Market Commentary

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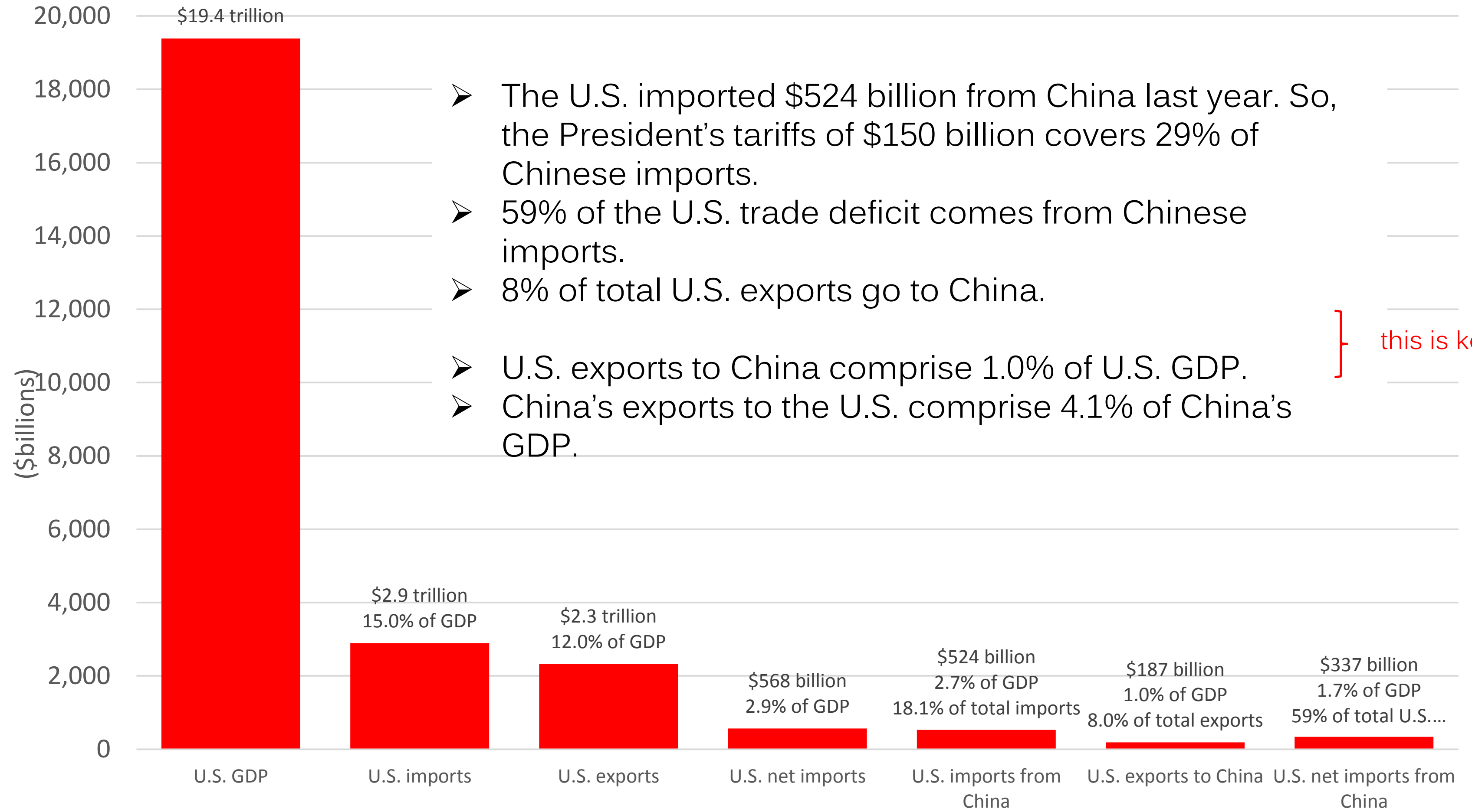
Nervousness

