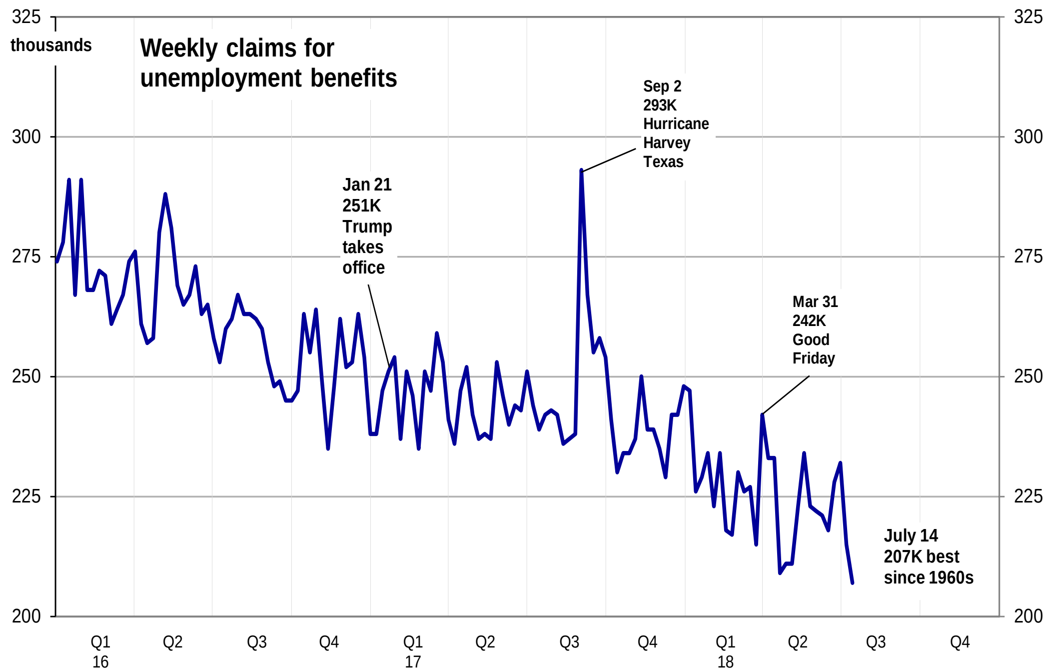
Housing construction is a leading indicator of the economy and the big decline today does not portend a rosy outlook in the second half of the year. Home builders are already starting to question the old adage if they build it, they will come. There have been anecdotal reports that many businesses are postponing making new investments because of the uncertainty caused by an escalation in trade tensions. Housing permits are holding at 1.273 million in June and may point the way for a rebound in June's 1.173 million housing starts. But make no mistake about it, the long and as yet unfinished recovery in residential housing construction looks to have stalled. The Federal Reserve may be on a gradual course of rate hikes for now, but it won't be for long, if it becomes apparent that higher mortgage rates have put the kabosh on residential housing construction.

Record low for jobless claims but has the economy reached full employment? (Thursday)

Breaking economy news. Jobless claims tumble to new record low of 207K in the July 14 week. Joking on asking whether economy has reached full employment. We looked back all the way to 1970 and jobless claims have never been lower. Record low jobless claims will keep the Fed on course for now to raise interest rates to normal levels. This means four more rate hikes are coming. Bet on it. There is no reason for interest rates to be below normal levels which stimulate the economy.

A ratcheting up of trade tariffs will bring job cuts U.S. companies are saying, so we are watching the weekly unemployment claims data closely to see when the tariffs start to hit the fan and threaten the economic expansion. No layoffs yet. If a recession is coming the blame will land squarely on the shoulders of Trump's economics team who advised him that the decades long trend towards globalization could be fixed without doing long term damage to the economy. That's a myth.

Jobless claims at record all-time lows show businesses have not cut back hiring yet on the uncertainty caused by increased trade tension. But cutbacks are coming if the Administration does not make a deal and stop the threats against America's trading partners. The irony is that factories cannot be brought back to America for now because there are no workers to man the machinery and tell the shop floor robots what to do. The economy is at full employment is what jobless claims are screaming and there is no one left in America without a job.



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