MORNING BRIEFING
April 23, 2018

Lots of Commotion

See the pdf and the collection of the individual charts linked below.

(1) What's worse: a flattening yield curve or rising bond yields? (2) By raising federal funds rate, Fed is signaling confidence in economy and storing up ammo to fight next recession. (3) The Fed is on top of the curve, neither behind nor ahead of it. (4) Bond yield target for rest of year: 3.00-3.50%. (5) Inflationary expectations rising along with oil and other commodity prices. (6) Despite flat US yield curve, no recession in global economy according to commodity prices. (7) No recession in credit quality spread or LEI. (8) German and Japanese bond yields remain near zero as ECB and BOJ balance sheets continue to swell. (9) Peak oil demand vs peak oil supply. (10) Remarkable strength in oil prices given soaring US and Canadian oil output. (11) Movie Review: "The Death of Stalin" (+ +).

Interest Rates: Keeping Score. What are stock investors rooting for in the fixed income markets? Stock investors have been fretting lately about the flattening of the yield curve. If it inverts, they'll be thrown into a frenzy; fearing that has always signaled an imminent recession. The yield curve spread between the 10-year US Treasury bond yield and the federal funds rate narrowed significantly after the Fed's latest rate hike on March 21. Last week, it widened as the bond yield jumped 14bps to 2.96%, the highest since January 9, 2014 (*Fig. 1* and *Fig. 2*). Stock investors didn't jump for joy. Instead, they fretted that the bond yield was approaching 3.00% and could soon breach that technically important level.

So what do stock investors want? I suppose they would be very happy if the Fed stopped raising the federal funds rate and the bond yield stabilized. But that's not going to happen because Fed officials are intent on normalizing the federal funds rate so that they will have more room to lower it to avert the next recession. Isn't that a bullish scenario for stocks in the long run? That's a rhetorical question. The longer the Fed can keep the expansion going, the more bullish that should be for stocks even though the short-term increase in interest rates creates somewhat more competition from bonds in this scenario. Besides, the Fed's ongoing tightening confirms that the economy is strong enough to absorb the gradual normalization of monetary policy.

If the yield curve were to steepen, with bond yields rising faster than short-term rates, then we would have to worry that the Fed is "behind the curve" in keeping a lid on inflation. The most recent behavior of the yield curve suggests that the Fed is doing the right thing, i.e., keeping inflationary pressures in check.

Debbie and I continue to expect that the 10-year yield will trade mostly between 3.00% and 3.50% over the rest of the year. We expect that the Fed will raise the federal funds rate range three more times this year at the June (1.75%-2.00%), September (2.00-2.25), and December (2.25-2.50) FOMC meetings (*Fig. 3*). Meanwhile, the Fed has started to reduce its holdings of US Treasuries, which are down $53 billion over the past 25 weeks through April 18 (*Fig. 4*). Over the course of the current fiscal year (from October 2017 through September 2018), the Fed expects to reduce its Treasury portfolio by $180 billion. Recall that the Congressional Budget Office is projecting a federal budget deficit of $804 billion during fiscal 2018, up $138 billion from fiscal 2017.

These are all potentially bearish developments for the bond market, for sure. However, they have been widely known. The jump in bond yields late last week was fueled by a jump in inflationary expectations, triggered by a jump in some commodity prices. Let's have a closer look:

(1) *Inflationary expectations and commodity prices.* Last week, the 10-year bond yield rose faster than its comparable TIPS yield ([*Fig. 5*]() and [*Fig. 6*]()). So the 10-year average inflation rate implied by the spread between these two yields rose to 2.17%, the highest since September 4, 2014, which is when the price of oil and other commodity prices went into a freefall.

There is a high correlation between this measure of inflationary expectations and both the price of a barrel of Brent crude oil and the CRB raw industrials spot price index, which doesn't include oil ([*Fig. 7*]() and [*Fig. 8*]()). While the price of oil jumped last week, the CRB raw industrials spot price index remained listless. The former gets lots of media attention, while the latter does not.

