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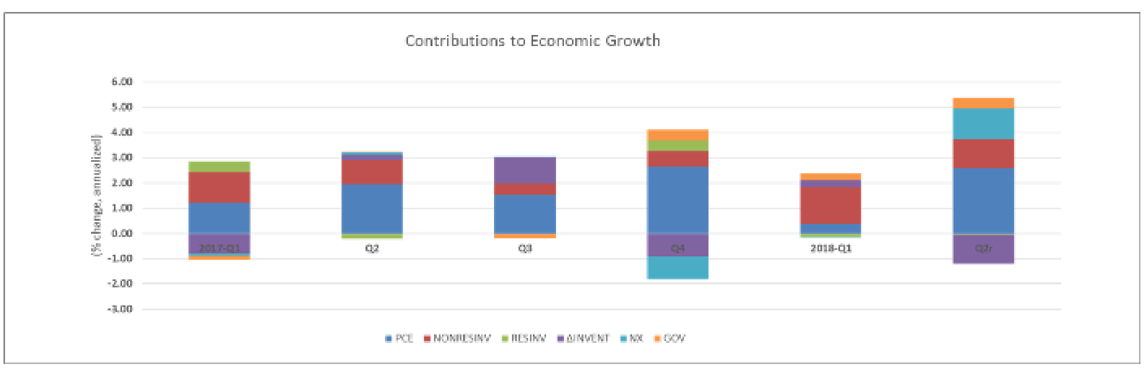
Advocacy Investing®

ROBUST DATA, STRONGER HEADWINDS

- **Data releases underscore a robust economy**
- **With the prospect of U.S. sanctions on Iranian oil exports looming , oil prices surge**
- **The Fed raised the benchmark rate by 0.25%, as expected, with a fourth rate increase expected in December and indicated that it is staying the course**
- **The global economy presents a mixed picture, with growth being hit by a Chinese slowdown, higher interest rates, tightening of monetary policy, higher oil prices, a strong dollar and trade tensions**
- **The U.S. economy is on track for 3% growth in 2018**
- **A sharp global bond sell-off pushes 10-year yields to a 7-year record**
- **U.S. equity markets brush off concerns and surges to new record levels, but remains volatile**

The third estimate of second quarter GDP showed little change, with economic output rising by 4.2% (annualized), unchanged from the previous estimate. Personal Consumption Expenditures (PCE), Non-Residential Investment, Government and Net Exports contributed to growth, while Residential Investment and Inventory Investment shrank, cutting into economic output.

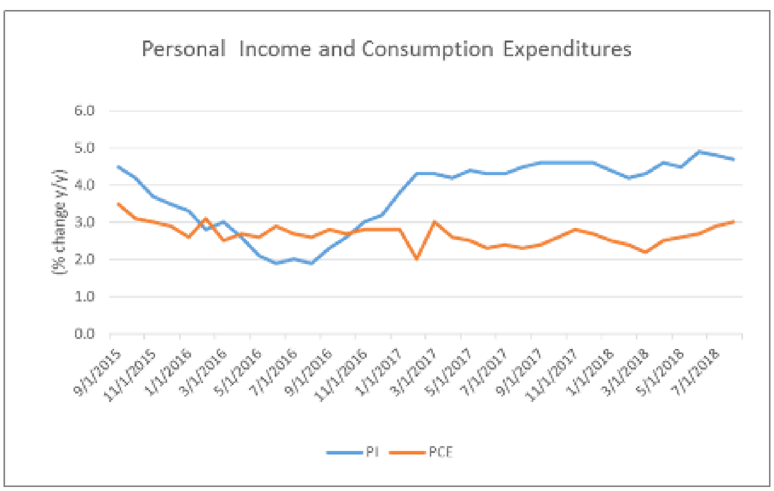
Figure 1: <u>Unchanged 2Q18 DP Estimate</u>



Data releases have softened somewhat in the past few weeks. Industrial Production and Manufacturing were up by respectively 0.4% and 0.2% month-on-month (m/m) in August. Durable Goods increased by 4.5% m/m in August—Durable Goods, Ex-transportation, rose by 0.1%, while Core Capital Goods fell by 0.5%. Factory Orders rose by 2.3% m/m in August as aircraft orders increased. September surveys were mixed: the Empire State Index of manufacturing activity fell to 19.0 from 25.6 the previous month, while the Philadelphia measure rose from 11.9 to 22.0 over the same period. The ISM-Manufacturing fell to 59.8 at the end of September from 61.3 a month earlier; the Markit PMI-Manufacturing rose from 54.5 to 55.6 over the same period, while the broad-based Chicago PMI fell slightly to 60.4 at the end of September from 63.2 the previous month.

