



## MORNING BRIEFING

October 2, 2018

### The World According to Jay

See the [pdf](#) and the [collection](#) of the individual charts linked below.

(1) FOMC is no longer accommodative, as interest rates gradually have normalized. (2) Normal may be a 3.00% federal funds rate. (3) Brainard says that shifting from headwinds to tailwinds might blow neutral rate higher for a short while. (4) Williams says that r-star's light is getting "fuzzy." (5) Powell has a short worry list: escalating trade war, high asset valuations, too much corporate debt, and unstable emerging markets with dollar-denominated debt. (6) Powell endorses supply-side economics, sort of. (7) FOMC's forecasts suggest Phillips curve is dead at the Fed. (8) National and regional price surveys show September dip from high readings during the summer. (9) Everyone agrees that labor market is tight.

**Fed I: Still Gradually Normalizing.** Investors need to know when and at what level the Fed will end its rate-hiking cycle. The best answers to these two questions are in the Fed's September [Summary of Economic Projections](#) (SEP), which was released following last Wednesday's FOMC meeting. Before we go there, let's have a quick look back at the Fed's slow and steady path of rate increases to date.

During December 2015, the Fed lifted the federal funds rate from 0.00%-0.25%, where it had been for nearly seven years, to 0.25%-0.50%. Since then, the Fed has raised rates seven additional times: one time during 2016 to 0.50%-0.75%, three times during 2017 to 1.25%-1.50%, and three times during 2018 to 2.00%-2.25% so far, including the 9/26 rate hike ([Fig. 1](#)).

If the FOMC continues to hike by 25bps on a quarterly basis, the federal funds rate would rise to 3.40% by the end of next year ([Fig. 2](#)). Melissa and I expect that the Fed will increase rates one more time this year to 2.25%-2.50%, three times in 2019 to 3.00%-3.25%, and one more time in 2020 to end at 3.25%-3.50%. Why do we expect that's where the Fed will stop? We simply agree with the FOMC's median forecast for the federal funds rate in the latest SEP. For the first time, it showed the Fed's 2021 federal funds rate projection, which is the same as that for 2020, at 3.40%.

These projections were endorsed by Fed Chairman Jay Powell during his 9/26 [press conference](#). None of what he said was a surprise because his latest pronouncements are consistent with his statements since becoming Fed chairman on February 5.

During his press conference, Powell stated that the Fed's latest move reflects the strength of the US economy "and is one more step in the process that we began almost three years ago of gradually raising interest rates to more normal levels." But what is normal, and when will we get there? Consider the following:

(1) *Dropping accommodative.* It was widely [noted](#) that the latest FOMC [statement](#) deleted the following language that had appeared in previous statements: "The stance of monetary policy remains accommodative." This sentence had been in every FOMC statement since December 16, 2015, when the Fed started its latest rate-hiking program. Some interpreted this to mean that the Fed is setting up for more aggressive rate increases. On the contrary, Powell reassuringly said that the language simply

had outlived its “useful life.” So the Fed will continue its gradual rate increases toward a neutral stance.

(2) *What is neutral?* The neutral level of the federal funds rate neither speeds up nor slows down the US economy. Instead, a neutral rate keeps the US economy moving ahead on an even keel. Policymakers have two main problems with achieving this outcome: The neutral rate cannot be directly observed, and it may be a moving target. Powell commented that he doesn’t “want to suggest” that the Fed has a “precise understanding of where accommodative stops.” He added that the Fed could change its estimate of the neutral rate.

(3) *Modestly restrictive.* During his press conference, Powell was asked if the Fed might end the tightening cycle in a “restrictive posture,” as Fed Governor Lael Brainard suggested in a 9/12 [speech](#). Powell responded: “It’s very possible.” He added: “Maybe we will keep our neutral rate here [i.e., at 3.00%], and then go one or two rate increases beyond it.” If the US economy continues to perform as the Fed expects, we expect that the Fed will stop tightening at around 3.25%-3.50% during 2020. That would be two 25-basis-point hikes above the SEP longer-run projection of 3.00% for the federal funds rate.

In her speech, Brainard explained: “In the latest FOMC SEP median path, by the end of next year, the federal funds rate is projected to rise to a level that exceeds the longer-run federal funds rate during a time when real GDP growth is projected to exceed its longer-run pace and unemployment continues to fall. The shift from headwinds to tailwinds may be expected to push the shorter-run neutral rate above its longer-run trend in the next year or two, just as it fell below the longer-run equilibrium rate following the financial crisis.”

