THE Econoclast

Advisory Service

Trends

January 2019 Research Report

Table of Contents

List of Tables and Charts

Michael Cosgrove
3419 Westminster, #251
Dallas, TX 75205

Ph. 214.890.7877
mikecosgrove@econoclast.com

Trends

January 2019 Econoclast® 1-7-19

In brief

In brief, 1) The U.S. economy is expected to grow 2.6% in 2019 and 2.2% in 2020, 2) Consumer spending, which is approximately 68% of GDP, increases about the same as GDP in both 2019 and 2020, 3) Capital spending could expand near 4% both years, 4) Residential construction may be about flat both years and 5) Net exports work to subtract from GDP growth.

Global Growth

Global growth slows this year compared to last as economic growth slows in China, the euro area, the U.S. and in Japan. At the margin, that slower growth helps hold down price pressures globally.

The ECB halted QE but the ECB won't raise interest rates this year and will maintain the size of their balance sheet. Inflation is well under 2% which means the ECB maintains their near-zero interest rates. Japan continues their QE efforts.

Corporate sales slow globally reflecting the slowdown in the Far East, U.S. and in Europe. Corporate profit growth also slows, reflecting that.

Federal Reserve

The important point is what the Federal Reserve **does**; not what they **say**. To date, the Fed appears to be on a path to invert the yield curve and induce a recession. That is the result unless the Fed backs off quantitative tightening. QT already created a bear market.

Equities

Positives include: Wide profit margins for this stage of the cycle, decent dividend growth, a relatively low level of interest rates, moderate inflation, a strong dollar and an earnings yield minus the 10-year Treasury yield that is supportive of equities. But the Fed's aggressive QT policy will smother those positives unless the Fed slows QT.

Yields

The Fed needs to slow QT and pause or reduce interest rates to allow the yield curve to take a more positive slope. If the yield curve does, that will be a signal to the Fed to eventually start talking about higher rates again. If the Fed doesn't back off, bond yields have peaked in this cycle.

Special Topic – Summary Page

Special Topic – Fed Policy, Inflation, Capital Markets (Summary Page)

Undershoot inflation

- The personal consumption deflator has been under 2% on a December year-over-year basis since 2011. It has been seven years since the PCE closed at 2% or above. Two percent is the Fed's inflation target.

Why so aggressive?

- In the face of that the Fed implemented a very aggressive tightening program of QT and jacking up interest rates.

Deflate equities and the economy

- Federal Reserve policy, despite Chair Powell's soothing comments on 1-4-19, remains on a path to deflate equity prices and the economy.

- Equities are a highly liquid market and are in line to deflate more unless the Federal Reserve slows or stops QT.

$1.2 trillion

- The Fed's QT program sucks out $1.2 trillion of liquidity over the next 8 quarters, counting the one we are in.

It is hard to understand the why

- It is hard to figure out why Federal Reserve officials did not pull back from their massive QT program coupled with jacking up interest rates when a multitude of capital market signals told them to do so.

- The other confusing aspect is that Fed officials don't adequately address their lack of understanding about the time lags associated with quantitative tightening.

- The Fed's job is primarily to control inflation and secondarily to encourage economic growth and full employment.

What is the Fed's Agenda?

- Inflation expectations are well under 2% and falling. So, what is the Fed's agenda?

- Watch what people do. The current Fed monetary policy is pushing for deflation in equities and a 2020 U.S. recession.

- That seems to be the Fed's agenda unless they cut back QT.

	2016	2017	2018e	2019f	2020f
Real GDP (%)	1.6	2.2	3.0	2.6	2.2
Treasury bond(%)	1.8	2.3	2.9	2.9	2.8
Vehicle sales(mm)	17.5	17.2	17.2	16.3	15.9
Housing starts(mm)	1.18	1.21	1.26	1.25	1.23
CPI (%) (y/y)	1.3	2.1	2.4	1.9	1.9
S&P 500 earnings($/s)	106.26	124.51	156.96	171.04	178.75
S&P 500 dividends($/s)	45.70	48.93	53.74	56.43	58.73

Special Topic

Special Topic – Fed Policy, Inflation, Capital Markets

QT

Quantitative Tightening

Why would the Fed want to push a healthy economy into recession?

