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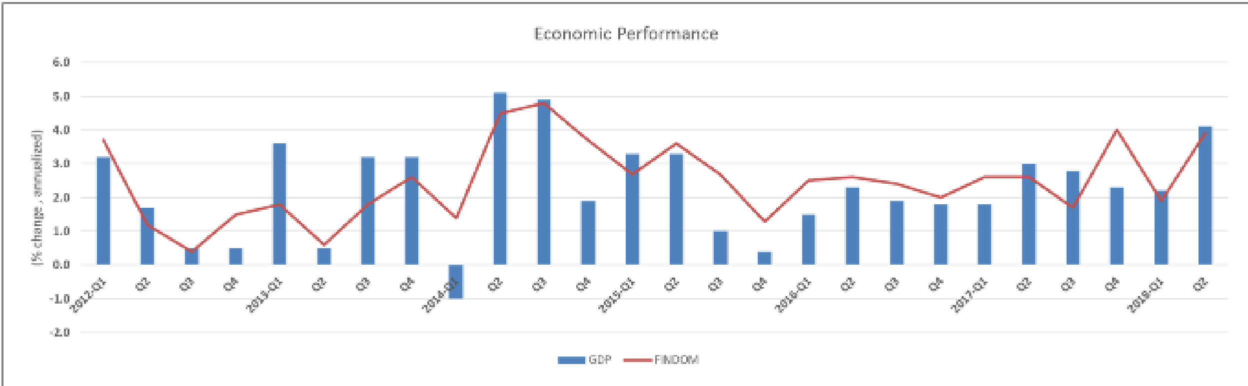
Advocacy Investing®

KEYNESIAN REPUBLICANS

- **Economic growth accelerated to 4.1% (annualized) in the second quarter**
- **Consumer confidence and households' spending remains strong**
- **The economy added 157,000 jobs in July, with unemployment down to 3.9%**
- **Bearish sentiment drives oil markets, but supply constraints loom**
- **Inflation is steadying at 2%, and the Fed remains on its tightening track**
- **10-year rates rise to 3%, but yield curve trend is flatter**
- **The global economy remains on track, but hiccups emerge**
- **The economy is experiencing a "sugar high," but questions about sustainability remain**
- **Geopolitical and economic risks cloud the short and medium term**
- **Noise dominates in volatile financial markets despite strong fundamentals**

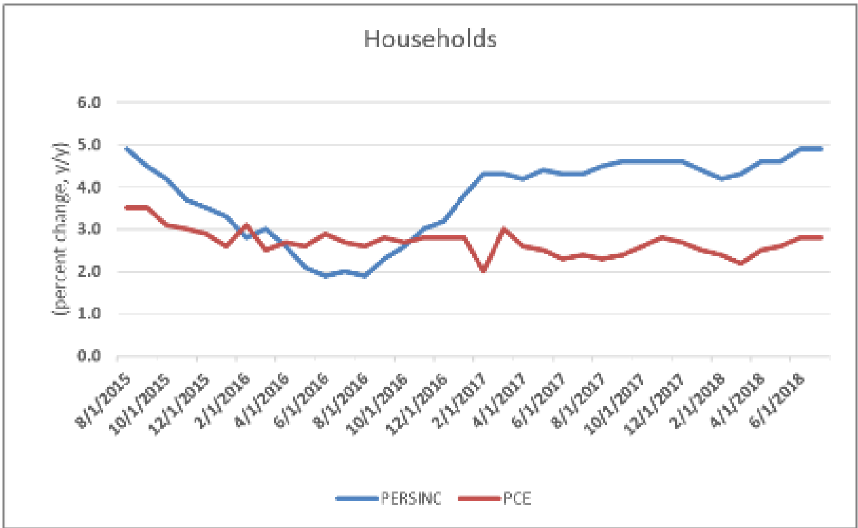
Economic performance in the second quarter came in very strong, as expected. Economic output rose by 4.1% in real terms (annualized, First Estimate) from 2.2% in the first quarter of 2018 (1Q18), the fastest rate since mid-2014. The main factors behind this acceleration was a surge in the pace of growth of Personal Consumption Expenditures (PCE, +4.0%, annualized) and Federal Expenditures (+3.7%). Non-Residential Investments, State and Local Expenditures and Net Exports all had positive contributions, while Residential Investments and Investment in Private Inventories both declined. Final Sales to Domestic Producers (which exclude Inventory changes and Exports) also rebounded by 3.9% from 1.9% in 1Q18.