- Tariffs
- The Fed and the Yield Curve
- The Economy

Trade
U.S. Imports and Exports % of GDP



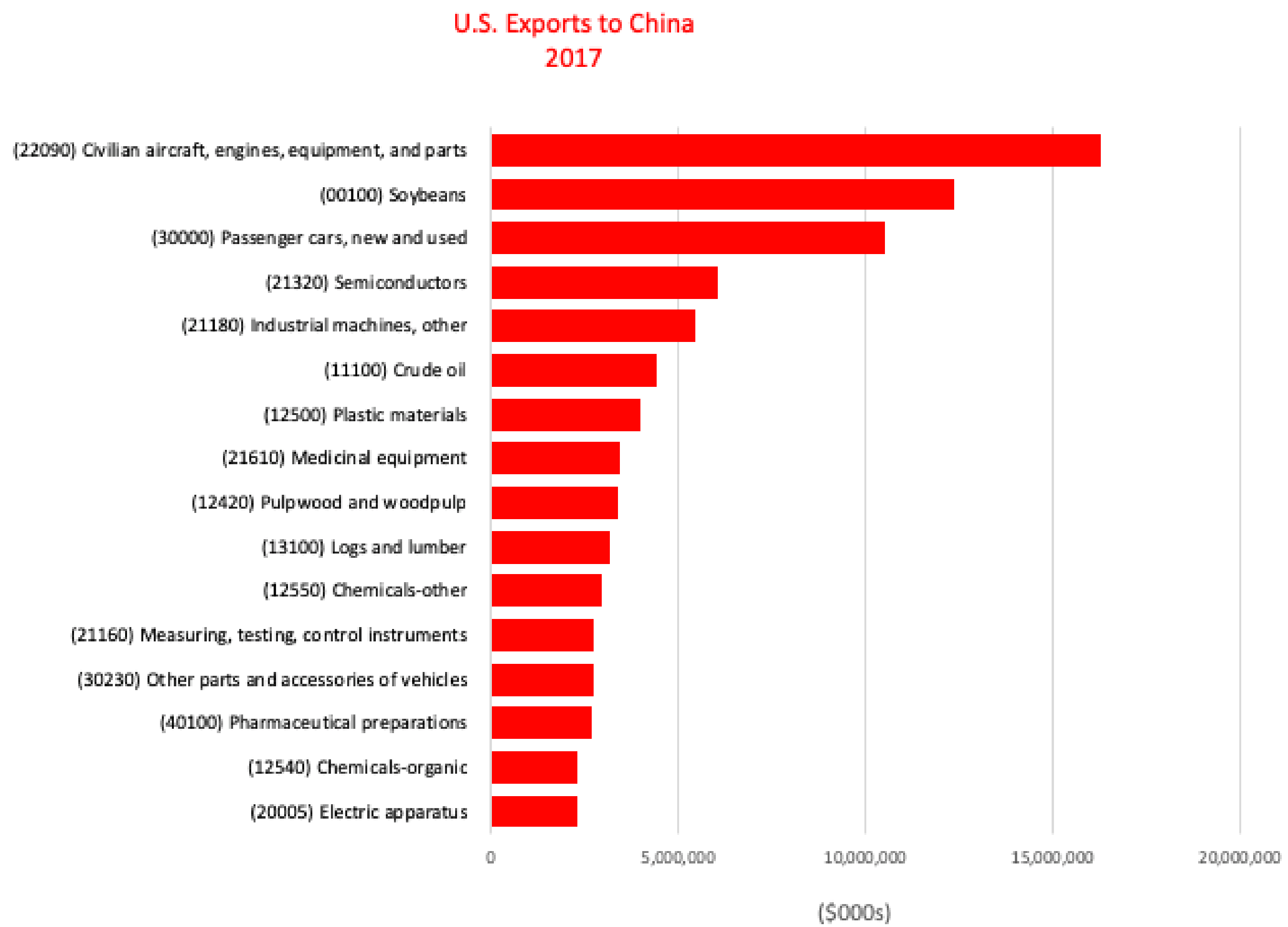
- The U.S. imported $524 billion from China last year. So, the President's tariffs of $150 billion covers 29% of Chinese imports.
- 59% of the U.S. trade deficit comes from Chinese imports.
- 8% of total U.S. exports go to China.

- 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

1/18/2018.

Trade
U.S. Exports to China



Aircraft and soybeans are our biggest exports to China.

Source: U.S. Census Bureau. Data for 2017.

Fed policy

- On a path to 3% fed funds rate -- maybe
- Fed funds rate close to “neutral”
- “Now is a good time to take stock …”
- 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

Federal Reserve Policy Moving Dovish

October 3, 2018
Chairman Powell:
“Interest rates are still accommodative, but we’re gradually moving to a place where they will be neutral. We may go past neutral, but we’re a long way from neutral at this point, probably. [PBS interview][stock market plunged]

