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Third Party Research June 19, 2018

USA Keeps On Truckin'/Credit Indicators Positive

***e*Research Corporation** is pleased to provide two articles by Scott Grannis for his Blog, "Calafia Beach Pundit".

In these articles, Mr. Grannis uses the trucking industry as proxy for the economy, and he then shows that key credit indicators are still flashing green.

The articles are reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **HERE**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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Bob Weir, CFA: Director of Research

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Tuesday, June 19, 2018

USA Keeps On Truckin'

Truck tonnage continues to post significant gains, according to the American Trucking Association's latest release. Tonnage is up 7.8% year-over-year, and it is up at an annualized rate of 7.8% year to date.

Chart #1

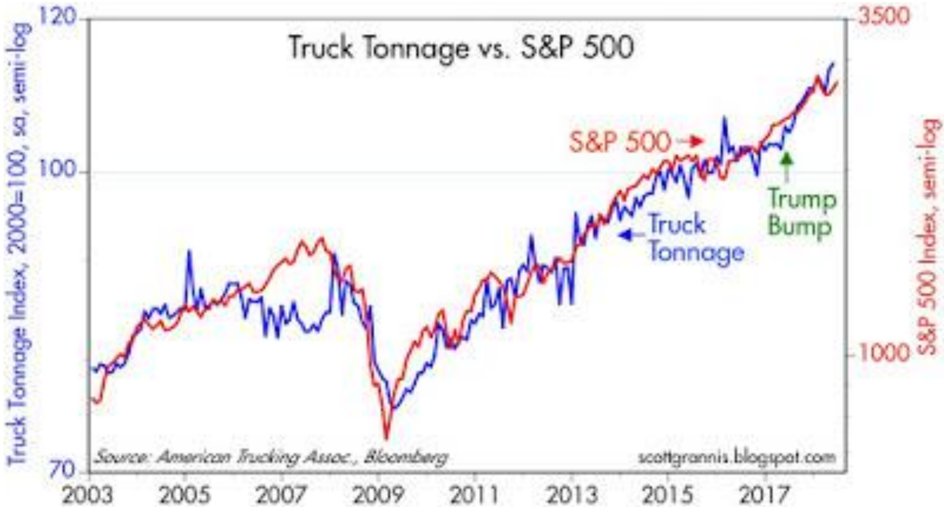


Chart #1 is an updated version of the one in my post last month, "Truck tonnage evidence of a Trump Bump." As it suggests, there is a strong correlation between truck tonnage—a good proxy for the physical size of the economy—and equity prices.

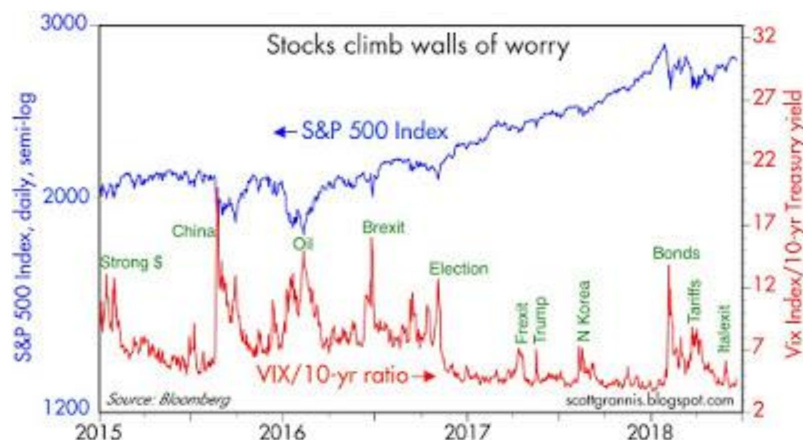
From the ATA's latest release, including some relevant facts:

> *"This continues to be one of the best, if not the best, truck freight markets we have ever seen," said ATA Chief Economist Bob Costello. "May's increases, both sequentially and year-over-year, not only exhibit a robust freight market, but what is likely to be a very strong GDP reading for the second quarter.*
>
> *Trucking serves as a barometer of the U.S. economy, representing 70.6% of tonnage carried by all modes of domestic freight transportation, including manufactured and retail goods."*

For all the reported angst over Trump's escalating trade war with China, the VIX/10yr ratio has barely budged (see Chart #2), which suggests the market does not expect much, if any, damage to occur as a result. My own assessment is that rising tariffs are acting as a headwind to growth, but that this will not prove terribly disruptive. Without this headwind, the economy would likely be on its way to sustained growth of 4% or more; with the headwind, we are more likely to see 3-4% growth.

