ODDO BHF
CORPORATES & MARKETS

Economy

Focus US
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A double capitulation

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Bruno Cavalier - Chief Economist
bruno.cavalier@oddo-bhf.com
+33 (0)1 44 51 81 35

Fabien Bossy - Economist
fabien.bossy@oddo-bhf.com
+33 (0)1 44 51 85 38

https://www.oddosecurities.com

The first capitulation was Donald Trump's to Nancy Pelosi, the leader of the Democrat opposition in the House. This brought the government shutdown to an end and reduced the degree of uncertainty. Good news! The second came from Jerome Powell. Recently, investors were anxious that the Fed's balance sheet might be shrunk to such an extent that it would asphyxiate the markets (which is highly debatable). The Fed's chairman must have feared that these concerns could trigger a financial shock. To prevent this, he opted to put monetary policy on hold for an extended period. Is this good news too? We are not so sure.

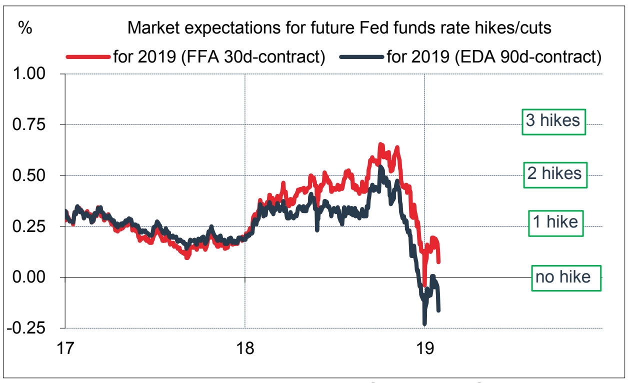
The week's focus

At the FOMC meeting of 30 January, there was no change to policy (as expected) but there was a notable change to the Fed's policy bias. In line with the recent statements made by officials, PATIENCE is now the watchword when it comes to the Fed's future actions. This is a vague enough term for anyone to read into it what they will.

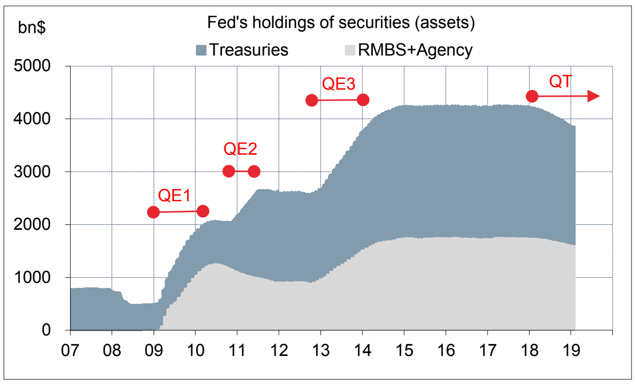
- This bias in favour of several rate hikes has disappeared from the press release. Instead, the Fed intends to take its time to think about its next steps. It has not closed the door to any options - rate hikes, or cuts if necessary. In the near future, the status quo is set to prevail, justified by the downtrend in the inflation profile, the markets' skittishness, the rise in external risks and the ongoing statistical fog created by the shutdown. At least six months of patience are a minimum. The market is tilting towards a longer period of status quo (lhs chart).
- The Fed no longer described the risks to the outlook as balanced, nor did it say if they are more on the up- or downside.
- In addition to its usual press release, the FOMC issued a second devoted to the normalisation of the balance sheet - as a sign that it is very sensitive to the markets' anxiety on this subject. It reiterated that the main monetary policy tool lies in setting the policy rates. Adjusting the balance sheet is of secondary importance. That said, the FOMC said it is willing to adjust the size or composition of its asset portfolio (rhs chart) if an easing of monetary policy proves necessary.
- Finally, and this is important, the Fed said it will opt for a liquidity system characterised by significant excess reserves held by the banks (the so-called floor system)[1]. This suggests that the process of shrinking the balance sheet will not continue for years, but only for several months or quarters.