Figure 1: The U.S. Economy Accelerates



Positive Data Releases: Industrial Production and Manufacturing rose by respectively 0.6% and 0.8% month-on-month (m/m) in June. Durable Goods gained 1.0% m/m—Durable goods ex-Transportation increased by 0.4% m/m, while Core Capital Goods rose by 0.6%. Factory Orders were up by 0.7% m/m. Mid-July surveys were mixed: the Empire State Index fell to 22.6 from 25.0 the previous month, while the Philadelphia measure of manufacturing activity rose from 19.9 to 25.7 over the same period. End-month surveys of business activity were also mixed: The ISM-Manufacturing fell to 58.1 at the end of July from 60.2 the previous month, while the Markit PMI-Manufacturing declined slightly from 55.4 to 55.3 over the same period. In contrast, the broader-based Chicago PMI rose to 65.5 from 64.1 over the same period.

Figure 2: Households Steady



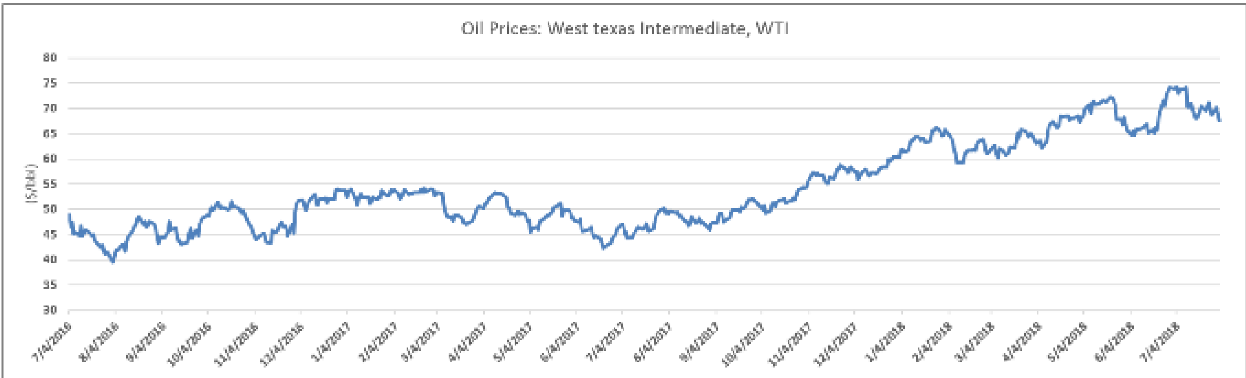
Retail Sales increased by 0.5% m/m in June—up by 0.3% m/m ex-food and gasoline. Personal Income and Personal Consumption Expenditures increased by 0.4% m/m each in June. Consumer Confidence remained solid. The University of Michigan-Reuters index of consumer confidence rose to 97.9 at the end of July from 97.1 the previous month and the Conference Board measure rose from 126.4 to 127.4 over the same period. The Services sector softened somewhat. The ISM Non-Manufacturing index slipped to 55.7 at the end of July from 59.1 the previous month, and the Markit PMI-Services fell from 56.5 to 56.0 over the same period.

The housing market showed signs of weakness, with Housing Starts, New Homes Sales and Existing Homes Sales all on a downward trend, as well as at multi-months low. Housing price increases, as measured by the Case-Shiller 20-City Index, cooled down to 6.5% year-on-year (y/y) in May from 6.7% the previous month. Construction spending fell by 1.1% m/m in June.

The trade balance deteriorated in June, with the deficit rising to $46.3 billion from $43.2 billion in May. Exports fell by 0.7% and imports increased by 0.6%. The dollar fell slightly in July, with the Dollar Index (DXY) losing about 1% for the month. However, the greenback has gained 6.7% from its 2018 low on February 14th.

