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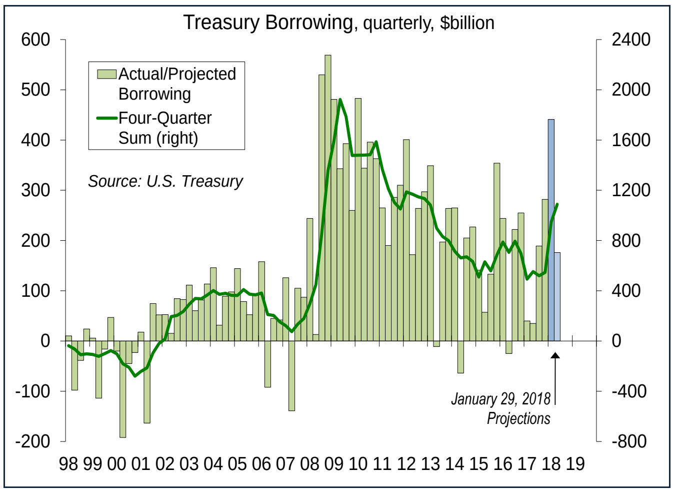
Weekly Economic Monitor

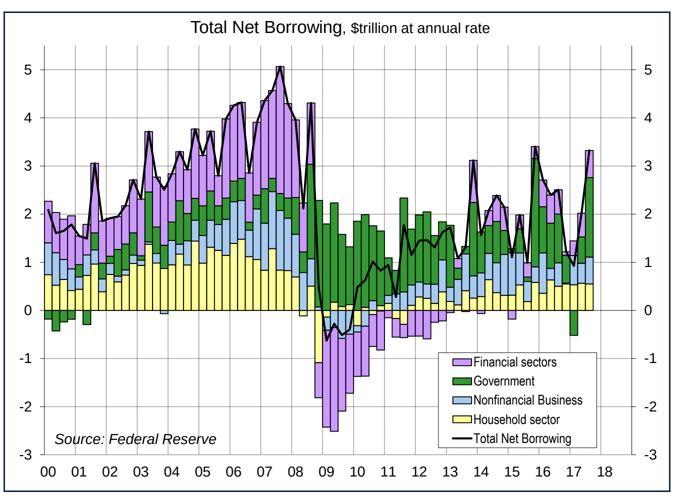
Bond Yields and Government Borrowing

Last week, Treasury announced that it expects to borrow $617 billion in the first half of 2018, vs. $75 billion in the first two quarters of 2017, and announced increases in the sizes of its regular monthly auctions of notes and bonds. It should then be no surprise why bond yields are rising.

Once a quarter, Treasury announces its expected borrowing need. It lays out the auction calendar and gives guidance on the sizes of the various auctions. These are expectations, actual borrowing will depend on tax receipts and the amount of cash it chooses to hold at the end of the quarter. However, while borrowing in 1H18 may be higher or lower than anticipated, the expectations is that there will be a lot more borrowing this year.

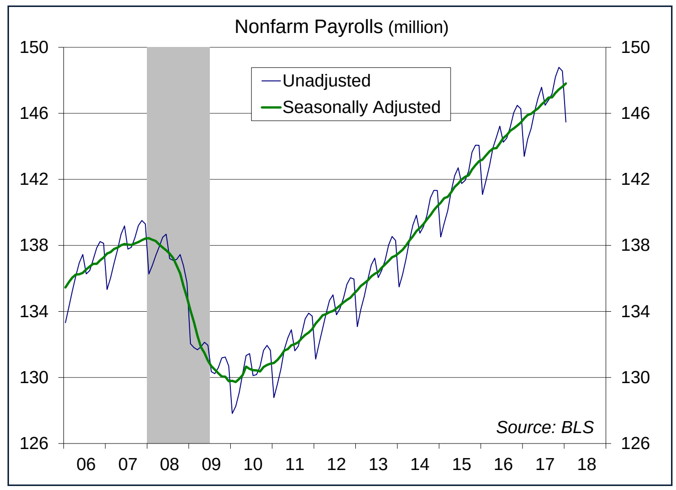


One might expect that to be related to the tax bill. Tax losses were more valuable in 2017, so much of what was underwater should have been written off, reducing federal tax receipts. However, the monthly Treasury statements show an increase in revenues for the Oct-Dec quarter relative to a year earlier.



