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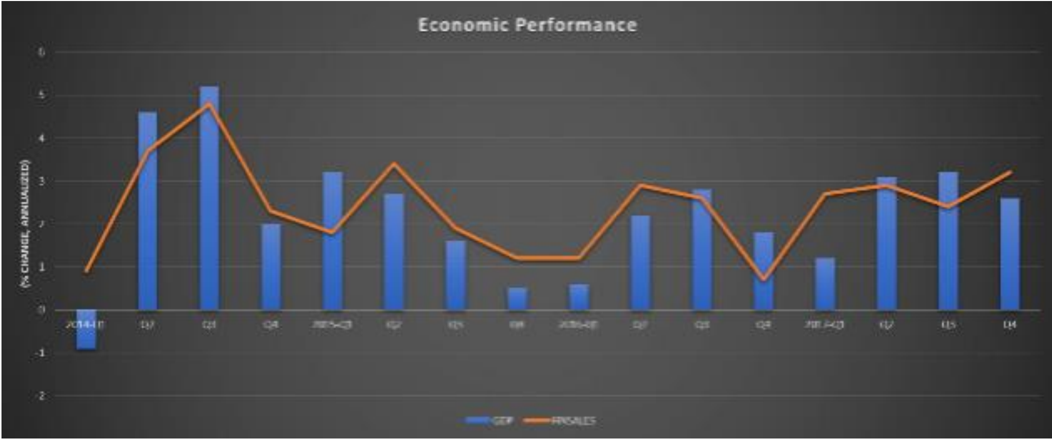
Advocacy Investing®

LATE MONTH JITTERS: IS A CORRECTION IN THE WORKS?

- **The economy expanded at an annualized pace of 2.6% in the fourth quarter**
- **Oil prices rebounded to a 25-month high, but Brent retreats from the $70 level**
- **The Federal Open Market Committee left the benchmark rate unchanged, but up to four rate increases are expected in 2018**
- **The new Fed Chair, Jerome Powell, is expected to continue in Janet Yellen's footsteps, but could face the challenge of inflationary pressures**
- **The IMF revises upward its global forecast for 2018-19**
- **U.S. economic growth is expected to remain strong in the medium term**
- **Stock market jitters in late January and early February revive concerns over an overextended equity market, as major stock indices dropped close to correction levels**

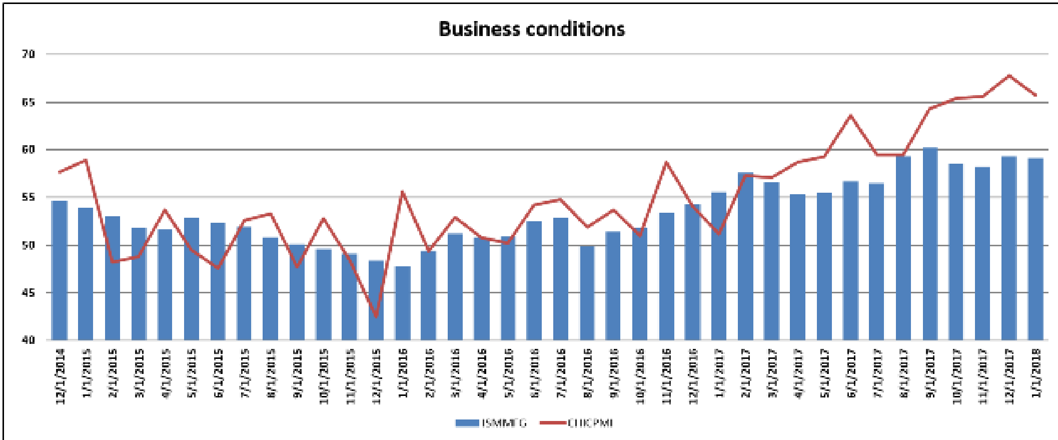
The economy grew at an annualized pace of 2.6% in the fourth quarter (first estimate) from 3.2% in the third quarter 2017 (3Q17). For the year as a whole, output increased by 2.3%, up from 1.5% in 2015—compared to an average of 2.3% over the 2010-2016 period. Private Consumption Expenditures (PCE), Residential and Non-Residential Investment and Government all made positive contributions to growth, while a sharp contraction in Inventories and a widening of the current account deficit (Net Exports) provided negative contributions. Despite the softening of growth, the underlying data underscore a robust economy, Final Sales to Domestic Consumers, (GDP, net of inventory adjustment and exports, but including imports, annualized), rose by 4.3% from 1.9% in 3Q17. PCE rose at its fastest pace in seven quarters, NonResidential Fixed Investment accelerated and Residential Investment rose sharply after two quarters of decline. However, the faster pace of growth and higher oil prices in the past few quarters has contributed to a sharp widening of the trade deficit. Note that the 4Q17 GDP numbers will be revised twice more over the balance of the first quarter.