Finally, Chair Powell on 1-4-19 implied that the Fed may need to reconsider the pace of balance sheet runoff. Balance sheet shrinkage of $120 billion/year or $10 billion/mo may have worked. But $600 billion/year has been excessive from the start. We have discussed this mistake in Fed policy since July 2018 but no, Federal Reserve officials kept saying that QT was on automatic pilot. We had an op-ed on this mistake in IBT (8-28-18) and in The Hill (10-19-18.)

Preference

Preferred Next Step

The Fed might consider decreasing QT to $10 billion/mo or at least cut back to $20 billion/mo and halt any interest rates increases. If not, Fed policy could eventually push the U.S. economy into recession.

Why ignore all the market signals?

It is hard to figure out why Federal Reserve officials did not pull back from their massive QT program coupled with jacking up interest rates when a multitude of capital market signals told them to do so. The other confusing aspect is that Fed officials don’t adequately address their lack of understanding about the time lags associated with QT.

Agenda?

Agenda?

The Fed’s agenda with this dual tightening program appears to have been: 1) create a bear market in equities, 2) drive down the 10-year Treasury to generate an inverted yield curve and perhaps 3) induce a U.S. recession.

It is not their job

It is not the job of the Federal Reserve to induce a recession or create a bear market in equities. The Fed’s job is primarily to control inflation and secondarily to encourage economic growth and full employment.

Their job is inflation

Inflation expectations are well under 2% and falling. So, what is the Fed’s agenda? Watch what people do. And the Fed is pushing for deflation in equities and a U.S. recession. The Fed achieved their deflation in equities.

Inflation expectations are falling

Why is the Fed continuing to follow this aggressive monetary tightening program?

Is it just to create a large negative wealth effect and a recession because the Fed thinks it’s about time for a recession? This recovery started in 2009. Do Fed leaders think that a 10-year expansion is long enough?

Or does the Federal Reserve want to create a recession going into the 2020 election?

Excess Reserves

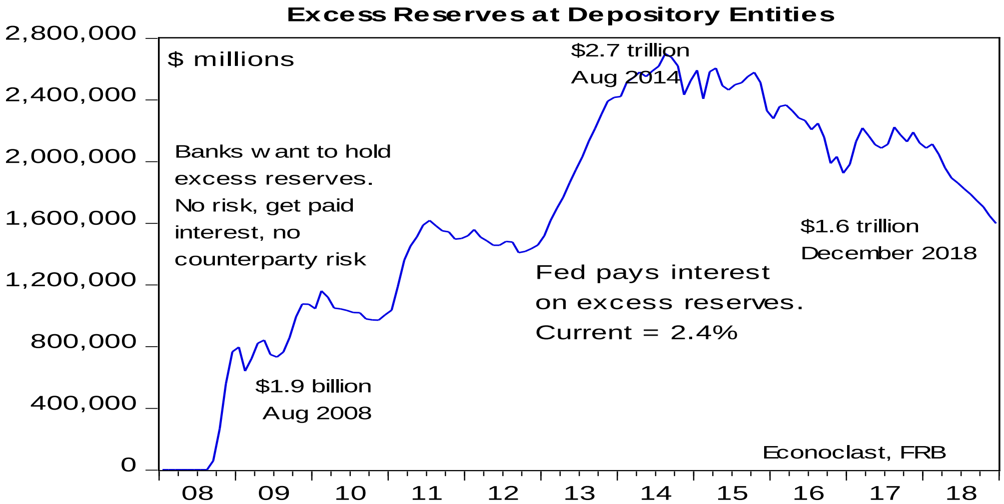
Excess Reserves

Excess reserves are lower by one trillion dollars compared to the peak. If excess reserves stayed at the $1.6 trillion level for all of 2019 and the interest rate paid to banks remained at the 2.4% level, which is the current rate, then commercial banks would be paid over $35 billion.

The Federal Reserve pays the banks with its profits. But that is $35 billion that doesn't go to the U.S. Treasury. That means the taxpayer is indirectly paying banks not to lend. We explained this in a July 19, 2014 IBD op-ed.

