Financial Market Weekly

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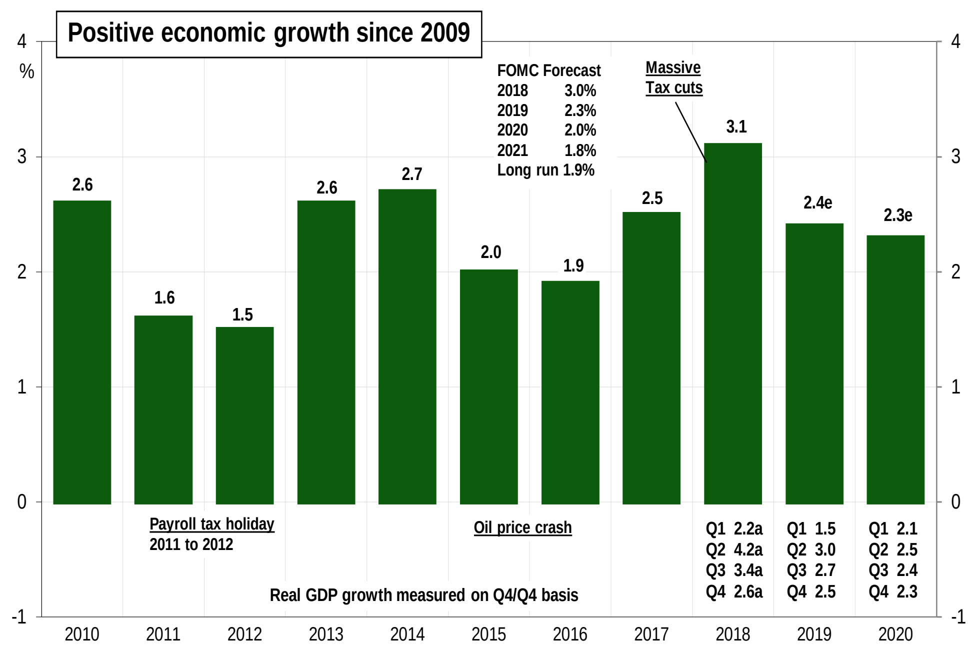
FULL SPEED AHEAD FOR THE ECONOMY WITH ECONOMIC GROWTH A RECORD LAST YEAR



Breaking economy news. GDP. It's been a long time in coming with the last report on December 21 and the fourth quarter data delayed until today due to the 35-day Federal government shutdown. The crosswinds the economy faces did not faze consumers or businesses one bit with consumption running faster at 2.8%, and business investment in equipment surging 6.7%, and software and other intellectual property investment made by companies jumping like hotcakes up 13.1%.

Real GDP growth was 2.6% in the fourth quarter and 3.1% for 2018 which makes this year the fastest yet in the long expansion from the recession now in its tenth year. The economy is unlikely to keep up this breathtaking 3% pace as the Tax Cuts and Jobs Act boost starts to fade, but it is also true that there is no sign of recession anywhere in today's report. Trump's economics team must surely be gloating as the

	Q2 17	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18r
REAL GDP	3.0	2.8	2.3	2.2	4.2	3.4	2.6
REAL CONSUMPTION	2.9	2.2	3.9	0.5	3.8	3.5	2.8
CONSUMPTION	2.0	1.5	2.6	0.4	2.6	2.4	1.9
Durables	0.6	0.5	0.9	-0.2	0.6	0.3	0.4
Nondurables	0.6	0.3	0.6	0.0	0.6	0.6	0.4
Services	0.8	0.7	1.2	0.5	1.4	1.5	1.1
INVESTMENT	1.0	1.5	0.1	1.6	-0.1	2.5	0.8
Business Plant	0.1	-0.2	0.0	0.4	0.4	-0.1	-0.1
& Equipment and	0.6	0.6	0.6	0.5	0.3	0.2	0.4
Intellectual Property	0.3	0.1	0.0	0.6	0.5	0.3	0.6
Homes	-0.2	0.0	0.4	-0.1	-0.1	-0.1	-0.2
Inventories	0.2	1.0	-0.9	0.3	-1.2	2.3	0.1
EXPORTS	0.4	0.4	0.8	0.4	1.1	-0.6	0.2
IMPORTS	-0.4	-0.4	-1.7	-0.5	0.1	-1.4	-0.4
GOVERNMENT	0.0	-0.2	0.4	0.3	0.4	0.4	0.1
Federal defense	0.2	-0.1	0.1	0.1	0.2	0.2	0.3
Fed nondefense	-0.1	0.0	0.2	0.1	0.0	0.0	-0.2
State and local	-0.2	-1.0	0.2	0.1	0.2	0.2	0.0
Below line: Percentage point contributions to Q4 18 2.6% real GDP							
Final estimate for Q4 is Thursday, March 28							