(4) *Future guidance.* That all sounds consistent with the idea that the Fed will probably halt its tightening cycle in the next couple of years. But what happens over the longer run is much more uncertain than it was when there was little room for rates to go anywhere but up. Just yesterday, New York Fed Governor John C. Williams gave a [speech](#) in which he suggested that “the case for strong forward guidance about future policy actions is becoming less compelling.”

Exploring the concept of the neutral rate, sometimes referred to by economists as “r-star,” Williams said: “Back when interest rates were well below neutral, r-star appropriately acted as a pole star for navigation.” But he added: “[A]s we have gotten closer to the range of estimates of neutral, what appeared to be a bright point of light is really a fuzzy blur, reflecting the inherent uncertainty in measuring r-star. More than that, r-star is just one factor affecting our decisions, alongside economic and labor market indicators, wage and price inflation, global developments, financial conditions, the risks to the outlook.”

**Fed II: Jay Talking.** Fed Chairman Powell has done a very good job of communicating with the financial markets community. Unlike the previous three Fed chairs, there’s not much ambiguity or jargon in his public pronouncements. We find it very refreshing to have a Fed chair who isn’t a trained economist. He has also managed to significantly reduce the often useless chatter coming from the Federal Open Mouth Committee, whose members have been known to pontificate regularly on monetary policy, often sowing confusion. There seems to be more signal and less noise under Powell.

In his latest press conference, Powell said he prefers the gradual pace of rate hikes because it gives the Fed the ability to “wait and see” how the US economy will absorb them. Powell said that he is equally concerned with risks to the upside and to the downside. Raise too quickly, and the Fed can “snuff out a recovery unnecessarily and inflation falls short” of its 2.0% target. Raise too slowly, and risk inflation overheating.

As Powell has said before on numerous occasions, he sees the risks to the economic outlook as “roughly balanced.” Powell listed several US economic strengths and potential vulnerabilities that could tip that balance in either direction. Let’s review:

(1) *Fiscal positives*. In September, the Fed increased its real GDP forecast for 2018—for the third time in a row this year—to 3.1%, up from 2.8% in June and 2.7% in March. When asked to confirm that fiscal policy had been factored into the Fed’s forecasts for growth, Powell responded that some of it is “no doubt” fiscal policy. Specifically, he referred to the tax cuts and spending increases as beneficial for growth and jobs.

“Fiscal policy is boosting the economy” and “ongoing job gains are raising incomes and confidence,” he said. Powell mentioned a couple of times that he has been pleasantly surprised by labor force participation.

(2) *Protectionism negatives*. Regarding Trump’s trade war, Powell said, “We’ve been hearing a rising chorus of concerns from businesses all over the country about disruption of supply chains, materials and cost increases, and a loss of markets.” Yet he brushed off those concerns. Interestingly, Powell noted that the tariffs “might provide a basis for companies to raise prices in a world where they’ve been very reluctant” to do so because of consumers’ ability to “compare prices on the internet.”

Further, Powell observed that it’s hard to see the impact of the tariffs on the US economy at the aggregate level. If all the tariffs announced were applied, Powell thinks the impact would still be small. The major risk for the outlook that Powell can foresee is the possibility of the tariffs being made permanent and impacting business confidence.

“Fair trade under internationally accepted rules can be a good thing,” stated Powell. “I think if this perhaps inadvertently goes to a place where we have widespread tariffs that remain in place for a long time for a more protectionist world, that is going to be bad for the US economy” and “other economies” too, he said.

(3) *Worry list*. Outside of trade, Powell discussed three other US economic vulnerabilities. One is that asset prices are in the “upper range” relative to historical averages. The second is elevated levels of nonfinancial corporate (NFC) debt. The third is that unstable emerging markets with dollar-denominated debt are vulnerable to rising interest rates in the US.

However, Powell sees these issues as posing only moderate risks to the outlook. Powell isn’t too worried about NFC debt and added that banks have taken on less risk now than they previously did. Likewise, Powell isn’t overly concerned about a correction in asset prices unless it were to coincide with a decrease in consumption. He mentioned that the Fed is monitoring emerging economies, but noted that only a few are at risk.

(4) *Another supply-sider?* We were most impressed by Powell’s HUGE endorsement of supply-side economics. Okay, we are exaggerating, but here is what he actually said during the Q&A:

“Oh, supply side effects, yeah. ... [W]e hope they’re huge, frankly. You know, the idea is ... you reduce taxation on corporations ... and allow faster expensing for investment. The idea is to encourage more investment and that is one of the things that drives productivity, which is one of the main things that drives rising incomes. [Supply side] effects are very uncertain ... [T]here’s no clear answer to exactly how these mechanisms work or how effective they are. And it would be soon to be seeing supply side effects. ... But ... I certainly hope ... that we’ll be marking up our estimates of potential growth.” Nice to know we are in the same camp as the Fed chairman!

