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Key Indicators Are Still Healthy

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

In this article, Mr. Grannis provides ample evidence that the U.S. economy is healthy, with no signs that a recession is ahead. The only caveat is the specter of increasing global trade wars.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Key indicators are still healthy**

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

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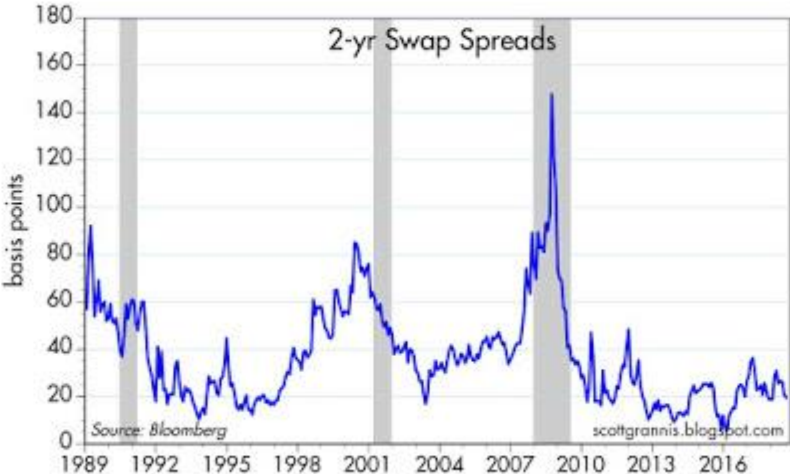
Monday, September 10, 2018

Key Indicators Are Still Healthy

This post recaps the market-based indictors that I think are very important to follow. On balance, things look quite favorable. As always, all charts contain the most recent data available as of today (with a few exceptions, as noted, where I have estimated the latest data-point).

Chart #1



I like to begin with 2-yr swap spreads (Chart #1), since they have proven to be excellent leading and coincident indicators of the health of financial markets and of generic or systemic risk (the lower the better, with 15-35 bps being a "normal" range).

A more lengthy discussion of swap spreads can be found here. Currently, swap spreads are almost exactly where one would expect them to be if markets were healthy and the economy were growing comfortably. The current level of swap spreads also tells me that liquidity is abundant; i.e., the Fed has not squeezed credit conditions nor tightened enough to disturb the underlying fundamentals.

Note that swap spreads have increased meaningfully in advance of past recessions and have declined in advance of recoveries. At current levels, swaps are consistent with healthy financial markets and an improving economy.

Chart #2

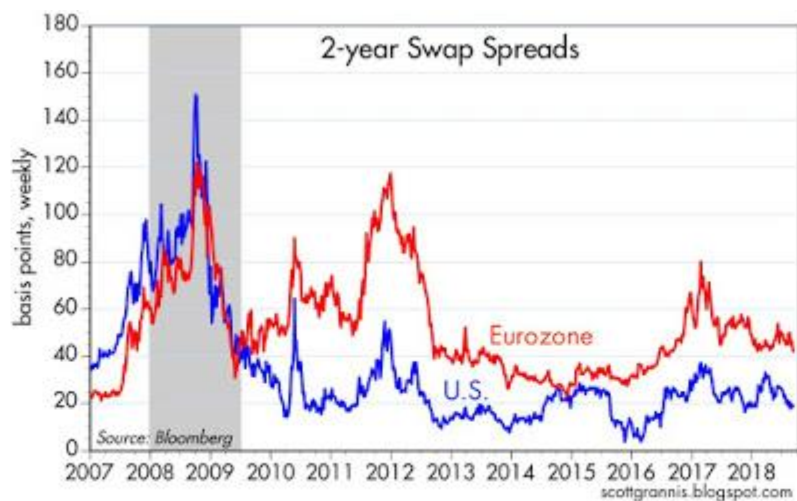


Chart #2 shows the same 2-yr swap spreads over a shorter period, and it adds Eurozone swap spreads for comparison. I note that conditions in the Eurozone have not been as healthy as in the USA for some time now, but conditions do appear to be improving on the margin of late. Not surprisingly, Eurozone stocks have under-performed significantly over the past decade. All eyes are thus on the USA as the world's growth engine.

