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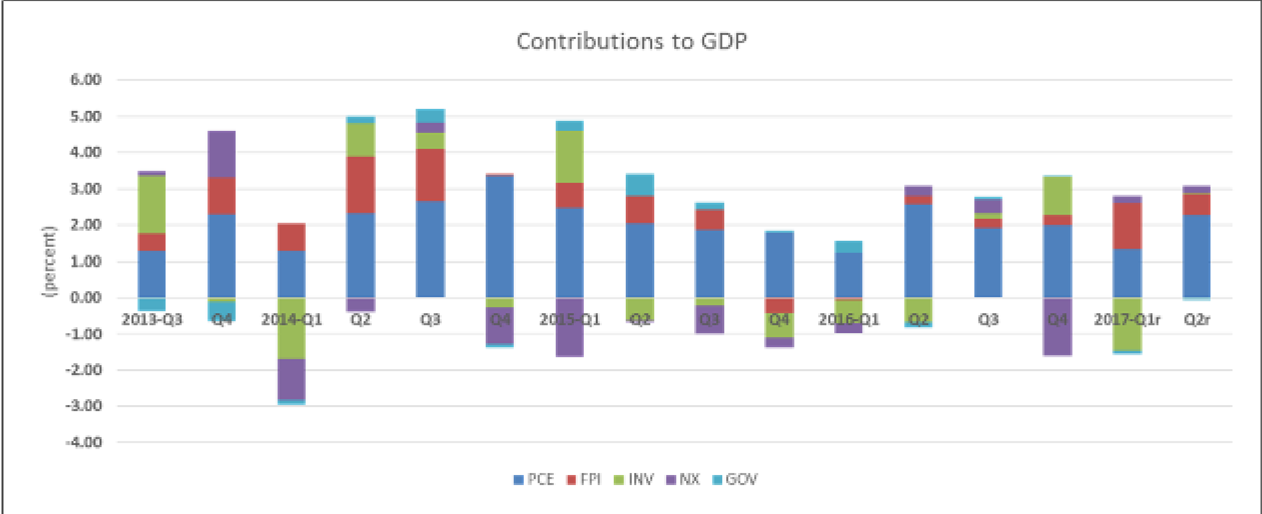
Advocacy Investing®

COME SEPTEMBER

- **A challenging September is expected to follow an eventful August, with no letting up of downside risks**
- **Economic growth in the second quarter was revised upward to 3%, annualized**
- **Data releases support continued economic growth**
- **Oil prices soft despite Hurricane Harvey's disruption of hydrocarbon sector**
- **Below expectations August payrolls numbers disappoint**
- **Fed likely to stick to its playbook despite soft inflation**
- **Hurricane Harvey's impact should be limited**
- **Congress and the Administration face a busy and contentious month**
- **Key battles to develop over the fiscal year 2018 Budget and raising the debt limit**
- **The global economic momentum continues**
- **Equity markets enter a typically difficult month—warning signs and downside risks pose a challenge**

Economic growth in second quarter 2017 (2Q17) was revised upward (second estimate) from 2.6% (annualized) to 3.0%, the fastest pace of growth since 1Q15. The main driver was strong Personal Consumption Expenditures (PCE). Non-residential investment, federal expenditures, inventory changes and net export also contributed to growth, offset by negative results from residential investment and state and local government expenditures. Final Sales to domestic purchasers—which exclude exports and inventory changes, but include imports—rose by 2.9% (annualized) from 2.7% in 1Q17. Growth averaged 2.1% in 1H17, in line with the trend over the past few quarters.

