MORNING BRIEFING
May 8, 2017

Bali Hai

See the collection of the individual charts linked below.

(1) Bond Vigilantes Model too bearish on nominal GDP. (2) Ignore q/q real GDP. Focus on stronger y/y comps. (3) Variations on a theme: Lower-for-longer growth, no-boom-no-bust, inflation is dead. (4) FOMC says Q1 slowdown was temporary. (5) Welcome to Bali Hai, with ideal weather conditions for investors. (6) Just beware of the dormant volcano. (7) Wage and price inflation remain as calm as the trade winds on a South Pacific island. (8) Earned Income Proxy is smoking. (9) Storm clouds in the commodity pits? (10) Chinese officials pumping the brakes while stepping on accelerator.

US Economy: Dormant Volcano. Everyone seemed to be bummed out by the 0.7% growth in real GDP during Q1 (*Fig. 1*). It was awfully weak given that it is a seasonally adjusted *annualized* rate. Then again, it wasn't a surprise given that the widely followed Atlanta Fed's GDPNow had nailed it. Furthermore, the Citibank Economic Surprise Index (CESI) dropped from a recent peak of 57.9 on March 15 to a recent low of -21.5 on May 2 (*Fig. 2*). Over that period, it tracked the weaker-than-expected reports of many of the indicators that were used to calculate Q1 real GDP.

The US Treasury 10-year bond yield certainly didn't confirm the strength shown by all the "animal spirits" reflected in the soft data (i.e., consumer and business surveys) since Election Day. The Bond Vigilantes Model tracks the relationship between this yield and the y/y growth rate in nominal GDP (*Fig. 3*). Some fixed-income strategists believe that the 10-year yield is the bond market's current assessment of the growth in nominal GDP. If so, then it hasn't been very accurate.

For example, despite the weakness in the quarterly real rate, nominal GDP rose 4.0% y/y during Q1, well above the 2.31%-2.62% range of the yield during Q1. On a quarterly average basis, the bond yield was 153 basis points below the growth of nominal GDP (*Fig. 4*). That's because the bond market may be focusing more on the benign outlook for the inflation component of nominal growth than on total nominal growth.

In any event, the economy may not be as weak as suggested by the quarterly real GDP stat. While the data are seasonally adjusted, there has been a funky tendency for the Q1 numbers to be among the weakest ones since the start of the current economic expansion. That's why Debbie and I prefer to give more weight to the y/y comparison, which showed a gain of 1.9% over the past four quarters, consistent with the roughly 2.0% growth in this measure since 2010 (*Fig. 5*). As for the CESI, it tends to be extremely volatile and cyclical; after going down sharply for a few weeks, it tends to go back up sharply for a few weeks. It's good at spotting soft patches, which more often than not are followed by hard patches.

Can you think of a more bullish environment for both stocks and bonds at the same time than the current one? "Lower-for-longer growth" has been a profitable mantra for both. "No boom, no bust" is another variation on this theme, which Debbie and I have been promoting during most of the current economic expansion. In this scenario, inflation is dead (or at least dormant), interest rates remain low, and the expansion continues at a leisurely pace.

The FOMC statement released last Wednesday confirmed that Fed officials remain in gradual rate-hiking mode, even though they believe that the economy is stronger than suggested by Q1 indicators: "The Committee views the slowing in growth during the first quarter as likely to be transitory and continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will stabilize around 2 percent over the medium term. Near-term risks to the economic outlook appear roughly balanced. … The Committee expects that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

We may be in "Bali Hai." This name refers to a mystical island, visible on the horizon but not reachable. It is a very mellow show tune from the 1949 Rodgers and Hammerstein musical *South Pacific*. The risk is that more and more investors will crowd into the lush tropical island, causing a melt-up in the island's dormant volcano. (Work with us here.)

