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WEEKLY ECONOMIC COMMENTARY

June 26, 2017

Softer Data Not Worrisome as the Fed Doubles Down

To no one's surprise, the Fed hiked the Fed funds rates in mid-June. While the move was well anticipated, the Fed's asset monetization plans were a minor surprise that contributed to mid-month weakness on Wall Street. The FOMC expects to begin a program of "balance sheet normalization" this year. The Fed is effectively doubling down on its more restrictive policy, coupling its rate hikes with an unwinding of the balance-sheet bloat created by three rounds of quantitative easing from 2008 to 2012.

Some economists and market watchers argue that the Fed's doubly restrictive policy is taking aim at non-existent inflation. We would not read too much into recent data that has been softer than anticipated, including the negative CPI reading for May '17. The general tone of economic activity is consistent with the uneven but steady growth that has characterized this multi-year expansion. Autumn data is likely to show seasonal strength. And pricing pressure is never too far below the surface.

THE FED ACTS

The Federal Reserve's Federal Open Market Committee (FOMC) lived up to expectations at its June meeting, hiking the fed funds rate by a quarter point. The latest hike represented the fourth in a cycle that was at first prolonged, with one year passing between the first (December '15) and second (December '16) hikes, but has lately accelerated, with the last three Fed moves having occurring within seven months.

While the hike was anticipated, some investors had begun to question the need for Fed action given less-than-robust recent signals in the economy. The Federal Reserve's FOMC statement of 6/14/17 coolly laid out the Fed's position on the current economic environment and why it felt the need to act.

Since it last met in May, according to the memorandum, the FOMC received information indicating that the labor market continues to strengthen and that economic activity has been rising modestly this year. Job gains have been solid, and the FOMC noted the decline in the unemployment rate. The FOMC statement also called out the pick-up in household spending in recent months and continued expansion in business fixed investment.

In view of "realized and expected" labor market conditions and inflation, the FOMC decided to raise the target range for the federal funds rate to a range of 1.0% to 1.25%. Although the committee directly cited inflation concerns as contributing to its rate decision, it also acknowledged that inflation "has declined recently" and is "running somewhat below 2 percent." While the FOMC expects inflation to remain below 2% in near term, it could stabilize around the Committee's 2% objective over the medium term. The Fed is thus being proactive on the pricing front.

Investors have long known that the Fed must address its balance sheet, which grew to $4.5 trillion over the course of three rounds of quantitative easing. The surprise was that the Fed's policy on unwinding would be announced blandly and with little fanfare in a routine post-FOMC statement.

The statement first noted that the committee is maintaining its existing policies of reinvesting principal payments of agency debt and mortgage-backed securities (MBS) into agency MBS; and rolling over maturing Treasury securities at auction. These policies result in no net growth in the Fed's balance sheet, but also do nothing to reduce holdings.

However, those policies are now set to change. The committee "currently expects to begin implementing a balance sheet normalization program this year, providing that the economy evolves broadly as anticipated." Beyond that terse statement, the FOMC statement (as well as the accompanying "implementation note") offered no real detail on how such a program might be implemented; the pace at which the Fed would seek to reduce its balance sheet; and a target range for the Fed's balance sheet once the program was completed.

Following the FOMC statement, Fed governors and FOMC members were slated to fan out across the nation to

(continued on next page)

speak at scheduled conferences. The Fed will also release results of its latest stress tests for over 30 of the nation's largest banks in the third week of June. While the stress test and latest rate hike will be topics of interest, Fed members will most likely be pressed for details on the great balance sheet unwinding set to begin later this year.

TEPID DATA NOT A SIGN OF A COOLING ECONOMY…

Within its June statement, the Fed noted that the "stance of monetary policy remains accommodative." Strictly speaking, real interest rates remain negative, based on the Fed funds rate (1.12% at midpoint) and with inflation running near 2%. But the Fed also hiked the discount rate (the lending rate charged by the central bank to commercial banks and other depository institutions), to 1.75% on a primary basis and to 2.25% on a secondary basis. Using that real-world rate of interest, investors could argue that the real interest rate is at least neutral if not slightly positive.

