MORNING BRIEFING
October 22, 2018

The Fed: Mind Games

See the collection of the individual charts linked below.

(1) Goldilocks growth, especially on y/y basis. (2) No recession here: Both CEI and LEI at record highs during September. (3) Yield curve spread still positive contributor to LEI. (4) Two identical strangers: The yield curve spread and the unemployment rate. (5) Stock market confused by conflicting fiscal and monetary policies and mixed Q3 corporate earnings reports. (6) Fed's confidence in the economy spooking investors, who now fear that 3.40% fed funds rate is more likely in 2020. (7) Fed replaces "accommodative" with "restrictive" lingo. (8) FOMC remarkably gloomy about long-run economic growth. (9) We pick a quarrel with Fed Governor Quarles.

US Economy: Running Hard, Not Hot. The US economy continues to grow at a solid pace without reviving inflationary pressures. The Atlanta Fed's latest GDPNow model estimate for real GDP growth is 3.9% for Q3-2018, following a gain of 4.2% during the previous quarter. On a y/y basis, the latest estimate would place real GDP growth at 3.2%, the highest since Q2-2015 (*Fig. 1*). That's running hard, but not hot. The same can be said about y/y growth in the Index of Coincident Economic Indicators (CEI), which is closely correlated with the comparable growth in real GDP (*Fig. 2*). The former logged in at 2.4% during September.

Notwithstanding the recent volatility in the stock market amid renewed fears about the prospects for the economy, both the CEI and Index of Leading Economic Indicators (LEI) rose to record highs in September, as Debbie discusses below (*Fig. 3*). One of the 10 components of the LEI is the yield curve spread, which edged up to 105bps last month from August's 98bps reading, which was the lowest since March 2008. Keep in mind that as long as this spread remains above zero (even if it has narrowed significantly), it remains a positive contributor to the LEI. Here are a few more interesting observations about the yield spread and the economy:

(1) *The jobless rate and the yield curve spread.* The LEI's yield curve spread is highly correlated with the national unemployment rate (*Fig. 4*). The latter was down to 3.7% during September, the lowest since the end of 1969. Often in the past when the jobless rate fell to such a low level, wage and price inflation would rise rapidly, after having fallen when the unemployment rate had been rising (*Fig. 5*).

This inverse relationship is commonly called the "Phillips curve." The Fed typically has responded to the tightening of the labor market and rising inflation by raising interest rates until monetary policy tightening caused a recession. The coincident flattening, and sometimes inverting, of the yield curve would anticipate the economic downturn. So far, there's no sign of this happening in the LEI's yield curve spread component, which remains solidly in positive territory; nor do the LEI's other components signal a downturn.

(2) *The Phillips curve and the yield curve spread.* Interestingly, since the early 1980s there has been a strong inverse relationship between wage inflation (measured using the y/y percent change in average

hourly earnings) and the yield curve spread (*Fig. 6*). That's not surprising given that the spread is so highly correlated with the unemployment rate. What is the current relationship of these variables telling us? The yield curve spread, comfortably in the positive zone, seems to confirm that while the economy is running hard, it isn't running hot enough to significantly boost inflation, which would trigger the kind of monetary tightening that would cause a recession, and an inversion of the yield curve.

(3) *A couple of regional business surveys.* Debbie reports below on October's regional business conditions surveys conducted by the Federal Reserve Banks of New York and Philadelphia. Their overall business conditions indexes remained near this year's elevated levels (*Fig. 7*). Interestingly, their price indexes have been trending lower in recent months (*Fig. 8*).

The Fed I: Too Much of a Good Thing? In recent weeks, Fed officials have been signaling that the economy may be too strong. No doubt, it has been running hard thanks, in part to President Donald Trump's tax cuts. But it has yet to show any sign of running too hot—i.e., hot enough to kindle inflation fires—based on the latest data from inflation barometers including the core CPI, PPI, import prices, and average hourly earnings (the most widely followed wages measure).

Indeed, average hourly earnings has been rising at a remarkably subdued pace despite the tight labor market. No wonder both the President and Larry Kudlow, director of the White House's National Economic Council, are upset with the Fed for raising interest rates. They believe that their supply-side policies can boost productivity-led economic growth without heating up inflation. While they are stepping on the accelerator, the Fed is tapping on the brakes.