**Fed III: Regional Prices Surveys.** Is the Phillips curve dead? The latest SEP suggests that Powell's Fed is much more inclined to think so than was Yellen's Fed. The latest SEP projections show real GDP growing 3.1% this year and 2.5% next year. The unemployment rate is projected to fall to 3.5% in 2019. Yet the core PCED inflation rate remains around 2.0%. There's no tradeoff between the unemployment rate and inflation in this forecast, even though the labor market is the tightest in decades and is expected to get even tighter.

Debbie and I tend to agree with this outlook, though we wouldn't be surprised if Trump's supply-side policies stimulated faster growth fueled by rebounding productivity, which would allow real wages to increase and inflation to remain subdued. For now, the latest national and regional surveys of business conditions show that both "prices paid" and "prices received" by manufacturers dipped during September but remained elevated compared to a year ago. That may reflect rising costs—including labor compensation, oil prices, and tariffs. However, they also moderated a bit last month.

Based on the five regional surveys conducted by the Fed district banks in Dallas, Kansas City, New York, Philly, and Richmond, the average of the prices paid and prices received indexes dipped in September by 6.3 points and 7.6 points to 42.0 and 18.6, respectively, from their July peaks. Both sets of indexes were below zero from about mid-2015 to mid-2016. They recently peaked at about 50.0 and 30.0, respectively, before tapering off in September ([Fig. 3](#)).

The regional prices paid composite is highly correlated with the national prices paid index included in the ISM manufacturing purchasing managers survey ([Fig. 4](#)). The ISM index is down from a recent peak of 79.5 during May to 66.9 during September. Similar dips were seen across the five Fed districts, with the exception of Richmond ([Fig. 5](#)).

Several of the regional survey reports mentioned the tightness of the labor market. Kansas City's September Manufacturing Survey [noted](#): "Finding people to work still is our greatest challenge. We are working 6 days a week and have a very difficult time getting people to show up. Overtime is taking a toll on the financial statement and on our employees. They want time off and it's hard to give it to them." As we've discussed previously, a similar story was told in the last several Federal Reserve Beige Books, the most comprehensive qualitative Fed survey of business conditions.

It seems reasonable to expect that employers may have to increase wages at a faster pace in order to attract hard-to-get employees. The question is: Will they do so or instead increase capital spending and boost productivity? Another question: Will they be able to pass through cost increases in industries that are competitive and being disrupted by technological innovations? We continue to believe that powerful secular forces will keep inflation at bay.

## CALENDARS

**US. Tues:** Powell, Quarles. **Wed:** ADP Employment 177k, ISM & IHS Markit NM-PMIs 58.0/52.9, MBA Mortgage Applications, EIA Petroleum Status Report, Evans, Barkin, Mester. (Econoday estimates)

**Global. Tues:** Japan Consumer Confidence 43.1, RBA Cash Rate Target 1.50%. **Wed:** Eurozone Retail Sales 0.2%/m/1.7%/y/y, Eurozone, Germany, France, and Italy C-PMIs 54.2/55.2/53.6/51.8, Eurozone, Germany, France, and Italy NM-PMIs 54.7/56.5/54.3/52.8, UK C-PMI & NM-PMI 54.0/54.0, Japan C-PMI & NM-PMI. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** ([link](#)): LargeCap's forward earnings fell for the first time in 18 weeks from a record high, but MidCap's and SmallCap's were both at new highs. A w/w decline in forward earnings has occurred at the start of earnings seasons in the past, but will be watched closely this time around as the impact of the China trade war could be starting to roost in US profit forecasts. Forward earnings activity has been relatively strong in the past 12 months: LargeCap's forward earnings have risen in 49 of the past 52 weeks, MidCap's in 50, and SmallCap's in 45. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap's forward earnings fell to 22.8% y/y from 23.2%, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's fell to 23.5% from 23.8%, down from mid-September's 24.1%, which had been the highest since April 2011 and compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped w/w to 34.2% from 34.6%, which compares to an eight-year high of 34.8% in mid-August and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 10.2%, 9.6%), MidCap (21.3, 12.3, 11.0), and SmallCap (29.0, 15.4, 11.3).