The Fed created this issue

The Fed pays $35 billion to banks this year



Inflation

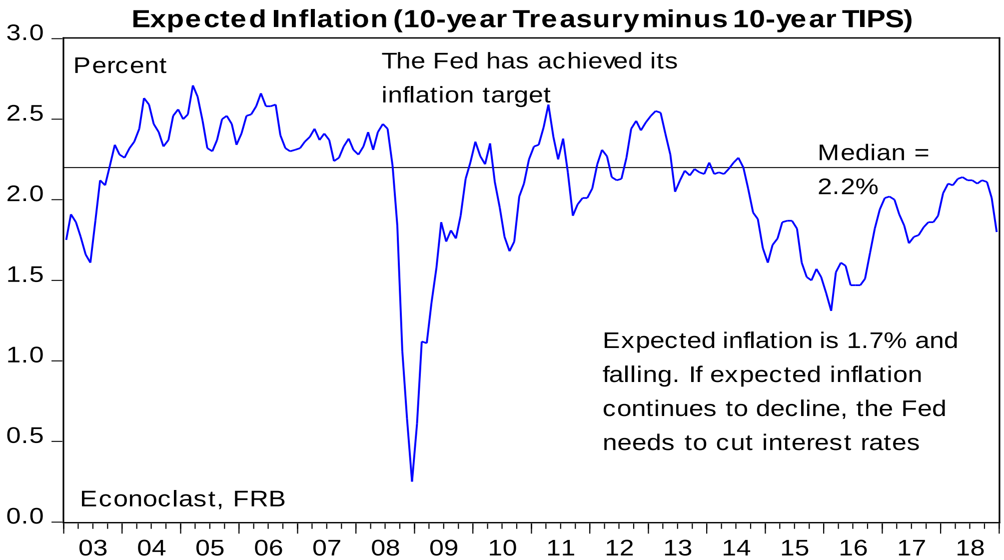
Inflation Expectations

Expected 10-year inflation, according to the following indicator, is 1.7% and falling. Expected 5-year inflation is 1.5%.

Expectations are:

1.7% for 10 years

1.5% for the next 5 years



Inflation

Inflation

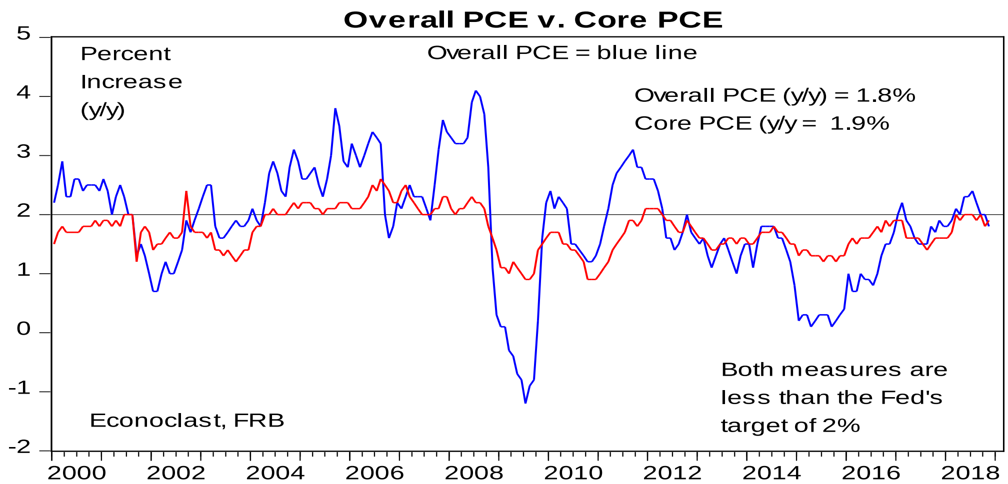
Under 2% since 2011

Expected inflation is in a downtrend. *The personal consumption deflator has been under 2% on a December year-over-year basis since 2011. It has been seven years since the PCE closed at 2% or above. In the face of that the Fed implemented a very aggressive tightening program of QT and jacking up interest rates.*

The Fed has achieved their inflation objective

What message is the Federal Reserve sending to capital markets? It comes back to what is the Fed's agenda? The longer this Fed continues its aggressive QT, the more it looks like the Fed wants to induce a recession.