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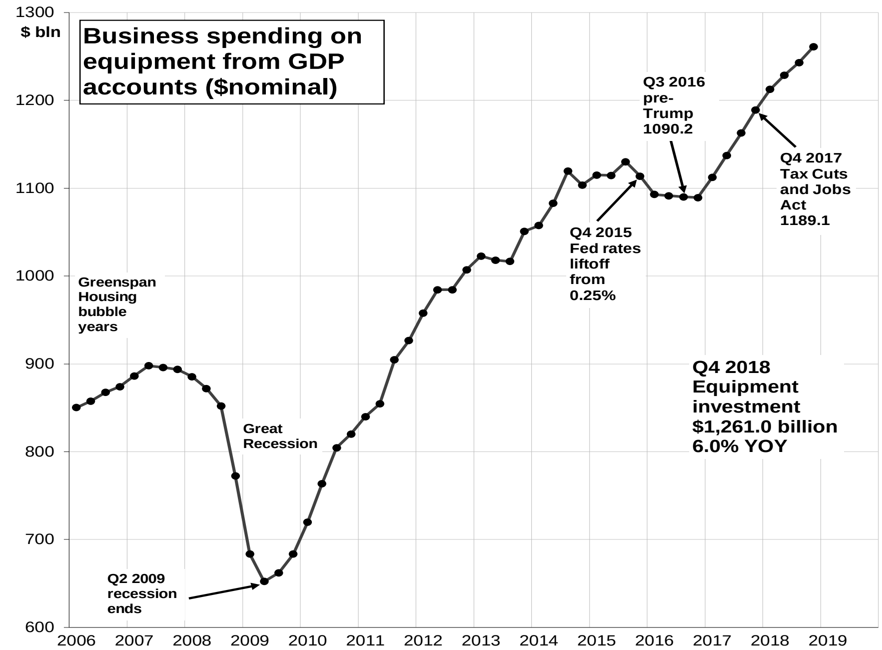
President has made good on his promise of 3% economic growth which beats the prior one-year record in this nearly ten-year old expansion of 2.7% in 2014 under President Obama.

Net, net, it's full speed ahead for the economy with economic growth a record last year. The economy finished the year with all guns blazing in spite of trade war worries and financial market turbulence which caused Fed officials to back down from their gradual rates path. Time will tell if policymakers made the right call as interest rates are still short of normal which hurts the investment returns for savers. Higher short-term interest rates can lead companies to postpone borrowing and investment spending, but that is not happening yet. There aren’t many companies who think a 2.5% interest rate cost for short-term borrowing is restrictive. It’s not holding them back. Investment in equipment and intellectual property continues and companies are borrowing record amounts from banks with commercial & industrial loans outstanding at all-time highs.



There's still some headwinds ahead in the first quarter with the 35-day government shutdown effect still to be seen and the frigid temperatures in much of the country. But so far so good for the economy. It's full speed ahead and we are hoping the economy won't embrace the Fed's pessimism over the outlook. The economy is stronger than Fed officials think. Bet on it.

P.S. Business investment spending on equipment and intellectual property (software, R&D) had a strong finish to the year increasing 8.4% in 2018 in nominal dollars versus 7.5% in 2017. The Tax Cuts and Jobs Act allows companies to write off equipment purchases more quickly. One standout was transportation equipment spending which rose 7.6% in 2018 versus a 3.5% increase in 2017. Corporate CEOs may tell pollsters that the risks of recession are rising, but they continue to buy long-lived equipment and software to meet the demand for their goods and services in the years to come. Doesn’t look like recession is in the cards this year or next.