Figure 1: **A Strong Finish to 2017**



Data releases underscore the strength of the economy. Consumer confidence remains high. The Conference Board index rose to 125.4 at the end of January from 123.1 the previous month, while the University of Michigan-Reuters measure fell slightly from 95.9 to 94.4 over the same period. Retail Sales rose by 0.4% month-on-month (m/m) in December (+0.4% ex. Food and Energy). Personal Income and Personal consumption Expenditures were each up by 0.4% m/m. On the industrial side, Industrial Production and Manufacturing were up respectively by 0.9% and 0.1% in December.

Figure 2: **Business Indicators Point Up**



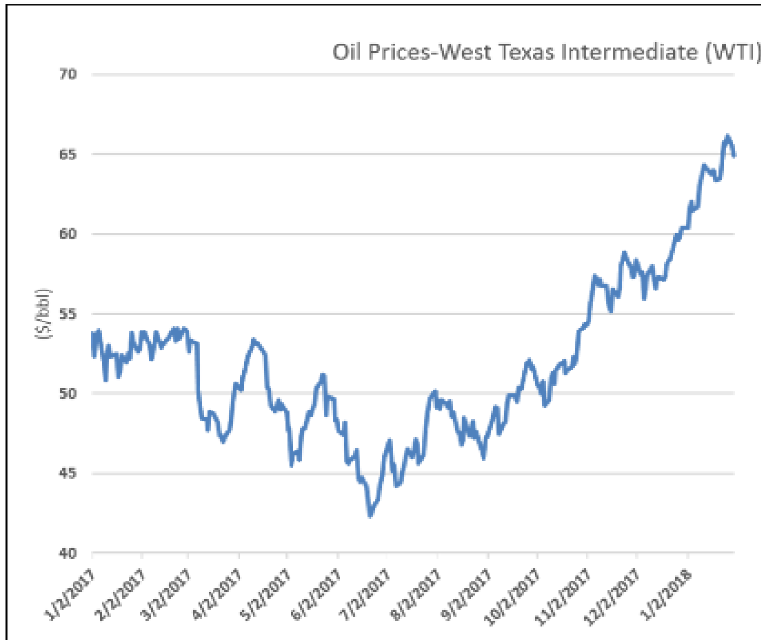
Durable goods rose by 2.9% m/m in December—0.6% ex-Transportation and minus 0.3% for Core Capital Goods. Early-month surveys fell, but remained robust: the Empire State Index fell slightly to 17.7 in January from 18.1 the previous month, while the Philadelphia measure fell from 27.9 to 22.2 over the same period. Late month surveys also fell back, but remained near their mutli-year highs. The ISM-Manufacturing fell to 59.1 at the end of January from 59.3 a month earlier, while the broader Chicago PMI declined from 67.6 to 65.7 over the same period. The Markit PMI Manufacturing rose from 55.1 to 55.5 over the same period. The services sector remained buoyant. The ISM-Non-Manufacturing index rose to 59.9 at the end of January from 56.0 the previous month, and the Markit PMI-Services remained flat at 53.3.

The trade deficit widened to $53.1 billion in December. Exports rose by 1.8% (m/m), but imports grew faster, by 2.5%. This brought the 2017 total trade gap to $810 billion, a 7.7% increase over the 2016 level. The dollar weakened further, with the dollar index (DXY) losing 3.3% over the month of January.

