D.J.'s Economix

A mix of economics and markets from Dwight Johnston

Economic Update

April 2017

California Credit Union League
Nevada Credit Union League

Faded glory

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Since the last Longer-term Commentary we've had a Fed tightening, Trump's first big failure on his legislative agenda, an airstrike against Syria, and a Nonfarm Payroll report that was the first disappointing jobs number in a year. That sounds like a script for sharply lower stock prices, but the indexes are down only modestly from the last month. The bond market performed more in line with the news, aside from the Fed tightening. Bond yields are down modestly.

While the markets still jump up and down occasionally, the fact is that neither stocks nor bonds will be able to make a definitive move higher or lower until we have more time to see whether or not Trump can produce any of legislative miracles he has promised.

As usual, we'll take a quick spin around the economy to start with. Last month I declared the Fed was mostly irrelevant at this point. This month we have more evidence of that to discuss.

Flattery will get you nowhere

Last month I wrote the following: "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." The March report took care of that flattery problem with a Nonfarm Payroll gain of only 98k vs. expectations of 175k.

The weather in March was actually worse than in January and February, and this throws off the seasonal adjustment factor used by the Bureau of Labor Statistics. Further, the survey week was the week of the big snowstorm in the eastern U.S. This demonstrates the importance of looking at longer-term averages instead of single-month numbers. The 3-month average gain for payrolls in 2017 stands at 178k, almost exactly the same pace of 2016.

There are other reasons not to worry about the March number. There are absolutely no anecdotal reports from other releases that indicate any weakness in the job market. The ADP private payroll estimate and the ISM manufacturing and non-manufacturing indexes all reported improving conditions, not deteriorating conditions. The other reason not to worry is to realize we're always going to get one or two shockers a year. Last year the May payroll was only 24k, which meant absolutely nothing in the longer-term.

There were a few takeaways to note in the report. The Professional and Business sector—the highest paying sector—scored a third consecutive strong gain. This time it was a gain of 56k. This implies business optimism remains high and is put into action. Construction gained only 6k jobs, but this came after 59k in February. Construction job gains are averaging a healthy 30k per month this year, despite builders' bemoaning the difficulty in hiring workers.

Into each payroll report, a little rain must fall. And the rain came down on the retail sector. The retail sector lost 30k jobs last month, and the outlook is grim with the announced and expected-to-be-announced store closings this year. This is not a one-month blip. This is a secular trend. Hopefully these displaced workers can find jobs in growing areas. I know one area of big growth in Southern California is warehouse workers. Surging online retail sales have caused an absolute boom in warehouse building.

Ending with good news, the Unemployment Rate fell to a 10-year low of 4.5%. And this was not all smoke and mirrors by reducing the labor pool. The participation rate was actually unchanged on the month.

Misery loves company

Nonfarm Payrolls wasn't the only report to suffer the indignity of badly underperforming estimates. New auto sales in March were expected to come at a pace of 17.2-17.4 million units annualized. Sales were 16.53 million. Several reasons were offered up for the miss: 1. Bad weather again; 2. The drop in used car prices caused some buyers to go that route (good for credit unions); 3. A glut of cars buyers don't want (small vehicles) and a shortage of vehicles they do want (large SUVs); and 4. A late Easter?

All excuses aside, the auto market is fine. Auto sales have plateaued. Sales were about 17.5 million for both 2015 and 2016. We could match that pace this year, but sales could also cool down. Frankly, I am surprised they have stayed this strong this long. Consider this: In the early 1990's the average vehicle age of cars on the road was five years. The average age now is approaching twelve years, as vehicle quality is much higher and model redesigns are less frequent. To that, add the fact that millennials are showing preferences to live urban and Uber.

A pace of 16 million units per year would be more in line with longer-term factors and represent a healthy market. Yes, it might cause fewer hours worked for auto workers, but it is still a healthy pace. Everything above that is gravy. I would not start to get concerned until the pace slows and stays below fifteen million.

In other consumer news, year-over-year Retail Sales posted another big month of almost 6%. Shopping online, Costco, and Home Depot have more than made up for the abandonment of Penney's, Macy's, and Sears.

The housing numbers remain strong, but volume in home sales—both new and existing—remain constrained by the lack of supply. Multiple offers used to be a California thing, but it's now a national game. In lower-priced areas this is causing big percentage gains in prices, but in already high-priced places like California prices are showing more limited gains in percentage terms.

I still remain a long-term bull on housing for reasons I've discussed before, but I am getting slightly concerned about some of the widespread fever-like behavior I've been reading about. Fevers can last a long time, however.

Faded glory

The Fed has become less and less relevant to the markets since the election of Donald Trump. Longer-term rates are down about 20 basis points since the March Fed tightening. But remember that the Fed also tightened in December, and longer-term rates are actually lower than prior to that tightening. That is two tightening moves for a total of 50 basis points, but longer-term rates are lower.

Certainly the bond market was well prepared for both tightening moves, but why did rates fall? The drop in rates has basically come on each perceived stumble by Trump. The colossal flop on health care emboldened bullish bond traders to maintain their bets that the Trump agenda will be delayed and watered down at best.

Since the Fed tightened this last time, several Fed officials have stated that instead of two more hikes this year perhaps three hikes would be appropriate. The March FOMC minutes also stated that "some" Fed officials argued that the Fed should begin reducing its balance sheet sooner than anyone expects. The reduction would not come from sales, but from not reinvesting proceeds from maturities, interest, and paydowns. This doesn't sound like much but would effectively be a tightening, as the Fed would collect almost $500 billion from the proceeds. That means the markets have to come up with a $500 billion buyer replacement.

Bond traders ignored this and all other "bad" news from the Fed simply because they don't believe the Fed. They have ample reason to turn deaf ears to their prognostications, given the Fed's long-term track record. In the past the Fed was the only game in town for traders to trade, and react and trade they did. Not anymore. There is a new sheriff in town.

For years the world revolved around central bankers. Now the world revolves around Donald Trump. If you had a choice, which one would you chose? Well you don't have a choice. It's Trump.

But bond traders can't completely write off the Fed as a fading institution. If Trump starts to have success on tax reform and other issues, bond traders will suddenly realize they have to face the Fed again. And they could find themselves confronting a tighter Fed, intent on raising rates and reducing the balance sheet. Also consider that in less than a year it might also be a Fed that is led by a chairperson not named Janet.

The Fed will have its day in the sun again, just not anytime soon.

Flag waving

Bond traders are so focused and committed to the likelihood of a Trump slump, they aren't even considering the alternative or other positive developments like these: 1.Trump has cooled some trade rhetoric (fingers crossed it stays that way); 2. Economic conditions around the globe are improving; 3. The world of negative interest bonds is shrinking. It's still huge at about $6 trillion but that is down $3 trillion in just four months. That would reduce the demand for U.S. debt; and 4. The Fed and foreign traders buy less just as the U.S. needs to fund an expanded budget. We've got another two or three months before we have to worry about these, but they could be coming onto the radar much sooner than bond traders believe.

Maybe these are just the ravings of a mad economist who is just tired of ultralow rates and fundamentals being relegated to the backseat. But, whenever the bond market gets as supremely confident of the outlook as it is now, it's time to wave the yellow caution flag. Or they could be right and in a few months I will have to wave a white surrender flag.