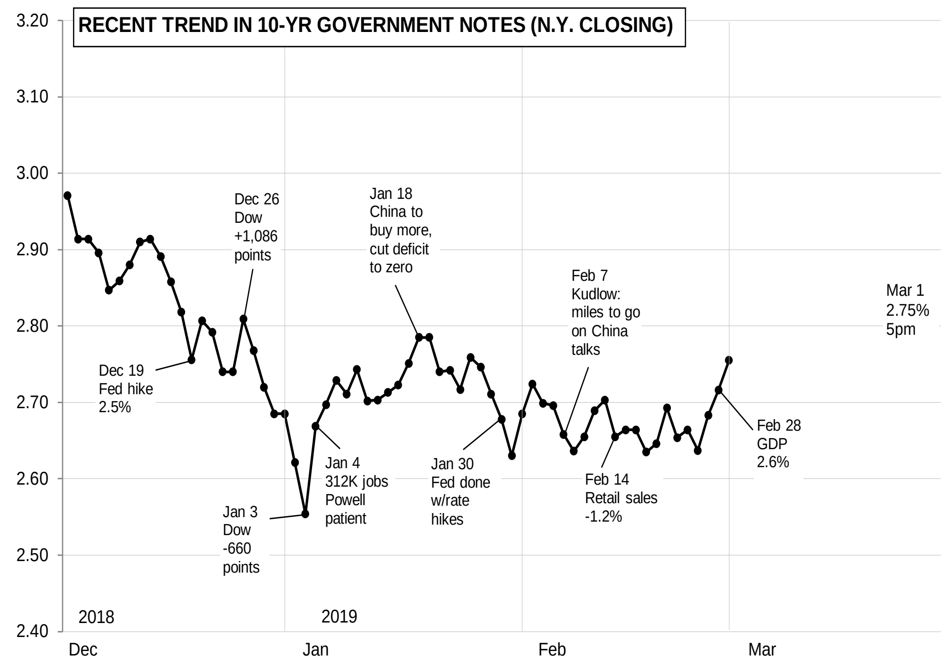
$BLN Nominal GDP expenditures	Q4 15	YOY%	Q1 16	Q2 16	Q3 16	Q4 16	YOY%	Q1 17	Q2 17	Q3 17	Q4 17	YOY%	Q1 18	Q2 18	Q3 18	Q4 18	YOY%
Equipment & Intellectual Property	1891.3	2.2	1878.6	1895.9	1903.4	1908.0	0.9	1947.7	1988.3	2021.7	2052.0	7.5	2105.3	2147.4	2176.4	2224.3	8.4
EQUIPMENT	1113.7	0.9	1092.8	1091.4	1090.2	1089.3	-2.2	1112.3	1137.4	1162.8	1189.1	9.2	1212.6	1228.8	1243.0	1261.0	6.0
Information processing equipment	357.4	2.8	349.0	353.1	356.3	358.8	0.4	368.5	379.0	386.5	393.7	9.7	401.9	410.2	415.8	410.6	4.3
Computers	99.8	-3.7	99.1	99.8	98.2	100.1	0.3	103.2	110.1	113.9	109.7	9.6	116.9	121.0	120.3	114.1	4.0
Other processing equipment 1	257.5	5.4	249.9	253.2	258.2	258.6	0.4	265.4	268.8	272.6	284.0	9.8	285.0	289.1	295.5	296.5	4.4
Industrial equipment	218.0	0.1	212.2	214.2	215.3	218.1	0.0	222.1	230.1	234.6	238.5	9.4	243.9	243.4	250.2	256.0	7.3
Transportation equipment	303.3	8.3	298.8	295.2	287.5	280.5	-7.5	282.4	279.4	285.0	290.4	3.5	300.7	303.5	302.9	312.6	7.6
Other equipment 2	235.0	-8.9	232.7	228.8	231.0	231.9	-1.3	239.2	249.0	256.8	266.4	14.9	266.1	271.7	274.1	281.7	5.7
INTELLECTUAL PROPERTY	777.6	4.1	785.8	804.5	813.2	818.7	5.3	835.4	850.9	858.9	862.9	5.4	892.7	918.6	933.4	963.3	11.6
Software	311.7	3.3	319.0	325.5	330.0	335.4	7.6	342.7	353.5	359.7	355.9	6.1	370.3	381.6	389.0	399.6	12.3
Research & Development (R&D)	387.4	4.1	388.1	400.1	403.7	403.2	4.1	412.1	416.5	417.8	425.0	5.4	439.7	453.1	459.7	478.4	12.6
Entertainment, literary, artistic	78.5	7.5	78.7	78.9	79.5	80.0	1.9	80.6	80.9	81.4	82.0	2.5	82.7	83.8	84.8	85.2	3.9

