Financial Market Weekly

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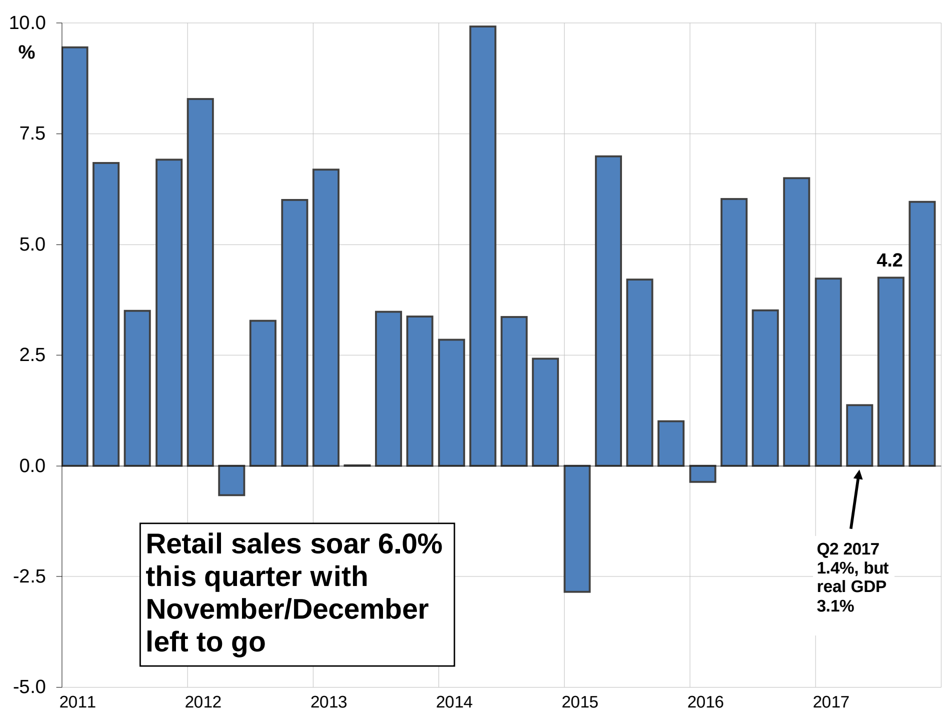
~~TAX REFORM WILL CREATE JOBS~~

CONSUMERS SPENDING THEIR TAX CUTS WITH ABANDON, MORE INFLATION TOO

We were going to lead this week with the *Tax Cuts and Jobs Act*, but will go instead with the more interesting and relevant October retail sales and CPI inflation reports on the economy. (At least until we can calculate better what this “bold legislation to overhaul America’s tax code for the first time in 31 years” means for us personally.) For retail sales, that huge leap of consumer expenditures in September, from the sky-high 18.5 million car sales and the hurricane storm-related surge in gasoline prices, got revised even higher, and the consumer managed to bring home more store-bought goods in October as well. Retail sales rose 1.9% in September revised up from 1.6% and October tacked on an additional 0.2% rise. And that's 0.4% and not 0.2% for October retail sales if gasoline prices had not come back down after the storms.



Looks to us that consumers are banking on getting that long-promised tax cut as their spending clearly knows no bounds. For all the talk of the slow growth 2% economy that needs to be jump-started by Washington deficit spending, priming the pump the President says is the phrase he came up with, consumer spending isn't languishing that's for sure.

Retail sales are up 4.6% the last year with more ca-ching noises for cash registers at the shops and malls that makes the economy's engines run fast and strong for this late in the economic expansion now in its ninth inning. And it isn't game over yet.

