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Economic & Financial Outlook

August 7, 2018

	S&P 500	10-year rate	Oil	Gold	Bitcoin	ETH
Fundamental value:	3000	4.0	$47	$830	NA	NA
Actual price:	2850	3.0	$70	$1,222	$7,130	$410

Business activity accelerated to a 4% annual rate in the second quarter. This brought the real growth rate for the past year to almost 3%, the fastest yearly growth in three years. The acceleration in growth is a result of this year's tax cuts and the ongoing removal of numerous government regulations.

Tax cuts have led to an explosive rise in corporate earnings. With 75% of the S&P 500 companies reporting, reported earnings are estimated to be up 29% from a year ago. Corporate profits are the lifeblood of the economy. They will lead to higher wages and even more jobs.

In spite of strong growth and soaring profits, stock prices have been subdued. The main problem is uncertainty over tariffs. Even though President Trump and the EU have agreed to work toward eliminating all tariffs, key details have yet to be worked out. Mexico and Canada also show hints of progress, but there is still nothing definitive.

The situation with China also is also in limbo. China has vowed it will not succumb to Trump's threat to place 25% tariffs on $200 billion of Chinese imports.

At present, the key issue regarding tariffs is how much damage tariffs will do. Judging from the impact on financial markets, Trump's threats and actions appear to be doing the most damage to China, next is Mexico and Canada, then the EU. While the US is incurring some disruption, it appears to be much less than that affecting our trading partners.

If the issue over tariffs lingers, I expect it will lower the growth rate in the US from the 4% vicinity to roughly 3%. So far, the reaction in US financial markets appears consistent with this estimate.

Due to our tax cuts and deregulation, the US is far less vulnerable to disruptions than our trading partners. Hence, there is more pressure on them than on the US to reach an agreement that lowers trade barriers. Since Trump continues to hold the upper hand in this dispute, I expect to progress on resolving these issues in the months ahead.

Aside from trade, some have raised concerns over monetary policy turning restrictive. Even though the Fed is set to raise interest rates next month and it continues selling $40 billion in securities each month, concerns over monetary restraint are not valid at this time.

The following section on monetary indicators discusses why policy is on a path that that will continue to support strong business activity. Once trade disputes are resolved, the economy will be able to sustain growth at a 4% pace.

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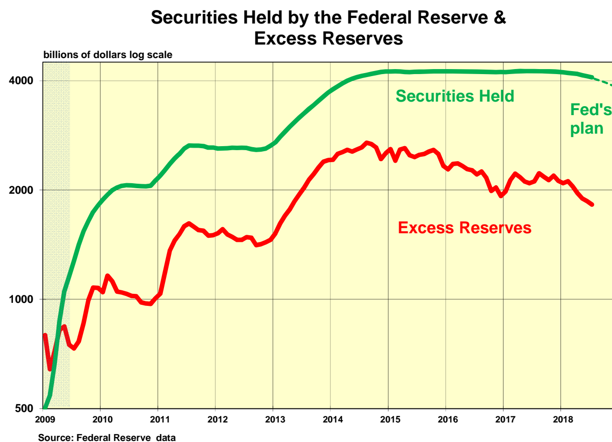
Monetary Indicators

The Fed is adhering to its plan to reduce the size of its balance sheet. For the current quarter, the plan is for the Fed to sell $40 billion in securities each month. Doing so will reduce bank reserves by $120 billion this quarter.

By itself, selling $120 billion in securities represents a restrictive monetary policy. The chart below shows how the Fed's holdings of securities will continue to decline as the Fed continues with its planned sales.



Under normal conditions when the Fed sells securities, monetary policy turns restrictive. In 2008 the Fed sold $300 billion in securities and ushered in the worst financial crisis since the Depression.

Since 2008 monetary conditions have been anything but normal. The Fed embarked on massive purchases of securities from 2009 through 2014. Initially, this was necessary to offset its massive sales during 2008.

By mid-2009, after purchasing more than enough securities to replace its sales of the previous year, the Fed went on to purchase $2 trillion more securities. This flooded the system with more bank reserves than banks could handle. As a result banks accumulated excess reserves, which are deposits banks leave with the Fed.

Excess reserves are potential liquidity since they can enter the economy when banks shift their deposits with the Fed into loans and investments. This is what has been happening over the past four years.

The downward trend in bank reserves has provided the necessary liquidity to offset the Fed's sales of securities.

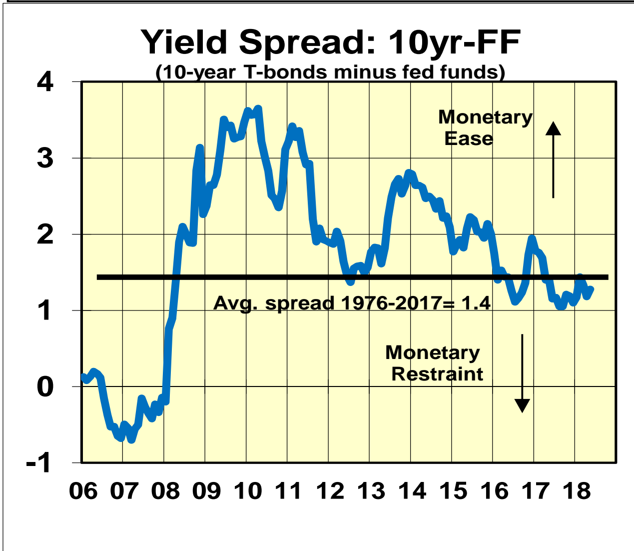
Other monetary indicators tend to confirm there is sufficient liquidity to maintain a moderate to strong increase in spending.

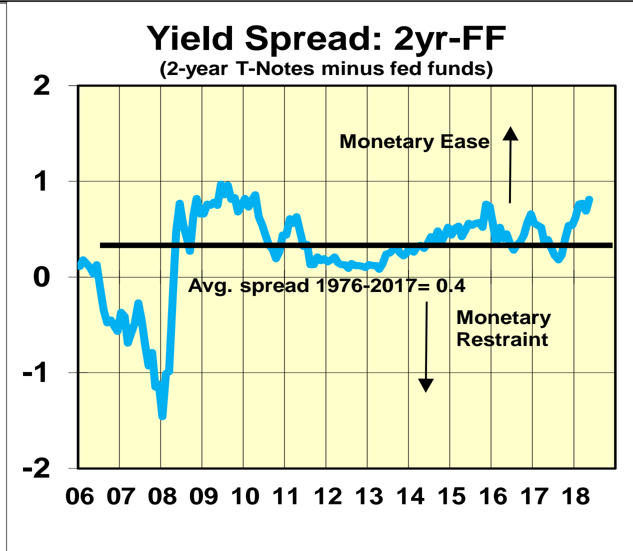
The spread between long and short-term interest rates is often a reliable indicator of monetary policy. The current above-normal spread between the yield on 2-year T-Notes and fed funds is associated with monetary ease. However, the flat to slightly negative spread for longer-term rates points to a neutral to slightly restrictive policy.

