D.J.'s Economix

A mix of economics and markets from Dwight Johnston

Longer-term Commentary

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California Credit Union League

Nevada Credit Union League

Replacing the Fed

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Since the last Longer-term Commentary, stocks went on a long, steady uphill climb while bonds had an up and down month. Trump was again a major factor for the markets, though somewhat less so than in prior weeks.

With the Trump factor toned down a bit, traders had time to focus on the economy and the Fed once again became a relevant point of discussion. There was a lot to like about the last round of economic reports, and the results left little doubt about the outcome of the March 15 FOMC meeting.

I am writing this a few days before the FOMC meeting and you might be reading this after the meeting, but I'll take the small risk that the Fed might surprise and discuss the presumed decision. I'll also review the economic numbers. And while Trump was not a major factor in the past four weeks, he did have his moments. I suppose I have to accept that every month I will have a section of this report devoted to all things Trump.

Consumers turn feelings into actions

The economy had been performing well before this year, and the numbers since the beginning of the year have continued that string of successes. The consumer sector showed it was alive, and at least some of the credit has to go to Trump. It's not what he has done, but it's the optimism his election sparked. Consumer Confidence readings have remained well above long-term trends, but a high level of the Consumer Confidence "mood poll" has not always translated into higher levels of consumer activity. This time it is.

Year-over-year Retail Sales rose by 5.6% in January, the best level in almost five years. March sales are expected to fall off a bit from that pace but should remain well above 4% for the fourth month in a row. After four years of 2.0-2.5% Y-O-Y growth, Retail Sales have developed a nice uptrend.

Auto sales in February equaled the January pace of roughly 17.6 million units on an annualized basis. That also matches the sales pace for all of 2015 and 2016. If the pace of sales remains at 17.6 million, that would be very good, but the January and February sales pace might be signaling a leg higher this year in sales. This is why: January and February are traditionally the slowest months of the year. In 2015 and 2016, the January/February averages were 16.4 million and 16.8 million, respectively. With the start of this year, auto sales could surprise to the upside.

It's far too early in the year to discuss the housing market. You will have to wait until March and April to make any assessment, but from the data in the slow winter months it's safe to say the appetite for houses remains strong. Existing home sales in January actually hit the best level since 2011. Housing Starts and New Home Sales were both better than expected. The supply of existing homes for sale has just tanked. That bodes well for home prices but not for volume of new loans. But I expect the supply will return to normal once the "selling season" begins.

So far, at least, higher mortgage rates do not seem to be having an impact, but the story could change if mortgage rates go up fifty to one hundred basis points. Rates have already had a huge impact on refinancing activity. Refis are running about 40% below the 2016 pace. The Mortgage Bankers Association forecasts a 45% drop in refis this year as long as mortgage rates hold steady where they are now. A few lenders have had better results by aggressively marketing fixed rate loans to adjustable rate borrowers, but that pool will dry up quickly.

Jobs data looking real

Nonfarm Payrolls in February rose by 235k, essentially matching the January gain of 238k. The construction sector was a standout with a gain of 58k, the best gain for that sector in ten years. The manufacturing sector added 28k, and 38k jobs were added in the professional/business sector. The only sector that lost jobs in February was retail. That is not a surprise from a seasonal standpoint and also from the headlines about retrenchment in brick and mortar stores.

Hourly wages grew by a mild .2% on the month, but the gain was enough to push the year-over-year rate to 2.8%. After several years of wage growth of 2.0-2.2%, we've now had six consecutive months of gains over 2.5%.

Finally, the Unemployment Rate dropped to 4.7% according to the household survey. This was especially encouraging, given it came with a big jump in the labor pool and move higher in the participation rate.

Now that I've given you all the good news, here are a few cautionary notes. The January and February payroll gains might be flattered by seasonal adjustment factors. As was the case last year, the weather was mild this year and the numbers could be a bit inflated. But that's a minor quibble.

While this was a good start to the year, I'll stick with my early prediction that payroll gains will drift down to 150k by the end of the year. While the labor pool is growing, the supply of skilled workers is shrinking. There are multiple industries reporting difficulty in filling jobs. Perhaps optimism for the future will encourage businesses to beef up training programs.

We could also be looking at an even tighter labor market toward the end of the year. Trump's immigration and deportation policies will subtract workers from the pool, especially in agriculture and construction.

A constricted labor force brings good news and bad. The good news is that wages are likely to rise more than expected. That's good news for workers at least. That would not be good news for the Fed and for business productivity.

I want to add one comment for you to file away in the cautious part of your brain: For states with significant agricultural exports, Trump's policies will hurt to the extent they are realized. For states with significant trade business, like California, Trump's policies are damaging. And for states with significant foreign visitor traffic, Trump's policies are already causing concern. Hopefully, his actual policies will be muted, but you might have to dial down your optimism if you live in those states most impacted.

But there is no reason to be overly skeptical or concerned about the job market just yet. The overall prospects remain positive based on what we know, and now we can finally be confident the numbers are real.

