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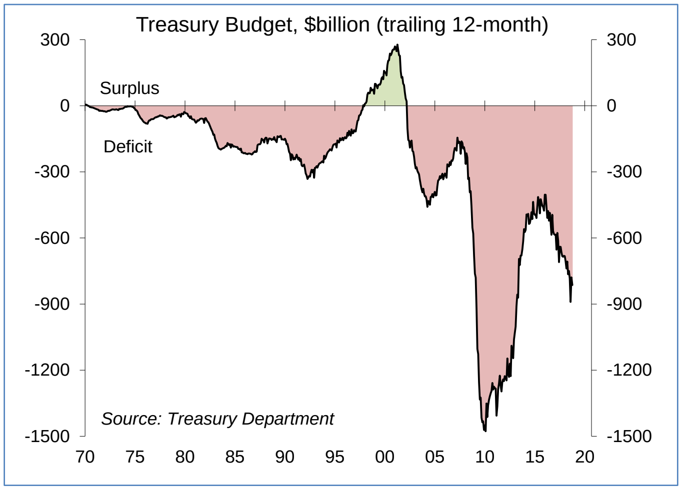
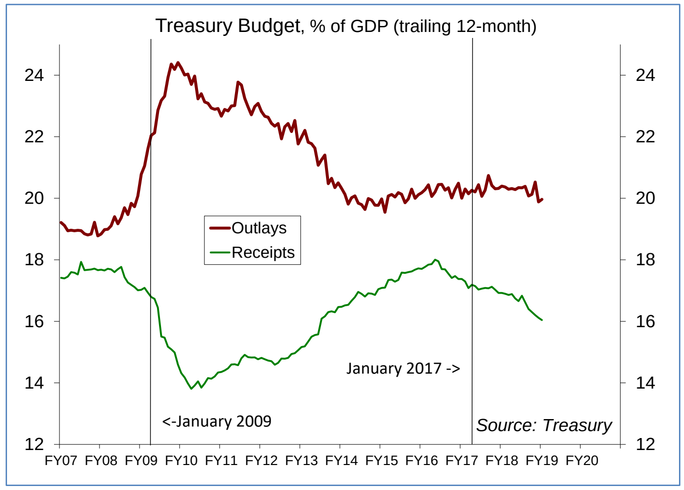
Weekly Economic Monitor

The Fiscal Policy Outlook – The midterm election results were about as anticipated, with Democrats gaining control of the House and Republicans retaining control of the Senate. Peace, love, and everyone sings Kumbaya, right? The new Congress begins in January. The current Continuing Resolution that funds the government expires on December 7, and we could see a showdown, but it should be easy for lawmakers to kick the can down the road. More troublesome is the deterioration in the federal budget outlook. It's not a crisis, but budget constraints will limit the scope for further fiscal stimulus, reduce the effectiveness of the automatic stabilizers, and will handcuff lawmakers in their ability to counter a recession.

The federal budget deficit totaled $779 billion in FY18 and is expected to exceed $1 trillion in FY19 – big numbers, but still relatively moderate as a percentage of GDP (about 3.9% and 4.7%, respectively). However, these large and rising deficits come with the economy at full employment. There are no signs of recession on the immediate horizon, but many see an economic downturn as inevitable at some point, and that will increase the deficit further. The switch in House control means we're unlikely to see "reforms" (that is, cuts) in Social Security and Medicare, which will continue to add to spending totals as the population ages.





There is no cliff effect here. The government currently has no problem borrowing. U.S. federal debt is not going to create a global financial crisis. Debt crises are set up by borrowing in currencies that you don't control, and the U.S., unlike Greece, has a printing press. The Fed has been raising interest rates which adds to the government's interest expense, but this has already been factored into budget projections. Still, long-term interest rates should trend gradually higher, reflecting a strong economy, tighter monetary policy, the Fed's balance sheet unwinding, somewhat higher inflation, and increased government borrowing.

Fiscal policy refers to government spending and taxation. Fiscal stimulus is a reduction in tax rates, increased government spending, or both. Note that there is still some fiscal stimulus in the pipeline for early 2019. The question, following the November 6 election results, is whether we'll see more stimulus, including a large-scale infrastructure package, in calendar 2019. Most likely, the answer is no. House Democrats are expected to reinstitute pay-as-you-go (PAYGO) rules, which means that any additional spending (beyond what's already legislated) would have to be offset by higher taxes or cuts to other spending areas.