1 Communication, medical, photocopy, office and accounting equipment; nonmedical instruments

2 Furniture; agriculture, construction, mining/oilfield, and service industry machinery; electrical equipment

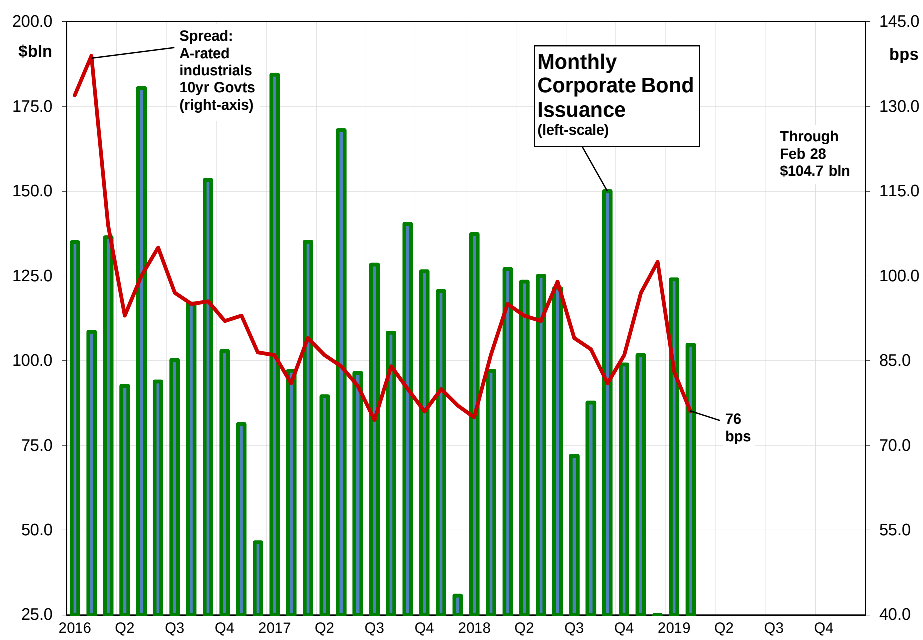
MARKETS OUTLOOK

	31-Dec 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	3.02	3.20	3.30	3.35	3.45	3.45	3.50	3.60	3.70
10-Yr Note	2.68	3.00	3.10	3.20	3.30	3.30	3.40	3.50	3.60
5-Yr Note	2.51	2.85	3.00	3.10	3.20	3.25	3.35	3.45	3.60
2-Yr Note	2.49	2.80	3.00	3.10	3.20	3.20	3.35	3.45	3.60
3-month Libor	2.81	2.70	2.95	2.95	3.20	3.20	3.45	3.45	3.70
Fed Funds Rate	2.50	2.50	2.75	2.75	3.00	3.00	3.25	3.25	3.50
2s/10s spread	19	20	10	10	10	10	5	5	0



Treasury bond yields rose 10 bps to 2.75% this week. Various factors were behind the move although the major one is the nearing US-China trade agreement. Yields in Germany moved higher on Wednesday and helped to push 10-yr Treasury yields higher. US GDP was stronger than expected at 2.6% and moved 10-yr yields above 2.70% for the first time since February 14. On Friday, consumer spending fell hard in December, and February ISM manufacturing fell to a new low, but Treasury yields still moved higher. Dow Jones Industrials has retraced 82% of the sell-off last year, but 10-yr yields closing at 2.75% are well below the 2019 3.26% high from October 9.

CORPORATE BONDS: MUFG, LAM RESEARCH, BROOKLYN GAS, RYDER



Corporate offerings were $26.5 billion in the March 1 week versus $28.5 billion in the February 22 week. On Wednesday, Rockwell Automation sold $1.0 billion 10s/30s. It priced a $425 million 3.5% 10-yr (m-w +15bp) at 85 bps (A3/A). The industrial automation company (control panels, sensors, motor control devices) will use the proceeds to repay its $631 million of commercial paper outstanding. Corporate bond yields (10-yr Industrials rated A2) were 76 bps above 10-yr Treasuries this week versus 79 bps last Friday.