For years Republicans—especially during the campaign years—have blasted each one of the job reports during the 77-month string of gains in payrolls. "The numbers were fake! The job market is a disaster!" So said many Republicans and Trump. Even GE icon Jack Welch accused the Bureau of Labor Statistics of being in cahoots with the Obama Administration to pump up the statistics. Trump famously claimed there were really 98 million unemployed people. That's true if you include retired people, people in school, and others that simply don't want or need to work.

Miraculously, all of the doubt about the veracity of the jobs report has disappeared. Congressional Republicans were positively gushing about the report, and the Trump administration was crowing. And pundits wonder why the politicians are viewed in the same light as used car salesmen. (I would like to pause and apologize to all used car salesmen.)

While the hypocritical responses to the jobs report were laughable, let's give credit where credit is due: First, the Bureau of Labor Statistics deserves credit. No matter what political party was in office, the BLS plodded away and reported both favorable and unfavorable reports to the office holder. You can argue with some elements of methodology, but there has never been any evidence the BLS has slanted the data.

Second, although Trump has not had time to implement any policy changes that would impact the jobs market, the post-election optimism was likely responsible for at least some of the strength in job creation the last two months. The challenge for Trump is how to keep that ball in the air.

On being "presidential"

While Trump was less of an obvious factor the last month, he did make some noise. On the plus side, his team rolled out a second attempt at a travel ban. I will not comment on the ban itself, but the rollout and implementation of the ban was a vast improvement over the disastrous first attempt. At least someone in his administration learned a lesson.

The second win for Trump was his performance, and I do mean performance, in his speech to Congress. Pundits were quick to praise him as being "presidential." Using his most serious I-know-what-I'm-talking-about voice, Fox News anchor Chris Wallace somberly declared, "I feel like tonight Donald Trump became President of the United States." (Pause for dramatic effect.) I wonder how he felt roughly 48 hours later when Trump tweeted he had been wiretapped.

The fact is, Trump was *not* being "presidential" in the speech. He managed to read the teleprompter without breaking character. Being "presidential" to those diehard Trump supporters means seeing him be the guy that goes wildly off-script, tweets random zingers, and doesn't mind stomping on toes for any reason that pleases him. That's who he is to those who put him in office. That is being "presidential" to them. Trump might occasionally stray into territory appealing to those hoping for the other "presidential" Trump, but Trump made it clear his real character is the tweeter-in-chief. He is not going to change. Anyone not onboard the Trump train will have to change their own expectations.

The markets are stuck between two Trumps

The stock market has actually done a fair job in the "acceptance" of the real Donald Trump. Stocks did reward the presidential performance with a 300 point rally in the Dow, but traders did not go overboard reacting negatively to follow-up wiretap tweets.

But the stock market does seem to be in an odd place. Traders, investors, market analysts, etc. remain mostly optimistic that Trump's tax reform and regulation relief will provide an economic boost. But, they seem afraid to push stocks for fear that the negative Trump will sink the ship with some very bad trade policies. Or perhaps Congress will sink it for him by not implementing any reform policies. But, stock traders are also afraid to sell. What if the positive things start to fall into place sooner than expected? They wouldn't want to miss that train.

Interest rates have moved little since the end of election week in November. But on February 24, bond yields did fall to new lows for this year. The 2-year was 1.15% and the 10-year was 2.31%. Bond traders were reacting in some degree to the drop in yields in the bond market in Europe with the news of gains by the anti-EU French presidential election; but for the most part, bond traders were betting that Trump could not get through his speech to Congress unscathed.

When Trump did ace that quiz, bond yields started to rise, and bond traders suddenly started to *listen* to what Fed officials were saying. For several days prior, Fed officials appeared to be reading from the same script that alerted the markets to the likelihood that the Fed would tighten on March 15. At the end of that week, Yellen all but confirmed a move. The market was not priced for that on February 24th.

By the end of last week, a tightening move was priced back into the bond market with the 2-year at 1.36% and the 10-year at 2.58%. But the hope of a non-presidential Trump is still a constraint on rising bond rates.

The Fed surrenders

There will be no drama surrounding the meeting on March 15, but there will still be some interest in the details. Traders will closely analyze the "dot game" results to see how many tightenings Fed officials expect this year. The bond market assumes it will be a total of three, based on what Fed officials have already said—but when? If they come early, that might leave room for a 4th move at the end of the year. This and other riveting discussions and conjectures will follow the statement and Yellen's press conference. But we all know what the Fed says it will do and *what it does* can be a mile apart.

I'm sure the Fed would like to be honest. The honest statement would be that they believe the economy can easily withstand a normalization of interest rates. They would like a 2% funds rate sometime next year. If being totally honest, they would also say they actually have no idea what will happen. They would say to some degree policy will depend on market reactions to European elections, but mostly it's all on Trump. For years the world revolved around the Fed. Trump has replaced the Fed.