For Trump's purposes, I believe, higher tariffs are a temporary disruptive factor that is necessary to achieve a long-term reduction in overall tariff barriers and freer overall trade. It is a risky gambit, to be sure, which could backfire if China continues to counter Trump's tariffs with more of their own. But, in the end, tariffs are so universally understood to be counter-productive that I find it hard to believe the escalation will not reverse sooner or later.

Chart #2



Meanwhile, the ongoing flattening of the yield curve (see Chart #3) is not a danger signal. It is more accurate to say that it reflects the market's judgement that, if anything, tariff wars will keep the Fed from hiking rates more than just a few times over the course of the next year, because the economy is not likely to "overheat." To date, no one is suggesting the economy will prove so weak that the Fed will need to lower rates: that's what would be necessary for the curve to invert. We'd also need to see much higher swap and credit spreads, which so far remain quite low, as I noted yesterday. (BW: Yesterday's article is presented after this one.)

<continued>

Chart #3

Monday, June 18, 2018

Key Credit Indicators Still Green

A typical boom-bust cycle starts with the Fed tightening monetary policy, usually in response to rising inflation and/or an economy that seems to be "overheating," or growing too rapidly. Prior to late 2008, when the Fed began its Quantitative Easing, tighter monetary policy worked by draining liquidity (i.e., by making bank reserves scarce and thus restricting banks' ability to create new loans), which in turn led to higher real borrowing costs and a general credit squeeze. Tight credit conditions and rising borrowing costs dealt a one-two punch to leveraged borrowers, and the bond market expressed this by pushing credit spreads higher as default risk rose.

We are now 2 ½ years into a Fed rate-hiking cycle: the Fed started raising short-term rates in late 2015 from a low of 0.25% to now 2.0%. Real yields have risen from -1.5% to now about zero—still very low from an historical perspective. Not surprisingly (since there has effectively been no tightening), there are still no signs of rising systemic risk or deteriorating credit conditions. Credit spreads remain low and liquidity remains abundant. Although the Fed has been draining bank reserves, they are still magnificently abundant, totaling about $1.9 trillion.

Bottom line: the Fed "tightening" cycle looks very different today than in the past, mainly because bank reserves are still quite plentiful and real borrowing costs are still very low.

Chart #1

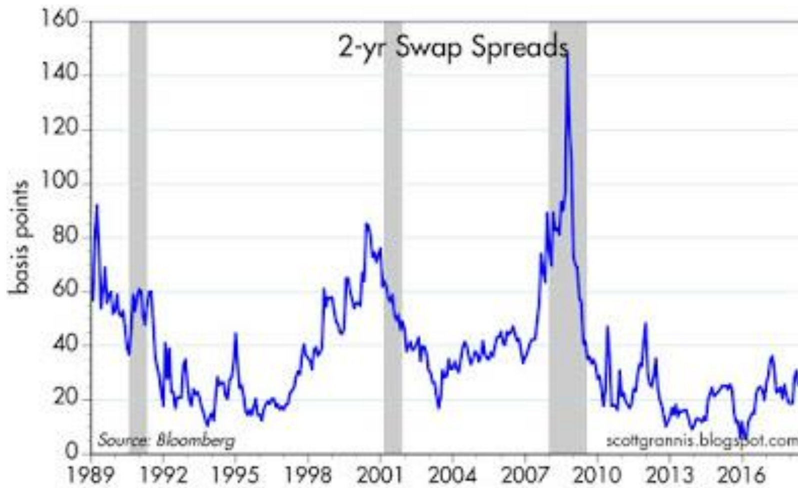


Chart #2

Swap spreads, shown in Chart #1, have traditionally been excellent coincident and leading indicators of economic and financial market health. (See my primer on swap spreads for more background.) Currently, swap spreads are generally low and fully consistent with healthy financial and economic conditions. Low swap spreads are also indicative of plentiful liquidity conditions and healthy risk appetites. Eurozone swap spreads (see Chart #2) are a bit elevated, however, suggesting that conditions in Europe are not as healthy as in the U.S.A. Not surprisingly, we observe that the Eurozone stock market has been underperforming the U.S.A. by a widening margin for the

past decade. But, despite their being elevated, Eurozone swap spreads are not indicating a serious credit squeeze.

