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

Weekly Notes on the **United States**

June 26, 2017. Worldwide Edition

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Markets Versus The Fed

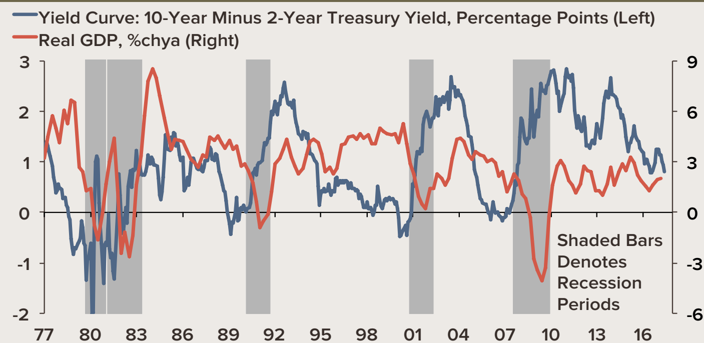
After rising to as high as 2.62% in March from 1.88% on Election Day, 10-year Treasury yields are down to 2.14%. In turn, the yield curve has been flattening, and we are increasingly being asked whether the bond market is starting to suggest significant recession risks. In contrast, equities have continued to set new highs, consistent with a not-too-hot-and-not-too-cold economy.

The yield curve has been a much more reliable leading indicator of recessions than the equity market, but it is not signaling a recession now. Recession signals require inversion, not just some flattening. That point is illustrated in the first chart below, which shows GDP growth and the spread between two- and 10-year Treasury yields; shaded bars mark recession periods. *Nor is flattening a reliable leading indicator of slowing in GDP growth.*

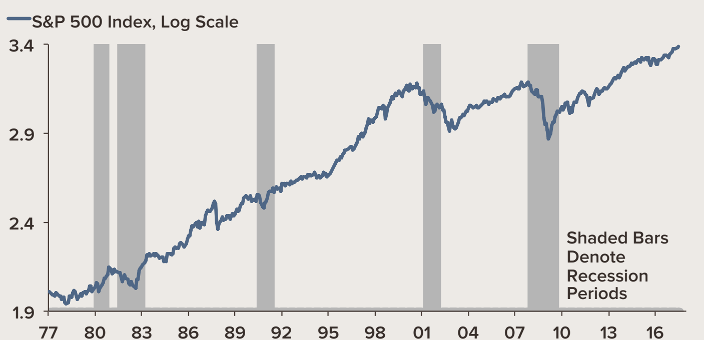
The yield curve is still upward-sloping despite sustained downward pressure on long-term yields from QE in the United States and abroad—based on the "stock effect" theory of how QE works. That downward pressure is being reflected in historically low 10-year term premiums, as we illustrate with the red line in the chart on the right.

Could the curve keep flattening if the Fed keeps tightening? Of course: Fed tightening is usually associated with curve flattening.

Yield Curve: Good For Signaling Recessions, Not Rate Of Growth



Equities Usually Fall Before Recessions, But Many False Alarms



Key Data Spotlight: June 26

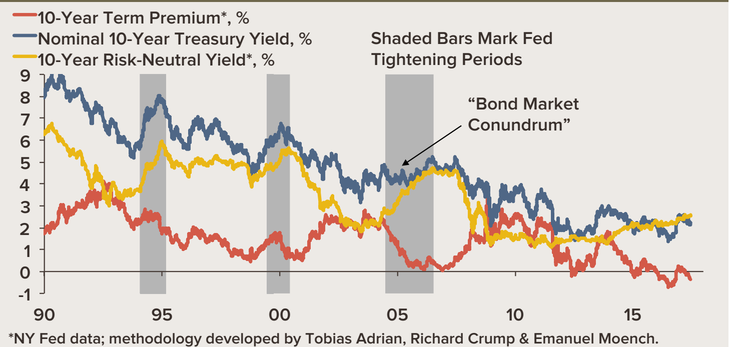
	Period	Previous (-2)	Previous (-1)	New Data Cons	New Data HFE
Durable Goods Orders (%m/m)	May	2.4	-0.8	-0.6	-1.0
Ex-Transportation	May	0.9	-0.5	0.4	0.8
Nondef Cap Goods Ex-Air	May	0.0	0.1	0.3	0.7
Dallas Fed Mfg Index	Jun	16.8	17.2	16.0	

However, if so, it is likely to be "bear flattening," with all rates rising. Inversion is unlikely for a while if long rates are rising and the Fed is tightening gradually; we view even a quarter point per quarter for funds rate increases as quite gradual.