Lower tax payments may show up in the January figures (the Treasury Budget figures will released on February 12).

Government borrowing rose sharply during the financial crisis and bond yields fell. However, demand for safe assets surged during the crisis. Moreover, the increase in government borrowing was offset by a massive deleveraging in the financial sector. Net national borrowing was little changed during the downturn. The situation now is completely different.



Nonfarm payrolls rose by 200,000 in the initial estimate for January, a bit stronger than expected, but we also had a downward revision to the two previous months (making it about a wash relative to expectations). Still, this is January that we're talking about. We lost more than three million jobs before seasonal adjustment, somewhat more than a year ago. Annual benchmark revisions were moderate by historical standards, but showed a stronger pace of job gains in 2016 (2.34 million) and 2017 (2.173 million) than was reported earlier.

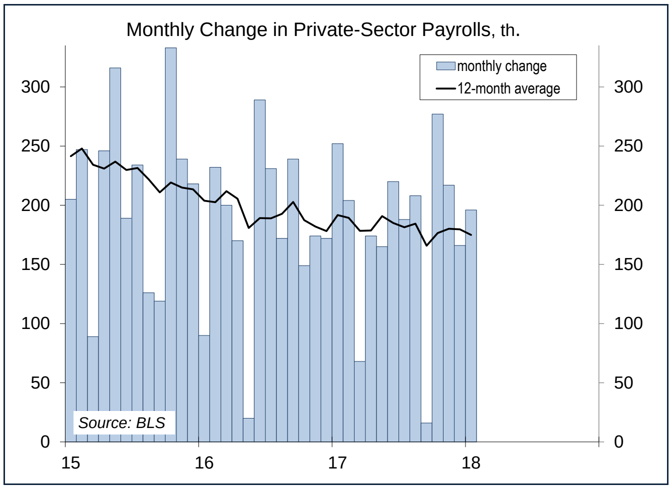
Average hourly earnings rose 0.3% in January, as expected, but upward revisions to October and November brought the year-over-year increase to 2.9%, the highest since May 2009. The Employment Cost Index, up 2.6% over the 12 months ending in December, is a better measure of labor cost pressures, but one still needs to account for productivity growth (unfortunately, a -0.1% annual rate in the preliminary estimate for 4Q17). Given the drop in corporate tax rates, rising labor cost pressures need not be too worrisome in the near term. However, while near-term improvement in job conditions is welcome, we're on an unsustainable trajectory.

Despite tighter monetary policy, credit conditions have gotten easier over the last year or two. This is a dilemma for the Fed. Tighter monetary policy will raise the short-end of the yield curve. Increased government borrowing will raise the long end.

	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
1/05/18	1.39	1.58	1.80	1.96	2.06	2.29	2.47	2.81	1.204	1.356	113.18	1.240	7136.56	2743.15	25295.87
1/26/18	1.41	1.64	1.80	2.13	2.24	2.47	2.66	2.91	1.242	1.418	108.38	1.232	7505.77	2872.87	26616.71
2/02/18	1.49	1.64	1.88	2.15	2.32	2.59	2.84	3.08	1.246	1.413	110.10	1.240	7240.95	2762.13	25520.96

Recent Economic Data and Outlook

It was a busy week for the economic data, but the financial markets were more concerned by the rise in bond yields.



Treasury reported that it expects to borrow $617 billion in the first two quarters of 2018, vs. $75 billion in the first half of 2017. Treasury announced increases in the sizes of the regularly monthly auctions of notes and bonds.

