

Market  
Commentary



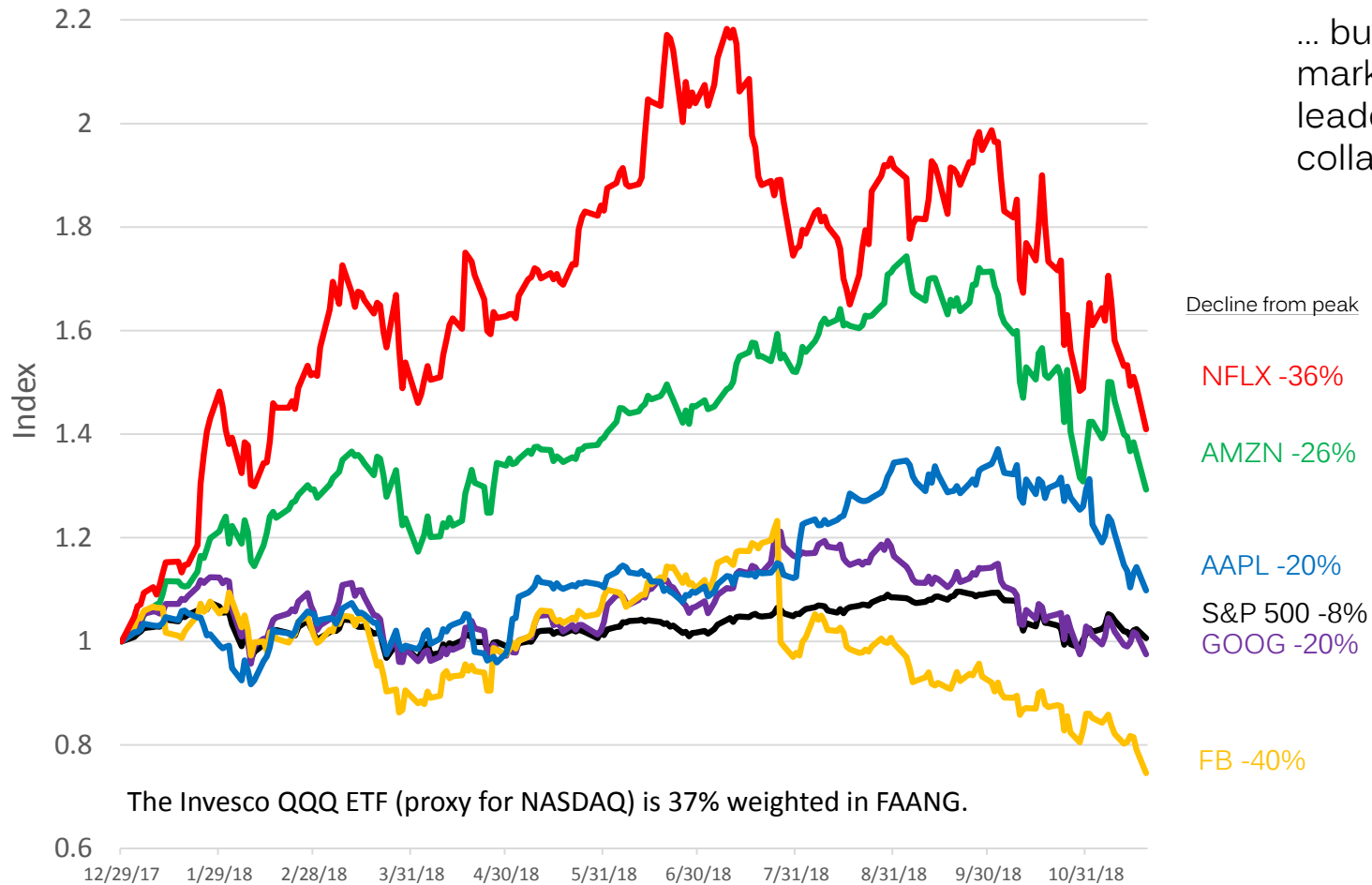
## Stock Market

- 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 still tame
- lack of irrational exuberance
- Are rising bond yields bad for stocks?