US Employment: No Hot Lava. The US labor market remains hot, but the heat isn't showing up in any of the wage or price data. It is certainly Bali Hai in the labor markets. Consider the following:

(1) As Debbie discusses below, the unemployment rate was only 4.4% in April. It was just 4.0% for adults, the lowest since June 2007 (*Fig. 6*). Yet average hourly earnings for production and nonsupervisory workers, who account for 70% of total payroll employment, rose merely 2.3% y/y during April (*Fig. 7* and *Fig. 8*). On the other hand, nonfarm business hourly compensation rose 3.9% y/y during Q1, though the series is quite volatile even on a y/y basis. The Employment Cost Index was up only 2.3% y/y during Q1 (*Fig. 9*).

(2) Wage and price inflation remain subdued, with the former outpacing the latter. So real hourly wages for all workers is up 0.7% y/y through March to a record high, and 5.2% since the start of 2009 (*Fig. 10*). The notion that real pay has stagnated for years is a myth. The unemployment rate is at a cyclical low for adults of just 4.0%, with the headline rate below 5.0% for the past 12 months. Full-time employment jumped 480,000 last month to the highest reading on record (*Fig. 11*).

(3) The good news for the economy is that wages of all workers have been rising faster than consumer prices for the past 54 consecutive months. The former rose 2.5% y/y during April, while the personal consumption expenditures deflator rose 1.8% in March (*Fig. 12*). Also uplifting is that our Earned Income Proxy for private-sector wages and salaries rose 0.8% m/m and 4.2% y/y during April (*Fig. 13*). This augurs well for retail sales and overall consumer spending in April (*Fig. 14*).

Global Economy: Commodity Clouds. The problem with tropical islands in the South Pacific is that the gentle trade winds can sometimes bring rough weather that is anything but pacific. In 1519, Portuguese navigator Ferdinand Magellan began a journey across the Atlantic Ocean to seek a western route to the Spice Islands via South America. In November 1520, after braving perilous seas and navigating through what are now known as the "Straits of Magellan," his small fleet entered an unfamiliar ocean, which seemed relatively calm at the time. So he named it the "Pacific Ocean."

Investors already are fretting that a storm is coming to Bali Hai. They are troubled by the recent drop in commodity prices. Debbie and I aren't fretting just yet. Our trusty CRB raw industrials spot price index remains 26% above its recent low at the end of 2015 (*Fig. 15*). The JP Morgan Global M-PMI edged down to a still-solid reading of 52.8 during April from a high of 53.0 the prior two months (*Fig. 16*).

The recent weakness in commodity prices, particularly iron ore, indicates that traders have learned to react very rapidly to changes in credit policies in China. During the second half of April, Chinese banking officials moved to rein in speculative excesses in the shadow banking system and in wealth management accounts. These officials have had a tendency to pump the brakes occasionally, only to step on the accelerator again at the first signs of an economic slowdown.

CALENDARS

US. Mon: None. **Tues:** NFIB Small Business Optimism Index 103.8, JOLTS, Wholesale Inventories 0.2%, Kaplan, Kashkari. (Bloomberg estimates)