FEDERAL RESERVE POLICY

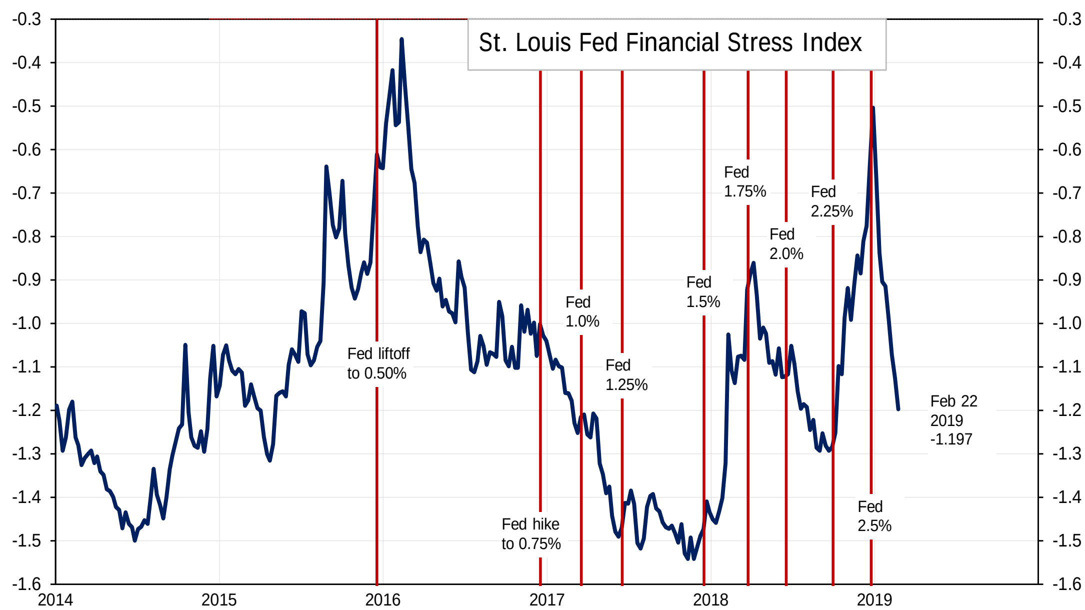
The Fed meets March 19-20 to consider its monetary policy. Not a lot to change Fed expectations this week. Fed Chair Powell even spoke to Congress twice this week and took questions, but he stayed on message that was first given out at the January 30 FOMC meeting press conference. Sure, things look okay today, not sure about tomorrow because: “Despite this positive outlook, over the past few months we have seen some crosscurrents and conflicting signals about the outlook. Growth has slowed in some major foreign economies, particularly in China and Europe. There is elevated uncertainty around several unresolved government policy issues, including Brexit, ongoing trade negotiations, and the effects from the partial government shutdown in the United States. Financial conditions tightened considerably late in 2018 and remain less supportive of growth than they were earlier in 2018. And, while most of the incoming domestic economic data have been solid, some surveys of business and consumer sentiment have moved lower, giving reason for caution.” Not sure which staff economist sitting behind him wrote the dismal script that the profession does so well.

Selected Fed assets and liabilities

Fed H.4.1 statistical release billions, Wednesday data	27-Feb	20-Feb	13-Feb	6-Feb	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2182.092	2182.201	2205.604	2205.713	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities (MBS)	1607.609	1614.150	1621.956	1621.809	0.000
Primary credit (Discount Window)	0.003	0.009	0.003	0.002	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)	0.000	0.000	0.000	0.000	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	0.088	0.068	0.071	0.066	62.000
Federal Reserve Assets	4021.7	4029.2	4076.3	4074.2	961.7
3-month Libor %	2.63	2.66	2.68	2.74	2.82
Factors draining reserves					
Currency in circulation	1712.356	1712.038	1709.649	1705.408	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	1.915	2.275	1.697	1.926	0.000
Reserve Balances (Net Liquidity)	1682.210	1619.745	1634.417	1658.863	24.964
Treasuries within 15 days	12.529	12.529	56.052	43.523	14.955
Treasuries 16 to 90 days	92.780	92.780	54.305	66.834	31.549
Treasuries 91 days to 1 year	274.117	274.118	275.447	275.448	69.272
Treasuries over 1-yr to 5 years	930.742	930.757	942.588	942.603	170.807
Treasuries over 5-yrs to 10 years	254.779	254.819	259.274	259.314	91.863
Treasuries over 10-years	617.145	617.197	617.938	617.990	101.337

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

The sky is still falling for Powell even with the stock market retracing over 80% of last year’s huge losses. You want to talk financial conditions, then these too have fallen back to less worrisome levels looking at the St. Louis Fed’s version of a financial conditions index, the same St. Louis Fed that is headed by President Bullard who once an ardent hawk, now never wants to hike interest rates ever again.



Anything interesting in Fed Chair Powell’s two days of testimony to Congress? The bar is low as he is the first noneconomist to run the Fed so the testimony is going to be less expert than it has ever been. Guess not, nothing of note, and a good thing too because we have run out of room on the page to discuss. Maybe next week. He did mention growth had slowed in major foreign economies including China. Conditions in China certainly look shaky with stocks there up 20% in 2019 YTD on Friday.

