Financial Market Weekly

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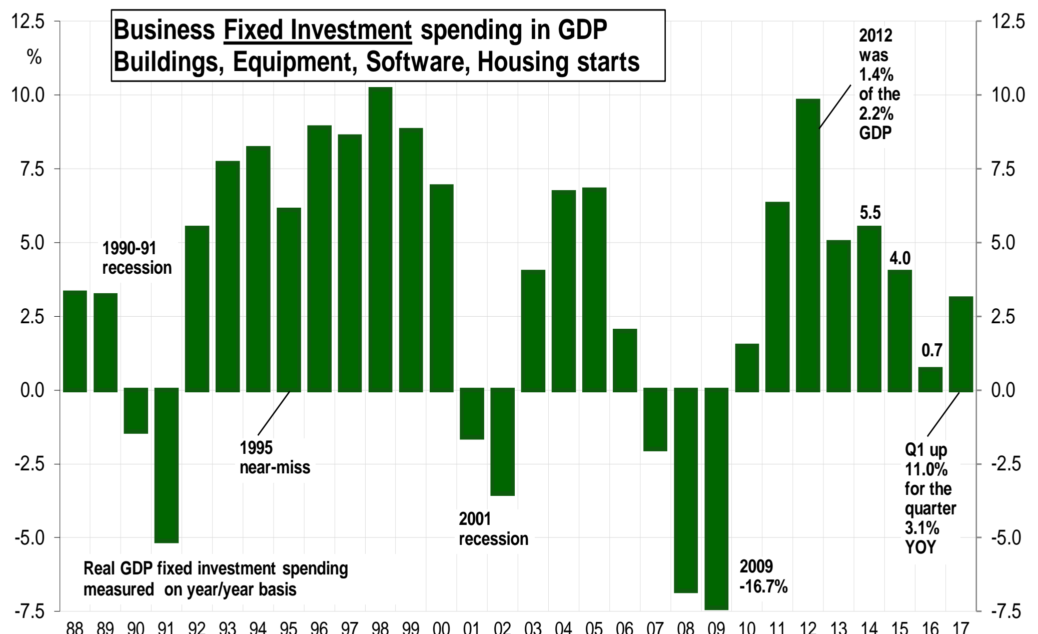
FED WAITING ON INVESTMENT NOW BEFORE RETURNING RATES TO NORMAL



There's always some reason not to return interest rates to pre-recession levels, the one that ended in June 2009. This is 2017. In speeches for over a year now, Fed Vice Chairman Fischer has been bringing up the imbalance between savings and investment as the reason for low interest rates. That's the theory anyway from the textbooks. The IS curve taught in college economics classes where the level of interest rates is determined by the investment-savings curve. Fischer has talked up this line of thinking for over a year in speeches. Interest rates are low because of too much savings, too little investment, or both. The Fed would like to bring rates up, but it isn't that easy he said.

It doesn't look that hard to raise rates to 3% from where we sit. Just announce the new higher rate at any future Fed meeting, and the market will dumbly follow along. Anyway, let's take a look this week at what actual investment is doing right now. It might be more useful than theorizing about where the rates intersection between savings and investment lies. We have no doubt Fed officials would be more gung-ho about raising rates if investment demand was more robust.

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There was not that much investment GDP-accounts wise in the housing bubble years after the 2001 recession. The Fed raised rates to 5.25% anyway. It is different this time; with the expansion entering its ninth year of advance, it would be understandable if one were to guess that companies have already borrowed and otherwise spent the money on equipment that they need to meet the demand for their goods and services. Leaving rates down here for longer will not increase borrowing or prompt additional investment spending one wouldn't think. It's not logical.

Investment in the economy isn't just as is commonly thought business capex. There is business spending on offices, warehouses, factories; there is business spending on long-lived equipment; there is spending on so-called intellectual property which is software, R&D expenditures, Entertainment (movies); and there is residential housing construction, popularly known as housing starts, including single-family homes, and apartments, remodeling of existing homes, and real estate broker commissions.

Fed officials want to see more business spending on investment, but nothing looks too out of line in the table here. Business fixed investment spending overall is up 15.3% over the last ten years ending in 2016 which is 1.5% per year for nominal spending; but keep in mind that investment spending during the recession collapsed 22% from 2006 to 2010 before recovering. If the Fed is waiting for more investment spending before moving interest rates up we could be in for a long wait. Again, the cost of money isn't the only reason why companies borrow and invest. Fed officials seem to think if they could only cut interest rates somehow further down that that would cause companies to borrow and invest more and help the economy grow. Sad. This stale line of thinking.

