Ten Key Charts Updated

***eResearch* Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis analyzes last week`s jobs data.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **10 key charts updated**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
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Ten Key Charts Updated

The economy grew 2.5% last year, which is a bit stronger than its annualized rate of growth during the expansion which began in mid-2009, and there is evidence that growth picked up a bit over the course of the year, likely due to a significant increase in business and consumer confidence. Regardless, my reading of the market tea-leaves suggests that the market's expectation for future growth is only slightly higher than what we have seen in the current expansion.

Although the sharp cut to the corporate income tax rate has found its way into a substantial rise in stock prices (because reducing the tax rate means that the discounted value of future after-tax earnings translates into a one-time boost to current valuations), the market has yet to price in a substantial increase in future growth fueled by the increased investment and jobs creation that the tax cut was designed to achieve. (To be sure, there is still no convincing evidence of a significant pickup in business investment.) The market is moving in an optimistic direction, of course, as witnessed by rising real and nominal yields, but we are still in the early innings.

Chart #1

I have been posting updated versions of Chart #1 for many years now. It shows how unique the current business cycle expansion has been in the economic history of the U.S. economy. From 1965 through 2007, the U.S. economy grew at a trend rate of about 3.1% per year. It slipped below this trend during recessions, and exceeded the trend during boom times. But it invariably returned to trend given a few years. (Milton Friedman in 1964 wrote a paper about this, calling it the Plucking Model.) The current expansion has been by far the weakest on record. Relative to its previous trend, the U.S. economy is more than $3 trillion smaller, in 2009 dollars, than it might have been had things played out this time as they have before.

What is the cause of this under-performance, especially considering that since late 2008 the Fed has massively expanded its balance sheet? My list of reasons lays the blame on two major factors: (1) an oppressive expansion of government, in the form of increased regulatory and tax burdens; and (2) a shell-shocked market that has only recently regained its former level of confidence in the wake of the Great Recession of 2008-2009.

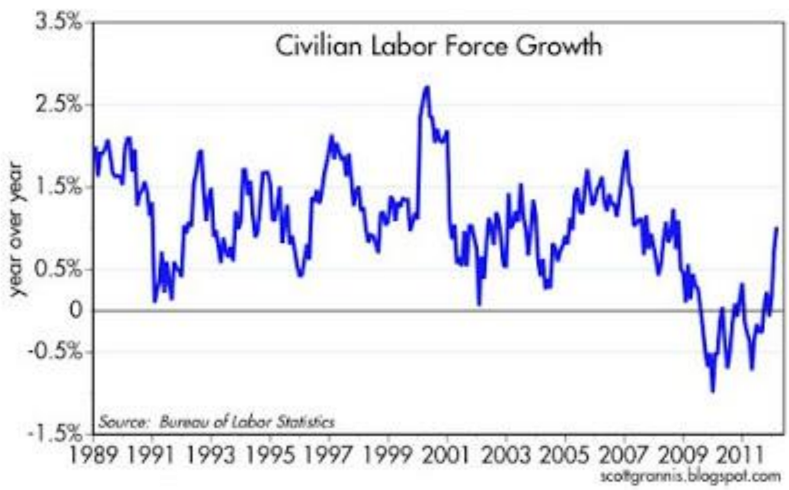
Confidence has returned, but only in the past year or so, as shown in Charts #2 and #3.

Chart #2

Chart #3

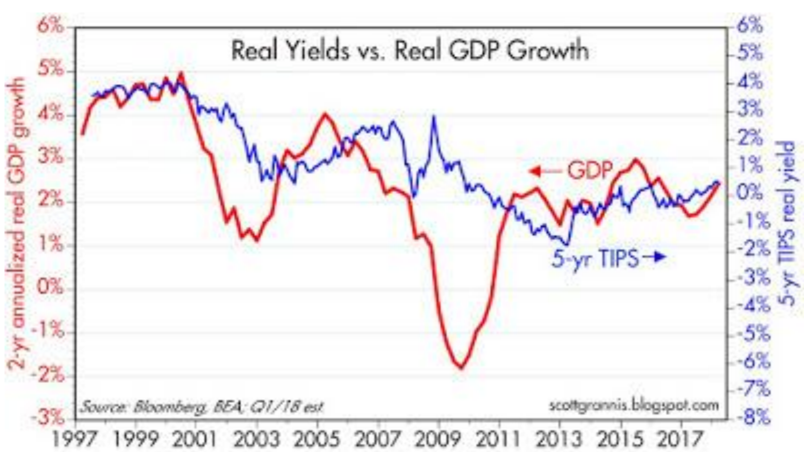
This increased confidence may be the precursor of increased business investment—of which there is no sign yet—but it does explain the recent surge in the labor force, as shown in Chart #4 below. It is only very recently that we have seen a big increase in the number of people looking for work.