Retail Sales rose by 0.1% m/m in August—0.2% ex. Autos and Gasoline. Consumer confidence jumped to record highs, with the Conference Board Index rising to an 18-year high of 138.4 at the end of September from 134.7 the previous month. The University of Michigan-Reuters measure fell slightly from 100.8 to 100.1 during the same period. Personal Income and Personal Consumption Expenditures rose by 0.3% m/m in August. The Services sector remains buoyant, with the ISM-NonManufacturing rising to 61.3 at the end of September from 58.5 the previous month, and the Markit PMI-Services slightly down from 54.8 to 53.5 over the same period.

Figure 2: **<u>Steady Households</u>**

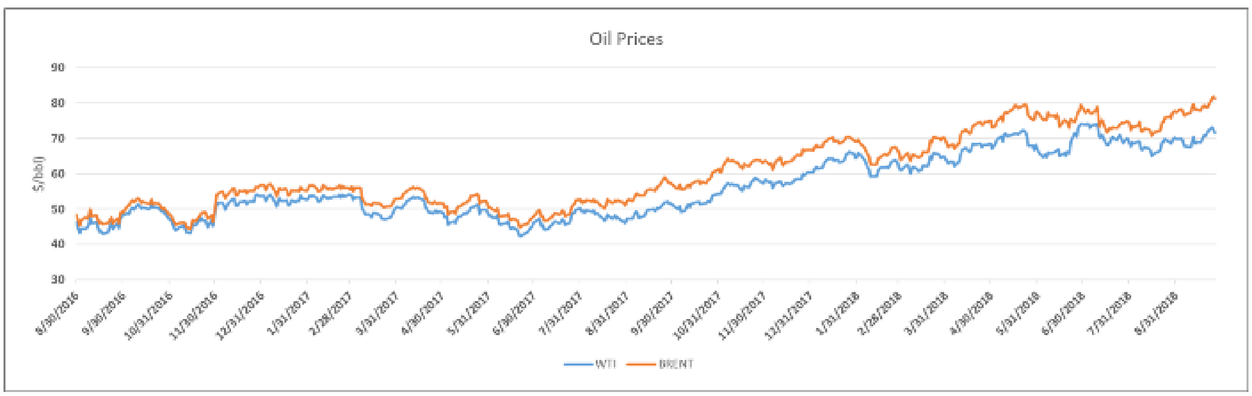


The trade deficit (goods and services) widened in August to $53.2 billion from $50.2 billion the previous month. Exports fell by 0.8%, while imports rose by 0.9%. The Current Account Deficit fell in the second quarter of 2018 (2Q18) to $101.5 billion from $121.7 billion the previous quarter. The dollar index (DXY) was flat in September, but ended the month with a gain of 7% over its 2018 low on February 1st.

Housing markets were mixed. Housing Starts rose in August, while Existing Home Sales fell slightly. Housing prices softened, with the Case-Shiller Core Logic 20-City index rising by 0.1% m/m in July – 5.9% year-on-year (y/y). Construction spending slowed, rising by 0.1% m/m in August.

Iran Sanctions Loom: Oil markets are being hit by the sharp reduction in Iranian exports ahead of the imposition of sanctions on November 4th, as well as obstacles to raising production by other OPEC producers. Oil prices, (West Texas Intermediate, WTI) jumped by 4.9% in September, ending the month at $73.25/barrel (bbl)—a 14% increase from its 3Q18 low on August 14th. Oil prices surged again in the first week of October, with Brent and WTI at respectively around $85 and $75/bbl at the end of the week, a 4-year high. Oil prices (WTI) peaked at over $76 in early October, easing to around $74 at the end of the first week of the third quarter.