Figure 1: **Composition of Growth, 2Q17**

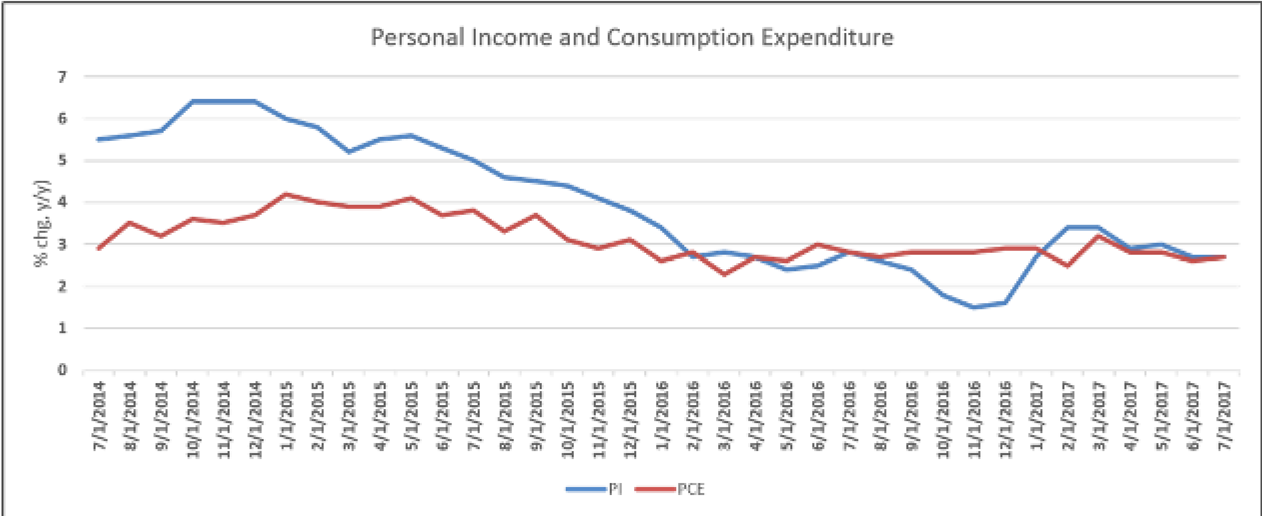


August data releases pointed upwards. Industrial production rose by 0.2% month/month (m/m), while manufacturing fell by 0.1% m/m. Durable goods declined by 6.8% m/m, but this decline came as the result of a large aircraft order being booked the previous month. Durable Goods, ex Transportation, actually rose by 0.4% m/m. Factory orders fell by 3.3% m/m (but the same caveat as Durable Goods applies here). Early-month surveys were positive: the Empire State Index rose to 25.2 in August from 9.8 the previous month, and the Philadelphia measure of manufacturing activity fell slightly from 19.5 to 18.9 over the same period. Late-month surveys confirmed the trends, with ISM-Manufacturing rising to 58.8 at the end of August from 56.3 the previous month, the broad-based Chicago-PMI was stable at 58.9, and the Markit PMI-Manufacturing showing a slight decline from 53.3 to 52.8 over the same period.

Consumer confidence surged at the end of August: the Conference Board index jumped to 122.9, its highest level since December 2000. The more conservative University of Michigan-Reuters measure fell from 97.6 to 96.8 over the same period. Retail sales gained 0.3% m/m in July. Personal Income and Personal Consumption Expenditures recovered in July after a slow June, rising respectively by 0.4% and 0.3% m/m. The services sector expanded, with the ISM-Non-Manufacturing increasing to 55.3 at the end of August from 53.0 a month earlier, and the Markit ISM-Services rising from 54.7 to 56 over the same period.

Exports and imports of goods and services fell by respectively 0.3% and 0.2% in July, and the trade deficit rose slightly to $43.7 billion. The dollar remained stable in August.