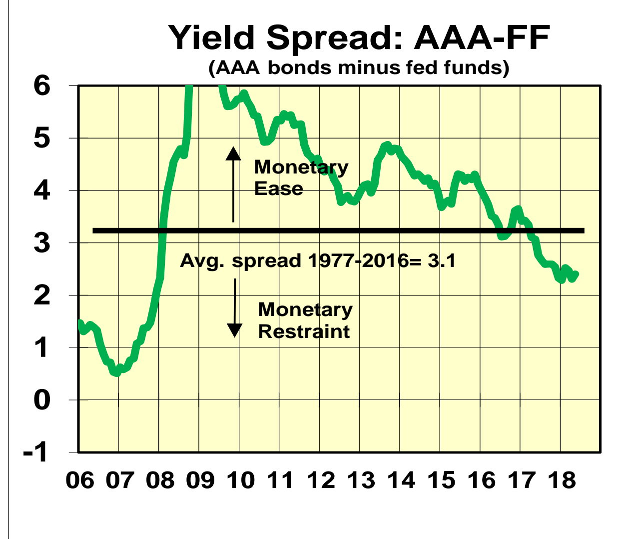
More conventional money data are also encouraging. Over the past year, currency, bank deposits, savings deposits and loans and investments are all increasing at rates of 4% to 6%. There is nothing unusual here.

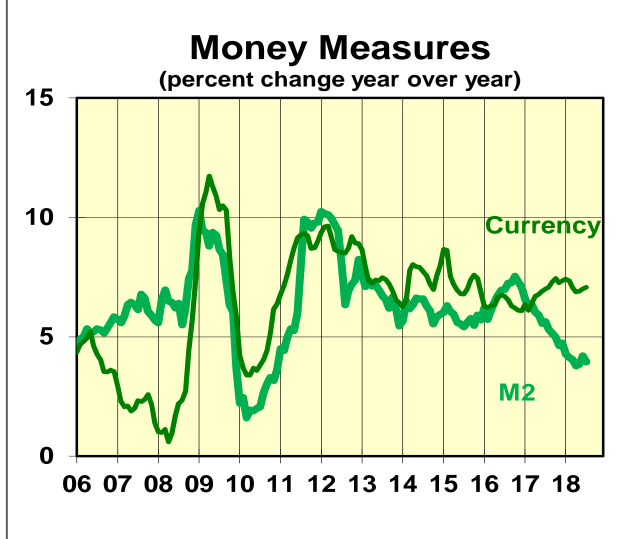
On balance, monetary policy remains conducive to permitting spending to grow at a rate of roughly 5%-6%.

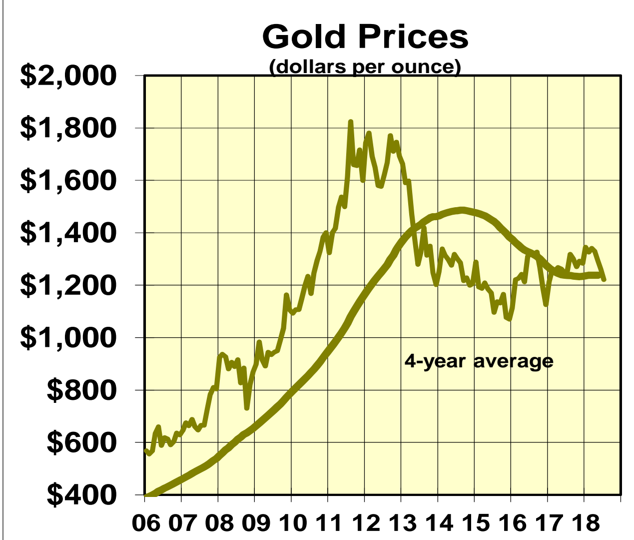
MONETARY INDICATORS

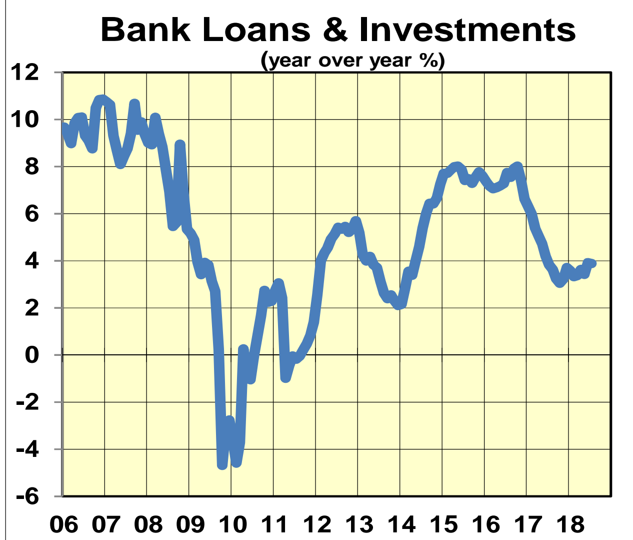












Sensitive Indicators

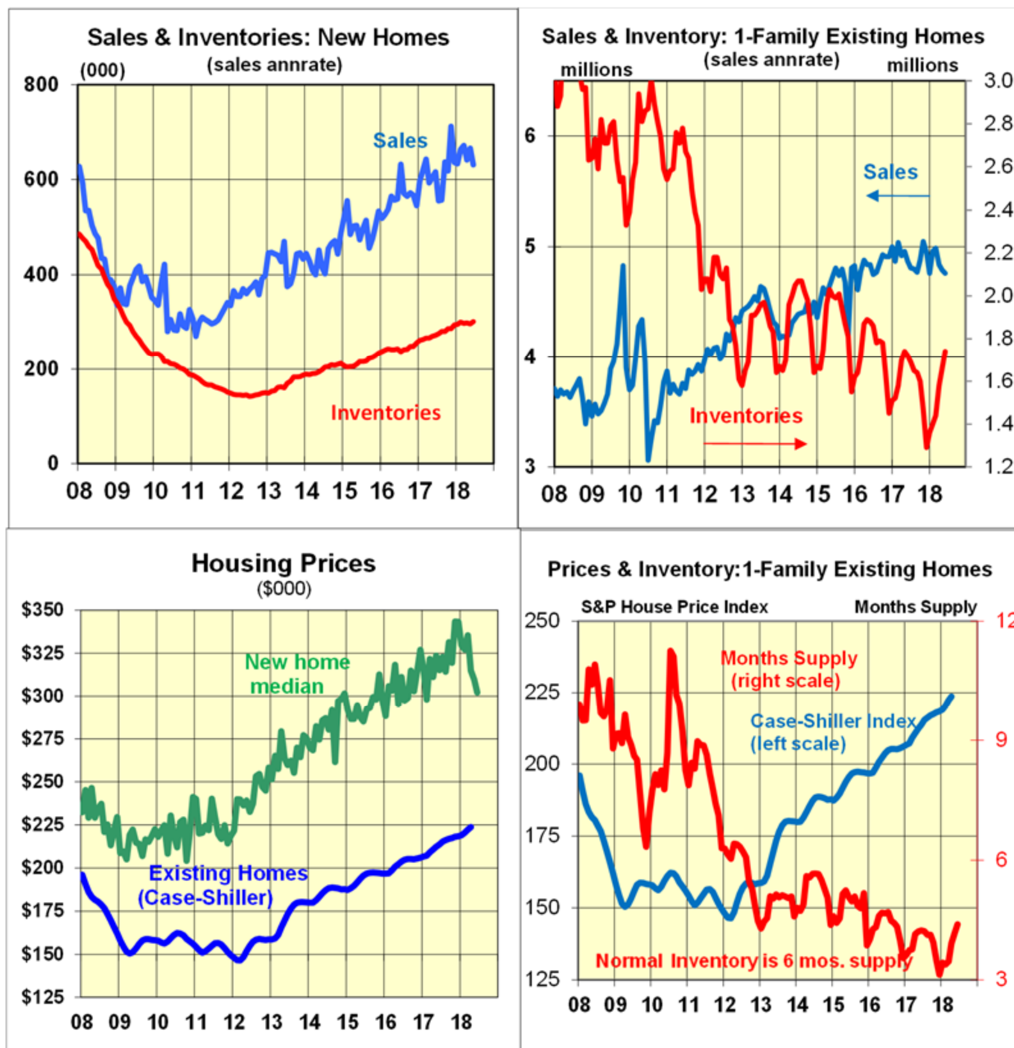
Sensitive indicators are mostly positive. However, there are tentative signs of easing in some areas.