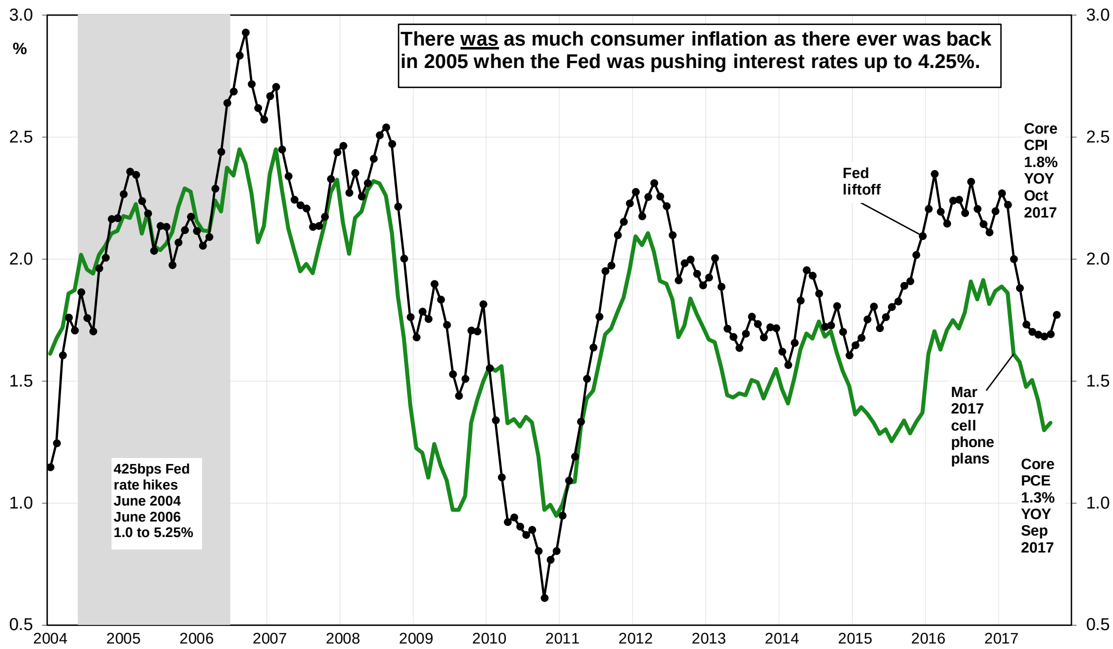
Motor vehicles up 5.4% the last year, furniture 4.8%, electronics 2.1%, building materials 11%, health and personal care 4.8%, Internet sales 9.6% stealing from Department stores which are down 1.4% the last year. The only other decline was 2.4% for sporting goods as baby boomers head for retirement and sit on the couch trying to work their smart phones while their grandkids laugh.

Retail sales vs. Personal Consumption Expenditures (PCE)

2016 % Total		Q2 16	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
100.0	Real PCE	3.8	2.8	2.9	1.9	3.3	2.4	
32.1	PCE Goods	6.0	3.2	4.7	0.7	5.4	4.2	
11.0	Durable goods	8.5	9.4	9.2	-0.1	7.6	8.3	
21.1	Nondurable goods	4.7	0.1	2.5	1.1	4.2	2.1	
67.9	PCE Services	2.8	2.7	2.1	2.5	2.3	1.5	
	Retail sales	6.0	3.7	6.0	4.5	1.4	4.2	6.0
	Retail sales ex-autos	7.3	2.0	4.8	6.4	1.1	4.2	4.2
	Auto sales (mln)	17.2	17.5	17.8	17.1	16.8	17.1	18.0

SAAR-Seasonally adjusted annual rates; % Total is nominal expenditures

Net, net, retail isn't on the ropes yet as consumers continue to spend on store bought goods that helps the economy grow. Spending late in an economic expansion when the economy is at full employment leads to more inflation. That's the textbook theory that is true this month. Core CPI inflation rose 0.2% to 1.8% year-on-year in October; two 0.2% monthly increases in the last three months shows inflation is heating up. Core consumer inflation is 1.8% a couple inches away from the Fed's 2% mandated target.