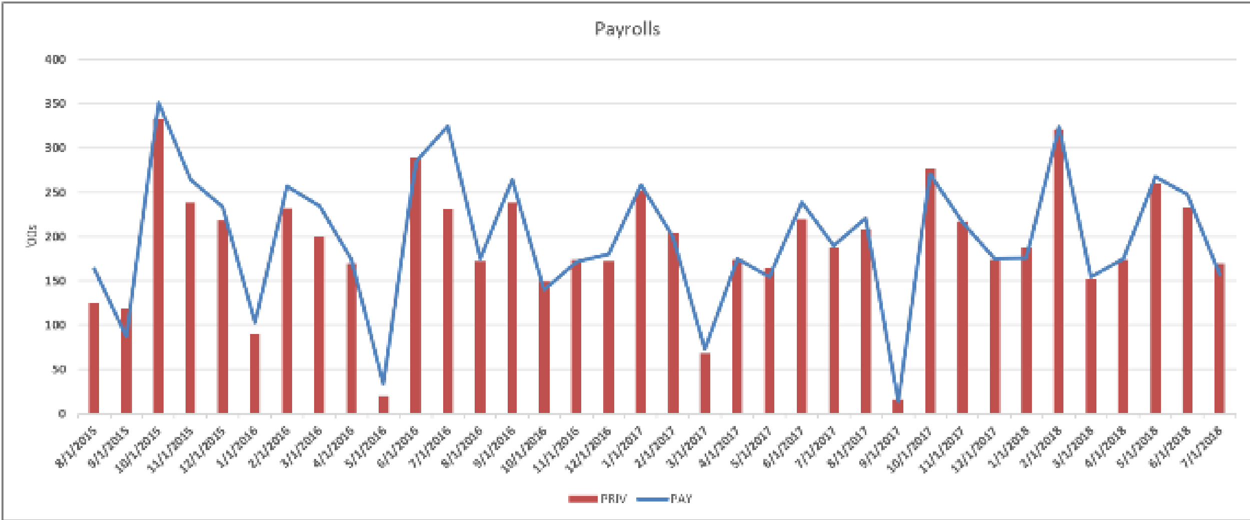
Oil Bears prevailed in July, leading to a sharp fall in oil prices: (West Texas Intermediate, WTI) falling from a 31-month high of $74.15 per barrel (bbl) at the end of June to a July low of $67.89 on July 23rd, ending the month at $68.39/bbl, a 7.8% monthly drop. Despite surging oil demand, markets were well supplied in July. OPEC production rose by 700 thousand barrels per day (TBD) to a 2018 high of 32.64 million barrels per day (MBD), and U.S. overall crude production reached 11 MBD—a 16% increase year-to-date (YTD). In particular, U.S. shale production rose to 7.34 MBD, up by 30% y/y. Other bearish factors were the increase in Russian production to its highest levels since 2016 and the unexpected rise in U.S oil inventories. Oil prices ended under $69/bbl at the end of the first week of August.

Figure 3: **<u>Oil Bears Dominate</u>**



Nevertheless, the supply situation is vulnerable to disruptions. In the very short-term, the suspension of Saudi shipments through the Red Sea after an attack on a Saudi tanker in the Bab-el-Mandeb Strait (at the mouth of the red Sea, off the coast of Yemen) has roiled the markets. In the longer term, the rising tensions between Iran and the United States have cast a pall over global oil supplies. The United States has warned oil importing countries to cease the purchase of Iranian oil by November 4th. Iran has retaliated by threatening to disrupt oil supplies through the Strait of Hormuz in the Persian Gulf. While China, India and several other Asia countries have resisted U.S. pressure, it is estimate that U.S. sanctions could cut Iranian crude exports by a third (or 700 thousand barrels per day, TBD). Other OPEC and non-OPEC producers have yet to prepare for such a supply disruption. Furthermore, potential military confrontation between the United States and Iran could lead to soaring prices.