Global. Mon: Eurozone Sentix Investor Confidence 25.2, Germany Factory Orders 0.7%m/m/2.1%y/y, China Trade Balance $35.3b, China Exports & Imports 11.3%/18.0% y/y, Japan Consumer Confidence, Canada Housing Starts 220k. **Tues:** Germany Industrial Production -0.7%m/m/2.6%y/y, Germany Trade Balance (euros) 21.5b. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index rose 0.6% last week, ranking 35th of the 49 markets as 39 rose in US dollar terms—compared to 28th a week earlier, when it rose 1.5% as 40 markets moved higher. The AC World ex-US index outperformed the US MSCI, rising 1.2% compared to a 2.4% gain a week earlier. EMU was the best-performing region last week with a gain of 3.7%, followed by EAFE (1.7%). EM Eastern Europe was the week's worst-performing region, with a decline of 1.9%, followed by EMEA (-0.9), BRIC (-0.9), EM Asia (0.1), and EM Latin America (0.7). Greece (9.4) was the best-performing country for a second week, followed by Belgium (5.8), Italy (5.4), Spain (5.1), and Ireland (5.0). Russia (-3.4) was the worst performer, followed by Australia (-2.7), China (-1.3), South Africa (-1.2), and Turkey (-1.1). The US MSCI is up 7.4% ytd, with its ranking stable w/w at 33/49, and continues to trail the AC World ex-US (10.6) on a ytd basis. Forty-six of the 49 markets are positive ytd, led by Argentina (41.1), Poland (33.2), Spain (25.2), Austria (22.1), and Korea (20.8). The worst country performers ytd: Russia (-8.1), Jordan (-1.9), Canada (-0.3), Morocco (0.4), and Egypt (0.9). EMU is now the best-performing region ytd with a gain of 16.6%, ahead of: EM Asia (15.7), BRIC (12.3), EM Latin America (11.9), and EAFE (10.7). The worst-performing regions, albeit with gains: EM Eastern Europe (0.7) and EMEA (3.1).

S&P 1500/500/400/600 Performance (*link*): Two of these three indexes rose last week, and LargeCap was at a record high for the first time in nine weeks. LargeCap's gain of 0.6% outpaced MidCap's 0.3% rise and SmallCap's 0.3% decline last week as 19 of the 33 sectors rose, down from 24 rising a week earlier. LargeCap closed out the week at a record high, but MidCap was 1.1% below its March 1 record and SmallCap ended 1.6% below its record high on February 21. Last week's top gainers: MidCap Tech (2.1%), LargeCap Tech (1.4), MidCap Health Care (1.2), and LargeCap Financials (1.2). Telecom dominated last week's worst performers: MidCap Telecom (-10.3), SmallCap Telecom (-5.3), SmallCap Energy (-3.9), SmallCap Materials (-2.8), and MidCap Consumer Staples (-2.7). Twenty-three of the 33 sectors are positive ytd, with LargeCap (7.2) beating MidCap (4.7) and both easily ahead of SmallCap (1.3). The biggest sector gainers ytd: LargeCap Tech (16.5), MidCap Health Care (15.0), SmallCap Health Care (12.0), MidCap Tech (11.2), and LargeCap Consumer Discretionary (10.8). Energy and Telecom dominate the worst performers ytd: SmallCap Energy (-27.3), MidCap Telecom (-27.1), MidCap Energy (-22.1), LargeCap Energy (-10.6), and LargeCap Telecom (-10.3).

S&P 500 Sectors and Industries Performance (*link*): Nine of the 11 sectors rose last week, and four outperformed the S&P 500's 0.6% gain. This compares to eight sectors rising a week earlier, when five outperformed the S&P 500's 1.5% gain. Tech was the best-performing sector for a second straight week, with a gain of 1.4%, followed by Financials (1.2%), Industrials (0.9), and Materials (0.7). Telecom fell for a seventh week and was last week's worst performer, with a decline of 1.2%, followed by Energy (-0.7), Utilities (0.1), Consumer Staples (0.1), Consumer Discretionary (0.1), Real Estate (0.3), and Health Care (0.6). So far in 2017, nine of the 11 sectors are higher, and four have outperformed the S&P 500's 7.2% gain. The best performers in 2017 to date: Tech (16.5), Consumer Discretionary (10.8), Health Care (10.1), and Materials (7.5). The seven sectors underperforming the S&P 500: Energy (-10.6), Telecom (-10.3), Financials (2.3), Real Estate (3.0), Utilities (6.3), Consumer Staples (6.6), and Industrials (6.7).