What if bond yields keep falling and the Fed keeps tightening? That scenario is highly unlikely, in our view. *While Fed officials are probably less responsive to the ups and downs in the economic data in the short run than traders and investors, and they are not afraid to project more tightening than markets are pricing in, the data will ultimately set the tone for both sides.* Implicitly, Fed officials believe that market participants are underappreciating the inflation implications of the downtrend in the unemployment rate, and that they have overreacted to some weaker-than-expected inflation data. *However, Fed officials will not follow through on their policy projections if the labor market weakens and the recent slowing in core inflation continues. Conversely, bond yields are likely to move up again if the labor market remains fairly strong and core inflation starts edging up again—as Fed officials are predicting.*

Given that choice, our vote is with the Fed. Indeed, as we have been discussing in the context of labor market arithmetic, we think

Term Premiums In The Bond Market Are Historically Low



*NY Fed data; methodology developed by Tobias Adrian, Richard Crump & Emanuel Moench.

Notice To Readers

High Frequency Economics Ltd. will not publish *Notes on the United States* on Monday, July 3, and Tuesday, July 4, in observance of the Independence Day holiday in the U.S. Our regular publication schedule will resume on Wednesday, July 5, with a four-page edition of *Weekly Notes*.

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HFE's Economic & Financial Forecasts

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

	2016				2017				Calendar Average			Q4/Q4		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2016	2017	2018	2016	2017	2018
Real GDP	0.8	1.4	3.5	2.1	1.2	**3.0**	**2.3**	**2.3**	1.6	**2.2**	**2.5**	2.0	**2.2**	**2.4**
Final Sales	1.3	2.6	3.0	1.1	2.2	**2.6**	**2.3**	**2.3**	2.0	**2.2**	**2.4**	2.0	**2.4**	**2.3**
Domestic Final Sales	1.2	2.4	2.1	2.8	2.0	**2.8**	**2.4**	**2.4**	2.1	**2.4**	**2.5**	2.1	**2.4**	**2.4**
Net Exports (pct pt contr)	0.0	0.2	0.9	-1.8	0.1	**-0.2**	**-0.2**	**-0.2**	-0.1	**-0.3**	**-0.1**	-0.2	**-0.1**	**-0.1**
Inventories (pct pt contr)	-0.4	-1.2	0.5	1.0	-1.1	**0.4**	**0.0**	**0.0**	-0.4	**0.0**	**0.1**	0.0	**-0.2**	**0.1**
Consumption	1.6	4.3	3.0	3.5	0.6	**3.2**	**2.3**	**2.3**	2.7	**2.5**	**2.5**	3.1	**2.1**	**2.3**
Business Fixed Investment	-3.4	1.0	1.4	0.9	11.4	**3.5**	**3.9**	**3.9**	-0.5	**4.6**	**3.5**	-0.1	**5.6**	**3.1**
Structures	0.1	-2.1	12.0	-1.9	28.3	**4.0**	**3.0**	**3.0**	-2.9	**8.8**	**3.1**	1.9	**9.1**	**3.0**
Equipment	-9.5	-3.0	-4.5	2.0	7.2	**3.0**	**5.0**	**5.0**	-2.9	**2.9**	**4.0**	-3.8	**5.0**	**3.3**
Intellectual Property	3.8	9.0	3.2	1.3	6.7	**4.0**	**3.0**	**3.0**	4.7	**4.2**	**3.1**	4.3	**4.2**	**3.0**
Residential Investment	7.8	-7.8	-4.1	9.6	13.7	**3.0**	**3.0**	**3.0**	4.9	**5.1**	**2.8**	1.1	**5.6**	**2.5**
Exports	-0.7	1.8	10.0	-4.5	5.9	**3.0**	**3.5**	**3.5**	0.4	**3.1**	**3.8**	1.5	**4.0**	**4.0**
Imports	-0.6	0.2	2.2	8.9	3.8	**4.0**	**4.0**	**4.0**	1.1	**4.4**	**4.0**	2.6	**3.9**	**4.0**
Government	1.6	-1.7	0.8	0.2	-1.1	**0.4**	**1.6**	**1.6**	0.8	**0.1**	**1.8**	0.2	**0.6**	**1.9**
Inventories (ch $B annual rate)	41	-10	7	50	4	**22**	**22**	**22**	22	**18**	**30**	50	**22**	**33**
CPI	0.1	2.3	1.8	3.0	3.1	**0.0**	**2.3**	**2.3**	1.3	**2.2**	**2.4**	1.8	**1.9**	**2.7**
Core CPI	2.5	2.1	2.1	2.0	2.5	**0.8**	**2.4**	**2.4**	2.2	**2.0**	**2.5**	2.2	**2.0**	**2.7**
Core PCE Prices	2.1	1.8	1.7	1.3	2.1	**0.8**	**2.1**	**2.0**	1.7	**1.6**	**2.1**	1.7	**1.7**	**2.3**
Unemployment (%, level)	4.9	4.9	4.9	4.7	4.7	**4.3**	**4.2**	**4.1**	4.9	**4.3**	**3.9**	4.7	**4.1**	**3.8**
Federal Budget Balance ($B, FY)									-586	**-625**	**-800**			
% Of GDP									-3.2	**-3.3**	**-4.0**			
												End Of Year		
Fed Funds Target (%, EOP)	0.38	0.38	0.38	0.63	0.88	**1.13**	**1.13**	**1.38**	0.4	**1.0**	**1.8**	0.63	**1.38**	**2.38**
10-Year Treasury (%, EOP)	1.8	1.5	1.6	2.4	2.4	**2.2**	**2.6**	**2.8**	1.8	**2.5**	**3.0**	2.4	**2.8**	**3.2**
30-Year Treasury (%, EOP)	2.6	2.3	2.3	3.1	3.0	**2.8**	**3.2**	**3.4**	2.6	**3.1**	**3.6**	3.1	**3.4**	**3.7**
S&P 500 (level, EOP)	2060	2099	2150	2239	2363	**2400**	**2300**	**2250**	2113	**2327**	**2200**	2239	**2250**	**2150**