Figure 4: <u>Solid Payrolls</u>

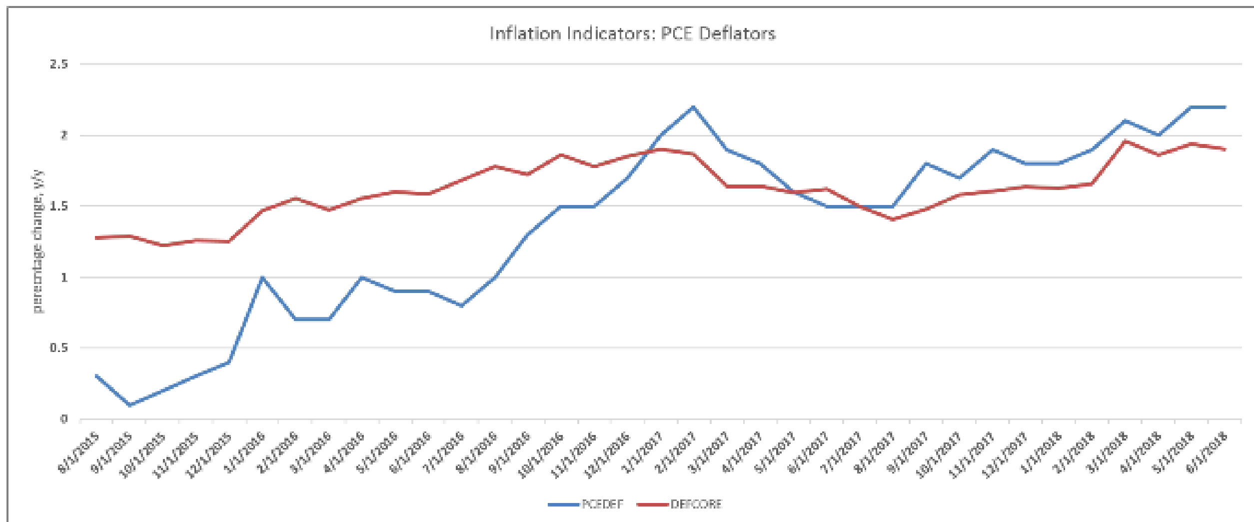


Steady as you go: The economy added 157,000 jobs in July (170,000 for the private sector). In addition, the previous two months number were revised upward by an aggregate of 59,000, bringing the three-month moving average to 224,000 (214,000 ytd)—compared to a 3-year average of 202,000. The gains were broad-based. The goods sector added 52,000 positions (Mining, +19,000; Manufacturing, +37,000; and Construction, -4,000); Private Business Services generated 118,000 jobs and government employment fell by 13,000. The Labor Diffusion Index (measuring the breadth of job creation across sectors) remained at 64.1%. Average Weekly Hours Worked were steady at 34.5, and average weekly hourly earnings rose by 0.3% m/m (2.7% y/y). In aggregate, the labor income proxy increased by 4.3% (annualized). The separate household survey showed unemployment (U3) and unemployment and underemployment (U6)

falling to respectively 3.9% and 7.5%. The labor participation rate (which could be inflated by seasonal factors) was steady at 62.9%. Initial Weekly Jobless Claims remained at a low 218,000. Overall, labor markets continue to tighten, but with modest gains in bargaining power and small earnings increases for workers.

Inflation is back, having picked up in recent months and solidified around 2.0%. Headline and Core Inflation (which excludes volatile items such as Food and Energy) rose by respectively 2.9% and 2.3% y/y in June. The PCE Deflator rose by 2.2% y/y, while the Core PCE Deflator, the Fed's preferred measure, increased by 1.9% y/y.

Figure 5: <u>Inflation is Back</u>



Bullish FOMC: In his second semi-annual testimony to Congress, Fed Chair Jay Powell reiterated the themes presented in the previous Federal Open Market Committee meeting. Powell stated that in the Fed's view, all indicators point to the continuation of steady economic growth: robust jobs gains, high levels of consumer confidence and higher after-tax incomes, robust investment and favorable financial conditions, and a supportive global economic environment. Inflation is a step function higher, with Headline Inflation at 2.9% y/y—and the less volatile Core Inflation is at 2%, up from 1.5% 12 months ago—and in Powell's view, inflation expectations have stabilized at around 2%. With this background in mind, Powell projected a steady and gradual increase in interest rates, back in the medium term to historic levels of around 4%.

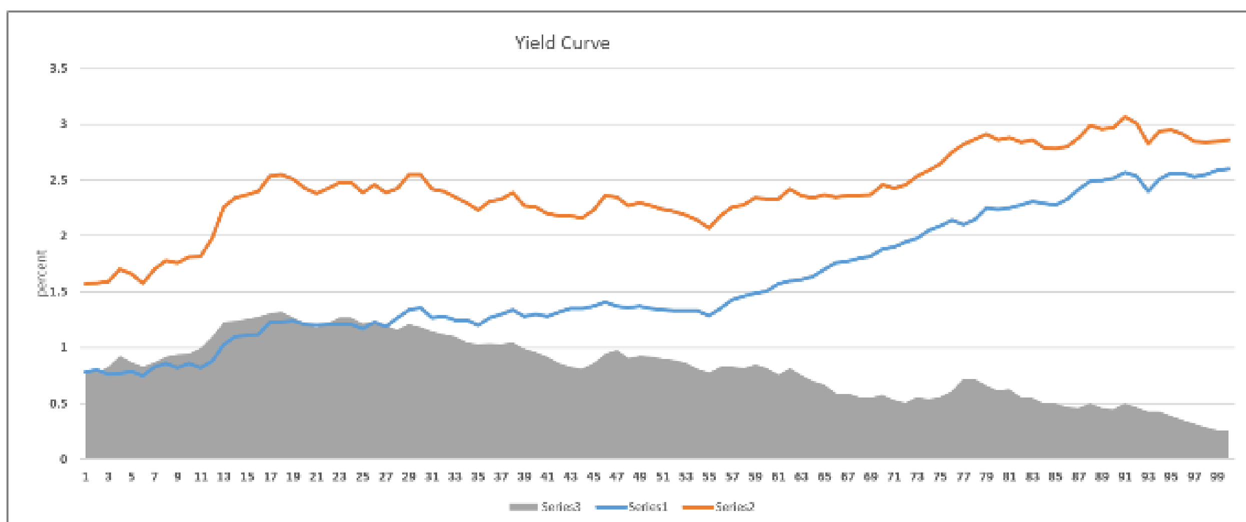
The Federal Open Market Committee (FOMC) met on July 31-August 1. Leaving the benchmark Fed funds rate unchanged at 1.75-2.0%. The FOMC statement characterized the U.S. economy

as "strong" for the first time since May 2007, an upgrade from the "solid" description of the previous (June) meeting. The FOMC also characterized the risks as "roughly balanced" and monetary policy as still being "accommodative."

