Market Commentary

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Point of View

Stock Market

- near record highs
- driven by global expansion and earnings surge
- lower $USD
- stocks are not over-valued
- margins are likely sustainable
- Fed is still accommodative
- inflation is tame
- lack of irrational exuberance
- Are rising bond yields bad for stocks?

Point of View
Signal-to-Noise Ratio

Signal-to-noise ratio is sometimes used metaphorically to refer to the ratio of useful information to false or irrelevant data in a conversation or exchange. For example, in online discussion forums and other online communities, off-topic posts and spam are regarded as "noise" that interferes with the "signal" of appropriate discussion.[1]

Noise:

- G-7 trade spat
- China trade war
- North Korea
- global slowdown
- peak earnings
- inflation jump
- 3% bond yield
- rising dollar

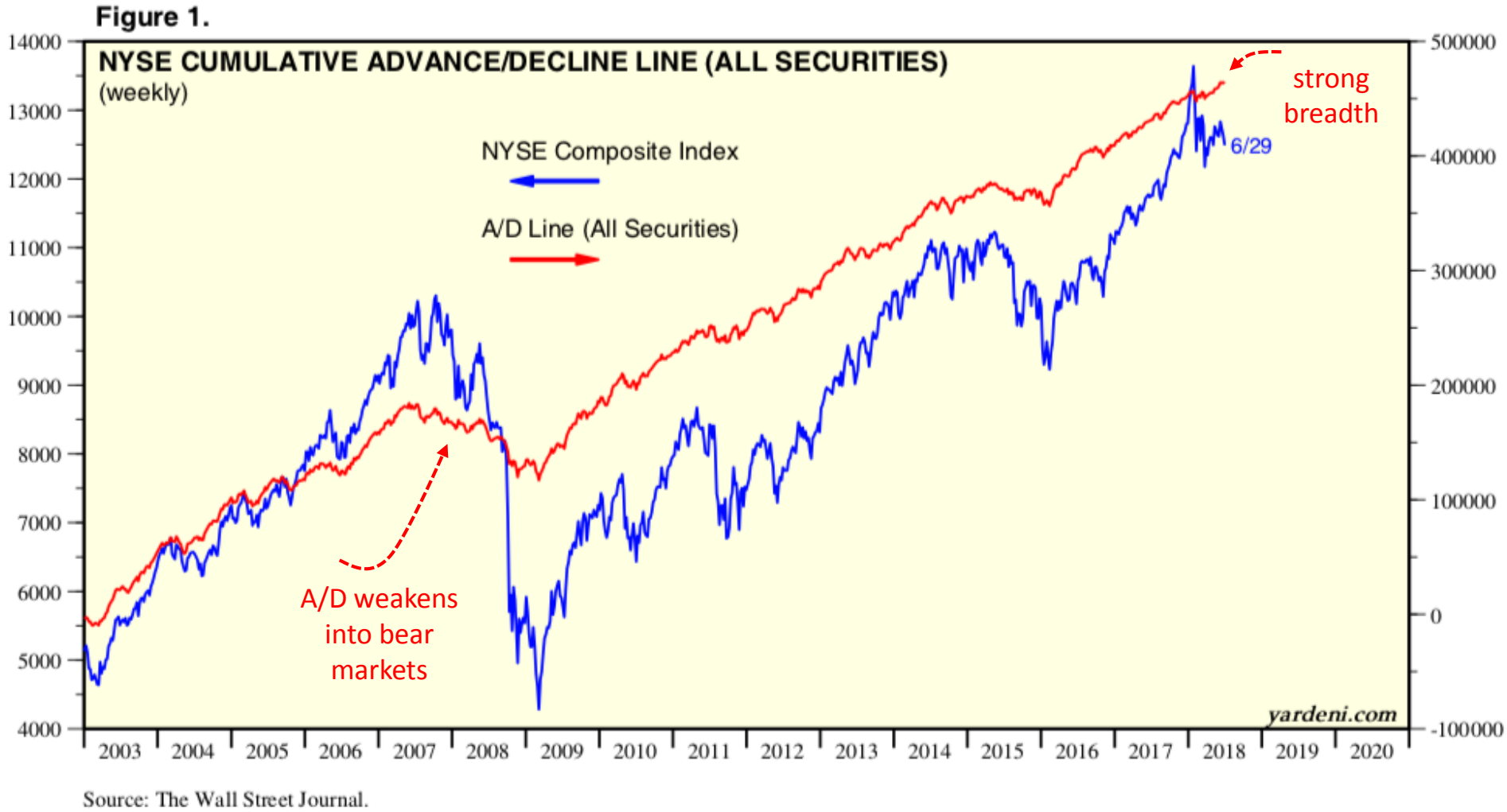
Signal:

- surging earnings
- surging U.S. economy

Despite the myriad distractions, investors are buying stocks on the “signal” of surging earnings and strong economic growth.