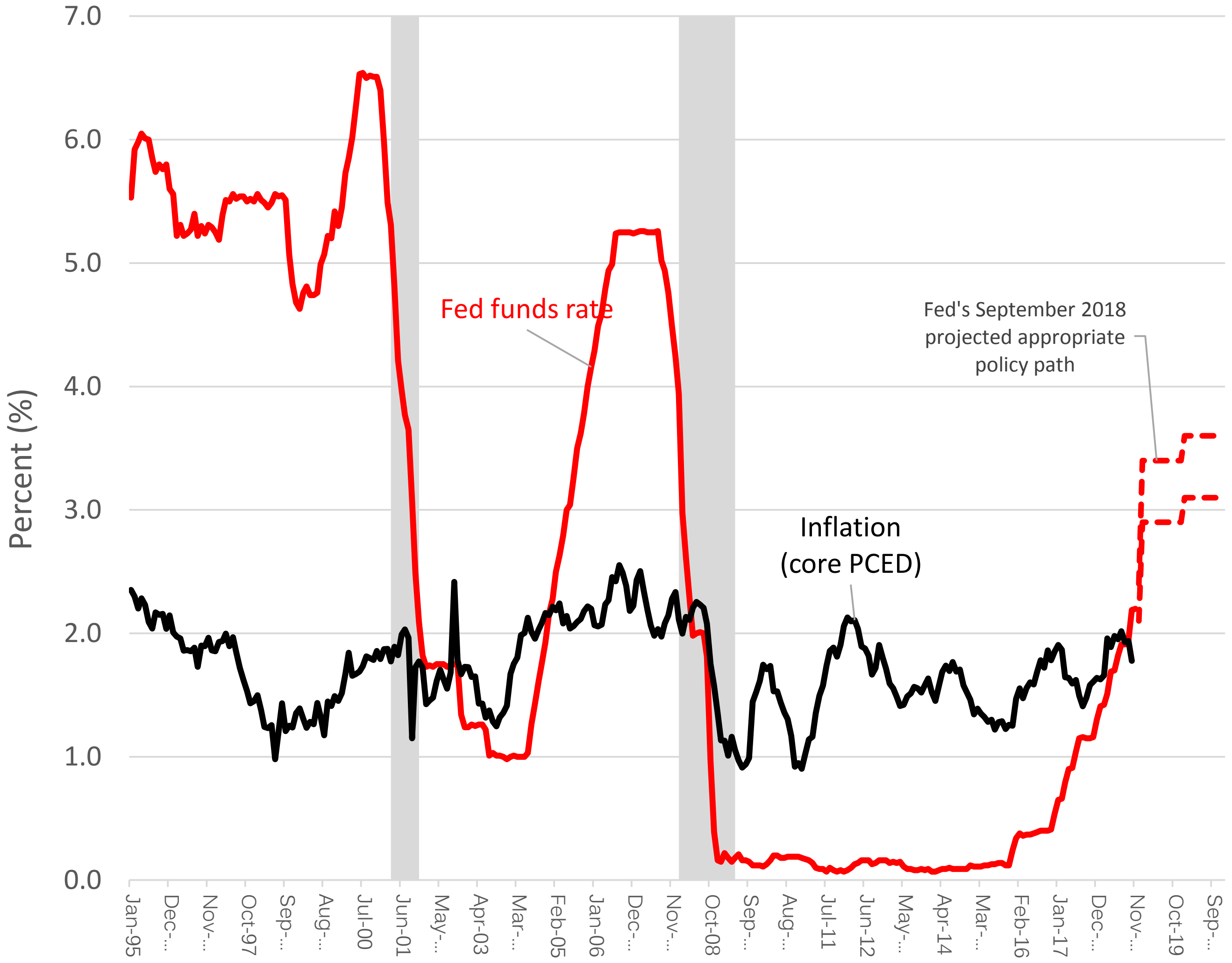
October 25, 2018
Vice Chairman Clarida:
“However, even after our September decision, I believe U.S. monetary policy remains accommodative.” [Speech at Peterson Institute]

November 15, 2018
Atlanta Fed President Bostic
"I don't think we are too far from a neutral policy, and neutral is where we want to be," Bostic said in prepared remarks for a speech in Madrid. "We may not be there quite yet, but I am inclined to think that a tentative approach as we proceed would be appropriate.” [CNBC]

November 16, 2018
Vice Chairman Clarida:
"As you move in the range of policy that by some estimates is close to neutral, then with the economy doing well it's appropriate to sort of shift the emphasis toward being more data dependent." [CNBC]

November 15, 2018
Chairman Powell:
"With labor market conditions close to maximum employment and inflation near our 2 percent objective, now is a good time to take stock of how we formulate, conduct, and communicate monetary policy," said Federal Reserve Chairman Jerome H. Powell. [Federal Reserve press release]

Federal Reserve Policy
Heading toward “neutral”



Until now, the Fed has kept the fed funds rate well below the rate of inflation – which constitutes stimulative monetary policy.

Historically, the fed funds rate was far higher than inflation immediately preceding recessions.

Source: Federal Reserve and BLS, monthly data. PCED through October 2018. Fed funds rate through November 2018.

Federal Reserve Policy
Yield Curve

FRBSF Economic Letter

2018-20 | August 27, 2018 | Research from the Federal Reserve Bank of San Francisco

Information in the Yield Curve about Future Recessions

Michael D. Bauer and Thomas M. Mertens

The ability of the Treasury yield curve to predict future recessions has recently received a great deal of public attention. An inversion of the yield curve—when short-term interest rates are higher than long-term rates—has been a reliable predictor of recessions. The difference between ten-year and three-month Treasury rates is the most useful term spread for forecasting recessions—without any adjustment for an estimate of the underlying term premium. However, such correlations in the data do not identify cause and effect, which complicates their interpretation.

The 2-year/10-year yield curve is not the right curve to watch.

Source: Federal Reserve Bank of San Francisco, August 27, 2018.