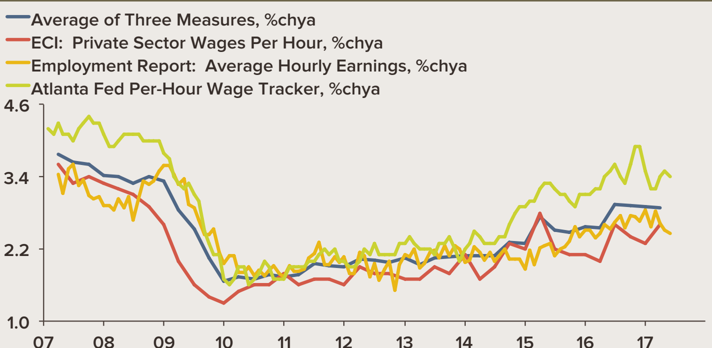
Fed officials are still underappreciating how hard it will be to stop the downtrend in unemployment. In other words, we think they are underestimating how accommodative monetary policy is now. We expect upward pressure on inflation to build as unemployment keeps falling. Wages are already accelerating, as we discussed a week ago.

5Y5YF TIPS Measure Reflects More Than Inflation Expectations

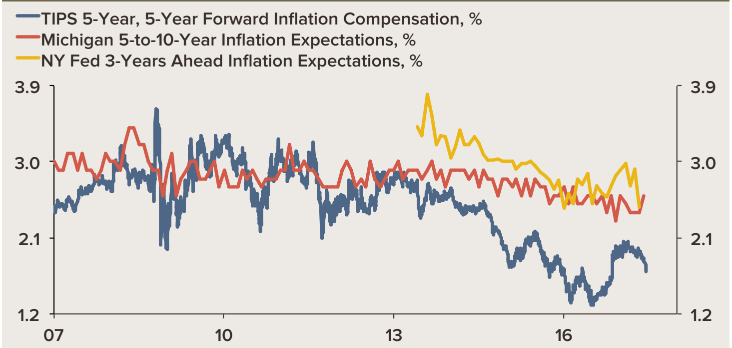
Fed critics can point to a decline in the five-year, five-year forward inflation compensation series derived from Treasury Inflation-Protected Securities—TIPS—and argue that inflation expectations are plunging. *However, as we have discussed many times previously, and as we illustrate once again in the top-left chart on page three, the five-year, five-year forward series tends to decline when oil prices decline, even though current oil prices should not have much impact on inflation five years hence.* The pattern appears to reflect changes in risk premiums, rather than inflation expectations.

