Steady As She Goes

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

In this article, Mr. Grannis confirms that the economy continues to provide good growth resiliency.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Steady as she goes**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
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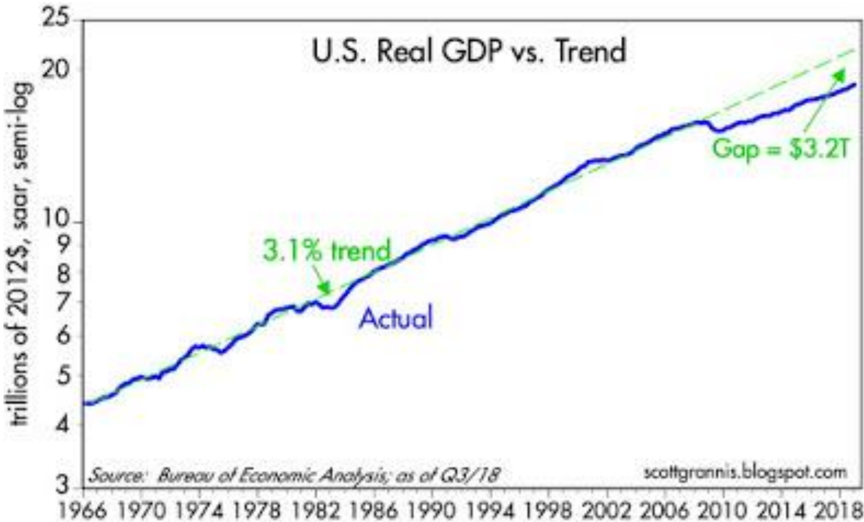
Steady As She Goes

Fed Chairman Powell yesterday made it clear that Fed policy is not a threat to the economy or to the market. He is not on the rate-hiking warpath, and he is not worried that the economy, which is growing nicely, is in danger of overheating. Not surprisingly, markets breathed a sigh of relief. The economic and financial market fundamentals are healthy, and the market's recent spate of worries are just that: worries.

Yesterday's release of the second estimate of Q3/18 GDP growth was largely unchanged from the first (+3.5%). If there is anything disappointing in the news, it is that the economy is not stronger, given that corporate profits are very strong. According to the latest NIPA data, after-tax corporate profits rose 19% in the year ending September 2018. According to GAAP (reported) profits, earnings per share for the S&P 500 rose over 22% in the year ending October 2018. Fabulous profits, indeed, but business investment remains moderate, and that is a big reason the economy is not stronger.

Trump has managed to reduce tax and regulatory burdens in impressive fashion, but his tweets and his tariff threats have created unnecessary distractions and unfortunate uncertainties, not to mention higher prices for an array of imported consumer goods. He has made America better, but not Great. Getting past the threat of trade wars, especially with China, will be the key to unlocking the future growth potential of the U.S. economy, which remains huge. All eyes will be watching for the results of Trump's meeting with Xi in Buenos Aires later this week.

Chart #1

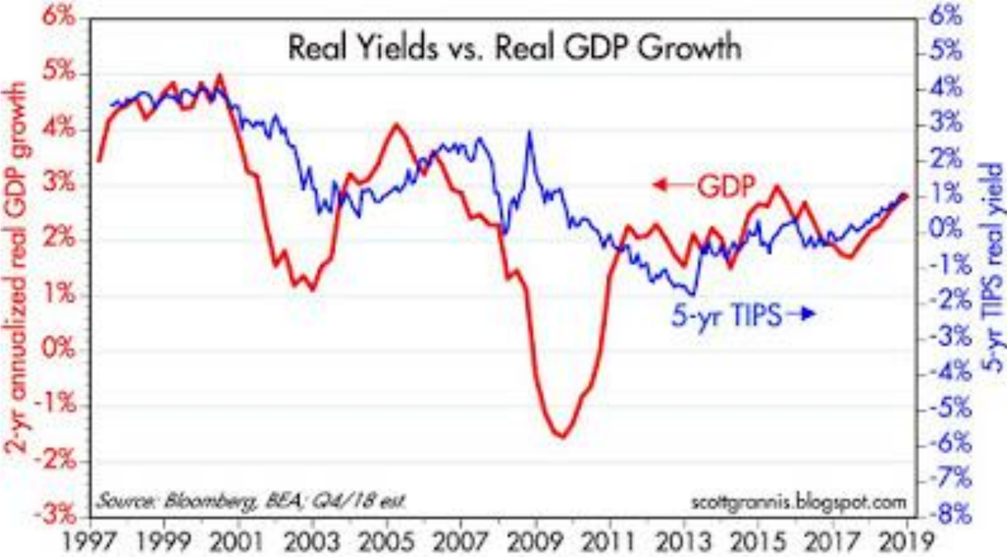


Thanks to plotting real GDP on a semi-log scale, Chart #1 makes it easy to see that the ongoing economic expansion has been the weakest in history.