However, the price of nickel, which is not included in the CRB index, did soar last week on concerns that Russian nickel producer Norilsk Nickel will be included under US sanctions on Moscow that have already led to a rally in aluminum prices, which is also not in the CRB. The price of copper is included in the CRB index, and it is also highly correlated with the expected inflation series ([*Fig. 9*]()). However, the price of copper remains stalled around $3.00 per pound, as it has been since late 2017.

The bottom line is that the bond yield jumped because inflationary expectations jumped mostly on a jump in the price of oil. The latter has been surprisingly strong, as we discuss in the next section. Debbie and I believe that it reflects the strength of the global economy. We aren't concerned that it will push up the core inflation rate (excluding energy).

(2) *Credit quality spread and leading indicators.* If the global economy is doing well, why has the US yield curve been mostly flattening so far this year? It's hard to imagine that the global economy would be prospering if the US economy is on the verge of a recession. Reflecting domestic economic strength, US imports have risen to record highs this year, certainly boosting the global economy.

An even more reliable signal of an imminent recession is the yield spread between the BoAML high-yield corporate bond index and the 10-year Treasury ([*Fig. 10*]()). Since the start of 2017, it has been remarkably subdued near previous cyclical lows. Keep walking, folks: There's no recession here.

There's also no recession in the Index of Leading Economic Indicators (LEI), as Debbie discusses below ([*Fig. 11*]()). The LEI rose to a record high during March. On average, it tends to top three months before recessions. Occasionally providing even earlier signals of a recession is the ratio of LEI to CEI, i.e., the Index of Coincident Indicators ([*Fig. 12*]()). It has been soaring over the past 15 months through March, yet it still remains below the previous two cyclical highs.

(3) *Foreign yields.* Despite all the commotion in the US government bond market, government bond yields remain subdued in Germany (0.47%) and in Japan (0.04). While the Fed has started to taper its balance sheet ($4.4 trillion in March), the assets of the ECB and BOJ rose to new record highs in March of $5.6 trillion and $5.0 trillion, respectively.

Crude Oil: Demand Outpacing Supply. It's obviously too soon to bet that peak oil demand will trump peak oil supply. When the price of oil took a dive in late 2014 and 2015, there was lots of chatter that oil demand was approaching a peak just as oil supplies and inventories were swelling. When oil prices were soaring in 2007 and 2008, there was lots of chatter about an imminent shortage of oil as new oil reserves were harder to find and more costly to exploit.

Helping to drive the price of oil lower in late 2014 and 2015 was a remarkable increase in US oil production thanks to fracking technologies (*Fig. 13*). Just as remarkable is that US oil field production fell only 12% from its 2015 peak to its 2016 low. Since then, it has soared remarkably to 10.5mbd in mid-April, surpassing its 9.6mbd peak during the week of June 5, 2015. Most remarkable is that despite all this oil drilling in the US, the price of a barrel of Brent crude oil has recovered from a recent low of $27.88 on January 20, 2016 to $74.06 on Friday. Here's more:

(1) US stocks of crude oil and petroleum products are down to the lowest level since the same time during 2015 (*Fig. 14*). The US days' supply ratio has dropped from a peak of 27.4 during the week of March 31, 2017 to 20.5 during mid-April (*Fig. 15*).

(2) Output of crude oil from the US and Canada combined rose to 13.9mbd at the end of last year, well exceeding that from Russia (10.5mbd) and Saudi Arabia (10.1mbd) (*Fig. 16*). Keep in mind that while the latter two countries have pledged to freeze their production, other producers haven't promised to do the same.

So why are oil prices rising? We doubt it's the plunge in Venezuelan oil output because that has been offset by more output from Iraq and Iran. Our conclusion is that the global economy remains strong despite chatter about its slowing.