1 See our *Eco Note from* 23 January 2019: "News and Fake news about Quantitative Tightening"

Fed: rate expectations according to futures contracts



Fed: asset portfolio



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- Labour market - Jobless claims were up by 53K for the week of **26 January**, with the shutdown period including a public holiday. As such there is nothing significant to report. The other employment data was the Employment Cost Index. This index was up 0.7% q-o-q in Q4 and +2.9% y-o-y, a new high in this expansionary phase.
- Real estate - The outlook remains blurred and, overall, the signals are negative. Pending home sales continued to decline (-2.2% in **December**, i.e. -9.5% y-o-y). New home sales rose sharply in **November** (+17%) but remained on a downtrend. According to S&P/Case-Shiller, the pace of increase in the price of existing homes continues to slow. At the national scale, the gain stands at 4.7% y-o-y, vs 6.7% at the beginning of 2018. The weakening is concentrated in the major cities of the west coast.
- Business climate – ahead of the ISM manufacturing report (due for publication this afternoon), the latest regional data remain mixed. The Dallas Fed's index picked up slightly, but the Chicago PMI index has plunged by 7.1 points to 56.7.
- Household confidence - Like similar surveys that have already been published (University of Michigan, Bloomberg), the Conference Board survey shows a marked correction. The index lost 6.4 points in **January**, after a 9.8-point decline in December. Over the past two months, this is a correction that is unprecedented since 2008. This sharp decline is almost entirely due to expectations. The current conditions of the labor market have not been altered. Several observers were quick to discern in the substantial gap in the "present *minus* future conditions" index, a clear sign of the weakening of the cycle. How we envy these experts that have the ability to resume the situation in one single metric whilst ignoring all of the others, including the fact that five weeks of shutdown might have weighed on expectations.

Monetary and fiscal policy

- On **25 January**, Donald Trump announced that he would sign a government funding law until **February 15**, ending the longest ever shutdown (35 days). Over the next three weeks, a solution to the "wall" issue must be found, failing which the US President is threatening to declare a state of emergency at the border with Mexico, which would allow him to bypass Congress to finance the "wall" (the legality of this option is a moot point). This delay appears above all as a way of making his defeat less bitter, as each passing day showed more and more clearly the damage of the shutdown at the economic (see Focus-US of last week) and political level. For example, due to a lack of air traffic controllers and security personnel, many airports have had to suspend flights. It was also clear that the tax authorities (IRS) would not be able to conduct the tax refunds season under normal conditions, since about half of the staff required to work without pay had not shown up. For its part, the Republican majority in the Senate was showing cracks.
- The Congressional Budget Office has estimated the effects of the shutdown on the level of economic activity and its growth rate. The closure of administrations led to a decrease in federal spending of $18bn in five weeks. This would trim real GDP growth by 0.2pt (on an annualised basis) in **Q4 2018** and by 0.4pt in **Q1 2019**. The return to normal would have a positive effect of +1pt in **Q2 2019**. The CBO points out that it was unable to include in its calculations indirect negative effects such as the impossibility of obtaining administrative authorisations (deferred expenditure), the absence of statistics (increased uncertainty), the loss of credibility of the federal state as an employer (quality of its workforce).

The week ahead

- With the end of the shutdown, statisticians from the BEA and the Census Bureau can resume their normal activities. First of all, the stock of pending data must be purged. The November statistics were already partly processed at the beginning of the shutdown and will be published in the coming days about a month late: construction spending, factory orders, foreign trade. For the December statistics, the timetable has not yet been established. The first estimate of the national accounts in Q4, which gives real GDP growth, therefore remains suspended. It can be assumed that the work overload may alter the publication for a few weeks before a complete return to normal. Regarding surveys, the main focus will be the ISM non-manufacturing sector index on **February 5**. On the same day, Donald Trump will finally be able to deliver the annual state of the Union address.