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Chart #3

Bloomberg publishes an index of financial conditions which incorporates a wide variety of market based indicators, shown in Chart #3 above. In contrast to the swap-spreads chart, higher values of this index are good. Here again, we see that financial conditions are healthy and rarely better.

Chart #4

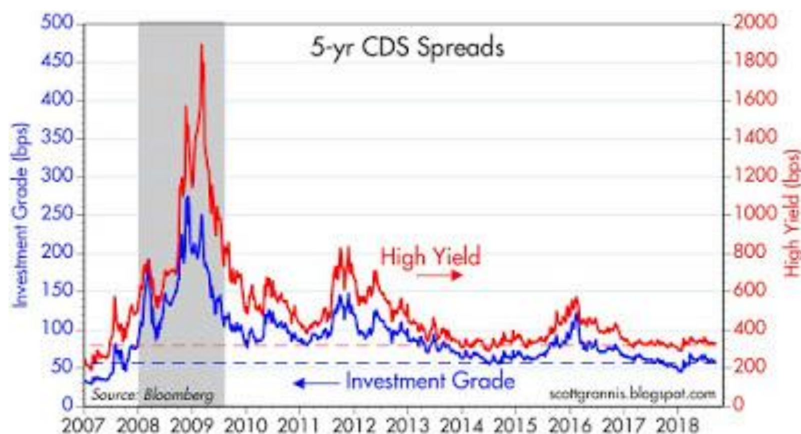

Chart #4 shows 5-yr CDS spreads (credit default spreads). These instruments are widely utilized by institutional investors, and are considered to be a highly liquid proxy for generic credit risk. Today, CDS spreads are rather low, which is good, though they have at times been lower. As with swap spreads, these spreads tend to rise in advance of economic trouble. So far, they show no sign of any threats.

Chart #5

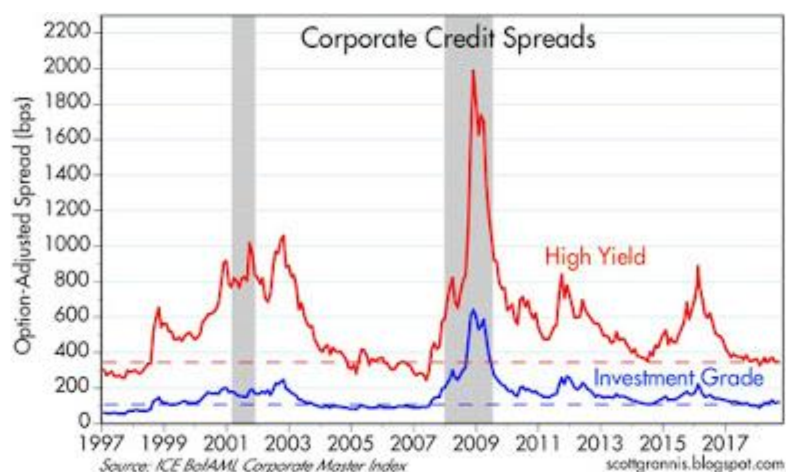

Chart #5 above shows average credit spreads for investment grade and high-yield corporate bonds. They tell the same story as CDS spreads: conditions today are healthy. The bond market is not concerned about credit risk, nor is it concerned about downside risks to the economy.

