

Market
Commentary
March 2018



Trade War

Trump doubles down: 'Trade wars are good, and easy to win'

- "When a country (USA) is losing many billions of dollars on trade with virtually every country it does business with, trade wars are good, and easy to win," Trump tweets.
- Trump announced Thursday that he will impose 25 percent tariff on steel and a 10 percent tariff on aluminum as early as next week.

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Senator Reed Smoot and Representative Willis Hawley

The Smoot-Hawley Tariff of June 1930, was the cause of the Great Depression, according to economist Ed Yardeni.

“The tariff triggered a deflationary spiral that had a deadly domino effect. Other countries immediately retaliated by imposing tariffs too. The collapse of world trade pushed commodity prices over a cliff. Exporters and farmers defaulted on their loans, triggering a wave of banking crises. The resulting credit crunch caused industrial production and farm output to plunge and unemployment to soar. In my narrative, the depression caused the stock market crash, not the other way around as is the popular belief.”¹

¹ *Predicting the Markets*, by Dr. Ed Yardeni, © 2018.



Trade Steel and Aluminum Tariffs

The problem is China's overcapacity and dumping.

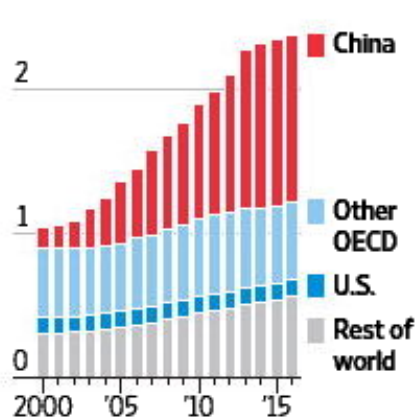
The solution is not tariffs on our friends.

The China Syndrome

Almost all of the increase in global steel and aluminum production and capacity since 2000 has been in China.

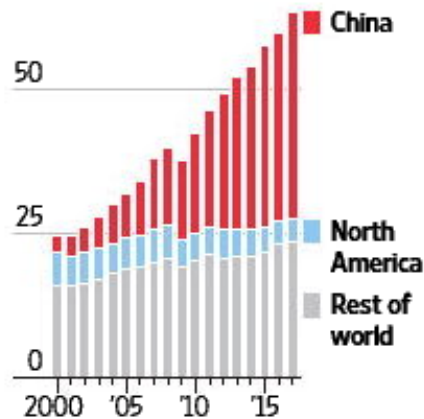
Global steel capacity

3 billion metric tons



Global aluminum production*

75 million metric tons

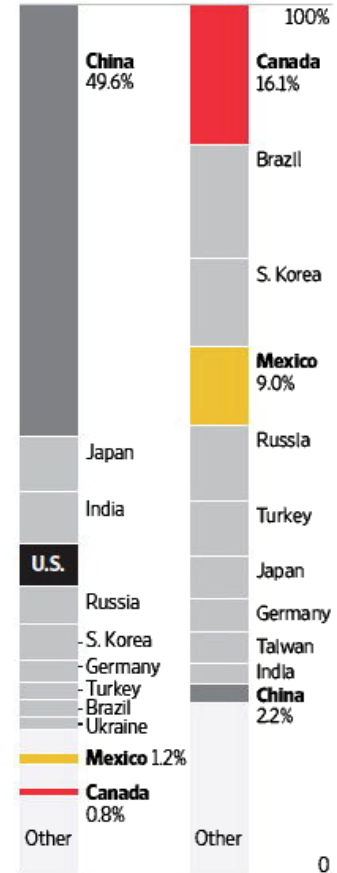


*Data from 2008 onward include estimates of unreported aluminum production for China.

Sources: Organization for Economic Cooperation and Development (steel);
International Aluminium Institute (aluminum)

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Share of global steel production 2016



Sources: World Steel Association (raw steel production); U.S. Dept. of Commerce (imports, annualized based on data through October)

Source: *The Wall Street Journal*, March 8 & 9, 2018.