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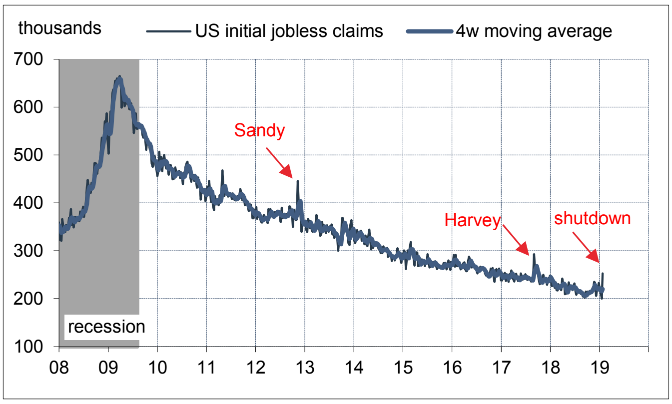
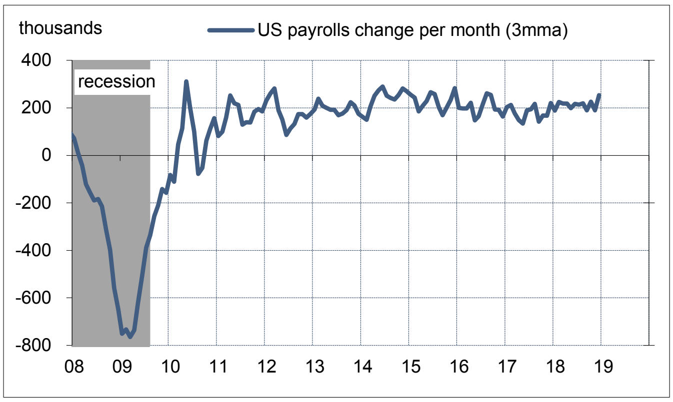
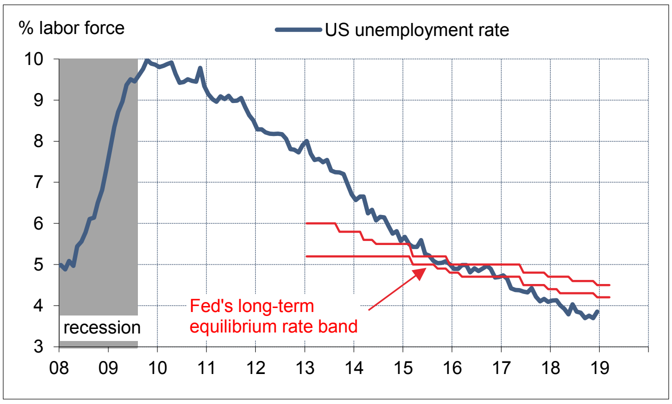
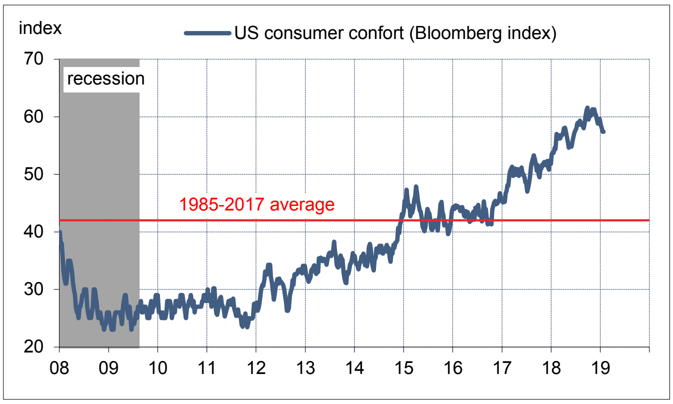
Appendix 1 - Labour market