Commodities Performance (*link*): Eight of the 24 commodities we follow rose last week, down from 12 rising a week earlier. The week's best performers: Live Cattle (3.4%), Lean Hogs (3.3), Kansas Wheat (2.9), and Wheat (2.3). Last week's laggards: Crude Oil (-6.2), Silver (-5.7), Brent Crude (-5.5), Sugar (-5.1), and Heating Oil (-4.6). The best performers in 2017 so far: Feeder Cattle (22.6), Lean Hogs (15.5), Aluminum (12.3), Live Cattle (10.6), and Cotton (10.1). The energy-related commodities are dominating this year's laggards to date again: Sugar (-21.5), Heating Oil (-16.8), Crude Oil (-13.8), GasOil (-13.7), Brent Crude (-13.5), Cocoa (-12.2), Natural Gas (-11.8), and Unleaded Gasoline (-9.9).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 8/24 commodities, 6/9 global stock indexes, and 14/33 US stock indexes compared to 13/24, 6/9, and 24/33 rising a week earlier, respectively. Twelve commodities trade above their 200-dmas, down from 15 a week earlier as Brent Crude, Gold, and Unleaded Gasoline turned negative w/w. Commodities' average spread fell to -0.3% from 1.2%. Among assets, Commodities walked away with three of the top five spots last week: Lean Hogs leads all commodities and all assets at 23.6% above its 200-dma, followed by Feeder Cattle (18.7) and Live Cattle (15.3). Live Cattle performed the best of all commodities and all assets last week, improving 3.4ppts. Sugar (-22.9) and Cocoa (-21.6) trade at the lowest of the commodity assets relative to their 200-dmas. Crude Oil was the worst performer of all commodities last week, tumbling 6.4ppts to -6.5%. The global indexes trade at an average of 6.5% above their 200-dmas, up from 6.1% above in the prior week. All nine of the global indexes trade above their 200-dmas, unchanged from a week earlier. Germany (13.0) leads the global indexes, and was the group's best performer last week with a 1.9ppt advance. China (0.2) is trading at the lowest relative to its 200-dma of the global assets and also had the weakest performance of its country peers last week, falling 1.8ppts. The US indexes trade at an average of 3.2% above their 200-dmas, with 26 of the 33 sectors above, down from a 4.0% average a week earlier, when 28 sectors were above. The US stock indexes no longer dominate the top ten assets trading above their 200-dmas as they did in early March. LargeCap Tech now leads all US stock indexes at 12.9% above its 200-dma, followed by MidCap Tech (12.0) and MidCap Health Care (11.6). MidCap Tech rose 1.7ppts w/w for the biggest gain among US stock indexes. MidCap Telecom trades 23.3% below its 200-dma, the lowest among the US stock indexes and all assets, and also tumbled 8.1ppts w/w for the worst performance of all assets.

S&P 500 Technical Indicators (*link*): The S&P 500 index remained in a Golden Cross last week for a 54th week (after 17 weeks in a Death Cross). However, the index's 50-day moving average (50-dma) relative to its 200-dma fell for a sixth week after rising since early December. Its 50-dma was 5.2% above its 200-dma, down from 5.3% a week earlier and from a 34-month high of nearly 5.5% in early April. That's up from a six-month low of 2.0% in early December and a 52-month low of -4.5% in March 2016. The S&P 500's 50-dma moved higher for a 25th week as the index closed above its 50-dma for a second week after two weeks below for the first time since the November election. The S&P 500 improved to 1.4% above its rising 50-dma from 1.1% above a week earlier and a 23-week low of -1.0% in mid-April. That's down from a 38-week high of 4.8% above its rising 50-dma on December 13 and compares to a 52-month high of 6.2% in March 2016 and a five-month low of -7.8% in January 2016. The S&P 500 continued its early November bounce off its 200-dma last week and rose to 6.7% above its rising 200-dma from 6.5% a week earlier and mid-April's 19-week low of 4.2%. That's down from a

38-month high of 9.4% on March 1. The 50-dma and 200-dma both rose together for a 23rd week, but at a slower pace than in recent weeks.