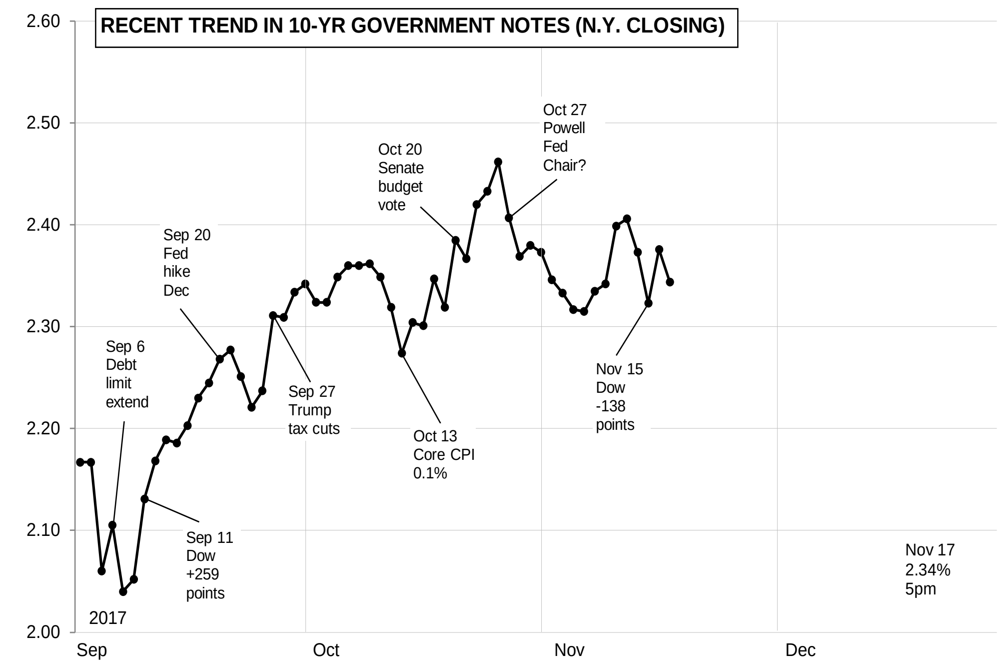
Why is it again they have their heads stuck in the sand and think PCE inflation is the better indicator of what consumers pay for goods and services? That's right we forgot, Greenspan made the call on that, steering the Federal Reserve from CPI to PCE, way back in the year 2000... a bum steer that was. The economy is certainly strong enough with enough inflation to put interest rates up to normal 3% levels, like right now, not gradually.

Retail spending with more inflation as well means the Fed can continue with its bold plan to raise rates at the final meeting this year. A rate hike in December doesn't need to be penciled in, Fed officials can take their fountain pens out and write it in permanent ink. Nothing but nothing is going to take a rate hike off the table on December 13. Bet on it.

MARKETS OUTLOOK

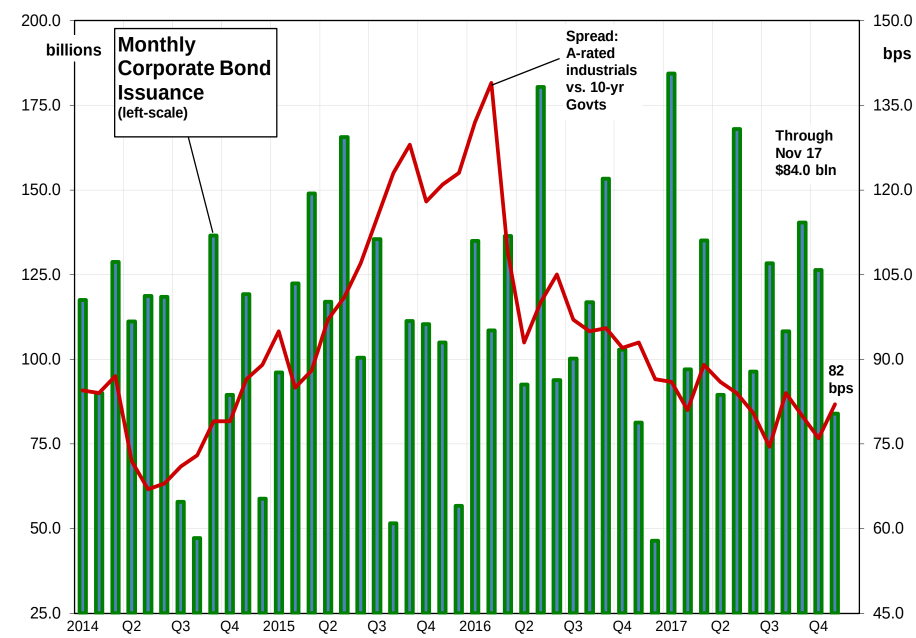
	29-Sep 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
30-Yr Treasury	2.86	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10	4.20
10-Yr Note	2.33	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90	4.00
5-Yr Note	1.94	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70	3.90
2-Yr Note	1.48	1.60	1.85	2.10	2.40	2.60	2.85	3.10	3.35	3.35	3.60	3.85
3-month Libor	1.33	1.65	1.90	2.20	2.45	2.70	2.95	3.20	3.45	3.35	3.70	3.95
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	3.75
2s/10s spread	85	90	85	90	80	80	65	60	45	55	30	15