As expected, the **Federal Open Market Committee** left short-term interest rates unchanged. The FOMC said that it *"expects that economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate"* and that *"the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."*

The January **Employment Report** showed further improvement in labor market conditions. Unadjusted payrolls fell by 3.085 million (vs. 2.877 million in January 2017). Adjusted payrolls rose by 200,000, with a net downward revision of -24,000 to November and December. Annual benchmark revisions raised job growth in 2016 and 2017, but not by a lot (private sector payrolls averaged a 180,000 monthly gain in 2017, vs. +178,000 in 2016). The unemployment rate held steady at 4.1%, although details showed a surge in the number of people who could not get to work due to poor weather. Average hourly earnings rose by 0.3%, as expected, but figures for November and December were revised higher, bringing the year-over-year gain to 2.9% (the three-month average was up 2.7% y/y).

The **Employment Cost Index** rose 0.6% over the three months ending in December (+2.6% Y/Y).

Personal Income rose 0.4% in December (+4.1% y/y), led by a 0.5% increase in private-sector wages and salaries (+5.2% y/y). Disposable income rose 0.3% (+3.9% y/y), up 0.2% (+2.1% y/y) adjusting for inflation. **Personal Spending** rose 0.4% (+4.6% y/y), with upward revisions to October and November. Personal tax payments rose 0.5% (+5.8% y/y). Adjusted for inflation, spending rose 0.3% (+2.8% y/y). The **PCE Price Index** rose 0.1% (+1.7% y/y), up 0.2% ex-food & energy (+1.5% y/y).

Unit Auto Sales fell to a 17.1 million seasonally adjusted annual rate in January, vs. 17.8 million in December and 17.3 million in January 2016. Sales of domestically built vehicles fell to 13.1 million, vs. 13.7 million in December and 13.4 million a year ago.

The Conference Board **Consumer Confidence Index** rose to 125.4 in the initial estimate for January, vs. 123.1 in December and 128.6 in November. Evaluations of current conditions edged lower (still strong), while expectations recouped about half of the ground lost in December.

Factory Orders rose 1.7% in December (+8.4% y/y), boosted by a surge in aircraft orders. Orders for nondefense capital goods ex-aircraft fell 0.6% (shipments rose 0.4%).

Nonfarm Productivity fell at a 0.1% annual rate in the preliminary estimate for 4Q17 (+1.1% y/y). Unit Labor Costs rose at a 2.0% pace (+1.3% y/y).

The **ISM Manufacturing Index** was essentially unchanged at 59.1 in January (vs. 59.3 in December). New orders and production remained strong. Employment growth moderated. Comments from supply managers were mostly upbeat.

The **ADP Estimate** of private-sector payrolls rose by 234,000 in the initial estimate for January (benchmark revisions are due next month). Gains were broad-based across industries.

The **Pending Home Sales Index** rose 0.5% in December (+0.5% y/y), mixed across regions.

Economic Outlook (1Q18): around 2.5% GDP growth.

Employment: Job growth has remained strong, but the pace should decline as the job market continues to tighten.

Consumers: Job and wage growth remain moderately supportive. Fourth quarter improvement partly reflects a rebound from the third quarter's hurricane effects.

Manufacturing: Sentiment surveys remain strong and orders have been improving. Factory output is rebounding from a soft 3Q. An improving global outlook has supported export growth.

Housing/Construction: Job growth has been supportive. Monthly figures are often erratic and supply constraints remain, but the underlying trends are relatively strong.

Prices: Core inflation has continued to trend below the Fed's 2% target, partly reflecting a "one-off" plunge in wireless telecom services. Wage pressures are moderate.

Interest Rates: The Fed remains in tightening mode, and is expected to continue gradually raising short-term rates, but personnel changes add uncertainty. Balance sheet reduction has begun and should not be disruptive for the markets.

