Financial Market Weekly

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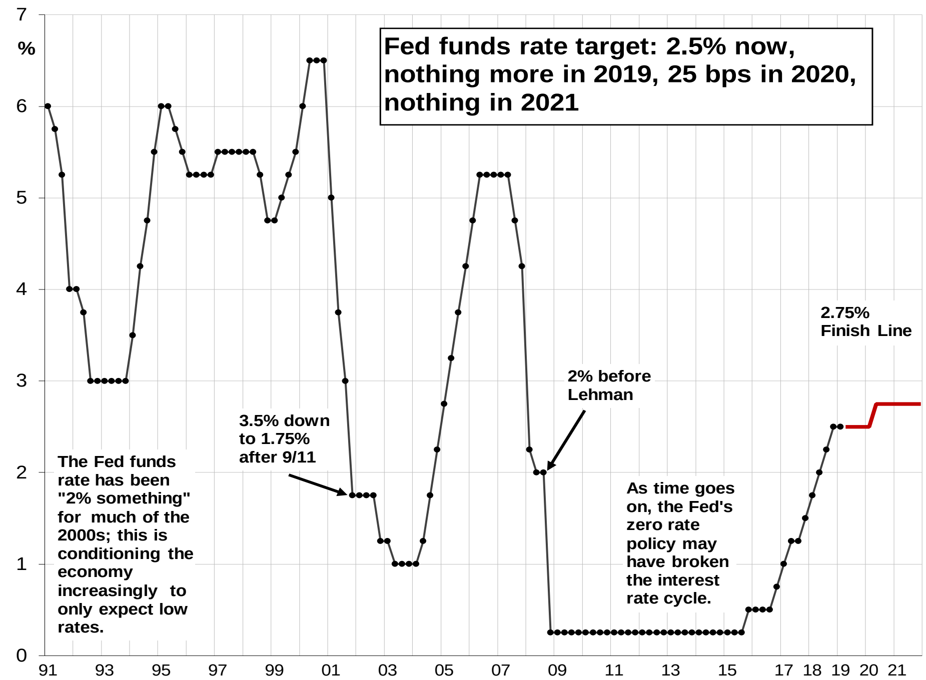
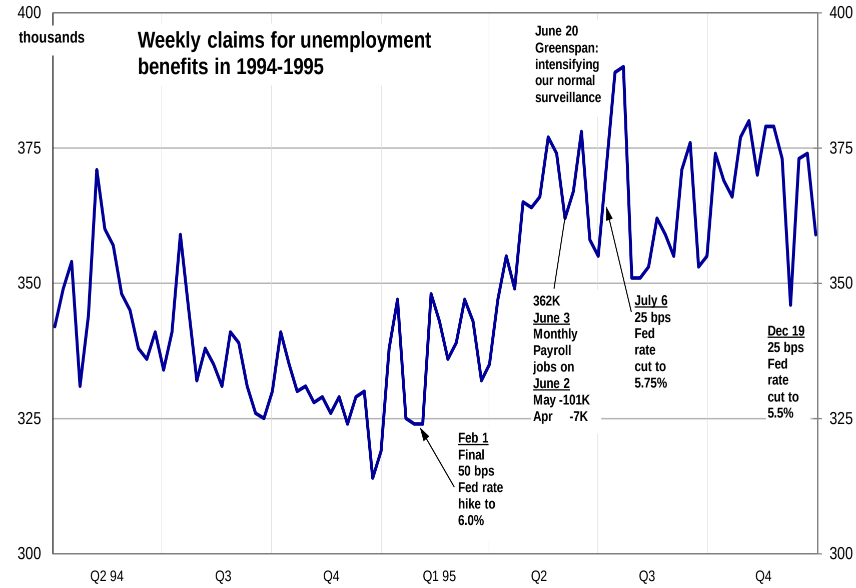
CAUTION: RATE CUTS DEAD AHEAD