Fed officials are generally well aware of the tendency of the five-year, five-year forward TIPS measure to move up and down with oil prices, and most of them will downplay the significance of the latest drop. Further weakening in "survey-based" inflation expectations measures would be noteworthy, however. Most important is the five-years-ahead expectations series from the Michigan sentiment survey, which rose slightly in the preliminary report for June, to 2.6% from 2.4%.

Wage Gains Have Been Accelerating



"Market-Based" Versus "Survey-Based" Measures



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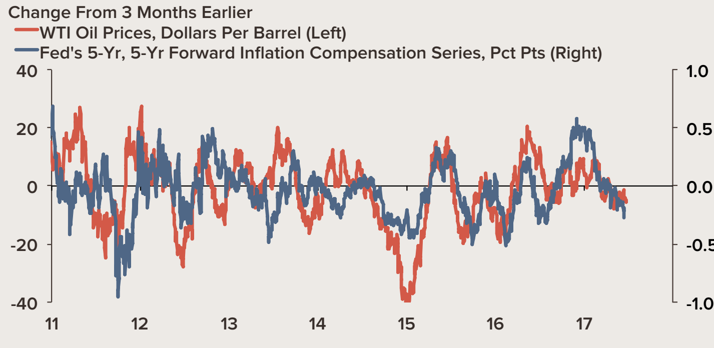
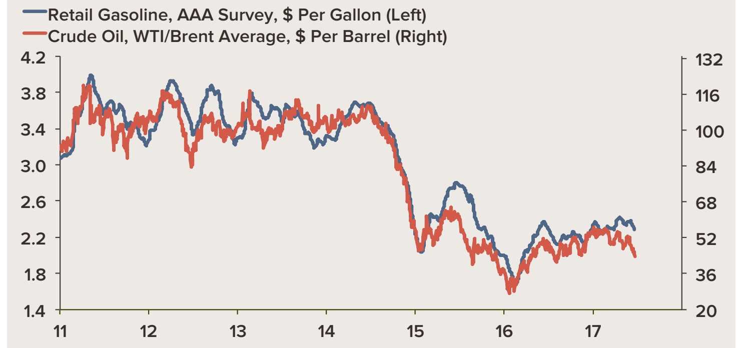
5-Year, 5-Year Forward TIPS Measure Fluctuates With Oil Prices



Decline In Oil Prices Has Been Modest Relative To 2014-16



Further weakening in the core inflation data would also be noteworthy, potentially to the point of stopping Fed tightening, although no one should be surprised by slowing in the core PCE index this week. That slowing has already been signaled by the CPI data. More important for markets and the Fed will be the next CPI report, on July 14.

Oil Price Decline Still Looks Relatively Modest

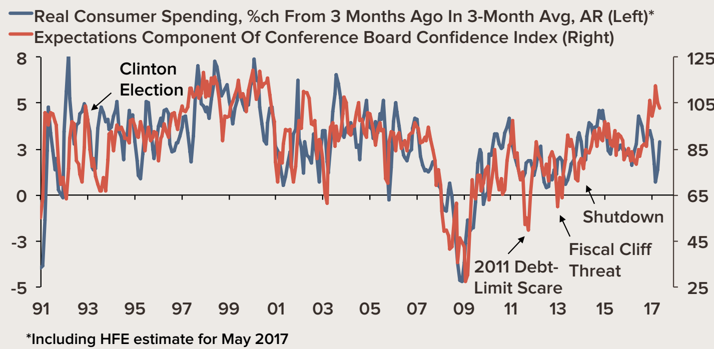
We don't think the recent weakening in oil prices is sizable enough to have a major effect on either core inflation or overall economic growth, but the impact on growth in particular merits watching. Certainly the decline in oil prices from mid-2014 through early 2016 had significant effects, both negative and positive, although the recent decline pales in comparison. Of course, sensitivity to prices is not linear: Levels appear to matter, not just changes.

On the positive side, lower oil prices boost real consumer spending, even with some of the boost to spending power saved rather than spent. Lower gasoline costs probably account for some of the rebound in real consumer spending so far in Q2. *We estimate total real consumer spending for Q2 to date—through May—is up at close to a 4% annual rate from the Q1 average, up sharply from a currently reported 0.6% pace in Q1. We expect the Q1 pace to be revised to at least 1% in this week's GDP report.*

On the negative side, lower oil prices discourage oil drilling and weaken demand for U.S. exports from oil-producing countries. *Those negatives appeared to more than offset the boost to consumer spending two years ago, although we don't anticipate any major effects this time if oil prices stop falling soon.* Moreover, the scope for mining-related investment to decline is more limited now than it was when prices started plunging in 2014: The level of investment is 0.5% of GDP, down from 1.1% in 2014. *Continued weakening would likely be associated with weakening in global trade flows, however.*