**S&P 500/400/600 Valuation** ([link](#)): Forward P/E ratios were broadly lower last week, but only slightly. LargeCap's weekly forward P/E edged down to 16.7 from a six-month high of 16.8 a week earlier, which compares to a post-election low of 16.0 in late March and is down from 18.6 on January 26—the highest since May 2002. That also compares to the post-Lehman-meltdown P/E of 9.3 in October 2008, but is well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E was down to a 21-week low of 16.4 from 16.6, and is nearing the 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E fell to a nine-week low of 17.5 last week from 17.7 and is down from a 24-week high of 18.3 at the end of August. That compares to a post-election low of 17.0 in mid-March and is well below its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed), but is comfortably above its three-year low of 15.5 in February 2016. Looking at the three indexes' daily forward price/sales (P/S) ratios, most were higher w/w but remain at levels well below January highs: LargeCap's P/S fell w/w to 2.09 from 2.11, and is down from a record high of 2.19 on January 26; MidCap's was steady at 1.33, which compares to its record high of 1.40, also on January 26; and SmallCap's fell to 1.03 from 1.04, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

**S&P 500 Sectors Quarterly Earnings Outlook** ([link](#)): With the books now closed on Q3, it's the time that analysts usually turn their attention toward trimming forecasts. Indeed, last week, the S&P 500's Q3-2018 EPS forecast dropped three cents w/w to \$40.56. That's down 1.2% since the end of Q2, but up 7.4% ytd and 8.2% since the passage of the TCJA. The \$40.56 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 21.6%, down from 21.7% a week earlier and down from 22.1% at the end of Q1. That compares to Q2-2018's blended 24.9%, Q1-2018's 26.6% (which is the strongest since Q4-2010 and likely to mark the peak of the current earnings cycle), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q2, the Q3-2018 estimate has risen 5.7% for the Tech sector, following the transfer of Google, among others, to the revamped Communications sector. The remaining 10 sectors are down since the end of Q2. The new Communication Services sector is the biggest decliner, with its Q3-2018 forecast down 48.6% since the end of Q2, followed by Consumer Discretionary (-2.8), Materials (-1.8), Energy (-1.1), Real Estate (-0.8), Consumer Staples (-0.7), Utilities (-0.6), Health Care (-0.3), Financials (-0.2), and Industrials (-0.2). The S&P 500's Q3-2018 forecasted earnings gain of 21.6% y/y would be its ninth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q3-2018, with eight at a double-digit percentage rate. That compares to all 11 positive during Q2, when nine rose at a



triple- or double-percentage rate. Three sectors are expected to beat the S&P 500's forecasted y/y earnings gain of 21.6% during Q3, down from four during Q2. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace and four outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q3 relative to very low earnings a year ago, with the pace slowing from Q2. The latest forecasted Q3-2018 earnings growth rates vs their blended Q2-2018 growth rates: Energy (97.8% in Q3-2018 vs 122.8% in Q2-2018), Financials (41.3, 27.5), Materials (29.9, 40.7), S&P 500 (21.6, 24.9), Tech (20.2, 28.9), Industrials (17.0, 20.2), Communication Services (14.9, 18.1), Consumer Discretionary (12.9, 21.3), Health Care (10.8, 18.3), Consumer Staples (7.1, 13.9), Utilities (4.8, 8.7), and Real Estate (4.4, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 18.6% y/y in Q3, down from a blended 21.9% in Q2; that compares to 24.5% in Q1-2018, 12.7% in Q4-2017, and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

**S&P 500 Q3 Earnings vs Past Quarters Trend** ([link](#)): Earnings estimate revisions activity for Q3-2018 is returning to the usual pattern of falling just before the earnings reporting season. This follows the unusual pre-reporting estimate increases seen for Q1- and Q2-2018 due to the TCJA. With the September-quarter books closed, the current Q3-2018 EPS forecast of \$40.59 is down 1.2% over the 13 weeks since the quarter's start. That drop compares to an average decline of 4.0% over the same time period in the 97 quarters dating back to 1994, and the TCJA-boosted gains of 5.1% and 0.6% during Q1 and Q2, respectively. Analysts expect EPS for Q3-2018 to be up 21.3% y/y on a frozen actual basis, which would mark the ninth straight quarter of higher EPS on a y/y basis and the fourth straight quarter of double-digit percentage growth. While the current forecast is below the 25.8% growth rate recorded for Q2-2018, it has a good chance of beating that mark and achieving the strongest growth since a 34.2% gain during Q4-2010. Since 1994, the Q3 earnings surprise has been positive in 18/24 years (all but 1997-1998, 2001, 2005, and 2007-2008). Q3 should mark the S&P 500's record 39th straight quarter of positive surprises—a streak dating back to Q1-2009.

