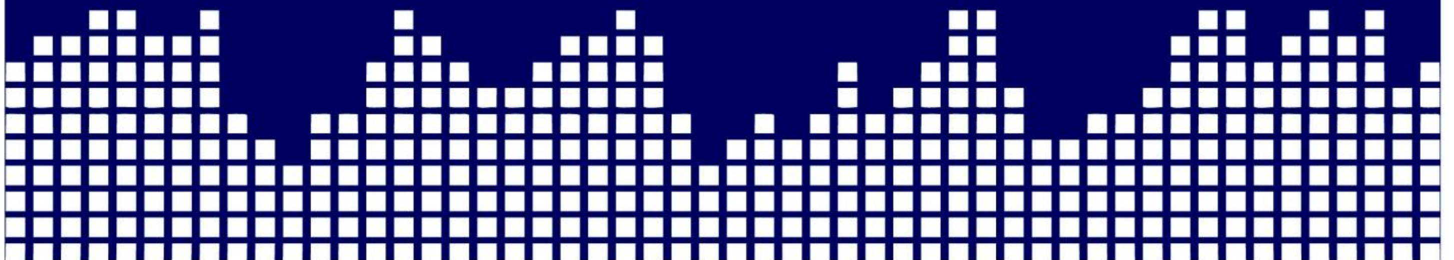
D.J.'s Economix

A mix of economics and markets from Dwight Johnston

Economic Update

August 2016



California Credit Union League

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Slow summer, fast fall?

August 9, 2016

After the excitement (turmoil) of late June and early July, the markets settled into an extended period of lethargic trading typical of the summer doldrums. Despite the calm, nothing underneath has really changed. The same longer-term risks are lurking, and the same mostly upbeat U.S. economic is continuing.

Last month I spent considerable time discussing the implications of Brexit and the distortions in the interest rate markets by questionable central bank policies. The commentary this month will be mostly about the economy, and you will probably be pleased that the commentary will be shorter than the last one.

Jobs vs. GDP

GDP was terrible, but does it matter? When it comes to which is more important, job growth or GDP growth, the debate has never been that close. Job growth wins, hands down. GDP has always received far less attention in the markets, and Fed officials, including Janet Yellen, rarely reference GDP. For the Fed it's jobs, inflation, and the global financial markets that matter. But the latest GDP report stirred up a surprising amount of controversy.

Most of you know that I am not a fan of GDP. The constant revisions to GDP and the outsized movements in GDP caused by the trade balance and business inventories are just two of the reasons why I find little use for GDP. The latest GDP report was no exception. Economists were looking for a gain of 2.4%, but the preliminary estimate was 1.2%. A full 1.2% was caused by a drop in business inventories.

A drop in business inventories represents less spending by businesses. If the decline was in conjunction with a drop in consumer demand, we would need to be concerned. But consumer spending rose by 4.2% in the second quarter, the biggest gain since the 4th quarter of 2014. Businesses are likely to replenish those inventories in the 3rd quarter. Without a doubt, business spending will still be a drag on the economy. Big businesses are still cautious on the global outlook for the same reasons that market traders are cautious — the unknowns from Brexit, the U.S. presidential race, and lingering concerns about China. But businesses are not going to have empty shelves heading into the holiday season.

There was also a subtraction of .5% from a decline in government spending. Anyone want to bet that government spending continues to decline?

The Atlanta Fed has a constantly updating site called "GDP Now." The Atlanta economists feed every new piece of relative data into the model to estimate GDP. This site has been getting a lot of market attention. The latest GDP Now reading — though based on little real data — estimates that GDP will rebound by 3.8% in the 3rd quarter. But that number will not be out until late October, and the 2nd quarter could be revised lower.

So with all the widely known flaws in GDP, why did it get so much attention? Frankly, I'm not sure, but I believe it is because GDP fit the mold for the longer-term scenario that is near and dear to the bond bulls – a dark and gloomy scenario. But the data that definitely did not fit that mold came a week later in the jobs report.

Job growth was terrific, and it does matter. The very weak payroll growth in May was viewed as a likely aberration when the number was released. The proof of that came the next month when June payrolls surged. But the June surge was also viewed as a likely aberration in the other direction. Economists were looking for a "normal" gain in Nonfarm Payroll jobs of 175k, but the U.S. added 255k jobs in July and the two prior months were revised higher. June no longer looks like an aberration, but a confirmation of a healthy job market that has averaged adding 194k jobs per month so far this year.

The good news in the jobs report didn't stop with the gain in payrolls. Wages rose more than expected, the average workweek moved higher, over 400k people declared themselves back in the labor pool, and the job gains were spread over every job sector other than in the energy field.

Is there a debate? What really matters to us? Is it some convoluted measure of the economy that gets constantly re-measured for years? Or, is it jobs and the consumer? You might disagree, but I think it's what matters to real people.