The housing market softened somewhat. New Home Sales, Existing Home Sales and Housing Starts all fell in December relative to their November levels, while housing prices (as measured by the Case-Shiller 20-city Index) rose by 6.4% year-on-year (y/y) in November. Construction activity rose by 0.7% m/m in December.

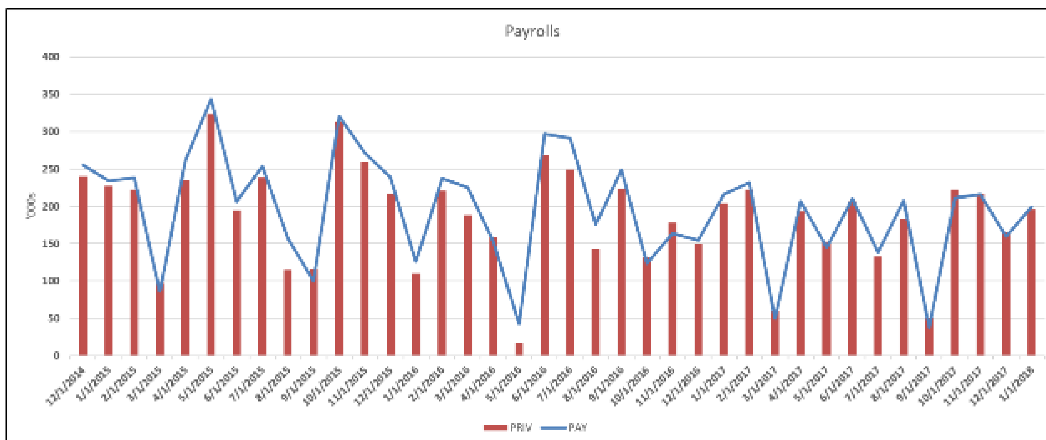
Oil Markets Tighten: Major OPEC and non-OPEC oil producers have maintained output discipline in the face of rising demand, and oil prices remained tight in January. Oil prices (West Texas Intermediate, WTI) rose to a 25-month high of $66.14/barrel (bbl) on January 26th before falling to $64.79 at the end of the month—a monthly gain of 7.2%. Brent prices also briefly broke through $70/bbl, before retreating to the high 60s. Oil prices fell to under $64/bbl in the first week of February in reaction to the financial markets turmoil. The rise in oil prices (which have gained 50% since their May 22, 2017 low) has led to a surge in U.S. crude production, which reached 10 million barrels per day (mbd) last November, its highest level in 47 years. Average U.S. oil production reached 9.3 mbd last year, and is forecast to increase to 10.3 mbd in 2018, making the country the largest oil producer in the world.

Figure 3: Oil Prices Jump



Moreover, U.S. oil imports have collapsed, while oil exports have reached 2 mbd. At prices over $60/bbl, we can expect a gusher of shale oil. At the same time, crude producer discipline should put a floor on oil prices at around $50/bbl.