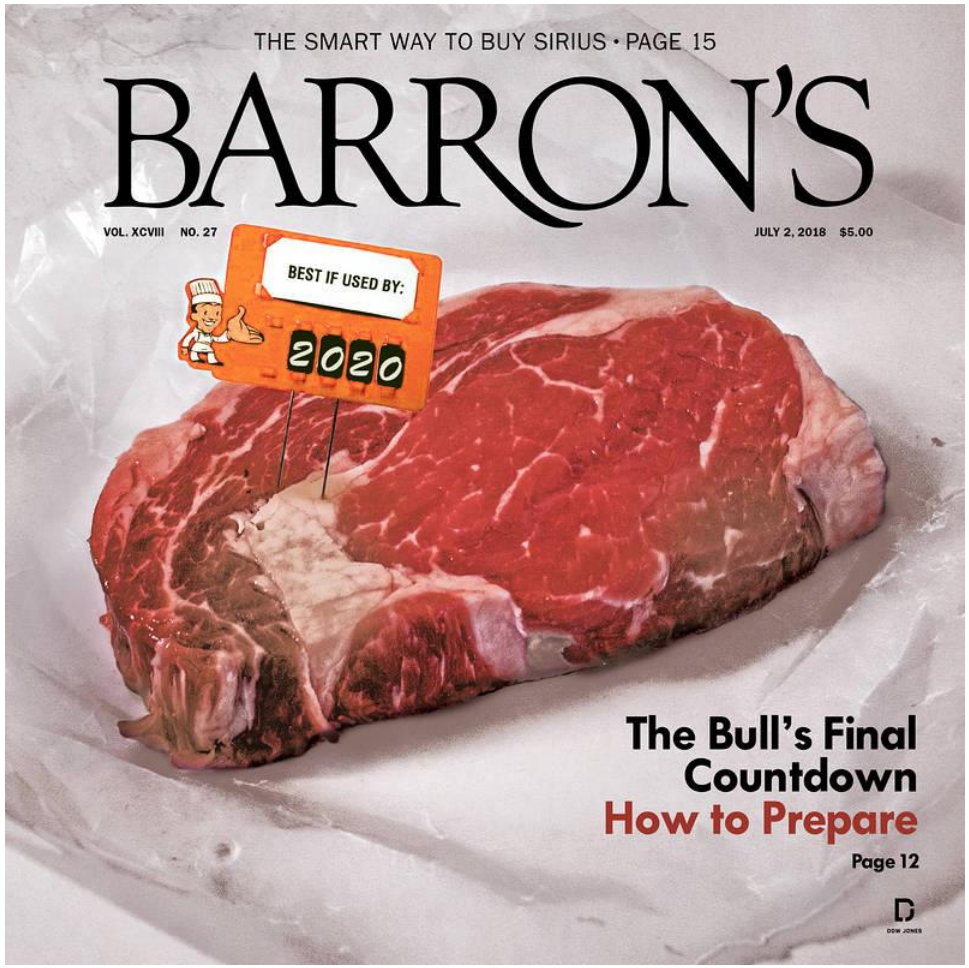
[1] Wikipedia, June 12, 2018.

Stock Market
S&P 500 Breadth – No Weakness



Source: Yardeni Research, Inc.

Stock Market
End of the Bull

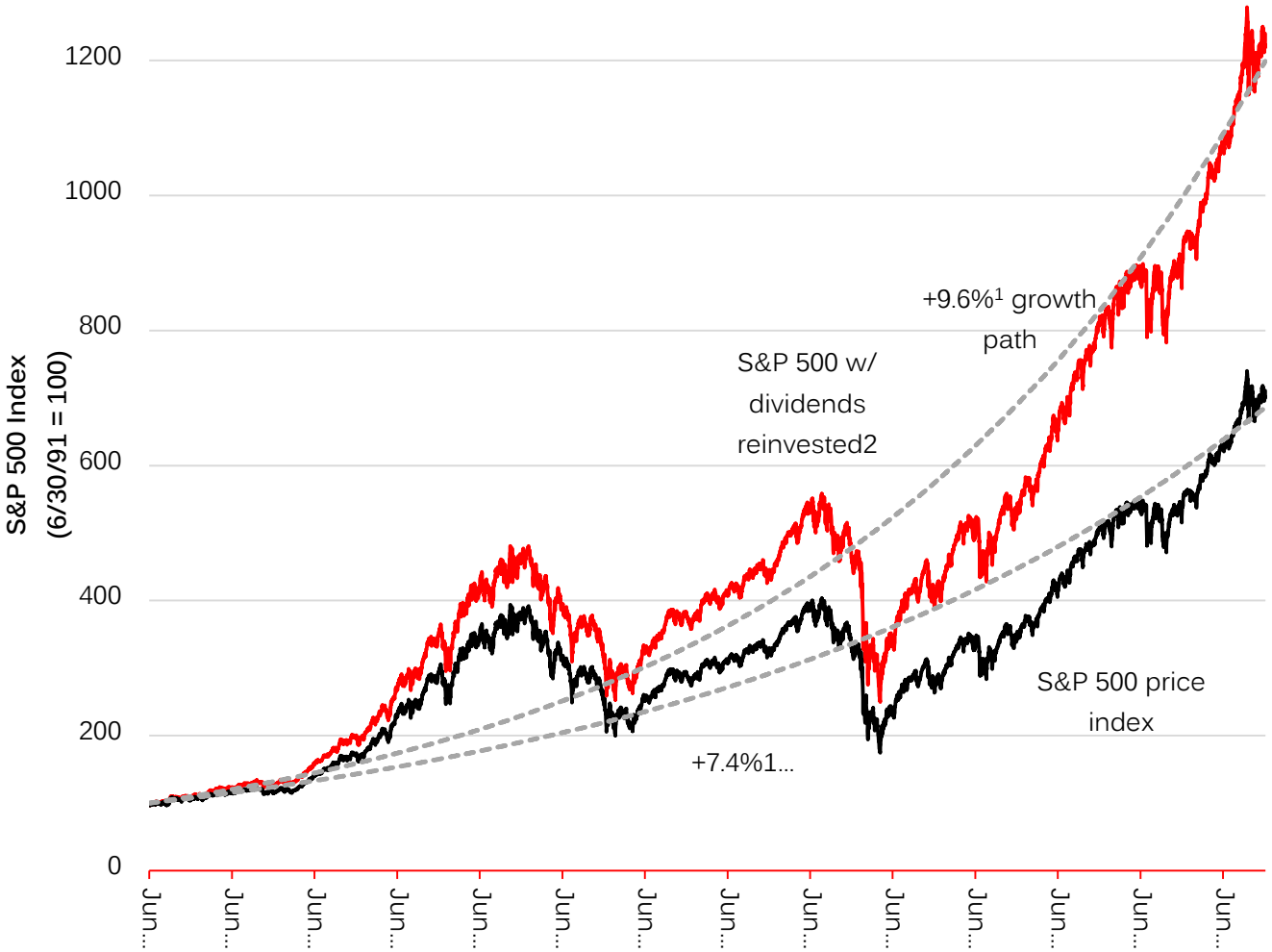


2020 expiration date:

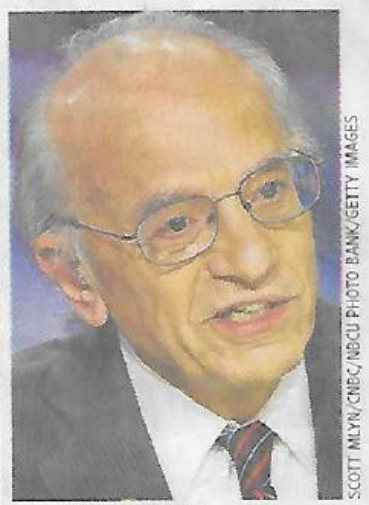
- The economy has been "juiced" by the tax cuts and spending package – which will fade.
- The Fed will be pushing rates higher and shrinking its balance sheet – monetary tightening.