10-year Treasury yields closed Friday at 2.34% after 2.40% the week before-- going nowhere. The 5 bps decline in yields Wednesday and 5 bps rise in yields Thursday took place overnight mostly before 8am NY time. Yellen told Congress early this year the rise in bond yields came as investors discounted the higher inflation that would occur from fiscal stimulus being undertaken when the economy was already at full employment. But the historic House tax vote Thursday didn't do much for yields. Market feels dead.



CORPORATE BONDS: ANTHEM, HONDA, TRANSCANADA, CBS, NEXTERA

Corporate offerings were $29.3 billion in the November 17 week versus $46.2 billion in the November 10 week. On Thursday, Ecolab Inc. sold $825 million 10s/30s. It priced $500 million 3.25% 10-yrs (m-w +15bp) at 93 bps (Baa1/A-). The water, hygiene, energy technology company will use the proceeds to repay and exchange debt. Corporate bonds (10-yr Industrials rated A2) were 82 bps above 10-yr Treasuries this week versus 80 bps last Friday.



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FEDERAL RESERVE POLICY

The Fed meets December 12-13 to consider its monetary policy. Fed funds futures odds are 92% so we doubt the Fed Doves will buck the advice from the markets to just do it already. That gets rates to all of 1.5%, with three more rate hikes penciled in as forecasts for 2018 ending next year at 2.25%. We were dismayed to hear ex-Goldman investment banker and now Dallas Fed President Kaplan say this week that rates were not too far from neutral and we guess he means 2 to 2.5% which doesn't do much for our 3% 10-yr Treasury yield forecast next year. Another relatively new inexperienced Fed official drinking the Kool-Aid economics staff research saying that the natural rate of interest is zero and not the 2% constant in the Taylor Rule which shoots the higher rates story in the foot. Cuts 200 bps off that path of rates. Fed Governor Powell seems to agree with this theory as well which essentially means we can't raise rates because the economy is not strong enough. At this point we need more inflation to get them going.

Selected Fed assets and liabilities

Fed H.4.1 statistical release billions, Wednesday data	15-Nov	8-Nov	1-Nov	25-Oct	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2456.641	2459.985	2459.827	2465.727	479.782
Federal agency debt securities	6.757	6.757	6.757	6.757	0.000
Mortgage-backed securities	1775.854	1770.630	1770.630	1770.563	0.000
Primary credit (Discount Window)	0.003	0.004	0.001	0.015	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	1.712	1.712	1.711	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	0.037	0.040	0.037	62.000
Federal Reserve Assets	4495.3	4505.4	4502.8	4508.2	961.7
3-month Libor %	1.42	1.41	1.38	1.37	2.82
Factors draining reserves					
Currency in circulation	1593.044	1591.737	1589.253	1584.028	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	35.038	74.546	87.165	112.057	0.000
Reserve Balances (Net Liquidity)	2357.806	2317.610	2281.472	2241.618	24.964
Treasuries within 15 days	7.869	11.043	11.043	8.701	14.955
Treasuries 16 to 90 days	48.442	56.307	28.456	39.496	31.549
Treasuries 91 days to 1 year	352.103	317.797	345.643	321.809	69.272
Treasuries over 1-yr to 5 years	1117.050	1111.537	1111.513	1133.435	170.807
Treasuries over 5-yrs to 10 years	292.840	329.680	329.644	328.941	91.863
Treasuries over 10-years	638.336	633.622	633.529	633.345	101.337