Economy

full-employment economy operating at full potential

+2.4% GDP growth forecast, compared to post-recession +2.2% average

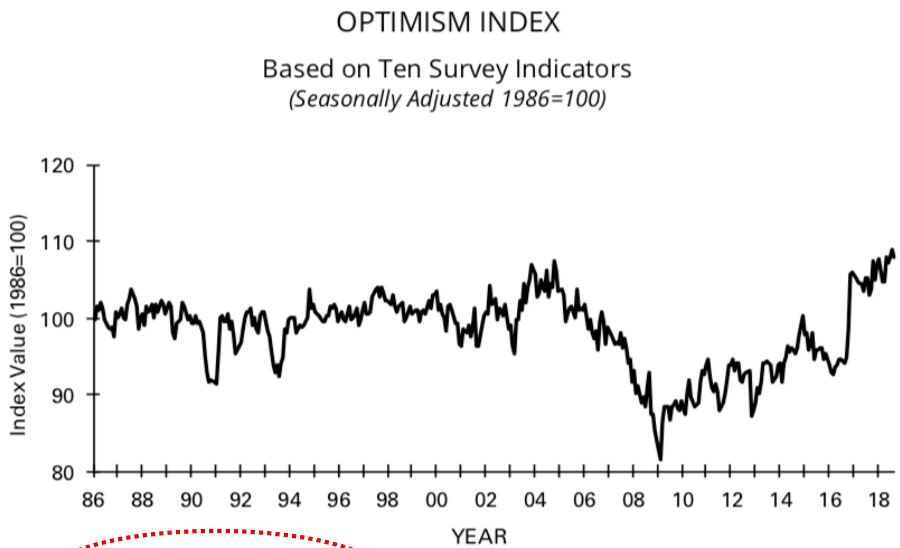
surge in LEI, small business optimism index, recovery in business investment
healthy growth in personal income, real DPI, strong retail sales
strong household balance sheets, savings rate, record FICO scores and low household financial obligations ratio
record high PMIs, strong hiring, record high job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

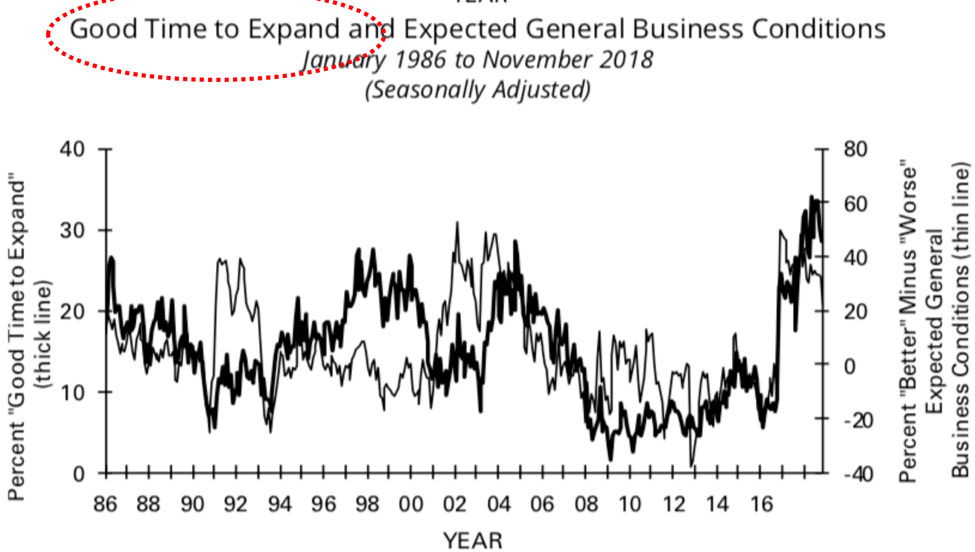
inflation expectations are anchored

"Information received since the Federal Open Market Committee met in September indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has declined. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year."

