D.J.'s Economix

A mix of economics and markets from Dwight Johnston

Longer-term Commentary

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A rude awakening

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The stock market had a great January. With the tax bill in place and the economy humming, what could possibly go wrong? What could possibly go wrong became apparent once giddy stock traders decided to look at how bond traders spent their January.

The steady rise in longer-term rates in January pushed the 10-year note yield up more than 40 basis points from the year-end close. Once stock traders took note, stocks started falling and falling and falling. A recovery has begun as of this writing.

In this month's commentary we'll talk about the return of volatility to the markets and the implications for the economy.

I will also explain why I am becoming more certain that the Fed might tighten one time (if at all) this year instead of the expected three times.

Just the facts

Before we get into a discussion on the markets and the Fed and all the what-ifs of those, let's review how the economy is actually doing so far in 2018. So far, so good.

Nonfarm Payrolls rose by 200k in January, and there were no quirky-looking components. We saw solid growth across all the key job sectors. Aside from the payroll report, Weekly Jobless Claims are at the lowest level in over forty years. There are no signs of any weakness in the job market.

But what got all of the attention in the jobs report was the hourly wage component. The year-over-year increase in wages jumped from 2.6% to 2.9%. This number is also what seemed to cause the bottom to fall out of stocks on that Friday before the turbulent week to follow.

As most of you know, I have been forecasting rising wages for some time, and I maintain that the Bureau of Labor Statistics hourly number did not reflect true wages gains. Several regional Feds as well as private economic research have published studies supporting this claim.

I do think the trend in wages is higher, and that we will look back at the end of 2018 and see a trend number at 3% or above. However, I don't believe this lone numbers tells us anything, and the markets severely over-reacted to this report.

The wage gain was widely written about as the largest year-over-year gain since 2009. That makes for a good headline grabber, but the truth is it wasn't a big deal at all. In March of last year, the year-over-year gain was 2.8%, very close to the 2.9%. And guess what? That y-o-y rate did not last past that single month report and quickly fell back to a range of 2.2% to 2.6% for the rest of 2017. As I said, I think the trend in wages is higher, but I refuse to jump on a single-month piece of data to support the case. Let's give this a few more months.

Here one more thing to keep in mind: Wage inflation is a symptom of inflation, not a cause of inflation. For those worried that wage inflation will lead to overall inflation, set those fears aside. Wage inflation has never led inflation.

Retail Sales were strong during the Christmas season, but that strength waned into the new year. Year-over-year Christmas sales were up a strong 5.5%, but Retail Sales in January was down .3%, dropping the year-over-year rate to 3.6%. January sales are notoriously volatile due to seasonal adjustment factors. Take the January report with a grain of salt. The next couple of months should see solid sales gains as tax refunds are spent.

Auto sales for January came in at a pace of 17.2 million units annualized. This is exactly the same pace for all of 2017. I expect the pace of sales this year to be a healthy if unspectacular rate of 16.5-17.0 million.

The housing market closed out 2017 in typical fashion—with a slight decline in activity during the Christmas season. We do not have January data yet. I discussed my outlook for housing in last month's commentary. I expected the shortage of housing to worsen and be the leading story of housing in 2018.

But the story could switch this year to the impact of rising mortgage rates on home prices and demand. For those in areas where home prices are reasonable (near the national median), rising rates should pose few problems, but for those in higher-priced areas (I'm talking to you, California), higher interest rates could slow the housing market by weakening demand and softening prices. I don't know where the pain threshold is, but I would think if the 10-year note approaches 3.5% the effects will start to show.

Inflation isn't a problem—yet. The core rate of inflation rose by .3% in January, but the year-over-year core rate was unchanged at 1.8%. The year-over-year rate might provide comfort to stock and bond traders worried about inflation, but they shouldn't get too comfortable. The reason for the unchanged y-o-y rate was that a .3% gain in January 2017 dropped off the comparison. In February a .2% increase will drop off, and that should limit any jump in the y-o-y rate.

But starting with the March data, the y-o-y comparisons will be in jeopardy. In March, a .1% decline in the core rate will drop off, and that will be followed by four consecutive months of .1% drop-offs. If the monthly core rates for the same five months of this year are .2% each month, the y-o-y rate will jump from 1.8% to 2.4%. Then the bond market will have a real problem and so will the Fed.

Wrapping up the economy sector, there is nothing to suggest any big changes in 2018 from 2017 unless it's an upgrade. But as I wrote, I think some risks to the economy might emerge in the latter part of the year.

<u>Now the fun stuff</u>

The stock market provided all the fun the past couple of weeks, if your idea of fun is a white-knuckled ride in a runaway train. As I mentioned earlier, stock traders ignored rise in rates until the very end of January, and then absolutely went into a panic in February.

The problem wasn't the nominal rate of the 10-year note, which went over 2.80%, it's how quickly it got there. At the beginning of the year, the consensus forecast was that the 10-year yield would be roughly 3% at the end of 2018, up from 2.40% at year-end 2017. But the speed at which the 10-year hit 2.80% startled the stock market. A slow, steady increase would have gone unnoticed.

That was Step One of the stock debacle. Step Two was the implosion of an obscure but popular trading vehicle—as Wall Street fondly refers to a "complex" security. This type of security or investment is not a security or investment at all. It serves no purpose other than providing a vehicle for rampant leveraging of bets for speculators using a derivative of elements in other investments. Wall Street is famous for leaving a trail of tears from "complex" security implosions. This was just another notch of their belts.