## US ECONOMIC INDICATORS

**Construction Spending** ([link](#)): Construction spending in August once again remained stalled at record highs. Total spending edged up 0.3% during the two months through August after no change the prior two-month period. Public construction spending continues to soar, increasing for the 11th time in 12 months, by a total of 14.0%, to its highest reading since July 2009. Meanwhile, private construction spending is stalled around record highs, falling -1.5% during the three months through August after rising 1.9% during the two months through May, with both nonresidential and residential construction showing little movement. Over the past five months, nonresidential and residential construction spending rose 0.3% and 0.4%, respectively. Within residential construction, home-improvement (1.8%) and multi-family (0.9) spending rose, while single-family (-0.6) inched lower.

## GLOBAL ECONOMIC INDICATORS

**Global Manufacturing PMIs** ([link](#)): Global manufacturing activity grew in September at its slowest pace in 22 months. September's JP Morgan M-PMI fell for the eighth time in nine months, after reaching a seven-year high of 54.5 at the end of last year, sinking to 52.2 last month. Developed nations (to 53.6 from 53.8) continued to record much stronger growth than emerging ones (50.3 from 50.8), though both have slowed since late last year—to the weakest readings since November 2016 and August 2016, respectively, with the latter very close to the breakeven point. Among the larger industrial nations, M-PMIs show that growth in the US (to 55.6 from 54.7) accelerated to a four-month high, beaten only by the readings registered by the Netherlands and Ireland. Meanwhile, manufacturing activity in the overall Eurozone (53.2 from 54.6) slowed to a two-year low, linked to a weakening trade cycle, with new export orders growing at the weakest rate in the current 63-month sequence of

growth—with exports in France & Germany contracting. Within the Eurozone, M-PMIs show the Netherlands (59.8, 3-month high) was the only country where growth accelerated last month, while Italy's (50.0, 25-month low) gauge shows its manufacturing sector is in danger of contracting. Here's the ranking of the other countries: Ireland (56.3, 2-month low), Austria (55.0, 23-month low), Germany (53.7, 25-month low), Greece (53.6, 2-month low), France (52.5, 3-month low), and Spain (51.4, 25-month low). Meanwhile, the rate of expansion in the UK (53.8 from 53.0) improved slightly last month after sinking to a 25-month low in August, while Japan's (52.5) M-PMI was unchanged at August's two-year low. The performance of emerging markets (on average) was the main drag on global manufacturing growth. China's M-PMI (50.0 from 50.6) recorded its lowest reading since May 2017—showing no growth—while Russia's (50.0 from 48.9) stabilized after contracting the prior four months. Meanwhile, upturns slowed in Taiwan (50.8 from 53.0), Brazil (50.9 from 51.1), Indonesia (50.7 from 51.9), Colombia (52.8 from 53.3) and Vietnam (51.5 from 53.7); Turkey (42.7 from 46.4) and Myanmar (47.5 from 46.4) continued to contract.

**US Manufacturing PMI ([link](#)):** Manufacturing activity in September held around 14-year highs, according to the ISM measure, while IHS Markit's gauge accelerated for the first time in five months. The ISM M-PMI edged down to 59.8 last month after rising four of the prior five months from 57.3 to 61.3—which was the best pace since May 2004. The new orders index (to 61.8 from 65.1) posted its 17th straight reading of 60.0 or above, while the production index (63.9 from 63.3) moved further above 60.0—to its highest reading since the start of the year—after dipping below 60.0 in July. Meanwhile, the new export orders sub-index (56.0 from 55.2) showed export growth remained robust, though down from February's seven-year high of 62.8. The employment index (58.8 from 58.5) accelerated for the third month to a seven-month high, while the supplier deliveries (61.1 from 64.5) gauge was above 60.0 for the eighth straight month, peaking at a 14-year high of 68.2 in June; inventories (53.3 from 55.4) continued to accumulate. The price index eased for the fourth month, to a 10-month low of 66.9, since climbing to a seven-year high of 79.5 in May. IHS Markit's M-PMI rose to 55.6 after falling the previous four months from 56.5 in April to its low for the year of 54.7 in August. According to the survey, "September data indicated a strong improvement in operating conditions across the U.S. manufacturing sector. The overall performance was driven by sharper rises in output and new orders, though new business from abroad continued to expand at only a marginal pace. A faster increase in new orders contributed to greater capacity pressures, with backlogs accumulating at the joint-fastest rate since September 2015."

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