Figure 3: <u>Oil Price Surge</u>

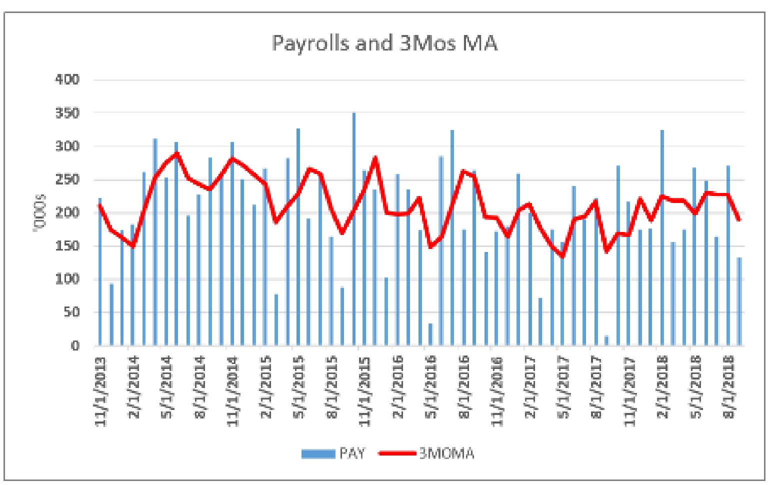


Iranian exports, which had reached 2.4 million barrel per day (MBD) after the nuclear deal, have fallen by 30% already. Most recently, India, Iran's second largest oil buyer, completely cut off its oil imports from Iran for November. European importers and South Korea had already cut their purchases of Iranian oil. Saudi Arabia increased its production to record levels 10.7 MBD, (close to capacity) in September, as did Russia, and both countries have agreed in principle to boost production further. The Gulf Cooperation Council countries, in theory have collectively about 2 MBD in excess capacity, (70% of which is in Saudi Arabia). While President Trump has once again attacked OPEC, accusing it of artificially curbing output, the GCC producers may not be able to ramp up production in significant amounts in order to offset losses of Iranian exports. In any case, they seem to be comfortable with higher oil prices.

Overall, the global supply-demand picture in 4Q18 is expected to be precarious. Despite the jump in U.S. production, global supplies of crude oil and condensates are expected to fall by 0.5 MBD in 4Q18 relative to 4Q17, to 100.3 MBD, while demand should rise by 1.4 MBD, to 101.4 MBD. Post-November 4th, oil prices could surge to over $90 bbl (WTI) and even $100/bbl.

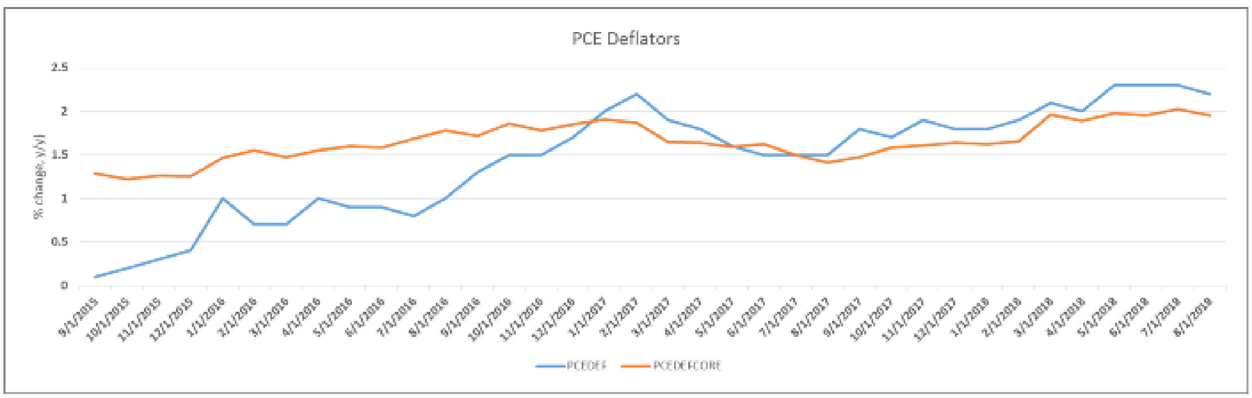
Payrolls slowdown: The September Establishment Survey showed a sharp slowdown in job creation, a below-expectations total of 134,000 (121,000 in the private sector). At the same time, the previous two months were revised upward by an aggregate of 86,000, bringing the three-month moving average to 190,000, from a monthly average of 212,000 year-to-date (ytd). Some of the decline reflects the impact of Hurricane Florence, which affected in particular the leisure industry in the Carolinas. The job gains were broadly distributed. The Goods Producing sector added 46,000 positions (Mining, +5,000; Manufacturing, +18,000; and Construction, +23,000), Private Services added 75,000 and Government 13,000. Average Weekly Hours were unchanged at 34.5, and Average Hourly Earnings rose by 0.3% m/m in September (2.8% y/y), and 3.4% (annualized) in 3Q18. The separate Household Survey indicated that the unemployment rate (U3) fell to a low of 3.7%, from 3.9% the previous month, while the broader measure of unemployment and underemployment (U6) rose to 7.5% from 7.4% the previous month. Labor Participation was unchanged at 62.7%. High frequency data showed a decline in Initial Weekly Jobless Claims to 207,000, consistent with a tightening labor market.