Source: *Barron's*, July 2, 2018.

Stock Market Arithmetic
Total Return = 7.4% earnings-driven price + 2.2% dividends reinvested



+9.6% per year S&P 500 total return over the last 27 years is in line with the stock market's long-term returns going back to 1926, or back even further to 1871.[3]



Jeremy Siegel believes the Trump rally 'has a way to run.'

The Wall Street Journal
December 12, 2016

Source: Standard and Poor's. Data through July 6, 2018.[1] Compound annual growth rate. [2] S&P 500 total return index.
[3] per Professor Jeremy Siegel's seminal *Stocks for the Long Run*, first published in 1994.

Fed policy

- inflation has met Fed's target
- on a path of steady hikes to 3% fed funds rate
- the Fed manages the yield curve
- the Fed has created every recession since the 1950s
- the Great Unwinding: bond yields set to start rising
- the entire yield curve is shifting higher

Jobs Report Keeps Fed on Rate Track

By Nick Timiraos

The June employment report gives comfort to Federal Reserve officials who have played down concerns about the economy overheating and leaves them on track to continue gradually raising interest rates.

Unemployment rose slightly, but mostly because strong hiring drew more workers into the labor force, something Fed officials want to see.

The unemployment rate ticked up to 4% in June from 3.8% in May, even though a separate survey showed employers added 213,000 jobs last month.

The data showed a strong pop in labor-force participation—the share of adults holding or seeking jobs. The workforce grew by 601,000, reflecting a surge in re-entrants, or people who used to work but weren't actively looking for work before their recent employment.

The report keeps Fed officials on track to hold rates steady at their July 31 to Aug. 1 meeting and does little to change market expectations that the central bank will next raise rates in September.

Fed officials raised their benchmark federal-funds rate in June for the second time this year, to a range between 1.75% and 2%, and penciled in two more increases this year.

The report appears to offer something for everyone around the Fed's boardroom table. It provides support for officials who have argued that the unemployment rate has understated the level of the slack in the economy because of a potential reserve of workers who aren't actively looking for jobs.

The data provided few signs of a run-up in wage growth. Average hourly earnings of private-sector employees rose 2.7% in June from a year earlier, in line with the pace seen in earlier months this year.

On the other hand, officials concerned about the economy overheating can point to the rate of hiring, which could push unemployment to levels last seen 50 years ago if it isn't accompanied by sustained increases in labor-force participation of the sort seen in Friday's report.

While the report gives the Fed a little more breathing room to resolve this debate, just how much room depends on whether last month's growth in the labor force—a noisy data series because it bounces around frequently from one month to the next—can be sustained.

Fed Chairman Jerome Powell nodded to potential benefits and risks of a tight labor market in a speech last month. "While persistently strong economic conditions can pose risks to inflation and perhaps financial stability, we can also ask whether there may be lasting benefits," he said.

A tight labor market could draw more Americans back to the workforce while raising productivity and the potential for output to increase without raising inflation, he said.

Employers have added an average 215,000 jobs a month this year, well above the level Fed officials think is needed to hold the jobless rate steady absent increases in workforce participation rates.

The share of adults age 25 to 54 who are working ticked up to 79.3% in June, matching the highest level seen during the current expansion.

JEFF MORNHEAD/THE CHRONICLE-TRIBUNE/ASSOCIATED PRESS

A job fair in Indiana in May. The June unemployment numbers are expected to keep the Fed on track to raise interest rates.

Last Friday's June jobs report signaled some additional slack in the labor force and no run-up in wage gains.

Source: *The Wall Street Journal*, July 7-8, 2018.

Federal Reserve Policy
Yield Curve

The New York Times

What's the Yield Curve? 'A Powerful Signal of Recessions' Has Wall Street's Attention

By Matt Phillips
June 25, 2018

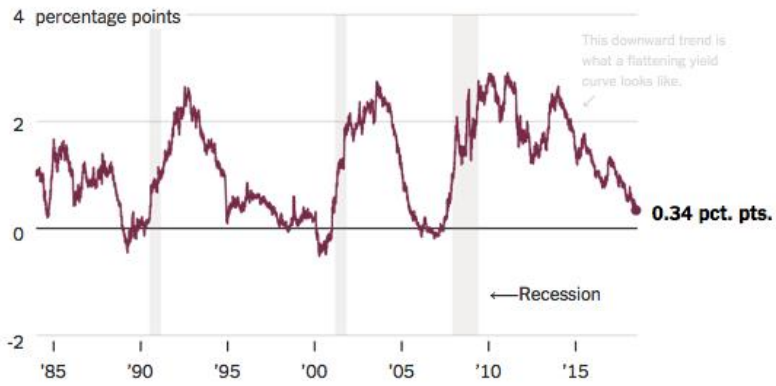
You can try to play down a trade war with China. You can brush off the impact of rising oil prices on corporate earnings.

But if you're in the business of making economic predictions, it has become very difficult to disregard an important signal from the bond market.

The so-called yield curve is perilously close to predicting a recession — something it has done before with surprising accuracy — and it's become a big topic on Wall Street.

This is the 2-year/10-year yield curve.
It's not the right curve to watch.