Figure 2: Households Recover



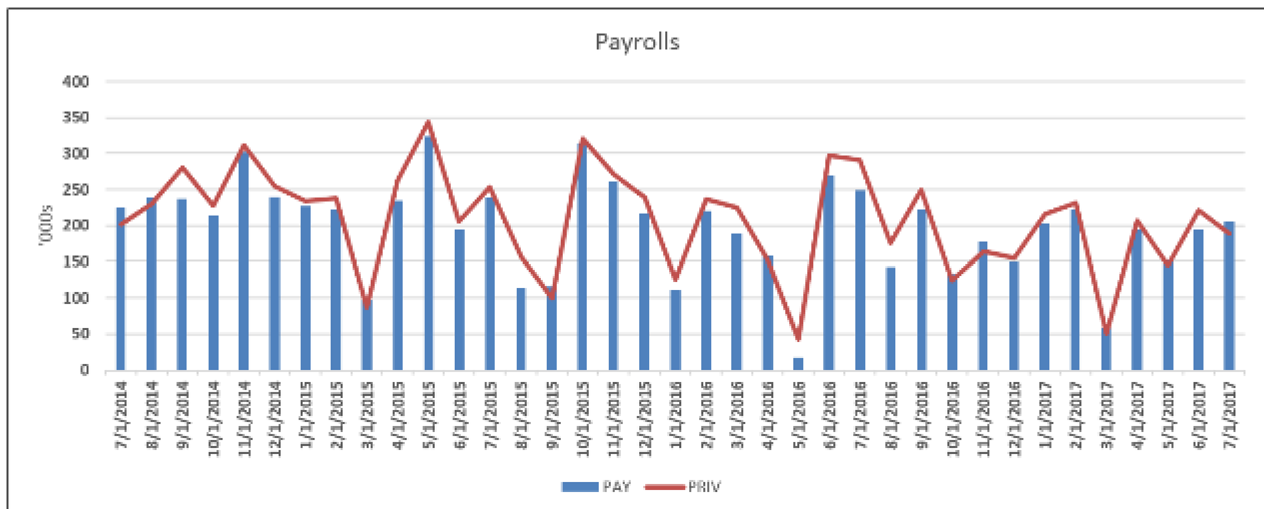
The housing market softened, with New Home Sales, Existing Home Sales and Housing Starts all slipping in July. House prices (Case-Shiller 20 city index) rose by a modest 0.1% m/m (5.7% y/y) in June. Construction spending fell for the second month in a row in July, contracting by 0.6% m/m.

Harvey Impact on Oil Markets is Minimal: Hurricane Harvey resulted in the temporary shutdown of some crude production and refining capacity, but ultimately will have little impact on oil markets. Oil prices (West Texas Intermediate, WTI) fell after Harvey made landfall from $47.87/barrel (bbl) to a one-month low of $45.96/bbl on August 25th. Prices recovered slightly, but ended August at $47.23, a 6% drop from end-July. Oil prices recovered slightly in the first week of September, to around $49/bbl. Some lingering disruptions could be felt as pipeline capacity is temporarily impaired, but the industry is expected to recover in a matter of weeks. Nevertheless, Harvey will have some lingering global impacts. The U.S. has become the world's leading exporter of refined products (4 million barrels per day, mbd), and the temporary shutdown of refineries in the path of the hurricane has led to the diversion of global product shipments from global markets to the U.S. This will lead to temporary shortages of products globally. The speed at which these shortages dissipate will depend on the pace of refineries' recovery. In the meantime, we will see some global product price impact over the next few weeks.

A Mixed Bag Payrolls Report: The August payrolls number came at a below-expectations 156,000 (private payrolls added 165,000). In addition, the numbers for June and July were

revised downward by a total of 20,000, bringing the year-to-date (ytd) average to 178,000. Despite the mildly disappointing number, there was some good news. The goods producing sector generated 70,000 jobs (Manufacturing, +36,000; Construction, +28,000; and mining, +7,000). The private business services added 95,000 and government payrolls shrank by 9,000. The private sector diffusion index (which measures the distribution of jobs gains across sectors) rose to 63.8, from 63.4 the previous month. Average weekly hours worked fell by 0.1, to 34.4, and average weekly earnings rose by 0.1% m/m (2.5% y/y). In combination, the labor earning proxy increased by 4.5% (annualized).