S&P 500 Sectors Technical Indicators (*link*): Six of the 11 sectors improved relative to their 50-dmas last week, and seven improved relative to their 200-dmas. Eight of the 11 sectors trade above their 50-day moving averages (50-dmas), unchanged from a week earlier and up from three in mid-April, which was the lowest since the election. Energy remained below for a 16th straight week, and Financials and Telecom were below for a seventh week. All 11 sectors were above their 50-dmas during mid-January, and all 11 were below the week before the election, for the first time since December 11, 2015. Nine of the 11 sectors were above their 200-dmas last week, unchanged from a week earlier as Energy remained below its 200-dma for an 11th week and Telecom for a seventh. Nine sectors are in a Golden Cross, with 50-dmas higher than their 200-dmas, unchanged from a week earlier and leaving Energy and Telecom still out of the club. All 11 had been in a Golden Cross during a 21-week streak that ended October 24, the longest such stretch since October 2014. Seven of the 11 sectors have rising 50-dmas, down from eight from a week earlier as Real Estate turned down for the first time in eight weeks. Financials' 50-dma fell for a sixth week; Energy's dropped for a 14th week; and Telecom's for a 13th. Just seven sectors have rising 200-dmas, unchanged from a week earlier as Utilities started rising and Health Care began falling. Real Estate's 200-dma fell for a ninth week; Telecom's dropped for a seventh; and Energy's for a second.

US ECONOMIC INDICATORS

Employment (*link*): Jobs growth rose more than expected in April, after weather caused the slowest pace of jobs growth since last spring in March. US companies expanded payrolls by 211,000 last month (21,000 above the consensus estimate of 190,000), after a downward revision to March (to 79,000 from 98,000) and an upward revision to February (232,000 from 219,000), for a net loss of 6,000. Private payroll employment rebounded 194,000 after gains of 77,000 (vs 89,000 preliminary) and 222,000 (221,000) the prior two months, for a net loss of 11,000. The breadth of job creation (percent of private industries increasing payrolls) for the one-month span (to 60.2% from 58.8%) moved back above 60.0% last month, while the three-month span was unchanged at 65.7%, near February's two-year high of 66.1%.

Earned Income Proxy (*link*): Our Earned Income Proxy (EIP) continued to reach new record highs last month, climbing for the seventh time in eight months, by 0.8% m/m and 3.2% over the period. Average hourly earnings, one of the components of our EIP, climbed 0.3% and 1.8% over the comparable periods, while aggregate weekly hours, the other component, advanced 0.5% and 1.4%. Compared to a year ago, the EIP increased 4.2% y/y, with wages up 2.5% (decelerating steadily from 2.8% in February) and aggregate hours 1.7% higher—the most since last April. Our proxy tracks income and spending closely and remains favorable for continued solid gains in both.

Employment by Industry (*link*): Hirings in leisure & hospitality, health care & social assistance, financial activities, and mining led April employment gains, while department-store payrolls were cut for the sixth straight month, by a total of 41,100. Leisure & hospitality (55,000) establishments boosted payrolls at the fastest pace since October 2015, led by restaurants—which added 26,200 jobs m/m and 259,800 the past year. Employment in health care & social assistance climbed 36,800 last month, above the Q1 average monthly gain of 25,830; these jobs are up 435,500 y/y. Financial activities jobs accelerated 19,000 last month after rising only 9,000 over the previous two-month period; the yearly gain continues to hover just below 200,000. Mining added to payrolls for the sixth consecutive month by a total of 43,900 after falling steadily from October 2014 through October 2016. Employment in other major industries—including manufacturing, wholesale trade, retail trade, transportation & warehousing, information services, and government—changed little last month.