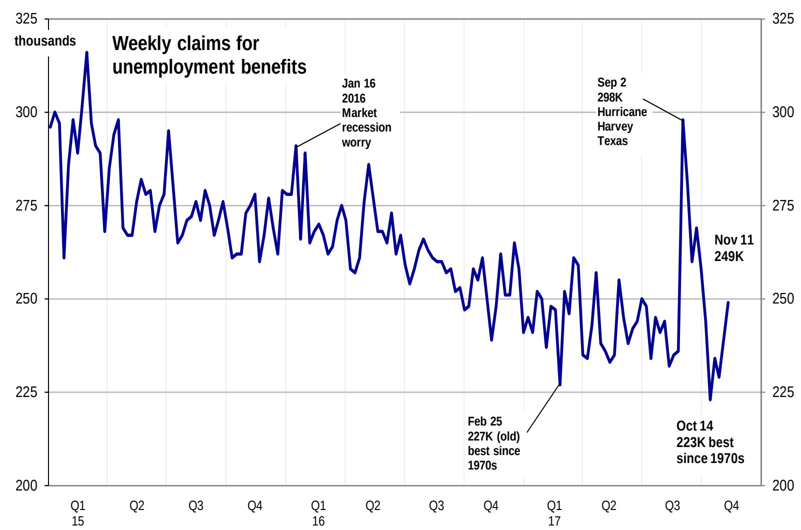
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

Don't blink or you'll miss it: the great balance sheet unwind has begun. The Fed's Treasury security holdings dropped $9 billion from $2.465 trillion on October 25, 2017.

OTHER ECONOMIC NEWS THIS WEEK

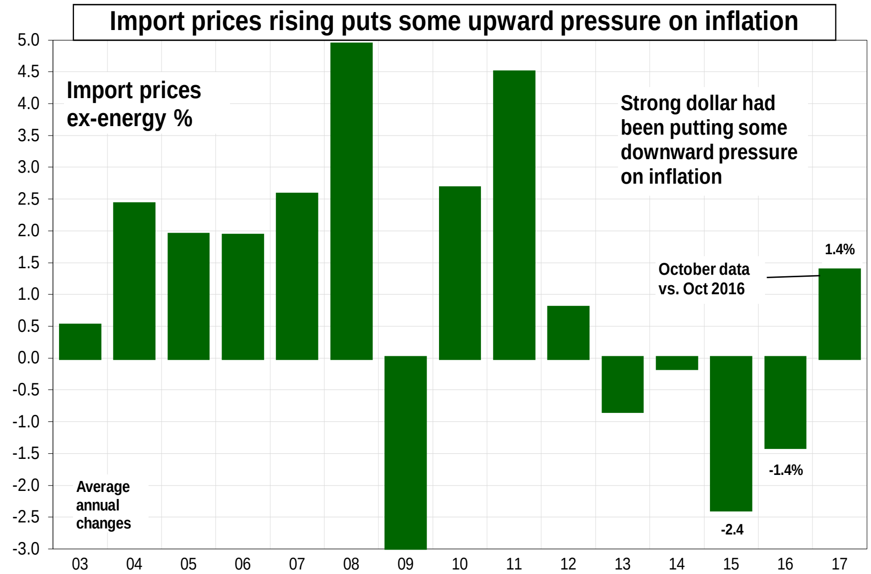
Factory output jumps; some inflation imported from overseas

Breaking economy news. Weekly jobless claims are up sharply the last couple of weeks to 249K now in the November 11 week that may be tainted by faulty seasonals in the Veterans' Day holiday week. This is not a sign that the labor market is suddenly stiffening up and Americans are getting sacked as the business climate outlook darkens. The economy remains firmly in full employment territory and we fully expect the unemployment rate to break below 4.0% in coming months. Labor is still in short supply and we still wonder if this will yet slow the economy's advance. Fewer slaves to row the boat.