Federal Reserve Press Release
November 8, 2018

Economic Data
Small Business Optimism Index - Gangbusters



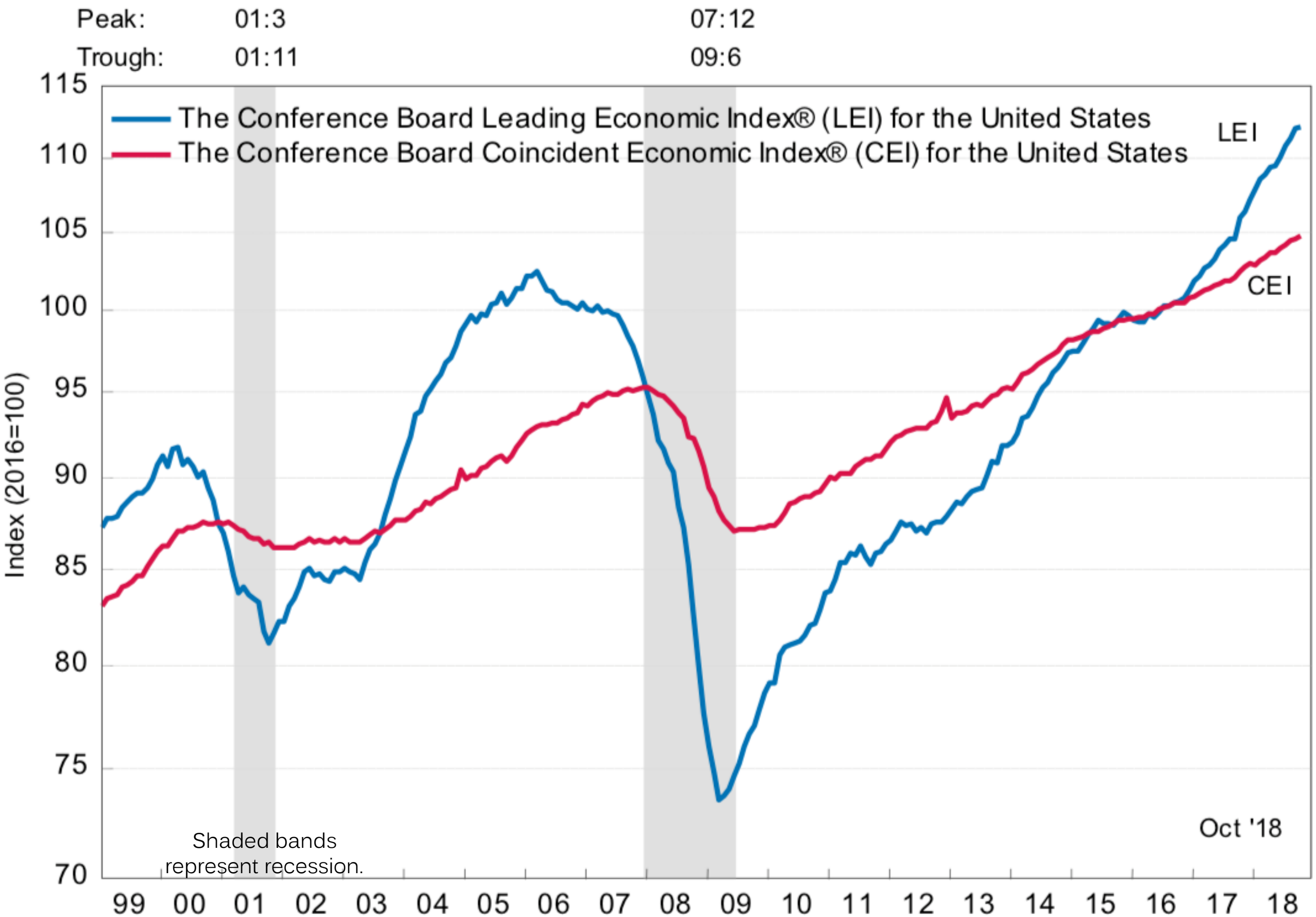


"The November reading continues the string of exceptionally strong readings that started with the 2016 election results. Labor markets remain extremely tight, with a record 25 percent of owners identifying the scarcity of qualified (not just "skilled") labor as their top business problem. Capital spending and job creation plans improved. Job openings gained 6 points, although inventory investment plans faded. Expected real sales and expected business conditions six months out did fall 7 and 5 points respectively, and the percent viewing the current period as a good time to expand lost 1 point. On balance, optimism faded modestly in November, but the decline seems unrelated to the election."

Expansion plans still near record highs.

Source: NFIB. November data released December 11, 2018.

Economic Data
U.S. Index of Leading Economic Indicators - Downtick



Up +0.1% in October, down from +0.5% in September and +0.4% in August

September Commentary:
"Economic growth could exceed 3.5 percent in the second half of 2018."

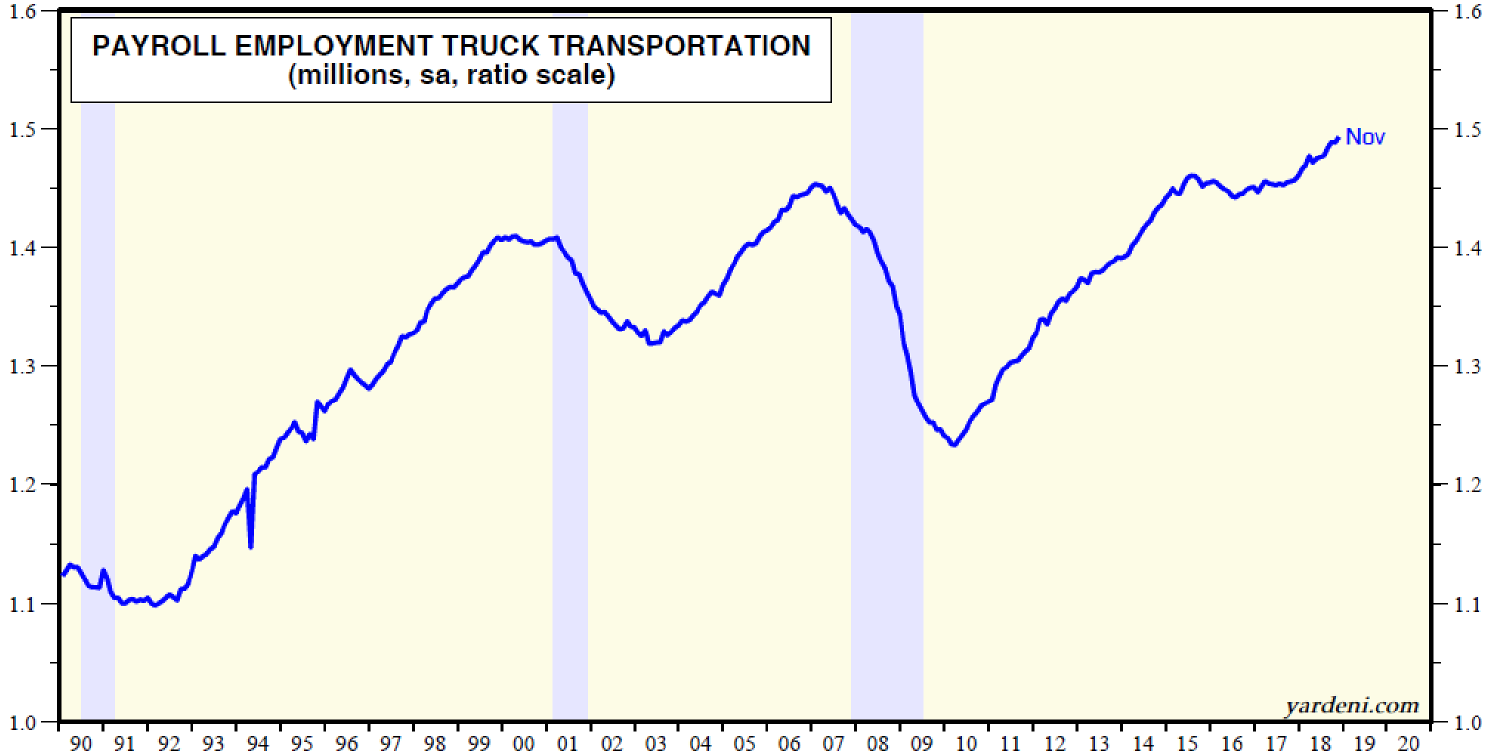
October Commentary:
"The US LEI increased slightly in October, and the pace of improvement slowed for the first time since May. The index still points to robust economic growth in early 2019, but the rapid pace of growth may already have peaked. While near term economic growth should remain strong, longer term growth is likely to moderate to about 2.5 percent by mid to late 2019."