That conflicting mix of fiscal and monetary policies has sent stock prices spinning over the past couple of weeks. Recently released Q3 corporate earnings reports have just compounded the instability: Some companies are reporting results confirming that the economy is doing just fine, while others—particularly the more cyclical ones—have been bruised by rising interest rates, rising oil prices, and the strong dollar; their earnings reports have raised warning flags about the economy. The mounting fear is that Fed officials are on course to make a serious policy mistake, i.e., moving interest rates higher too rapidly despite the cracks showing up in some earnings reports.

Perhaps most unsettling: Some Fed officials have signaled in the weeks since their September 25-26 meeting that the economy may be so strong that they might have to raise the federal funds rate higher than they had mentioned doing in the past. That would be unfortunate given how well they've prepared the financial markets for a federal funds rate raised to 3.00% by the end of 2019. Now they're talking more about 3.40% in 2020. Is that really necessary? A "gradual normalization" of the federal funds rate to what they've claimed is a "neutral" rate (3.00% in 2019) has been clearly telegraphed and is widely anticipated. Why suddenly speculate about turning restrictive in 2020?

In meetings with our accounts in Kansas last week, many expressed concerns that the Fed could trigger a financial crisis and cause a recession. That's been the modus operandi of the Fed near the tail-end of every business-cycle expansion, especially when the economy was running both hard and hot (*Fig. 9* and *Fig. 10*). If it is currently showing few if any signs of mounting inflationary pressures, what's the rush to start talking about pushing the federal funds rate above neutral? Indeed, why not raise the federal funds rate even more gradually to assess how the economy is responding to monetary normalization after roughly 10 years of abnormal ultra-easy monetary policy? Good questions.

In the next section, we review the recent pronouncements from Fed officials suggesting that they may not be as level-headed as my friends in Kansas. But before we go there, let's go straight to our conclusion: We think that the economy will remain strong, on balance, with some weakness in interest-rate-sensitive sectors. We think that inflation will remain subdued. We expect to see more evidence that productivity is making a comeback, especially in manufacturing as manufacturing comes back to the US.

If that happens, then Fed officials may have to acknowledge that NAIRU, the non-accelerating inflation rate of unemployment, might be lower than they currently believe. The Congressional Budget Office (CBO) estimates that NAIRU is currently between 4.5% and 5.0% (*Fig. 11*). The actual unemployment rate fell well below that range, to 3.7%, during September, yet inflation hasn't accelerated. Could it be that NAIRU, which is unobservable, might be lower than the CBO's model estimates? We think so. By the way, the CBO's model also shows the ratio of actual real GDP to potential at 1.0 during Q2, the highest since Q4-2007 (*Fig. 12*).

Fed II: Talking About Going Restrictive. It was widely noted that the 9/26 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 the omission to mean that the Fed is setting up for more aggressive rate increases. On the contrary, at his 9/26 press conference, Fed Chairman Jay 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.

Nevertheless, the markets are starting to fear that the Fed may be heading toward restricting economic growth. Consider the following:

(1) *The dot plots*. The Fed's quarterly dot plot has become the semi-official playbook for the FOMC. It showed that on March 21, the committee's median forecast for the federal funds rate was raised from 3.1% in 2020 to 3.4%, further above the "longer-run" forecast of 2.9%, which had also been raised from 2.8%, as shown in *Table 1*.

By the way, the dot plot is included in the quarterly Summary of Economic Projections (SEP) provided after the March, June, September, and December FOMC meetings. The SEP notes: "Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy."

(2) *The latest minutes.* Despite the March 21 increase in the 2020 federal funds rate forecast, the S&P 500 rose 13.6% from this year's low on February 8 to a record high on September 20. It's down 5.6% since then, partly because Fed officials have upped the ante by signaling that their policy might have to turn from accommodative to neutral to outright restrictive given the strength of the economy. That gave the 3.4% forecast for 2020 more credibility. So, for example, the word "restrictive" appeared in September's FOMC minutes for the first time during the current economic expansion as follows:

"Participants offered their views about how much additional policy firming would likely be required for the Committee to sustainably achieve its objectives of maximum employment and 2 percent inflation. A few participants expected that policy would need to become modestly **restrictive** for a time and a number judged that it would be necessary to temporarily raise the federal funds rate above their assessments of its longer-run level in order to reduce the risk of a sustained overshooting of the Committee's 2 percent inflation objective or the risk posed by significant financial imbalances. A couple of participants indicated that they would not favor adopting a **restrictive** policy stance in the absence of clear signs of an overheating economy and rising inflation."

(3) *Brainard & Powell open to overshooting neutral.* During the Q&A of his press conference, Powell was asked whether the Fed might end the tightening cycle in a "restrictive posture," as Fed Governor Lael Brainard had 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's 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."

