High Frequency Economics®
Daily Data Analysis and Assessment of the Global Economy

Weekly Notes on the **United States**

October 15, 2018. Worldwide Edition

Jim O'Sullivan, Chief Economist

Just A Bit Of Volatility?

The main reason Fed officials are tightening monetary policy now is to stop the downtrend in the unemployment rate and avert overheating. That means employment needs to slow dramatically. Financial stability concerns help the case for tightening as well, but the main driver of the Fed's actions is the overheating threat from a tight and still-tightening labor market.

In turn, Fed officials are trying to slow employment by making financial conditions less accommodative. They are doing that mainly by raising the funds rate—their main policy lever—although the relationship between the funds rate and financial conditions broadly can vary significantly. We touched on that point in our last *Weekly Notes* when we wrote, "The amount of Fed tightening required will ultimately depend on many variables, including not just the data but also the extent to which a rising funds rate leads to tightening of financial conditions broadly."

The equity market is an important contributor to financial conditions, but there are many others as well, including Treasury yields, credit spreads, the exchange rate and bank lending standards. They are all influenced by the Fed's actions, but they can also be influenced and determined by other developments, including foreign developments.

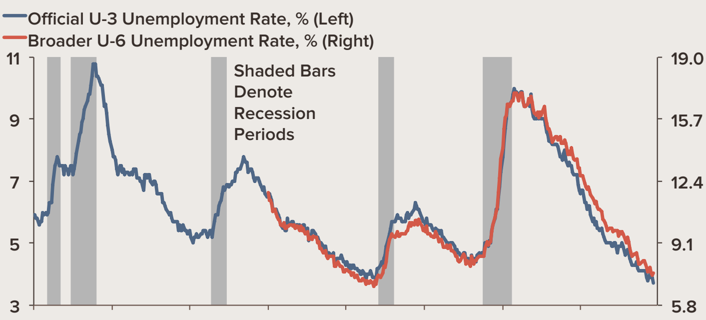
Key Data Spotlight: October 15

	Period	Previous (-2)	Previous (-1)	New Data Cons	New Data HFE
Retail Sales (%m/m)	Sep	0.7	0.1	0.6	0.4
Ex Autos	Sep	0.9	0.3	0.4	0.1
Ex Autos & Gas	Sep	0.9	0.2	0.4	0.1
Control	Sep	0.8	0.1	0.4	0.2
Empire State Survey (index)	Oct	25.6	19.0	20.0	19.0
Business Inventories (%m/m)	Aug	0.1	0.6	0.5	0.5

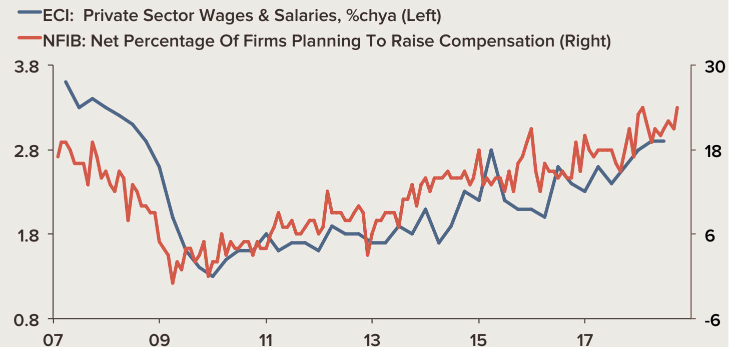
Our forecast for continued gradual Fed tightening has assumed gradual tightening of financial conditions. We have been assuming that the U.S. equity market will fall, but only modestly. We have been assuming that bond yields will keep edging up.

Against that backdrop, the weakness in equities last week was attention grabbing, but little more than volatility from a longer-term perspective: The S&P 500 is down 4.1% from a week ago and 5.6% from the all-time high reached on September 20. That is not even a "correction," which is generally defined as a 10% drop. The index is merely back to where it was in July, and the level is still higher than

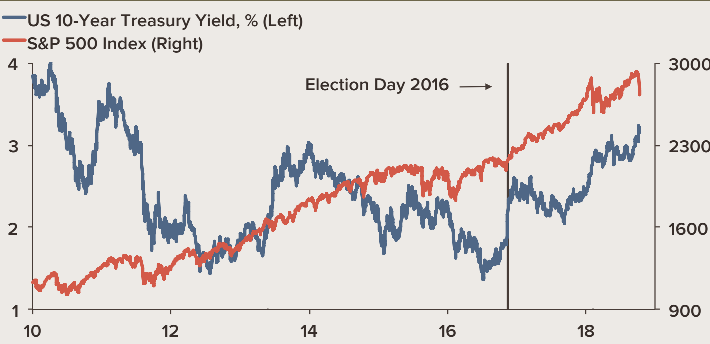
Unemployment Is Low And Still Trending Down