# Stock Market Tech Wreck

More specifically, the problem is with the FAANG stocks.



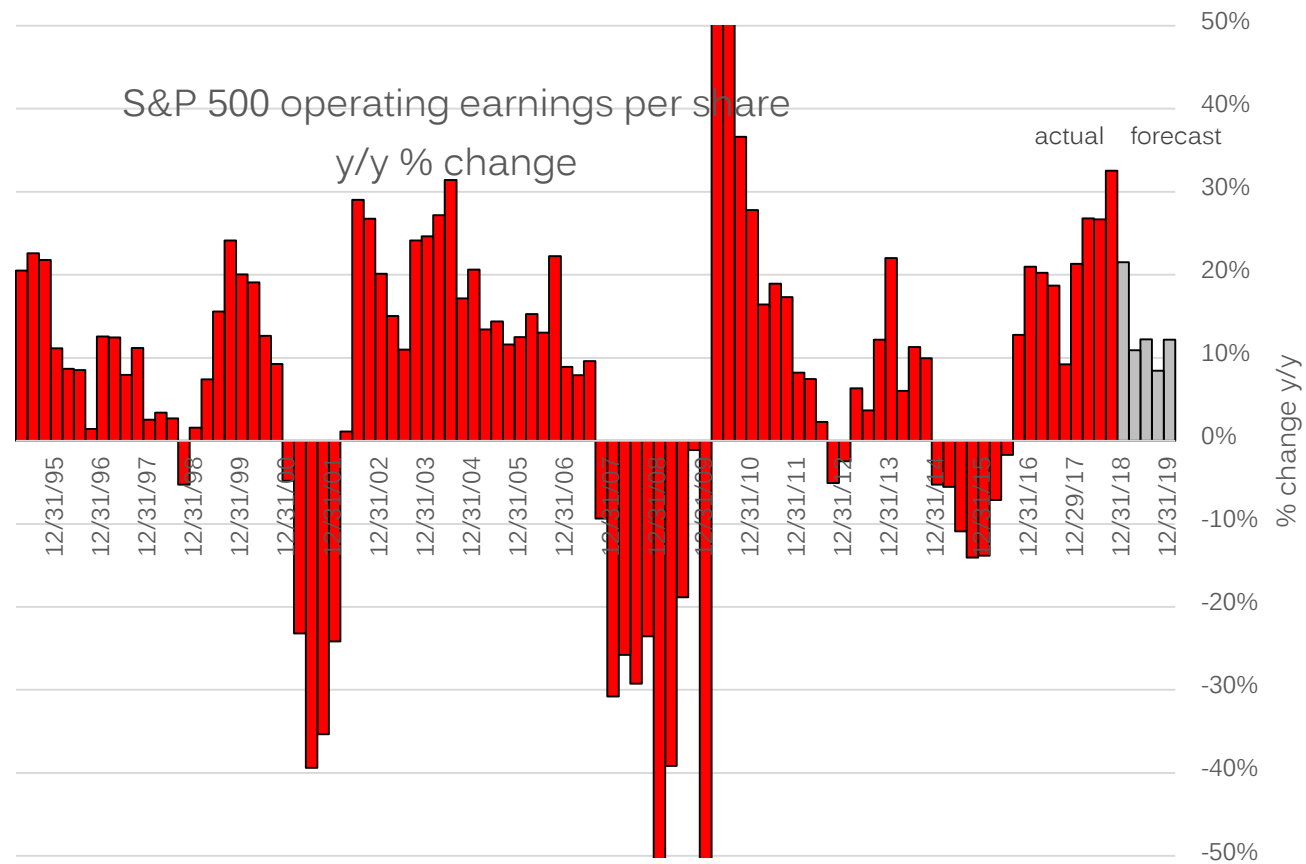
... but, FAANG market leadership collapsed.