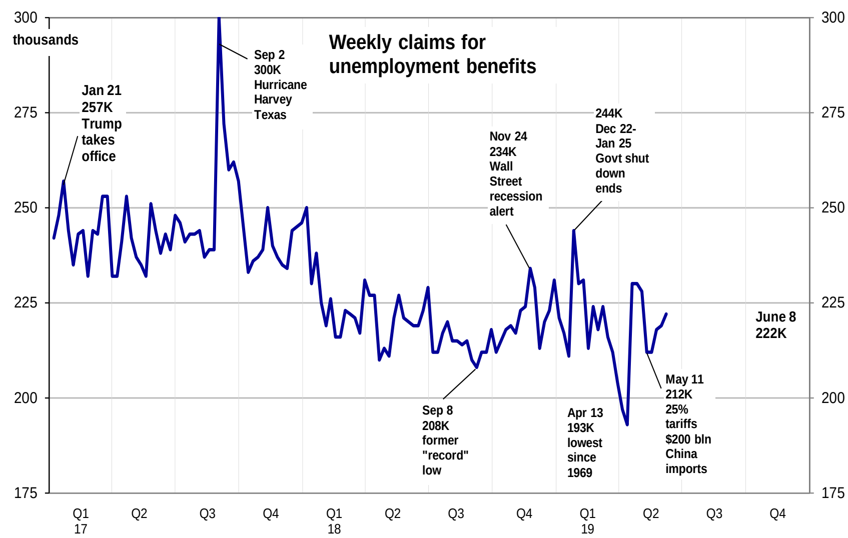
Hope not. We figure if we say it, maybe it won't happen. President wants rate cuts because with our beautiful low inflation he reasons, interest rates are too high. We don't know that rates are too high, but risk management rate cuts are in the Fed's toolkit, Fed Vice Chair Clarida has said. There's a greater risk of mismanagement down at the Federal Reserve in Washington that has lost track of where we are in the business cycle. After a ten-year "record" economic expansion, companies aren't going to borrow a lot more and invest more money in the economy whether interest rates are 2.5% or 1.5% or 3.5%. Don't cut interest rates unless the recession clouds offshore have moved in and are dumping torrential rains on us. Don't cut interest rates unless there are job losses. We aren't sure what Clarida was doing in 1995, but those were not insurance-style rate cuts. We thought the economy was going into a recession. Ask Greenspan. We call the whole 1995 episode a near-recession miss. The Fed raised rates quickly and erratically, throwing in big 50 bps and 75 bps

> Clarida on CNBC with Liesman 6-4-2019 …in past episodes, in the '90s, we did have insurance cuts by the Fed. We had one in 1998, in the Fall of 1998, in part because of global turbulence in global markets, and the Russia/Asia crisis. And then, in '95, the Fed also put in place some insurance cuts. So, I'm not going to get into what we're going to do going forward, but that has been in the monetary policy tool kit in the past.

moves, to 6% in February 1995. That 6% level was a bridge too far, pushing rates 300 bps higher in a year's time. There is a big difference between cutting rates from a 6% Fed funds rate that may be too high and a 2.5% Fed funds rate which doesn't sound particularly high given core CPI inflation is 2.0%. Anyway, it is premature to cut rates before signs of a slowdown actually appear. Clarida on CNBC earlier this year (April 11) said that the Fed's "rate cuts are not always associated with recession," but the 1995 rate cuts certainly were done for recession risk reasons. Payroll jobs had fallen two consecutive months in the Friday, June 2, 1995 report. Greenspan told the Economic Club of New York on June 20 that it was "time for intensifying our normal surveillance and analysis of ongoing developments to gauge whether policy is appropriately positioned to foster sustained economic expansion." The Fed cut rates on Thursday, July 6, 1995 from 6.0 to 5.75 percent.



