Financial Markets This Week

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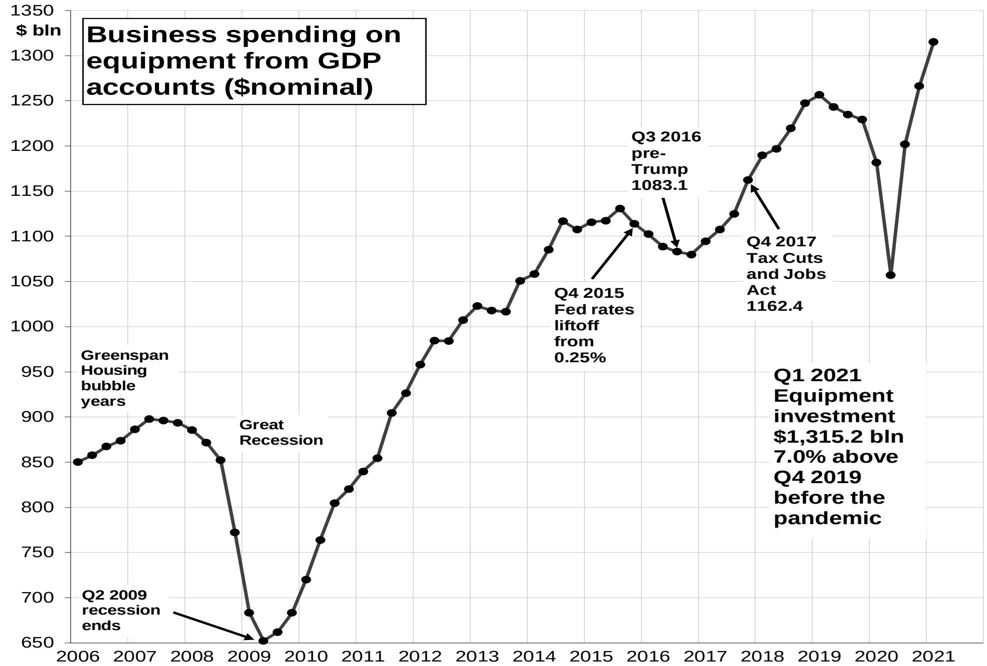
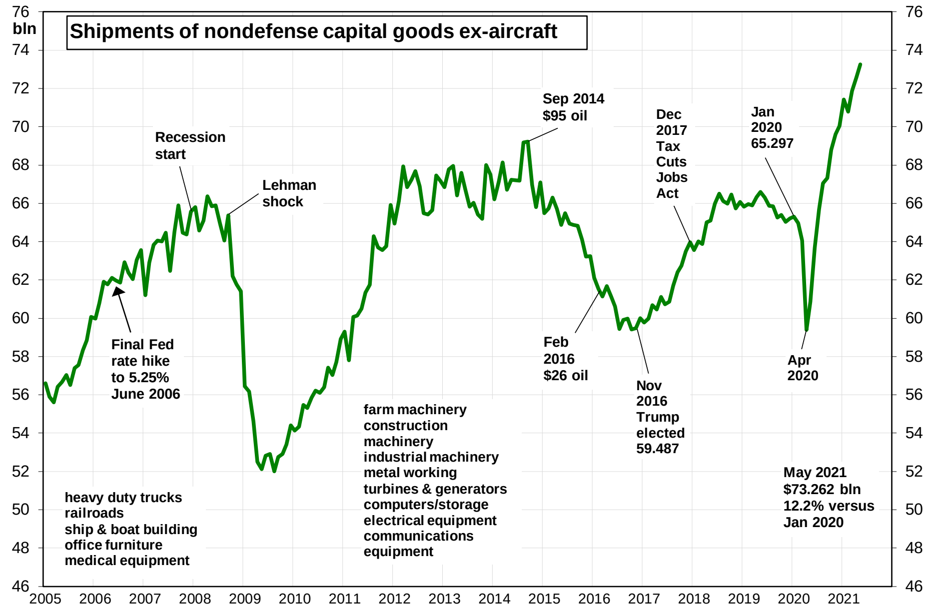
BUSINESS INVESTMENT SET TO SLOW



It looks good on paper. Business investment in new equipment has soared. Investment plants the seed for future growth, the economics textbooks say. But we wonder whether the good news of strong business equipment purchases will last. Companies may have over-ordered. Someone flipped a switch in the pandemic and the famous just-in-time orders made at the last minute may have switched over to pay up now, buy it quick and have it ready in inventory because supply disruptions mean you may not be able to get the equipment when you need it. The pandemic made companies do what they didn't want to do; now the economy has reopened, things will change. At the very least Washington policymakers have to admit the recession is long gone looking at equipment expenditures where it took one year to recover in this recession as opposed to the Great Recession of 2007-09 when it took 4-1/4 years to recover. Recovery means stimulus isn't needed.