In a recession, taxes fall and some spending increases (unemployment benefits and food stamps), which helps to offset private-sector weakness. These automatic stabilizers will be less effective in the next downturn (as taxes will have less room to fall).

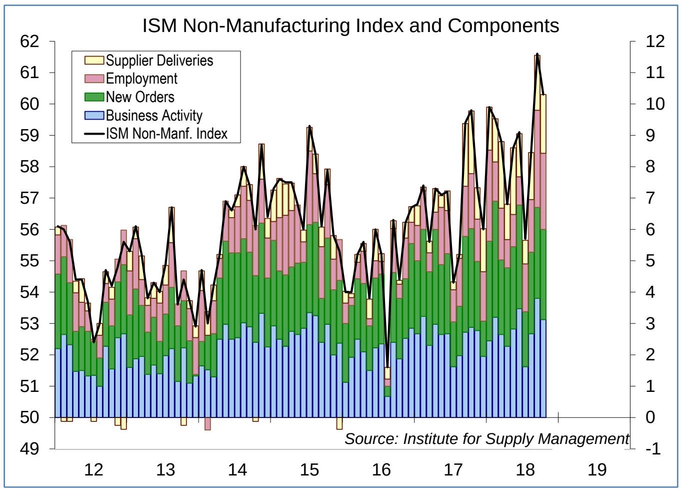
Many investors worry about foreigners buying U.S. debt – or more precisely, what happens when foreigners stop buying U.S. debt. When we run trade deficits, we effectively borrow from the rest of the world. The dollars spent on imports come back to us, partly into the bond market, helping to keep long-term interest rates lower than they would be otherwise. The U.S. trade deficit is driven by the strength in the domestic economy (we consume more domestic goods *and* more imported goods), and not by "bad trade deals." A smaller trade deficit would mean reduced net purchases of U.S. assets. Yet, research shows that tariff increases lead to lower domestic output and productivity, but have only a small impact on the trade deficit. While some of the recent increase in imports may be stockpiling ahead of further tariff increases, we shouldn't be surprised that tariffs haven't done much to reduce the trade deficit. In contrast, the larger federal budget deficit means more borrowing from the rest of the world (and implicitly, large trade deficits). None of this should be controversial – it's basic economic theory backed by plenty of empirical evidence.

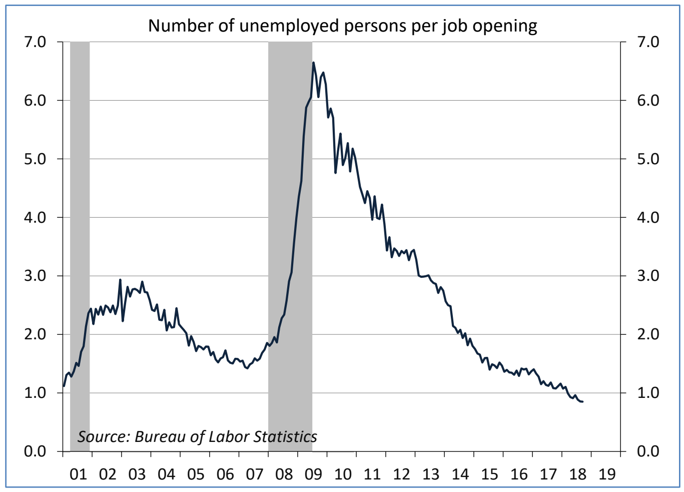
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
10/12/18	2.28	2.44	2.66	2.85	2.93	3.00	3.15	3.32	1.156	1.315	112.02	1.302	7496.89	2767.13	25339.99
11/02/18	2.33	2.50	2.70	2.91	2.98	3.04	3.22	3.46	1.138	1.297	113.09	1.311	7356.99	2723.06	25270.83
11/09/18	2.36	2.52	2.73	2.93	3.00	3.05	3.19	3.40	1.133	1.298	113.77	1.322	7406.90	2781.14	25989.23

Data Recap – The economic data calendar was thin and uneventful. The midterm election results were about as expected, with the Democrats taking control of the House and Republicans increasing their majority in the Senate. Stock market participants embraced the idea of a split Congress, at least temporarily. The Fed left short-term interest rates unchanged.