Stock Market

- near record highs
- driven by global expansion and earnings surge
- lower \$USD
- and cheap oil
- stocks are fully-, but 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?



Fed policy

- on a path of steady hikes to 3% fed funds rate
- inflation has lagged Fed's forecast
- the Fed manages the yield curve
- the Fed has created every recession since the 1950s
- first rate hikes have signaled stock market lift-off
- the Great Unwinding: bond yields set to start rising



Bond Yields

- recent lowest yields in history
- yields don't make sense fundamentally
- yields held down until the ECB's QE taper



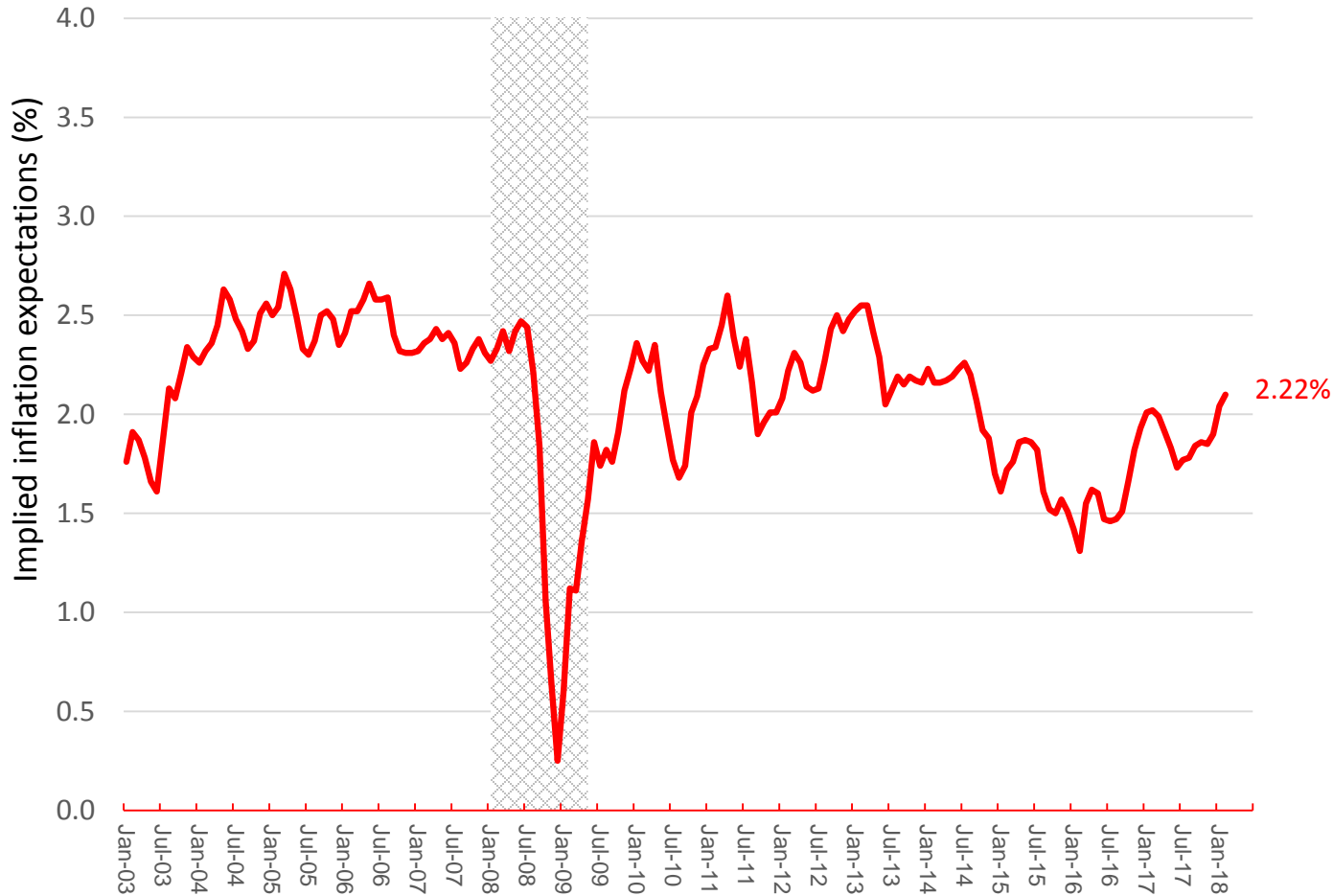
Inflation

- headline PCE +1.7%, +1.5% core, same as December
- headline CPI +2.3%, +1.9% core
- employment cost inflation rising
- productivity drives declining unit labor costs
- inflation expectations are gradually rising



Bond Yields Inflation Expectations Jump Higher

U.S. Treasury Bond Yield minus TIPS Yield
10-year Maturity



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 February 2018.



Point of View

March 2018

Economy

full-employment economy operating at full potential

+2.5% Q4 GDP growth compared to +2.2% post-recession average

+2.7% GDP growth forecast

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 record 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