Nominal GDP is $22,061.5 billion in Q1 2021 and business investment in equipment is a modest $1,315.2 billion or 6.0% of the total. An important part. Can it last is the question. Should it last is the question given the economy is at peak rate growth. Nominal spending on equipment in GDP had weakened in 2016 as part of the overall manufacturing slowdown in the country which we call the oil recession where industrial production fell for about a year and a half. There was a rebound in GDP equipment activity even before the Tax Cuts and Jobs Act was signed in December 2017.

The monthly data on business equipment purchases comes out in the durable goods report that was released on Thursday this week. We usually take a look at durable goods orders even though there is a better breakdown of durable goods shipments.



Many orders are shipped immediately so it is hard to separate the two. Our monthly proxy for business investment spending is nondefense capital goods shipments ex-aircraft. Shipments were still headed skyward in May 2021. Unfortunately, there is less detail than we want or at least it is hard to say why these capital goods shipments are so strong. The May durable goods report is preliminary and we have to wait for the May factory orders data for more detail, and a revision of the data, when it is released July 2.

But our early analysis of shipments in April point to a few areas of strength even if most of the equipment categories are up since the best economy in fifty years before the pandemic. Actually, shipments were already fading in 2019 before the recession which is thought to be caused by the ongoing trade war uncertainty between the U.S. and China. Nevertheless, nondefense capital goods shipments ex-aircraft from the fourth quarter of 2019 before the pandemic through April 2021 are up 11.2% to record levels which is an increase of $7.275 billion. Machinery is the biggest category accounting for almost half of all shipments and these were up $2.231 billion or one-third of the total $7.275 billion increase since the pandemic. Some of the machinery equipment standouts for which there are data are farm, construction, HVAC, and industrial machinery. Oil and gas drilling equipment only subtracted $0.284 billion from total shipments despite the plunge in crude oil prices.

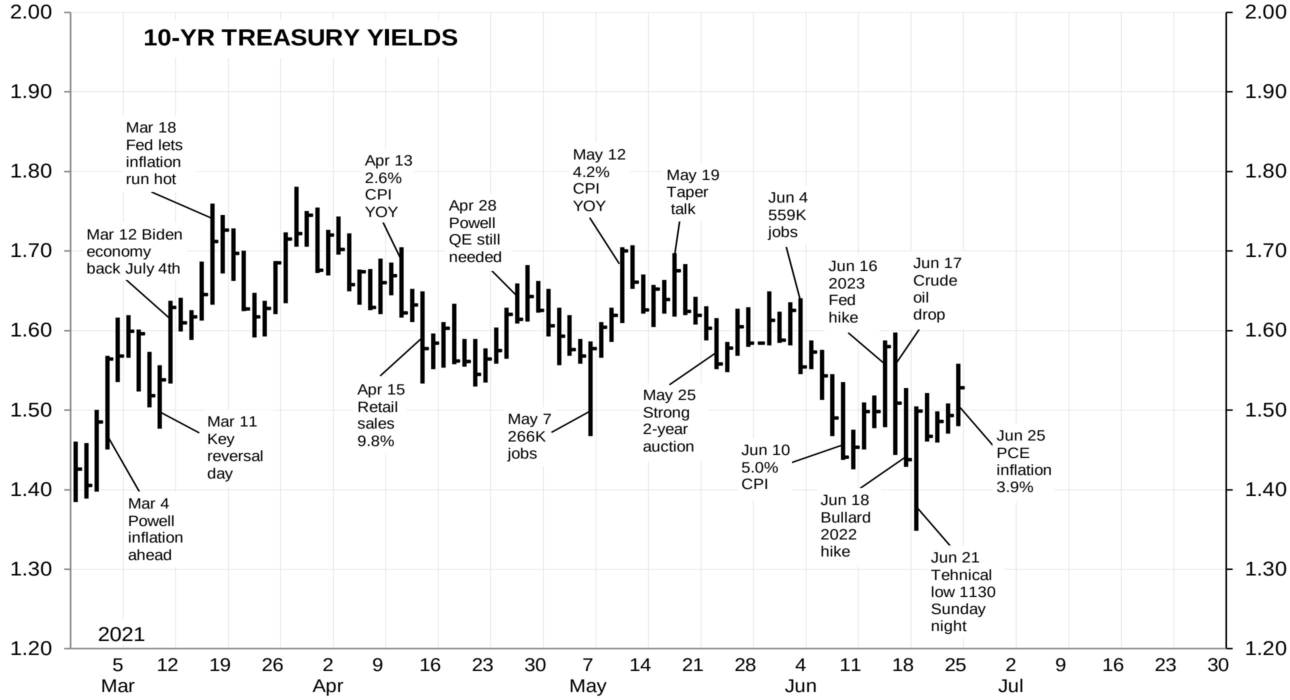
Changes in Pre-Pandemic Durable Goods Shipments