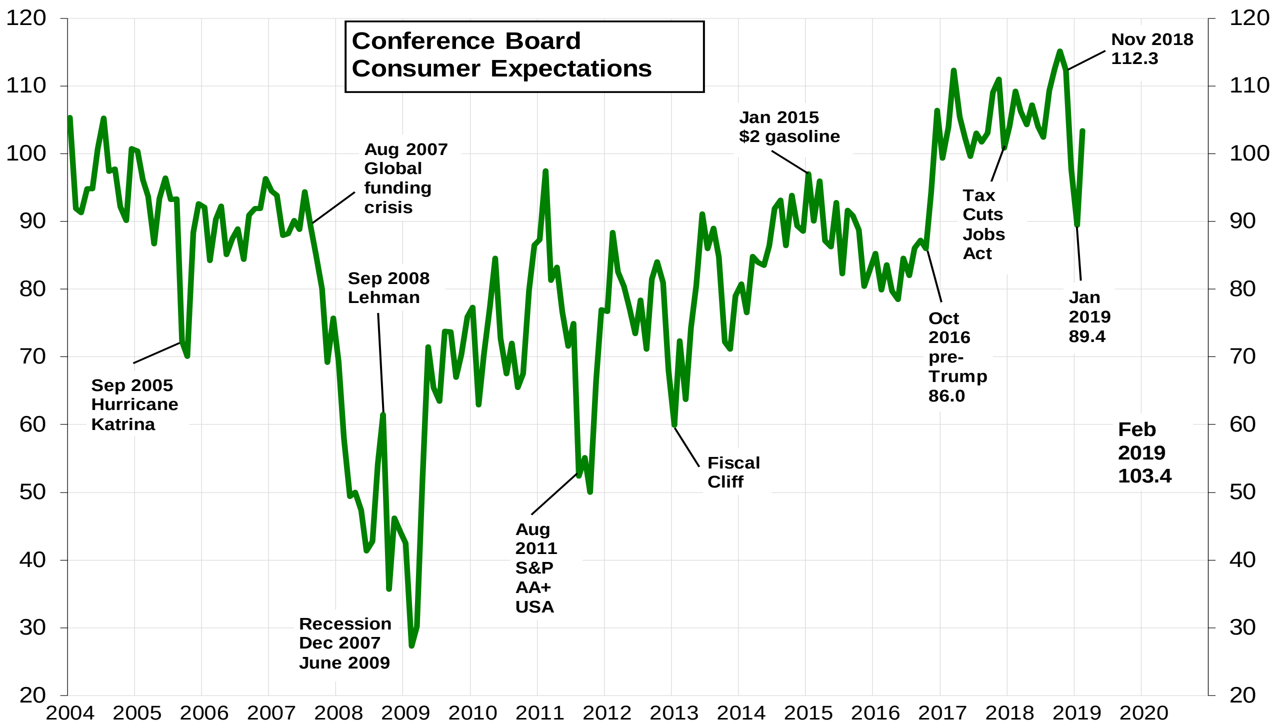
OTHER ECONOMIC NEWS THIS WEEK

Consumer confidence is back (Tuesday)

Breaking economy news. Consumer confidence roared back to life in February in the aftermath of the December and January worries about stock markets and the Federal government shutdown. Fed officials scurried to the sidelines in January and their caution looks to be completely unwarranted as consumer spirits are soaring. Today's confidence data should go a long way to putting one or two rate hikes back on the table this year.

The Fed may well be data dependent but this is harder to achieve in practice as they risk overreacting to the latest news on the economy and business conditions. Policy makers also risk transmitting their own caution onto the backs of the consumer and weighing the economy down with an overly pessimistic outlook. Their patience has been rewarded with today's warmer temperature reading on the consumer and it is time for the Fed to get back in the game.