Chart #4



As the chart below shows, the level of real yields on TIPS tends to track the economy's trend real growth rate (I use trailing 2-yr annualized growth as a proxy for what the market perceives the current trend to be), much as common sense would suggest.

Chart #5



Thanks to TIPS (Treasury Inflation-Protected Securities), we have real-time knowledge of the market's expectation for risk-free, inflation-adjusted returns. (TIPS pay a real rate of interest in addition to whatever the inflation rate happens to be. The price of TIPS varies inversely with the market-determined level of the real yield on TIPS.)

When economic growth was booming in the late 1990s, TIPS paid a real rate of interest of about 4%, since they had to compete with the market's expectation for 4-5% real economic growth. But with the trend rate of growth having now slowed to just over 2%, the real rate of interest on TIPS is only modestly positive: 0.5% for the next 5 years, as of today. If the market thought the U.S. economy was on track to deliver 3%+ rates of growth in the years ahead, I am confident that the real yield on 5-yr TIPS would be in the neighborhood of 1-2%, if not higher. As it is, I think the market is currently priced to the expectation that real growth will average about 2.5% in the next few years. That is good, but nothing to write home about.

Chart #6 below compares the real yield on 5-yr TIPS (red line) with the ex-post real yield on the Fed funds rate, using the Fed's preferred measure of inflation, the PCE Core deflator. This is akin to viewing two points on the real yield curve: overnight rates and 5-yr rates.

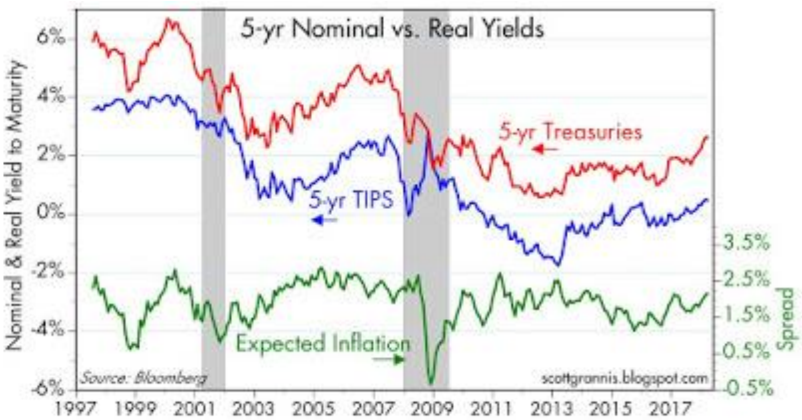
Chart #6

Using bond market math, the red line is the market's expectation for what the real Fed funds rate is going to average over the next 5 years. And of course, the real Fed funds rate (blue) is the rate that the Fed is actually targeting. As you can see, the market expects only a modest amount of tightening from the Fed in the years to come. That makes sense only if both the market and the Fed agree that the economy has limited upside growth potential.

If the market thought the economy was set to grow at a 3%+ rate for the next several years, the market would immediately assume—and the Fed would probably agree—that there would be a more aggressive series of rate hikes in the future, not just 3 or 4. Even still, when the Fed raises rates in response to stronger growth expectations, that is not tightening, it is more a following action. To be really tight, the Fed would have to raise real rates to at least 3%, and the yield curve would have to flatten or invert.

Chart #7 compares the real and nominal yields on 5-yr Treasuries (red and blue lines) with the difference between the two (green line), which latter is the market's expectation of what the CPI will average over the next 5 years.

