WEALTH MANAGEMENT INTERNATIONAL, LTD.
Proactive Investment Management & Financial Planning

Weekly Economic Recap & Comment

Week Ended November 16, 2018

Now that the recent tax cuts and government spending hikes have been in place for a while, we're paying closer attention to the evolving trends in the federal budget balance. The ***October Treasury statement*** showed a cumulative 12-month deficit of $816.3 billion, up 19.5% from the $683.2-billion deficit in the 12 months ended in October 2017. Federal outlays totaled $4.162 trillion in the year through October, for a gain of 3.8% from the prior 12-month period. That was in line with the typical rise in outlays since 2015, but it was well below the average increase of 4.7% over the last two decades. The main reason the deficit widened so much was that federal receipts in the 12 months through October totaled just $3.346 trillion, for a meager rise of 0.5% from the previous year. In spite of the strong economy, the rise in receipts was much weaker than the average increase of 3.4% over the last 20 years. In sum, the government is pumping a huge amount of stimulus into the economy on top of the strong uptrend in underlying demand. That's helping keep the economy 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. Many investors are only now responding to these risks, but we started to cut our exposure to stocks and other volatile assets 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 further cut risk sometime after the next market rebound.

Reflecting the strong underlying demand mentioned above, ***October retail sales*** jumped by a seasonally-adjusted 0.8%, erasing their slight 0.1% declines in both September and August. Some of the jump in October came from surging car sales, but that wasn't the whole story. ***October retail sales excluding autos*** were up 0.7%, after falling 0.1% in September and rising 0.1% in the month before that. Total retail sales in October were up a healthy 5.9% year-over-year, while sales ex-autos were up an even stronger 6.7%. Since both those gains were well above the 2.5% increase in consumer prices over the last year, it's clear that the actual volume of sales is rising rapidly.

As we've noted before, the strong labor market remains the biggest driver for consumer demand. Companies are creating lots of new jobs, unemployment has fallen to very low levels, and wages are rising. In the latest data on labor demand, ***initial jobless claims in the week ended November 10*** rose by a seasonally-adjusted 2,000 to 216,000, and the four-week moving average of claims rose to 215,000. However, those were still some of the lowest figures in the last 50 years. Initial applications for unemployment benefits remain historically low, so it's clear that layoffs remain quite limited.

Increased consumer demand, higher government spending, and an upswing in corporate investment have been a boon for the industrial sector. In the latest data, ***October industrial production*** rose only slightly by a seasonally-adjusted 0.1%, after a revised 0.2% gain in September, but the weakness came mostly from declines in the volatile mining and utility industries. In the dominant manufacturing industry, production rose a healthy 0.3% for the second straight month. Overall industrial production in October was up 4.0% from a year earlier, led by a 12.9% rise in mining output and a 2.7% increase in factory production. Utility output was up 1.2% year-over-year. Just as important, the report said ***October industrial capacity utilization*** stayed high at 78.4%. That was slightly lower than the 78.5% rate in each of the two prior months, but it was still above the 20-year average of 77.3%. With factories, mines, and utilities producing above their rated capacity, we think corporate managers have little incentive to cut prices but plenty of incentive to hike prices further. In other words, high capacity utilization is boosting inflation pressure.

Another source of inflation pressure is that inventories are getting leaner. ***September business inventories*** increased by a seasonally-adjusted 0.3%, after a rise of

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0.5% in August. However, most recent inventory increases have been weaker than the rise in sales. The ***September business inventory-to-sales ratio*** was unchanged at 1.34 for the third straight month, but that was well below the recent peak of 1.43 in early 2016. The inventory ratio would have to fall further to reach the levels below 1.30 that were common right before the last recession. Nevertheless, we think inventories are already lean enough to give firms another reason to raise prices.

Still, there is one place where inventories are starting to look excessive again. In a report on the energy sector, ***commercial crude oil inventories in the week ended November 10*** surged by 10.270 million barrels, posting their biggest increase since January 2017 and marking their eighth straight weekly rise. Total stockpiles rose to an 11-month high of 442.057 million barrels, a significant 2.4% above their five-year moving average (an industry benchmark that suggests supply and demand are in balance). One reason for the inventory surge was that ***domestic crude oil production in the week ended November 10*** jumped to a new record high of 11.700 million barrels per day. We still think continued economic growth, rising usage around the world, and reduced exports from big producers (such as Iran and Venezuela) should help keep inventories in check and support global prices. We are therefore maintaining our exposure to broad commodity funds in our more aggressive portfolios. However, the new rebound in U.S. production and stockpiles could weigh on prices and overall inflation in the near term.

Similarly, the latest report on prices in international trade contained some contradictory signs for domestic inflation. ***October import prices*** jumped by a seasonally-adjusted 0.5%, accelerating from their revised increase of 0.2% in September. Most of the jump in October came from higher prices for imported energy products, even as rising production and increased inventories were starting to weigh on the market for domestic crude oil. In contrast, ***October nonfuel import prices*** rose a more modest 0.2%, after being flat in the previous month. Overall import prices in October were up 3.5% on the year, but because of the strength of the dollar and weakening economic growth abroad, nonfuel import prices were up just 0.7%.

Nevertheless, in spite of the softening price hikes for energy and foreign goods, the key gauge of consumer prices showed inflation pressure remains relatively high. The ***October consumer price index (CPI)*** rose by a seasonally-adjusted 0.3%, accelerating from its mild increase of 0.1% in September and marking its biggest monthly gain since January. Even excluding the volatile food and energy components, the ***October "core" CPI*** rose 0.2%, after two straight months of 0.1% increases. The overall CPI in October was up 2.5% from a year earlier, and the core CPI was up 2.1%. Both measures have been above the Fed's target of 2.0% for at least ten straight months, which we think will help convince the policymakers to keep hiking interest rates.

Patrick Fearon, CFA
Chief Investment Officer

Upcoming U.S. Data

Date	ET	Release	For	Consensus Forecast	Prior
19-Nov	10:00	NAHB Housing Market Index	Nov	NA	68
20-Nov	8:30	Housing Starts	Oct	NA	1201K
20-Nov	8:30	Building Permits	Oct	NA	1241K
21-Nov	7:00	MBA Mortgage Applications Index	17-Nov	NA	-3.20%
21-Nov	8:30	Durable Orders	Oct	NA	0.80%
21-Nov	8:30	Durable Goods –ex transportation	Oct	NA	0.10%
21-Nov	8:30	Initial Claims	17-Nov	NA	216K
21-Nov	8:30	Continuing Claims	10-Nov	NA	NA
21-Nov	10:00	Leading Indicators	Oct	NA	0.50%
21-Nov	10:00	Univ. of Michigan Consumer Sentiment - Final	Nov	NA	98.3
21-Nov	10:00	Existing Home Sales	Oct	NA	5.15M
21-Nov	10:30	Crude Inventories	17-Nov	NA	+10.3M
21-Nov	12:00	Natural Gas Inventories	17-Nov	NA	+39 bcf

Source: Briefing.com

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