Fed III: Deep in the Weeds. Above, Melissa and I reviewed this year's path of the SEP's median federal funds rate forecasts through 2021. It's interesting to do the same for real GDP growth.

Table 2 shows that the median forecast of the FOMC has increased from 2.5% at the end of last year for this year to 3.1% in September's SEP. Growth is expected to decelerate to 2.5% next year, to 2.0% in 2020, and to only 1.8% in 2021, which is deemed to be the long-run potential of the economy.

That's a fairly dour outlook. FOMC participants aren't buying the supply-side story that tax cuts may boost productivity. So they feel compelled to raise rates to slow the economy back down to its long-run potential to keep inflationary pressures from rising as a result of the short-run stimulative impact of Trump's tax cuts. No wonder Trump isn't happy with Powell. He probably regrets not having extended Janet Yellen's employment contract.

The SEP also shows that the median forecast for the unemployment rate fell from 3.9% at the end of last year for this year to 3.7% last month. Next year, it is expected to fall to 3.5% and stay there through 2020. But then it is projected to edge back up to 3.7%. The long-run jobless rate is deemed to be 4.5%, the same as the CBO's estimate for NAIRU (*Table 3*). No wonder Fed officials are talking about turning restrictive: They believe the unemployment rate is already well below its non-accelerating inflation rate! What if they are wrong and inflation remains subdued, as we expect?

Finally, the SEP's median inflation forecast, based on the core PCED, is remarkable. For this year, it was raised from 1.9% at the end of last year to 2.0%. Over the next two years, it is expected to be 2.1%. FOMC participants believe that, thanks to their monetary policymaking, inflation will remain right in line with their 2.0% target for the foreseeable future (*Table 4*).

Fed IV: Too Much Free Time? Could it be that Fed officials have too much free time on their hands, and that's why they concoct all sorts of cockamamie theories? For example, consider the 10/18 speech by Fed Governor Randal K. Quarles titled "Don't Chase the Needles: An Optimistic Assessment of the Economic Outlook and Monetary Policy." He starts with two Hamletesque questions:

"How long can this strong growth be sustained? The answer depends largely on what form growth takes. Growth that is supported by increases in the productive capacity of the economy should be durable. However, if growth primarily reflects strong demand that stretches production beyond its sustainable capacity, the economy will run into constraints that will result in slower growth, higher prices, or a potentially destabilizing buildup of financial imbalances. So, which is it?" He isn't sure, which is why he supports the Fed's gradual normalization of monetary policy.

Quarles hopes that there is still enough slack in the labor market and that technological innovations will boost productivity growth enough to boost potential output without reviving inflation. He fears that if that doesn't happen, then strong demand could lift inflation.

He acknowledges that "potential output is unobserved and can only be inferred from the behavior of other measured economic indicators." He states that inflation is "the primary indicator of the economy's position relative to [its] potential." Now put on your thinking caps:

"Perhaps inflation is just sending a signal of people's trust in the Fed's ability to meet its inflation objective. If so, no complaints here. That is a good thing. However, a problem does arise if the Fed remains reliant on inflation as our only gauge of the economy's position relative to its potential. There are risks in pushing the economy into a place it does not want to go if we limit ourselves to navigating by what might be a faulty indicator. Anchored inflation expectations might mask the inflation signal coming from an overheated economy for a period, but I have no doubt that prices would eventually move up in response to resource constraints. The ultimate price, from the perspective of the dual mandate, would be an unanchoring of inflation expectations."

I hope no further explanation is required, because I'm not sure there is much more I could add to explain this head-spinning concept.

CALENDARS

US. Mon: Chicago Fed National Activity Index 0.18. **Tues:** Richmond Fed Manufacturing Index 24, Bostic. (Econoday estimates)

Global. Mon: None. **Tues:** Eurozone Consumer Confidence.