Movie: "The Death of Stalin" (+ +) (*link*) is an uproarious satire based on the true events surrounding the death of Josef Stalin. The film has a great cast playing the grisly cast of characters who composed the ruling committee of the Soviet Union back then. Steve Buscemi has lots of fun playing Nikita Khrushchev, whose masterful power play against the depraved Lavrentiy Beria put him in charge of the Soviet Union.

CALENDARS

US. **Mon:** Composite, Manufacturing, and Nonmanufacturing PMI Flash Estimates 54.6/55.0/54.5, Chicago Fed National Activity Index 0.29, Existing Home Sales 5.528mu. **Tues:** Consumer Confidence Index 127.0, Richmond Fed Manufacturing Index 16, New Home Sales 630k, FHFA Home Price Index 0.5%, S&P Corelogic Case HPI 0.7%m/m/6.2%y/y.(*Wall Street Journal* estimates)

Global. **Mon:** Eurozone, German, and France Composite PMI Flash Estimates 54.8/54.8/55.9, Eurozone, Germany, and France M-PMI Flash Estimates 56.1/57.5/53.5, Eurozone, Germany, and France NM-PMI Flash Estimates 54.6/53.7/56.5, Japan PMI Flash Estimates, Poloz, Wilkins. **Tues:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 102.8/106.0/99.5, Australia CPI 2.0% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index rose 0.6% last week, ranking 19th out of the 49 markets in a week when 30 countries rose in US dollar terms and the AC World ex-US index rose 0.3%. That compares to the index's 2.0% gain a week earlier, which ranked 17th as 37 markets rose and the AC World ex-US index gained 1.3%. EMEA performed the best last week with a gain of 2.2%, ahead of EM Eastern Europe (1.9%), EMU (0.7), and EAFE (0.4). The underperforming regions were EM Asia (-0.7), BRIC (-0.4), and EM Latin America (0.1). Greece was the best-performing country as it surged 8.3%, followed by Russia (3.6), Sweden (3.2), Ireland (3.2), and Egypt (2.6). Of the 22 countries that underperformed the AC World ex-US MSCI last week, New Zealand fared the worst as it fell 4.8%, followed by Pakistan (-4.7), Mexico (-3.4), Taiwan (-2.7), and the Philippines (-2.5). On a ytd basis, the US MSCI improved w/w to a 0.1% gain from -0.5% a week ago, but dropped in the performance ranking to 29/33 from 28/33. The US MSCI is now ahead of the AC World ex-US (-0.2) in the ytd period. Most of the emerging market regions and 29/49 countries are in positive territory ytd. EM Latin America has risen 7.2% ytd and leads EMU (2.6), BRIC (1.0), EM Asia (0.5), and EAFE (0.0). EMEA (-1.6) and EM Eastern Europe (-0.8) are the only laggards relative to the AC World ex-US's performance. The best country performers ytd: Colombia (16.3), Peru (13.5), Italy (12.1), Thailand (9.9), and Finland (9.4). The worst-performing countries ytd: the Philippines (-14.6), Turkey (-12.0), Argentina (-8.4), New Zealand (-7.5), and Canada (-6.0).

S&P 1500/500/400/600 Performance (*link*): All three market-cap indexes rose last week as SmallCap performed best with a gain of 0.9%, a whisker ahead of MidCap (0.9%) and easily beating LargeCap (0.5). LargeCap is now down 7.1% from its record high on January 26, worse than the declines of MidCap (-4.7) and SmallCap (-1.8) since then. Twenty-two of the 33 sectors rose in the latest week, down from 25 rising a week earlier. Energy and Telecom dominated the best performers in the latest week: SmallCap Energy (4.7), MidCap Energy (3.8), SmallCap Telecom (3.6), LargeCap Energy (2.6), MidCap Telecom (2.5), and SmallCap Materials (2.5). The biggest underperformers for the week: LargeCap Consumer Staples (-4.4), MidCap Consumer Discretionary (-1.1), and LargeCap Real Estate (-1.0). Fifteen sectors are now positive to date in 2018, up from just three in early February. The best-performing sectors ytd: SmallCap Health Care (18.2), MidCap Health Care (8.5), MidCap Tech (4.8), MidCap Telecom (4.4), LargeCap Tech (4.4), and LargeCap Consumer Discretionary (4.4). The worst performers ytd: SmallCap Real Estate (-12.9), LargeCap Consumer Staples (-11.8), LargeCap Telecom (-9.6), LargeCap Real Estate (-8.5), and MidCap Real Estate (-8.5).