Source: Yahoo Finance, data through November 19, 2018.



# Stock Market S&P 500 Peaking Earnings Growth

Q3 2018 marks the peak in y/y earnings growth.



Source: Standard and Poor's Inc. Data as of November 15, 2018.



## Fed policy

- On a path to 3% fed funds rate
- Fed funds rate close to “neutral”
- 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]

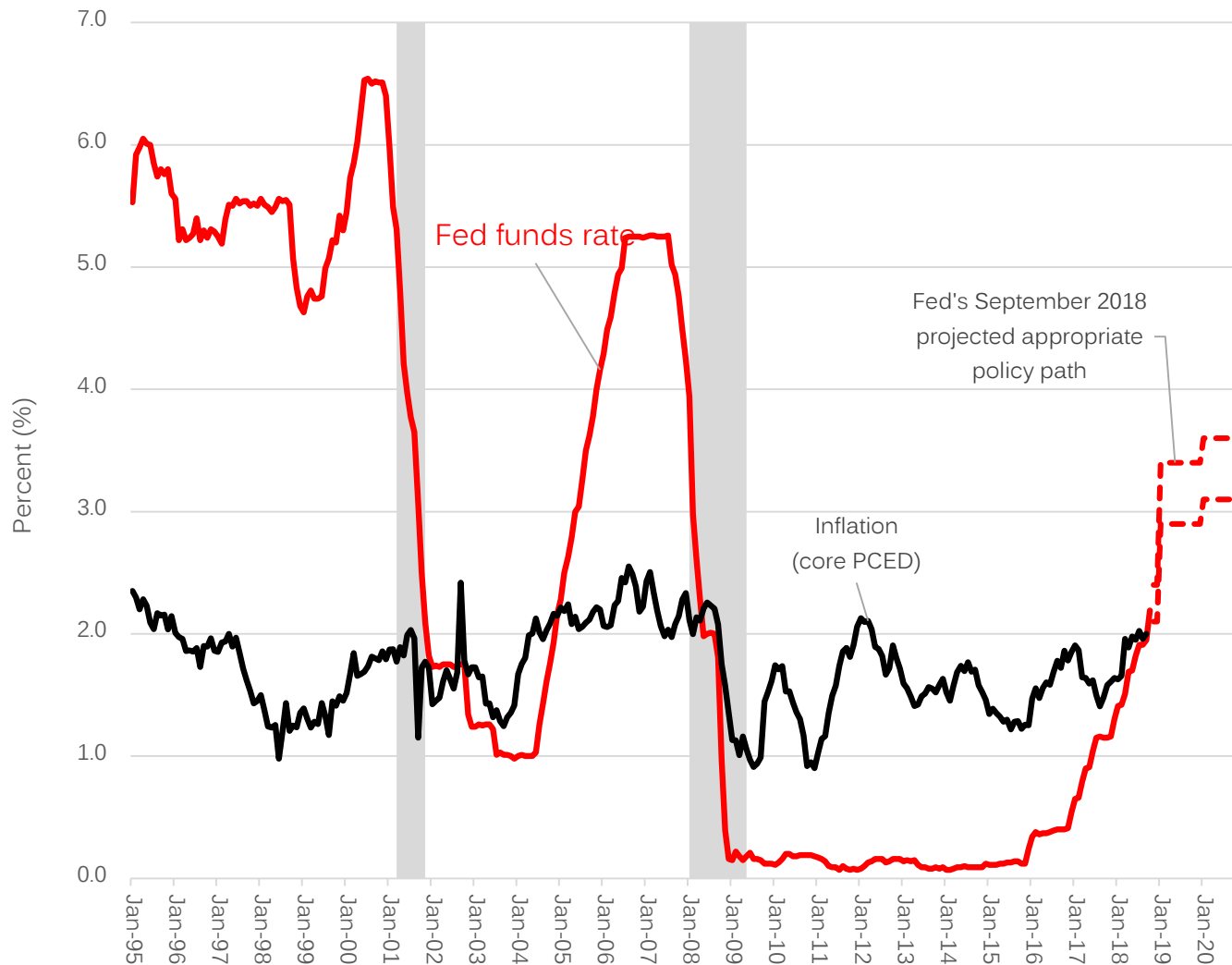
November 15, 2018

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 September 2018. Fed funds rate through October 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