Mainly, the Street regards Fed policy as no longer accommodative because of the double dose of restrictive policy – higher rates and "quantitative tightening" – coming down the pike. As noted, some question the Fed's timing, given a softening in economic data. We see any softening as temporary, and reflecting a tad of pre-summer seasonality.

The data points that have prompted these concerns include housing and automotive data from the consumer economy. Housing is a sector subject to periodic pauses that allow realignment between buyers and sellers. Meanwhile, housing prices continue to rise, partly reflecting supply scarcity but also the nascent and overdue introduction of millennials into the housing market.

The slowdown in nonfarm payrolls growth is another red flag. The Atlanta Fed scaled back its closely watched GDPNow model, to 3.1% for 2Q17 GDP from a prior 3.5%, following the May nonfarm payrolls report and May auto sales data, both released early in June. While the auto units SAAR has declined by 3.7% in the past year, total spending on vehicles & parts has increased 4.4% over the past 12 months. The revenue growth reflects a richer mix of SUVS, pickups and crossovers in relation to sedans, as well as rising electronic content per vehicle.

Argus Chief Investment Strategist Peter Canelo points out that BLS (Bureau of Labor Statistics) nonfarm payrolls and the ADP private employment survey often diverge, particularly in the early part of the year. The divergence has lasted longer than usual this time, stretching across the first half of 2017, with BLS readings shrinking while the ADP numbers remain strong. Based on strong ADP data, the Household survey, and weekly unemployment new claims (near a 30-year low), Peter believes the seasonal adjustors in the BLS nonfarm payrolls report are distorting and under-counting the real pace of jobs growth.

The preliminary 1Q17 GDP report (second release) included 0.6% growth in personal consumption expenditures. While the latest reading was particularly weak, PCE in both real and nominal terms has been slowing since mid-2016. At the same time, "core" measures of retail sales – which normally move with PCE – have been on the rise since 3Q16. Core retail sales growth improved from 1.5% in 2Q16, to 3.0% in 4Q16, and to 3.9% in 1Q17. Strategist Canelo also called out other retail metrics that contradict the PCE trend, including total retail sales as compiled by the Department of Commerce (up 4.5% in May) and SpendTrend same-store sales (up 4.0% in May from 2.6% a year earlier).

The consumer price index declined 0.1% sequentially in June and is up 1.9% for the past 12 months. The CPI less food and fuel, up 0.1% in June, is up 1.7% for the past 12 months. The BLS points out that many categories outside food and fuel, including apparel, airline fares, and medical care services, unexpectedly declined in May. We expect those categories to creep higher going forward.

We have argued that even as the consumer has hit pause, the industrial economy has shown signs of accelerating. The ISM's purchase managers' indexes (PMIs) for manufacturing and services have averaged 56.1 since February '17. Markit, which calculates PMIs for a multitude of global economies, reported a lower PMI for the U.S. – but also pointed to PMIs in the upper 50s for both the Eurozone and the U.K. Even Japan, a perpetual slow-growth economy, recently showed its best PMIs for manufacturing and services since 2015.

…NOR A HARBINGER OF RECESSION

While the Fed's rate hikes are pushing rates higher at the lower end of the U.S. Treasury yield curve, geo-political and other factors are driving a safe-haven trade that is pushing down rates at the long end of the curve. The three-month T-bill yield was at 0.99%, as of 6/19/17, up from 0.77% a month prior. Meanwhile, the 10-year Treasury yield has declined to 2.17% at present from 2.25% a month ago and 2.47% three months ago.

Despite this moderation in the slope of the yield curve, we do not believe recession risk is elevated. The decline in long yields at least partly reflects high demand for U.S. Treasuries in an uncertain word, amid supply scarcity as the deficit remains constrained for now. Mainly, the data sketched above signals expansion rather than contraction in the industrial economy.

Since the mid-June FOMC meeting, Wall Street has been wondering if the Fed's double-whammy of rate hikes and quantitative tightening is the proper policy at present. We would argue it is the right remedy. Fed policy is most effective when the central banks seeks to stay in front of the inflation curve, rather than trying to play catch up. And the Fed would do well to begin unwinding its enormous balance sheet sooner rather than later, when economic conditions may not be as good and global appetite for U.S. Treasury debt may not be as voracious as at present.

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