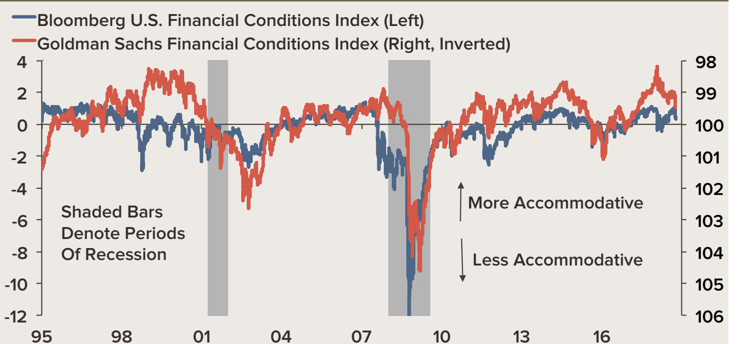
Wage Gains Are Picking Up



The S&P 500 Is Back To Where It Was In July



Financial Conditions Still Appear Accommodative



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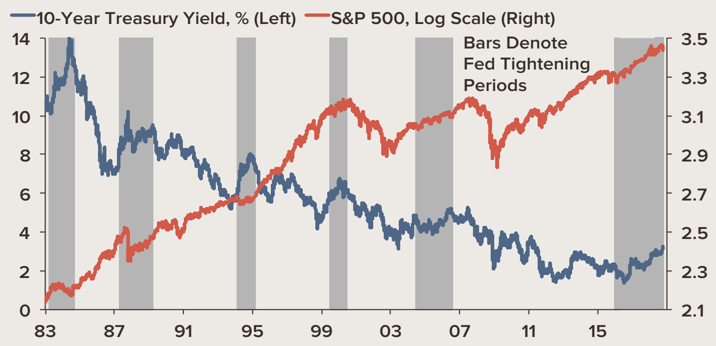
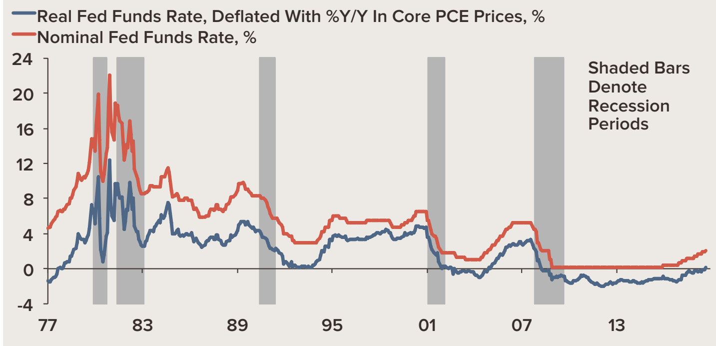
Markets Have Varied During Fed Tightening Cycles



Funds Rate Remains Low, Including In Real Terms



where we expect it to be in a year's time. It is up 3.5% for 2018 to date and 29.3% since the 2016 election. *The weakening is certainly not making us change our forecast for the economy or the Fed. We continue to forecast quarter-point rate hikes at each of the next five end-of-quarter FOMC meetings, and then one more hike in 2020. That said, our tone will change if equities keep falling 4% per week.*

Calibrating Fed Tightening

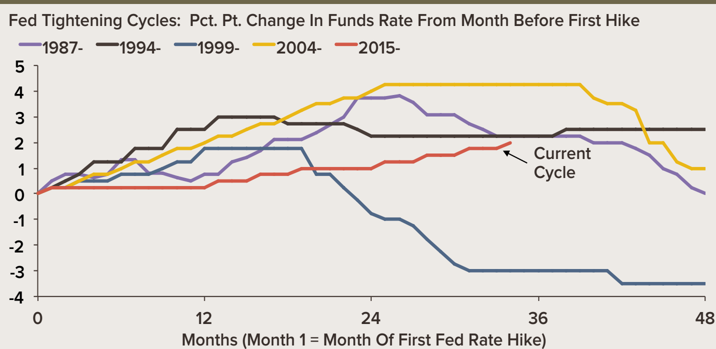
The importance of financial conditions for the transmission of monetary policy has been emphasized by Fed officials frequently over the years. Former New York Fed President Dudley was especially clear on that point when he said the following before the current tightening cycle began: "If financial market conditions do not tighten much in response to higher short-term interest rates, we might have to move more quickly. After all, the point of raising short-term interest rates is to exert some restraint on financial market conditions. In contrast, if financial conditions tighten unduly, then this will likely cause us to go much more slowly or even to pause for a while."