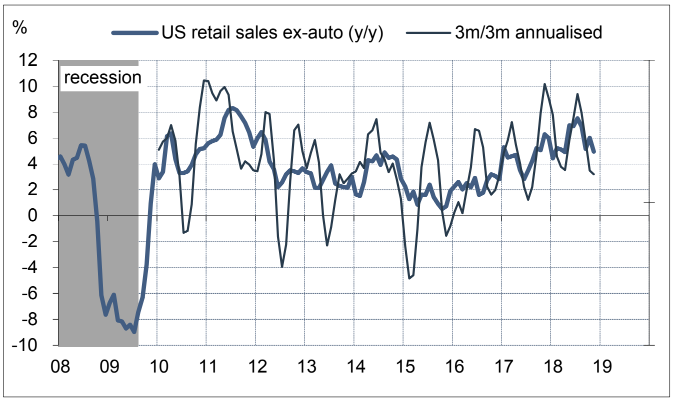


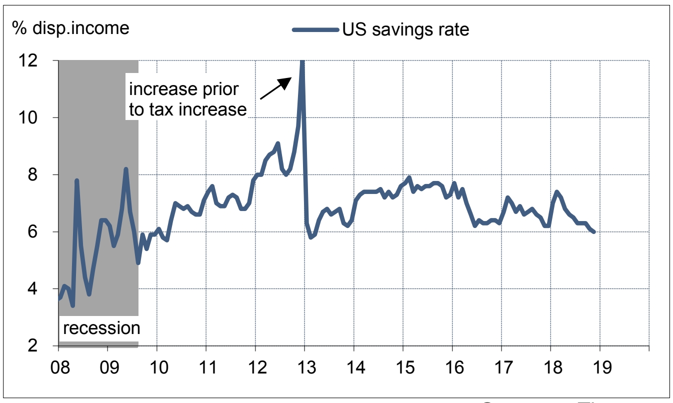


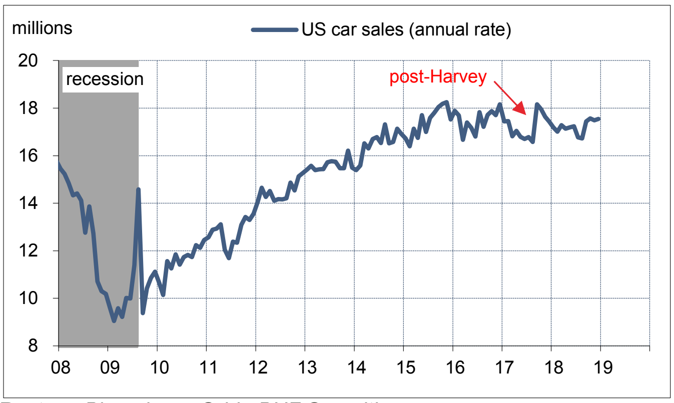


Appendix 2 - Consumer









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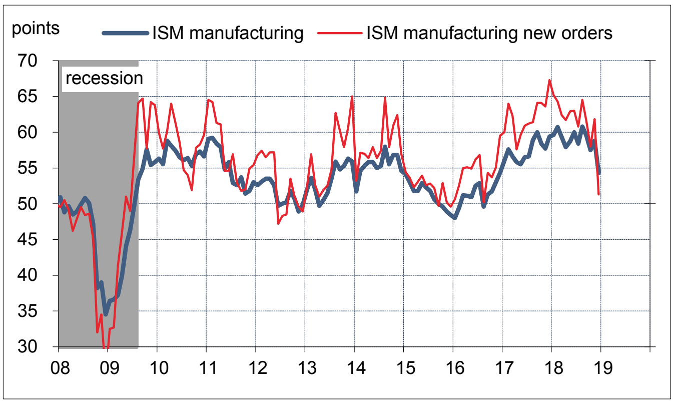
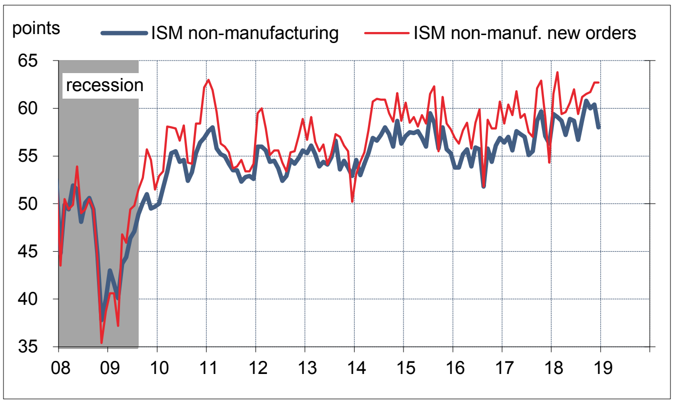
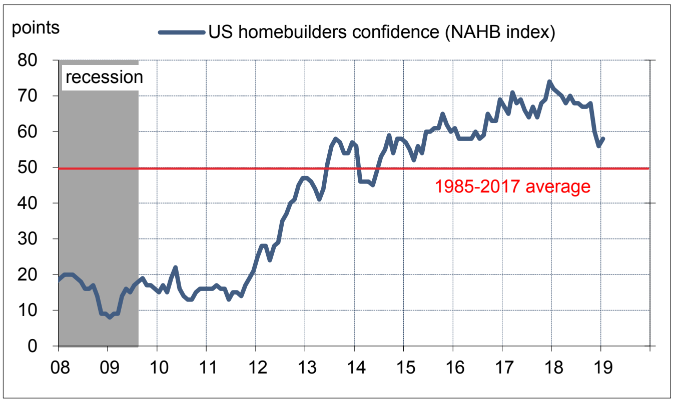
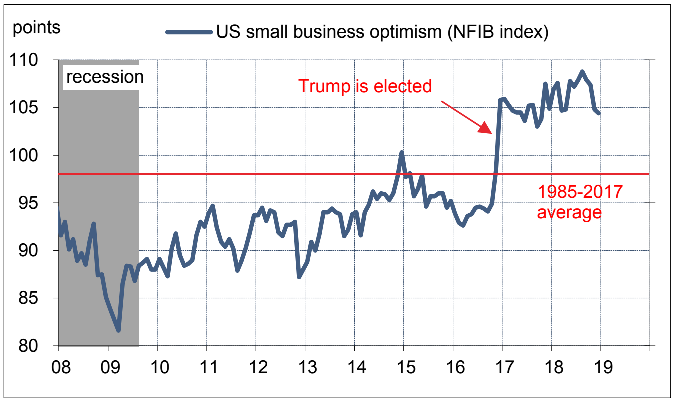
Appendix 3 - Business climate