Sales of new and existing homes are flat to down and inventories remain low. However, homebuilders remain very optimistic with their survey in July showing a strong reading of 68.

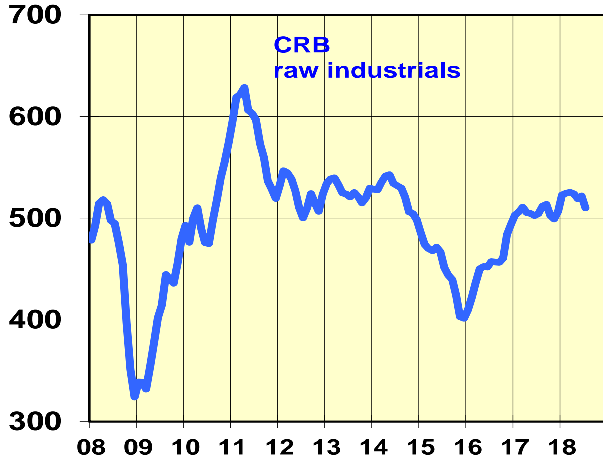
In spite of concerns over tariffs, stock prices have regained their losses from earlier in the year. ISM business surveys eased a bit in July and are now in the mid-50s to 60s. These are still strong readings, just not as strong as in prior months.

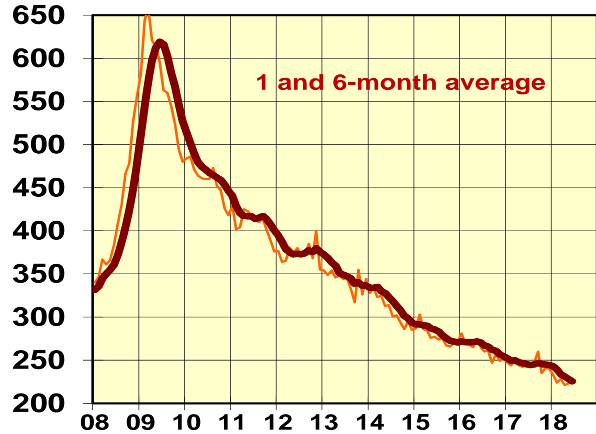
Unemployment claims are hitting new record lows and new orders for durable goods remain in a strong uptrend.

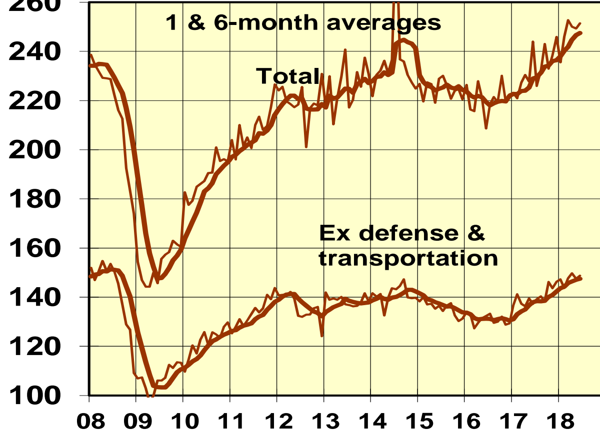
As for coincident indicators, manufacturing output and vehicle sales are flat to down. Consumer spending is up and inventories are down. With spending up and inventories down, the recent weakness in production and vehicle sales should soon come to an end.