Chart #6

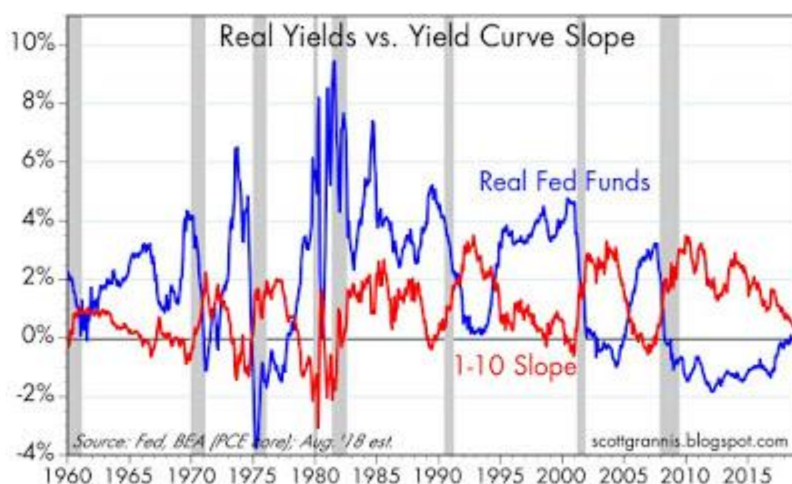

Chart #6 above is a classic, since it shows how Fed tightening has preceded every recession in the past half century. Monetary tightening shows up in different ways: (1) in the level of real short-term interest rates, over which the Fed has direct control; and (2) in the slope of the yield curve.

When real short rates rise significantly and the yield curve becomes flat or inverts, a recession eventually follows. Today, many worry that the yield curve is almost flat, but it is important to view this in the light of very low real short-term rates. This combination tells me that the Fed has

not yet begun to tighten monetary policy. The current slope of the yield curve tells us that the market expects the Fed to raise rates gradually, and not excessively. To date, the various hikes in the Fed's target rate have served mainly to offset a gradual rise in inflation over the past year or so. At its current pace, the Fed is likely years away from becoming "tight."

Chart #7

Chart #7 compares the nominal yield on 5-yr Treasuries to the real yield on 5-yr TIPS (inflation-indexed bonds). The difference between the two is the market's expected average rate of consumer price inflation over the next 5 years. Inflation expectations are relatively stable and, at 2%, they are almost exactly what the Fed is targeting. From this, we can assume the Fed is doing a reasonably good job of balancing the supply and demand for money. This should be comforting and reassuring to a market that continually frets that something might be on the verge of going wrong.

<continued>

Chart #8

Chart #8 above compares the real yield on 5-yr TIPS to the inflation-adjusted (real) yield on the overnight Fed funds rate. The latter is the same series shown in the blue line of Chart #6 above. The comparison of the two here is important, since the red line is effectively the market's best guess as to what the blue line will average over the next 5 years. This is, thus, another way of judging the slope of the yield curve. A true yield curve inversion would almost certainly find the blue line exceeding the red line, as it did prior to the past two recessions, since this implies that the market expects the Fed to ease monetary policy in the future, presumably because of deteriorating economic health. According to Chart #8, the front end of the real yield curve is steepening, not flattening, and that is good.

The market is mistakenly focusing too much attention on the nominal yield curve. The real yield curve is more important, and its current message is definitely positive.

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Chart #9

Real yields are driven in large part by the Fed's actions, especially in the very front end of the yield curve. However, 5-yr real yields are also driven by the market's perception of the health of the economy. Chart #9 above shows how the level of real yields tends to follow the economy's trend growth rate. Currently, real yields are rising slowly, in line with the gradual strengthening of economic growth. There is no sign here of excessive optimism. If anything, both the market and the Fed are behaving in a cautiously optimistic manner.

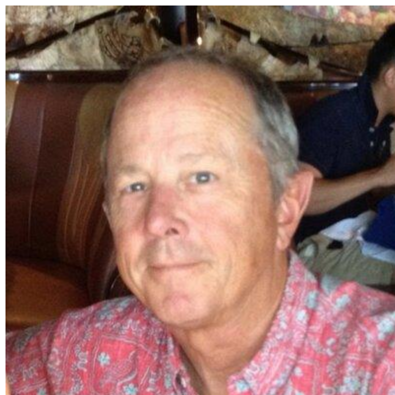
Summary:

On balance, all of these indicators are in healthy territory. Consequently, it is reasonable to assume that the economy is going to be growing for the foreseeable future. Systemic risks are low, inflation expectations are low and stable, and liquidity is abundant. The Fed has been doing a good job, and there is no sign they are going to upset any applecart. There is not much more you could ask for at this point.

We do not live in a risk-free world, however. For now, what risks there are, are concentrated in the trade-related sectors, thanks to the tariff wars that Trump seems to relish. For now, trade risks are undoubtedly acting as a headwind to growth, without which the market might be getting quite enthusiastic about the future.

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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