No recession threat on horizon yet

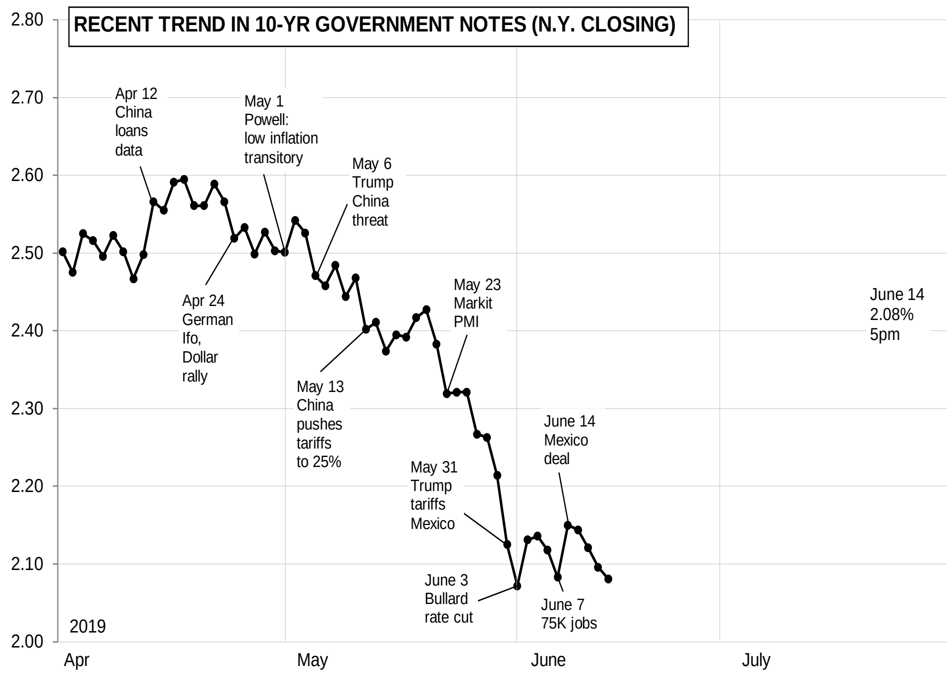


Although it was Greenspan who first used weekly jobless claims as his go to indicator showing when the economy is in the process of "cumulative deterioration," unemployment claims have been overused by bond market yahoo bulls and Wall Street dealers shouting the sky is falling and rate cuts are coming. Last November, unemployment claims showed a slight increase that sparked an outcry from the Street that recession was near. It didn't happen, and it's a little harder to see what the fuss was all about now as the annual benchmark revision in March this year wiped away some of the upward trend. To conclude, Fed Chair Clarida has said the Fed has done rate cuts before in the 90s without there having to be a recession. That isn't our recollection of what happened. Maybe he is paving the way to push forward the president's well-known view on rates. We keep wondering what Powell, Clarida, Trump and Mnuchin talked about at their dinner at the White House in early February. They haven't caved yet, but the president's criticism continues on at high-volume. Let's see if the Fed press statement on June 19 says an adjustment in policy might be needed "soon." We still believe getting out ahead of a Trump trade war recession is inappropriate because the forecasts could be wrong. Businesses are still borrowing, and are still making new investments, so cutting rates from 2.5 to 2.25 percent will do nothing.

MARKETS OUTLOOK

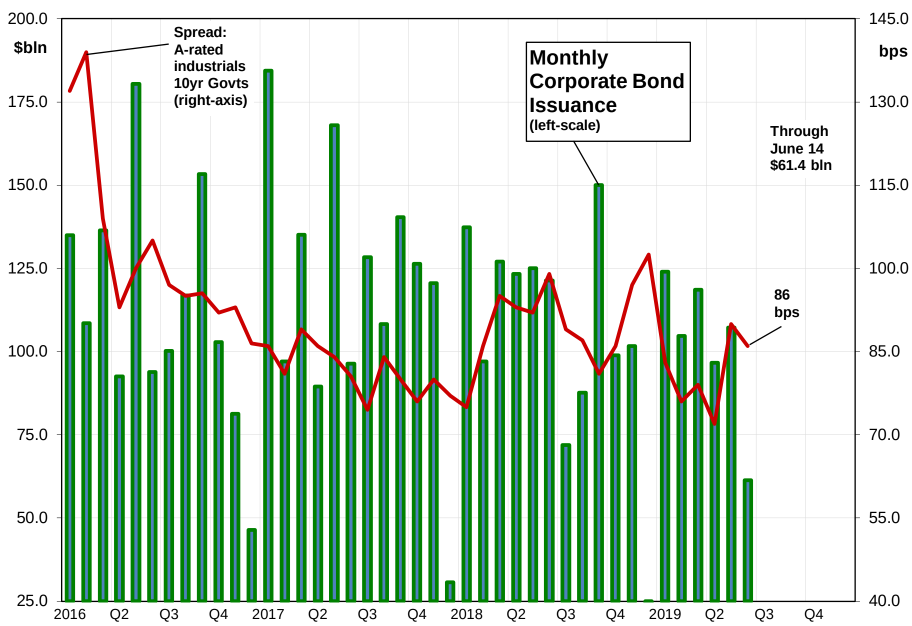
	29-Mar 2018	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	3.00	3.00	3.10	3.10	3.25	3.20	3.20
10-Yr Note	2.41	2.60	2.70	2.90	2.90	3.10	3.10	3.10
5-Yr Note	2.23	2.45	2.60	2.80	2.80	3.05	3.05	3.05
2-Yr Note	2.26	2.45	2.50	2.70	2.70	2.90	2.95	3.00
3-month Libor	2.60	2.60	2.60	2.90	2.90	3.10	3.10	3.10
Fed Funds Rate	2.50	2.50	2.50	2.75	2.75	3.00	3.00	3.00
2s/10s spread	15	15	20	20	20	20	15	10

In what may be a preview of what is yet to come for the bond market if the Fed cuts interest rates, bonds rallied, yields fell Wednesday night in New York at 930pm as Australian unemployment stayed high at 5.2% so maybe the Reserve Bank might cut rates a second time. 5.2% didn't look so high, and the central bank just cut rates from 1.5 to 1.25% on June 4, clearly not realizing they are out of bullets. Yields almost made a new 2019 low on Friday, bond prices following gold prices at 2am in the morning. Stronger retail sales pushed 10-year yields 3-4 basis points higher to 2.11% on Friday before closing the week at 2.08%. Atlanta Fed GDPNow is 2.1% in Q2 was 1.4% last week.



CORPORATES BONDS: AMERICAN TOWER, DTE ENERGY, UNUM GROUP

Corporate offerings were $34.1 billion in the June 14 week versus $26.5 billion in the June 7 week. On Monday, Fiserv sold $9.0 billion 5s/7s/10s/30s. It priced a $3.0 billion 3.5% 10-yr (m-w +25bp) at 137.5 bps (Baa2/BBB). The global provider of financial services technology solutions will use the proceeds in connection with the acquisition of First Data Corp. Corporate bond yields (10-yr Industrials rated A2) were 86 bps above 10-yr Treasuries this week versus 87 bps last Friday.