Every Cycle Is Different

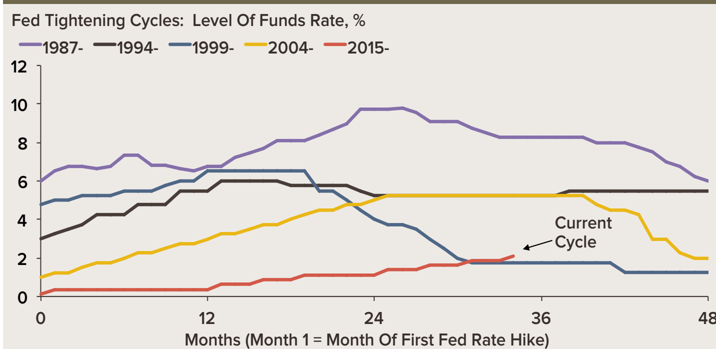
The accompanying charts illustrate the extent to which changes in market variables, as well as the funds rate, have varied across recent Fed tightening cycles. We have featured the upper-left chart—which shows the S&P 500 and 10-year Treasury yields, along with shaded bars to mark Fed tightening cycles—many times. The chart above—which shows the funds rate and shaded bars to mark recessions—is included regularly as well. The charts below are new, however. In them, we directly compare the path of the funds rate, as well as the S&P 500 and 10-year Treasury yields, in the current tightening cycle with the path in the previous four cycles. We start each variable in the month before the tightening cycle began; we then show the following 48 months, during which some tightening cycles have turned into easing cycles. That pattern seems unlikely in the current cycle, which started almost three years ago—in December 2015.

Not surprisingly, the charts illustrate how "gradually" the Fed has been tightening, with the rate of increase in the funds rate unusually

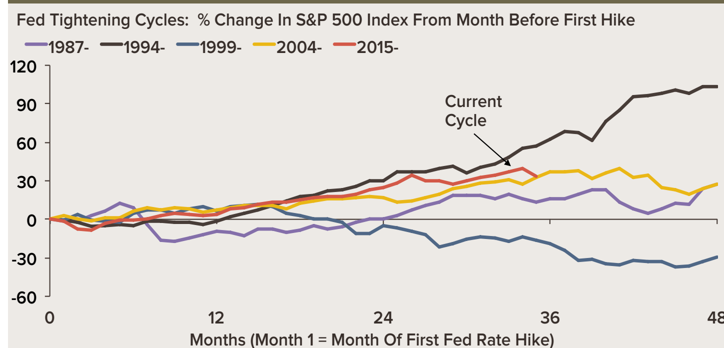
Exceptionally "Gradual" Fed Tightening



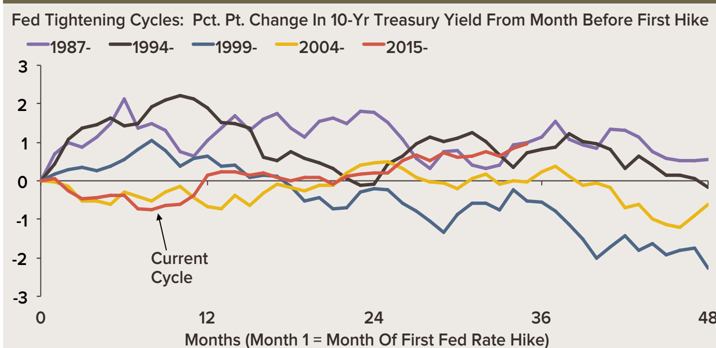
...Even With An Exceptionally Low Starting Point



S&P 500 Is Up By More Than 30% Since Tightening Began



...10-Year Treasury Yields Are Up By Around 90 Basis Points



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HFE's Economic & Financial Forecasts

%ch From Previous Period, Annual Rate, Except Where Noted; ***Forecasts In Bold***