Chart #3

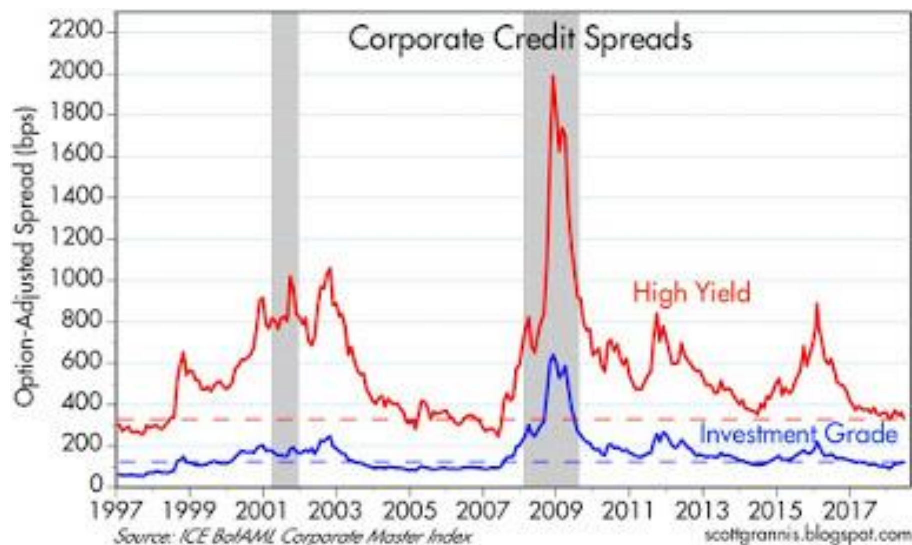


Chart #4

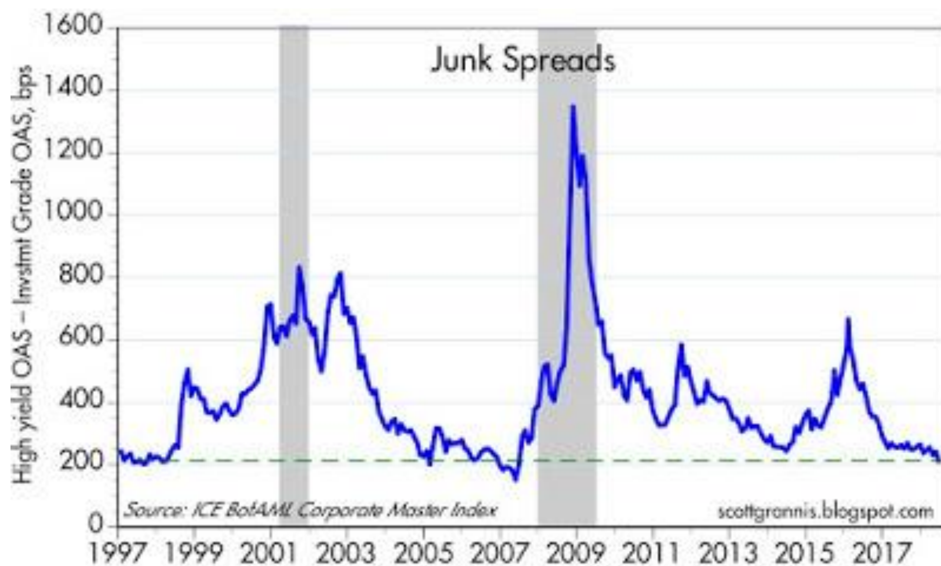


Chart #3 shows the spreads on investment grade and high yield (aka "junk") corporate bonds, and Chart #4 shows the difference between these two spreads. All three measures of corporate credit risk are low by historical standards, and they appear to have been improving in recent years.

