Weekly Economic Recap & Comment
Week Ended November 2, 2018

As usual, we thought the monthly employment report was the week's most important data. The report showed ***October nonfarm payrolls*** rose by a seasonally-adjusted 250,000, accelerating nicely from a revised gain of 118,000 in September and easily beating the average monthly increase of 209,700 over the last year. Payrolls were up 1.6% from the same month one year earlier, surpassing their average annual rise of 0.9% over the last two decades. The ***October unemployment rate*** was unchanged at an extremely low 3.7%, but it would have fallen even lower except that more than enough people entered the labor market to fill all the new jobs. Finally, ***October average hourly earnings*** rose to $27.30, for an increase of 2.4% year-over-year when you use our calculation method. That rise is relatively large, but the media is reporting an even bigger rise of 3.1% because they're using a calculation method that we think is less accurate. In any case, the figures confirm that the overall economy is still growing briskly, so we expect continued profit growth and a rebound in stock prices in the near term. We are therefore maintaining a significant exposure to equities for the time being (in our strategies that include them). The problem is that demand is rising faster than supply in a wide range of industries, putting upward pressure on prices and interest rates. We still think broad, long-standing factors such as population aging and new technologies will ultimately limit how bad inflation will get. All the same, excess demand is creating a risk that the Federal Reserve may hike interest rates more aggressively than investors currently expect, or that rising costs will eventually hurt corporate profits and short-circuit the economic expansion. There are also yellow flags in the government policy environment, such as risky posturing in national security and international trade disputes. Finally, stocks are trading at high valuations, making them vulnerable to selling. The recent drop in the stock market shows many investors are only now responding to these risks, but we started to cut our exposure to stocks and other risky assets ahead of the pack – back in August – especially in our strategies that aim to be more conservative. If the data keeps coming in like it has been, we expect to cut risk further in the coming months.

In data on the demand for labor late in the month, ***initial jobless claims in the week ended October 27*** fell by a seasonally-adjusted 2,000 to 214,000. The four-week moving average of claims rose slightly to the same level, but that was still one of the lowest readings in the last five decades. With initial applications for unemployment benefits so minimal, it's clear that layoffs remain low, and/or jobs are so plentiful that those who do get laid off rarely bother to apply for benefits.

In a sign that strong labor demand and rising wages continue to buoy optimism, the Conference Board this week said its ***October consumer confidence index*** rose to an 18-year high of 137.9, compared with a revised 135.3 in September. With confidence so extraordinarily high, we think consumer spending will continue to rise and help keep the overall economy humming in the near term.

For more detail on what's driving the consumer sector, nothing beats the monthly report on personal income and spending. ***September personal income*** rose only modestly by a seasonally-adjusted 0.2%, after a revised 0.4% gain in August and an average monthly increase of 0.4% over the last year. Nevertheless, ***September personal consumption expenditures (PCE)*** rose by a healthy 0.4%, slowing only slightly from the 0.5% increases in each of the previous two months and matching the average gain over the last year. Personal income in September was up 4.4% from one year earlier, but PCE was up a stronger 5.0%. Finally, the report included the Fed's preferred gauge of inflation. Excluding the volatile food and energy components, the ***September "core" PCE deflator*** was up 2.0% year-over-year for the fifth straight month. That marked the longest period in which PCE inflation was at or above the Fed's target of 2.0% since 2012.

The negative aspect of the tight labor market is that it makes workers more expensive. Reflecting that, the ***third-quarter employment cost index*** jumped by a seasonally-adjusted 0.8%, after a rise of 0.6% in the second quarter. Overall employment costs in the third quarter were up 2.8% from the same period one year earlier, with wages and salaries up 2.9% and benefit costs up 2.6%. That means the annual rise in employment costs is now stronger than at any time since the last recession.