Table 1. Overview of the World Economic Outlook Projections

(Percent change unless noted otherwise)

	Year over Year					
	Estimate		Projections		Difference from October 2017 WEO Projections 1/	
	2016	2017	2018	2019	2018	2019
World Output	3.2	3.7	3.9	3.9	0.2	0.2
Advanced Economies	1.7	2.3	2.3	2.2	0.3	0.4
United States	1.5	2.3	2.7	2.5	0.4	0.6
Euro Area	1.8	2.4	2.2	2.0	0.3	0.3
Germany	1.9	2.5	2.3	2.0	0.5	0.5
France	1.2	1.8	1.9	1.9	0.1	0.0
Italy	0.9	1.6	1.4	1.1	0.3	0.2
Spain	3.3	3.1	2.4	2.1	-0.1	0.1
Japan	0.9	1.8	1.2	0.9	0.5	0.1
United Kingdom	1.9	1.7	1.5	1.5	0.0	-0.1
Canada	1.4	3.0	2.3	2.0	0.2	0.3
Other Advanced Economies 3/	2.3	2.7	2.6	2.6	0.1	0.1

Global economic activity continues to firm up. Global output is estimated to have grown by 3.7 percent in 2017, which is 0.1 percentage point faster than projected in the fall and ½ percentage point higher than in 2016. *The pickup in growth has been broad based, with notable upside surprises in Europe and Asia.* Global growth forecasts for 2018 and 2019 have been revised upward by 0.2 percentage point to 3.9 percent. The revision reflects increased global growth momentum and *the expected impact of the recently approved U.S. tax policy changes.*

Source: IMF, *World Economic Outlook*, January 22, 2018.