Business fixed investment is 15.3% higher than 2006 peak before the recession

Nominal or Current Dollars $billions

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Business fixed investment	2613.7	2609.3	2456.8	2025.7	2039.3	2198.1	2449.9	2613.9	2821.0	2963.2	3014.8
Structures	415.6	496.9	552.4	438.2	362.0	381.6	448.0	463.6	530.7	507.3	493.8
Ex-oil & gas	319.6	394.7	435.4	363.2	275.8	269.3	313.9	324.2	374.4	406.1	442.2
Oil & gas drilling	96.0	102.2	117.0	75.0	86.2	112.3	134.1	139.4	156.3	101.2	51.6
Equipment	856.1	885.8	825.1	644.3	731.8	838.2	937.9	982.8	1040.7	1086.1	1057.0
Intellectual property products	504.6	537.9	563.4	550.9	564.3	592.2	621.7	647.9	679.6	717.9	758.0
Residential housing construction	837.4	688.7	515.9	392.2	381.1	386.0	442.2	519.5	570.1	651.9	706.1

We did want to point out a few things in this somewhat boring table on business investment over the years. One. Business spending on structures, taking out the oil & gas drilling, is up sharply from 2006, thinking offices, warehouses, and manufacturing factories believe it or not. The weakness is really due to the collapse in oil & gas drilling structures from $156.3 billion in 2014 to $51.6 billion in 2016 during the crude oil price crash. If the Fed wonders where business investment spending is, this is it.

Two. Business spending on equipment collapsed 27.3% from 2007 to 2009, but is now well above the pre-recession highs, growing an average of 9.2% from 2010 through 2015… can't really ask for more capex on equipment from corporate America than this fast pace of growth moving from recovering to all-time record high expenditures. Equipment spending did fall back 2.7% in 2016 with the monthly durable goods orders data suggesting the weakness was in oil & gas drilling and farm equipment machinery. Business spending on "intellectual property" continues at a rapid rate as people keep

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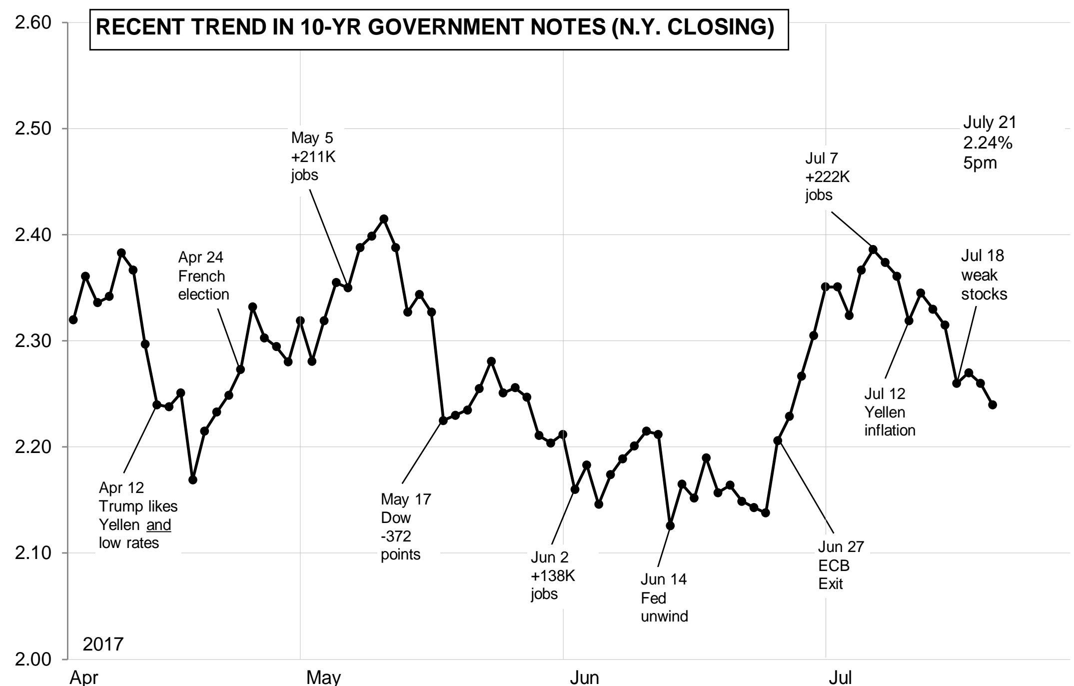
going to the movies… actually R&D expenditures to enable future growth through technological advances remains quite strong, and spending on software is too.