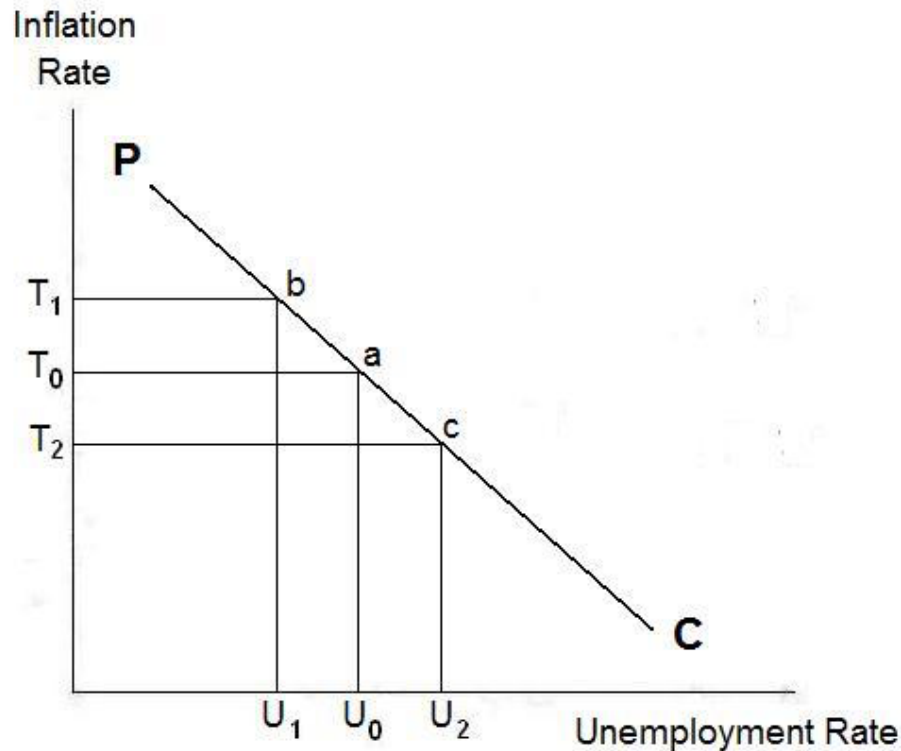




## Inflation

- What Phillips curve?
- Headline PCEC +2.0%, +2.0% core
- Headline CPI +2.5%, +2.1% core
- Employment cost inflation rising
- Productivity drives declining unit labor costs
- Inflation expectations are gradually rising