Step Three of the washout was the cleaning out of positions that were tangentially impacted by the "complex" security.

Step Four was the recovery, which came in fits and starts.

Step Five is still to come: Learning if the recovery will hold and determining if there will be any lingering effects.

The fallout

If the stock market's wild ride has come to end, there will be zero impact on the economy. If the recovery in stocks that we're seeing as I am writing this fails, and the stock market enters a deep and broad decline, we will see the impact in the economy. Businesses that were gearing up spending and hiring plans after the tax bill passage will most likely put those plans on hold for now. Doesn't take a rocket scientist to figure that out. A recession would still not be a certainty, but it would likely mirror the short, shallow recession in 2001, which was a stock-market led recession.

I have no idea where stocks will go from here, the Dow could be up 1,000 or down 1,000 the day I post this, but I would hope stocks are entering a period of less complacency. Complacency has been the hallmark of the stock market for the past two years, and that has led to stock price inflation and a complete disregard for any possible risks to the stock market. The return of a more open-minded attitude toward both the opportunities and risks in stocks is a healthy thing.

The stock market is now going through that mindset adjustment from complacent to balanced, but the bond market went through that in January.

Sea change in the bond market

For at least the last five years, the consensus among the world's largest bond accounts was that the global economy would weaken. First, Europe was going to implode and drag the world into the next crisis. That didn't happen, so they turned to predicting a China implosion. That didn't happen, either. Finally, they turned to the U.S. and said the recovery here would soon die of old age. Once again, didn't happen.

The narrative shifted last year when it became obvious that U.S. and global economies were improving. Bond bulls said the Fed would push short term rates too high and drive the economy into a recession. Bond bulls were also complacent about inflation. And, until the end of the year, the yield curve flattening trade was the hottest ticket in town. Bond bulls were looking for the 10-year note yield of 2% or lower by the end of this year, while the Fed raised short-term rates to 2% or higher.

But something happened after the first of the year. While the inflation data has not changed, expectations have. Bond traders started to take seriously reports from businesses about how hard it was to finds workers and they were being forced to escalate wages. They also started listening to manufacturers who are reporting higher input costs.

The mindset shift was subtle, and the unwinding of some of those positions was quite orderly. But, that probably tells us that only a few of those bullish positions have been unwound.

Bullish bond traders seem to have woken up to the massive shift in the supply/demand factor for treasuries. I discussed this in the January comment, and I have an update: It's worse than we thought. The forecast at that time was the Treasury would have to issue $600 billion in new debt this fiscal year. But, the Treasury is now estimating that including the off-budget items (disaster relief, war related expenses, Social Security, etc.) and lower tax receipts, the Treasury will be issuing $1 trillion in debt. Moreover, that number will move to $1.1-1.3 trillion in fiscal years 2019 and 2020. And, this assumes economic growth of 3%. This is all coming at a time when the Fed is out of the market and the European Central Bank is moving that direction. While bullish bond traders have started to acknowledge this, I don't think they have recognized what a profound shift this really is. My year-end forecast of a 3.50-3.75% ten-year yield might not be high enough. On this issue, I don't think bond traders have lost enough complacency.

But we can't leave the subject of complacency without discussing the source of that complacency—the Fed— and what the future holds for this new Fed.

<u>The case builds for a go-slow Fed</u>

In January I stated the case why I thought it was likely that the Fed would not tighten in March, despite the market's view that an increase was a lock. I based this on the theory that the Fed would not want to tighten and appear to be attempting to offset the positive impacts from the tax bill. This would be partially due to politics of the Trump appointees, but the Fed could justify the decision not to tighten by pointing to the still low inflation rate. They could also claim they want to give inflation more time to prove the rate will stick and not fade as it did last year.

Now I have two more possible arguments: The first, and less likely, is that an extended and deep decline in stocks would prevent the Fed from moving. Unless stocks do start moving lower again, that one is off the table.

The second argument, and more likely, is the rise in longer-term interest rates might be enough to hold off the Fed. The 10-year yield is currently 50 basis points above the yield on the 10-year the day *after* the December tightening. That means the Fed has done nothing while longer-term rates rose. The rise in longer-term rates is in effect two tightening moves and does impact financial conditions. Of course, the rise in longer-term rates is only partially catching up to what the Fed has already done, but the Fed might refrain from tightening again in March until they have time to assess how much of an impact the current rise in longer-term rates has had.

The consensus case for three rate hikes still looks reasonable, but how many times has the consensus case been right? I will maintain the view that the Fed will go slow until I'm proven wrong or I see a serious uptick in inflation.

The short list

I've thrown a lot at you this month. Let me just boil it down to a few key takeaways:

- The stock market turmoil is unlikely to last but did likely end the overly complacent attitude in the market. This should continue to be a more volatile year.
- Bonds have made a big move in a short time as big bond accounts have also lost their complacency and confidence about the Fed and inflation. Given the 3% level on the 10-year is close, there will be a lot of resistance to go above it before it breaks, if it breaks. That means we should have a period of relative calm in the bond market.
- The economy should continue to do well. Job growth should be steady, though the monthly payroll numbers could decline due to the tight labor pool. Wages should be on clear trend higher later this year.
- Consumer spending will not get a big boost from the tax cut, but consumers will continue to spend at a healthy pace based on confidence in the job market
- Higher inflation is not a problem yet, but risks rise in the second half of the year.
- The Fed will be moving at a slower pace than expected, but longer-term rates will still move higher.

If the first six weeks of 2018 is at all representative of what is to come the rest of this year, I won't have to complain about dull markets.