While Powell seemed to underplay downside risks—in the Fed's view, risks are roughly balanced—the sharp flattening of the yield curve is back at the center of monetary policy discussions. The flattening of the yield curve is the result of a sharp increase in yields at the lower end of the yield curve. Neil Kashkari, the president of the Minneapolis Fed, has expressed concern that the flattening yield curve could invert, signaling a recession, which should lead the Fed to slow the pace of rate increases. However former Fed Chair Ben Bernanke blames the yield curve trends in part on the distortions introduced by the Fed's securities purchases.

The unexpected tirade by President Trump against the Fed's interest rate increases and dollar strength had a minimal impact on markets, and is not expected to affect the Fed's policy trajectory. Nevertheless, it is a reflection of the long-standing populist opposition to central bank independence. However, the administration's economic policy makers quickly walked back the President's comments, assuring the markets of both continued Fed independence and the hands-off dollar policy. Neither the President's attack of the Fed, nor the acceleration of growth in 2Q18, or the latest payrolls report are expected to change the pace of monetary tightening: two more rate increases this year and up to four in 2019, bringing the benchmark rate to 3.25-3.50% by the end of 2019.

Figure 6: <u>Yield Curve Flattens</u>



The yield curve continued to flatten, with the 10-year/2-year Treasury Note spread falling by 0.06% (6 bp) in July to 0.26%, down from 0.52% at the beginning of the year. However, the 10-year yields jumped unexpectedly to almost 3.0% in the first few days of August, reversing the flattening.

Box: The International Monetary Fund (IMF) Mid-Year Projections:

The IMF issued its revised global forecast (World Economic Outlook, WEO, July 2018). The WEO noted that global growth remains solid, while at the same time global risks have shifted to the downside. Economic growth has peaked in some major advanced countries and regions (in particular the Eurozone and Japan) and is less synchronized. At the same time, the main risks to growth come from escalating trade tensions, rising commodity prices and the tightening of monetary policy by some of the major central banks. The IMF projects output growth for 2018 at 3.9%. While the overall forecast is unchanged, growth projections for the Eurozone and Japan have been revised downwards relative to the April WEO. The recent meeting of the G-20 finance ministers has also warned about the negative impact of the global trade tensions initiated by the United States.

Table 1: IMF Forecasts (July 2018)

GDP, % y/y	2016	2017	2018	2019
World	3.2	3.7	3.9	3.9
USA	1.7	2.3	2.9	2.7
Eurozone	1.8	2.4	2.2	1.9
Japan	1.0	1.7	1.0	0.9
Emerging Markets	4.4	4.7	4.9	5.1
o/w China	6.7	6.9	6.6	6.4
Global Trade Volume	2.2	5.1	4.8	5.5

Global Hiccups: As the global cyclical upswing enters its second year, the global economy remains on a growth trajectory, albeit a more tentative one. The JPMorgan Global PMI-Manufacturing fell for the third consecutive month in July, to 52.7 (from a high of 54.5 last December). The Eurozone indicators remain positive as the region enters its sixth year of expansion, but have slipped somewhat. Economic growth in the Eurozone registered at 0.3% quarter-on-quarter (q/q) in 2Q18. However, the Eurozone PMI-Manufacturing fell at the end of July, its seventh consecutive monthly decline. The Markit PMI Composite fell to 54.3 at the end of July from 54.9 the previous month. The UK remains the outlier in the G-7, as the impact of Brexit slows the economy even further. The Chinese economic indicators point to a growth slowdown: the Caixin PMI-Manufacturing fell to 51.5 at the end of July from 51.9 the previous month. Furthermore, the escalating trade war with the United States is clouding growth prospects. In response, the Chinese government has introduced economic stimulus measures and has pumped more liquidity in the banking system.

The major central banks' monetary policies remain asynchronous, although we are seeing some convergence. The Fed continues on its cautious tightening path, while at the same time following a "Quantitative Tightening" designed to gradually shrink its balance sheet. The Bank of England just announced an interest rate increase, and the European Central Bank (ECB), increasingly bullish on growth and inflation, is starting to end and eventually reverse its Quantitative Easing (QE). The Bank of Japan, on the other hand, remains committed to QE for the foreseeable future.