S&P 500 Sectors and Industries Performance (*link*): Seven sectors rose last week as six outperformed the S&P 500's 0.5% gain. That compares to eight rising a week earlier, when four outperformed the S&P 500's 2.0% gain. Energy was the best-performing sector with a 2.6% surge, ahead of Industrials (2.1%), Consumer Discretionary (1.7), Financials (1.6), Materials (1.5), and Utilities (1.1). Consumer Staples was the biggest underperformer with a drop of 4.4%, followed by Real Estate (-1.0), Telecom (-0.3), Tech (-0.2), and Health Care (0.3). Just three sectors are in the plus column so far in 2018, up from two a week earlier and down from nine in early March. In an unusual twist, only three sectors are ahead of the S&P 500's 0.1% ytd decline: Tech (4.4), Consumer Discretionary (4.4), and Energy (1.5). The eight ytd underperformers: Consumer Staples (-11.8), Telecom (-9.6), Real Estate (-8.5), Utilities (-4.6), Materials (-2.6), Health Care (-0.7), Industrials (-0.4), and Financials (-0.2).

Commodities Performance (*link*): The S&P GSCI index rose 1.2% w/w as 15 of the 24 commodities we follow moved higher. That compares to a 5.5% gain in the prior week, which was its biggest since December as 21/24 commodities rose. Last week's strongest performers: Aluminum (8.3%), Nickel (6.3), Cocoa (5.9), Zinc (3.8), and Silver (3.0). Last week's biggest decliners: Sugar (-2.7), Kansas Wheat (-2.5), Wheat (-2.5), Soybeans (-2.3), and Corn (-2.3). The S&P GSCI commodities index is up 7.1% ytd and near its highest level since December 2014. The best performers so far in 2018: Cocoa (44.2), Kansas Wheat (17.5), Unleaded Gasoline (16.9), Nickel (16.3), and Crude Oil (13.2). The biggest laggards of 2018 to date: Sugar (-21.7), Live Cattle (-14.7), Coffee (-6.7), and Natural Gas (-6.3).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 14/24 commodities, 8/9 global stock indexes, and 21/33 US stock indexes, compared to 21/24 commodities, 8/9 global stock indexes, and 24/33 US stock indexes rising a week earlier. Commodities' average spread rose w/w to 7.3% from 6.5%. Eighteen commodities trade above their 200-dmas, up from 16 a week earlier. Cocoa leads all commodities and all assets at 29.6% above its 200-dma, but Aluminum (17.2%) rose 8.3ppts w/w for the best performance of all commodities and all assets. Sugar trades at 14.6% below its 200-dma, the lowest of all assets. Kansas Wheat (9.9) and Soybeans (4.8) both fell 2.6ppts w/w for the worst performances among all commodities. The global indexes trade at an average of 1.8% above their 200-dmas, up from 1.2% in the prior week. Five of the nine global indexes trade above their 200-dmas, unchanged from a week earlier. Brazil (11.2) still leads the global indexes, but Japan (2.8) rose 1.6ppts w/w for the best performance among the global indexes. China (-5.1) trades at the lowest among global assets and also fell 2.8ppts w/w for their worst performance. The US indexes trade at an average of 2.2% above their 200-dmas, with 22 of the 33 sectors above, up from 1.4% below a week earlier, when 21 sectors were above. SmallCap Health Care (18.3) still leads all US stock indexes relative to their 200 dmas; SmallCap Energy (10.1) rose 4.5ppts for the biggest gain among US stock indexes last week. SmallCap Real Estate (-10.1) trades the lowest among all US stock indexes, but LargeCap Consumer Staples (-8.2) fell 4.1ppts for the worst performance among US stock indexes and all assets.