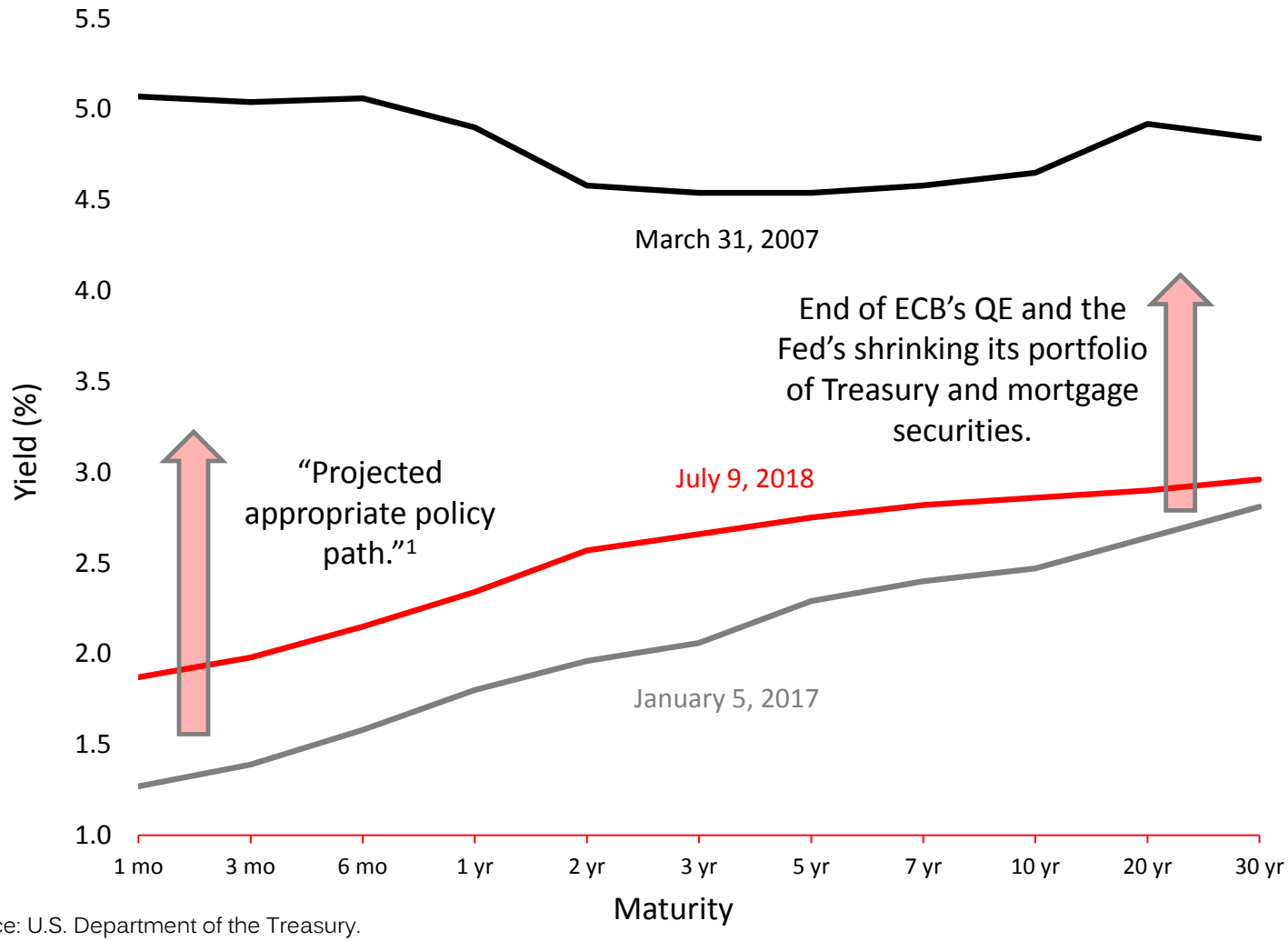
The yield curve, once it inverts, has a track record of **signaling that a recession is coming.**



By The New York Times | Source: Federal Reserve Bank of St. Louis | Note: Data as of June 21

Source: *The New York Times*, June 25, 2018.

Federal Reserve Policy
Policy Normalization Means Guiding the Entire Yield Curve Higher



The Fed is allowing its bond portfolio to gradually run off; and the ECB is planning to taper its QE program. Those two actions will probably result in gradually higher bond yields such that the shape of the yield curve could remain sloped, as is presently the case, as the entire curve shifts higher.

Source: U.S. Department of the Treasury.
[1] Federal Reserve projections released June 13, 2018.

Bond Yields

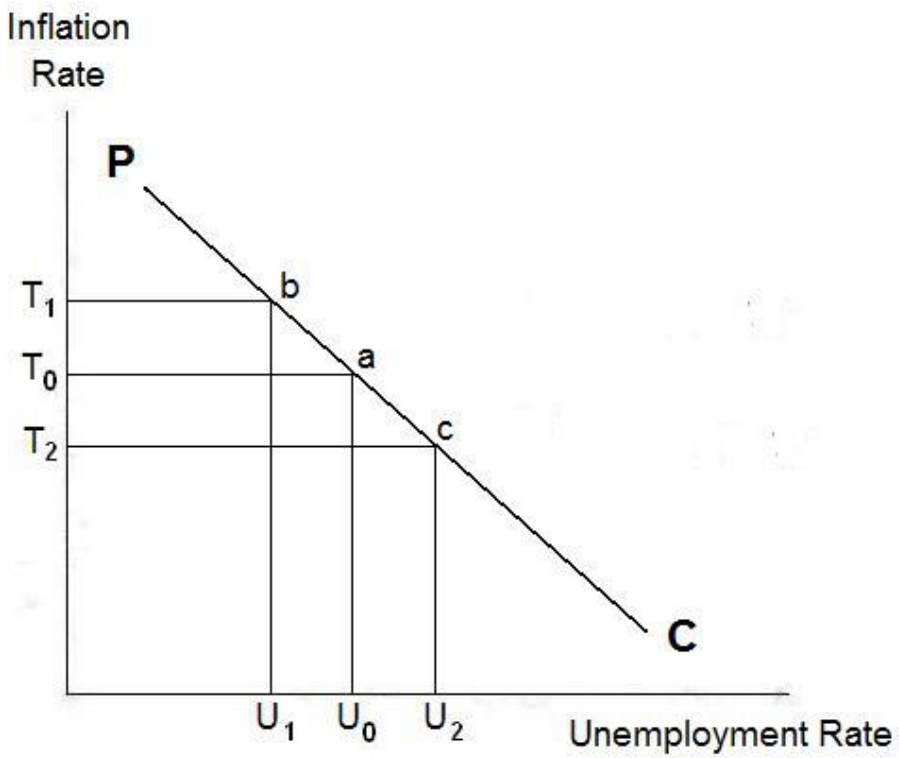
- recent lowest yields in history
- yields don't make sense fundamentally
- Fed's QE took yields to those levels
- yields might be higher absent the ECB's QE
- the wind-down of the ECB's QE will remove a weight on U.S. Treasury yields