	2018				2019				Calendar Average			Q4/Q4		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020	2018	2019	2020
Real GDP	2.2	4.2	**3.5**	**3.0**	**2.7**	**2.5**	**2.2**	**2.0**	**2.9**	**2.8**	**1.9**	**3.2**	**2.4**	**1.7**
Final Sales	1.9	5.4	**1.6**	**3.3**	**2.8**	**2.4**	**2.1**	**1.8**	**2.9**	**2.7**	**1.8**	**3.0**	**2.3**	**1.7**
Domestic Final Sales	1.9	4.0	**3.2**	**3.2**	**2.9**	**2.6**	**2.2**	**1.9**	**3.0**	**2.8**	**1.9**	**3.1**	**2.4**	**1.8**
Net Exports (pct pt contr)	0.0	1.2	**-1.8**	**0.0**	**-0.2**	**-0.2**	**-0.2**	**-0.2**	**-0.2**	**-0.3**	**-0.2**	**-0.1**	**-0.2**	**-0.2**
Inventories (pct pt contr)	0.3	-1.2	**1.9**	**-0.3**	**-0.1**	**0.1**	**0.2**	**0.2**	**0.0**	**0.1**	**0.1**	**0.2**	**0.1**	**0.0**
Consumption	0.5	3.8	**3.7**	**3.0**	**2.7**	**2.3**	**2.3**	**1.9**	**2.7**	**2.8**	**2.0**	**2.7**	**2.3**	**1.9**
Business Fixed Investment	11.5	8.7	**2.5**	**5.0**	**4.5**	**4.1**	**2.3**	**2.3**	**6.9**	**4.1**	**2.1**	**6.9**	**3.3**	**1.9**
Structures	13.9	14.5	**0.0**	**3.0**	**3.0**	**3.0**	**2.0**	**2.0**	**5.9**	**3.1**	**0.8**	**7.7**	**2.5**	**0.0**
Equipment	8.5	4.6	**2.0**	**6.0**	**5.0**	**4.0**	**2.0**	**2.0**	**7.2**	**4.0**	**2.1**	**5.2**	**3.2**	**2.0**
Intellectual Property	14.1	10.5	**5.0**	**5.0**	**5.0**	**5.0**	**3.0**	**3.0**	**7.1**	**4.9**	**3.1**	**8.6**	**4.0**	**3.0**
Residential Investment	-3.4	-1.4	**-1.8**	**-1.0**	**-1.0**	**-1.0**	**-1.0**	**-1.0**	**0.1**	**-1.1**	**-1.6**	**-1.9**	**-1.0**	**-2.0**
Exports	3.6	9.3	**-5.5**	**5.0**	**3.5**	**3.5**	**3.5**	**3.5**	**4.1**	**3.0**	**3.0**	**2.9**	**3.5**	**2.7**
Imports	3.0	-0.6	**7.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.4**	**4.1**	**3.5**	**3.3**	**4.0**	**3.2**
Government	1.5	2.5	**3.1**	**3.5**	**3.1**	**3.1**	**2.4**	**2.4**	**1.8**	**3.0**	**2.2**	**2.7**	**2.7**	**2.0**
Inventories (ch $B annual rate)	30	-37	**52**	**38**	**34**	**37**	**45**	**53**	**21**	**42**	**56**	**38**	**53**	**57**
CPI	3.5	1.7	2.0	**2.5**	**2.6**	**2.6**	**2.7**	**2.9**	**2.5**	**2.5**	**2.9**	**2.4**	**2.7**	**3.0**
Core CPI	3.0	1.8	2.0	**2.5**	**2.6**	**2.6**	**2.7**	**2.9**	**2.2**	**2.5**	**2.9**	**2.3**	**2.7**	**3.1**
Core PCE Prices	2.2	2.1	**1.5**	**2.2**	**2.3**	**2.3**	**2.4**	**2.6**	**1.9**	**2.2**	**2.6**	**2.0**	**2.4**	**2.8**
Unemployment (%, level)	4.1	3.9	3.8	**3.6**	**3.5**	**3.4**	**3.3**	**3.3**	**3.9**	**3.4**	**3.3**	**3.6**	**3.3**	**3.3**
Federal Budget Balance ($B, FY)									**-782**	**-1050**	**-1125**			
% Of GDP									**-3.9**	**-4.9**	**-5.0**			
												End Of Year		
Fed Funds Target (%, EOP)	1.63	1.88	2.13	**2.38**	**2.63**	**2.88**	**3.13**	**3.38**	**1.8**	**2.8**	**3.5**	**2.38**	**3.38**	**3.63**
10-Year Treasury (%, EOP)	2.7	2.9	3.1	**3.2**	**3.3**	**3.5**	**3.6**	**3.7**	**2.9**	**3.5**	**3.9**	**3.2**	**3.7**	**4.0**
30-Year Treasury (%, EOP)	3.0	3.0	3.2	**3.4**	**3.5**	**3.7**	**3.8**	**3.9**	**3.1**	**3.7**	**4.0**	**3.4**	**3.9**	**4.1**
S&P 500 (level, EOP)	2641	2718	2914	**2800**	**2768**	**2735**	**2703**	**2670**	**2753**	**2735**	**2620**	**2800**	**2670**	**2570**