Figure 4: Payrolls



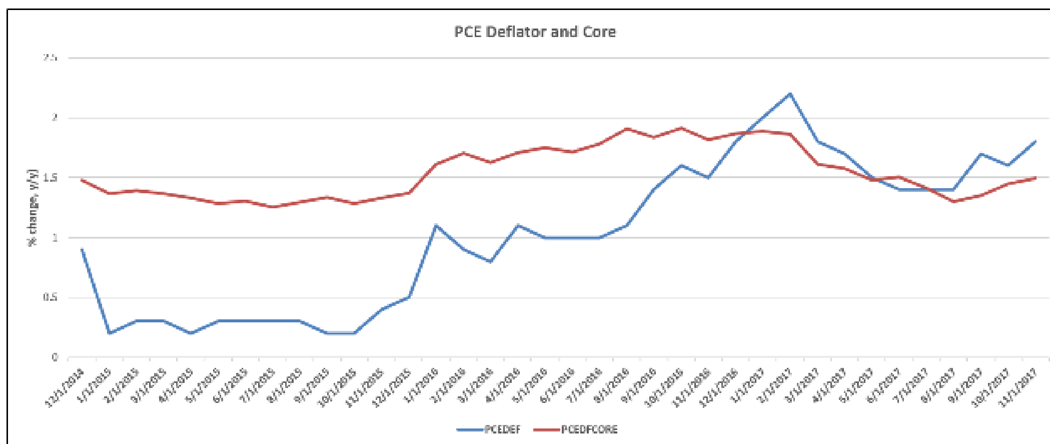
Back on Trend: The economy added 200,000 jobs in January (196,000 in the private sector), roughly at the market consensus. In addition, the previous two months' numbers were revised upwards by 36,000, bringing the 3-month average to 192,000. The goods-producing sector added 57,000 jobs (mining, 6.000; manufacturing, 15,000; and construction, 36,000). Private services positions increased by 139,000 and government hired an additional 4,000. Average hourly earnings rose by 0.3% m/m, but average weekly hours fell to 34.3 from 34.5 the previous month. In combination, this led to a rise in the labor proxy earnings of 2.9% (annualized). The separate Households' Survey indicate that the unemployment rate (U3) was steady at 4.1%, while the unemployment and underemployment rate (U6) rose to 8.2% from 8.1% in the previous month. Labor force participation remained at 62.7%. High frequency data also remained at historic lows, with the weekly Initial Jobless Claims falling to 230,000 in the last week of January. Overall, with the waning of the distortions caused by the three hurricanes of 2017, the data shows a labor market that is close to full employment, with potentially stronger wage growth.

The Fed Stays Put, for Now: There were no surprises in Janet Yellen's last Federal Open Market Committee (FOMC) meeting (January 30th-31st). The FOMC statement underscored the strength of the economic recovery ("solid"), but left the Fed Funds rate unchanged. Inflation remains soft, with the Fed's preferred indicator, the PCE Core Deflator, at 1.5% year-on-year (y/y) in December. Jerome Powell, the new Fed chair, took office on February 5th. He has indicated that he will not depart significantly from Yellen's policy of gradual normalization of interest rates and shrinking of the Fed balance sheet. The latest employment report will strengthen the case for monetary normalization, and we expect three to four more interest rate increases this year. However, tightening labor markets and the short-term fiscal stimulus from the tax cuts could pose a challenge to the Powell Fed. If they lead to inflationary pressures in the next few months, it could lead to a faster pace of monetary tightening. Meanwhile, we are witnessing the simultaneous increase in bond yields and a flattening of the yield curve. The 10-year T-Bond yield reached a 45-month high of 2.88% on February 5th—up by 0.40% in the past year, and the 10-year Treasury Note to 2-year Treasury Note spread has fallen to its lowest level in over 10 years, 0.56%—down by 0.70% in the past year.

Passing the Baton at the Fed

Janet Yellen is vacating the Fed Chair position after only one term. While she was not reappointed by President Trump, she presided over the Fed during a time of steady, albeit slow growth, low inflation and sharply falling unemployment. Yellen was criticized by the left and right alike, either for raising interest rates too soon or following a "reckless" monetary easing. Nevertheless, she leaves a legacy of supporting economic growth and providing a smooth exit from Quantitative Easing.

Figure 5: <u>Subpar Inflation</u>



The global economy is powering along. According to the latest IMF update, (January 22, 2018), global growth continues to surprise on the upside, with risks skewed to the downside. The recovery, which started in mid-2016, is widespread, with 120 countries representing 75% of world GDP experiencing growth. Global economic growth accelerated from 3.2% in 2016 to 3.7% in 2017. The IMF expects that the stimulus provided by the tax cut package in the U.S. could increase the pace of U.S. output growth this year by 0.2%, to 2.7%. Business activity indicators also remain very strong. The eurozone PMIs rose to record levels in January. The Chinese PMIs retreated from their December highs, but remain above 50. Strong business and consumer confidence and still-easy financial conditions should propel economic growth in the next two years, which is expected to reach 3.9% in each of 2018 and 2019, to almost the pre-2008 crisis levels.