Monthly levels Q4 2019	Apr 2021	Change $ mln	Change Percent	
65,220	72,495	7,275	11.2	Nondefense Capital Goods Shipments ex-aircraft
32,333	34,564	2,231	6.9	Machinery and equipment
1,743	2,046	303	17.4	Computers, storage devices, peripheral equipment
2,698	3,168	470	17.4	Communications equipment
1,556	1,542	-14	-0.9	Search and navigation equipment
8,621	9,676	1,055	12.2	Electromedical, measuring, and control instruments
11,117	12,246	1,129	10.2	Electrical equipment, appliances, and components
2,548	2,620	72	2.8	Heavy duty trucks
2,969	3,168	199	6.7	Ships and boats

The second two biggest categories of shipments adding to the total were Electromedical, measuring and control instruments ($1.055 billion) and Electrical equipment, appliances and components ($1.129 billion). The top three then, including Machinery, accounted for 60% of the surge in shipments into the record books from Q4 2019 pre-pandemic levels to April 2021. The stay-at-home economy did bring big increases in computers and in communications equipment, 17.4% for both, yet these did not add all that much to the total increase.

In conclusion, it doesn't look like it on the charts but we still expect business investment spending as shown by long-lived nondefense capital goods shipments ex-aircraft to slow. It looks like there was over-ordering of equipment during and after the pandemic which should subside as business conditions normalize. Real GDP was unrevised at 6.4% in the first quarter this week and while Q2 forecasts are high due to a rebuilding of inventories and consumers flashing $1400 checks, the economy is set to slow and business capital spending with it.

INTEREST RATES

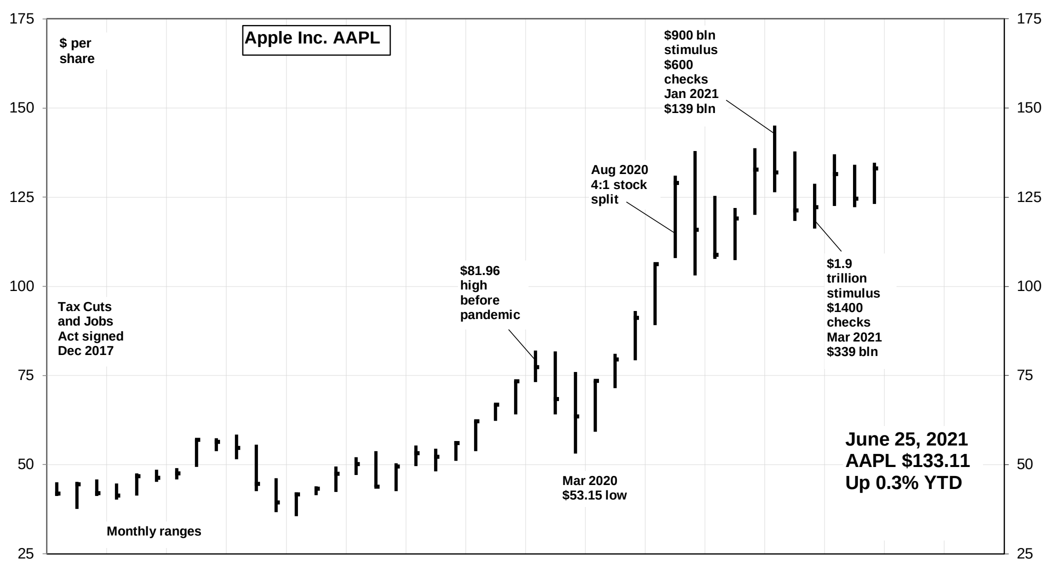


The bond market calmed down after Sunday night's unexplained 11pm ET yield plunge to 1.35% as well as last week's volatility triggered by the FOMC meeting. Rate hikes are still a long way away after Powell's Tuesday testimony with his statement released Monday afternoon. Stocks bounced Monday starting at the 930am ET opening with Friday's sell-off on Bullard and quadruple witching seen as overdone. Friday's core PCE inflation was the worst since the 90s, but bond futures had to think about it, initially rallying a quarter point for 6-7 minutes. 10-yr yields closed the week at 1.53%.