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



The Fed's Clear Course: Inflation weakened, with Headline Inflation up 2.7% y/y in August (from 2.9% in July). Core Inflation (excluding Food and Energy) registered 2.2% y/y from 2.4% in July. The PCE Deflator rose at a slower rate of 2.2% y/y and Core PCE Deflator (The preferred measure of the Fed) increased by 2.0% y/y. With this background in mind, the Federal Open Market Committee (FOMC) met on September 25th-26th. The FOMC statement underscored the strong economic growth and stable inflationary expectations, and predicated its decision to raise the Fed Funds target rate by 0.25% (25 bp) to 2.00-2.25% on the continuation of these trends, with risks being "roughly balanced." The Fed also revised upward its 2018 economic growth forecast to 3.0-3.2%. At the same time, the FOMC dropped the "accommodative" language from its statement, which opens the door for one more rate increase in 2018 and up to four in 2019.

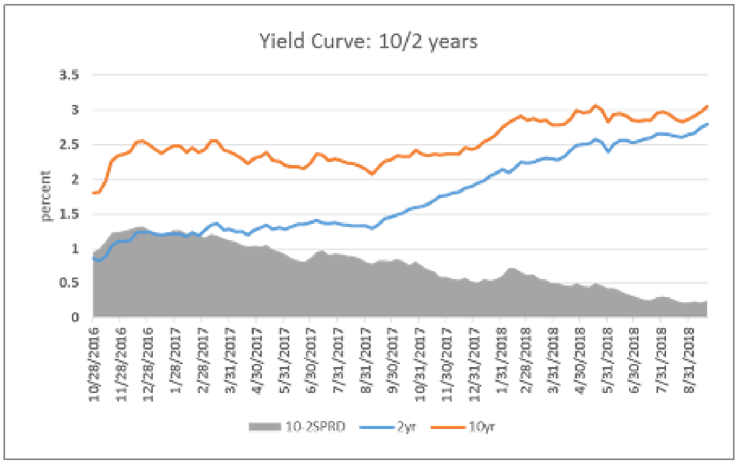
Figure 5: <u>Inflation Settles at 2%</u>



In a recent speech, Fed Chair Powell reiterated his position stating that "Our course is clear: Resolutely conduct policy consistent with the FOMC's symmetric 2 percent inflation objective, and stand ready to act with authority if expectations drift materially up or down". The latest employment numbers are likely to strengthen the case for the Fed staying the course.

The 10-year U.S. Treasury yield is now steady above 3.0%. The yield curve had stabilized by late September with the 10-year yield at 3.07% and the 10 year/2 year Treasury yield spread steady at around 22 bp. However, a stream of positive economic data and concerns about inflation caused a sharp sell-off of Treasuries, pushing the 10-year rate to a seven year high of over 3.20%, with a steepening of the yield curve.

Figure 6: **Yield Curve**



The global economy presents a mixed picture. Global manufacturing activity has been hit by a slowdown in world trade and the related increase in trade tensions between the United States and China. The Markit Global Manufacturing PMI fell to 52.2 at the end of September from 52.6 the previous month. Global economic growth has slowed in the second half of the year from 4.5% to a trend 4.0%. With the exception of the United States, all of the major developed economies and China have slowed down to trend growth. Manufacturing activity in China seems to have slipped, with the Markit PMI-Manufacturing falling to 50—the tipping point between expansion and contraction—at the end of September. In the Eurozone, the Markit PMI-Manufacturing, while still signaling expansion, has fallen to a 2-year low of 53.2 at the end of 3Q18. On the positive side, Eurozone unemployment continues to fall, down to 8.1%, the lowest since November 2008. Eurozone inflation also remains low. Despite low inflation, the European Central Bank (ECB) is tightening monetary policy, having cut its purchases of bonds by half.