Figure 3: <u>Labor Markets Cool Down</u>

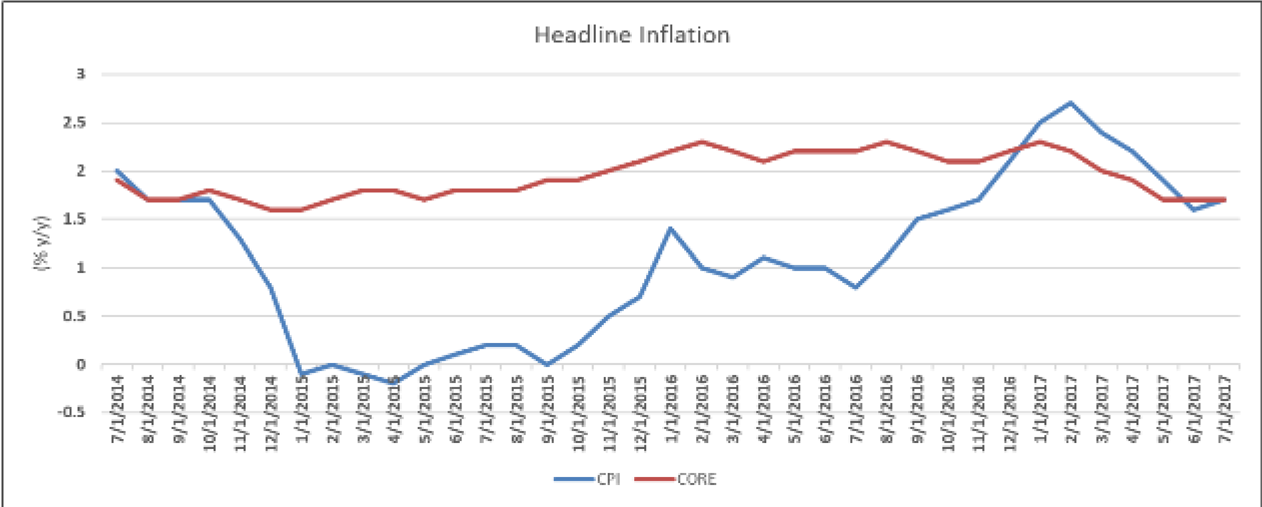


The separate households' survey showed unemployment (U3) edging up to 4.4% from 4.3% in July, and unemployment and underemployment (U6) stable at 8.6%. Labor force participation was stable at 62.9%. Initial weekly jobless claims continue to hover at record lows. The overall labor market trends remain solid. While Hurricane Harvey is expected to distort the labor markets over the next few months, we can expect an underlying average of 160,000-180,000 monthly jobs creation over the medium term. The real challenge remains the low wage inflation.

Jackson Hole Symposium: Central bankers and academics gathered in Jackson Hole for their annual Economic Policy Symposium, sponsored by the Kansas City Fed, on the last weekend in August. The topic was "Fostering a Dynamic Global Economy." The central bankers expressed confidence that the cyclical and synchronized global recovery was alive and well. However, the central bankers also focused on key challenges facing the global economy: weak productivity

and the negative impact of trade and technology on workers incomes and national and global inequality. At the same time, the main central banks warned against stripping the reinforced post-crisis financial regulations—a message directed primarily at the Trump administration and the Republican-dominate Congress.