The challenge for businesses is to offset the rise in employment costs by raising their workers' productivity, i.e., by boosting their average value of output per hour

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worked. Unfortunately, new data this week showed that after stripping out price changes and seasonal impacts, ***preliminary third-quarter nonfarm productivity*** rose at an annualized rate of just 2.2%, slowing from a revised growth rate of 3.0% in the second quarter. The productivity gain trailed the rise in employment expenses, so ***preliminary third-quarter unit labor costs*** rose at a rate of 1.2%, erasing their decline in the previous period. Third-quarter productivity was up just 1.3% from one year earlier, far weaker than the average annual rise of 2.0% over the last two decades. The year-over-year rise in unit labor costs moderated to 1.5% in the period, but we think that still leaves firms with a tough choice: Keep raising prices, accept lower profit margins, or both.

Fortunately, actual business activity is still growing, but there are signs that rising costs and production bottlenecks are starting to slow things down. The Institute for Supply Management announced this week that its ***October ISM manufacturing index*** fell to a seasonally-adjusted 57.7, down from 59.8 in September and an 18-year high of 61.3 in August. The ISM indexes are designed so that readings over 50 point to expanding activity, so the October figure suggests the factory sector is still growing quite broadly. Nevertheless, we were struck by the fact that while all the major subindexes on new orders, production, employment and the like were down in October, there were significant increases in the subindexes on prices paid and supplier deliveries (a gauge of bottlenecks).

Other data this week showed weaker building activity. On a seasonally-adjusted basis, the report showed ***September construction spending*** was flat, after a revised 0.8% jump in August. However, things looked better from a longer perspective. Overall construction spending in September was up 6.4% year-over-year, led by a 10.0% rise in public works spending. Outlays on commercial construction were up 6.7% on the year, while outlays on private residential construction were up 4.1%.

In the energy sector, ***commercial crude oil inventories in the week ended October 27*** rose by 3.217 million barrels to a total of 426.004 million barrels. That left inventories at their highest level since early June, and it meant stockpiles are now just 1.1% below their five-year moving average (an industry benchmark that suggests supply and demand are in balance). The data also showed ***domestic crude oil production in the week ended October 27*** rose back up to its recent record high of 11.200 million barrels per day. For now, we still think continued economic growth and rising usage around the world should help keep inventories in check and put additional upward pressure on prices. We are therefore maintaining our exposure to broad commodity funds in our more aggressive portfolios. However, if U.S. production and stockpiles rise too much further, we may need to revisit that decision.

Finally, in a report on the international sector, the ***September trade balance*** showed a seasonally-adjusted deficit of $54.0 billion, after a revised deficit of $53.3 billion in August. The report said exports and imports both rose 1.5% during September, but rising domestic demand and the strong dollar have actually been giving the advantage to imports over the last year. September exports were up a healthy 7.2% from a year earlier, but imports were up an even stronger 9.8%.

Patrick Fearon, CFA
Chief Investment Officer

Upcoming U.S. Data

Date	ET	Release	For	Consensus Forecast	Prior
5-Nov	10:00	ISM Services	Oct	NA	61.6
6-Nov	10:00	JOLTS - Job Openings	Sep	NA	7.136M
7-Nov	7:00	MBA Mortgage Applications Index	3-Nov	NA	-2.50%
7-Nov	10:30	Crude Inventories	3-Nov	NA	+3.2M
7-Nov	15:00	Consumer Credit	Sep	NA	$20.1B
8-Nov	8:30	Continuing Claims	27-Oct	NA	1631K
8-Nov	8:30	Initial Claims	3-Nov	NA	214K
8-Nov	10:30	Natural Gas Inventories	3-Nov	NA	+48 bcf
8-Nov	14:00	FOMC Rate Decision	Nov	NA	2.13%
9-Nov	8:30	PPI	Oct	NA	0.20%
9-Nov	8:30	Core PPI	Oct	NA	0.20%
9-Nov	10:00	Univ. of Michigan Consumer Sentiment - Prelim	Nov	NA	NA
9-Nov	10:00	Wholesale Inventories	Sep	NA	NA

Source: Briefing.com

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