Economic Data

Small Business Optimism Index

Small Business Optimism Index



Source: National Federation of Independent Business

American Bankers Association

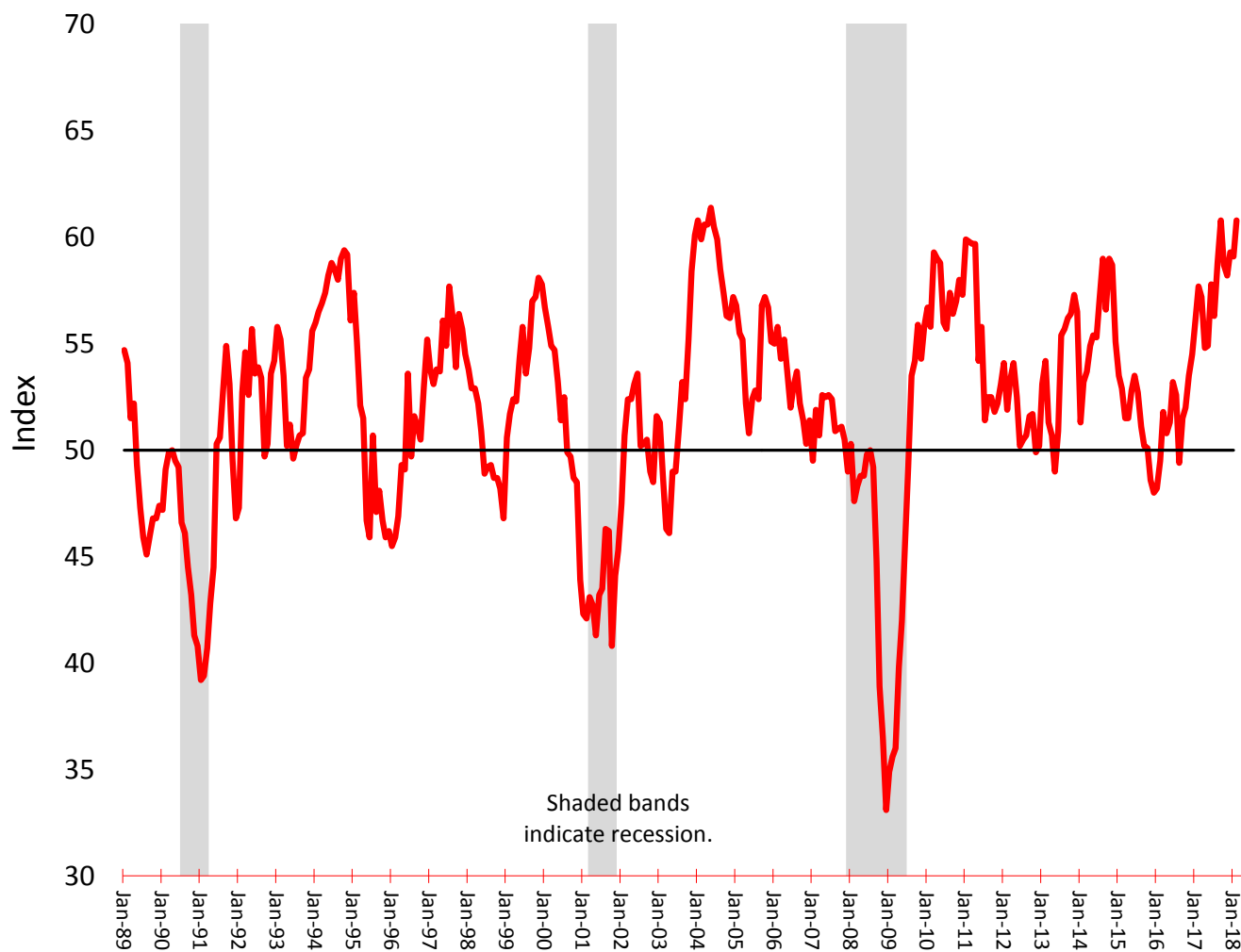
“When small business owners have confidence and certainty in the economy, they’re able to hire more workers and invest in their business,” said NFIB President and CEO Juanita Duggan. “The historically high readings indicate that policy changes – lower taxes and fewer regulations – are transformative for small businesses. After years of standing on the sidelines and not benefiting from the so-called recovery, Main Street is on fire again.”

Source: NFIB and ABA. Data released March 13, 2018.



Economic Data

ISM Manufacturing Purchasing Managers Index - Booming



February's 60.8 back to the record all-time high.

February's new orders at 64.2 is very strong.

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.