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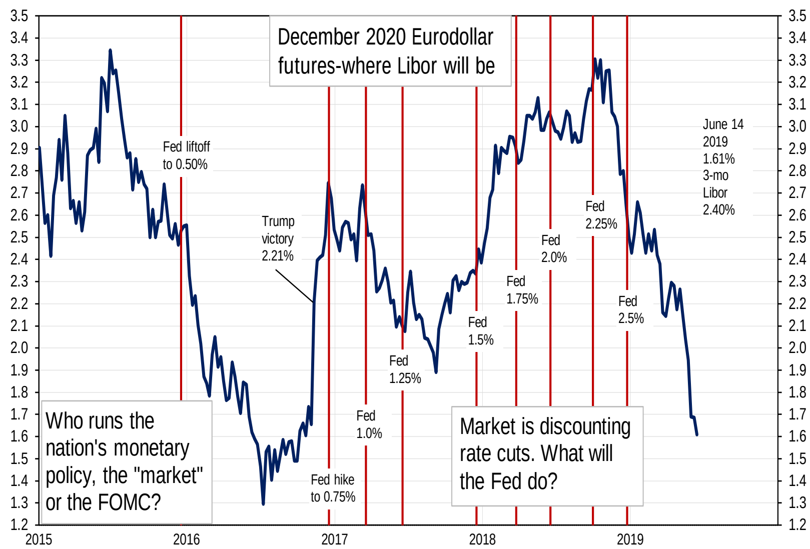
FEDERAL RESERVE POLICY

The Fed meets June 18-19 to consider its monetary policy. Even the market isn't looking for a rate cut at the June meeting. Not sure what the market reaction would be if the Fed press statement gives a heads-up and says an adjustment in policy might be needed "soon." Maybe the market tries to fully discount a rate cut at the next Fed decision date on July 31. We hope there's no rate cut on July 31 because we will be on summer holiday. October Fed funds futures closed at 1.92% which means two 25 bps rate cuts more or less by the September 17-18 meeting. It's hard to understand why the Fed allowed the market to discount so much easing, if Fed officials were not going to eventually throw the market a bone. The president also wants rate cuts. He tweeted about the Fed on Tuesday, saying "They don't have a clue."

Fed statement May 1 2019
The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes. In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.

Fed Policy-key variables	2019	2020	2021	Long Term
Fed funds	2.4	2.6	2.6	2.8
PCE inflation	1.8	2.0	2.0	2.0
Unemployed	3.7	3.8	3.9	4.3
GDP	2.1	1.9	1.8	1.9
March 2019 median Fed forecasts				



Fed Individual Forecasts Fed funds rate by year-end				Longer
Votes	2019 End	2020 End	2021 End	run
1	2.375	2.375	2.375	2.500
2	2.375	2.375	2.375	2.500
3	2.375	2.375	2.375	2.500
4	2.375	2.375	2.375	2.500
5	2.375	2.375	2.375	2.500
6	2.375	2.375	2.625	2.500
7	2.375	2.375	2.625	2.750
8	2.375	2.625	2.625	2.750
9	2.375	2.625	2.625	2.750
10	2.375	2.625	2.625	2.750
11	2.375	2.625	2.875	3.000
12	2.625	2.875	2.875	3.000
13	2.625	2.875	2.875	3.000
14	2.625	2.875	2.875	3.000
15	2.625	3.125	3.125	3.250
16	2.875	3.125	3.375	3.500
17	2.875	3.375	3.625	
Median	2.375	2.625	2.625	2.750
Meeting	Mar 19	Mar 19	Mar 19	Mar 19

Regardless, Fed officials will update their latest forecasts for the first time since March. There has been an escalation in the trade war of course, but their real GDP estimate of 2.1% in 2019 is already quite low. We will see if they take that one lone rate hike in 2020 off the table. There were 6 forecasts for higher rates by the end of 2019, but we can't recall any Fed official talking that way. We guess the unthinkable could happen and there could be some forecasts for a rate cut or two in 2020.

As far as market expectations, October Fed funds futures more or less discount two rate cuts to 2.0% by the September meeting, and three rate cuts are discounted by the December 2019 Fed meeting. December 2020 Eurodollars wouldn't mind a 1.5% Fed funds rate at expiration.