Apple up 0.3% YTD

Apple announced its first quarter earnings on April 28. Revenues rose 54% from a year ago to reach a new March quarter record. Net sales were $89.584 billion in Q1 2021 with iPhone sales 53.5% of the total. The company remains optimistic, helping "users to meet this moment in their lives." Nasdaq was back in the news this week with three record high closes. Economists worry about how the tech companies will continue making big money after the pandemic, but investors certainly do not.

S&P 500 Weights	
Top 6: 23% of S&P	
5.80	AAPL
5.57	MSFT
4.10	AMZN
2.28	FB
1.45	TSLA
2.04	GOOGL
2.01	GOOG
23.25	Top 6



FEDERAL RESERVE POLICY

The Fed meets on July 27-28, 2021 to consider its monetary policy. The markets tumbled last Friday when St. Louis Fed President Bullard said his Dot was for a rate hike in 2022. Only two days earlier at the FOMC meeting we learned that a majority of Fed participants want to hike rates in 2023 for the first time. Powell downplayed the Dots Forecasts at that Wednesday Fed meeting press conference, but Bullard's comments Friday morning about why many on the Committee had changed their votes due to a worsening inflation outlook with the economy's strong reopening were convincing at the time. This week's Powell in testimony on Tuesday reiterated that it was a shortfall of employment that was the problem and that inflation was expected to settle back down. Just to make sure we don't miss the "maximum employment goal is more important than inflation" point, the next morning, Fed Governor Bowman said they were going back out on the road with the Fed Listens tour or as we would call it the Why We Won't Raise Interest Rates tour.

> Income inequality? Powell responds:
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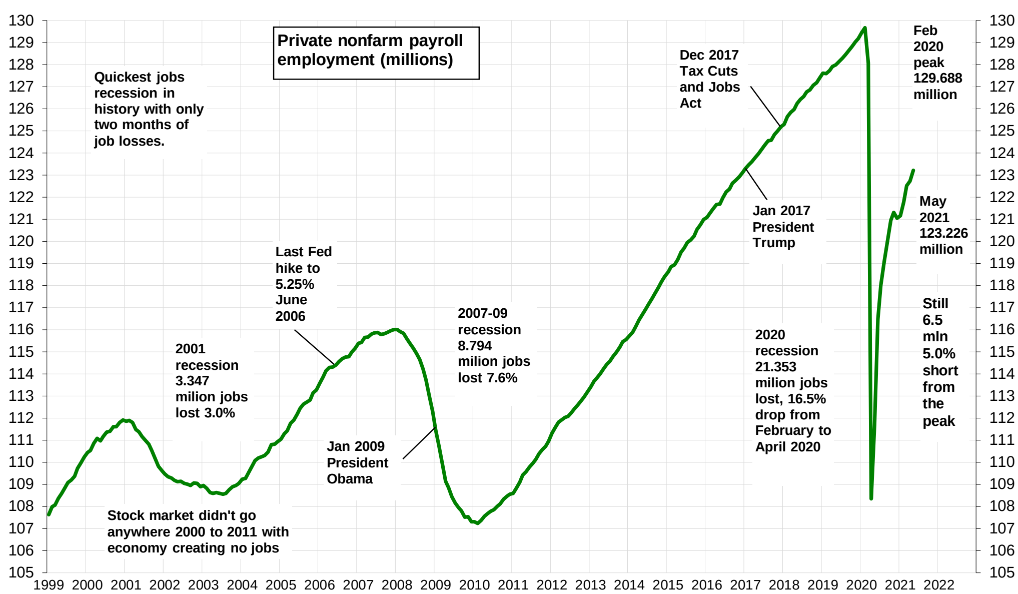
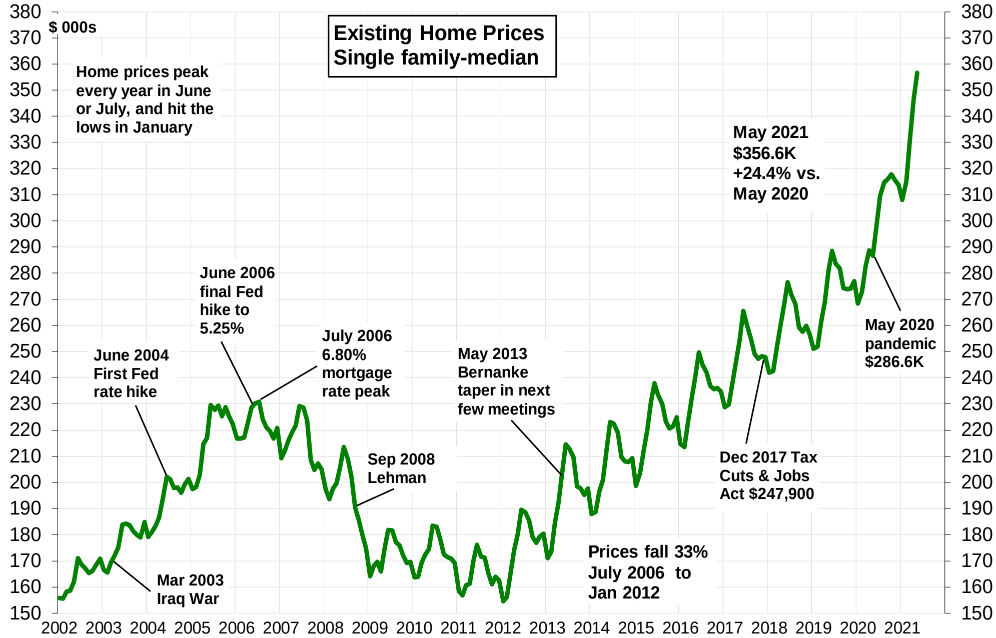
> What we can do, really, is to focus principally on the employment mandate and to assure that we achieve maximum employment, which we now define as a broad and inclusive goal. Meaning, we will not just look at the headline numbers for unemployment, we'll look at all kinds of measures of unemployment, including unemployment and employment for various groups, ethnic groups, gender groups, and things like that.
>
> We will also under our new framework, respond to shortfalls only in full employment. We will not raise interest rates preemptively because we think employment is too high because we fear the possible onset of inflation. Instead, we will wait for actual evidence of actual inflation or other imbalances.