Keynesian Republicans: With the massive tax cut and the boost in federal spending kicking in, the economy enjoyed a sugar high (aka a Keynesian stimulus) in 2Q18. Growth could have been even higher if it were not for a sharp fall in inventories. While the higher pace of growth represented a sharp departure from the 2.1% average pace of the preceding 14 quarters, there are questions about the sustainability of this pace of growth. Special factors were at play in 2Q18. First, the pace of PCE growth is unlikely to be sustainable—PCE rose by an average of 2.7% in the previous 14 quarters. Second, the surge in government spending started to kick in during 2Q18, and much of the growth is due to a base effect. Third, the surge in exports has been tied in part to a sharp increase in presales of agricultural products in anticipation of the imposition of retaliatory tariffs by America's main trading partners, in particular China. While we could expect the growth pace to keep up in 3Q18, the fiscal "sugar high" should fade in the second half of the year. Furthermore, the economy continues to face headwinds from higher oil prices, rising interest rates, a widening current account deficit, rising inflation and trade tensions. Overall, expect growth of 2.8-3.2% over the second half of the year. Meanwhile, the administration faces a soaring fiscal deficit, but is talking about bypassing Congress to push for an additional tax cut of $100 billion on capital gains.

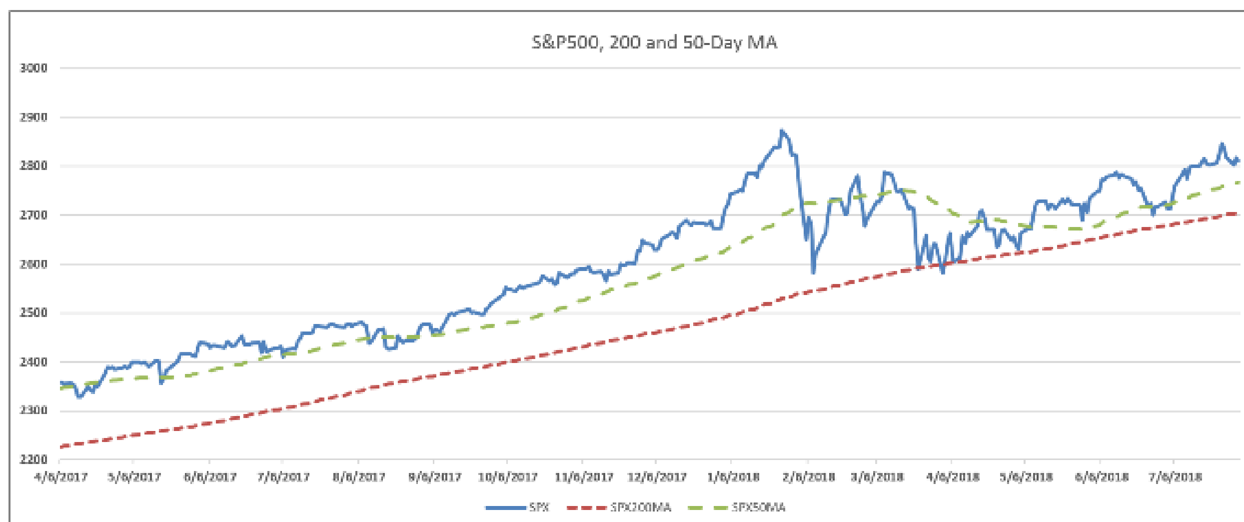
Global Risks
Trade Tensions: Trade tensions ebb and flow. President Trump continues to focus on tariff threats as a policy instrument. However, there seems to be a truce with the European Union, where the visit by the president of the European Commission, Jean Claude Juncker, has led to talk of a free trade agreement negotiation with the EU. At the same time, the Trump administration has escalated its anti-Chinese rhetoric, threatening to increase existing tariffs imposed a few weeks ago from 10% to 25%, and ultimately impose tariffs on the entirety of Chinese imports. China has threatened to retaliate, announcing new tariffs on August 8th.
Iran: President Rouhani of Iran and President Trump have been exchanging fiery messages, with Trump once again threatening untold consequences for Iran, and Iran responding by threatening to close the Straits of Hormuz. The Trump administration is openly calling for the destabilization of Iran and regime change. The recent incident on the Red Sea, which forced a temporary stop to Saudi oil exports through the Bab-el-Mandeb Straits, further illustrates the vulnerability of the oil routes in the region. President Trump's off-the-cuff offer to meet without pre-conditions with his Iranian counterpart was quickly nixed by his own State Department and rejected by Iran. The Trump administration reimposed the sanctions removed as a result of the nuclear deal (JCPOA) on August 6th. The EU promptly responded by reinforcing their commitment to the JCPOA and invoking a "blocking statute" that would prohibit EU firms from complying with secondary U.S. sanctions.
Mid-Term Elections: The 2018 Mid-term elections are less than 100 days away. Democrats seem to have a slim advantage, with a 50-50 chance of gaining control of the House and possibly the Senate. Such an outcome would effectively tie the hands of the Trump administration in the last two years of his current term.

