Basis Points

Weekly Market Commentary

Basis Points – January 29, 2019

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Above the Fold

- Dan Clifton of Strategas Research notes that contrary to popular opinion and media stories, the fiscal stimulus in 2019 will exceed that in 2018. The stimulus coming this spring from larger than normal tax refunds will be a major boost, as will much lower energy prices than consumers paid last year. WSJ reports have questioned the size of coming tax refunds, but Dan feels those notes are misleading at best, and most tax filers will see a larger than expected refund. His numbers show that the tax/gas benefit was $73 billion to consumers in 2018 but looks more like $89 billion in extra stimulus in 2019. A large change to the Alternative Minimum Tax (AMT) will help to fuel tax refunds in the coming months.
- Strategas also notes that recessions are always associated with shocks that drive unemployment up. A rise in unemployment of 0.4 percent or more would be a good signal of coming economic stress, but we have not seen any such upticks so far this cycle. Unless an actual broad-based business decision to fire employees develops, which comes with costs for the companies, a recession remains unlikely.
- Caterpillar shares slid 8 percent after the company reported slower sales and reduced profit expectations for 2019, hurt by slowing growth in China and rising costs. Nvidia stock slid 12 percent, hurt by weaker guidance for the coming quarter. U.S. companies are still expected to report solid growth for the final quarter of 2018, and with results reports so far from roughly a fifth of S&P 500 firms, about 70 percent of corporations have posted better-than-expected earnings so far this reporting season. Big technology companies will weigh in with profit numbers and guidance later this week, including reports from Apple, Amazon, Microsoft and Facebook.

Three Things

- Big Pharma companies are feeling the heat from political corners who want to dramatically change drug pricing in the U.S. and are offering a compromise in

Medicare drug price caps. PhRMA, the drug industry's leading trade group, is considering a proposal that would commit member companies to limiting increases in the prices of drugs purchased by Medicare. The proposal is aimed at persuading the administration to drop its Part B plan, which includes tying Medicare drug prices to those in other countries. The PhRMA idea is to limit drug price increases from exceeding inflation.
- Many energy companies are easing their plans for growth of natural gas production over the next year, amid worries that supplies of gas are outpacing demand and could push gas prices even lower than the depressed level where they sit today. Last week, EQT Corp. and Gulfport Energy became the latest big gas producers to say they will spend less on drilling this year than last year and aim to maintain their present level of output rather than increase it. The announcements represent a major shift in an industry not known for slowing its own growth and follow many energy sector investors who have urged shale drillers to stop boosting production while prices are low.
- The Fed's employment market commentary released last week notes strong labor markets in most Fed districts, noting "Employment increased in most of the country, with a plurality of Districts reporting modest growth. All Districts noted that labor markets were tight and that firms were struggling to find workers at any skill level. Minneapolis indicated that construction firms had turned down business because they could not find workers, and Atlanta reported that a few contacts were either actively overstaffing or retaining employees through lulls in demand in anticipation of future growth."

Did You Know

The Fed board will convene for a two-day meeting Jan. 29-30 and may discuss an end to the program of selling bonds that began in 2017. A change in the pace of bond selling would mark an earlier end to the program than expected and would be seen as a positive step by the financial markets. With interest rate hikes seemingly on hold for now, the Fed's stated plan for its bond holdings will be a closely watched topic at this week's meeting, and each word in its commentary will be important to Fed-watchers.

The job of the Federal Reserve board is not to make financial market investors happy, help support stock prices or to manage market volatility. The Fed's only mandate is to promote economic growth and full employment, with price stability, i.e., low inflation. Managing to these mandates can be a very tricky task, as attempting to influence the massive $19 trillion in annual U.S. economic output can prove to be very complicated.

The Fed may seem as if they have immense power to control financial markets and asset prices, but the Fed board has very limited ways in which to affect economic and monetary policy. For the Fed, influencing the U.S. economy is like piloting a 747 airliner, if the cockpit was bare except for only two levers. The first lever, the level of short-term interest rates, can be moved up or down, depending on the Fed's view of the economy and its need for measures to promote or dial back economic growth.

The second lever is the Fed's balance sheet, or its holdings of government securities. The Fed can add capital to the financial system by purchasing bonds in the open market and holding these bonds on its balance sheet. When bonds are purchased by the Fed, the purchase is paid for with cash that then enters the financial system. If the Fed wants to decrease the total amount of capital sloshing around the financial system, it can then sell these bonds by trading the bonds for cash, thereby taking cash out of the system. The Fed's two levers can influence economic activity in a profound way, but are blunt force instruments that are not always precise tools to use to influence economic stability.

To stimulate the economy after the financial crisis of 2008-09, the Fed vastly increased the amount of bonds that it purchased and held, increasing its holdings from $925 billion in 2008 to a peak of $4.5 trillion in 2017. This large injection of cash into the financial system had the task of supporting asset prices and stimulating the economy. The Fed's large demand for bonds pushed bond prices up and pressured interest rates down, which also had the effect of promoting and stimulating economic growth by keeping interest rates low.

Beginning in mid-2017, the Fed announced a plan to decrease its bond holdings by gradually selling the bonds it holds or by not reinvesting the cash from bonds that matured. The initial plan was to gradually decrease the Fed's bond holdings over many years to about $1.5 trillion. However, the Fed now seems to be considering ending that bond-selling program much earlier than expected. Continued low levels of inflation, changes in their outlook for the U.S. economy and front-page dislocations, such as the trade war with China and the government shutdown, may all be reasons for the Fed to end its bond sales early. The press conference following the Fed meeting's conclusion will be closely watched and Fed chairman Powell's commentary will be heavily parsed for clues as to the Fed's chosen path, so stay tuned.