For many decades the economy averaged 3.1% annual rates of growth. But, since the Great Recession ended in mid-2009, the economy has averaged only 2.3% annualized growth. Things have picked up a bit of late: in the year ending last September, growth was 3%. A decade of sub-par growth has created a potential GDP "gap" of at least $3.2 trillion. In the past year alone, the U.S. economy has missed out on over $3 trillion in income—which averages out to over $20,000 per worker—that could have been earned if the economy had kept up with its previous trend.

Chart #2

Chart #2 compares the 2-year annualized growth rate of GDP with the real yield on 5-year TIPS.



There is a strong tendency for real yields to track the growth rate of the economy. Real yields began to rise just after the November 2016 election, from -0.4% to 1% today.

The outlook for the economy has improved, but we are still looking at moderate rates of growth in the 2.5-3% range. To get excited, we will need to see growth rates of 3-4%, and real yields of 2% or better.

I remain optimistic that this will occur, but we are not there yet. More confidence and more investment are what is needed, and a lower-tariff solution to our mounting China angst would be a wonderful tonic in that regard.

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Chart #3

Chart #3 shows real gross private domestic investment. Like GDP, investment has been rising at a sub-par rate for the past decade. We need to see a lot more investment for the economy to get exciting.

Chart #18 in my previous post shows a proxy for business investment—capital goods orders. They have been very unimpressive by historic standards. We have seen some nice improvement since late 2016, but this needs to continue.

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Chart #4

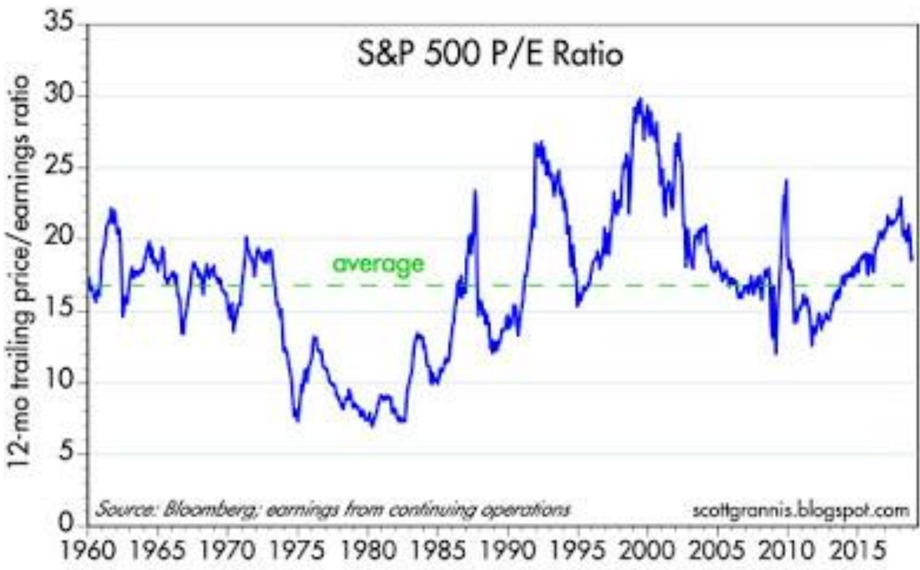
Chart #4 compares after-tax corporate profits to nominal GDP

Chart #5

Chart #5 shows the same profits as a percent of GDP going back 60 years.

Corporate profits these days are close to their strongest levels ever relative to the economy, roughly 50% higher than their long-term average. Is it any wonder that the PE ratio of the S&P 500 (18.76 today, according to Bloomberg) is higher than average (16.85)? (see Chart #6, next page)

Chart #6



If there is any message in charts #4-6, it is that the market does not believe all this good news will last and, despite record-level profits, valuations are only moderately above average.