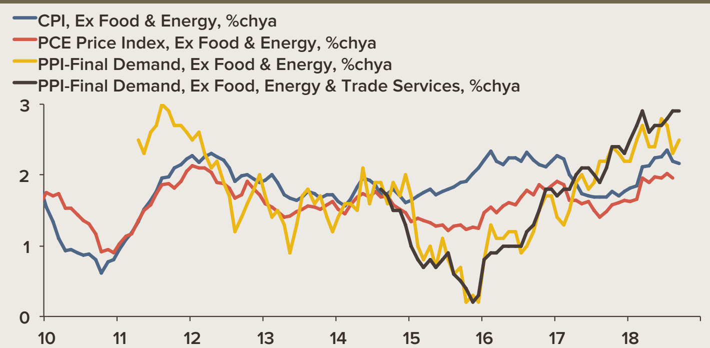
slow and the level still low. *The changes in the equity market don't appear extreme, although performance has been somewhat better than average, thus adding stimulus:* Despite Fed tightening, the S&P 500 is up 33% since the month before tightening began. *While the level of 10-year yields is still historically low, the cumulative change is starting to look more significant:* At 3.15%, the 10-year yield is up from 2.2% in the month before the tightening cycle began.

Officials Still Aiming For Modestly-Above-Neutral Funds Rate

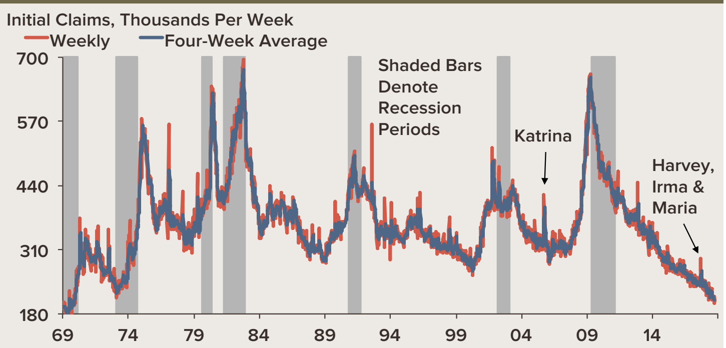
The Fed chairman has not made any public comments since October 3, but we are fairly confident that he is also viewing last week's market action as little more than volatility. There was certainly no signal from the officials who did speak last week that their policy outlook had changed—including Chicago Fed President Evans, Dallas Fed President Kaplan and Kansas City Fed President George.

President Evans, who in the past has been viewed as a "dove," once again suggested that policy will probably have to be made slightly restrictive because of the very low unemployment rate. Here is a quote: "I expect the unemployment rate to fall to 3.5% before it eases back up a little bit. This is an environment where I'm not worried about inflation. I think inflation could go to 2.2%, 2.3%, and that's easily consistent with symmetric 2% inflation. But with unemployment like that, setting policy ever so slightly restrictively makes sense." His estimate of a "slightly restrictive" funds rate appears to be in the 3-to-3.5% range—up from a 2.125% level currently.

Core Inflation Measures Have Picked Up, On Balance



Jobless Claims Remain Low



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This Week In Brief

Note: "SS" prefix denotes Snapshot for these data.

Monday, October 15

- **SS: Retail Sales (9)/8:30 EDT**
  Consensus: Total 0.6%, ex-autos 0.4%, ex-autos & gas 0.4%, control 0.4%. HFE: 0.4%, 0.1%, 0.1%, 0.2%. The units data suggest a strong gain in the auto component. Non-auto sales probably rose much more modestly, due in part to Storm Florence effects. The net result should still be a 3%-plus quarter for annualized real consumer spending growth.
- **Empire State Survey (10)/8:30 EDT**
  Consensus: 20.0, after 19.0. HFE: 18.0. The index has averaged 20.2 so far this year, up from 16.1 last year.
- **Business Inventories (8r)/10:00 EDT**
  Consensus: 0.5%. HFE: 0.5%.