**Figure 1. The Phillips Curve**



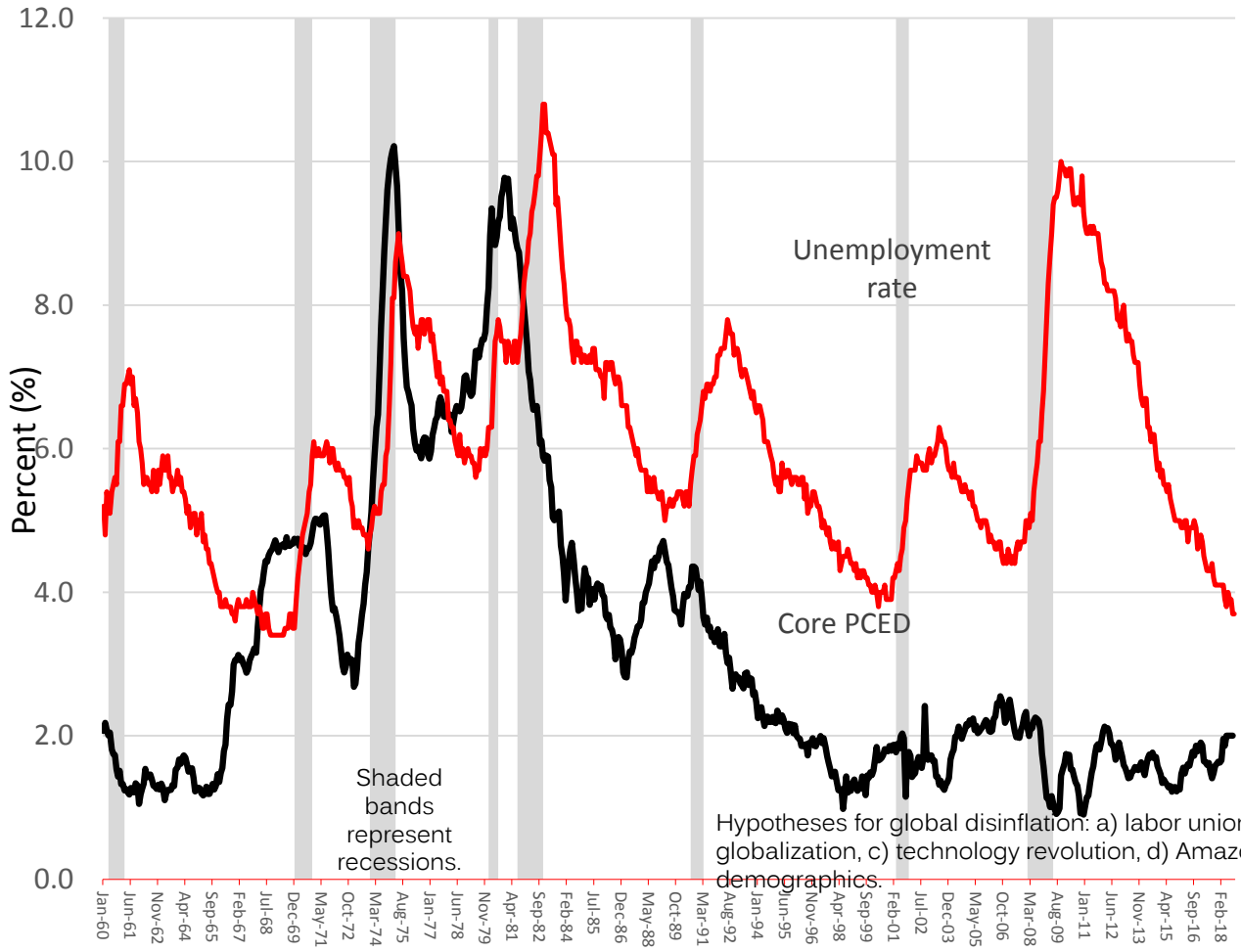
This simple schematic illustrates the common notion of an inverse relationship between inflation and the unemployment rate.

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.



# Inflation Phillips Curve – Unemployment vs. Inflation



This chart illustrates the historic relationship between inflation and the unemployment rate.

The correlation coefficient is +0.28, suggesting a positive, not inverse, relationship.

3.7%

2.0%

Hypotheses for global disinflation: a) labor unions lost power, b) globalization, c) technology revolution, d) Amazon, e) aging demographics.

Source: NBER, BLS, Federal Reserve Bank of St. Louis. Unemployment data through October 2018; core PCED data through September 2018.



# Point of View

## November 2018

### Economy

full-employment economy operating at full potential

+2.7% 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

“Our economy is strong. Growth is running at a healthy clip.

Unemployment is low, the number of people working is rising steadily, and wages are up. Inflation is low and stable.”

Jerome Powell  
Chairman of the Federal Reserve  
September 27, 2018



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