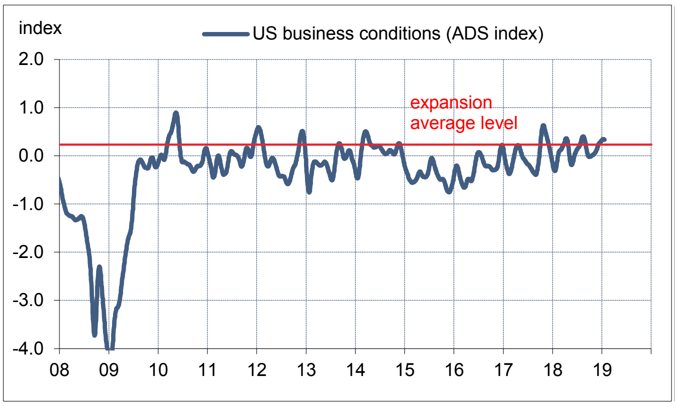


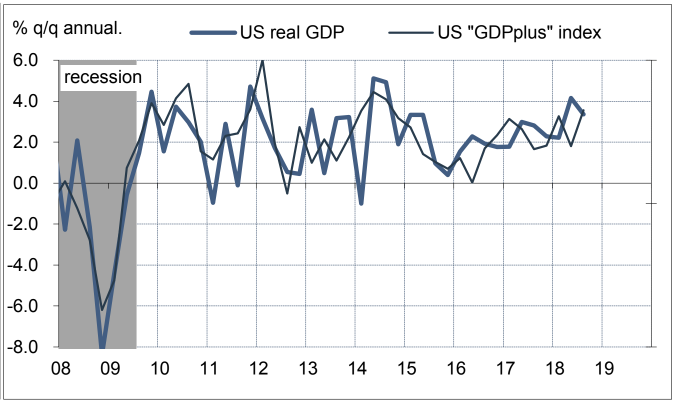


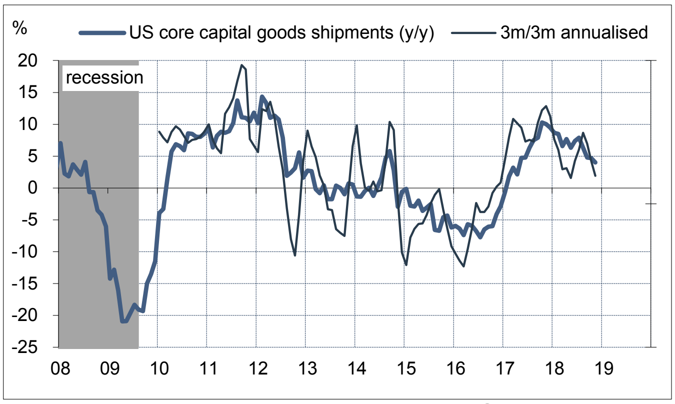


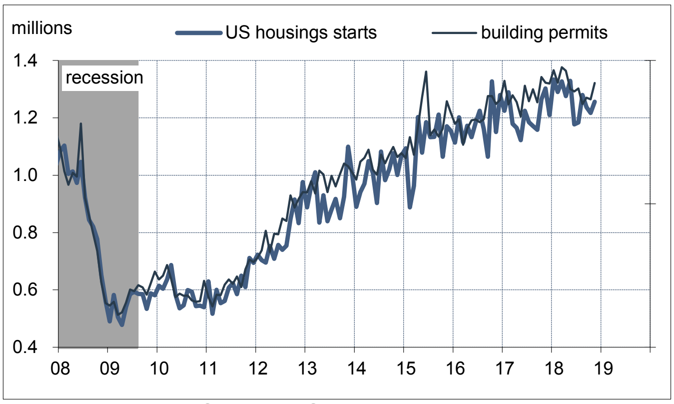


Appendix 4 - Conditions of economic activity









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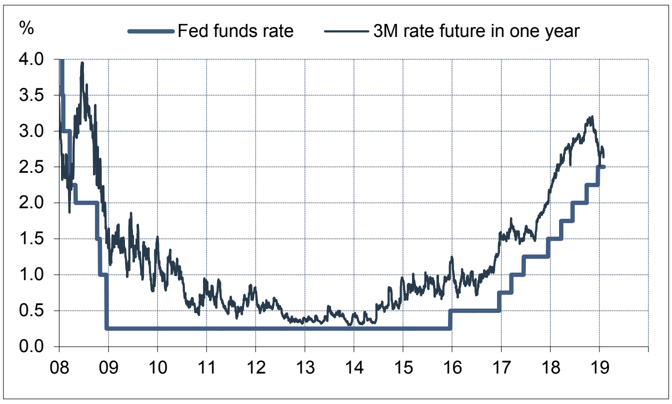