This Week:					forecast	last	last –1	comments
Monday	2/05	9:00	Powell swearing in					Good luck!
		10:00	**ISM Non-Manf. Index**	Jan	***56.5***	56.0	57.3	moderately strong
Tuesday	2/06	8:30	Trade Balance, $bln	Dec	***-52.3***	-50.5	-48.9	higher
			goods only		***-72.7***	-70.9	-69.2	reported wider in the advance estimate
		1:00	Treasury Note Auction					$26 billion in 3-year notes
Wednesday	2/07	1:00	Treasury Note Auction					$24 billion in 10-year notes
Thursday	2/08	7:00	BOE Policy Decision					no change
		8:30	Jobless Claims, th.	2/03	***240***	230	231	still subject to seasonal noise
		1:00	Treasury Bond Auction					$16 billion in 30-year bonds
Friday	2/09		no significant data					PyeongChang opening ceremonies
Next Week:								
Monday	2/12	10:00	**ISM Non-Manf. Index**	Jan	***57.0***	56.0	57.3	likely to remain moderately strong
Tuesday	2/13	6:00	Small Business Optimism	Jan	***NF***	104.9	107.5	still elevated
Wednesday	2/14	8:30	**Consumer Price Index**	Jan	***+0.4%***	+0.1%	+0.4%	seasonals add to gasoline rise
			year-over-year		***+2.0%***	+2.1%	+2.2%	moderate
			ex-food & energy		***+0.2%***	+0.3%	+0.1%	potential for an upside surprise
			year-over-year		***+1.7%***	+1.8%	+1.7%	roughly steady
		8:30	Real Hourly Earnings	Jan	***-0.1%***	+0.2%	-0.3%	nominal earnings rose 0.3%
		8:30	**Retail Sales**	Jan	***+0.4%***	+0.4%	+1.3%	unit auto sales reported lower
			ex-autos		***+0.5%***	+0.2%	-1.0%	higher gasoline prices should add
			ex-autos, bld mat, gasoline		***+0.4%***	+0.4%	+1.2%	moderate core sales
		10:00	Business Inventories	Dec	***+0.4%***	+0.4%	0.0%	assumed up about 0.4% in GDP estimate
Thursday	2/15	8:30	Jobless Claims, th.	2/10	***240***	***240***	230	still subject to seasonal noise
		8:30	**Producer Price Index**	Jan	***+0.5%***	-0.1%	+0.4%	seasonals add to gasoline price rise
			ex-food & energy		***+0.2%***	-0.1%	+0.3%	moderate old core
			ex-f, e, trade services		***+0.2%***	+0.1%	+0.4%	some pipeline pressures showing
		9:15	**Industrial Production**	Jan	***+0.4%***	+0.9%	-0.1%	utility output likely to remain high
			Manufacturing Output		***+0.4%***	+0.1%	+0.3%	aggregate hours 0.2%
			Capacity Utilization		***78.2%***	77.9%	77.2%	trending a bit higher
		10:00	Homebuilder Sentiment	Jan	***73***	72	74	still elevated
		1:00	TIPS Auction					30-year TIPS
Friday	2/16	8:30	Import Prices	Jan	***NF***	+0.1%	+0.8%	little impact from soft dollar
			ex-food & fuels		***NF***	-0.1%	+0.2%	higher raw materials, flat finished goods
		8:30	**Building Permits, mln.**	Jan	***1.310***	1.300	1.303	weather and seasonal adjustment noise
			% change		***+0.8***	-0.2	-1.0	but a moderately strong underlying trend
			Housing Starts		***1.250***	1.192	1.299	erratic in recent months
			% change		***+4.9***	-8.2	+3.0	watch for revisions
		10:00	New Home Sales, th.	Jan	***640***	625	689	choppy, but a relatively strong trend
			% change		***+2.4***	-9.3	+15.0	bigger test will come in the spring
		10:00	UM Consumer Sentiment	m-Feb	***97.0***	95.7	95.9	seen a bit higher