Chart #5

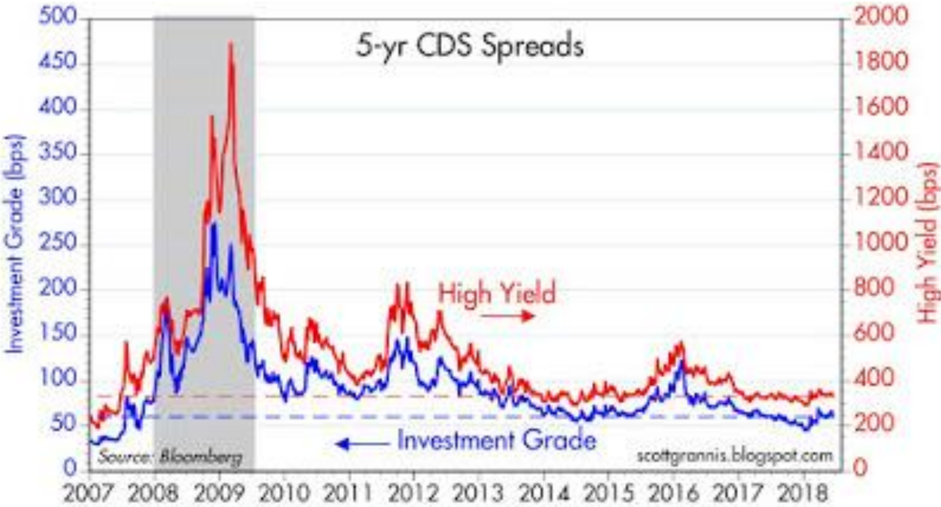


Chart #5 shows Credit Default Swap spreads for 5-yr investment grade and high-yield corporate bonds. Credit Default Swaps are highly liquid contracts used by institutional investors to hedge generic credit risk. Here too we see that spreads are quite low.

Chart #6

Chart #6 compares the yield on 5-yr A1-rated industrial bonds to the yield on 5-yr Treasury yields. Both have been rising since the Fed started raising rates.

Chart #7

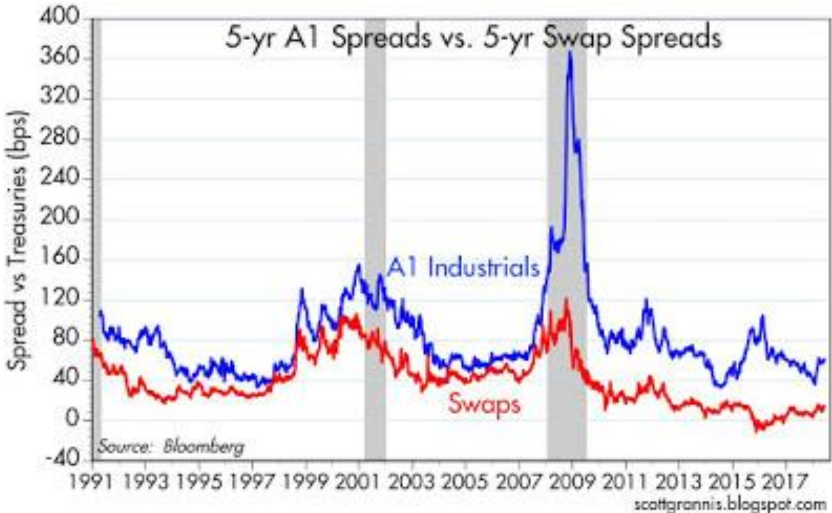


Chart #7 compares the spread on 5-yr A1 Industrials to 5-yr swap spreads. Both are relatively low despite the substantial increase in yields. Note how spreads rose in advance of prior recessions, at a time that the Fed was pushing yields higher. This is further confirmation that the Fed has not been tightening. If anything, these two charts (#6 and #7) suggest we are still in the middle of what could prove to be a very long business cycle expansion.