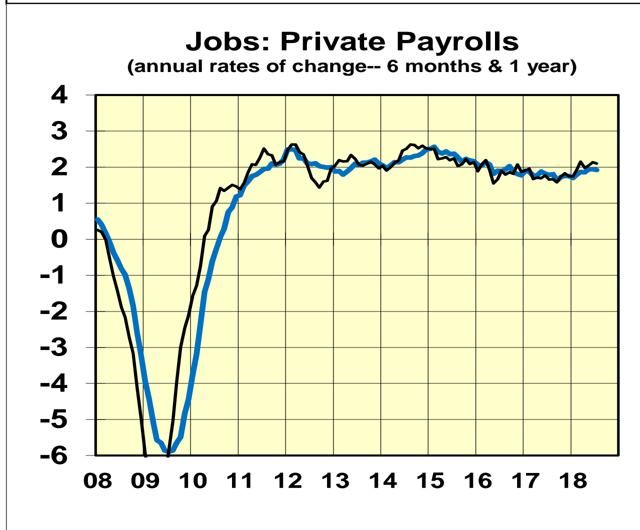
SENSITIVE INDICATORS

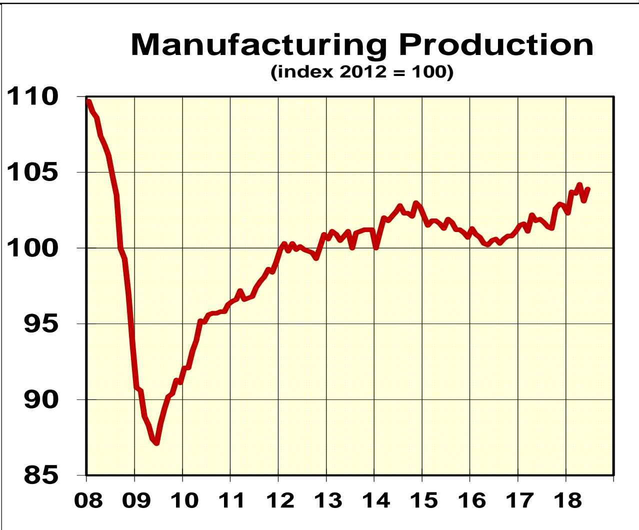


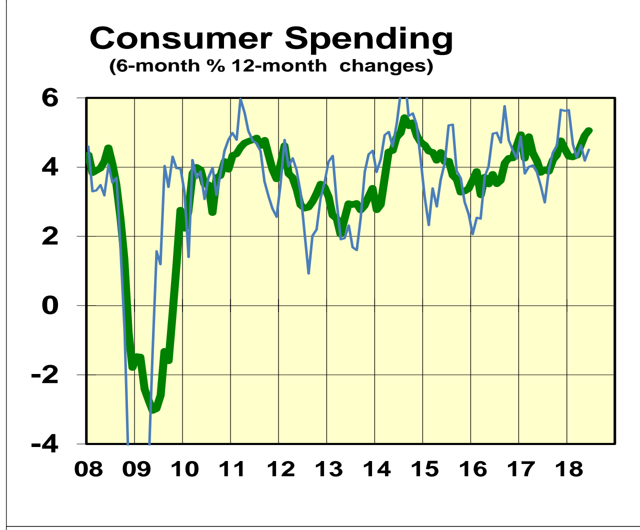


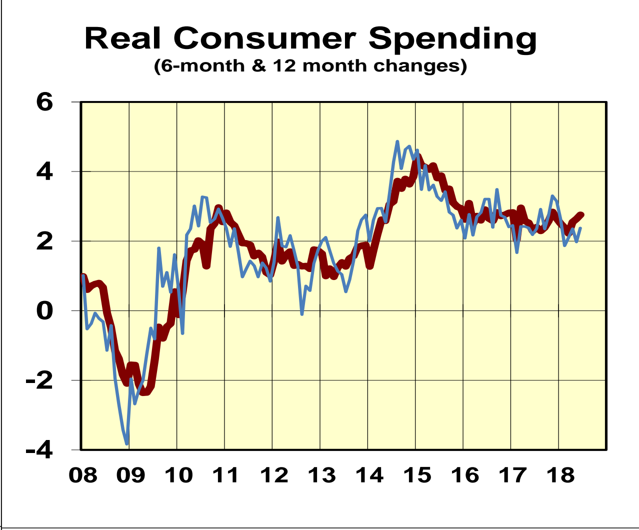


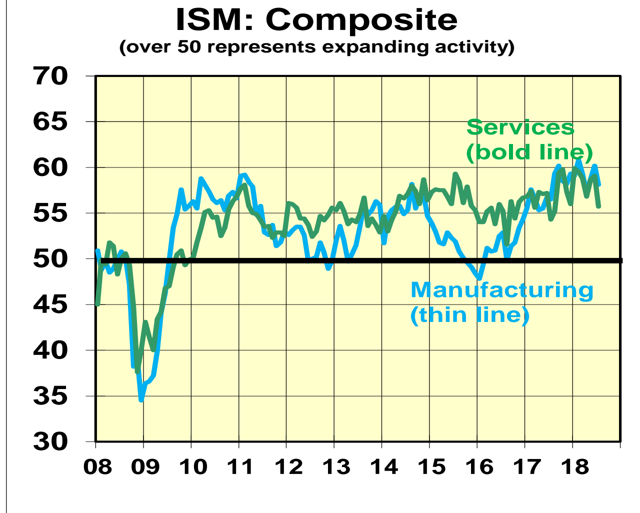
ECONOMIC INDICATORS

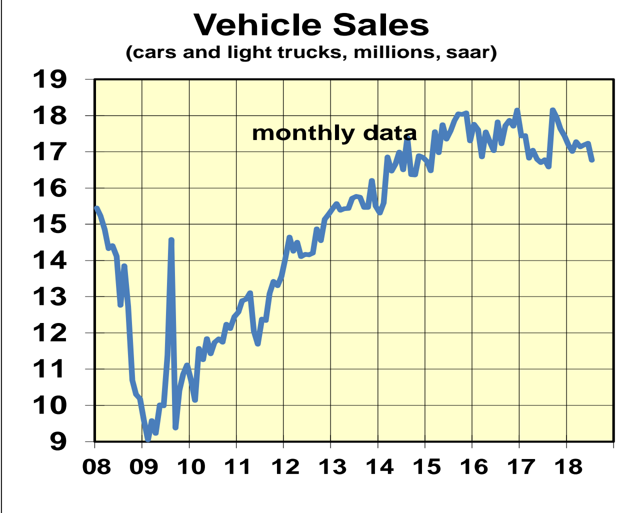












Inflation Indicators

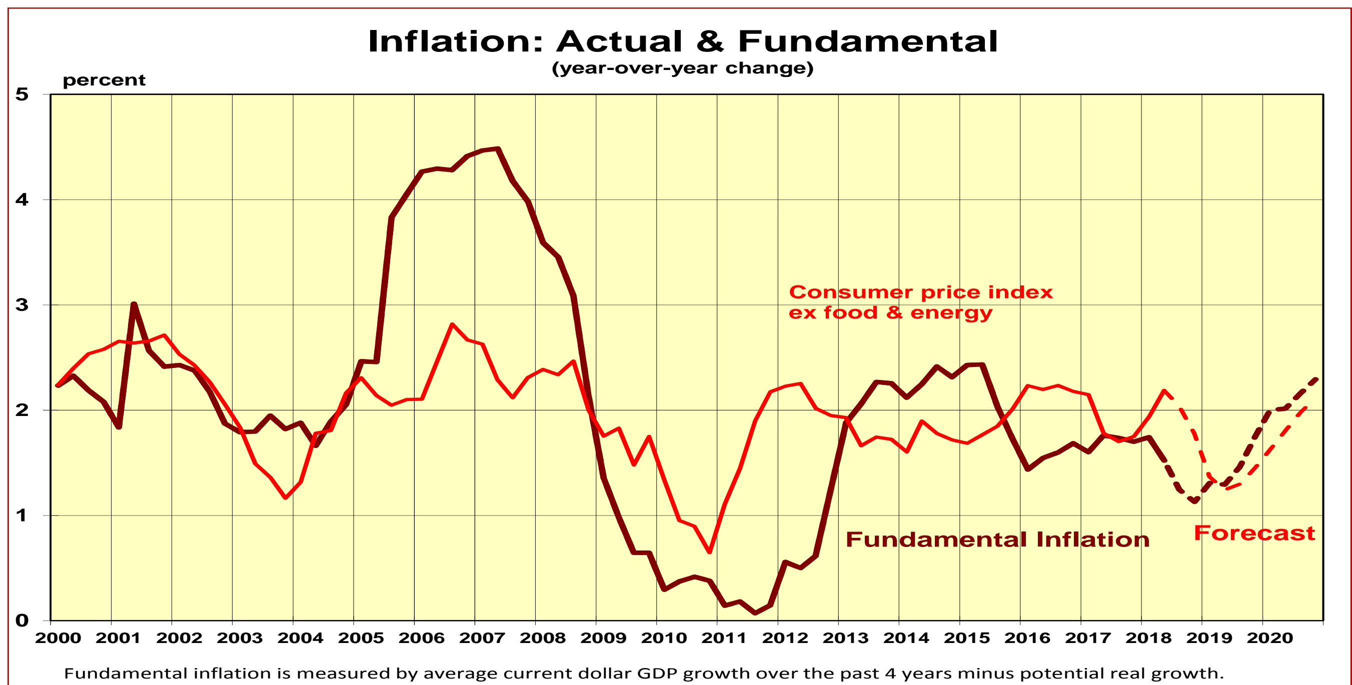
Inflation occurs when an increase in current dollar spending exceeds the economy's ability to produce output. Over the past 4 years the yearly pace of spending has averaged close to 4%. The economy has grown at a pace of roughly 2%. The difference between spending and output leaves the fundamental or underlying inflation rate in the 2% vicinity.