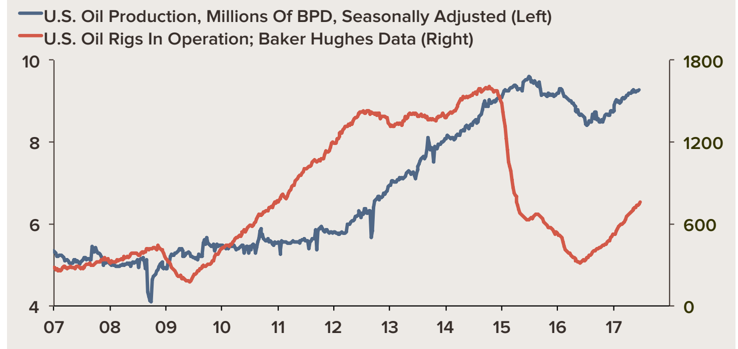
The latest data on exports and oil drilling look quite positive for growth, as we illustrate in the two charts directly below. At 57.5, the

Consumer Spending Has Reaccelerated After Weakening In Q1

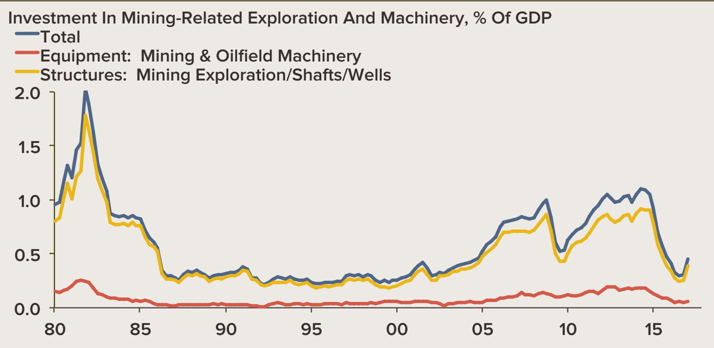


*Including HFE estimate for May 2017

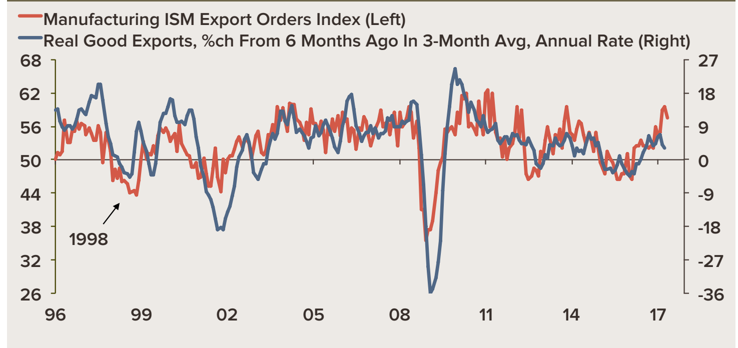
Number Of Oil Rigs In Operation Has Been Trending Up Again



Oil-Related Investment Is Down Dramatically Since 2014



Export Orders Are Rising Solidly



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May reading for the export orders index in the manufacturing ISM survey was down from 59.5 in April, but it was solidly above the zero-growth 50 mark. The Baker Hughes series on active oil rigs has been trending up fairly steadily.

Growth Remains Strong Enough To Keep Slack Shrinking

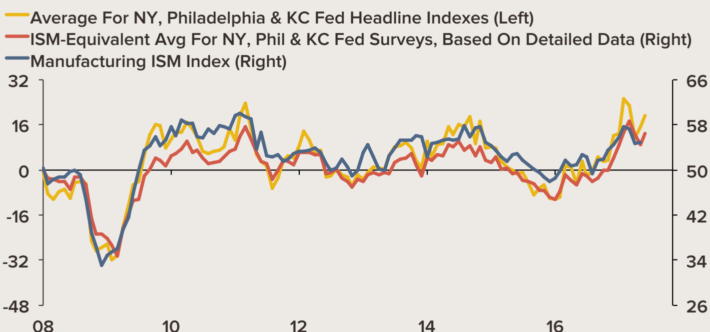
More broadly, real GDP growth appears to be accelerating significantly in Q2 after weakness in Q1: *We continue to forecast a 3.0% rate, up from what we expect to be around a 1.5% pace in Q1 after this week's revision*. The Q1 growth rate has already been revised to 1.2% from 0.7% originally.