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index was unchanged last week; that follows a 4.1% drubbing a week earlier, which was its worst decline since late March. The index ranked 16th out of the 49 markets in a week when 13 countries rose in US dollar terms; that compares to the prior week's 36/49 ranking when just five markets rose. The AC World ex-US index edged down 0.3% for the week; that compares to a 3.5% drop a week earlier, which was its biggest in eight months. EM Latin America rose 1.6% for the week, easily outpacing EMEA (0.2%), EAFE (-0.1), and EMU (-0.2). EM Asia (-1.3) was the biggest underperformer relative to the AC World ex-US last week, followed by BRIC (-1.0), and EM Eastern Europe (-0.8). Turkey was the best-performing country as it soared 4.0%, followed by Brazil (3.5), the Philippines (3.4), Hungary (2.8), and Indonesia (2.5). Of the 23 countries that underperformed the AC World ex-US MSCI last week, Ireland fared the worst, falling 3.2%, followed by the Czech Republic (-2.5), South Africa (-2.5), Argentina (-2.4), and Pakistan (-2.4). The US MSCI still ranks an astounding 2/49 ytd with its 3.4% gain far ahead of the AC World ex-US (-11.4). Most countries—44/49—and all regions are in negative territory ytd. Falling less on a ytd basis than the AC World ex-US are: EM Latin America (-4.4), EM Eastern Europe (-6.1), EAFE (-9.8), and EMEA (-10.5). EM Asia (-17.2) is now the biggest laggard relative to the AC World ex-US's performance, followed by BRIC (-16.4) and EMU (-12.0). The best country performers ytd: Israel (6.3), the US (3.4), Norway (3.3), Finland (0.7), and Peru (0.2). The worst-performing countries ytd: Argentina (-54.7), Turkey (-44.9), Greece (-34.2), Pakistan (-32.3), and South Africa (-29.8).

S&P 1500/500/400/600 Performance (*link*): The LargeCap and MidCap indexes were flat for the week, but SmallCap dropped 0.3% to fall further into correction territory. LargeCap ended the week 5.6%

below its record high on September 20, ahead of MidCap (-8.7, August 29) and SmallCap (-12.4, August 31). Eighteen of the 33 sectors moved higher in the latest week, compared to all 33 falling a week earlier, for the first time since early February. The best performers in the latest week: LargeCap Consumer Staples (4.3), SmallCap Utilities (3.9), MidCap Utilities (3.7), SmallCap Communication Services (3.7), and SmallCap Consumer Staples (3.6). SmallCap Energy was the biggest decliner last week, falling 4.2%, followed by SmallCap Consumer Discretionary (-3.1), MidCap Energy (-3.0), LargeCap Consumer Discretionary (-2.0), and LargeCap Energy (-1.9). LargeCap is up 3.5% ytd and is now leading both SmallCap (2.8) and MidCap (-1.5). Sixteen sectors are now positive to date in 2018, down from 18 a week earlier and compared to just three in early February. The best-performing sectors ytd: SmallCap Health Care (28.3), MidCap Health Care (22.1), SmallCap Communication Services (19.0), MidCap Energy (12.8), LargeCap Tech (11.1), LargeCap Health Care (10.7), and MidCap Communication Services (9.8). The worst performers ytd: LargeCap Materials (-12.1), MidCap Materials (-10.8), MidCap Consumer Discretionary (-9.7), SmallCap Real Estate (-9.0), and MidCap Financials (-8.7).

S&P 500 Sectors and Industries Performance (*link*): Six of the 11 sectors rose last week, the same six that outperformed the S&P 500's flat performance. That compares to all 11 falling a week earlier, when seven outperformed the S&P 500's 4.1% decline. Consumer Staples was the best-performing sector with a gain of 4.3%, ahead of Real Estate (3.2%), Utilities (3.0), Financials (0.8), Communication Services (0.7), and Health Care (0.5). Consumer Discretionary was the biggest underperformer, with a drop of 2.0%, followed by Energy (-1.9), Materials (-1.3), Information Technology (-1.2), and Industrials (-1.0). Just four sectors are still in the plus column so far in 2018, down from five a week earlier and nine in mid-September, which had matched the best ytd count also achieved in early March. However, four sectors have outperformed the S&P 500's 3.5% ytd gain, up from three a week earlier. The ytd leaders: Tech (11.1), Health Care (10.7), Consumer Discretionary (8.0), and Utilities (3.6). The seven ytd underperformers: Materials (-12.1), Communication Services (-7.7), Financials (-4.6), Consumer Staples (-4.3), Industrials (-3.6), Real Estate (-3.5), and Energy (-0.6).