Although inflation has averaged close to the 2% area for the past five years, it has frequently moved above or below its fundamental. The current year is no exception. A surge in commodity prices associated with the pickup in the business activity raised inflation above its fundamental rate.

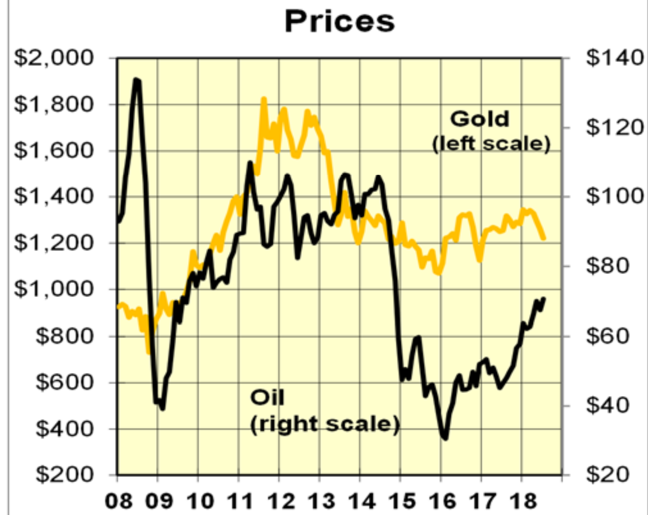
The current forecast anticipates the four-year average spending pace will remain close to 4% this coming year. However, real growth in the economy is forecast to be 3%-3½%.

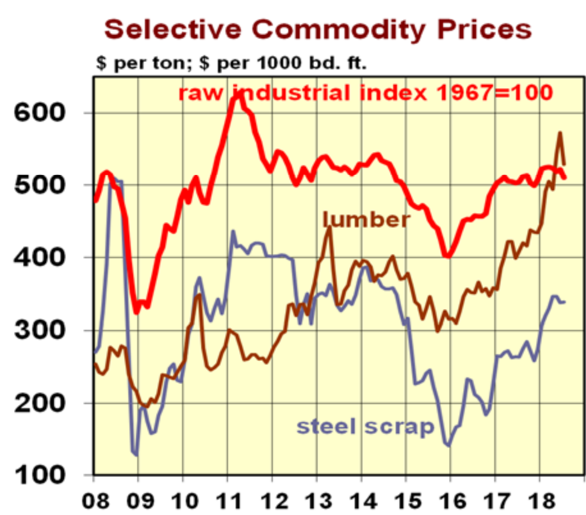
My forecast calls for inflation to be slightly above 2% this year amid a shortage of resources as growth accelerates. There is also always the potential for tariffs to artificially raise prices above where they would have been.

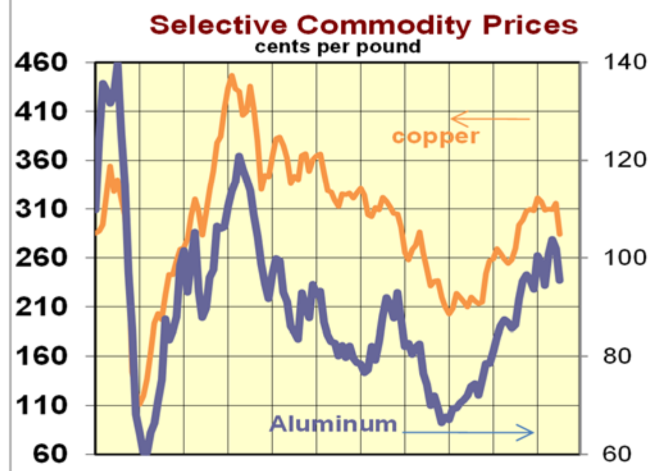
This increase in inflation is likely to be temporary. A boost in productivity resulting from tax cuts will help keep inflation at or below the Fed's 2% target.

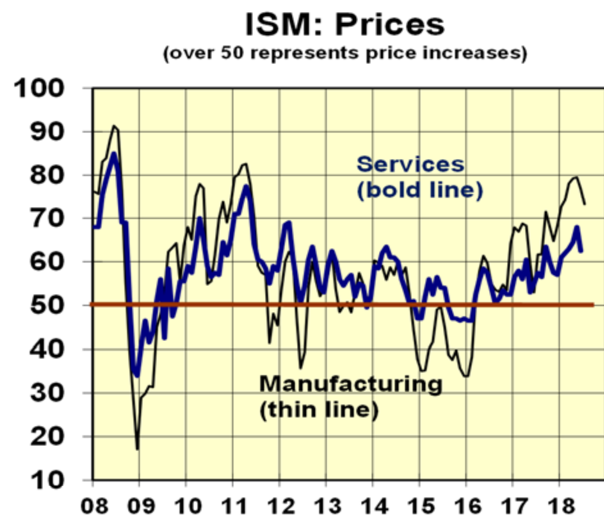


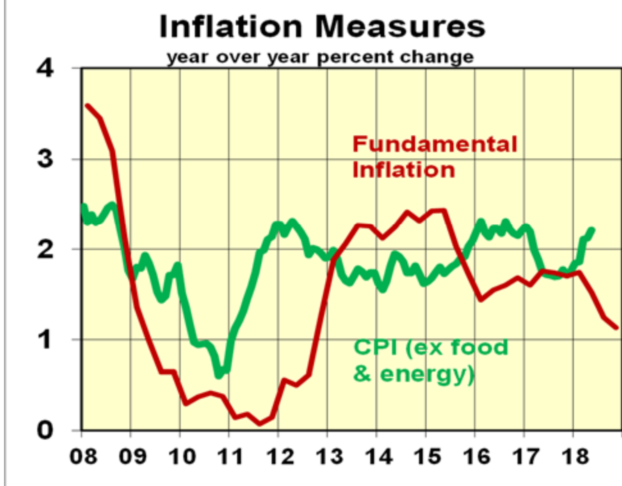
INFLATION INDICATORS











Fed Policy and Interest Rates

The Fed has to be pleased with its plan to gradually return to normal with respect to both interest rates and the size of its portfolio.

So far, its program for gradual increases in its fed funds target rate has been both predictable and widely anticipated. This has led to a relative calm in financial markets as the Fed moves interest rates closer to their fundamental levels.