Sugar Highs and Noise: Equity markets recovered strongly in July, with the S&P500 rising by 4.8% between the end of June and the July peak of 2,846 on July 25th—10.3% higher than the 2018 low on January 29th. However, the index reversed itself in the last week of July, before ending the month at 2,816, a 3.7% monthly gain. However, markets remained volatile in the first few days of August, with technology stocks under pressure—Apple's strong results helped the markets recover. A new milestone was reached on August 1st when Apple became the first trillion dollar company (by market cap) in stock market history. Markets continued to gain in the first week of August, with the S&P500 up by 0.5% in the week ending August 3rd—the fifth consecutive weekly gain for the market index.

The market fundamentals seems solid. S&P500 earnings are expected to grow by 20% in 2018, and economic growth in 2Q18 was the fastest in four years. Moreover, corporations are flush with cash from abroad following the tax changes of 2017. The cash holdings overseas are estimated at about $2 trillion, with two thirds held by tech companies. This cash hoard is feeding into record money returned to shareholders in the form of stock buybacks and dividends. Stock buybacks totaled an estimated $700 billion in 1H18, up from about $600 billion

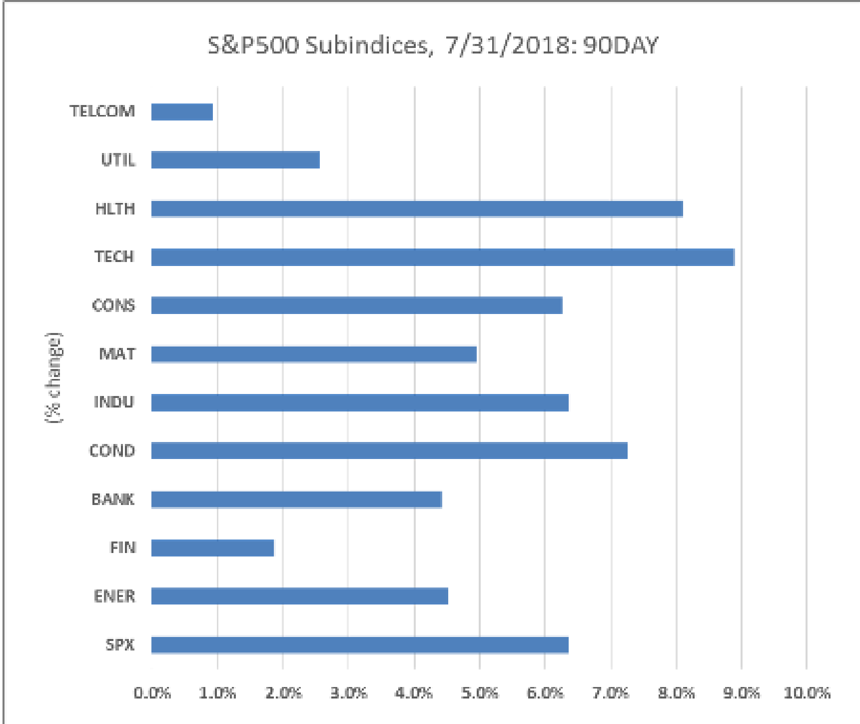
for all of 2017. However, these numbers hide some underlying weakness. First, the massive corporate tax cut accounts for a large portion of the improvement in the bottom line—while after-tax earnings for S&P500 corporations rose by 23.3% y/y in 2Q18, pre-tax earnings actually fell—and this "base effect" is unlikely to be repeated. Valuations have fallen, and the S&P500 prospective price-to-earnings ratio has fallen from 20 earlier in the year to 17.5, its early 2015 level. Second, while the Tech sector has accounted for about half of the market gains, overall, winners and losers have been about equal. Furthermore, the tech sector, which has been a major driver of earnings and market gains, is facing critical challenges—and we are seeing major divergences within the tech sector itself. Third, as mentioned before in this report, there are doubts about the sustainability of the pace of economic growth experienced in 2Q18. Finally, the market is volatile, subject to a significant amount of noise coming from trade tensions, the muddled policy messages coming from the White House, as well as domestic and geopolitical risks.