The U.S. economy grew at trend in 2017. Economic growth has been bolstered by robust PCE (running ahead of income growth by about 1%) and a strong recovery in business spending. There are few drags on the economy in the medium term, and the recent tax cut will provide additional short-term stimulus—at the expense of a sharp widening of the fiscal deficits. However, there are some downside risks. First, the sharp rise in oil prices and the potential acceleration of inflation will cut into household income gains. Second, fiscal deficits are expected to rise to over $1 trillion this (fiscal) year and next, and the deficit hawks of the GOP could push for deep expenditure cuts. Third, a Fed concerned about an overheating economy could accelerate the pace of interest rate hikes. Fourth, higher deficit and political turmoil could lead to a loss of international confidence, making it more difficult to finance the deficits and resulting in a jump in bond yields. While we do not see a recession in the horizon, the flattening of the yield curve is a signal that should be watched. Expansions do not generally die of old age, and recessions are usually caused by a shock. This time, things are different though. With record high deficits and low interest rates, neither the government, nor the Fed have much ammunition to counteract a potential slowdown.

Potential Risk Factors:

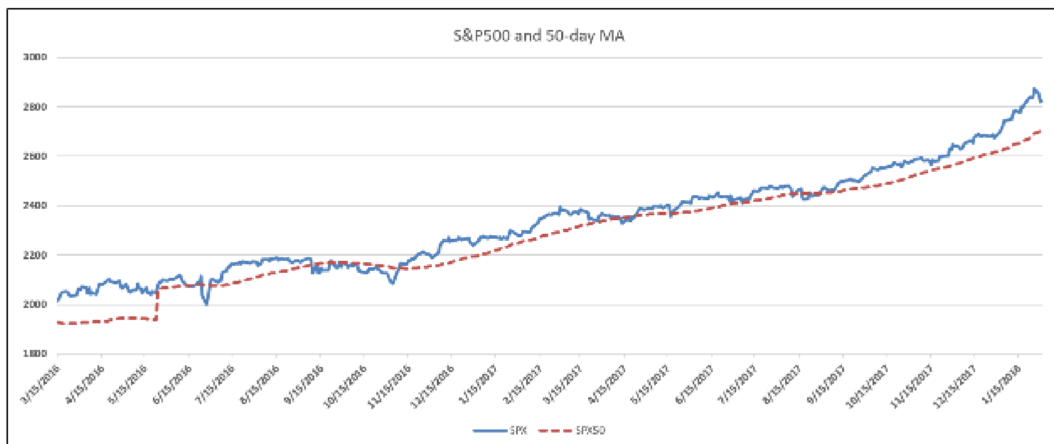
Russia Probe: Less than 24 hours after a uneventful State of the Union Address by President Trump, the U.S. political scene is once again in turmoil over the publication of the controversial Nunes memo from the Republican side of the House Intelligence Committee on the role of the FBI in the Russia probe. While the White House and some of the Congressional Republicans pushed for its publication, the FBI and the Department of Justice have expressed strong opposition to its release. The controversy is not over, as the House Intelligence Committee voted to release the Democratic rebuttal to the Nunes memo. At this point, it is unclear if the White House will allow its release. A White House-FBI standoff in the extreme, could lead to a situation similar to the "Saturday Night Massacre" under Nixon, which led to a constitutional crisis and ultimately Nixon's resignation. We have already seen some impact of the Nunes memo on the market.

North Korea: Despite the pre-Olympic rapprochement between the two Koreas, tensions remain high between the U.S. and North Korea.

Trade Wars: Fresh from his speeches at the World Economic Forum and the State of the Union, President Trump has escalated his trade rhetoric. While so far we have seen only minor tariff boosts, more significant tariffs could lead to trade tensions with China and other major trading partners. Furthermore, negotiations on upgrading NAFTA are at a standstill.

Government Shutdown: The next deadline for reaching a budget/immigration deal is February 8th, and while unlikely, an impasse between the GOP and the Democrats could potentially lead to another shutdown.