While we wait for the unemployment rate to fall further from the 6.7% level when the Committee met in December 2020 to bring us closer to QE tapering, we would note that Powell said this week it is not just the unemployment rate level that is the issue because maximum employment is broader than that. The unemployment rate is lower than it would otherwise be due to millions who dropped out of the labor force: May's 5.8% rate is more like 9.0%. That's why when judging when the Fed might raise interest rates the first time, the level of payroll employment incorporates the unemployed and the dropouts. Despite Bullard's worry over inflation, his boss is Fed Chair Powell who doesn't see an issue with inflation. He is more focused on maximum employment. You can watch the level of payroll employment for yourselves to see how fast the US economy is returning to the best economy in 50 years before the pandemic and as we get closer to filling the gap, only then would the Fed under Powell be more amenable to raising interest rates.



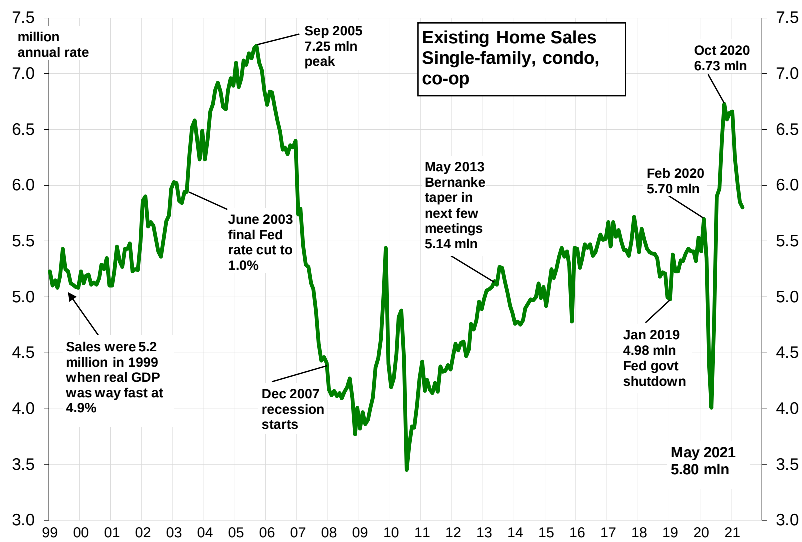
OTHER ECONOMIC NEWS

Home price bubble closer to exploding (Tuesday)



Breaking economy news. Existing home sales in May fell 0.9% to 5.80 million at an annual rate, providing evidence that the sharp rise in home prices is softening demand. Realtors say there isn't enough supply on the market, but we think home price appreciation and modestly higher mortgage rates are holding some buyers back. It should make home buyers think twice. It certainly looks like a bubble if median single-family home prices nationwide jump 24.4% in May from prior year levels, led by the West up 24.6% to $513,700. Northeast home prices were the laggard if you call it that, rising just 17.0% year-year.