Fed funds futures F6-14-2019	
2.37%	Fed effective rate
2.325%	July contract
1.92%	Oct contract
1.69%	Jan 2020 contract
Odds at June, September, December Fed meetings	

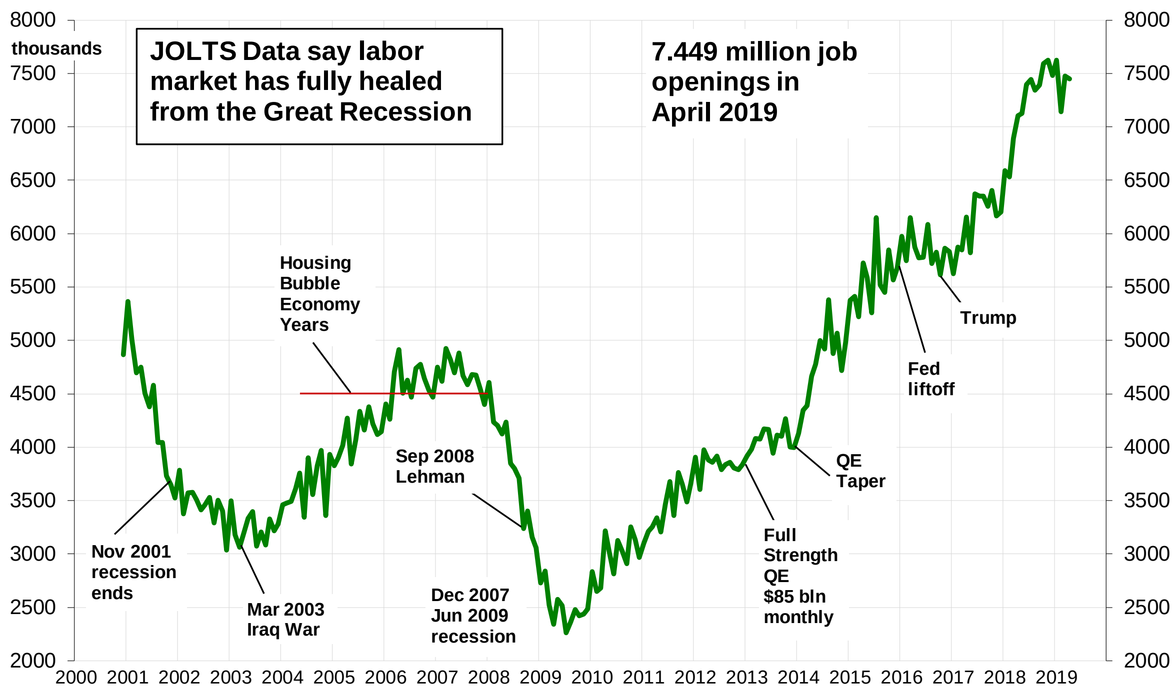
OTHER ECONOMIC NEWS THIS WEEK

Better get a new job while the getting is good (Monday)

Companies were still hiring in April, with Help Wanted signs across the land

Breaking economy news. JOLTS data for April 1, job openings and labor turnover survey. 7.449 million jobs are going begging in April which is just short of the 7.626 million record established in November last year. The Federal government shutdown, collapse in the stock market, and escalation in the trade war with China and the world has only brought down the number of help-wanted signs out there by a small fraction. We hope the Fed doesn't panic and cave in to the market's demand for two or three rate cuts because monetary stimulus sure cannot create any more jobs out there if there are 7.4 million already needed right now. Same story. Job openings are plentiful and are more than enough to put the 5.888 million unemployed behind that May 3.6% unemployment rate to work. We aren't sure what the politicians are going to promise voters in this election because everyone is already working with a chicken in every pot.

Net, net, the job openings in the country remain near all-time records in April which means if the economy is running out of gas it is only because it is running out of workers to hire to man the factory floors and to work in retail, education, healthcare, and businesses from the West Coast to the East Coast and everywhere in between. We don't need factories coming back from overseas that's for sure as manufacturers right now are trying to hire 501 thousand people. Stay tuned. Story developing. The labor market was still one of the strongest in history in April and time will tell if this is just the calm before the storm or whether the market's doom and gloom recession calls are just plain wrong. We hope the bond market is right. We like nothing better than seeing millions of people lose their jobs. Who was it who said the bond market has forecast 9 of the last 5 recessions again? The bond market is always certain, but not always right.