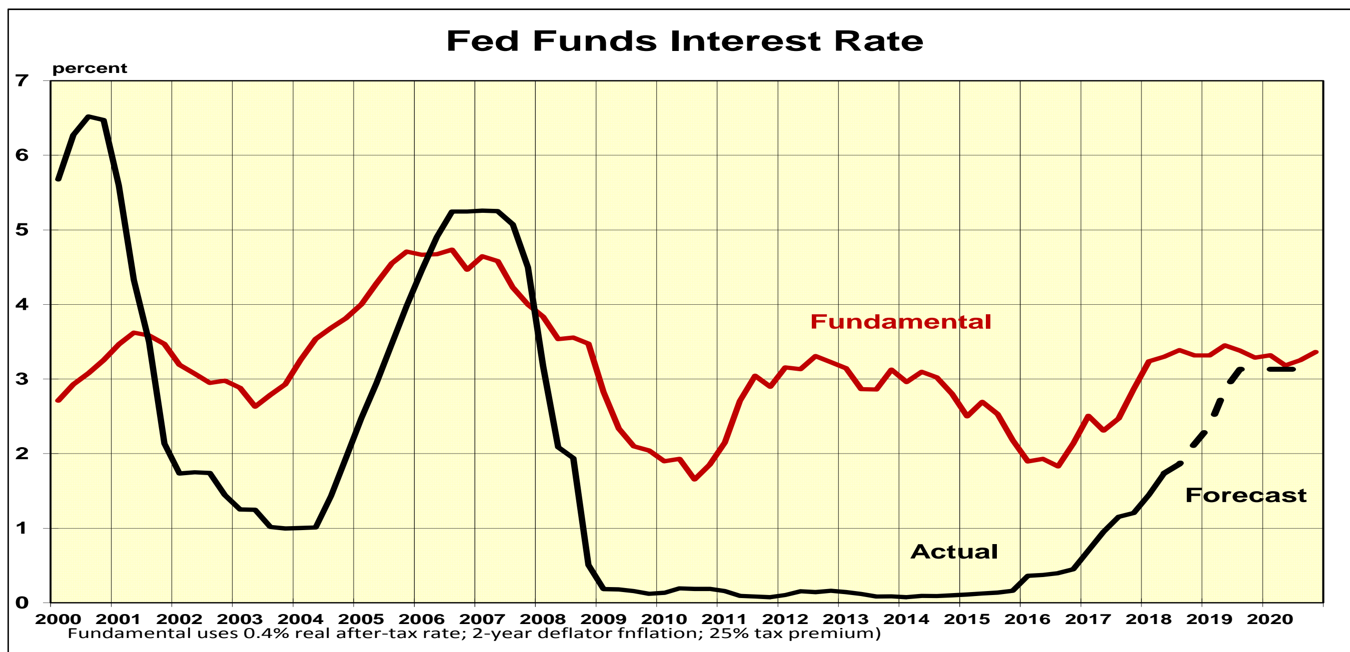
The next likely increase in the fed funds target will occur in next month. Futures markets place a 94% probability of a ¼ percentage point increase at the Fed's September meeting. If, as I expect, growth remains strong, the Fed will increase rates again at year end.

Changes in interest rates are no longer directly related to purchases and sales of securities. Instead the target rates are determined by massive overnight offsetting purchases and sales of securities. As a result, changes in interest rates no longer reflect monetary ease or restraint. However, as interest rates move closer to levels justified by economic conditions, they are closer to reflecting normal market conditions. This is positive.

While monetary policy is no longer directly tied to interest rates, it can be influenced by the Fed's current monthly sales of securities. The Fed is currently selling $40 billion of securities each month on its way to selling $50 billion in securities in the fourth quarter and thereafter.

As indicated in the section on *Monetary Indicators*, the normally restrictive impact of the Fed's sales of securities is being offset by banks shifting their deposits from the Fed into loans and investments.

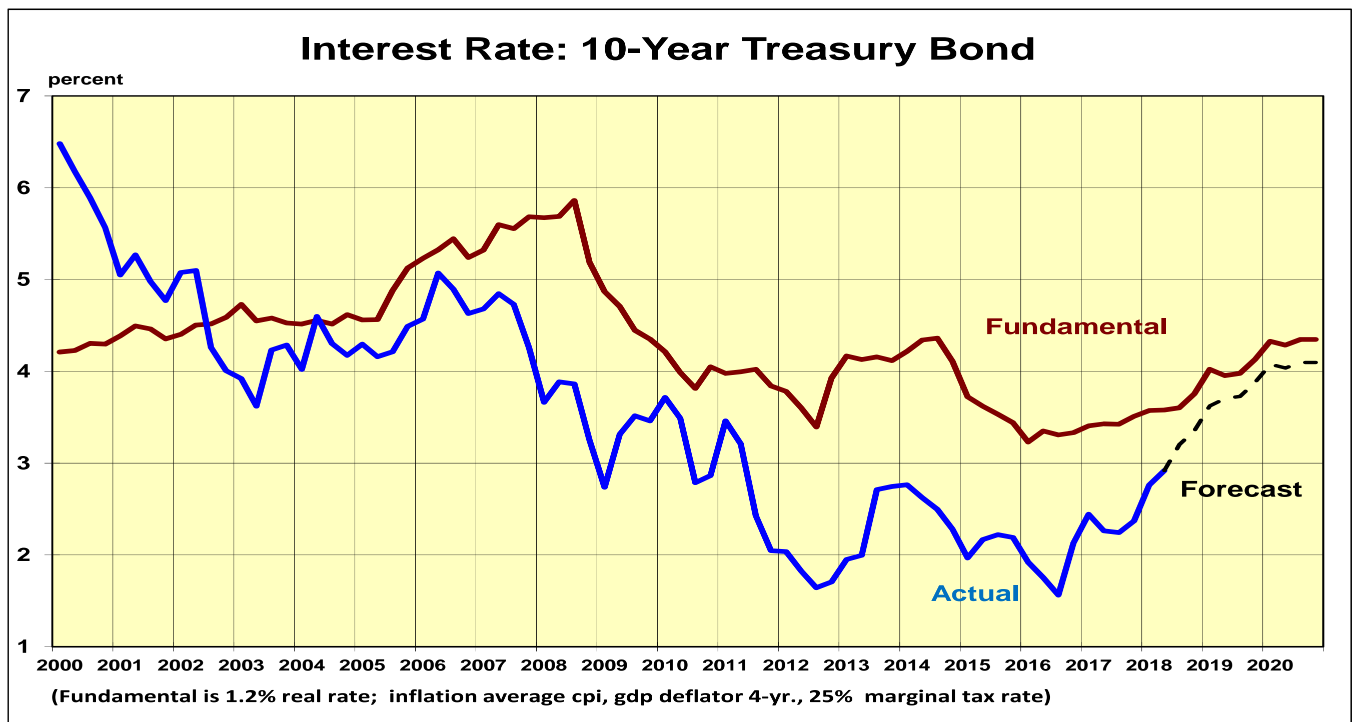
Fortunately, the banks' behavior has acted as a powerful stabilizing force. By injecting liquidity to offset the Fed's sales, monetary policy has remained conducive to growth. If this continues, the Fed's sales of $50 billion a month of securities beginning in October can continue without creating a restrictive monetary policy.



LONG-TERM INTEREST RATES

It's been almost two years since the 10-year T-Note hit its low for the cycle. As with the downward move that preceded it, the upward move has been erratic. At 3.0%, the 10-year T-Note is now at its highest point in 7 years.

The combination of more rapid growth in the economy, government sales of securities to fund the debt and Fed's sales of securities are all likely to drive longer-term interest rates higher toward their fundamental rates.