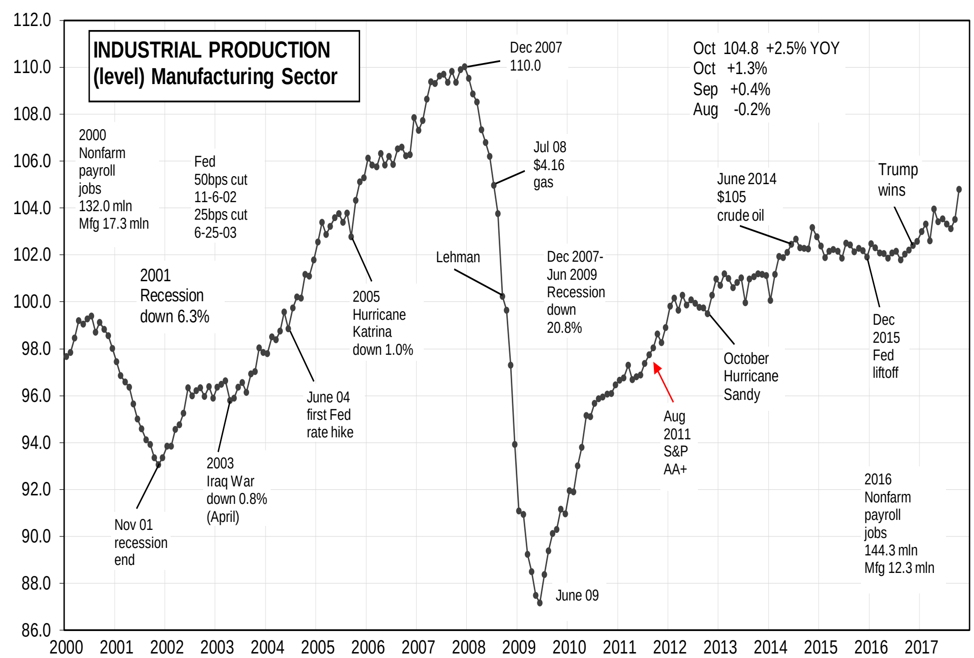


We aren't bringing factories back to America, but some inflation is coming in from overseas. Nonfuel import prices were 0.2% higher in October, following on 0.3% monthly gains in August and in September. Year-on-year these prices of imported goods coming ashore here are up 1.4% so the earlier strong dollar weak import price trend is over, and Fed officials' worries about low inflation should start to lessen. Prices of industrial supplies and materials (less energy) are up sharply the last three months.

And we aren't bringing factories back to America, but who cares as manufacturing output is surging and it isn't just a bounce from the hurricanes and it isn't just the recovery in oil & gas drilling production. Total production fell 0.5% in August, blown off course by the hurricane storms, but rallied back 0.4% in September and tacked on another 0.9% increase in October. Output overall stands 2.9% higher than it was a year ago.