<u>Housing on cruise control but has it hit the speed limit?</u>

It's been a good housing season. Existing Home Sales nationally are the highest in several years, and New Home Sales are up. Both might have been even better had the supply of homes in the affordable category not been so low. Sales have actually declined in the lower end of the market due to that supply problem. But sales have also declined in some of the most expensive markets in the country, and supply has risen. The most expensive areas of LA, San Francisco, and New York appear to have topped out. As an example, the median home price in San Francisco is an outrageous $1,350,000 (per CoreLogic), a meager 3.9% gain year-over-year. But the median price is actually down about 2% since January. Moreover, the number of sales is down roughly 10%.

I'm not worried about the upper end sector of the housing market, but we do have to think about how the middle sector might also follow suit. In fact, in many areas we have already seen prices flatten out. The problem is that affordability has reached some levels that are flashing caution lights. And this is with mortgage rates at historic lows. Imagine what would happen if rates rise by 1-2%.

Don't get me wrong. I'm still long-term positive on the future of housing, not from the perspective of ever-rising prices, but from the perspective that a big base of demand has been built by an escalation of housing formations since the recession. This base should provide the kind of demand anytime the housing market slips.

The lesson here is not to shrink from lending on housing but to make sure your borrowers have "skin in the game." Down payments of 5% or even 10% might not be enough protection in this expensive housing market. It's always tempting to help borrowers buy that home in expensive markets, if that's the market you are in, but it's also worth considering if you are hurting or helping that borrower.

Not much to say about autos

Auto sales rebounded sharply in July, hitting an annualized pace of almost 18 million for the first time since November of last year. The number might have been a bit inflated by rental sales, and auto makers did have to get very aggressive with incentives. I do think that auto sales have plateaued this year, but the view from here is still pretty good on auto lending.

Future world

With everything status quo for the moment, let's look ahead at just a few of the next possible events that could break the logjam in the markets:

Yellen speaks; will anyone listen? It's been a long time coming, but the markets have started tuning out all Fed officials. After the last FOMC meeting, Fed officials hit the speaking circuit as usual. But traders did not react to any of the comments despite the fact that a few speakers made direct references to future policy action. After months of back and forth comments and conflicting viewpoints that all turn out to be wrong, traders seem to finally have gotten the message that there is only one Fed official to listen to — Janet Yellen

Yellen will give her first address since the last FOMC meeting at the big Jackson Hole Conference on August 26. Traders are anxious to hear what her emphasis will be, and if she will tip her hand on monetary policy. Will she emphasize the job growth, or will she chose to switch the focus to GDP? Switching to GDP would be a big change for her and signal a new direction for the Fed.

Yellen is unlikely to signal any move in September, but traders would like to hear her take that off the table entirely. But why should traders pay any more attention to Yellen than they do other Fed officials? Yes, she is the Chairman, but Yellen's track record of misleading cues is just as bad as the rest of the Fed.

As you know by now, I think the Fed has lost all credibility and have pursued policies that will have long-term negative implications. But traders all have August 26 circled in red on their calendars.

September surprises? The first September date to circle will be September 2, when the next jobs report will be released. Certainly another huge gain in jobs or wages could change the landscape for the Fed. The next FOMC meeting will be September 21, but I think it is highly unlikely the Fed will move at that meeting regardless of the jobs report.

Some market analysts believe this standoff in the market will start to resolve itself in September, with the stock market taking a beating. They are basing this mostly on the fact that the market has gone nowhere, needs a washout decline, and September has historically been a bad month for stocks. If stocks have more than a garden variety selloff, you know that will get Janet Yellen's attention.

October vote in Italy could restart EU exit fears. The Italian Prime Minister has called for a referendum on a major restructuring of the government in Italy. He said if the referendum fails, he will resign. While this is not in any way a vote on exiting the EU, the political party that stands to gain is the anti-EU party. The assumption is that the drumbeat to exit the EU will start early next year.

This date might slide into November, and the PM has backed off his pledge to resign though still leaving the door open to do so. But when this vote does come, it will be a big deal.

You know what November brings. The election date is November 8. A very close election will heighten market volatility before and after the vote. If the race isn't close, November 8 will not be an important date. But first things first. We can't be sure that both of these candidates will make it all the way to November 8. Turmoil around the election could come sooner than we expect.

A drama-free December? By the time December rolls around, hopefully all the drama of the next three months will be behind us and we can all have a merry Christmas.

Still on hold

I've maintained a positive outlook on the economy all year despite the noise, and that has proved to be the right call. But I remain frustrated by stubbornly low levels of interest rates, and I am concerned about developments in central bank policies around the globe. While I remain positive, I do have some fear that global events and disastrous central bank policies could overtake the economy next year. But for the time being, I'm remaining on hold.