Tuesday, October 16

- **SS: Industrial Production (9)/9:15 EDT**
  Consensus: Production 0.2%, capacity use 78.2%. HFE: 0.2%, 78.1%. Manufacturing output probably rose solidly, led by the auto component. Utilities output likely fell.
- **SS: NAHB Survey (10)/10:00 EDT**
  Consensus: 67, following 67. HFE: 67. At 67, the index is still fairly high, but it is down from as high as 74 in December. The decline implies some loss of momentum.
- **JOLTS Job Openings & Labor Turnover Survey (8)/10:00 EDT**
  The job openings rate probably remained high, consistent with continued strength in hiring.
- **TIC Flows (8)/16:00 EDT**

Wednesday, October 17

- **MBA Mortgage Applications (10/12)/7:00 EDT**
- **SS: Housing Starts (9)/8:30 EDT**
  Consensus: Starts 1210K, following 1275K, permits 1280K, following 1249K. HFE: 1190K, 1250K. Starts probably fell after a surge, due in part to Storm Florence effects. Through the volatility, the trend has been up so far this year, but with some loss of momentum in recent months.
- **FOMC Minutes (9)/14:00 EDT**
  The main change in the FOMC statement was the dropping of the reference to policy being "accommodative."

Thursday, October 18

- **SS: Initial Jobless Claims (10/13)/8:30 EDT**
  Consensus: 210K, following 214K. HFE: 210K. Claims remain low, even with a modest boost from Storm Florence; we estimate about a 9K boost in the latest week, unchanged from the prior week. Storm Michael will likely boost claims as well, but probably not until next week's report.
- **SS: Philadelphia Fed Survey (10)/8:30 EDT**
  Consensus: 20.0, following 22.9. HFE: 20.0. The index has averaged 23.1 so far this year, down from 27.4 last year but still quite high.
- **Index of Leading Indicators (9)/10:00 EDT**
  Consensus: 0.5%. HFE: 0.5%. We will review the forecast after permits are reported.

Trend In Core Inflation Up, Even With Weak September Data

Last week's CPI data were tamer than expected, with the core index up just 0.12% month-over-month. *The 12-month change in core prices held at 2.2%, although that is up from 1.7% a year ago, consistent with a gradual uptrend. We forecast a 2.7% pace by the end of 2019.*

As we discussed in our *Daily Notes*, we expect the core PCE price index to be reported up 0.1% in September as well. *That implies a slowing in the 12-month change to 1.9% from 2.0%, although 1.9% would still be a net pick-up from 1.5% a year earlier. We forecast a 2.4% pace by the end of 2019.*

Focus Turns To Growth This Week

This week's economic calendar mainly features growth indicators, including retail sales, several housing reports and the first two regional manufacturing surveys for October. *We expect the details of the retail sales report—for September—to be less impressive than the headline data, although they should still be consistent with a 3%-plus annual rate of growth in real consumer spending—and overall real GDP—in Q3. We expect the housing data—most notably, starts—to have a weak tone, although we caution against extrapolating unless the trend-setting housing market index keeps falling. We expect the main indexes in the manufacturing surveys to remain fairly high, albeit down a little. We also expect jobless claims to remain low. The slight rise in claims in the last few weeks has been more than accounted for by Storm Florence effects in North and South Carolina. Storm Michael will likely boost claims as well—temporarily—but probably not until next week's report.*

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This Week In Brief (Continued)

Friday, October 19

- **SS: Existing Home Sales (9)/10:00 EDT**
  Consensus: -0.9%/5.29M. HFE: -1.3%/5.27M. Sales have been slipping; our forecast implies down 1.9% in the past year.
- ***Treasury Budget (9)/14:00 EDT (Date Not Set)***
  Consensus: $75.0B, following $7.9B in September 2017. HFE: $116.0B. The release date for the September report, the last of FY18, has not yet been announced. The CBO estimates that the deficit rose to $782B, or 3.9% of GDP, in FY18 from $666B/3.5% in FY17.

This Week's Funding

Mon	Announcement—4-week bills (October 16)
	Announcement—8-week bills (October 16)
	Auction—3-month, 6-month bills
Tue	Auction—4-week bills
	Auction—8-week bills
Thu	Announcement—3-month, 6-month bills (October 22)
	Announcement—2-year notes (October 23)
	Announcement—2-year FRN (October 24)
	Announcement—5-year notes (October 24)
	Announcement—7-year notes (October 25)
	Auction—30-year TIPS

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