S&P 500 Technical Indicators (*link*): The S&P 500 price index rose 0.5% last week and improved relative to its short-term 50-dma and long-term 200-dma trend lines. The index remained in a Golden Cross (50-dma higher than 200-dma) for a 103rd straight week (after 17 weeks in a Death Cross), yet the index's 50-day moving average (50-dma) relative to its 200-dma dropped for an 11th week to a 68-week low of 2.9% from 3.0%, and is down from a 55-month high of 7.2% in early February. This Golden Cross reading compares to a four-year low of -4.5% in March 2016. The S&P 500's 50-dma rose for the first time in five weeks, ending its worst performance since it fell for seven weeks before the 2016 election. The 200-dma continued to rise, as it has done since May 2016, but at near the slowest pace since October 2011. The index improved to 0.8% below its now-rising 50-dma from 1.1% below its falling 50-dma a week earlier, which compares to a 25-month low of 5.6% below its falling 50-dma near the end of March and a two-year high of 6.2% above its rising 50-dma on January 29. The S&P 500 appears to have successfully tested its 200-dma again, improving to 2.2% above its rising 200-dma from 1.9% above its rising 200-dma a week earlier and from 0.6% below on April 3, which was the lowest reading since June 2016. That compares to a seven-year high of 13.5% on January 29 and a four-year low of -10.1% in August 2015.

S&P 500 Sectors Technical Indicators (*link*): Last week saw eight sectors improve relative to their 50-dmas and 7/11 rise relative to their 200-dmas. At the week's end, four of the 11 sectors traded above their 50-dma (all but Energy and Utilities), up from two a week earlier as Industrials and Materials turned positive and joined Energy and Utilities. That compares to all 11 below at the end of March, which was the first time that has occurred since February 2016. Utilities was positive for a fourth week, and Energy was positive for a second week. The longer-term picture—i.e., relative to 200-dmas—shows 6/11 sectors trading above, up from 5/11 above a week earlier, which was the lowest since January 2016. Materials moved above its 200-dma in the latest week and joined these four other sectors: Tech (above 200-dma for 94 straight weeks), Consumer Discretionary (76 straight weeks), Financials (32 weeks), and Energy (2 weeks). On the other hand, Consumer Staples was below for a ninth week, Real Estate below for a 16th week, and Utilities below for an 18th week. All 11 sectors had been above both their 50-dmas and 200-dmas briefly in mid-December for the first time since July 2016. However, six sectors are still in a Golden Cross (50-dmas higher than 200-dmas), unchanged from a week earlier. All 11 had been in a Golden Cross in mid-January for the first time since a 26-week streak ended in October 2016. Energy was out for a second week, Telecom for a third, Consumer Staples for a fifth, Real Estate for an 11th, and Utilities for a 13th. Nine sectors have rising 50-dmas now (all but Consumer Staples and Telecom). That's a sharp turnaround from a week earlier when Energy was the only sector rising, and from early April when all 11 sectors had falling 50-dmas in the worst count since before the election in November 2016. Consumer Staples 50-dma fell for an 11th straight week and Telecom for a 10th week. Eight sectors have rising 200-dmas, up from seven a week earlier as Telecom turned higher w/w. That's up from six in early February, which was the lowest since May 2017. The 200-dmas for Real Estate and Utilities fell for a 15th week and Consumer Staples dropped for a ninth week.