The **Federal Open Market Committee** left short-term interest rates unchanged (federal funds rate target at 2.00-2.25%). In its policy statement, the FOMC repeated that recent information *"indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate."* The unemployment rate *"has declined"* (vs. *"stayed low"* in the previous statement). Officials recognized that *"growth of business fixed investment has moderated from its rapid pace earlier in the year."* The FOMC expects that *"further gradual increases"* in the federal funds rate will be required to achieve its goals.

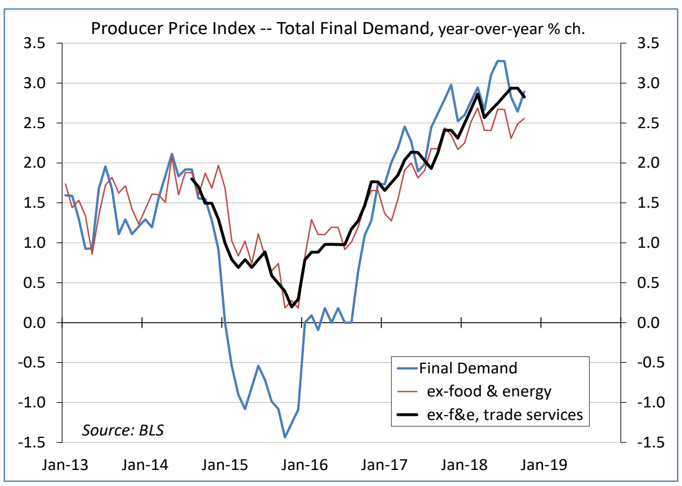
The **ISM Non-Manufacturing Index** edged down to 60.3 in October, vs. 61.6 in September and 58.5 in August. Business activity growth slowed, but remained strong. Growth in new orders remained brisk. Employment growth was a bit less robust. Details remained consistent with moderately strong growth in the overall economy. In their comments, supply managers continued to express concerns about tariffs, labor market constraints, and transportation issues.

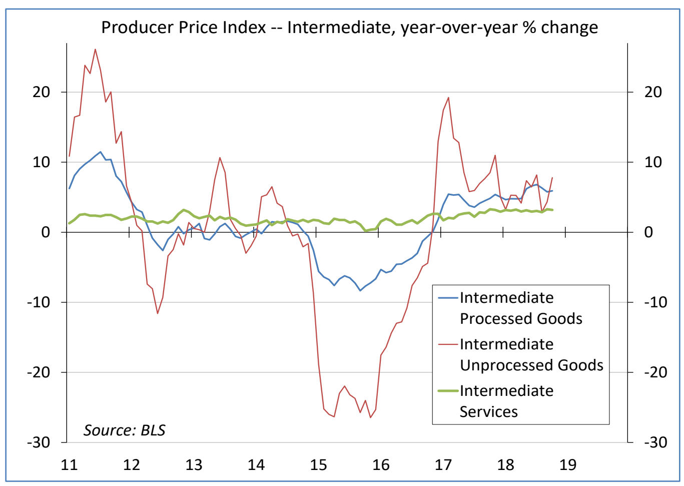




The **Job Opening and Labor Turnover Survey** (JOLTS) continued to suggest tighter labor market conditions. For the private sector, the hiring rate edged down (in a narrow, but relatively high, range over the last year). The quit rate remained elevated.

The **Producer Price Index** rose 0.6% in October (+2.9% y/y), boosted by a 2.7% rise in energy (amplified by the seasonal adjustment and expected to reverse in November) and a 1.6% rise in trade services (higher wholesaler margins, which should be temporary).





The University of Michigan's **Consumer Sentiment Index** edged down to 98.3 in the mid-November reading, vs. 98.6 in October and 100.1 in September. Income expectations improved further, but respondents also expect higher inflation and interest rates.

This Week – The retail sales data (Thursday) will add color to the consumer spending outlook. However, the financial markets have downplayed most of the economic reports in recent weeks and this week should be no exception. Fed Chairman Powell participates in a moderated conversation on Wednesday. Fed Vice Chair of Supervision Quarles will present his semi-annual testimony to the House Financial Services Committee on Wednesday and to the Senate Banking Committee on Thursday. Fed Governor Lael Brainard speaks on the increasing role of artificial intelligence in the financial sector (Tuesday).