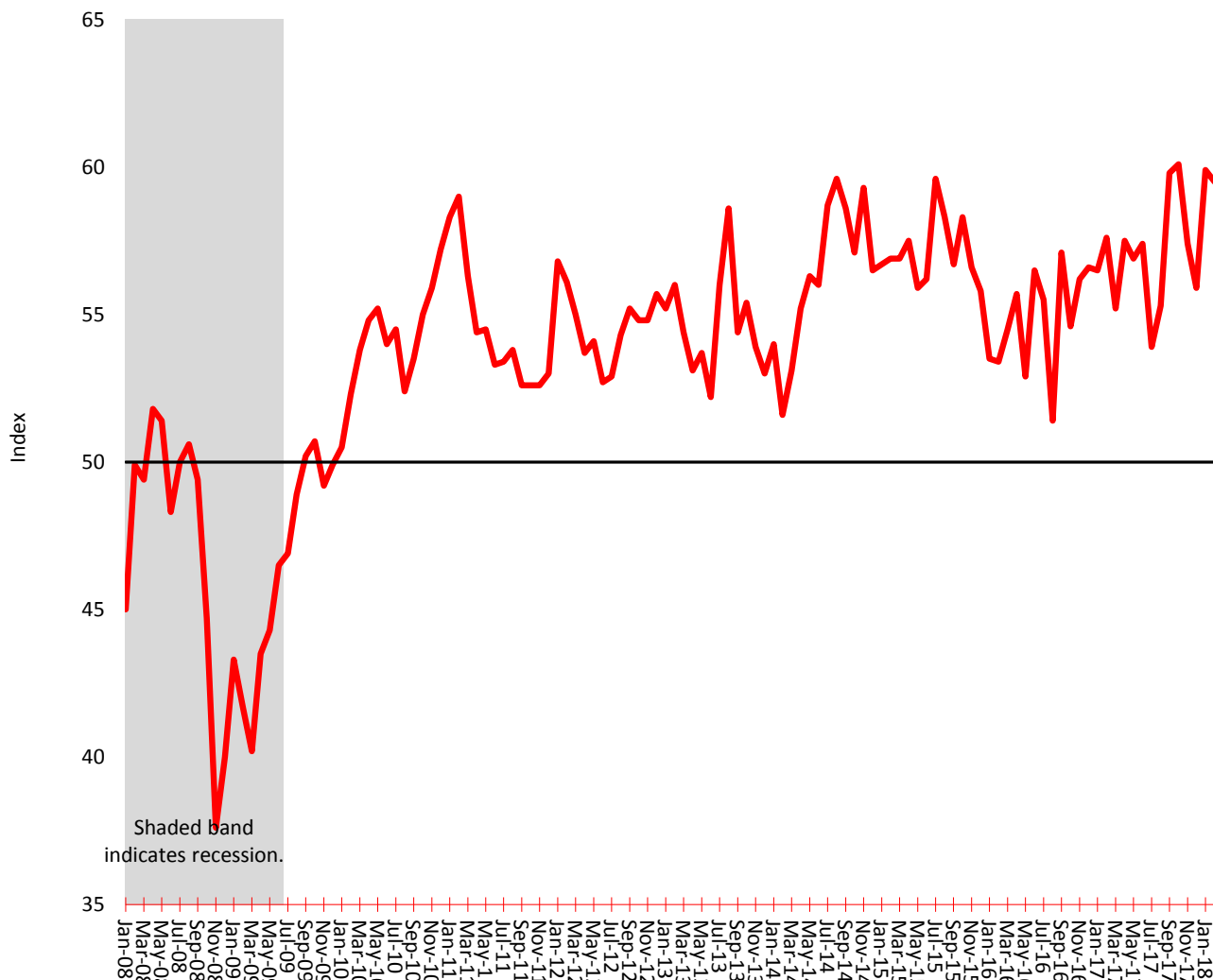
Source: Copyright 2018, Institute for Supply Management; data through February 2018.

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 Managers Index



February at 59.5, holding up near record highs.

New orders surge to 64.8.

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

Source: Copyright 2018, Institute for Supply Management; data through February 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."