US ECONOMIC INDICATORS

Leading Indicators (*link*): The Leading Economic Index (LEI) continued to hit new record highs in March, advancing for the sixth consecutive month; it hasn't posted a decline in 23 months. March's 0.3% gain was less than half the average monthly gain of 0.7% recorded the previous three months, but the Conference Board noted that the LEI's "six-month growth rate increased further and points to continued solid growth in the U.S. economy for the rest of the year." Of the 10 components, only three contributed negatively last month, with two of them—the average workweek (-0.07ppt) and jobless claims (-0.05)—employment-related, which the Conference Board says bears watching in the near future. The third negative contribution, from real core nondefense capital goods orders (-0.01), was trivial. The biggest positive contributions were posted by the interest rate spread (0.15), ISM diffusion index (0.13), consumer expectations (0.10), and building permits (0.07), followed by negligible contributions from the leading credit index (0.04) and real consumer goods orders (0.01); stock prices were neutral last month.

Coincident Indicators (*link*): Coincident Economic Index (CEI) also hit another new high in March; it has posted only one decline since January 2014. The CEI advanced for the sixth time in seven months, climbing 0.2% in March and 1.6% over the period; it's up 8.7% since January 2014. All four components contributed positively again last month, and all hit new record highs: 1) Industrial production, which was the only negative contributor in January, was the biggest positive contributor for the second month—rebounding 1.5% over the two months ending March. Last month's advance was the fifth in the last six months, for a total gain of 3.9% over the span, to a new record high. 2) Real personal income—excluding transfer payments—rose for the seventh time in nine months, by a total of 1.7% over those months, to another new high. 3) Nonfarm payroll employment continued to head straight up to new record highs, though March's 103,000 rise was less than a third of February's 326,000 gain. Worth noting, weather distortions are common for March—payrolls were up only 73,000 in March 2017 and 78,000 in March 2015. 4) Real manufacturing & trade sales increased for the tenth time in 11 months, by a total of 3.3%, setting new record highs along the way.

Regional M-PMIs (*link*): Two Fed districts have reported on manufacturing activity for April—New York and Philadelphia—and they show growth in the sector remains solid. We average the composite, orders, and employment measures as data become available. The composite index (to 19.5 from 22.4) this month was not too far from its recent high of 28.5 in October—which was the highest reading since July 2004. The Philadelphia (23.3 from 22.3) region is showing steady growth through the first four months of this year—with April's pace virtually matching the four-month average, while New York's (15.8 from 22.5) growth is easing. The new orders gauge (13.7 from 26.3) deteriorated this month after improving markedly last month, as orders growth in both the Philly (18.4 from 35.7) and New York (9.0 from 16.8) regions slowed—though Philly orders expanded at double the pace of New York's. The employment measure (16.6 from 17.5) was little changed for the second month, but manufacturers in the Philly (27.1 from 25.6) region continued hire at a robust rate, while New York (6.0 from 9.4) factories added to payrolls at less than a third of the pace recorded at the end of last year.

GLOBAL ECONOMIC INDICATORS

World CPI (*link*): Global inflation remained subdued in March, with the CPI up 3.7% y/y, hovering just below 4.0% since last May. The rate fell from a peak of 5.5% during September 2011 to a recent low of 3.2% during May 2016, before moving back above 4.0% in the early months of 2017. March's inflation rate for advanced economies climbed to 1.9% y/y, holding just below 2.0% the past 12 months. The rate for emerging economies was 4.8% y/y, its lowest rate since October 2009.

Japan CPI (*link*): March's core CPI ex fresh food, the Bank of Japan's main inflation gauge, eased to 0.9% y/y after rising to 1.0% in February, which was the highest since March 2015. It remains considerably below the central bank's 2.0% target rate. The core-core CPI's yearly rate—which excludes food and energy—held at February's 19-month high of 0.3%; the rate was negative from February through July of last year. The headline rate slowed to 1.1% y/y after reaching a three-year high of 1.5% in February. Among the individual components, prices were above year-ago levels for fuel (4.0% y/y), food & beverages (1.9), medical care (1.7), transportation & communication (1.7), reading & recreation (0.5), and education (0.4); they were below a year ago for furniture & household utensils (-1.4) and housing (-0.2), while clothing prices were unchanged.

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