While the data has softened somewhat, economic growth remains on track, driven by Personal Consumption Expenditure, Capital Expenditures and the (fading) fiscal stimulus. The likely widening of the current account deficit will subtract from GDP growth, but could be offset in part by a recovery in inventory investment. Rising oil prices will create a headwind, particularly if they rise to the low-90s. Longer-term factors include the impact of trade tensions, rising interest rates and inflation and the fading of the 2018 tax cut-cum-spending package stimulus, as well as a global economic growth slowdown. The Fed has revised its median 2018 growth projection to 3.2% for the year as a whole—which could mean growth of 2.5-3.0% (annualized) for each of 3Q18 and 4Q18—with growth slowing down to around 2.5% in 2019.

Risk Factors:

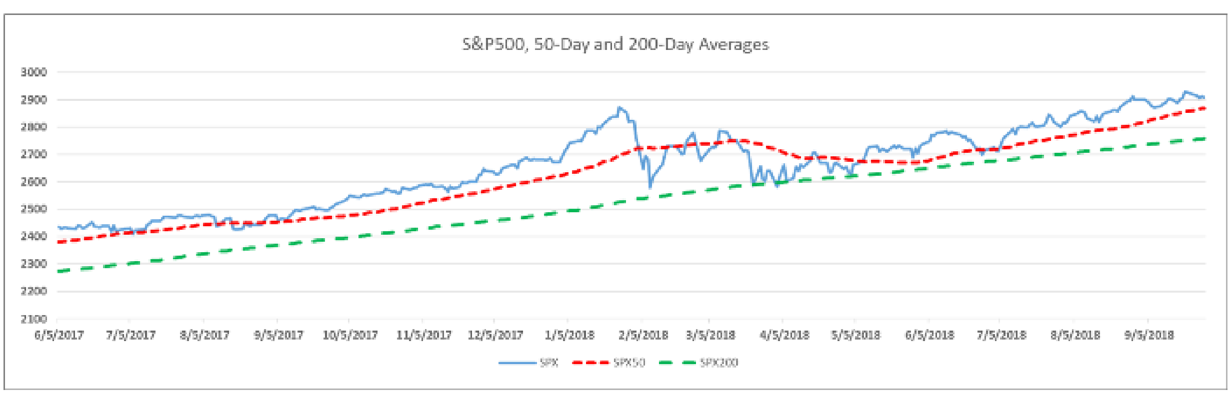
Trade: The just-concluded (The United States-Mexico-Canada Trade agreement, USMCA) has cooled down somewhat the global temperature on trade disputes. In contrast, the radical trade actions of both the United States and China, which basically have imposed tariffs on most of the bilateral trade have stoked tensions between the two countries. From all indications the trade tensions with China are unlikely to be resolved soon, as both sides gear up for a prolonged confrontation, threatening global growth.

Iran: Despite fiery attacks against Iran by Trump and his key national security advisors at the UN General Assembly and Security Council meetings, the U.S. is moving away from direct confrontation with Iran. Instead, it is trying to tighten sanctions and blunt the effort by the other signatories of the JCPOA to find alternative/non-dollar barter mechanisms to continue trading with Iran.

Oil Price Increases: Related to the Iran sanctions, we are seeing a surge in oil prices, with a potentially negative macroeconomic impact. Moreover, the impact of oil prices is non-linear: a moderate price increase could benefit oil producing companies with a minimum impact on the rest of the economy, including the all-important households. However, a sharper increase in prices to historically high levels has a sharp adverse impact on the economy, directly through impacting purchasing power, and indirectly through higher inflation and weakening business and consumer confidence.

The U.S. Mid-Term Elections: While the latest ruckus on the confirmation of a new SCOTUS justice has erased some of the perceived electoral advantage of the Democrats in the upcoming Mid-term Congressional elections, the party remains confident of winning back at least the House of Representatives.