Chart #7

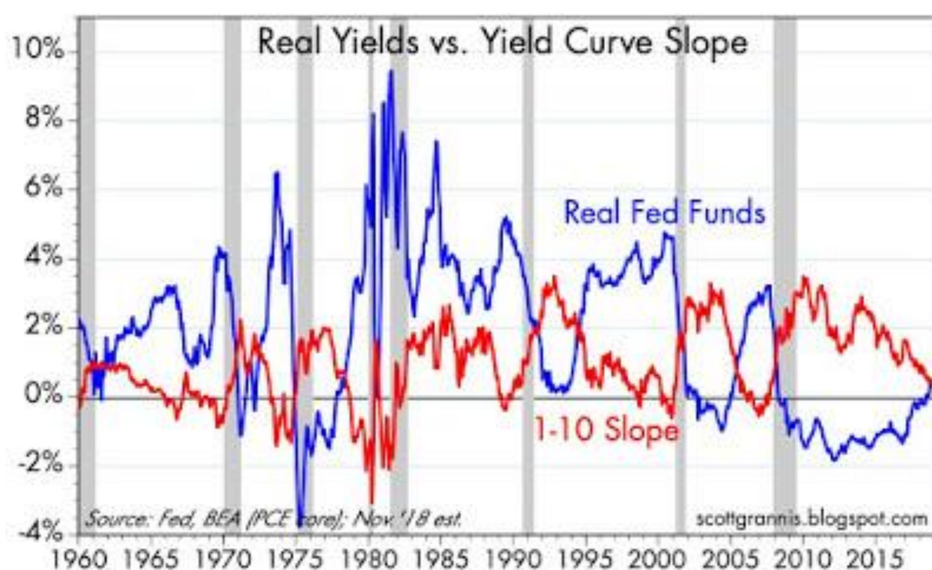
Chart #7 shows the risk premium that investors demand to hold stocks instead of risk-free 10-year Treasuries.

If PE ratios remained at today's level (18.75x), and if corporations paid out all their profits in the form of dividends, then the dividend yield on stocks would be the inverse of the PE ratio: 5.33%.

Yet if this were certain to persist, then only a fool would pass up stocks in favor of lower-yielding Treasuries. Instead, investors apparently figure that corporate profits are likely to decline meaningfully relative to GDP. I made this same point three years ago and also seven years ago.

Chart #8

Chart #8 is one of my favorite recession-watch charts.



Every recession has been preceded by a significant tightening of monetary policy, and that tightening can be measured by: (1) a relatively high real Fed funds rate (2-3%); and (2) a flat or inverted Treasury yield curve.

Currently the real funds rate is a bit less than 0.5%, and the yield curve remains positively sloped. Neither metric is threatening a recession, and neither is the Powell Fed. (I should note that the recent increase in the real funds rate is mainly the by-product of a decline in the PCE Core inflation rate.)

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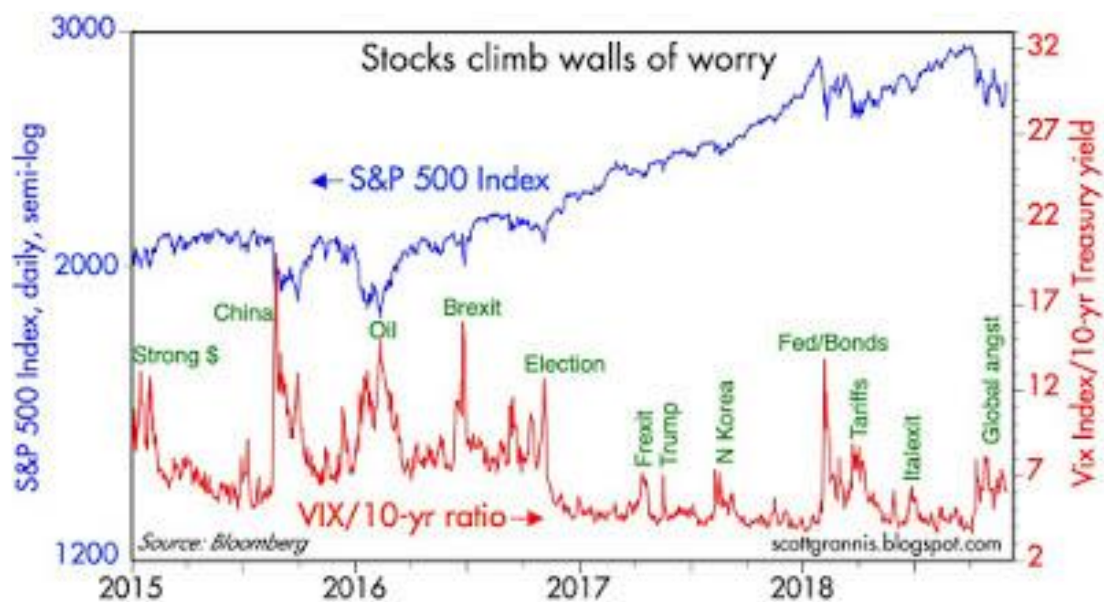
Chart #9

Finally, Chart #9 updates one of my favorites.



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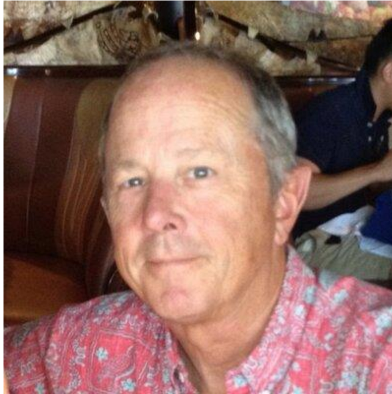
ABOUT THE AUTHOR



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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