Commodities Performance (*link*): Last week, the S&P GSCI index fell 1.2% as seven of the 24 commodities that we follow move higher. That compares to a 2.8% decline a week earlier, which was its biggest since mid-July when 11/24 commodities rose. Last week's strongest performers: Sugar (6.3%), Coffee (4.8), Natural Gas (2.6), Gold (0.5), and Live Cattle (0.5). Last week's biggest decliners: Lean Hogs (-6.2), Lead (-3.3), Crude Oil (-2.7), Corn (-1.8), and Nickel (-1.7). The S&P GSCI commodities index is up 7.3% ytd. Its current level is down 5.5% from its four-year high on October 3, which was just half of its record high in July 2008 before the financial crisis. The top performer so far in 2018 is Kansas Wheat (20.8), followed by Wheat (20.6), Brent Crude (18.5), GasOil (18.0), and Crude Oil (14.7). The biggest laggards of 2018 to date: Lean Hogs (-28.1), Zinc (-20.4), Lead (-19.8), Silver (-14.6), Copper (-13.9), and Aluminum (-10.8).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 7/24 commodities, 6/9 global stock indexes, and 17/33 US stock indexes, compared to 11/24 commodities, 0/9 global stock indexes, and 2/33 US stock indexes rising a week earlier. Commodities' average spread fell w/w to -1.5% from -1.1%, and 11 commodities trade above their 200-dmas, up from 10 a week earlier. Natural Gas leads all commodities and all assets at 15.7% above its 200-dma, but Sugar (15.1%) rose 7.0ppts w/w relative to its 200-dma for the best performance among all assets. Lean Hogs (-23.2) still trades the lowest of all commodities and all assets, and fell 4.5ppts w/w for the worst performance among all assets. The global indexes trade at an average of 5.1% below their 200-dmas, up from -5.5% in the prior week. Just two of the nine global indexes trade above their 200-dmas, unchanged from a week earlier. Brazil (4.6) leads the global indexes, but Indonesia (-4.2) rose 1.5ppts w/w for the best performance among global assets. China (-15.2) continues to trade at the lowest point relative to its 200-dma among global assets, but Japan (0.3) dropped 0.6ppts for the worst performance among global assets last week. The US stock indexes trade at an average of 1.1% below their 200-dmas, with 16 of the 33 sectors above, up from -1.6% a week earlier, when 10 sectors were above. SmallCap Communication Services (10.1) now leads the US stock indexes, but LargeCap Consumer Staples (3.3) rose 4.4ppts last week for the best performances among US stock indexes. MidCap Financials (-10.5) now trades the lowest among all US stock indexes relative to 200-dmas, but SmallCap Energy (-7.6) fell 3.8ppts w/w for the worst performance among US stock indexes last week.

S&P 500 Technical Indicators (*link*): The S&P 500 price index was unchanged last week and remained solidly below its short-term 50-day moving average (50-dma) trend line and a hair below its long-term 200-dma. The index remained in a Golden Cross (50-dma higher than 200-dma) for a 130th straight week (after 17 weeks in a Death Cross) as the S&P 500's 50-dma relative to its 200-dma fell for just the third time in 20 weeks. The current Golden Cross reading of 3.7% is down from 4.0% a week earlier and a 27-week high of 4.1% in early October, but well below its 55-month high of 7.2% in early February; these compare to its 25-month low of 1.0% at the end of May and four-year low of -4.5% in March 2016. The S&P 500's 50-dma fell for a second week following 19 straight weekly gains, which compares to declines during eight of the 10 weeks from mid-March to late-May in what was then the worst performance since before the 2016 election. The index successfully tested its 50-dma at the end of June, and improved to 3.6% below its falling 50-dma from a 28-week low of 3.8% below its falling 50-dma a week earlier. That 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 200-dma edged down at the end of the week for the first time since May 2016 when it had been slowly declining for nine months. The S&P 500 had successfully tested its 200-dma in early April, but ended the week unchanged at a 30-week low of less than 0.1% below its rising 200-dma, down from a six-month high of 6.4% during the week ending September 21. That compares to 0.6% below the index's rising 200-dma on April 3 (the lowest reading since June 2016) and a seven-year high of 13.5% above its 200-dma on January 29.