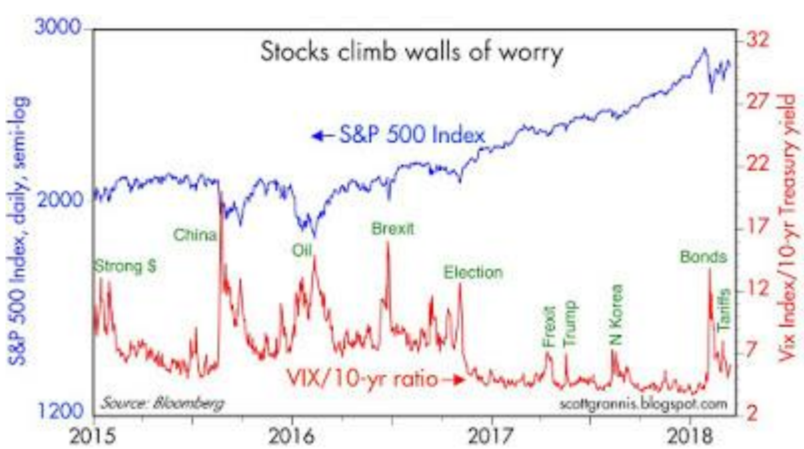
Chart #7



With 5-yr inflation expectations today at 2.15%, the market is reasonably sure the Fed will be able to hit its 2% inflation target (on the core PCE deflator, which tends to run about 30 or 40 bps lower than the CPI). Looking ahead, the market sees pretty much the same amount of inflation that we have seen over the past few decades. The market is thus fairly confident that the Fed is not going to do much going forward, and whatever it does, the Fed is unlikely to be too tight or too easy. You may not agree with that assessment, but that is what the market tea-leaves are saying.

Chart #8

Chart #8 shows how sensitive the stock market is to bouts of anxiety, as proxied by the ratio of the VIX "fear" index to the 10-yr Treasury yield.



The latest market correction was triggered earlier this year by concerns that rising nominal yields might threaten economic growth, but that quickly faded, only to worry more recently that Trump's tariffs might spark a global trade war. Whatever the case, the market is not very worried these days, nor is it very optimistic.

A general lack of concern about the economy's health is evident in Charts #9 and #10.

Chart #9

Swap spreads—an excellent coincident and leading indicator of economic and financial market health—are up a bit of late, but still within what might be considered a "normal" range. The swap market is reflecting a relative abundance of liquidity and little if any concerns about systemic risk.

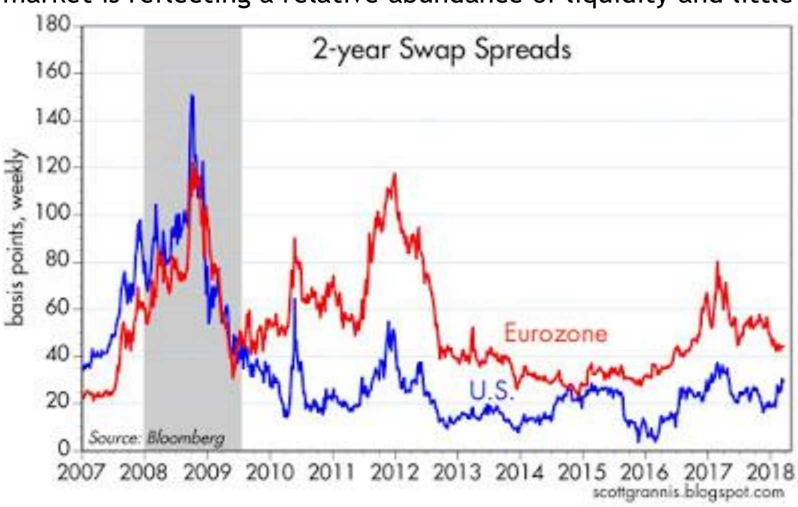
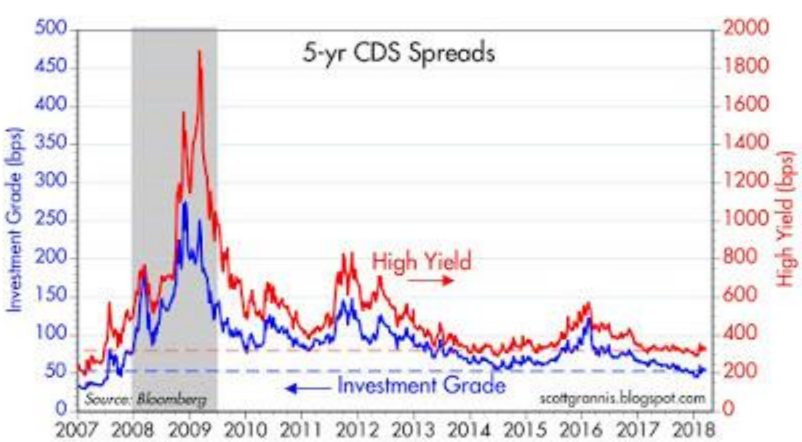


Chart #10

Credit Default Spreads—highly liquid and coincident indicators of the market's perception of credit risk—are also up a bit of late, but still relatively low.