Unemployment (*link*): The unemployment rate sank to 4.4% in April, matching the low of the previous expansion. The civilian labor force rose only 12,000 last month, while those not in the labor force climbed 162,000. The participation rate ticked down from 63.0% to 62.9%, showing little movement over the past year. April's adult rate (4.0%) fell to a new cyclical low, while the teenage rate rose to 14.7% from March's cyclical low of 13.7%; the college grad rate (2.4) continues to hold near its cyclical low of 2.3% posted in November. Those working part-time for economic reasons (a.k.a. "involuntary part-time workers") fell 281,000 to 5.3 million (3.3% of the civilian labor force) in April, and 698,000 the past 12 months. The U6 rate—which includes marginally attached workers—and the sum of the underemployment and jobless rates both sank to new cyclical lows of 8.6% and 7.7%, respectively.

Wages (*link*): Wage inflation—as measured by the average hourly earnings rate for all workers on private nonfarm payrolls (AHE)—climbed 0.3% in April after a 0.1% uptick in March; the yearly rate slowed for the second month to 2.5% from 2.6% in March and 2.8% in February. The wage rate for goods-producing industries (2.5% y/y) continued to bounce around 3.0%—though has moved to the bottom of the range, while service-providing's (2.6) was just below its recent high of 2.8%. Within goods-producing, the construction rate (2.1) fell to a 15-month low, while the natural resources rate (1.4) continued to ease; the manufacturing rate (2.7) held near March's 12-month low of 2.6%. Within service-providing, the rate for transportation & warehousing (2.6) continued to trend higher, while wholesale trade's (1.8) sank to its lowest reading since August 2015; leisure & hospitality (4.3) remained stalled at recent highs. Rates for utilities (2.6) and retail trade (1.1) stayed on volatile downtrends, while rates for information services (4.6), financial activities (2.2), and education & health services (1.9) continued to move sideways; the rate for professional & business services moved out of its flat trend, accelerating above 3.0%.

Productivity & Labor Costs (*link*): Productivity contracted last quarter, boosting labor costs. Nonfarm productivity sank 0.6% (saar) during Q1, following gains of 1.8% and 3.3% the prior two quarters. Hours worked (1.6%, saar) grew at a faster pace than output (1.0) last quarter, which was the weakest in a year. Unit labor costs accelerated 3.0% (saar), while hourly compensation (2.4) decelerated during the quarter, recording its smallest gain in a year. On a year-over-year basis, nonfarm productivity rose only 1.1%, fluctuating in a range from -0.6% to +1.6% the past six years; output was 2.4% above a year ago, with hours worked 1.3% higher. Unit labor costs rose 2.8% y/y; hourly compensation (3.9) posted its best y/y gain in three years.

Consumer Credit (*link*): Consumer credit in March accelerated for the second month, increasing $16.4 billion, following gains of $13.8 billion in February and $9.7 billion in January—which was the weakest since July 2012. Nonrevolving credit, which includes student and auto loans, expanded $14.5 billion, the largest gain since last October. Revolving credit advanced $3.6 billion in the two months through March after contracting $3.9 billion in January, which was the first monthly loss since November 2013.

GLOBAL ECONOMIC INDICATORS

Eurozone Retail Sales (*link*): Eurozone retail sales in March continued to set new record highs. Sales rose for the third straight month, up 0.3% m/m and 0.9% over the period. The increases during the first three months of this year more than reversed the 0.4% decline during the final two months of last year. March's advance was led by gains in sales of nonfood products—excluding fuel (0.4%) and food, drinks & tobacco (0.2), which more than offset a 0.3% decline in automotive fuel. Among member states for which data are available, sales exceeded 1.0% in Estonia (1.6%), Luxembourg (1.5), Slovakia (1.2), Austria (1.1), and Malta (1.1); the biggest sales losses occurred in Portugal (-2.3) and Slovenia (-2.2). Data were available for two of the Big Three economies: France posted another solid gain, advancing

0.6% following a 0.8% rise in February, while Germany's increase slowed to 0.1% after rebounding 1.1% in February.

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