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

The new Fed is the old Fed

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Economic releases continued to surprise to the upside, for the most part, since the last Longer-term Commentary. The impact of the hurricanes seems to have been less than expected. We also learned this month who the next Fed Chairman will be.

The meaty phase of the long-awaited tax reform process also began as the House introduced the outline of its tax reform plan.

Longer-term rates had been on a steady rise since mid-September. During the third week of October the 10-year note yield hit 2.47% and appeared to be on the verge of breakout to the upside. But the bond bull crowd managed to dig deep to find enough reasons—however flimsy—to turn the tide.

This month we'll take a quick review of the latest data and look at these events over the past month and discuss what they really might mean for the future of the economy and interest rates.

Jobs just average

Nonfarm Payrolls rose by 261k in October on the post-hurricane rebound, and the two prior months were revised higher by a total of 90k. The September decline of 33k was revised to a gain of 18k. The average for the two-month hurricane reports is about 140k, which is close to the 162k average for all of 2017.

The Unemployment Rate fell to 4.1%, but that was mostly due to a decline in the participation rate. The big disappointment was the wage component. Hourly wages were flat vs. expectations of .1-.2%. This is payback for the .5% gain in September and drops the year-over-year rate to 2.4%. But this, too, comes with a hurricane explanation. One reason for the outsized .5% jump in September wages was the 107k decline in low wage jobs in the restaurant and bar category. That sector recovered 90k jobs in October. That leaves the two-month average at .25%, which is slightly above average.

Hourly wages were flat in October after September's last month's big .5% gain. But the two-month average is .25%, which is about average for the year.

There were no other outstanding features of the report. Most of the hurricane noise should be out of the next report and we'll get a "clean" picture. I expect the next report to be about average as well.

The good news keeps rolling in

There were several other good news indicators over the past month, starting with auto sales. Auto Sales in September surged to and 18.5 million units annualized on hurricane replacement vehicles. Auto analysts were expecting October sales to return closer to this year's "normal" of 16.5 million, but sales came in at a very strong pace of 18 million. Clearly, there was some leftover hurricane related buying, but that factor does not explain the full impact on sales the last two months.

In another positive sign for the consumer, year-over-year Retail Sales has now moved back above 4% for two consecutive months after a mini-slump over the summer. Retail surveys are also showing that consumers expect to ramp up Christmas spending this year. Maybe consumers are just feeling better.

Feeling better is certainly what the latest Consumer Confidence reading suggests. Confidence surged to the highest level in seventeen years. Consumers reported feeling better about their jobs and the prospects for higher wages.

The National ISM manufacturing fell just slightly, but this still left ISM near multi-year highs. The Non-manufacturing ISM index rose to the best level since 2004.

In other news, the preliminary estimate of 3rd quarter GDP came in at 3%, marking the second consecutive quarter of growth at 3% or greater for the first time since 2014. If you're a long-term reader of this commentary, you know I don't think much of GDP as a reliable or timely indicator of anything that is relevant to actual people. The only reason I am bothering to mention this is that, if not for the hurricanes, growth would have been between 3.5-4.0%. Stronger growth has been evident in plenty of other data the past few months, and this merely confirms that. The only caveat is that .7% of the growth was due to higher business inventories. Inventories is one of those million moving pieces of GDP that can skew the numbers, and one of the reasons I am not a fan of GDP.

Growth has not been limited to the U.S. Statistics from Asian and European economies have continued to exceed expectations. This brings up something else that gets little attention: Industrial commodity prices have been on a steady rise throughout the year, and this has not been based on the usual speculative trading crowd. There has been solid growth in worldwide demand. That demand is also showing up in surging shipping costs.

Why am I bringing up all these other data points that I rarely include? I just want to demonstrate the momentum that has developed in the global economy. If that momentum does continue (and there is nothing yet to suggest it won't), we could be looking at a scenario next year that will shake the foundation of the secular bull market in bonds.

The Fed — new is old

Before I get to the new, let's just mention the old. The Fed more or less confirmed that they are planning a fed funds rate increase in December, and the statement left three or four rate increases on the table for 2018. This was not a surprise, and a lot can happen to disrupt that plan next year. One thing that won't happen next year is that Janet Yellen will lead the rate increase charge. Out with the old—no offense or reference to age, Janet—and in with the new.

Jerome "Jay" Powell has been nominated to take the chair. After months of speculation, Powell's nomination was obvious days before it was made. For a change, Trump played it safe with this choice. Powell should have an easy confirmation path as he is a Republican and he is considered to be a Yellen clone. You might wonder how a clone of Yellen beat the original Yellen. Trump won't say it, but it came down to one thing: Obama put Yellen in the Chair. There was no way Trump could abide that.

For those who read my Daily Comment, the following was what I wrote on Powell, but I am including it here for those who read only the monthly comment.