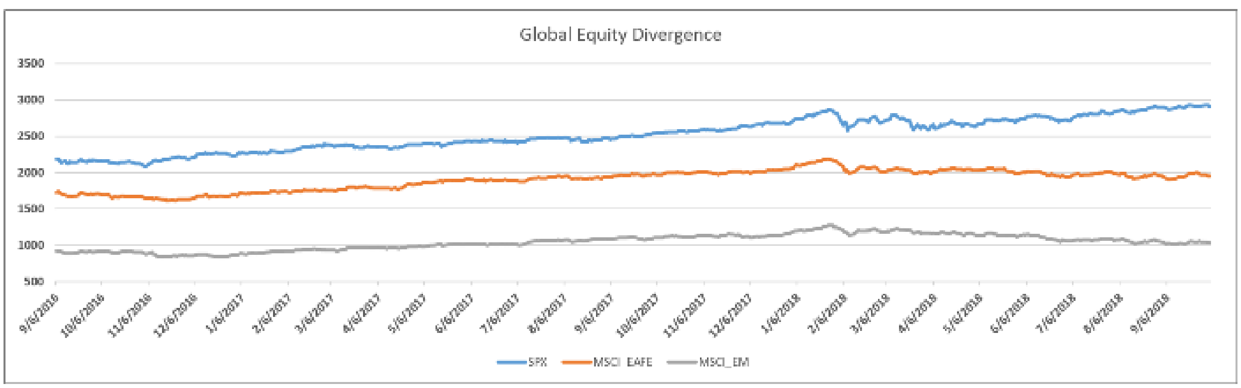
Figure 7: Bulls Prevail



Global Markets Divergence: Two trends are emerging in global financial markets in 3Q18: a strong U.S. equity performance and a widening performance gap between the United States and global equity markets. The U.S. markets were back to risk-on, as the S&P500 gained 6.7% in 3Q18, from 3.0% in 2Q18 and a 2.0% contraction in the first quarter of 2018. However, most of the 3Q18 gains came in the first two months of the quarter, with the index gaining less than 1% in September.

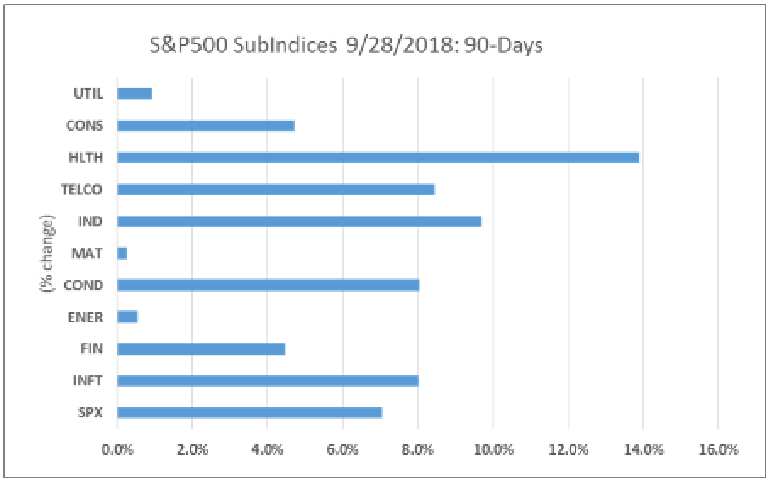
In the short term, the U.S. markets seemed to have become oblivious to political risks (both domestic and global), as well as trade tensions, focusing instead on the positive macroeconomic environment and the strong (at least in the short-term) earnings picture. In addition, markets have been supported by the surge in buybacks, expected to reach $770 billion in 2018 and almost $1 trillion in 2019. In contrast, equity markets outside the United States have been stressed by the strong dollar, trade tensions, emerging markets volatility and European fault lines, and global indices have lagged. The MSCI-EAFE (developed countries outside North America and the MSCI-EM (emerging markets were down at the end of 3Q18 by respectively 9.3% and 18% from their 2018 peak in January.

Figure 8: <u>A Widening Gap</u>



However, the markets have marked time in the first week of October. The S&P500 climbed to a record 2,925 on October 3, only to fall sharply in reaction to the Treasury sell-off at the end of the week, ending the week 2,894, a 2% drop from its record level of 2,939 on September 20th, a weekly decline. This volatility reflects the on-going fragility of the equity markets aging bull trends.

Figure 9: S&P500 Sub Indices



With earnings growth returning to more normal levels, we expect the equity markets to plateau, with a higher probability of a correction over the next few months. Four questions will dominate markets over the medium term: will the global bonds sell-off continue? Will oil prices hit $100/bbl? Will Congress flip in the Mid-term elections? And will the Emerging Markets troubles be contained?