Figure 7: S&P500 Back in Bull Territory



There are also some longer-term trends in play. First, an increased divergence between economic and corporate performance—two consecutive quarters of strong earnings growth have barely moved the needle and the S&P500 remains under its 2018 high reached in January. Second, an increased dispersion of asset values—200 companies in the S&P500, led by technology, account for most of the corporate sector's profit.

Figure 8: S&P500 Sub Indices



Most companies are cutting back on their 2H18 earnings estimates. Together, these factors tend to amplify the impact of short-term factors and noise on financial markets. Furthermore, the policy, political and global environments should remain unsettled. Since late-July, the index seems to have found support at the 2,800 level, a level that should be sustained over the next few weeks.

July Data Releases

Economic Data Releases-July 2018	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (2Q18 % Annualized, First estimate)	2.2%	4.2%	4.1%	3.0%	4.8%
PCE Deflator (%, y/y) (June)	2.2%	2.3%	2.2%	1.9%	2.2%
Core PCE Deflator (% ,y/y)	1.9%	2.0%	1.9%	1.9%	2.2%
CPI (%. y/y) (June)	2.8%	2.9%	2.9%	2.7%	2.9%
Core CPI (%, y/y)	2.2%	2.2%	2.3%	2.2%	2.3%
Employment					
Initial Jobless Claims ('000) (last week July)	217	218	218	216	225
Non-Farm Payrolls ('000), July	248	190	157	150	215
o/w Private Sector	234	184	170	148	204
Unemployment (U3, %) June	4.0%		3.9%		
Underemployment (U6, %)	7.9%		7.5%		
Labor Force Participation (%)	62.9%		62.9%		
Balance of Payments					
Trade Deficit $ billion) (June)	$43.2	$45.6	$46.3	$41.0	$47.3
Exports (% m/m)	1.9%		-0.7%		
Imports (% m/m)	0.5%		0.6%		
Current Account Deficit ($ billion, 1Q18)	$116.20	$129.30	$124.10	$123.00	$138.00
Dollar Index-eom (July)	95.39		94.5		
Oil Prices-eom (WTI, $/bbl) (July)	$74.15		$68.39		
Industrial & Manufacturing					
Corporate Profits (y/y) 2Q18	0.1%		2.7%		
Bus Inventories (m/m) (June)	0.3%	0.4%	0.4%	0.3%	0.4%
Empire State (July)	25.0	22.0	22.6	17.0	26.0
Philadelphia (July)	19.9	22.0	25.7	18.0	24.5
Chicago PMI (July)	64.1	64.3	65.5	57.3	64.8
Markit PMI Mfg (July)	55.4	55.5	55.3	55.4	55.8
ISM Mfg (July)	60.2	59.5	58.1	58.0	60.4
Industrial Production (% m/m, (June))	-0.5%	0.6%	0.6%	0.4%	0.9%
Manufacturing (% m/m) (May)	-1.1%	0.8%	0.8%	0.6%	1.0%
Durable Goods (m/m) (June)	-0.3%	3.2%	1.0%	1.1%	5.0%
Durable Goods, ex transp (m/m)	0.3%	0.5%	0.4%	0.0%	0.8%
Durable Goods, Core Capital (m/m)	0.7%	0.5%	0.6%	0.3%	0.5%
Factory Orders (m/m) m/m May	0.4%				
Services					
Markit PMI Composite (July)	56.0	56.3	55.9	54.3	56.5
Markit PMI Services (July)	56.5	56.3	56	56.2	56.3
ISM Non-MFG (July)	59.1	58.8	59.7	57.9	59.0
Consumer Spending					
Retail Sales (% m/m) June	1.3%	0.5%	0.5%	0.3%	1.0%
Retail Sales, ex Gasoline, Food (% m/m) June	1.4%	0.5%	0.3%	0.1%	0.3%
UMich Consumer Sentiment (end-July)	97.1	97.1	97.9	97.0	98.5
ConfBd Consumer Confidence (end-Jul)	126.4	127.0	127.4	126.0	128.5
Personal Income (%, m/m) (June)	0.4%	0.4%	0.4%	0.3%	0.5%
Personal Consumption Expenditures (%, m/m) (June)	0.5%	0.4%	0.4%	0.4%	0.5%
Housing Market					
Housing Starts ('000) (June)	1,337	1,320	1,173	1,285	1,350
New Home Sales ('000) (June)	666	668	631	550	685
Existing Home Sales (MM) (June)	5.41	5.44	5.38	5.35	5.52
Construction Spending (%, m/m) (June)	1.3%	0.3%	-0.011	-0.3%	1.1%
Case Shiller-20 City (%, m/m) May	0.2%	0.3%	0.2%	2.0%	0.4%
Case Shiller-20 City (%, y/y)	6.7%	6.6%	6.5%	6.4%	6.9%

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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