Inflation

- What Phillips curve?
- headline PCED +2.3%, +2.0% core
- headline CPI +2.7%, +2.2% core
- employment cost inflation rising
- productivity drives declining unit labor costs
- inflation expectations are gradually rising

Inflation
Phillips Curve

Figure 1. The Phillips Curve

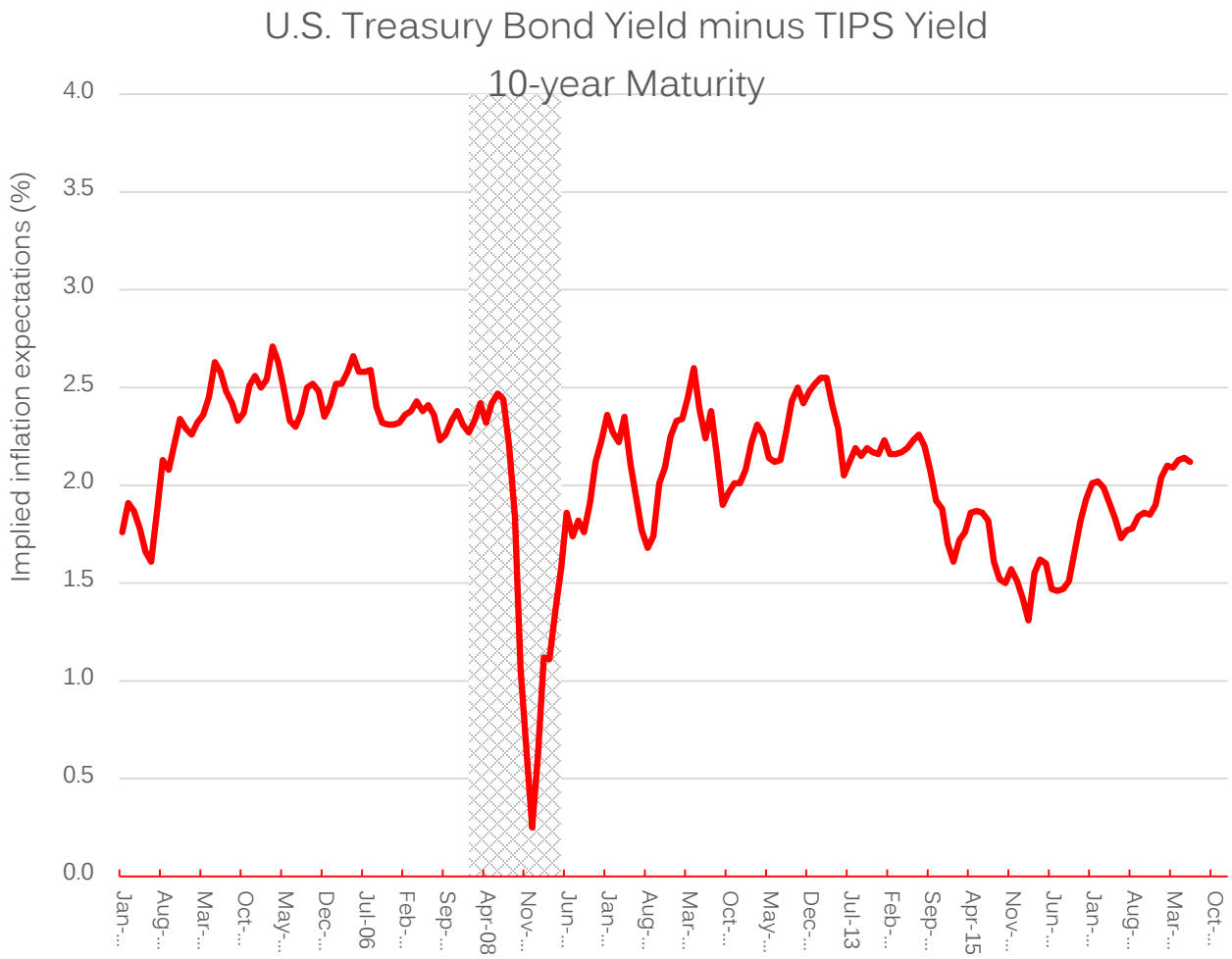


This simple schematic illustrates the common notion of an inverse relationship between inflation and the unemployment rate.

The theory behind the Phillips Curve: as labor becomes scarcer employers bid up wages, which are passed through to consumers in the form of higher prices.

This discussion is relevant at present because to the extent the Fed believes the Phillips Curve exists, today's record low unemployment rate might push them to head off higher inflation with more aggressive monetary tightening.

Bond Yields
Rising Inflation Expectations



The difference between the nominal 10-year Treasury bond yield and the TIPS yield gives the market's opinion for a 10-year inflation forecast.

Rising inflation expectations but still modest by historic comparison.

Source: Federal Reserve. Monthly data through June 2018.

Economy

full-employment economy operating at full potential

+3.0% GDP growth forecast, compared to post-recession +2.2% average

surge in LEI, small business optimism index, recovery in business investment
healthy growth in personal income, real DPI, strong retail sales
strong household balance sheets, savings rate, FICO scores and low household financial obligations ratio
record high PMIs, strong hiring, record high job openings, new low unemployment rate, record low weekly unemployment claims, strong vehicle sales, rising housing starts

inflation expectations are rising

"I feel this is pretty much a Goldilocks economy. … I see this is all pretty positive."

John Williams
President nominee of the New York Federal Reserve Bank and vice chairman of the FOMC
May 4, 2018

Source: *The Wall Street Journal*, June 4, 2018.