Figure 4: Inflation Underperforms

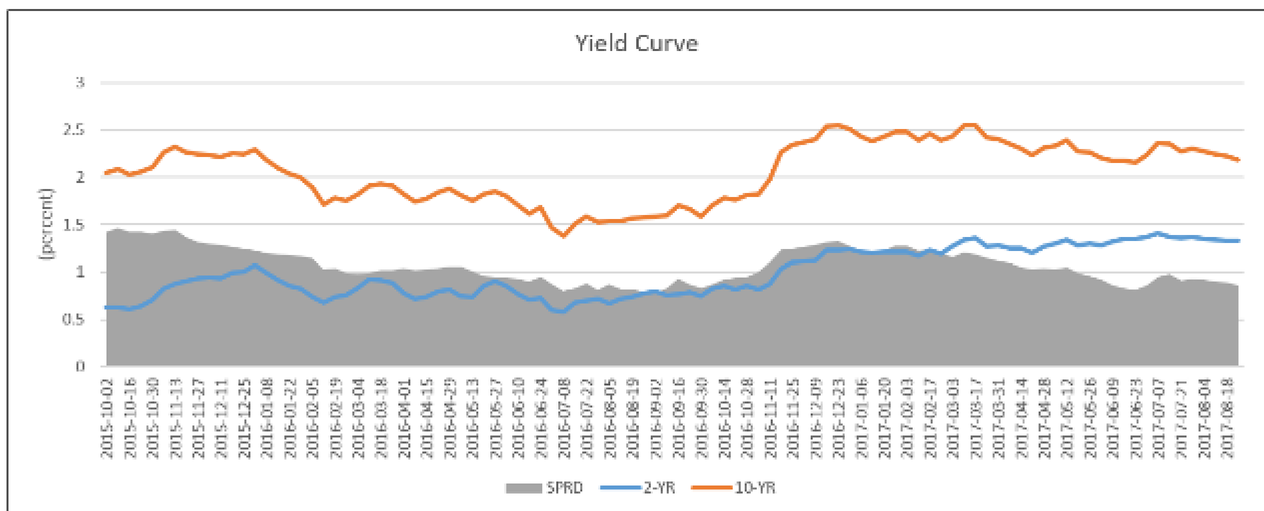


The Fed Holds its Ground: Inflation continues to soften, with the Fed's preferred measure (Core PCE Deflator) registering a 1.4% increase y/y in July from 1.5% in June. Nevertheless, the message from the Fed remains unchanged: gradual interest rate normalization with one more interest rate increase likely in December 2017, and a very gradual balance sheet shrinkage likely to start in September. The latest payrolls report is not expected to affect the Fed's decision-making. Interest rates continued to slide, with the 10-year Treasury yield at a 10-month low of 2.08% in early September, down from the 2.37% level in mid-July. The yield curve continued to flatten, with the spread between 2-year and the 10 year Treasury note down .27% since its 2016 high. The spread is now 0.86%.

The global economy continues to show signs of strength, and should grow at over 3% for the remainder of the year after a robust performance in 1H17. For the first time in a decade, all 45 member countries of the Organization for Economic Cooperation and Development (OECD, the club of the richest and most important developed and emerging market countries) are all growing apace. Eurozone business and consumer confidence is at its highest level since 2007, and the area is expected to grow at 2.0-2.5% this year. Eurozone inflation is also picking up, and the euro is at its highest level since January 2009. While the positive economic picture gives the

ECB the opportunity to end its quantitative easing, ECB president Draghi has cautioned against a premature tightening. The next main event in the European Union is the German parliamentary election on September 24th—barring an unlikely surge by the Social Democrats (SPD), Chancellor Merkel's conservative CDU-CSU coalition is expected to prevail once again. Brexit talks have hit an impasse, which should affect negatively the British economy. In emerging markets, China business indicators are positive, with both the Caixin PMI Manufacturing and Composite up, and the economy is expected to expand at a steady 6.0-6.2%. Indian economic growth is also accelerating. Brazil is out of its long recession and other emerging market economies are growing at a sustained pace. The main issue in the major economies is the persistence of underperforming inflation.