STOCK PRICES

In the May 22nd bi-monthly report I described how the use of the S&P long-term earnings trend and AAA corporate bond rates can be used to estimate the fundamental value of the S&P 500. This approach shows that with the S&P 500 now at 2850 the index is 7% below its fundamental value.

The most important component of any analysis of stocks is earnings. The chart below shows the long-term reported earnings trend for the S&P 500 companies. I use reported profits because they have been fairly consistently below operating profits. This consistency suggests that over time operating profits tend to be overstated by roughly 10%.

With 75% of the companies reporting, second quarter profits are estimated at $34.70. This brings the 4-quarter trailing average to $123, which is on the middle trend line in the above chart. The tendency for earnings to return to this path over widely diverse business environments suggests the earnings trend is a reliable guide to future earnings.

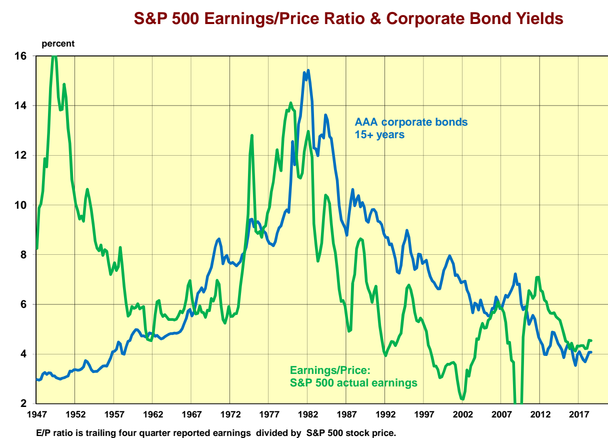
The greatest value in identifying this earnings trend is in determining when earnings are well above or below this trend line. If we annualize second quarter earnings they amount to $139, which is 13% above longer-term trend earnings.

The major cut in corporate taxes is one reason earnings are currently soaring. This raises an important issue surrounding future earnings. Did the tax cut provide a one-time permanent boost to earnings? Or, is the boost temporary so that earnings will return to their prior trend?

I believe the earnings boost from the corporate tax cut will not be permanent. In a competitive environment, companies will be forced to use their additional earnings to raise wages and reinvest heavily in research and new equipment. This will raise their cost of doing business and eventually return earnings to its longer-term trend.

Since this process will take time, it's important to assess the extent to which analysts and others might get carried away with overly optimistic earnings estimates.

Comparing the earnings/price ratio (E/P) on stocks to the yield on AAA bonds can help place future earnings estimates in perspective. The chart below shows the history of this relationship.



A normal situation is for the return on stocks to be lower than the return on bonds. This is due to the expectation of additional income from rising profits. Exceptions occur when stocks are out of favor, as they were for years following the Depression and after the financial crisis of 2008.

Whenever the yield on stocks is higher than the yield on high-grade bonds it provides another indication that stocks are viewed as less attractive than bonds.

The following analysis can be instructive in assessing the extent to which expectations regarding future earnings are consistent with further increases in stock prices.

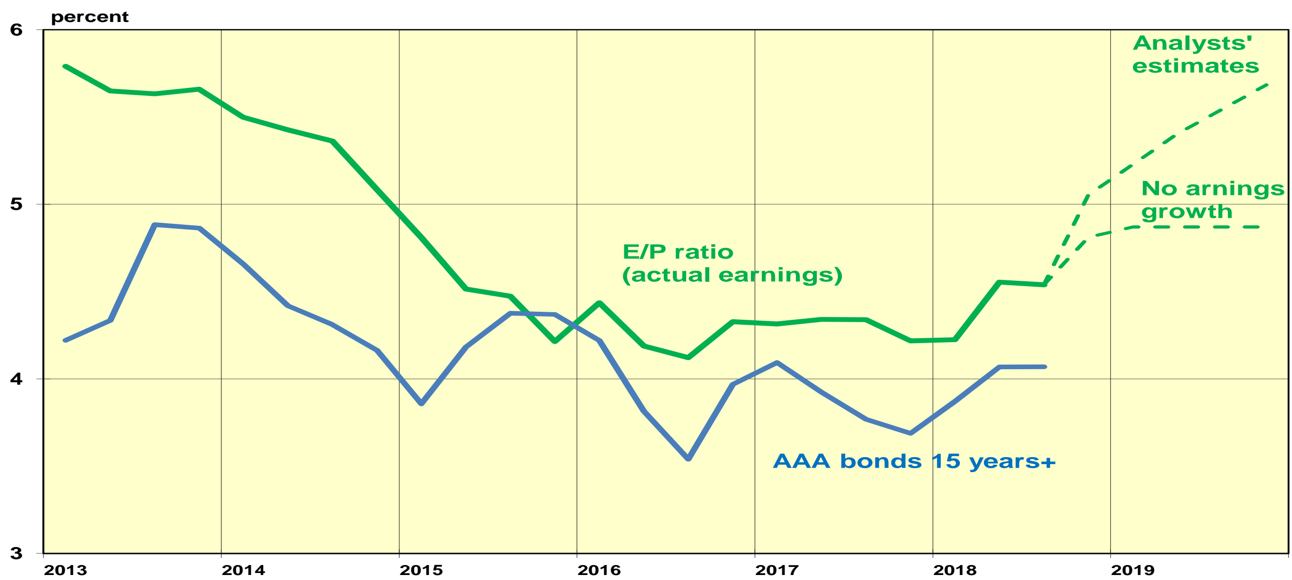
This chart shows the implication for the E/P ratio under the assumption that the S&P 500 stays at its current price of 2850.

It has two extreme assumptions for earnings. The first assumes no increase in S&P 500 company earnings after the second quarter of this year. The E/P ratio continues to rise since second quarter earnings are at an all-time high and since earnings are a 4-quarter trailing average.

The second assumption is that earnings rise in line with analysts' estimates according to Silverblatt. These estimates have tended to overstate actual earnings.

The pattern shows that without an increase in stock prices, the likely E/P ratio will be significantly higher than the rate on bonds. (I expect a combination of higher stock prices and rising bond rates will narrow the gap between the returns to stocks and those to bonds.)

I will update this analysis from time to time in an effort to determine the extent to which investors continue to view stocks as an inferior asset relative to bonds.