Retail sales results for August and September were surprisingly soft. It's not unusual for consumer spending to be uneven over time. We could see an upside surprise in October or revisions to the previous figures. Unit motor vehicle sales improved a bit further last month. Retail employment has been soft in recent months, which would seem to coincide with a moderation in sales.

This Week:					*forecast*	last	last –1	comments
Monday	11/12		Veterans Day Holiday					bond market closed (NYSE open)
Tuesday	11/13	6:00	Small Business Optimism	Oct	***NF***	107.9	108.8	still elevated
		10:00	Fed Gov Brainard speaks					"AI and the New Financial Landscape"
Wednesday	11/14	8:30	**Consumer Price Index**	Oct	***+0.3%***	+0.1%	+0.2%	seasonal adjustment adds to gasoline
			year-over-year		***+2.5%***	+2.3%	+2.7%	moderate
			ex-food & energy		***+0.2%***	+0.1%	+0.1%	seen ticking up slightly
			year-over-year		***+2.2%***	+2.2%	+2.2%	steady
		8:30	Real Hourly Earnings		***-0.1%***	+0.3%	+0.1%	nominal earnings rose 0.2%
		10:00	Fed VC Quarles testimony					Supervision and Regulation (House)
		5:05	**Powell conversation**					"global perspectives"
Thursday	11/15	8:30	Jobless Claims, th.	11/10	***214***	214	215	still a low trend
		8:30	Import Prices	Oct	***NF***	+0.5%	-0.4%	choppy
			ex-food & fuels		***NF***	-0.1%	-0.2%	near-term trend lower, after 1H gains
		8:30	**Retail Sales**	Oct	***+0.4%***	+0.1%	+0.1%	seen picking up
			ex-autos		***+0.4%***	-0.1%	+0.2%	lackluster to moderate
			ex-autos, bld mat, gasoline		***+0.3%***	0.0%	0.0%	a soft trend (watch for revisions)
		10:00	Business Inventories	Sep	***+0.3%***	+0.5%	+0.7%	higher
		10:00	Fed VC Quarles testimony					Supervision and Regulation (Senate)
Friday	11/16	9:15	**Industrial Production**	Oct	***+0.4%***	+0.3%	+0.4%	moderate
			Manufacturing Output		***+0.5%***	+0.2%	+0.3%	aggregate hours rose 0.5%
			Capacity Utilization		***78.3%***	78.1%	78.1%	trending higher
Next Week:								
Monday	11/19	10:00	Homebuilder Sentiment	Nov	***67***	68	67	seen edging a bit lower
Tuesday	11/20	8:30	**Building Permits, mln**	Oct	***1.250***	1.270	1.249	single-family still strong
			% change		***-1.6***	+1.7	-4.1	multi-family noise
			Housing Starts		***1.220***	1.201	1.268	expected to pick up
			% change		***+1.6***	-5.3	+7.1	watch for revisions
Wednesday	11/21	8:30	Jobless Claims, th.	11/17	***215***	***214***	214	still a low trend
		8:30	**Durable Goods Orders**	Sep	***NF***	+0.7	+4.7	Boeing orders not reported yet
			ex-transportation		***+0.2***	0.0	+0.3	a lackluster trend
			nondef cap gds ex-aircraft		***+0.1***	-0.1	-0.2	soft in recent months
		10:00	Existing Home Sales, mln	Sep	***5.10***	5.15	5.34	somewhat restrained
			% change		***-1.0***	-3.4	-0.2	tight supplies, affordability issues
		10:00	Leading Econ Indicators	Oct	***0.0***	+0.5	+0.4	drags from jobless claims and stocks
		10:00	UM Consumer Sentiment	Nov	***98.2***	98.6	100.1	98.3 at mid-month
Thursday	11/22		Thanksgiving Day					market closed
Friday	11/23		Black Friday					early market close

Coming Events and Data Releases

November 27	CB Consumer Confidence (November)
November 28	Real GDP (3Q18, 2nd estimate) New Home Sales (October) FOMC Minutes (11/7-8)
November 29	Personal Income and Spending (October)
December 3	ISM Manufacturing Index (November)
December 7	Employment Report (November)
December 19	FOMC Policy Decision, press conf.
December 25	Christmas Day (markets closed)
January 1	New Year's Day (markets closed)
January 30	FOMC Policy Decision, press conf.
March 20	FOMC Policy Decision, press conf.
May 1	FOMC Policy Decision, press conf.