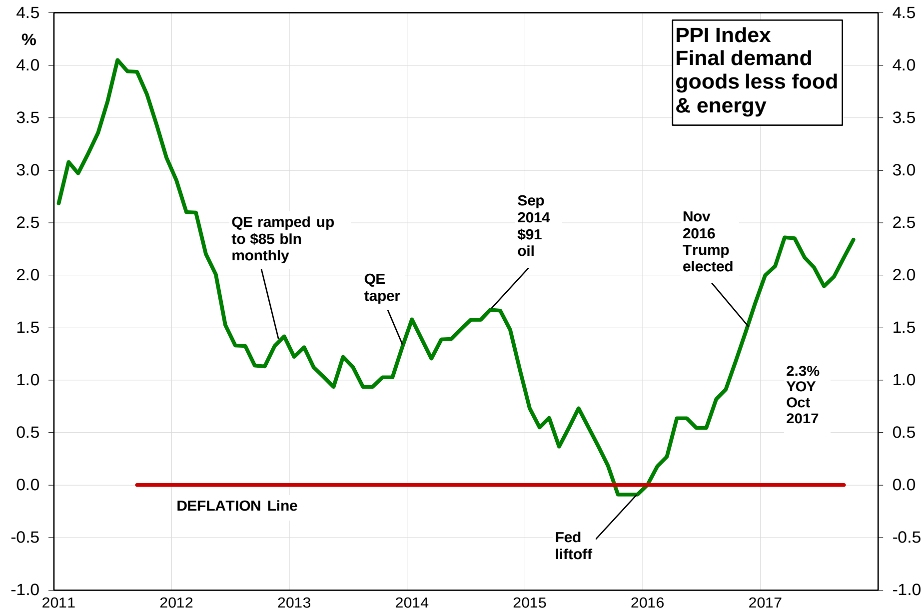
Manufacturing industrial production is at the best level since the recession bottomed way back in June 2009. Plunging crude oil prices in 2014 seemed to put the kibosh on factory output for a time, but this year production is up sharply. Manufacturing production fell 0.8% in 2015 and rose 0.7% in 2016, but in 2017 production through October has jumped 2.2%. Manufacturing activity is back and we don't know whether the Trump administration should get the credit for manufacturing's change in fortune or not, but the economy is clearly benefiting and jobs in manufacturing are up sharply with hundreds of thousands of positions going unfilled currently.



Net, net, the economy is roaring back to life and shows no sign of a slowdown from its advanced age. This economy looks unstoppable especially with tax cut stimulus on the way. Put another log on the fire, this economy is roaring hot. Production is pulling out all the stops to make sure this economic expansion will be one for the record books. The Clinton economic miracle lasted ten full years: forward growth that lifted all the boats and this current expansion shows all the signs of going on even longer. The Fed is right to continue with its gradual pace of rate hikes as the economy looks unstoppable and a rate hike in December to 1.5% would hardly cause a dent in this expansion that has gained new life. The economy is better than you think. Bet on it.

If producers see more inflation, then consumers are gonna get it sometime

If producers see more inflation, then consumers are gonna get it sometime somewhere in the end. (PPI inflation report released on Tuesday, a day ahead of the CPI inflation report released on Wednesday.)



Breaking economy news. PPI inflation report, once the most widely traded economic indicator in the world along with the international trade deficit. The trade deficit might get some more respect if Trump keeps going on his pledge: The massive TRADE deficits must go down quickly. Words he issued after his tour of Asia not during it.

Anyway, PPI inflation up 0.4% where the consensus forecast was looking for a rise of just 0.1%. Does this mean there will be more of a pass-through effect on prices from producers to consumers tomorrow in the CPI inflation report? Probably not, the correlation month-to-month has not been great. We are already sticking our neck out with a 0.2% increase in core CPI tomorrow where the year-on-year rate remains 1.7% a few ticks short of the Fed's 2% inflation target.

We have to keep repeating that the Fed indeed has an inflation target because the rest of the world and we mean everyone doesn't care if the Fed ever gets inflation to rise closer to 2%. The economy is already at full employment meaning Americans have already won the battle with the recession and financial crisis that ended nearly a decade ago. The economy won already.

Net, net, inflation is starting to rear its ugly head at the producer level with PPI final demand goods rising 2.8% the last year. Reports that inflation is dead or too low is not true in every corner of the economy. Most of the increase is in the relatively new PPI category of services which rose 0.5% in October after rising 0.4% in September.

It won't be long before producers will be faced with having to raise the prices of consumer goods if inflation continues to percolate here down at the lower stages of manufacturing and production. Final demand goods prices less food and energy look solid as well rising 0.2% in August, 0.3% in September and now 0.3% again in October.

Inflation is heating up. Don't count inflation out yet is the message for the Fed in today's report because producers see inflation is stirring. Today's inflation data will keep the Fed on course to raise rates a final time this year at the December meeting. The economic idea that full employment produces the sparks of greater inflation pressures certainly looks true this morning. The economy is stronger than you think. Bet on it.

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