Global Economy
Global Economies are Booming

J.P.Morgan

PMI™ By IHS Markit

Uptick in April and May

News Release

MARKET SENSITIVE INFORMATION
EMBARGOED UNTIL: 1100 (New York) / 1500 (UTC) July 5th 2018

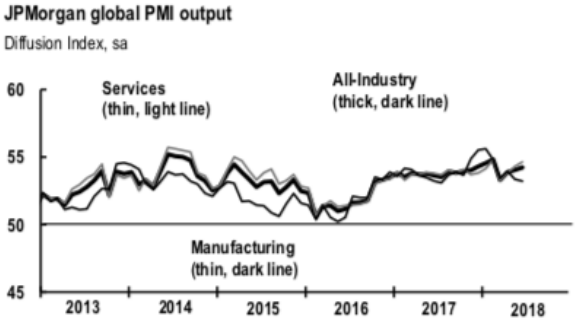
J.P.Morgan Global Manufacturing & Services PMI™

Produced by J.P.Morgan and IHS Markit in association with ISM and IFPSM

Stronger services growth takes Global PMI to four-month high

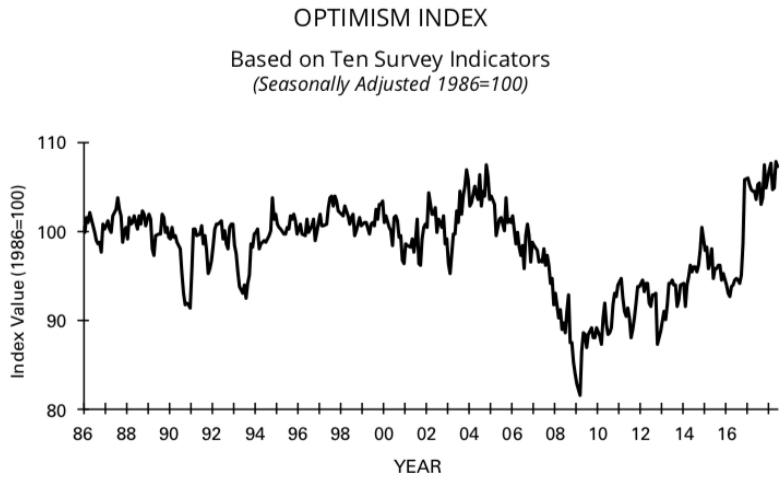
The end of the second quarter saw a mild improvement in the rate of global economic expansion. Output growth accelerated to a four-month high and was among the best over the past three-and-a-half years. The solid trend in job creation was also sustained, with the rates of increase achieved since August 2017 better than those registered throughout much of the prior decade.

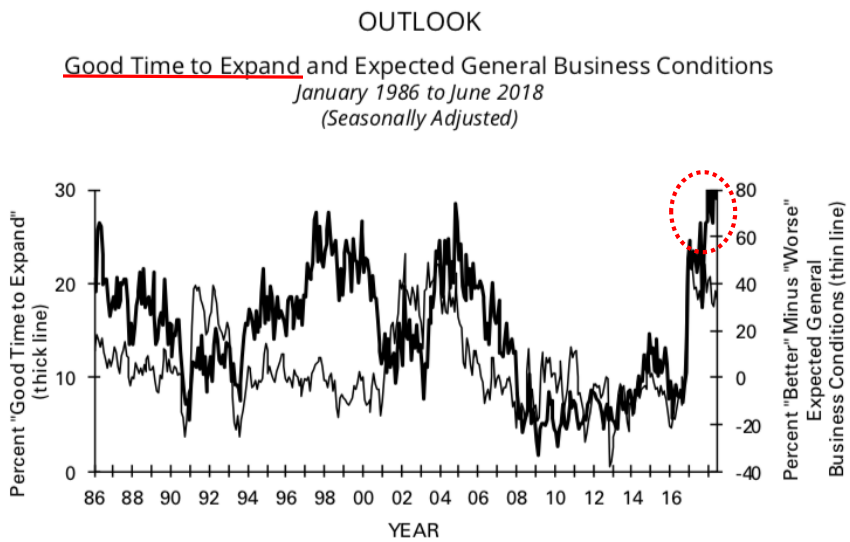
The J.P.Morgan Global All-Industry Output Index[1,2] – which is produced by J.P.Morgan and IHS Markit in association with ISM and IFPSM – rose to 54.2 in June, up from 54.0 in May. The headline index has signalled expansion for 69 consecutive months.



Source: IHS Markit Ltd., July 5, 2018.

Economic Data
Small Business Optimism Index - Gangbusters





Source: NFIB. Data released July 10, 2018.

released this morning

The Small Business Optimism Index posted its sixth highest reading in survey history for the month of June, at 107.2, down 0.6 from May. "Small business owners continue to report astounding optimism as they celebrate strong sales, the creation of jobs, and more profits," said NFIB President and CEO Juanita Duggan. "The first six months of the year have been very good to small business thanks to tax cuts, regulatory reform, and policies that help them grow." Highlights from the June report include:

- Owners reported some of the strongest nominal sales in years.
- Plans to invest in additional inventories advanced solidly.
- Plans to create new jobs posted a solid gain and the percent of owners with open positions tied the record high.
- Reports of compensation increases remained historically high and finding qualified workers easily held on to the top spot in the "*single most important business problem*" list.

Economic Data
Small Businesses

Small businesses play a major role in the American economy:

- Represents 99% of all employer firms
- Employ about half of private-sector employees
- Generated 60% to 80% of net new jobs annually over the last decade
- Create more than half of nonfarm private gross domestic product (GDP)

Table 2.

Percentage of Total Employment by Enterprise Employment Size: 2003–2012

(For information on confidentiality protection, sampling error, nonsampling error, and definitions, see *www.census.gov/econ/susb/methodology.html*)

Enterprise employment size	Percentage of total employment									
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Enterprises with fewer than 500 employees	50.7	50.9	50.4	50.2	49.6	49.4	49.2	49.1	48.5	48.4
Very small enterprises	18.4	18.4	18.3	18.0	18.1	17.8	18.1	18.4	17.9	17.6
Small enterprises	17.8	17.9	17.6	17.6	17.3	17.1	16.9	16.6	16.6	16.7
Medium enterprises	14.5	14.6	14.5	14.6	14.2	14.5	14.1	14.2	14.0	14.0
Large enterprises	49.3	49.1	49.6	49.8	50.4	50.6	50.8	50.9	51.5	51.6

Source: U.S. Census Bureau, 2012 Statistics of U.S. Businesses.