Finally, residential housing construction at $706.1 billion in 2016 is still lower than $837.4 billion in 2006 before the housing bubble popped. Investment spending on everything but oil & gas drilling and housing construction looks fully recovered. Oil & gas drilling is a special case tied to the price of crude oil perhaps, but residential housing construction is activity that Federal Reserve officials hope to bolster by keeping interest rates low: mainly the interest rate costs of borrowing for the purchase of a new home.

To sum up, investment in the economy does not look all that weak, and the argument that rates are low because of a lack of investment demand looks to be pretty unconvincing. The reason the overall structure of interest rates is low at present is because the Fed target for the funds rate is just 1.25%. It is also not helpful that some senior Fed officials are saying the Fed funds rate may only need to go up to 2.0 to 2.5 percent. And maybe not even that high. They don't know that they don't know.

MARKETS OUTLOOK

	30-Jun 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
30-Yr Treasury	2.83	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10
10-Yr Note	2.30	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90
5-Yr Note	1.89	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70
2-Yr Note	1.38	1.60	1.85	2.10	2.40	2.60	2.85	3.10	3.35	3.35	3.60
3-month Libor	1.30	1.65	1.90	2.20	2.45	2.70	2.95	3.20	3.45	3.35	3.70
Fed Funds Rate	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50
2s/10s spread	92	90	85	90	80	80	65	60	45	55	30
Libor/funds spd	5	15	15	20	20	20	20	20	20	10	20



Yields drifted down further this week from the 2.4% highs reached on last month's 222K jobs report. Yellen started the bond rally we guess with the market thinking the committee was concerned enough about inflation short of the 2% target to delay anymore rate hikes perhaps. How a 1.25% Fed funds rate helps push up inflation or how a 1.5% Fed funds rate stops inflation moving higher is beyond us. Yields fell sharply on Tuesday with the Dow industrials down as much as 158 points intraday, the new volatility, partly on the delayed Obamacare vote in the Senate.

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FEDERAL RESERVE POLICY

The Fed meets July 25-26 to consider its monetary policy. We are not expecting anything to happen, although Yellen did tell Congress recently that the balance sheet unwind's official starting announcement would take place "relatively soon." Wouldn't that be a kick in the head if they announced it on July 26? The market at the moment is expecting the balance sheet announcement in September and for the final of the Fed's forecasted three rate hikes this year to take place in December (raising the Fed funds rate 25 bps to 1.50% in case you forgot). Our official forecast looks for four rate hikes this year, because it's the right thing for them to do. 100 bps of normalization this year is gradual, snail's pace slow enough as compared with the 200 bps per year during Greenspan's time (2004-06).

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	19-Jul	12-Jul	5-Jul	28-Jun	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2465.145	2465.121	2465.096	2465.046	479.782
Federal agency debt securities	8.097	8.097	8.097	8.097	0.000
Mortgage-backed securities	1779.394	1770.281	1770.281	1770.280	0.000
Primary credit (Discount Window)	0.051	0.001	0.001	0.084	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)	1.710	1.709	1.709	1.709	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	0.041	0.055	3.070	0.035	62.000
Federal Reserve Assets	4523.6	4513.4	4513.8	4509.6	961.7
3-month Libor %	1.31	1.30	1.30	1.30	2.82
Factors draining reserves					
Currency in circulation	1561.884	1564.816	1565.957	1559.134	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	144.731	179.172	240.029	263.669	0.000
Reserve Balances (Net Liquidity)	2250.646	2238.951	2169.650	2118.108	24.964
Treasuries within 15 days	11.794	1.278	1.278	12.885	14.955
Treasuries 16 to 90 days	32.799	44.593	44.593	34.924	31.549
Treasuries 91 days to 1 year	276.684	275.578	275.577	256.069	69.272
Treasuries over 1-yr to 5 years	1152.629	1152.805	1152.801	1174.374	170.807
Treasuries over 5-yrs to 10 years	357.347	357.263	357.258	353.845	91.863
Treasuries over 10-years	633.892	633.604	633.589	632.949	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

OTHER ECONOMIC NEWS THIS WEEK

Housing is back as we forecast

Breaking economy news. Housing starts are back in a big way. This is just the sort of investment demand in the economy that the Federal Reserve needs to see in order to continue with its gradual pace of rate hikes.