Figure 6: Market Momentum

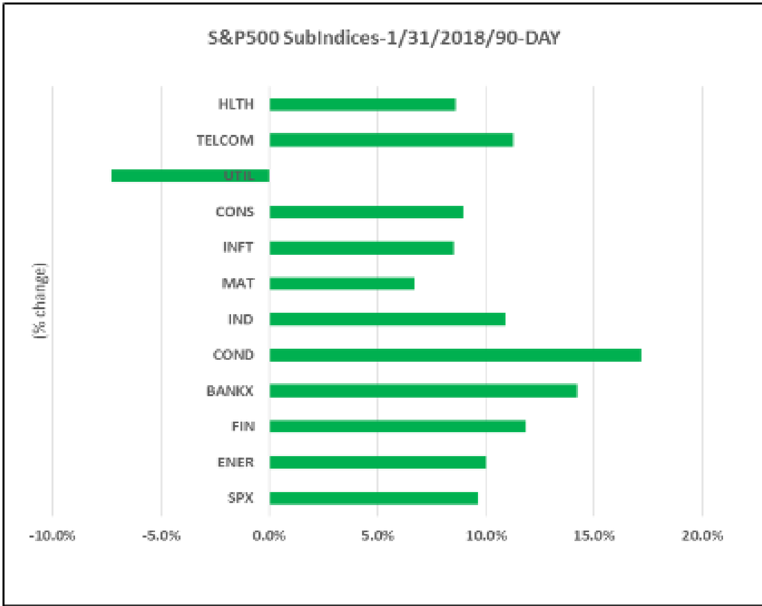


A Jittery End to a Strong Month: Overall, the S&P500, which broke decisively through 2,800 on January 18th, ended the month at 2,815, down from its January 26th high of 2,872, but nevertheless a gain of 5.4% for the month. The bull run was broad, with all sectors except Utilities and Telecoms showing monthly gains at the end of January—the rally was led by Consumer Discretionary, Information Technology and Banks. We witnessed similar patterns from both a 90-day and one-year perspectives. However, the ride is far from smooth, and the markets have suffered a sharp reversal since the beginning of the last week of January, experiencing their worst week since September 2016. The stock market rout began on Feb 2nd, with the release of the January payrolls report, and S&P500 fell by 6.1% before settling at around 2,640 on February 6th, having lost all of its' gains from the past two months. The markets remain very jumpy, and volatility (as measured by the VIX), the volatility index doubled in the past week to around 18, the highest level since mid-2016. Meanwhile, bond yields have surged, with the 10-year yield touching 2.90% before settling around 2.77% on February 6th. Overall, the market came close to a correction—defined as a 10%+ drop—but the story has not yet ended.

While the strong payrolls report had been cited by analysts as the culprit for the market reversal, not much has changed materially on the economic or financial side. The Fed might slightly accelerate the pace of monetary tightening, but that was expected. Inflation remains under 2%, and is not expected to go much higher than 2% in the foreseeable future. In my view,

the markets are pricing in two factors. First, rising political risks, which have increased in the wake of the release of the Nunes memo and President Trump's confrontation with the FBI, and second, the prospect for soaring fiscal deficits resulting from the recent massive tax cuts, which raise the prospect of sharply higher interest rates.

Figure 7: S&P500 SubIndices



There are still forces that could propel the markets forward. Corporate profits remain strong, with EPS rising by an estimated 11% y/y in 4Q17. Tax cuts could amplify this trend, with double digit gains in 2018. In addition, there is a good chance that corporate earnings coming back as a consequence of the corporate tax cut could go into buybacks and special dividends instead of capital investments, muting corporate growth prospects. Also, with investors piling up in the same trades, positions are extended to the extreme. Markets are expensive, with the Cyclically-Adjusted Price Earnings ratio (CAPE) at 34 relative to a historic average of 18, but still 1/3 lower than the dot-com boom peak.

The question is whether the momentum in the so-called reflation trade (favoring equity and commodities at the expense of havens such as the U.S. dollar and sovereign bonds) will continue. Or will markets use the current developments as a pretext to engineer a correction? The best we can expect in the short term is a mild correction and a settling down around current or slightly lower levels.