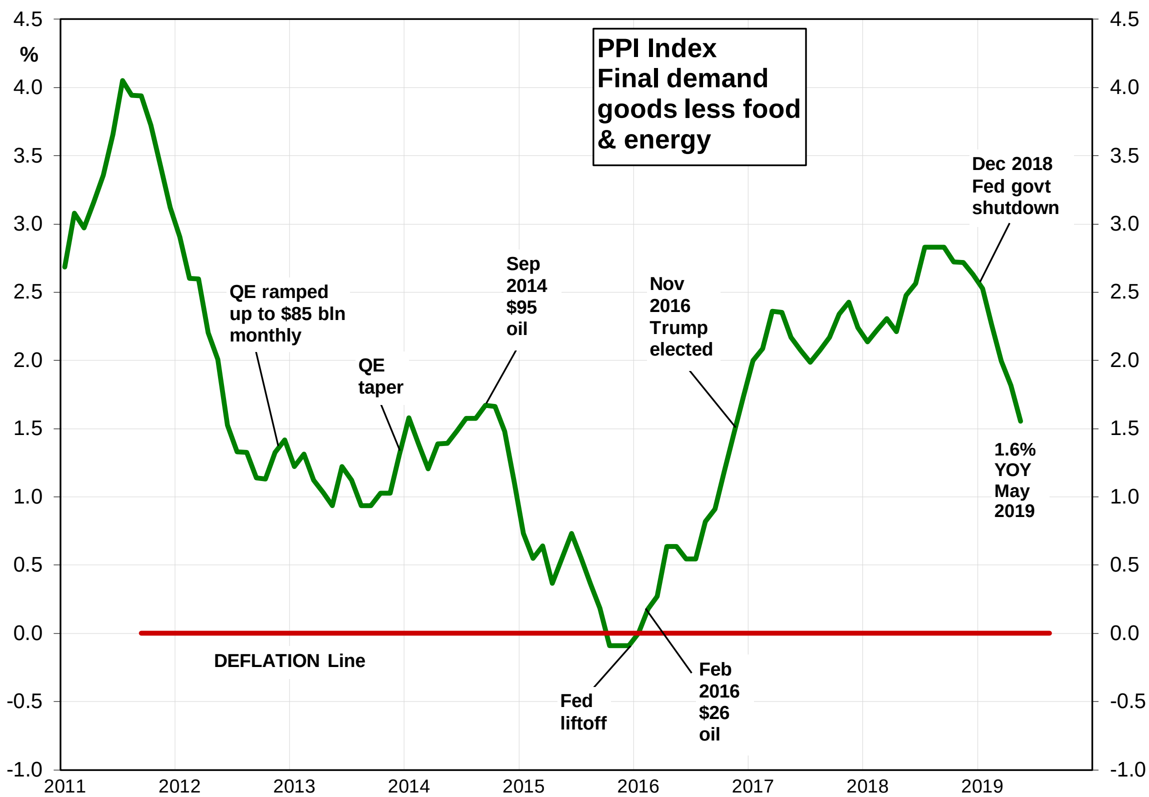
Very low 0.1% PPI inflation is a beautiful thing (Tuesday)

Breaking economy news. PPI inflation rose 0.1% in May and is up a modest 1.8% from year earlier levels. In April, PPI inflation was up 2.2% year-to-year.

Final demand goods prices less food and energy have slowed to a crawl and were unchanged both in April and in May. Low inflation is a beautiful thing the president tweeted this morning and truth be told most of the inflation we have had this year has been energy prices. Energy prices rose 1.7% in February, 5.6% in March, 1.8% in April, and now back down 1.0% in May. Energy prices are within final demand goods prices. Inflation is not heating up in the broader economy at the industry level which is remarkable given the economy was just short of a ten year expansion in May. This puts risk management style rate cuts on the table when the Fed meets next week.

> Donald J. Trump
> @realDonaldTrump
> The United States has VERY LOW INFLATION, a beautiful thing!
> Sent via Twitter for iPhone at 810am EDT before 830am PPI release.

Net, net, economic demand may be slowing in the US with the modest increase in producer prices in May. Producers have no pricing power to raise prices in an economy that has slowed this year after already having spent the Tax Cuts and Jobs Act monies in 2018. The weak reading on prices at the producer level means consumer inflation remains in check. The Federal Reserve is much more likely to consider a risk management style rate cut at next week's meeting with inflation remaining short of target given the strong encouragement of the president and the markets. Fed funds futures have discounted almost three rate cuts by the time of the December 2019 Fed meeting. Stay tuned. Story developing.



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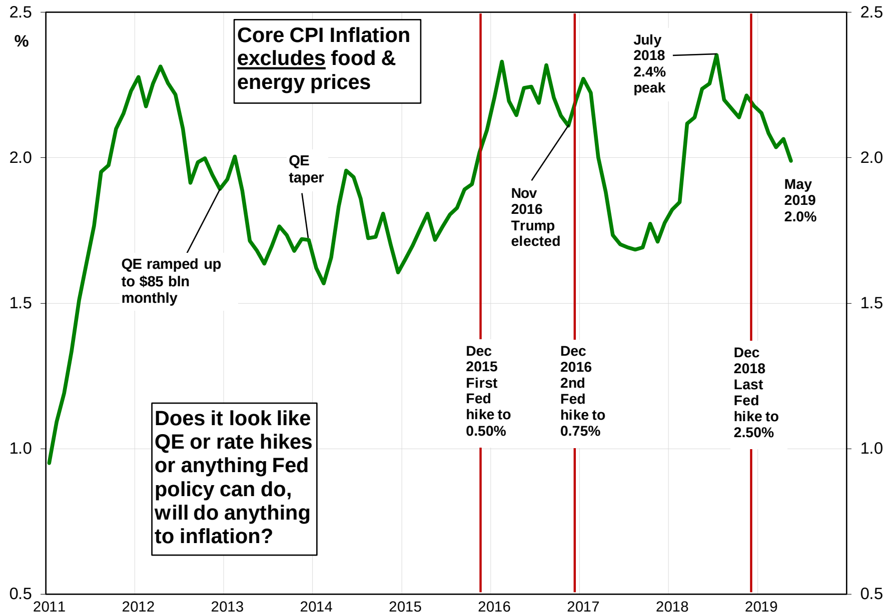
Inflation is cool for four straight months teeing up a Fed rate cut (Wednesday)