Figure 5: Yields Slip as Yield Curve Flattens



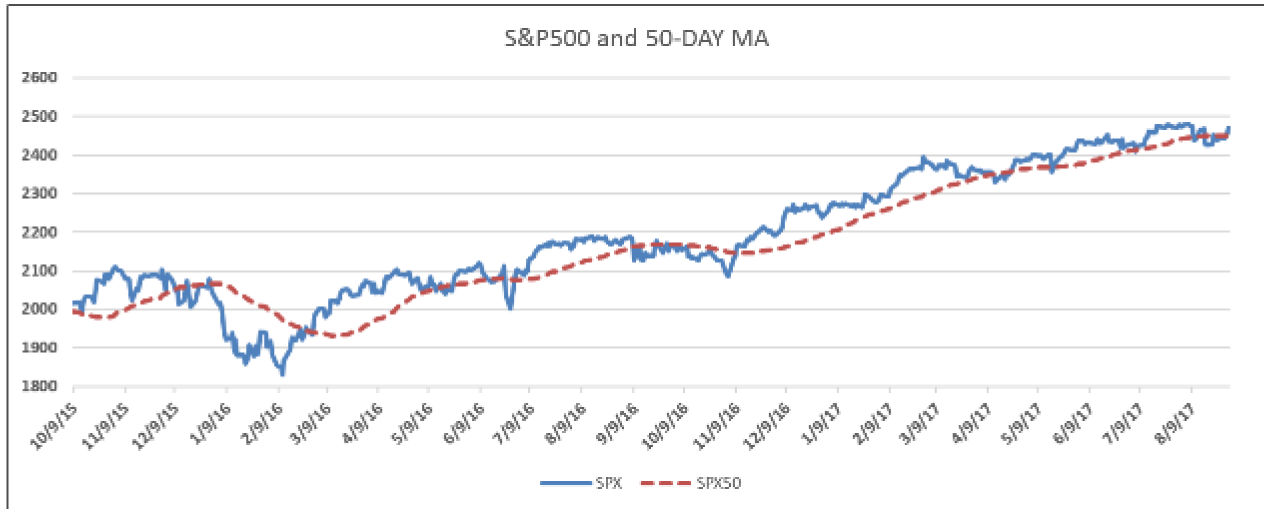
Policy Challenges: Dealing with the aftermath of Hurricane Harvey and the DACA (Dreamers Act) has added to the heavy September calendar of the White House and Congress. The immediate problem facing Congress is the need to raise the Federal debt ceiling and approve the FY2018 budget (starting October 1st). An additional complication has been the threat by President Trump to allow a government shutdown if Congress does not approve preliminary funding for a wall on the US-Mexico border. However, with deep divisions within the Republican Party, as well as between Congress and the White House, and the continued chaos in the White House, the outlook for any quick resolution of these pressing economic policy issues remains bleak. At best, Congressional leaders are pushing for a "clean" increase in the debt ceiling and a kicking of the can down the road in the form of a continuing spending resolution to year-end.

There is the possibility of a compromise. Using Hurricane Harvey relief as a pretext, the GOP could agree to include stopgap spending and debt ceiling measures in a hurricane emergency aid package, pushing a political reckoning to year-end. This move could in theory clear the decks for a tax reform package. However, the crowded legislative agenda, deep divisions within the GOP, the lack of cooperation by the Democrats, and more generally the inability of the Trump administration to present coherent policy proposals, means that any significant tax reform is unlikely to happen this year—although some limited and less controversial proposals might be voted upon. In addition, the Republicans seem to have opted to shut the Democrats out by considering using a "reconciliation" legislative process. Such an approach requires only a simple majority, but limits tax cuts to a ten-year period and requires them to be "revenue-neutral." This means that any revenue losses would have to be matched by deep cuts in non-defense discretionary spending, which would doom Trump's massive infrastructure promise.

The strong economic results show that the U.S. economy, driven by robust spending by households and businesses, is maintaining solid momentum. Household Personal Consumption Expenditures (PCE) have been growing at a steady pace of 2.7% (annualized) over the past four quarters, and business capital expenditures have accelerated to an annualized pace of 7.1% in 1H17, from 0.7% in 2016. Global conditions remain favorable and the weak dollar provides an additional boost. Nevertheless, maintaining the 3% pace could be problematic, and 2.0-2.5% growth rate over the medium term is more likely.