Chart #8

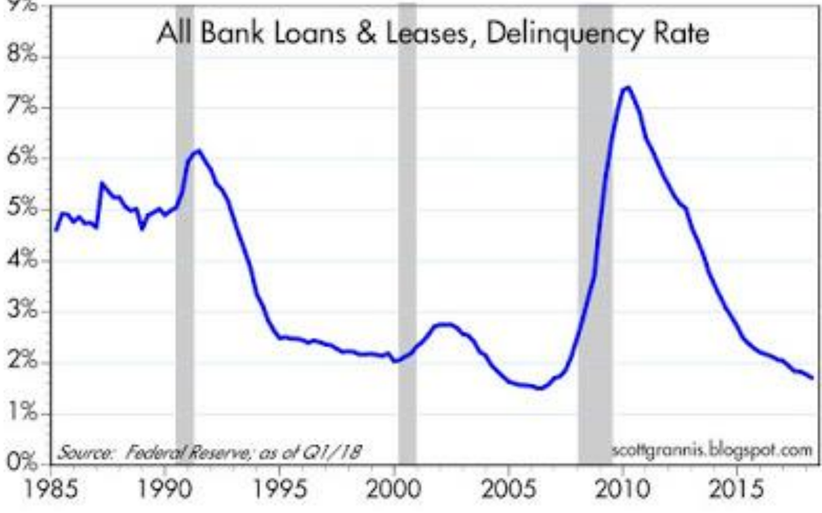


Chart #8 shows the delinquency rate on all bank loans and leases, as of March, 2018. Here we see

still more confirmation that rising yields have not negatively impacted businesses. Delinquency rates have been falling for almost a decade, and continue to do so.

Chart #9

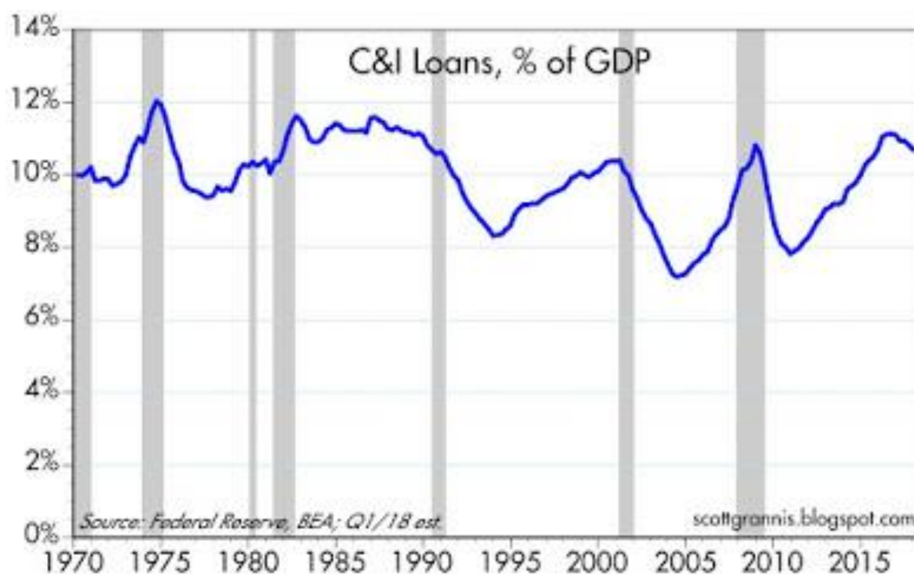
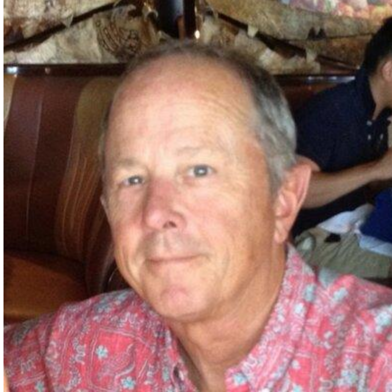


Chart #9 shows the ratio of C&I Loans (Commercial and Industrial Loans, a good proxy for bank loans to small and medium-sized businesses) to nominal GDP. Here we see little, if any, sign of excess, and little, if any, indication that businesses are being unusually starved for credit.

Taken together, these key market-based indicators of credit conditions are still flashing "green." There is no sign of rising systemic or credit risk, liquidity conditions are still plentiful and, thus, the outlook for the economy is healthy.

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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