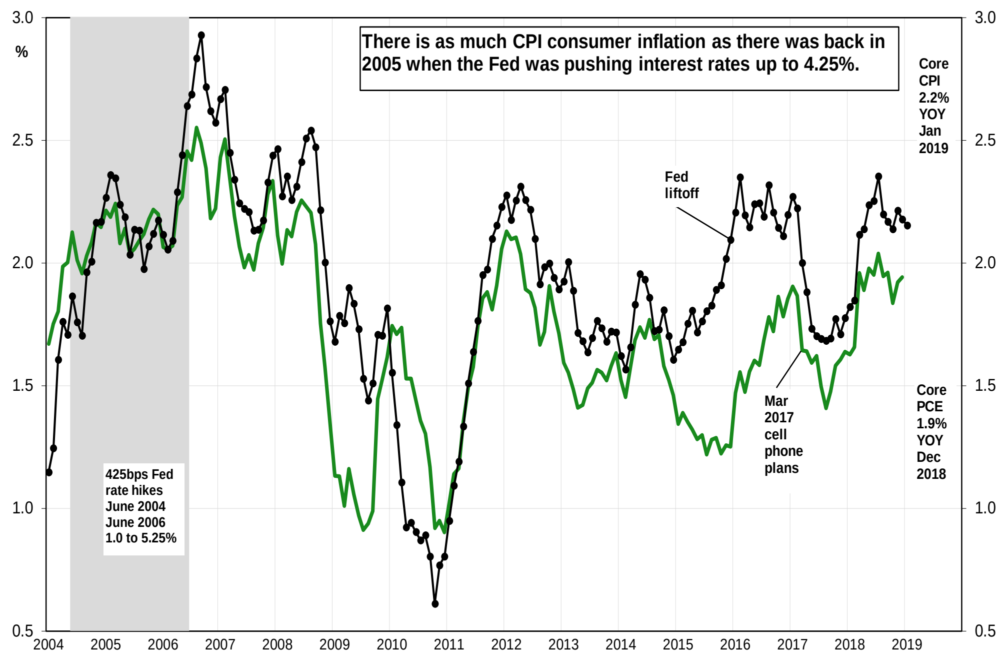
Consumers don't have any worries at all with the confidence index jumping nearly ten points to 131.4 in February from 121.7 in January. It is looking increasingly likely that the sharp drop in December retail sales was an anomaly. Based on today's confidence reading we expect the consumer to restart the economy's engines in coming months. Rate hikes are coming. Bet on it. The economy is stronger than you think.



Economy has plenty of room to run with incomes growing and inflation steady as a rock (Friday)

Breaking economy news. The personal income report that was long delayed from the 35-day Federal government shutdown. Real consumer spending did decline 0.6% in December which confirms the weak retail sales report that frightened markets a couple of weeks ago. Consumers start the year off in a hole which will make it hard for real GDP to rise much more than 1.5% in the first quarter after the fourth quarter's 2.6% growth reported yesterday. Real consumer spending in December will put real consumer spending in Q1 2019 at -0.9% if there is no rebound in January, February, and March. We do expect a rebound of course albeit there are some temporary factors aside from the government shutdown, like the colder winter weather in much of the country that should keep first quarter economic growth modest. Wages and salaries continue to grow however and this gives the consumer the means to keep spending later on in 2019. Income tax refunds have caught up and were fairly normal at $116.8 billion in February versus the $121.0 billion paid out in February 2018.

Net, net, consumer confidence has rebounded and it is no wonder given that wages and salaries of Americans are growing and remain unscathed by the market turbulence late last year. Wages and salaries rose 0.3% in January after a 0.5% increase in December. Consumer spending was down in December, but the consumer is not out of the game. The uncertainty and questions over the outlook that Fed officials fear have not hit the consumer's wallet. There is no sign of caution on the part of consumers. No sign that headwinds are greater than the economy's tailwinds.



Core consumer inflation looks rock solid at 1.9% the last year. The Fed risks their own credibility when they try to make a mountain out of a molehill about why it is important that inflation should be 2.0 percent and not 1.9 percent. The idea that inflation should run 2.1 percent to make up for the 1.9 percent undershoot looks like something that should remain on a dusty chalkboard in a lecture at university and never make it into the real world as a driver of the Fed's monetary policy. The economy's fortunes are not affected by whether inflation is 1.8 percent or 2.2 percent. The Fed can remain patient, and take the first six months off if they like this year, but we expect them to restart the higher rates path soon as the economy still has the potential to heat up given this is the tightest labor market in decades. Stay tuned. Story developing.