This chart shows how the LEI has definitively rolled over well in advance of the last two recessions.

The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers' new orders – consumer goods and materials; 4) ISM index of new orders; 5) manufacturers' new orders, nondefense capital goods; 6) building permits – new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury less fed funds; 10) index of consumer expectations.,
Source: ©The Conference Board. Data through October 2018, released November 21, 2018.

Economic Data
Another Leading Indicator

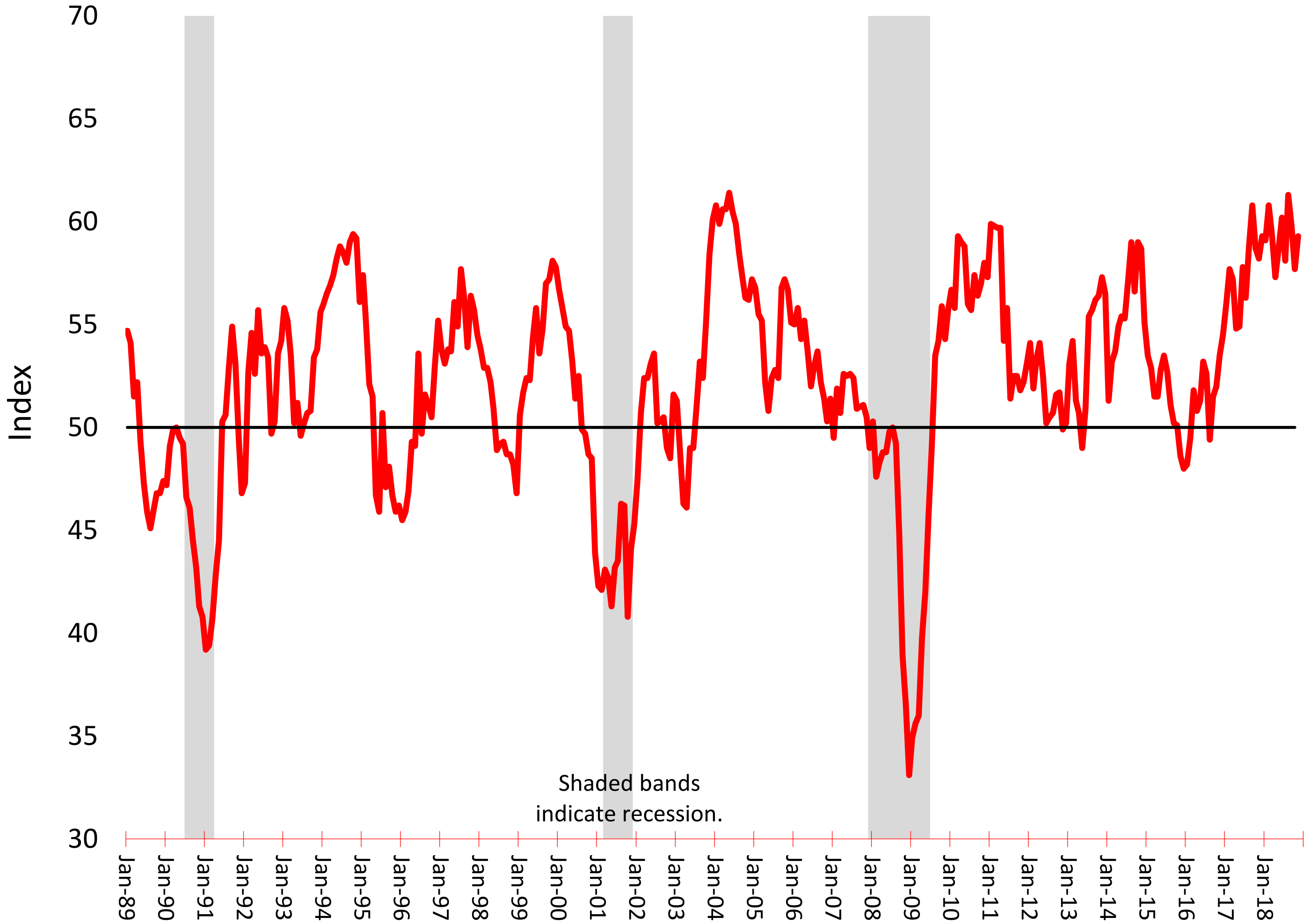
Figure 12.