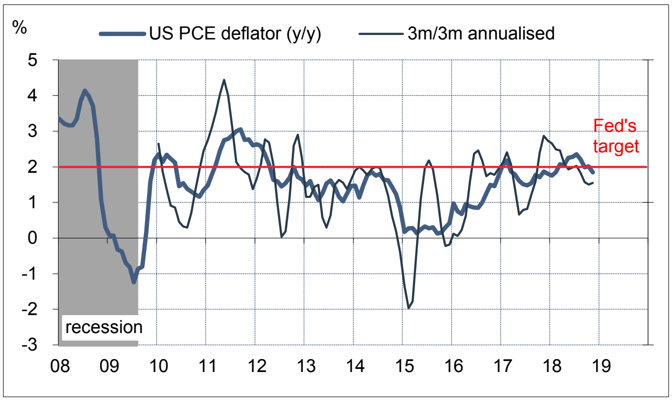
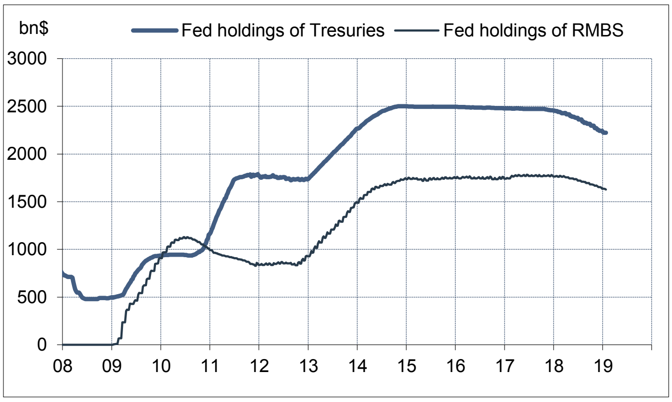
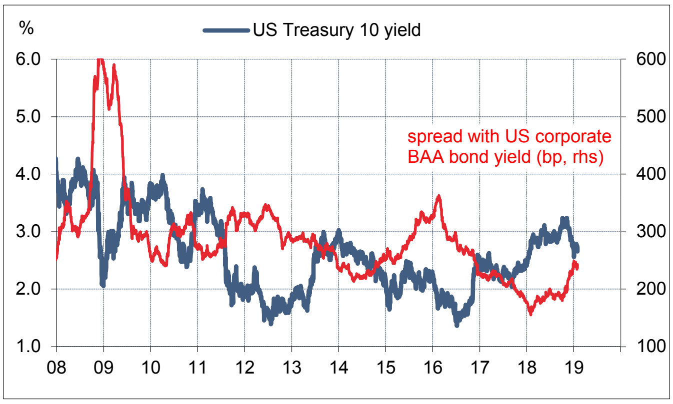
Appendix 5 - Inflation and monetary policy

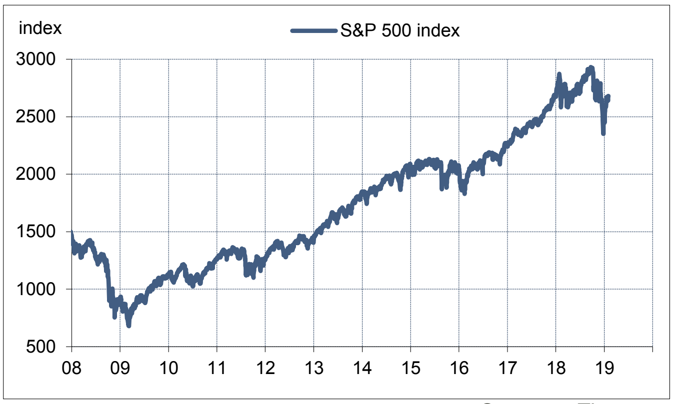






Appendix 6 - Financial markets





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