Why the very aggressive QT

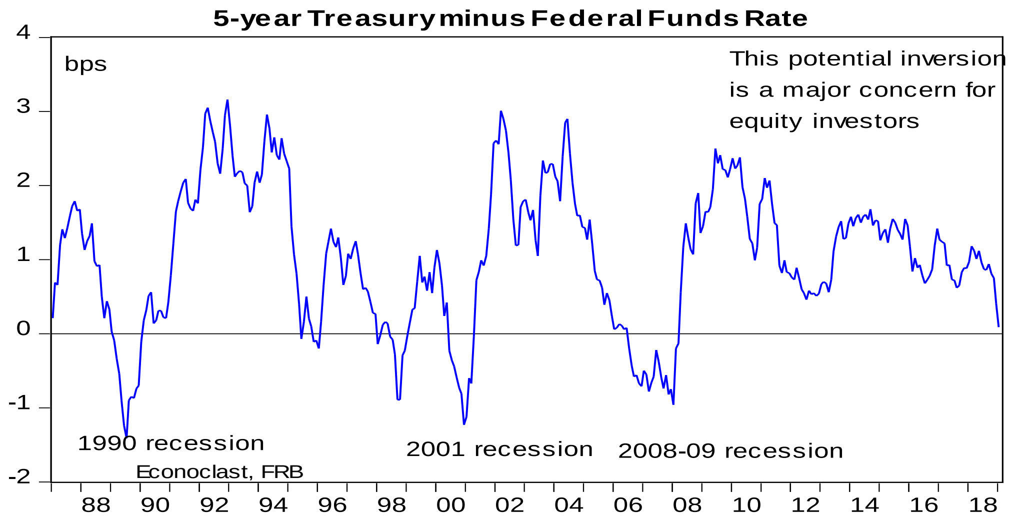


Stop Sign

Stop Sign for the Fed

The bond market has been sending signals to the Fed to halt its aggressive tightening program. The following 5-y minus the funds rate is one of those measures. Fed officials seem to think they know more than bond investors.

The bond market has been telling the Fed to stop



Equity

Equity Implications

Only talk so far

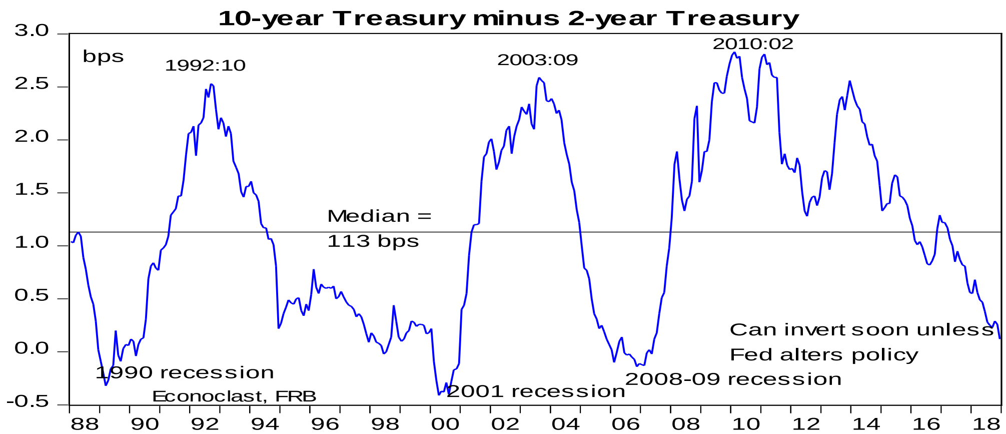
Federal Reserve policy, despite Chair Powell's soothing comments on 1-4-19, remains on a path to deflate equity prices. Equities are a highly liquid market and are in line to deflate unless the Federal Reserve slows or stops QT. *The Fed's QT program sucks out $1.2 trillion of liquidity over the next 8 quarters, counting the one we are in*. That program, regardless of what Fed officials say, takes aim at equities and secondly at the real economy.