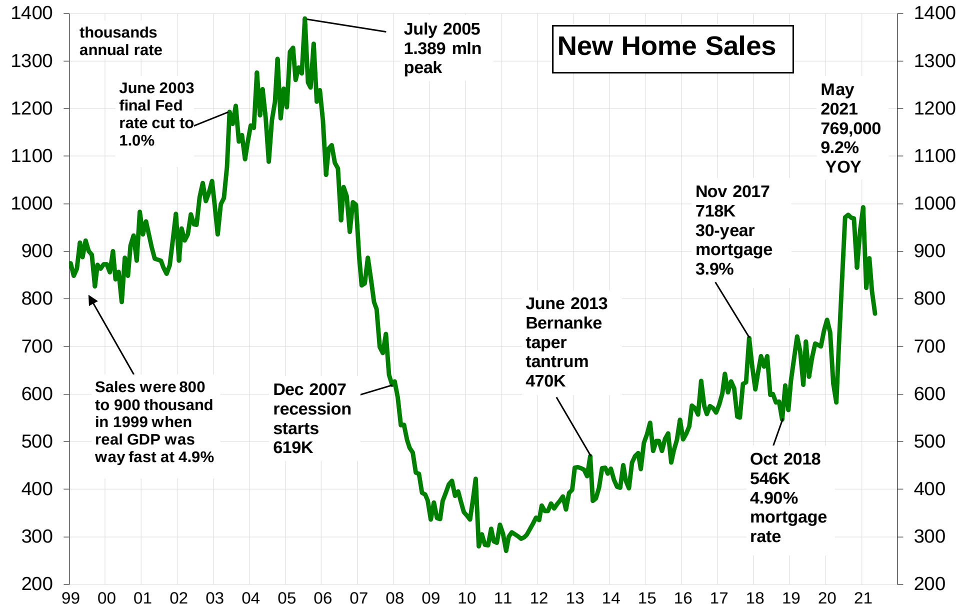
Net, net, the housing price bubble continues to inflate with homes rapidly becoming unaffordable for most Americans. With home prices up over 20% the last year, it is only a matter of time before so-called shelter costs in CPI inflation start to tick up which will serve to make this inflation more permanent and less transient than Fed officials believe. It is irrelevant whether this housing market is not like the 2006 housing crash because fewer no-doc loans are made by financial institutions who generally continue to observe strict underwriting standards for the mortgage loans they make.



The risk to the American economy is that if asset prices fall sharply, either in home prices or in the stock market, the sudden drop can affect the confidence of consumers and businesses quite quickly. The point is if home prices increase over 20 percent in a short one-year period of time, there is a risk that prices fall and bring down the entire U.S. economy with it. The Federal Reserve was quick to step in when asset prices tumbled in February and March last year, but they are much too slow to exit these emergency stimulus policies once asset prices have stabilized. Actually, asset prices haven't stabilized, they are soaring and look out below if prices fall back to earth. This is not a good news for the economy report, it is news that home prices are moving so high that they risk bringing down the entire economy if they fall. As the economy moves away from the stay-at-home life in the months ahead, new homes will no longer be in hot demand, and we are keeping our fingers crossed that home prices won't fall hard once the Fed starts taking the punch bowl away and sends record-low mortgage rates back up.

New home sales are slow partly due to the weather down South (Wednesday)

Breaking economy news. New home sales fell 5.9% in May to 769 thousand at an annual rate. Sales are down mostly on the 14.5% drop in the largest region of the South where there was some turbulent weather at least early in the month with tornadoes. New home sales along with existing home sales suggest home buying activity is past its peak and we believe some of the softening is due to higher prices. New home sales are more of a leading indicator as sales are recorded when sales contracts are signed as opposed to existing home sales that are recorded 30-60 days later at closing.



Supply seems less of an issue than it is for existing home sales where there are not enough homes on the market; traditionally, new home sales run significantly less than new home construction. New home sales in May 2021 were 769 thousand where single-family home starts in May were 1.098 million.

Powell told Congress yesterday that inflation was transitory, let's hope so for home price inflation because home prices continue to move sharply higher. We don't know what is going to happen when the stay-at-home economy shifts to going back to the office. We expect there will be some buyer's remorse one or two years from now for new home buyers. New home median sales prices are not going up as much as existing home sales with their 20%-plus gains perhaps as prices are set by builders as opposed to realtors and owners. In any case, new home sales median prices jumped 10.9% in December 2020, the first year-year gain since 2017. Median prices were $374.4 thousand in May 2021 which is 2.5% higher than December 2020.