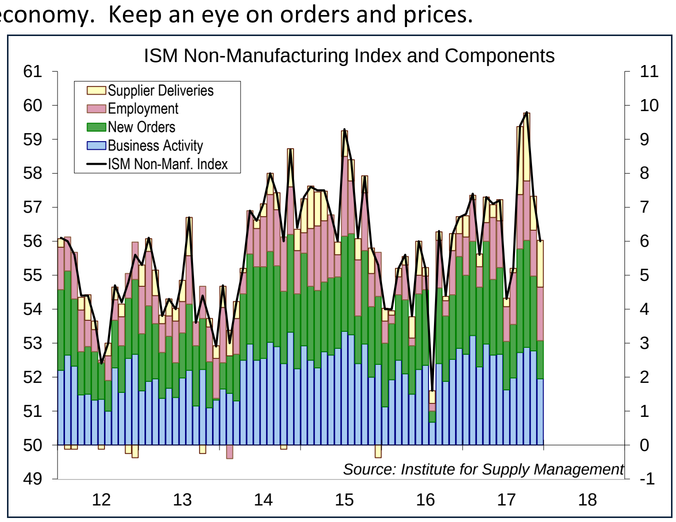
This Week…

The economic data calendar thins out. The ISM Non-Manufacturing Index would normally have some market-moving potential, but investors are expected to remain focused on earnings reports and bond market worries. Political turmoil in Washington may also be a factor. The December trade figures could have important implications for 4Q17 GDP revisions (and expectations for 1Q18). Imports, which have a negative sign in the GDP calculation, subtracted nearly two percentage points from headline growth (and in turn, a partial reversal would add significantly to 1Q18 GDP growth).

Monday

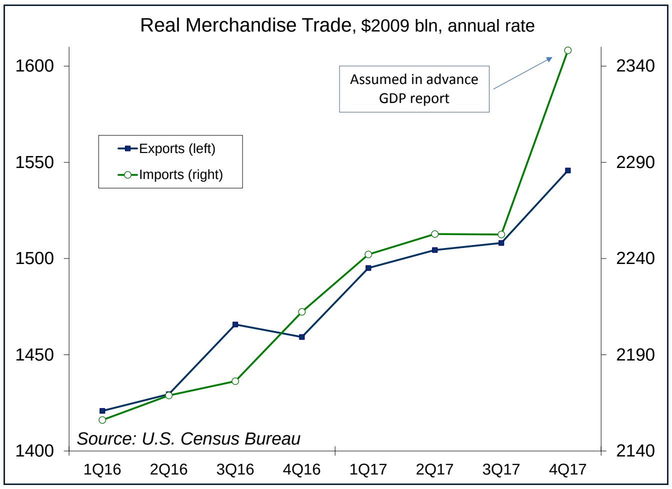
Powell Swearing In – The new Fed chair will be sworn in.

ISM Non-Manufacturing Index (January) – The ISM's other survey is subject to a fair amount of noise from month to month, especially in January. Still, the underlying trend has remained consistent with moderately strong growth in the overall economy. Keep an eye on orders and prices.



Tuesday

Trade Balance (December) – Exports rose sharply in the advance estimate of 4Q17 GDP growth. However, imports exploded sharply to the upside. Part of the improvement reflects a rebound from the third quarter's hurricanes, which delayed port traffic for the Gulf and Florida. Still, averaging the third and fourth quarter shows unexpected strength in the second half of the year. Part of the gain in imports could be stockpiling of parts and raw materials ahead of possible NAFTA disruptions. The advance trade figures for December were delayed due to the brief government shutdown and released at the same time as the advance GDP report. There could be some change in the final report, but any big revisions would most likely show up in next month's report.