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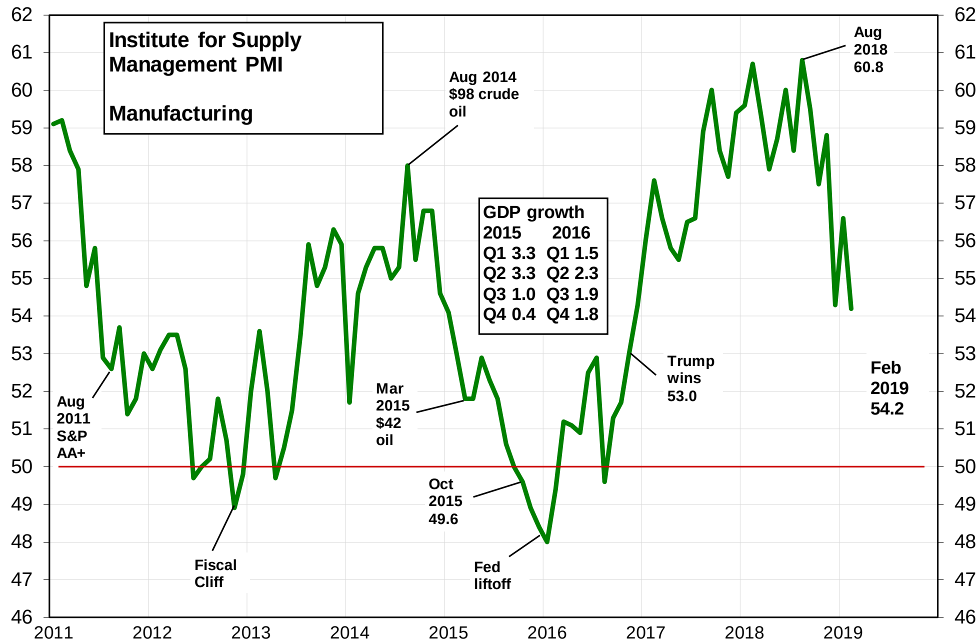
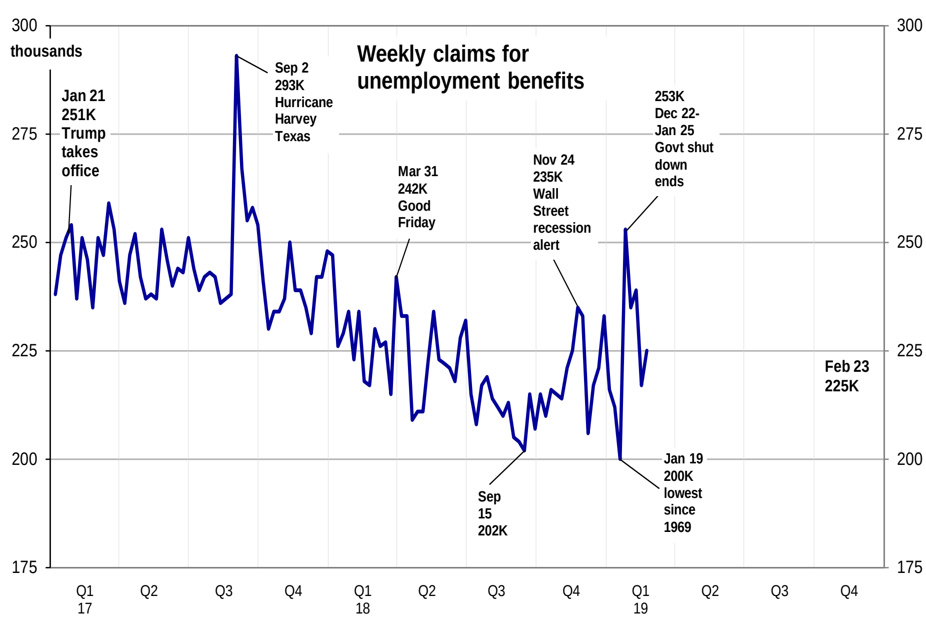
ISM manufacturing index hits new low in February (Friday)



Breaking economy news. The ISM manufacturing survey of purchasing managers fell to a new low of 54.2 in February. It is in a downtrend from 60.8 in August, moving down with crude oil prices, just like it moved lower with the crash in oil prices in late 2014. Keep in mind that "manufacturing" is expanding as long as the index is above 50.0 and a recession is not signaled until the index falls all the way to 42.9 (wait for it). We aren't sure whether the index is forward looking or whether the respondents are looking back at the recent hard data weakness: the 1.0% drop in December nondefense capital goods orders ex-aircraft, and the 0.9% drop in January manufacturing industrial production. The stock market has recovered about 80% of its recession-magnitude 19.4% decline from October to December and yet the purchasing managers index is still down from the highs last year. Purchasing managers responses remained relatively upbeat with many comments saying orders were steady to strong or meeting expectations with the cold weather and supply constraints an issue. One industry, fabricated metal products, was concerned about a slight recession later in 2019 based on some indicators. Not sure what their beef is with fabricated metal orders up sharply in October, November, and December, an increase of 9.0% over December 2017 levels. Maybe they are reading the newspapers too much. Meanwhile, this ISM report keeps the Fed on the sidelines, this is one of their risks: "some surveys of business and consumer sentiment have moved lower."

Unemployment claims hold near lowest (best) levels since 1960s



Jobless claims were little changed at 225K in the February 23 week. They were lower at the 200K line in September and then again in January. No recession signaled by job layoffs yet. Careful what you wish for. "CEOs Say Recession Is Top Worry for 2019." Job layoffs rising to 275 to 300 thousand would indicate America has a problem.

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