- Powell has been a member of the Federal Reserve Board of Governors since 2012.
- He is considered moderate to dove-ish on monetary policy, along the lines of Janet Yellen.
- Powell has also stated he would be open to lessening regulatory burdens. This could have been his main selling point to Trump.
- Powell's other government experience was a two-year stint as Assistant Secretary of the Treasury under President George H.W. Bush.
- Powell is *not* an economist and has no working experience in economics. Some of you might think this is a big plus, but the last Fed Chair with no economic background was G. William Miller, who lasted one disastrous year (1978) as Fed Chairman.
- Powell is a lawyer. I think we can all agree this is *not* a good thing. He is a graduate of Princeton and Georgetown University School of Law.
- Most of his post-collegiate career has been with investment banks in a variety of capacities, but mostly in the deal-making realm.
- Powell is *not* a billionaire. In his 2016 filing he listed assets of only $55 million.

That is all we know for sure at this point about Powell. He has mostly flown under the radar while at the Fed. He never gave a speech that the caused any reactions from the bond market. That will change. The more you look at him and his background, the more curious his selection seems to be. We also know that we don't know what kind of Chairman he will be. We'll find that out when he faces the first rough patch.

Powell will take over February 1, 2018. Yellen will chair the December meeting and then have her swan song at the January 31, 2018 meeting. Ms. Yellen is the first one-term Chairman since the aforementioned G. William Miller. Yellen is not leaving due to ineptitude as was the case with Miller; she merely had the misfortune of being named Fed Chair by Obama.

Tax reform funhouse open for business

With the pick-a-chairman game over, the attention has immediately turned to a pick-a-tax-cut game. The House has introduced its version of the plan, but that merely starts the game. I see no point in writing much about the specifics of this particular first salvo, as the final plan will likely look much different, but here are a few quick thoughts.

The key component, in the hearts and minds of stock traders, was the reduction of the corporate tax rate to 20%, effective January 1. This looks like it will stick. You did not see a big positive market reaction to the news since it was well anticipated. You would have seen a big negative reaction had it been watered down.

The bill proposes capping state and local tax deductions and also mortgage interest rate deductions for new mortgages. The caps are high enough that it will not impact many of those other than in the highest income bracket. I don't know how much or what part of this proposal will stick.

Realtors, builders, and mortgage brokers are already wailing at the top of their lungs about the lower mortgage deduction cap and how this would be a disaster for the housing market. That is a crock, to put it politely. The cap is still a generous (for most parts of the country) $500,000. And for those people with mortgages over $500,000, they can afford it. They did not a buy a house for the mortgaqe interest deduction, especially with rates this low.

The fact is that the mortgage interest deduction should be 0%. It is one of the largest and most unfair deductions in the current tax code. We are the only major country in the world that has that deduction, and the lack of that deduction certainly has not limited housing market growth and home prices in those countries. As an example, the home ownership rate in Canada is 69% and is 71% in the U.K, two of the most expensive markets in the world. The home ownership rate in the U.S. is under 64%. Don't let anyone scare you about changes in interest deductions. People buy homes for many reasons, and the mortgage interest deduction is way down the list.

I will admit that in some high cost states like California, the equation is more complex. If you currently own a home with a mortgage of $500,000 or more and want to trade up to a home with a mortgage of say $750,000, you might think about the tax implications. Layer on top of that the limit on deductibility of property taxes, and some home owner might decide to stay put and visit Home Depot more often. But this might not mean lower home prices; it could mean higher home prices. Supply in this already super-tight market could shrink.

Housing related entities are also crying about increasing the standard deduction, which they also say will detract from the benefits of home ownership. Certainly there will be many homeowners who will be better off using the standard deduction. But isn't that the whole point of tax reform? Leave consumers better off and simplify the process.

Those are just a few of the key points of the bill, but now the bill must go through the House committee sausage mill. Once that is completed, the House sends the bill to the Senate for them to send it through their torture chamber. After that, the bill goes to a joint committee to iron out disagreements before a vote in the House and Senate. Only after that process will the bill go to the President's desk.

Still feel good about the chances of tax reform before Christmas? If so, you are truly an optimist.

But here is the key point: As long as the bill is alive and still has the corporate tax cut along with some individual tax cuts, it really doesn't matter to the markets or to the economy whether the bill is signed in December or March. The bill will go through some tortuous times in the weeks ahead, and the stock market might express its displeasure, but as long as it lives, we're good.

Staying alive

Speaking of things that are still alive, longer-term rates simply refuse to breakout into a new uptrend. Or more precisely, the bullish global bond trading crowd refuses to give up on the secular bull market trade. I won't repeat what I've written so often about regarding the Fed and global central bank money-fueled leverage crowd. Let's just say the crowd has thinned just a tiny bit the last few weeks, but most of them remain in the room and will pull out all the stops to keep the bull alive. But at this point, I think evidence is mounting that the protective wall around the bull crowd could crumble next year.