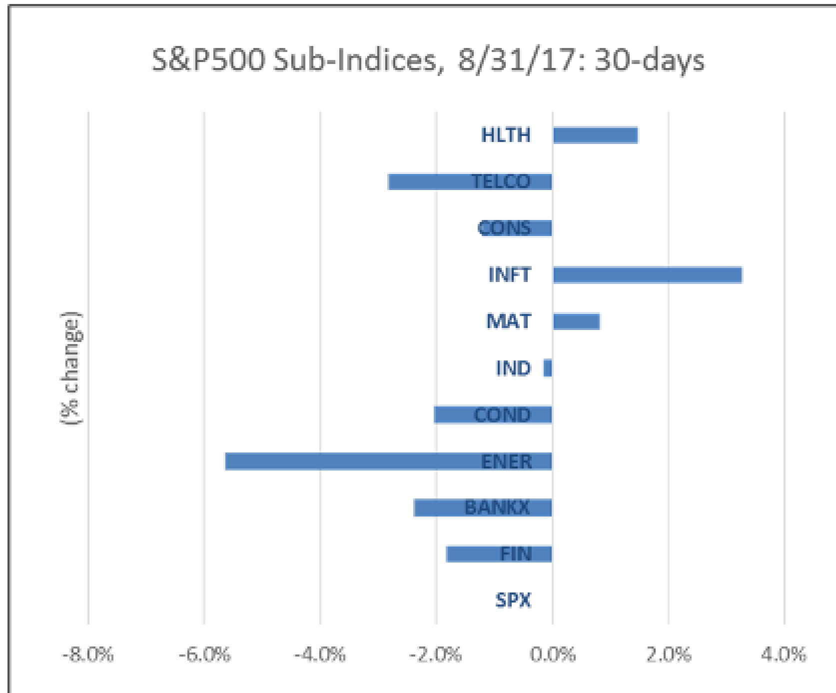
Hurricane Harvey will have a passing impact on economic growth, shaving perhaps up to 0.5% (annualized) from 3Q17 growth. In past natural disasters, we have seen significant, but temporary swings in initial jobless claims (up), monthly payroll numbers (down), and industrial production and car sales (down). In addition, inflation could spike up as oil prices rise. Furthermore, the increase in gasoline prices will result in a temporary hit on household pocketbooks, potentially dampening spending. However, as in the case of previous natural disasters, the reconstruction phase—which in this case could prove to be an extended one, given the extent of the damage—will cause an economic rebound, especially in the most affected areas (Texas, Louisiana, and perhaps some adjoining states. There are however two unknowns. First, the extensive infrastructure damage could delay the recovery. Second, the amount and timing of government financial assistance will be critical in helping cities and households to rebuild. While President Trump has promised extensive aid, funds will ultimately have to be approved by Congress.

Figure 6: Markets at Neutral



The Cruelest Month: September has been a difficult month for equity markets, which have declined 60% of the time in the past 60 years, with an average decline of 0.8%. During the month of August, equity markets retreated from their early August records. The S&P500 peaked on August 7th at 2,480—an 11.1% gain ytd. With little new information on fundamentals, markets focused on event risk, and were rattled by President Trump's threat earlier this month to provoke a government debt default—proving once again that the chaotic White House is the major source of political risk. Markets have been highly volatile, with the S&P500 struggling to hold on to the 2,450 level. The market index reached an all-time high of 2,480 on August 7th before falling to a six-week low of 2,425 on August 17th. Since then, it has been volatile and ended August at 2,450, from 2,470 at the end of July. Delving into deeper detail, we see that the cyclical sectors have been in retreat in the month of August, while defensive sectors have gained. The markets briefly rallied in the first day of September, only to fall sharply on the post Labor Day reopening.

Figure 7: Cyclicals in Retreat



Strong economic performance in 2Q17 boosted the markets, which had shrugged off the economic policy gridlock, Hurricane Harvey and geo-political risks. However, there are concerning indications that the market bull might falter, as the policy and geopolitical proverbial chickens come home to roost. Bond yields are in free fall, the yield curve continues to flatten, and the proportion of S&P500 stocks which trade above their 50-day moving average has declined sharply. Moreover, the North Korean nuclear issue continues to fuel higher levels of geopolitical risks. However, the North Korean crisis can be characterized as binary, which complicates the market reaction. All-in-all, we can expect a highly volatile month, with the market setting a resistance level for the S&P500 at around 2,480.