Net, net, new home sales are a leading indicator and right now they point to a moderate slowdown in the American economy that has seen over-the-top growth largely due to policy stimulus from Washington from Federal Reserve officials and from those large Economic Impact Payments from Congress. New home sales are well off the peak of 993 thousand in January this year as home prices barrel ahead and price many buyers with limited means out of the market.

New Home Sales

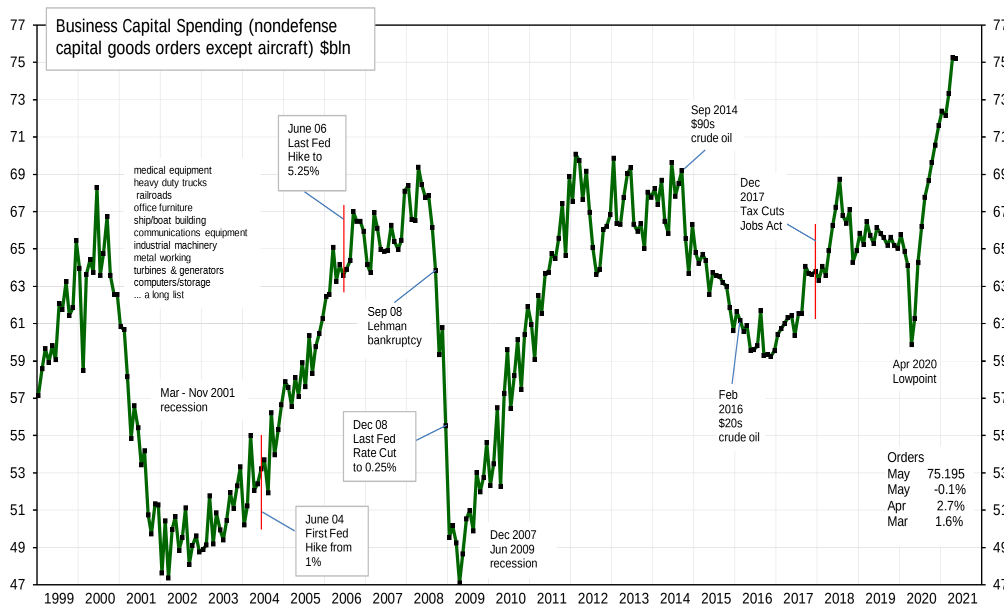
	Total	Northeast	Midwest	South	West	Median Price $
Dec 2020	943	41	112	553	237	365,300
Jan 2021	993	47	124	575	247	373,200
Feb	823	40	104	465	214	362,000
Mar	886	51	113	562	160	348,300
Apr	817	39	95	505	178	365,300
May	769	52	95	432	190	374,400
	Thousands at Seasonally Adjusted Annual Rate					

Heavy rain of economic data doesn't change outlook (Thursday)

Breaking economy news. Too many economic reports to sift through this morning, third look at real GDP in the first quarter when everyone wants to see the second quarter data due on July 29, advance look at the trade deficit for May, weekly unemployment claims, and durable goods orders for May.

Real GDP was the same in today's third-look data at 6.4% in Q1 2021. Inventories were a drag in the first quarter and will swing back the other way and add to growth in Q2 2021. The heavy lifting will be done by the consumer however where even 10% real growth is not impossible. It was Bernanke originally who argued that growth doesn't mean a rate hike years ago, maybe that is true, but economic growth this strong sure doesn't require the Federal Reserve to keep printing $120 billion of new emergency stimulus money each month either.

Our proxy for monthly business investment in new equipment anyway is in the durable goods report today. Nondefense capital goods ex-aircraft remain near record highs in May both in orders and in shipments which are often the same thing. New orders for nondefense capital goods ex-aircraft fell 0.1% in May to $75.195 billion, but are actually higher than we knew with April's 2.2% gain revised to up 2.7%.



Net, net, it looks like the economy continues to astound us with the speed and strength of the recovery from what is turning out to be the quickest recession in history. Real GDP is looking even stronger in the second quarter thanks to the Federal government's stimulus checks that are still being spent by consumers. The first batch of $1400 checks first hit consumer bank accounts on March 17 and real GDP in the second quarter could be as high as 9% if we did the back of the envelope calculation correctly. The second quarter is likely to be the peak growth rate we will see this year and spending from companies and consumers should gradually subside to more normal levels by the end of the year.

The history books criticized Washington's response to the Great Recession over a decade ago, so the Federal government and the Federal Reserve pulled out all the stops and flooded the economy with a veritable tidal wave of money this time. We still wonder what happens when the stimulus money is gone as it could lead to a nasty withdrawal where growth takes a big hit. Nevertheless, today's heavy rain of economic data doesn't change the outlook for now and the economy is still moving forward back to the best economy in fifty years before the pandemic struck.