Breaking economy news. CPI inflation for May rose 0.1% and is rising just 1.8% the last year, and core inflation, up a modest 0.1%, has slowed to a 2.0% rate of increase the last twelve months. Core inflation was held down by used car and truck prices falling 1.4%, hotels/motels are down 0.1%, your prescription drugs meds are down 0.2%, airline fares that Powell said were one reason low inflation was transitory are rising this month, and clothing prices, also a transitory lowflation reason, were unchanged in May although 3.1% lower than a year ago. That's going to change with new tariffs on the way unless apparel companies can teach other nations to knit sweaters as well as Chinese workers can do.



Low inflation has made many goods cheaper by dozen this month where even home prices are not going up as fast as they were. Shelter costs rose 0.3% from November to February, increased to 0.4% in March and April, and now shot down in May to a slower 0.2% increase.

The million dollar question is how long the Fed sits still while this low inflation environment continues to persist. Is the low inflation something transitory or does it reflect underlying weakness of demand in the broader economy? Inflation has cooled to modest 0.1 percent monthly changes for four straight months which means the market drums for a Federal Reserve rate cut next week are going to beat even louder. Fed officials are under tremendous pressure both from the president and the markets to cut interest rates to help sustain this long economic expansion and make it move into the record books.

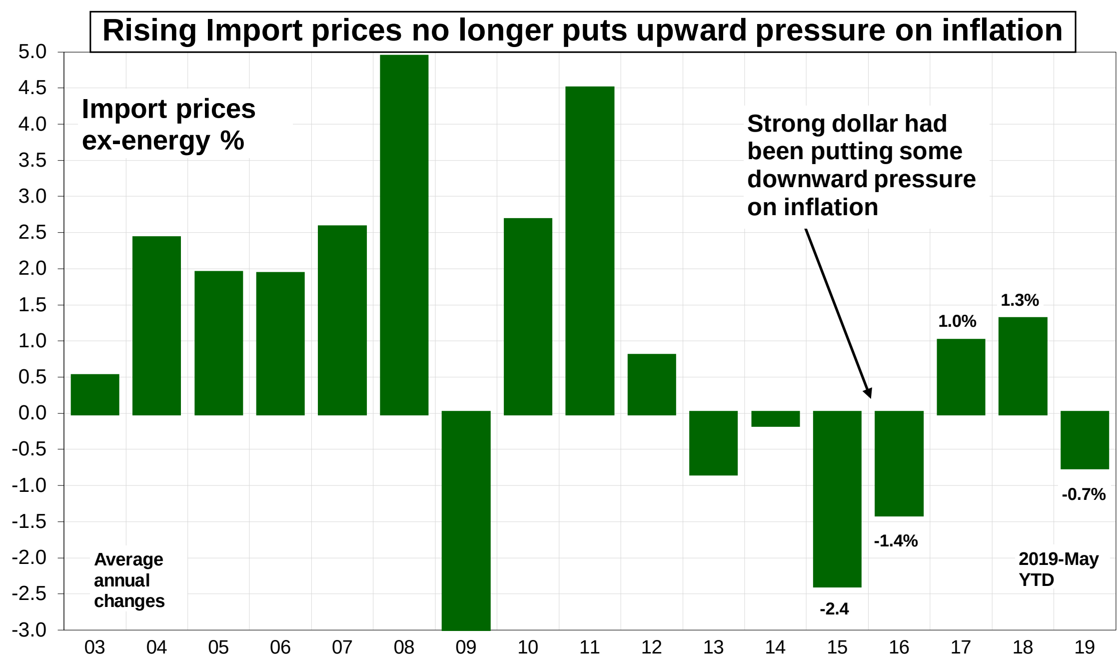
They don't have a clue. The president has called into question whether they know what they are doing and that low inflation is a beautiful thing which means the Fed should cut interest rates. The market has bet for a while now that the Fed will cave to the president's demands, and today's inflation data give Fed officials the cover they need to deliver a rate cut or at least signal one is coming soon when they meet next week. The Fed is data dependent, and the market is betting 0.1% core inflation will tip the scale in their decision to cut interest rates.

Trade war but import prices are falling down falling down (Thursday)

Trade war but import prices are falling down falling down

Breaking economy news. Weekly jobless claims rose slightly to levels that don't even begin to signal the economy is headed over the cliff towards recession. June 8 claims were relatively low at 222 thousand. Business surveys are increasingly cautious with many C-suite executives seeing recession next year, but worries aside, companies continue to hold on tight to their employees for now. Recession doesn't become a recession until companies lay off workers.