8/7/2018	Actual			Forecast				YEARS			
	2017 IV	2018 I	2018 II	2018 III	2018 IV	2019 I	2019 II	2017	2018	2019	2020
GROSS DOMESTIC PRODUCT	19832	20041	20403	20685	20973	21272	21557	19485	20525	21689	22842
%ch	5.1	4.3	7.4	5.7	5.7	5.8	5.5	4.2	5.3	5.7	5.3
REAL GDP	18224	18324	18507	18677	18854	19032	19195	18051	18590	19271	19885
%ch	2.3	2.2	4.1	3.7	3.9	3.8	3.5	2.2	3.0	3.7	3.2
CHAIN PRICE INDEX	1.088	1.093	1.102	1.107	1.112	1.118	1.123	1.079	1.104	1.126	1.149
%ch	2.5	2.0	3.0	1.9	1.8	2.0	2.0	1.9	2.2	2.0	2.1
CPI- ALL URBAN%ch	3.3	2.5	2.3	1.7	1.3	1.4	1.4	2.1	2.4	1.6	2.3
FUND. INFLATION%ch	1.7	1.7	1.5	1.2	1.1	1.3	1.3	1.7	1.4	1.5	2.1
PRETAX PROFITS	2085	2111	2239	2271	2304	2338	2370	2181.9	2231.3	2384.6	2514.9
%ch	-23.7	5.2	26.6	5.8	5.9	6.0	5.6	2.4	2.3	5.5	5.7
PRETAX PROFITS ADJ (1)	2151	2177	2305	2337	2370	2404	2436	2099.3	2297.5	2450.8	2581.1
%ch	9.8	5.0	25.7	5.7	5.7	5.8	5.5	3.2	9.4	5.4	5.6
AFTER-TAX PROFITS	1666	1719	1824	1850	1877	1905	1931	1798	1818	1943	2050
%ch	-29.6	13.3	26.8	5.9	5.9	6.0	5.7	3.5	1.1	5.5	5.8
AFTER-TAX PROFITS ADJ(1)	1732	1785	1890	1917	1943	1971	1997	1715.7	1884.0	2009.7	2116.5
%ch	10.6	12.9	25.7	5.7	5.7	5.8	5.5	4.5	9.8	5.6	5.6
PERSONAL INCOME	17103	17319	17503	17745	17992	18249	18493	16831	17640	18606	19595
%ch	5.0	5.1	4.3	5.7	5.7	5.8	5.5	4.4	4.8	5.4	5.6
REAL DISPOSABLE INCOME	14066	14220	14310	14448	14602	14761	14909	13949	14395	14967	15453
%ch	2.3	4.4	2.6	3.9	4.4	4.4	4.1	2.6	3.2	3.8	3.3
PRODUCTIVITY	1.089	1.091	1.095	1.099	1.105	1.110	1.116	1.084	1.097	1.118	1.141
%ch	0.3	0.4	1.5	1.7	2.0	2.0	2.0	1.2	1.2	2.0	2.0
CIVILIAN EMPLOYMENT	153.9	154.9	155.4	156.1	156.8	157.4	158.1	153.3	155.8	158.4	161.1
%ch	0.4	2.7	1.2	1.8	1.7	1.7	1.7	1.3	1.6	1.7	1.7
UNEMPLOYMENT RATE	4.1	4.1	3.9	4.1	4.1	4.1	4.1	4.4	4.1	4.1	4.0
INDUSTRIAL PRODUCTION: mfting	102.8	103.2	103.7	104.4	105.0	105.7	106.3	101.9	104.1	106.7	109.3
%ch	5.2	1.7	2.1	2.5	2.5	2.5	2.5	1.2	2.1	2.5	2.5
LIGHT VEHICLE SALES (2)	17.7	17.2	17.2	17.5	17.6	17.6	17.7	17.2	17.4	17.7	18.0
Domestic	6.2	5.7	5.5	6.0	5.9	5.8	5.9	6.3	5.8	5.9	6.0
Imports	11.4	11.5	11.7	11.5	11.7	11.7	11.8	10.9	11.6	11.8	12.0

(1) Profits adjusted for capital consumption and inventory adjustment. Second quarter 2018 are estimates.
(2) Millions at seasonally adjusted annual rates.

8/7/2018	Actual			Forecast				Years			
	2017	2018	2018	2018	2018	2019	2019	2017	2018	2019	2020
Monetary Aggregates quarterly:	IV	I	II	III	IV	I	II				
M2 %ch at annual rates	3.8	2.7	4.4	5.0	5.0	5.0	5.0	5.6	4.1	5.0	5.0
Securities less excess reserves (bil$)	2091	2121	2238					2104			
year over year % change	-6.8	-0.1	5.2					3.5			
Interest Rates:											
ICE BoA ABB corp bonds 15+years	4.27	4.45	4.74	4.63	4.91	5.17	5.60	4.45	4.68	5.6	6.2
ICE BoA AAA corp. bonds 15+ years	3.69	3.87	4.07	4.03	4.46	4.72	5.00	3.87	4.11	5.1	5.6
10-YR GOVT SECURITIES	2.37	2.76	2.92	3.03	3.36	3.62	3.70	2.33	3.02	3.7	4.1
5-YR GOVT SECURITIES	2.07	2.54	2.77	2.75	3.02	3.25	3.53	1.91	2.77	3.6	3.9
2-YR GOVT SECURITIES	1.70	2.16	2.47	2.66	2.68	2.87	3.36	1.40	2.49	3.4	3.6
3-MONTH T-BILL	1.22	1.55	1.85	2.11	2.38	2.62	3.11	0.94	1.97	3.1	3.4
FEDERAL FUNDS RATE	1.20	1.45	1.74	1.86	2.13	2.37	2.86	1.00	1.79	2.9	3.1
3-MONTH LIBOR RATE	1.47	1.93	2.34	2.36	2.48	2.72	3.21	1.26	2.28	3.2	3.5
BOND EQUIVALENT RATES:											
FEDERAL FUNDS	1.21	1.46	1.75	1.88	2.15	2.40	2.90	1.01	1.81	2.9	3.2
3-MONTH LIBOR	1.48	1.95	2.37	2.39	2.51	2.76	3.26	1.27	2.30	3.3	3.5
3-MONTH T-BILL	1.24	1.58	1.88	2.15	2.43	2.67	3.18	0.95	2.01	3.2	3.5
STOCKS:											
S&P 500	2605	2733	2703	2848	2907	2927	2956	2448	2819	3026	3383
S&P 500 reported earnings past 4 Qtrs.	109.9	115.4	123.1	140.0	142.0	144.0	145.2	105.3	130.1	145.5	149.1
S&P 500 p/e on reported earnings	23.7	23.7	22.0	20.3	20.5	20.3	20.4	23.2	21.6	20.8	22.7
S&P 500 operating earnings past 4 Qtrs.	124.5	132.2	140.0	148.7	155.3	159.8	162.8	117.5	144.1	163.1	167.8
S&P 500 p/e on operating earnings	20.9	20.7	19.3	19.2	18.7	18.3	18.2	20.8	19.6	18.6	20.2
S&P 500 trend earnings*	120.1	122.0	124.0	125.9	127.9	130.0	132.0	117	125	133	142
S&P 500 p/e on trend earnings****	21.7	22.4	21.8	22.6	22.7	22.5	22.4	20.9	22.4	22.7	23.9

*reported earnings based on a 6.5% long-term growth rate; current quarter annualized.
*price earnings based on reported earnings trend

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The value of bonds fluctuates with changes in market conditions. When sold, bonds and bond shares may be worth more or less than their original cost.

Standard Deviation is a measure of the volatility of returns of the portfolio and is a method of quantifying the risk associated with an investment. In mathematical terms, standard deviation is the square root of the variance. Variance is a measure of dispersion of a set of data points around their mean value. The mathematical expectation of the average squared deviations from the mean.

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P/E ratio (performance to earnings ratio) - a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

Chain Price Index is an alternative measurement of the Consumer Price Index that considers product substitutions made by consumers and other changes in their spending habits.

Government and Treasury Bills are guaranteed by the U.S. Government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.