S&P 500 Sectors Technical Indicators (*link*): Five of the 11 S&P 500 sectors deteriorated last week relative to their 50-dmas and 200-dmas. Nine sectors are trading below their 50-dmas now, up from all 11 below a week earlier for the first time since the end of March and only the second time since February 2016. These two sectors rose above their 50-dma in the latest week: Consumer Staples and Utilities. In late July, all 11 sectors had traded above their 50-dmas, the most since early December. The longer-term picture—i.e., relative to 200-dmas—shows six sectors trading above currently, up from four a week earlier, which was the lowest since June 19. That's a swift reversal from 11 sectors above their 200-dmas on September 26. Consumer Discretionary fell below its 200-dma in the latest week for the first time in 102 weeks, but these three sectors rose above: Communication Services, Consumer Staples, and Real Estate. The remaining three sectors still trading above their 200-dmas: Tech (120 straight weeks), Health Care (21), and Utilities (17). All 11 sectors had been above both their 50-dmas and 200-dmas briefly in mid-December 2017 (for the first time since July 2016). Nine sectors are still are in a Golden Cross (with 50-dmas higher than 200-dmas), down from 10 a week earlier, as Financials left the Golden Cross club after just four weeks and joined Materials, which has been out for 25 straight weeks. All 11 sectors had been in a Golden Cross back in mid-January (for the first time since a 26-week streak ended in October 2016). The 50-dma turned higher w/w for Consumer Staples and Utilities, joining Communication Services and Health Care as the only sectors with rising 50-dmas now. That's down from eight sectors above their 50-dma in early October and compares to all 11 sectors with falling 50-dmas during early April (the worst count since before the election in November 2016). Five sectors have rising 200-dmas now, as Real Estate zigged above yet again and joined these four sectors: Consumer Discretionary, Health Care, Tech, and Utilities. That's up from four a week earlier, which had been the lowest count since March 2016.

US ECONOMIC INDICATORS

Leading Indicators (*link*): The Leading Economic Index (LEI) reached yet another new record high in September—exceeding the previous record high posted in March 2006 by nearly 10%. The LEI advanced 0.5% last month, following unrevised gains of 0.4% and 0.7% the prior two months—continuing its streak of no declines since May 2016. The LEI is up a solid 4.4% ytd and 7.0% y/y, its best yearly growth rate since September 2010. “The US LEI improved further in September, suggesting the US business cycle remains on a strong growth trajectory heading into 2019,” according to Ataman Ozyildirim, director and Global Research chair at The Conference Board. He went on to say that economic growth could exceed 3.5% during the second half of 2018, but warned “unless the momentum in housing, orders and stock prices accelerates, that pace is unlikely to be sustained in 2019.” Eight of the 10 LEI components contributed positively in September, with the largest contributions coming from consumer expectations (0.14ppt), ISM new orders index (0.13), interest rate spread (0.12), and the leading credit index (0.11); the average workweek (-0.07) and building permits (-0.02) were the only components detracting from growth.

Coincident Indicators (*link*): September’s Coincident Economic Index (CEI) also hit another new record high; it has posted only one decline since January 2014, and that was at the start of this year. The CEI advanced 0.1% last month and 1.6% since January’s -0.1% dip. Once again, all four components contributed positively last month—and all rose to new record highs: 1) Nonfarm payroll employment was the biggest positive contributor to September’s CEI, along with real personal income. Last month’s 134,000 increase in payroll employment slowed from August’s 270,000 gain, as Hurricane Florence caused job losses in the retail trade and leisure & hospitality industries. 2) Real personal income—excluding transfer payments—rose for the 13th time in 15 months, by 0.2% m/m and 3.3% over the period. 3) Industrial production expanded 0.3% last month after gains of 0.4% and 0.3% the prior two months; the Fed noted that Hurricane Florence had a minimal impact on September output—reducing it by less than 0.1ppt. September’s gain was the seventh in the past eight months for a total gain of 2.9%. Output expanded 5.1% y/y—the strongest yearly growth rate since December 2010. 4) Real manufacturing & trade sales increased for the 16th time in 17 months, by a total of 4.4% over the period. The yearly growth rate slowed to 2.1% y/y—half November’s recent peak of 4.2%.

Regional M-PMIs (*link*): Both Fed districts that have reported on manufacturing activity for October so far—Philadelphia and New York—showed factories are humming. We average the composite, orders, and employment measures as data become available. The composite index accelerated for the second month to 21.7 this month from 18.8 in August; it peaked at 28.5 last October—which was the best reading since July 2004. New York’s composite index (21.1 from 19.0) accelerated slightly, while Philadelphia’s (to 22.2 from 22.9) virtually matched September’s robust pace. The new orders gauge (20.9 from 19.0) also improved for the second month, climbing back toward May’s 14-year high of 28.3 this month, led by faster orders growth in the New York (22.5 from 16.5) region; billings in the Philly (19.3 from 21.4) area slowed a bit, though remained at an elevated level. The employment measure (14.3 from 15.5) reveals job gains were close to August’s pace, as manufacturers in the Philly (19.5 from 17.6) region hired at a faster rate and those in New York (9.0 from 13.3) hired at slower pace this month.

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