Sources: National Federation of Independent Business website (top panel); U.S. Census Bureau, Statistics of U.S. Businesses Employment and Payroll Summary: 2012, released February 2015 (bottom panel)..

Economic Data
Bank Loans

Businesses Crank Up Borrowing At Banks

By Rachel Louise Ensign

Business borrowing is picking up, a welcome relief for banks and a sign of strength for the U.S. economy.

Preliminary second-quarter data from the Federal Reserve indicate the year-over-year growth rate of business loans rose to 5.5% in late June from less than 1% near the end of 2017. The upturn marks the reversal of a slump in business-loan growth that began in earnest about two years ago.

The rebound reflects increased confidence at companies. In April, Manvee, a Milwaukee wholesale bakery, decided to take out loans for more than $4 million from Indiana-based lender **Old National Bancorp**, said co-owner Thomas Roepsch.

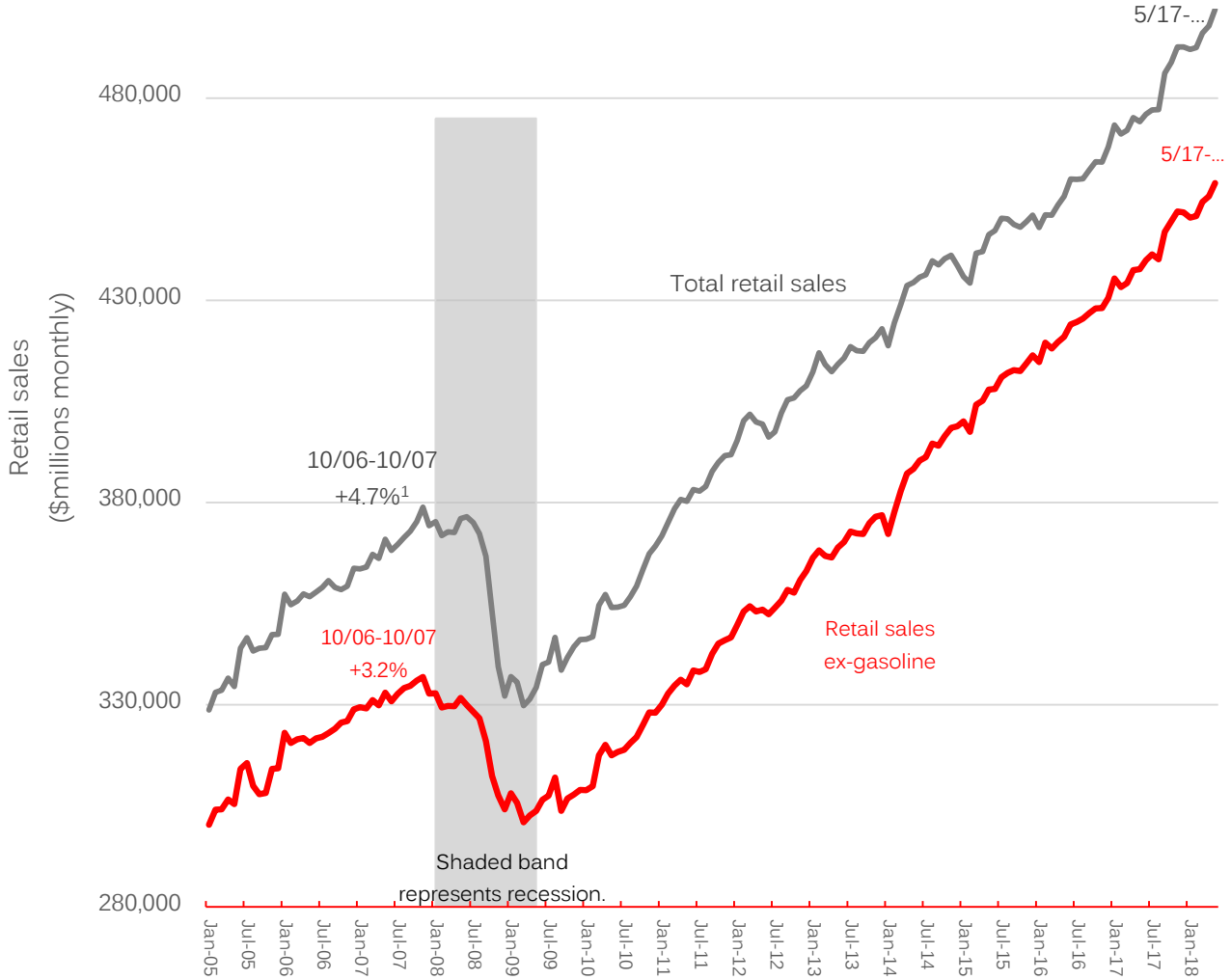
"We're trying to keep up with growth," he said. "People are knocking on the door asking for more of our products."

Manvee plans to use the loan to expand into Indiana and invest in automation and delivery trucks, he said.

Optimism leads to business borrowing and spending.

Source: *The Wall Street Journal*, July 9, 2018.

Economic Data
Retail Sales



Retail sales are booming, growing faster than pre-recession.

May ex-gasoline +4.9% y/y.

Source: U.S. Census Bureau. Data through May 2018. [1]In the year 10-06-10/07 the price of crude oil surged +46% causing consumer expenditures on gasoline to surge as well.

Trade
U.S. Imports and Exports % of GDP

- The U.S. imported $524 billion from China last year. So, the President's tariffs of $150 billion covers 29% of Chinese imports.
- 59% of the U.S. trade deficit comes from Chinese imports.
- 8% of total U.S. exports go to China.

- U.S. exports to China comprise 1.0% of U.S. GDP.
- China's exports to the U.S. comprise 4.1% of China's GDP.

this is key

Source: U.S. Census Bureau. Includes goods and services. Data for 2017. China's 2017 GDP was $12.86 trillion, reported by the South China Post 1/18/2018.