Import prices non fuel continue to decline this month which puts the Fed's 2 percent target further out of reach and increases the odds of a rate cut in the next few meetings by Fed officials who are starting to lose patience. Trade war escalation has battered markets but those cheaper by the dozen imports that Americans crave are coming ashore at even lower prices than last year. What a deal. Import prices are down the last three months ending in May and 1.4 cheaper than the year before. The year before this they were 1.8 percent higher which is quite a turnaround driven in large part by the dollar's changing value in foreign exchange markets.

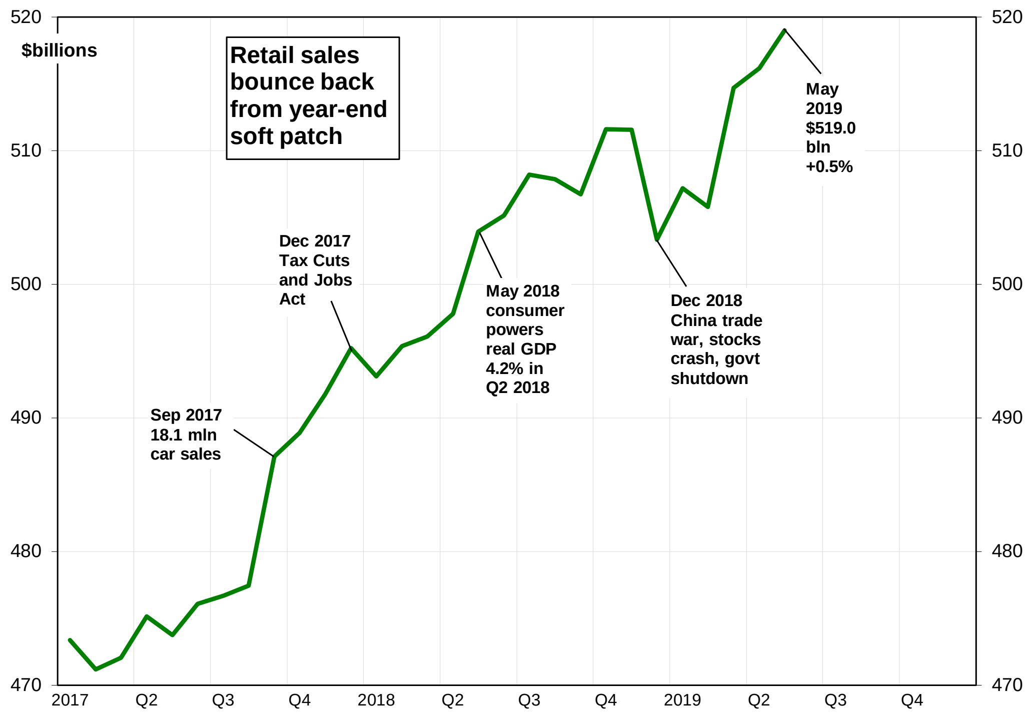


Sputtering retail sales signal Fed rate cut is near. Wait for it. (Friday)

Breaking economy news. Retail jobs have declined in recent months, but now retail sales are soaring to record heights. This is not the picture of an economy that is in headlong retreat. The consumer wasn't affected by the escalation in America's trade war with China to say the least. We guess they could be buying in advance of the 25% tariffs spreading to all of China's $539 billion of exports to the US last year. Nah. Can't be the case. This retail spending boom is the real thing. Solid as a rock. Retail sales rose 0.5% in May and that -0.2% decline a month ago in April has been revised to a moderate gain of 0.3%.

Hang onto your hats, retail sales in the second quarter are up 7.1% with June data left to go, which is the biggest jump since the second quarter of 2018 when sales rose 7.3%. The consumer is famously two-thirds of the economy, does this mean real GDP is going to rise 4.2% this quarter, the same as it did in Q2 2018? This isn't your father's recession or any other kind of recession. Dollars continue to flow in this economy propping up growth. Eating and drinking the consumer is: up 0.7% in May. Internet sales from your sofas: up 1.4%. Sporting goods jumping 1.1%. Electronics up 1.1% in May. Darn near every category of retail spending is higher in May.

Net, net, don't count this economy out yet the consumer is saying as they show the way by opening their wallets and purses to spend the money that makes the economy hum. Fed officials seem to have talked themselves into a blue funk here as they struggle to reconcile the message of plunging bond yields which are discounting recession with the actual economic data. The Fed is data dependent. We will see.



Today's spending data don't require monetary stimulus from the Federal Reserve, and it doesn't need a heads up from Fed officials next week either that says an adjustment in policy may be needed soon. This is not an economy that requires the support of the Federal Reserve. Take the summer off is our advice to worried Fed officials. You need a long rest. Stop intervening in the markets and chasing the business cycle up and down with rate hikes and rate cuts. Sit this one out. You don't have to play every game. You can still be a winner by sitting on the bench. Stay tuned. Story developing as the world turns.

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