The number of drivers has peaked prior to economic slowdowns.

Source: Yardeni Research, Inc., December 11, 2018. BLS and NBER data.

Economic Data
ISM Manufacturing Purchasing Manager Index - Booming



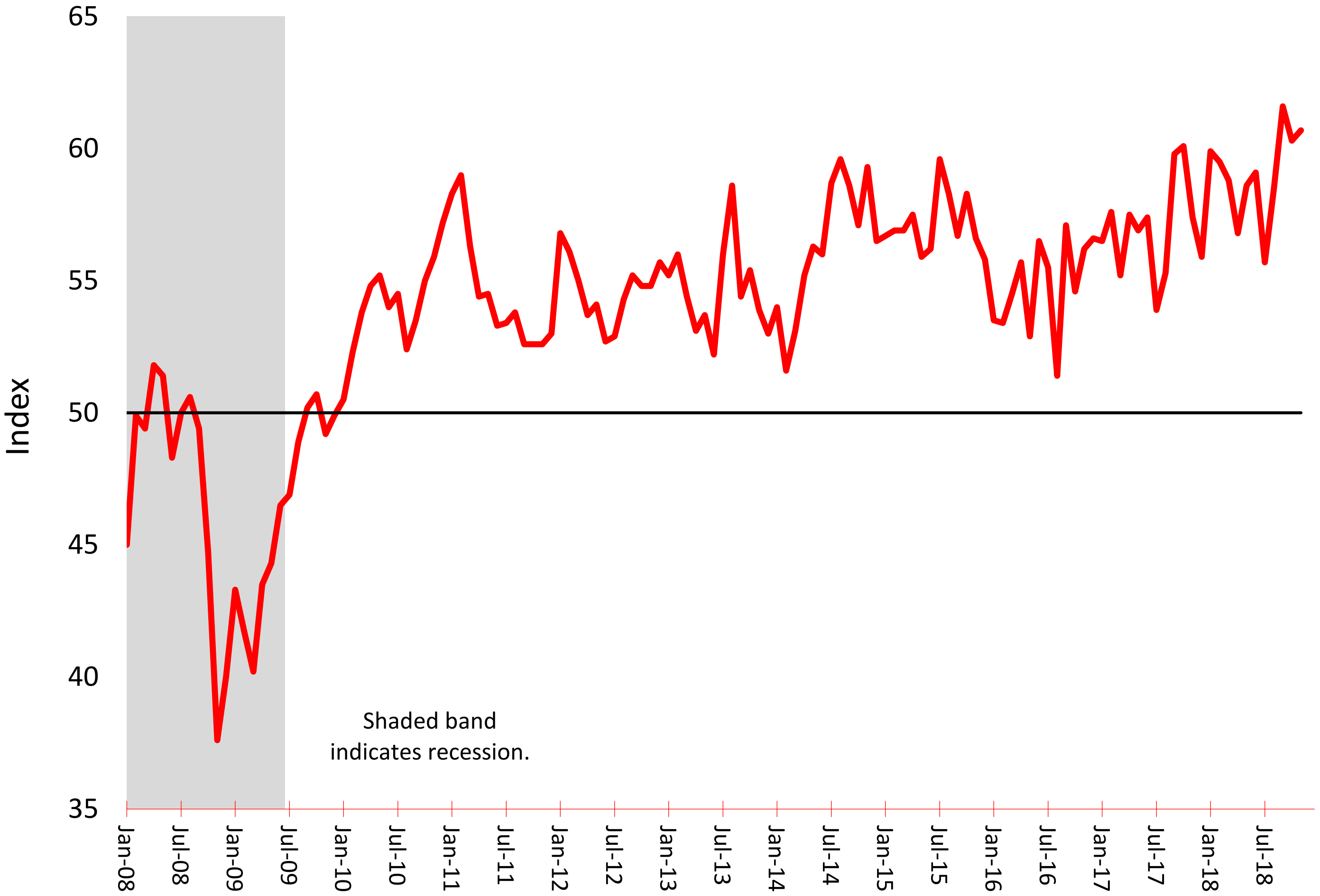
November at 59.3 ticked up from October's 57.7. New orders at 62.1 jumped from October's 57.4.

Note the historic volatility in the manufacturing PMI.