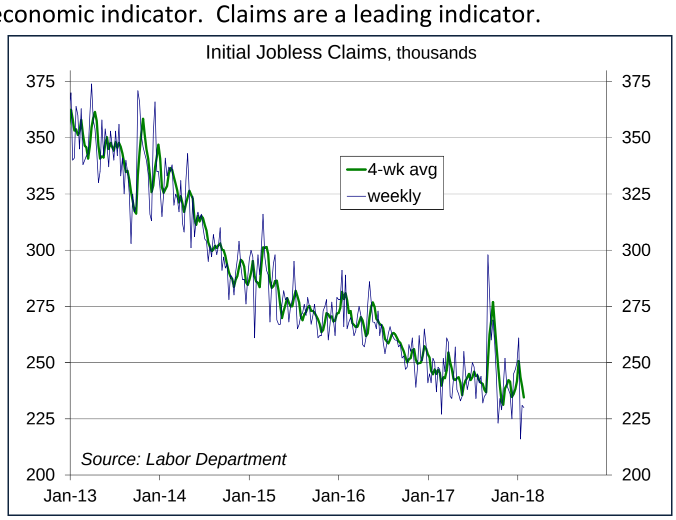


Wednesday

No significant data.

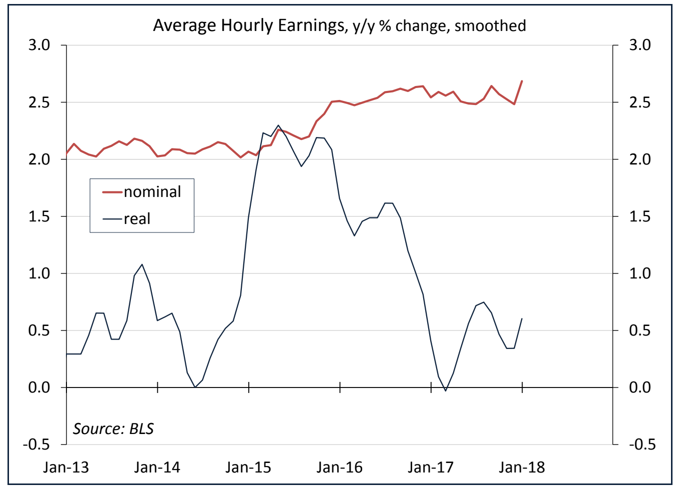
Thursday

Jobless Claims (week ending February 3) – The seasonal spike in unadjusted claims was somewhat smaller this year, consistent with a further tightening in overall labor market conditions. Weekly figures were still be subject to seasonal noise, but the underlying trend in claims is expected to remain low over the next several weeks. Nonfarm payrolls are a coincident economic indicator. Claims are a leading indicator.



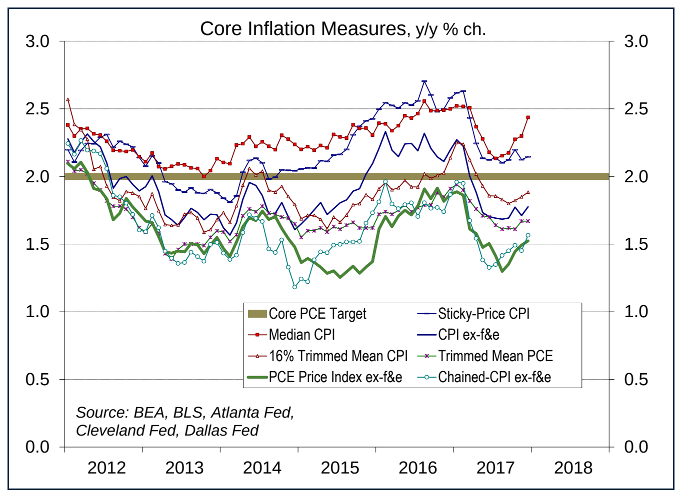
Friday

No significant data.



Next Week ...

The inflation reports should be the focus of the mid-month economic data releases. January figures are subject to a number of potential quirks (seasonal adjustment is tricky), but pressures have been rising – the question is by how much.



Coming Events and Data Releases

February 19	Presidents Day Holiday (markets closed)
February 21	FOMC Minutes (January 30-31)
February 27	Durable Goods Orders (January)
February 28	Real GDP (4Q17, 2nd estimate)
March 9	Employment Report (February)
March 21	FOMC Policy Decision, press conf.
May 2	FOMC Policy Decision (no press conf.)
June 13	FOMC Policy Decision, press conf.
November 6	Election Day