Bond Market

Bond Market Message

The 10-y minus 2-y spread has been telling us that. Chair Powell and most Fed officials have ignored the signals from the fixed income market. They act like the capital markets are unimportant.

The Fed acts like the capital markets are unimportant



Fundamentals

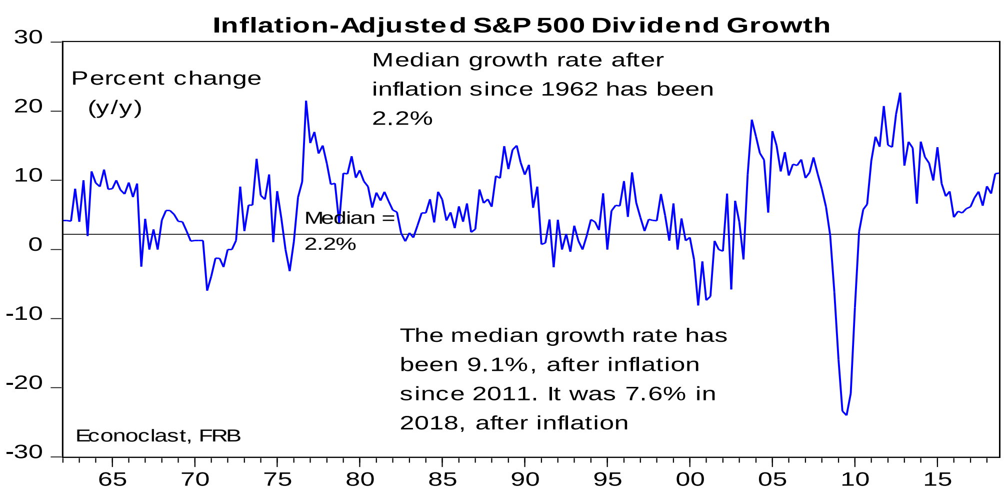
Fundamentals for Equities are Positive

Dividends

S&P 500 Dividends

Dividend growth was nearly 8%, after inflation, in 2018.

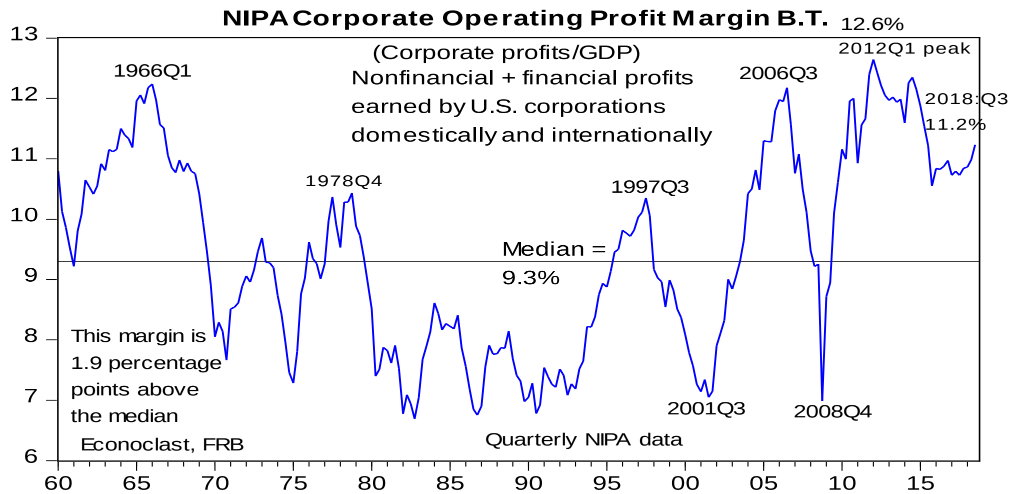
It may be 5% before inflation this year



Profit Margin **NIPA Profit Margin**

Profit margins continued to hold up through 2018 Q3. Fourth quarter numbers are likely to show wide profit margins again. This is very positive and suggests that corporations could pay slightly higher compensation and continue with wide margins. Of course, sales will slow this year reflecting a slower-growing global economy so profit growth will be significantly slower this year.

Wide margins for this stage of the business cycle



Earnings Yield

PP 9-13 are left blank