The pick-up in GDP in Q2 likely reflects payback for exaggerated weakness rather than a significant break from what has been a near-2% trend. However, the pace still appears to be more than sufficient to keep employment growth fairly strong and the unemployment rate declining. That is also our takeaway from still-low jobless claims.

The claims data are pointing to a rebound in payrolls growth in next week's report for June after the slowing in May. The first three regional manufacturing surveys for June have suggested some strengthening in the manufacturing ISM index next week as well, as we illustrate in the chart below. In contrast, Markit's manufacturing PMI fell a little in the flash report for June, although the combined information from the regional data is more useful for forecasting the ISM index. Three more regional surveys will be released this week.

Other highlights this week include the core PCE price index, personal income and spending, durable goods orders, revised GDP, both major consumer confidence indexes, the advance data on foreign trade and a Q&A session with Fed Chair Yellen.

Initial June Regional Surveys Suggest Still-Solid ISM Reading



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This Week's Funding

Mon	Announcement—4-week bills (June 27)
	Auction—3-month, 6-month bills
	Auction—2-year notes
Tues	Auction—4-week bills
	Auction—5-year notes
Wed	Auction—2-year FRN
	Auction—7-year notes
Thur	Announcement—4-week bills (July 3)
	Announcement—3-month, 6-month bills (July 3)

This Week In Brief

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

Monday, June 26

- **SS: Durable Goods Orders (5)/8:30 EDT**
  Consensus: Total -0.6%, ex-transportation 0.4%, core capital goods 0.3%. HFE: -1.0%, 0.8%, 0.7%. Orders were probably held down by a decline in the volatile aircraft component.
- **Dallas Fed Manufacturing Index (6)/10:30 EDT**
  Consensus: 16.0, following 17.2.

Tuesday, June 27

- **Redbook Store Sales (6/27)/8:55 EDT**
- **SS: Case-Shiller Home Prices (4)/9:00 EDT**
  Consensus for 20-city index: 0.5%. HFE: 0.0%. The seasonally adjusted index has tended to be weak in April.
- **SS: Conference Board Consumer Confidence (6)/10:00 EDT**
  Consensus: 116.0, following 117.9. HFE: 118.0. The index likely remained high, helped by a still-improving labor market.
- **Richmond Fed Manufacturing Index (6)/10:00 EDT**
  Consensus: 7, following 1.
- **Fed Chair Yellen Speaks in London/13:00 EDT**
  The format will be Q&A; a prepared text will not be released.

Wednesday, June 28

- **MBA Mortgage Applications (6/26)/7:00 EDT**
- **SS: Advance Economic Indicators (5)/8:30 EDT**
  Consensus: Goods trade balance -$66.0B, wholesale inventories 0.2%, retail inventories NA. HFE: -$66.0B, NA, NA. Some of April's rise in the deficit was probably reversed.
- **SS: Pending Home Sales (5)/10:00 EDT**
  Consensus: 0.8%. HFE: 1.0%. The index probably resumed its modest uptrend after two declines.

Thursday, June 29

- **SS: GDP (Q1 third estimate)/8:30 EDT**
  Consensus: GDP 1.2%, vs 1.2% currently, GDP price index 2.2%, versus 2.2%, core PCE prices 2.1%, versus 2.1%. HFE: 1.5%, 2.2%, 2.1%. The Quarterly Services Survey suggests an upward revision to consumption.
- **SS: Initial Jobless Claims (6/27)/8:30 EDT**
  Consensus: 240K, following 241K. HFE: 245K. Claims remain low, consistent with no significant slowing in jobs growth.

Friday, June 30

- **SS: Personal Income And Spending (5)/8:30 EDT**
  Consensus: Income 0.3%, nominal spending 0.1%, core PCE prices 0.1%. HFE: 0.3%, 0.1%, 0.0%. The 12-month change in core prices probably fell to 1.4% from 1.5%. We estimate real consumption is up at close to a 4% annual rate so far in Q2.
- **SS: Chicago PMI (6)/9:45 EDT**
  Consensus: 58.0, following 59.4. HFE: 57.0. The index has been strong relative to the ISM index in recent months.
- **Univ. Of Michigan Consumer Sentiment (6f)/10:00 EDT**
  Consensus: 94.5, following 94.5. HFE: 95.0. Confidence readings have generally remained fairly high.

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