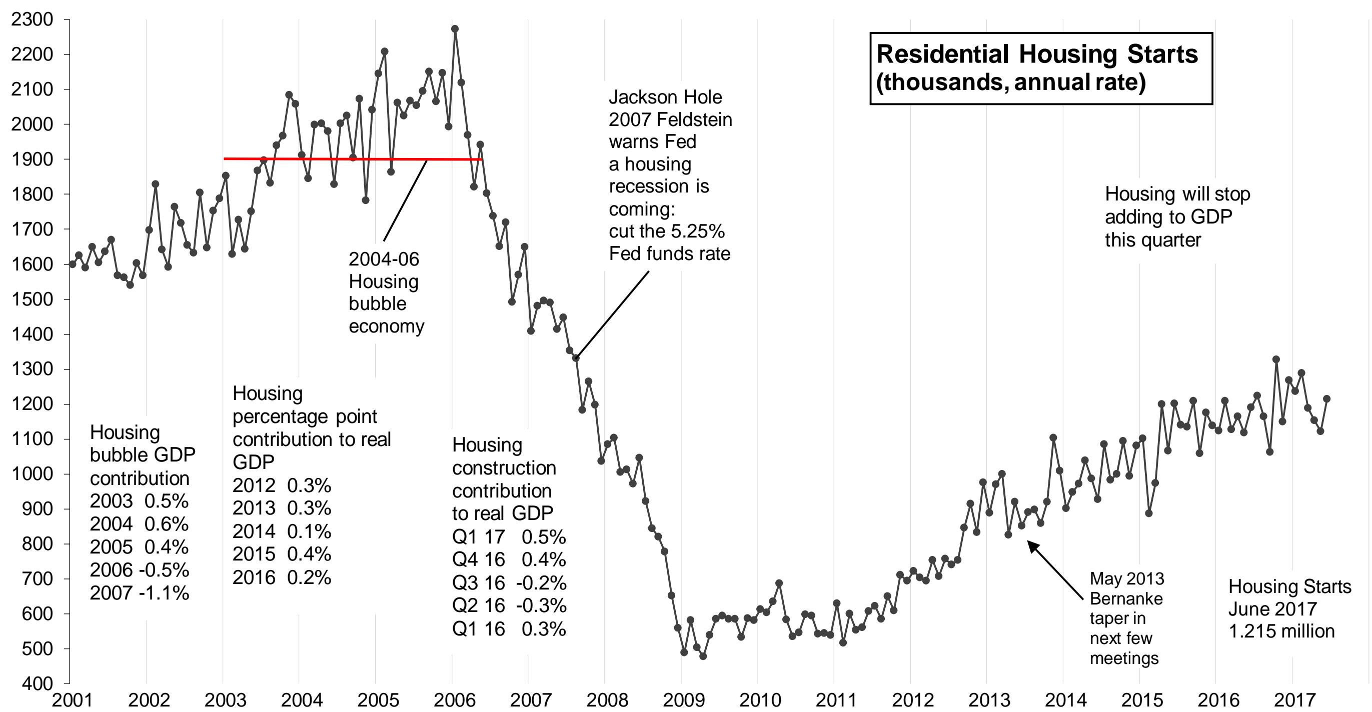
While the results nationwide were a little uneven with the biggest market down south actually falling back somewhat, and with enormous gains in the Northeast and a big gain in the Midwest, the overall level of housing activity across the Nation is certainly stabilizing and looks primed for stronger growth later on this year.

Housing Starts Total, Single-Family, Multi-Family											
	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
June 17	1215	849	366	158	59	205	134	533	448	319	208
May 17	1122	799	323	86	54	168	139	554	418	314	188
June 16	1190	770	420	114	73	188	114	587	413	301	170
% Chgs											
Jun/May	8.3	6.3	…	83.7	9.3	22.0	-3.6	-3.8	7.2	1.6	10.6
Jun/Jun	2.1	10.3	…	38.6	-19.2	9.0	17.5	-9.2	8.5	6.0	22.4

Our message to homebuilders is to build it, baby, build it. Because right now home prices are simply out of sight for many buyers and the cost of housing is simply one of the most prominent headwinds the Trump economics team faces when it comes to bolstering economic growth. At this late stage of the recovery the economy is in desperate need of shelter: we need an increase in the supply of

affordable housing in the United States. Workers cannot continue to produce if they don't have a roof over their heads.

Net net, housing construction has been the weak link in this long economic expansion from the end of the last recession. And right now it looks like the clouds are starting to clear a little bit over the outlook for home construction, and we expect further gains in housing starts, especially single family homes, in the months ahead. For the Fed, this enables them to continue with the plan for a final rate hike this year in December and we expect them to announce the start of the balance sheet unwind imminently with the move coming at the very latest at the September meeting this year. The economy is stronger than Fed officials think. Bet On It.



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