Trade
A (Hopefully) Positive Outcome

'The world will not do something stupid'

Tae Kim | @firstadopter
Published 8 Hours Ago | Updated 7 Hours Ago

CNBC

- Warren Buffett is optimistic the U.S. and China will avoid a serious trade conflict.
- "It's counter to the interests of every country in the world. The world thrives on trade," Buffett tells CNBC.

Wilbur Ross's goal:

"We're going to go through some bumps in the road, but the target is elimination of tariffs or other barriers," said Mr. Ross. "The net effect will be much more freedom and more global trade."

Source: *The Wall Street Journal,* July 9, 2018.

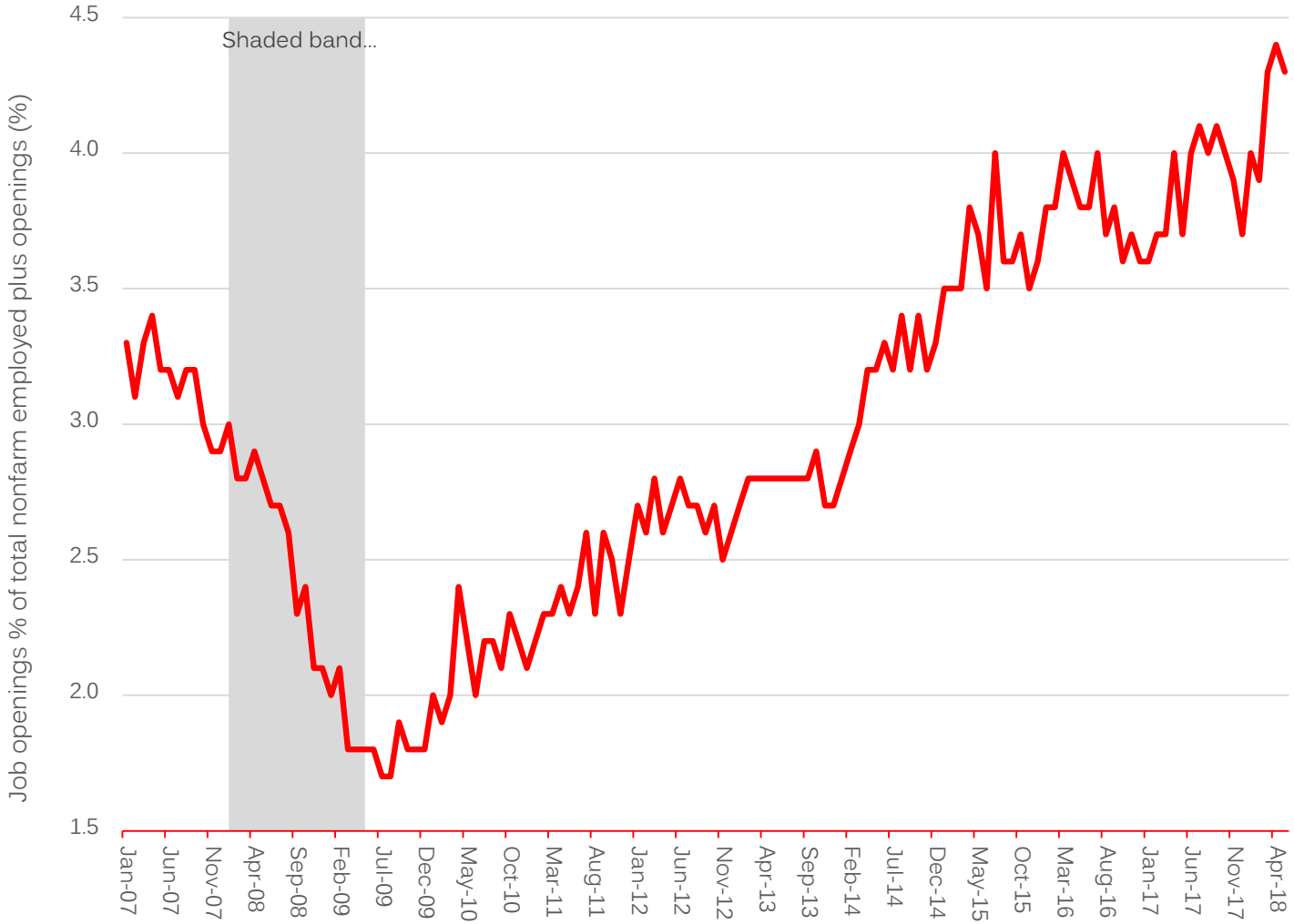
Warren's not worried.

Source: *CNBC* website, May 7, 2018.

Jobs

- full-employment
- new jobs will soon be limited
- good news in part-timers data
- record job openings
- declining participation rate due to ageing
- Still some slack?
- strong relative U.S. job formation forecast long-term
- strong real wage and income growth
- mean and median incomes bottomed
- myth: "... but we're not creating good jobs"

Economic Data – Jobs
Job Openings Rate – Record High



Breakout to record highs.

Source: U.S. Department of Labor, NBER. Data through May 2018, released July 10, 2018. The job openings rate is computed by dividing the number of job openings by the sum of employment and job openings and multiplying that quotient by 100.

Crude oil

- price rebound with OPEC cut
- U.S. rig count collapse and rebound
- U.S. production rising to fill OPEC cuts

Federal budget

- CBO's March 2018 forecasts
- the entitlements problem hasn't gone away
- rising debt/GDP ratio
- low U.S. tax burden allows flexibility to solve long-term entitlements problem

Federal Deficit and Debt
Federal Debt % of GDP through 2047

Source: Congressional Budget Office (CBO), *The 2017 Long-Term Budget Outlook*, March 2017; and CBO's April 2018 *The Budget and Economic Outlook: 2018 to 2028*. [1]CBO's 10-year and extended baselines generally reflect current law and are meant to serve as benchmarks for measuring the budgetary effects of proposed changes in federal revenues or spending. They are no meant to be predictions of future budgetary outcomes; rather, they represent CBO's best assessment of how the economy and other factors would affect revenues and spending if current law generally remained unchanged.

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