Note how this indicator has slumped well below 50 even during periods of strong economic expansion, eg. 1995, 1999, 2003, 2013.

Source: Copyright 2018, Institute for Supply Management. Data through November 2018.
ISM: "A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. A PMI in excess of 43.1 percent, over a period of time, generally indicates an expansion of the overall economy."

Economic Data
ISM Non-Manufacturing Purchasing Manager Index - Booming



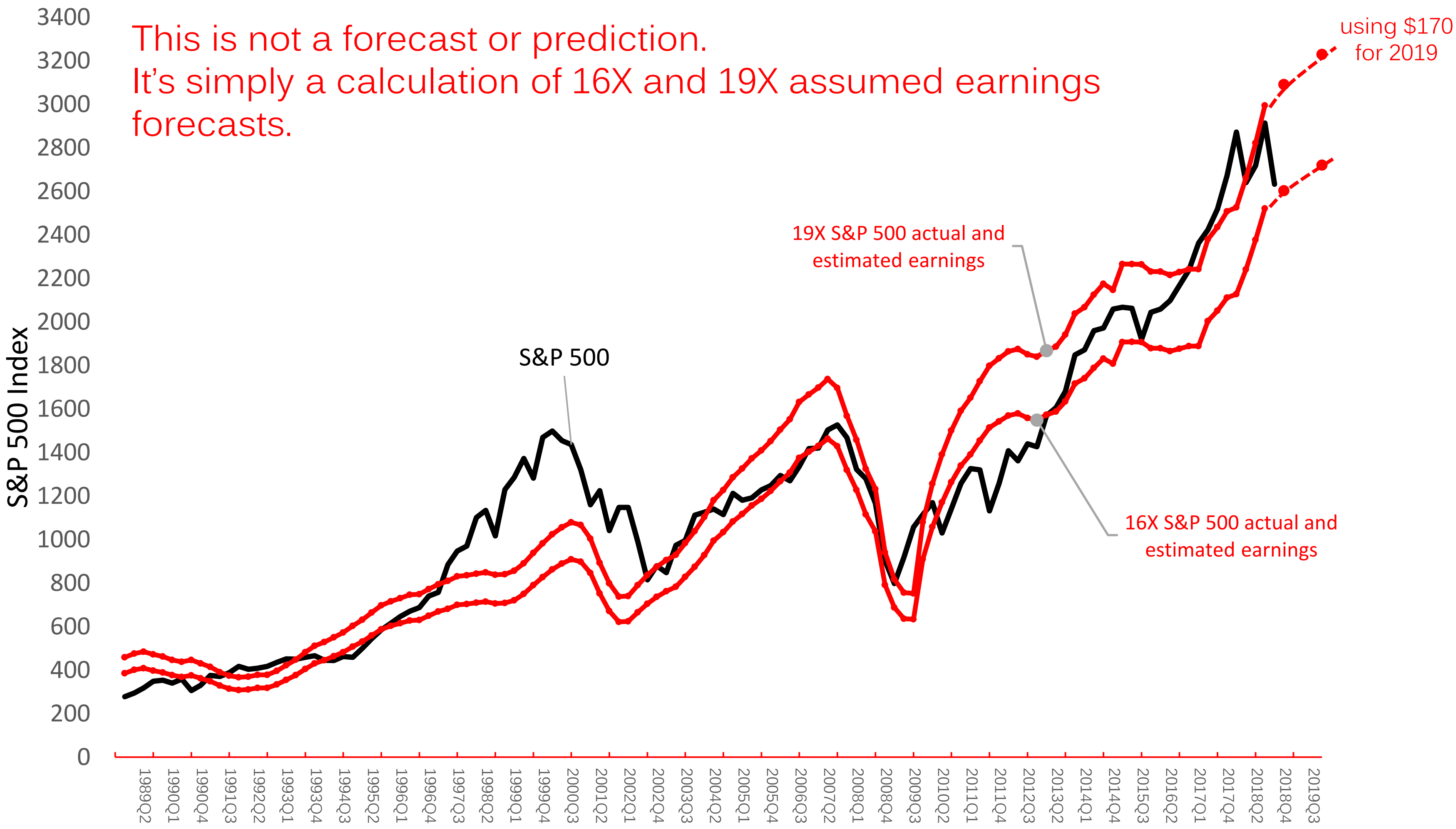
November at 60.7, ticked up from October's 60.3, and off just slightly from September's record 61.6.

November's new orders at 62.5 rose from October's 61.5, and higher than September's blowout 61.6.

Non-manufacturing captures the vast majority of the U.S. economy.

Source: Copyright 2018, Institute for Supply Management; data through November 2018. This data series was created in 2008. ISM: "A reading above 50 percent indicates that the non-manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting."

Valuation
S&P 500 – What if we use $170 for 2019 Earnings Estimate?



[1] 2017, 2018 (estimated) and 2019 (estimated) bottom-up S&P 500 operating earnings per share as of December 10, 2018: for 2017, $131.98; for 2018(e), $162.70; for 2019(e), $170.00. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S for actual and estimated operating earnings from 2015. Standard and Poor's for index price data as of December 7, 2018; and actual operating earnings data through 2014.

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