January Data Releases

Economic Data Releases-January 2018	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP(4Q17 % Annualized, First Estimate)	3.2%	2.9%	2.6%	2.2%	3.3%
PCE Deflator(%, y/y) (Dec)	1.8%	1.7%	1.7%	1.7%	2.0%
Core PCE Deflator (% ,y/y)	1.5%	1.6%	1.5%	1.5%	1.7%
CPI (%. y/y) (Dec)	2.2%	2.1%	2.1%	2.0%	2.3%
Core CPI (%, y/y)	1.7%	1.7%	1.8%	1.6%	1.8%
Employment					
First Time Claims ('000) (last week Jan)	231	235	230	234	240
Non-Farm Payrolls ('000), Jan	160	175	200	150	205
o/w Private Sector	166	172	196	142	200
Unemployment (U3, %) Jan	4.1%		4.1%		
Underemployment (U6, %) Jan	8.1%		8.2%		
Labor Force Participation (%), Jan	62.7%		62.7%		
Balance of Payments					
Trade Deficit $ billion) (Dec)	$50.4	$51.9	$53.1	$51.2	$57.2
Exports (% m/m)	2.3%		1.8%		
Imports (% m/m)	2.5%		1.2%		
Current Account Deficit ($ billion, ,3Q17)	$100.60		$124.4		
Dollar Index-eom (Nov)	92.24		89.17		
Oil Prices-eom (WTI, $/bbl) (Jan)	$60.42		$64.79		
Housing Market					
Housing Starts ('000) (Dec)	1299	1280	1192	1230	1320
New Home Sale ('000) (Dec)	689	680	625	625	710
Existing Home Sales (MM) (Dec)	5.78	5.75	5.57	5.50	5.90
Construction Spending (%, m/m) (Dec)	0.6%	0.5%	0.7%	-0.3%	0.8%
Case Shiller-20 (%, m/m) (Nov)	0.7%	0.6%	0.7%	0.4%	0.7%
Case Shiller-20 (%, y/y)	0.6%	0.6%	0.6%	0.6%	0.7%
Industrial & Manufacturing					
Corporate Profits (y/y) 3Q17	9.9%		10.0%		
Bus Inventories (Dec)	0.0%	0.3%	0.4%	0.2%	0.4%
Empire State (Jan)	18.0	19.60	17.7	15.00	21.00
Philadelphia (Jan)	27.9	25.00	22.2	21.00	31.80
Chicago PMI (Jan)	67.8	64.0	65.7	60.0	67.7
Markit PMI Mfg (Jan)	55.1	55.5	55.5	54.2	55.5
ISM Mfg (Jan)59.358.659.157.760	59.7				
Industrial Production (% m/m, (Dec)	-0.1%	0.4%	0.9%	0.3%	0.6%
Manufacturing (% m/m) (Dec)	0.3%	0.3%	0.1%	0.0%	0.5%
Durable Goods (m/m) (Dec)	1.7%	0.6%	2.9%	-1.0%	1.5%
Durable Goods, ex transp (m/m)	0.3%	0.6%	0.6%	-0.1%	1.0%
Durable Goods, Core Capital (m/m)	0.2%	0.5%	-0.3%	0.0%	0.7%
Factory Orders (m/m) m/m (Dec)	1.5%	1.7%	1.7%	0.3%	2.5%
Services					
Markit PMI Services (Jan)	53.7	53.3	53.3	53.3	53.5
ISM Non-MFG (Jan)	56	56.2	59.9	55.2	57.2
Consumer Spending					
Retail Sales (% m/m) (Dec)	0.9%	0.8%	0.4%	0.1%	0.8%
UMich Consumer Sentiment (end-Jan)	95.9	97.0	94.4	95.3	99.0
ConfBd Consumer Confidence (end-Jan)	123.1	123.6	125.4	120.0	125.1
Personal Income (%, m/m) (Dec)	0.3%	0.3%	0.4%	0.2%	0.5%
Personal Consumption Expenditures (%, m/m) (Dec)	0.8%	0.5%	0.4%	0.3%	0.8%

Dr. Pakravan has been a senior economic strategist in global financial markets for over 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.

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