As I noted last October, and as has proven recently to be the case, rising growth expectations would almost surely result in an unexpected rise in real and nominal interest rates. Higher-than-expected rates would depress bond prices and, in similar fashion, could depress the market's PE ratio (which is the inverse of the earnings yield on equities, and thus similar to a bond price), thus limiting further gains in equity prices to a rate that is somewhat less than the increase in earnings.

The days of booming equity markets are fading, but there is still decent upside if and when the market begins pricing in faster growth and the business community follows through with increased investment and faster jobs creation. Meanwhile, there is no obvious reason to worry about a recession or a major stock market correction.

Thanks and congratulations, Larry!

My career as an economist began in 1980, the day I stumbled upon John Rutledge's CEI Forecasting Conference on the campus of Claremont McKenna College. At the time, I was in the midst of the MBA program at Claremont Graduate University, having previously received a BA in Philosophy at Pomona College (economics, I would learn, draws heavily from philosophy and business). Larry Kudlow happened to be the key speaker at the conference. He spoke of inflation, gold, the dollar, and economic growth, and all those things strongly resonated with me, as I had recently returned from four years in Argentina (1975-1979). I remember thinking there was nothing in the world that could be more exciting than to follow in his footsteps. Thanks, Larry, for being such an inspiration.

While living in Argentina I had the "privilege" of surviving inflation that raged at well over 100% per year, suffering gargantuan swings in the value of the peso (which lost over 95% of its value), and witnessing the military takeover of the failed government of Peron's widow, Isabel. Following macro-economic variables daily in Argentina was critical to survival, and in Larry I saw that my experiences in Argentina could serve as the foundation for an economics profession in the U.S.A. One year after seeing Larry speak, I was working for John Rutledge and meeting the likes of Larry, Art Laffer, Jude Wanniski, Bob Mundell, David Malpass, and Steve Moore. I grew up on the supply- and monetarist-side of the economics profession, because I became convinced that those disciplines held the key to best understanding how economies and markets work. Politically, I'm a libertarian, because I am convinced that governments and bureaucrats can never be as effective and efficient as free markets, and more government necessarily means less individual freedom, and that can never be a good thing.

Larry was the first economist who inspired me, and we have been close in our thinking ever since (he even reads this blog). Although we have not always agreed on everything, and neither of us can claim to have forecasted the Great Recession, we share the most important values: a strong and stable dollar (which implies low and stable inflation), strong and steady economic growth, limited government, rule of law, and free markets (which imply free trade). We both know that any country that embraces those values is bound to be a place of opportunity and prosperity. Larry's whole life has prepared him for a position in which he can help influence the policies that will make the U.S.A. strong and prosperous. Congratulations, Larry, you have made it.

So, naturally, everyone wants to know why Trump picked Larry, and why Larry chose to accept, since they have diametrically opposing views on trade and tariffs.

The best explanation that comes to mind is that Trump has persuaded Larry that higher tariffs are: (1) temporary; and (2) a tool with which to pressure China into opening its markets to more foreign goods and services and respecting intellectual property rights.

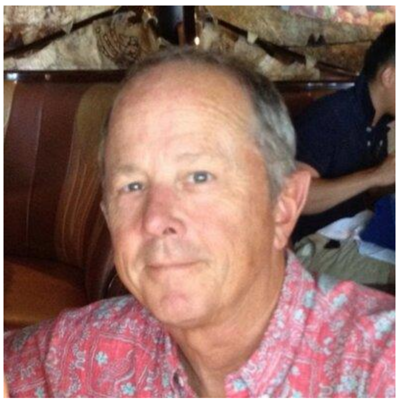
A minor transgression, if you will, that will eventually yield a greater payoff. If nothing else, Larry's presence at the NEC will be a critical offset to Peter Navarro, and a voice of reason and experience that may keep Trump from wandering into "left" field. That Trump chose Larry, knowing his opposition to tariffs, speaks well to Trump's judgment on this one.

Larry is a good man, an excellent economist, and a seasoned persuader. He is a great choice for director of the White House National Economic Council.

For more, today's WSJ has two excellent articles which faithfully round out the person that is Larry Kudlow: here and here.

BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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