September Data Releases

Economic Data Releases-September 2018	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP(2Q18 % Annualized, Third estimate)	4.2%	4.3%	4.2%	4.0%	4.5%
PCE Deflator(%, y/y) (August)	2.3%	2.3%	2.2%	2.2%	2.3%
Core PCE Deflator (%, y/y)	2.0%	2.0%	2.0%	1.9%	2.1%
CPI (%. y/y) (August)	2.9%	2.8%	2.7%	2.7%	3.0%
Core CPI (%, y/y)	2.4%	2.3%	2.2%	2.3%	2.5%
Employment					
First Time Claims ('000) (last week September)	215	213	207	210	220
Non-Farm Payrolls ('000), August	270	180	134	150	185
o/w Private Sector	254	175	121	145	190
Unemployment (U3, %) (July)	3.9%	3.8%	3.8%	3.8%	3.9%
Underemployment (U6, %)	7.4%		7.5%		
Labor Force Participation (%)	62.7%		62.7%		
Balance of Payments					
Trade Deficit $ billion) (July)	$50.00	$53.70	$53.20	$47.60	$54.00
Exports (% m/m)	-1.0%		-0.8%		
Imports (% m/m)	0.9%		0.6%		
Current Account Deficit ($ billion,2Q18)	$121.7	$104.0	$101.5	$102.0	$122.0
Dollar Index-eom (August)	95.14		95.3		
Oil Prices-eom (WTI, $/bbl) (August)	$69.80		$73.40		
Housing Market					
Housing Starts ('000) (August)	1,174	1,240	1,282	1,171	1,253
New Home Sales ('000) (August)	608	630	629	608	650
Existing Home Sales (MM) (August)	5.43	5.36	5.34	5.29	5.45
Construction Spending (%, m/m) (August)	0.2%	0.4%	0.1%	0.0%	0.6%
Case Shiller-20 City (%, m/m) (July)	0.2%	0.1%	0.1%	-0.2%	0.4%
Case Shiller-20 City (%, y/y)	6.4%	6.3%	5.9%	6.2%	6.4%
Industrial & Manufacturing					
Corporate Profits (y/y) 2Q18	6.7%		6.4%		
Bus Inventories (m/m) (August)	0.1%	0.5%	0.6%	0.2%	0.6%
Empire State (September)	25.6	23.0	19.0	20.0	25.0
Philadelphia (September)	11.9	19.0	22.9	13.9	21.1
Chicago PMI (September)	63.2	62.3	60.4	59.0	64.5
Markit PMI Mfg (September)	54.7	54.5	55.6	52.9	55.6
ISM Mfg (September)	61.3	59.9	59.8	59.0	61.0
Industrial Production (% m/m) (August)	0.4%	0.4%	0.4%	0.1%	0.5%
Manufacturing (% m/m) (August)	0.3%	0.3%	0.2%	0.2%	0.7%
Durable Goods (m/m) (August)	-1.2%	2.2%	4.5%	4.0%	4.5%
Durable Goods, ex transp (m/m)	0.2%	0.5%	0.1%	0.3%	1.0%
Durable Goods, Core Capital (m/m)	1.5%	0.4%	-5.0%	0.2%	0.4%
Factory Orders (m/m) m/m (August)	-0.5%	2.1%	2.3%	0.7%	3.1%
Services					
Markit PMI Services (September)	54.8	52.9	53.5	52.9	54.9
ISM Non-MFG (September)	58.5	58.0	61.6	57.0	59.0
Consumer Spending					
Retail Sales (% m/m) (August)	0.7%	0.4%	0.1%	0.2%	0.5%
Retail Sales, ex Gasoline, Food (% m/m)	0.9%	0.4%	0.2%	0.2%	0.4%
UMich Consumer Sentiment (end-September)	100.8	100.8	100.1	96.0	101.0
ConfBd Consumer Confidence (end-September)	134.7	131.7	138.4	130.0	134.3
Personal Income (%, m/m) (August)	0.3%	0.4%	0.3%	0.3%	0.5%
Personal Consumption Expenditures (%, m/m) (August)	0.4%	0.3%	0.3%	0.2%	0.4%

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.