August Data Releases

Economic Data Releases-August 2017	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP(2Q17 % Annualized, 2nd Est)	1.2%	2.8%	3.0%	2.5%	3.0%
PCE Deflator(%, y/y) (Jul)	1.4%	1.4%	1.4%	1.4%	1.6%
Core PCE Deflator (% ,y/y)	1.5%	1.4%	1.4%	1.4%	1.6%
CPI (%. m/m) Jul	0.0%	0.2%	0.1%	0.1%	0.2%
Core CPI (%, m/m)	0.1%	0.2%	0.1%	0.1%	0.3%
Employment					
First Time Claims ('000) (third week August)	235	237	236	235	240
Non-Farm Payrolls ('000), Aug	189	180	156	147	205
o/w Private Sector	202	180	165	140	200
Balance of Payments					
Trade Deficit $ billion) (Jul)	$43.50	$44.60	$43.70	$43.00	$45.20
Exports (% m/m)	1.2%		-0.3%		
Imports (% m/m)	-0.2%		-0.2%		
Current Account Deficit ($ billion, 1Q17)	$116.80				
Dollar Index-eom (Aug)	92.86		92.91		
Oil Prices-eom (WTI, $/bbl) (Aug)	$50.14		$47.23		
Industrial & Manufacturing					
Corporate Profits (y/y) 1Q17	11.5%		8.1%		
Bus Inventories (Jul)	0.3%	0.4%	0.5%	0.3%	0.4%
Empire State (Aug)	9.8	9.80	25.2	7.00	15.00
Philadelphia (Aug)	19.5	17.00	18.9	13.00	22.00
Chicago PMI (Aug)	58.9	58.6	58.9	57.7	61.6
Markit PMI Mfg (Aug)	53.3		52.8		
ISM Mfg (Aug)	56.3	56.6	58.8	55.5	57.5
Industrial Production (% m/m, (Jul)	0.4%	0.3%	0.2%	0.0%	0.4%
Manufacturing (% m/m) (Jul)	0.2%	0.2%	-0.1%	-0.1%	0.3%
Durable Goods (m/m) (Jul)	6.4%	-5.8%	-6.8%	-8.3%	-1.9%
Durable Goods, ex transp (m/m)	0.1%	0.4%	0.5%	-0.1%	0.8%
Factory Orders (m/m) m/m (Jul)	3.2%	-3.2%	-3.3%	-3.8%	-0.2%
Services					
Markit PMI Services (Aug)	54.7	56.9	56.0	54.6	56.9
ISM Non-MFG (Aug)	53.9	55.8	55.3	53.5	57.0
Consumer Spending					
Retail Sales (% m/m) (Jul)	0.3%	0.4%	0.5%	0.2%	0.6%
UMich Consumer Sentiment (end-Aug)	97.6	97.4	96.8	93.0	98.0
ConfBd Consumer Confidence (end-Aug)	120	120.6	122.9	118.0	124.4
Personal Income (%, m/m) (Jul)	0.0%	0.4%	0.4%	0.3%	0.5%
Personal Consumption Expenditures (%, m/m) (Jul)	0.2%	0.4%	0.3%	0.0%	0.2%
Housing Market					
Housing Starts ('000) (Jul)	1213	1225	1155	1174	1250
New Home Sale ('000) (Jul)	630	610	571	590	622
Existing Home Sales (MM) (Jul)	5.510	5.565	5.44	5.410	5.650
Construction Spending (%, m/m) (Jul)	-1.4%	0.6%	-0.6%	-1.3%	1.0%
Case Shiller-20 (%, m/m) (Jun)	0.1%	0.3%	0.1%	0.0%	0.8%
Case Shiller-20 (%, y/y)	5.7%	5.8%	5.7%	5.4%	5.9%

Dr. Pakravan has been a senior economic strategist in global financial markets for 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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