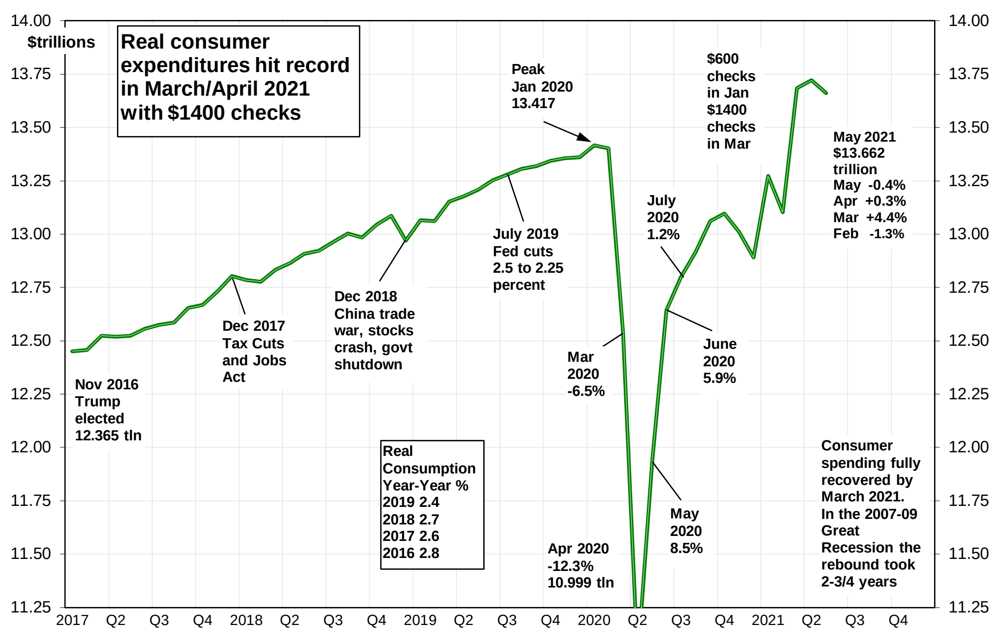
Consumer is facing more inflation and running out of income (Friday)

Breaking economy news. The personal income report for May and for this month there is none. It was all a mirage, money given and then taken away. Personal income was $20.8 trillion in May, down from $21.2 trillion in April, and $24.4 trillion in March… March with the $1400 checks for millions of Americans. It is an exaggeration to say American's are rich and that they can draw on their incomes to spend for months to come and support a continued robust expansion of the economy. Americans have lost $3.6 trillion in income since March. It's a big number and a big deal.

Real consumer spending fell a sharp 0.4% in May and we were surprised spending did not fall further because incomes are falling sharply as the Washington stimulus effect fades. Consumer spending is running hot at roughly 10% in the second quarter, but beneath the surface, these real expenditures are starting to slow. If you are waiting for a shift in purchases from goods like cars to services like vacations, you will have a long wait as more robust services spending will not keep the recovery on the fast track. In May, real consumer spending on durable goods fell $111.3 billion while services spending increased just $33.6 billion.

For inflation, maybe some in the market are breathing easier as PCE inflation in May is just 3.9% year-year versus 5.0% CPI inflation in May year-over-year reported two weeks ago. But 3.9% is still robbing savers with money in the bank earning zero interest. Negative real rates erode real wealth. The Fed's low rates policy continues to throw savers under the bus.

Net, net, the consumer drives economic growth, but the million-dollar question is how long will they be able to sit behind the wheel and steer the economy to a better tomorrow. Consumers are running out of income fast and that means spending will slow dramatically later this year. Don't get too used to those 6.4% GDP numbers last quarter and talk of 10% GDP growth in the current quarter. Growth is going back down to 2% and the slowdown will be more dramatic than the markets are expecting.



This isn't a typical economic recovery, it is the fastest rebound in economic history and it no longer deserves emergency stimulus from Washington. Policymakers in Washington are misreading the economic tea leaves and their policies are not normalizing as quickly as the economy is. It took 2-3/4 years for the consumer to recover from the 2007-09 recession, this time it has taken just one year and a couple of months for consumers to return to their old ways before the pandemic. Moreover, the threat from inflation is real with the monthly changes in core PCE inflation of 0.4% in March, 0.7% in April, and 0.5% in May translating to annualized rates of 4.8%, 8.4%, and 6.0%, respectively. Inflation is happening now and it has nothing to do with so-called base effects dropping away as last year's deflation during the pandemic falls out of the picture. Inflation hits more Americans harder than joblessness does. Stay tuned. Story developing.

Analyst Certification

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