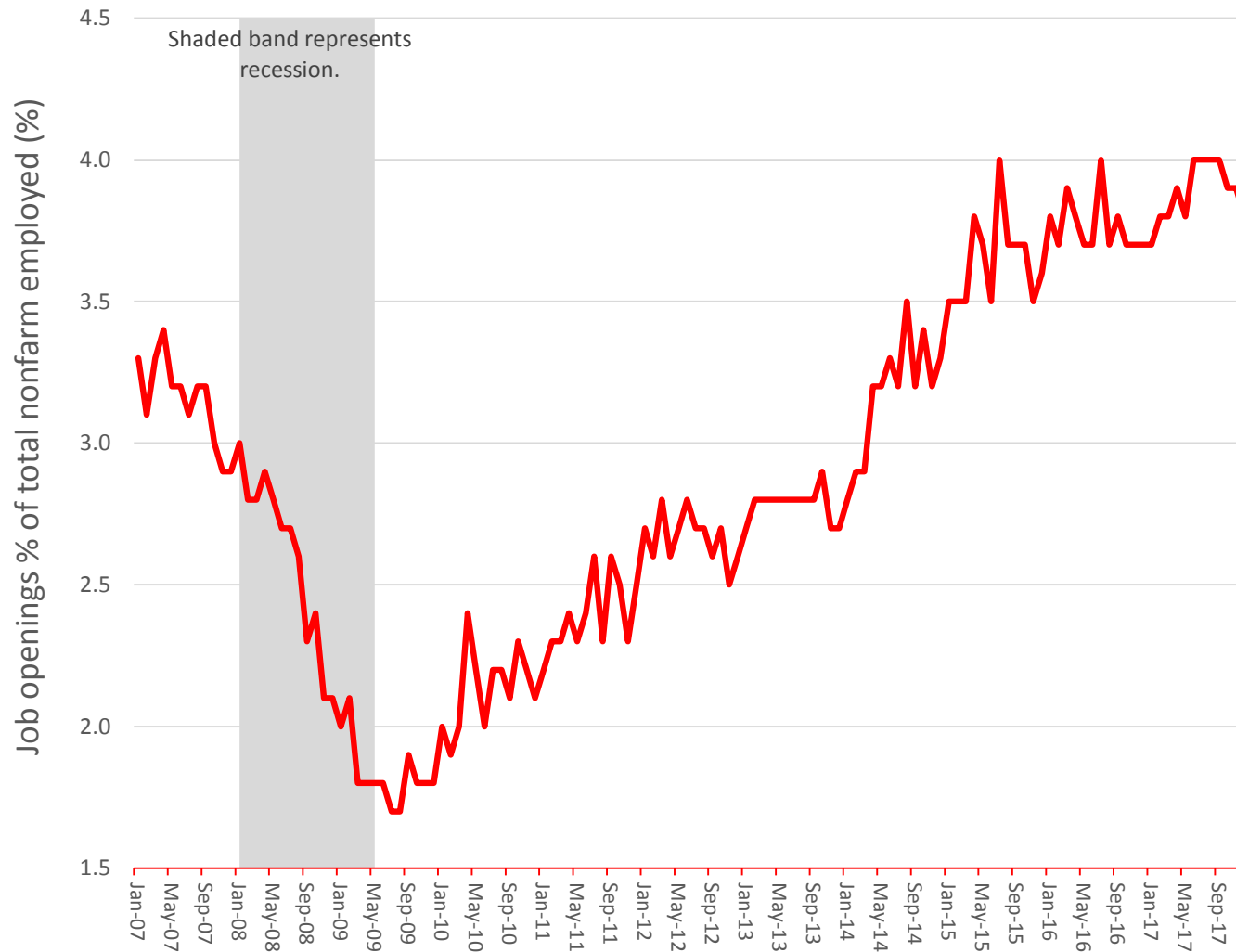
Jobs

- full-employment
- new jobs will soon be limited
- good news in part-timers data
- record job openings
- declining participation rate due to aging
- 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 – Record High



Record highs.

Source: U.S. Department of Labor, NBER. Data through December 2017, released February 7, 2018.



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