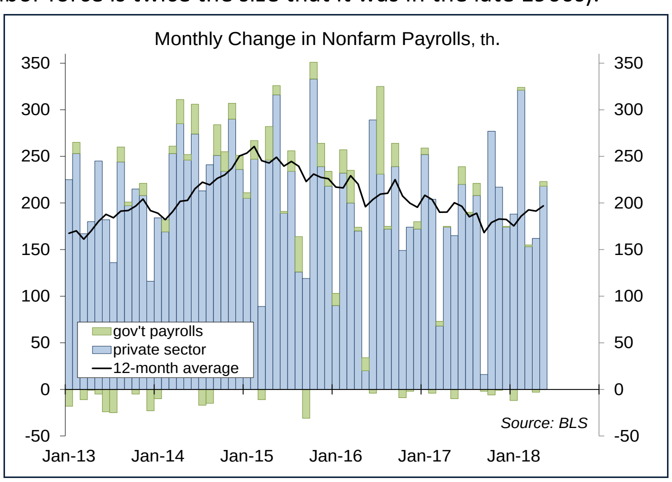
Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com **June 4, 2018**

Weekly Economic Monitor

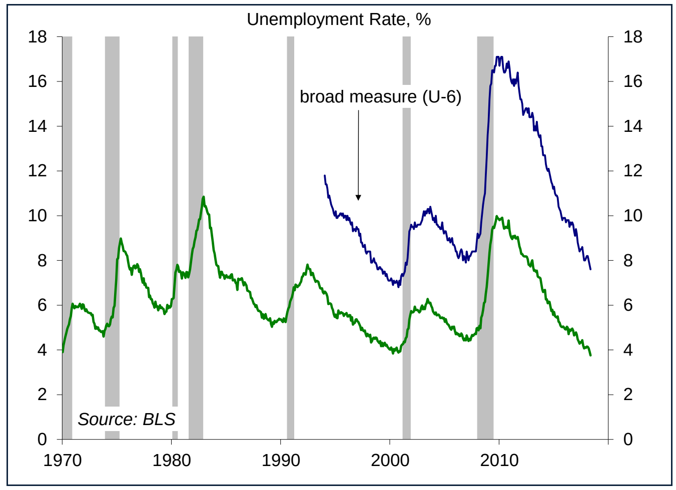
The May Employment Report

Nonfarm payrolls rose by 223,000 in the initial estimate for May, stronger than expected, but not statistically outside of the moderately strong trend of the last year. We need a little less than 100,000 jobs per month to absorb new entrants into the workforce. Hence, it's no surprise that the broad range of data has indicated a further tightening in labor market conditions. The unemployment rate, 3.8% in May, is trending lower. Measures of underemployment are falling. Obviously, that can't go on forever. Wage pressures still appear to be moderate overall, although salary increases are more apparent for skilled labor positions, and we can probably expect faster wage growth in the months ahead. This creates a dilemma for the Fed.

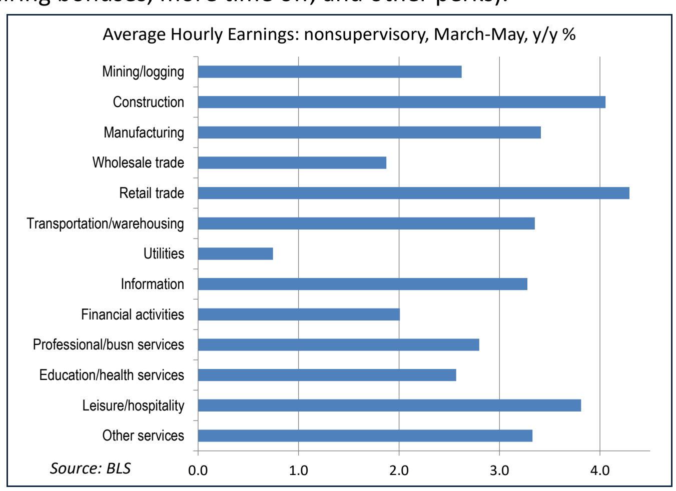
There's always a fair amount of noise in the monthly payroll estimate (as reflected in the chart below). Seasonal adjustment can be tricky, but the underlying trend has remained relatively strong this year. We know that demographic changes (the aging of the population) imply significantly slower growth in the labor force than in past decades (when the baby-boomers were entering, female labor force participation was rising, and immigration was higher). Job growth has to slow as the U.S. runs out of people to hire. That hasn't happened yet, as there appears to have been greater slack than previously thought. Fed officials fear that the unemployment rate has fallen below a level consistent with normal underlying frictions in the labor market. Initial claims for unemployment benefits, for example, have been trending at multi-decade lows (impressive, in that the labor force is twice the size that it was in the late 1960s).



Nobody knows what the natural rate of unemployment is. In the past, unemployment rates of around 4% have been associated with pending recession. That's because the Fed's attempts at slowing the economy typically result in a harder landing than expected. Alternatively, the central bank may have waited too long to tighten and was forced to move more aggressively later on (this is the main argument behind the Fed's current path of gradual rate hikes).



Average hourly earnings are not the best measure of labor costs pressures. However, the trend for production workers is higher in a number of industries that are currently showing strength. The Fed's most recent Beige Book noted that *"shortages of qualified workers were reported in various specialized trades and occupations, including truck drivers, sales personnel, carpenters, electricians, painters, and information technology professionals."* Firms are responding by raising compensation packages (some increase in salaries, but also hiring bonuses, more time off, and other perks).

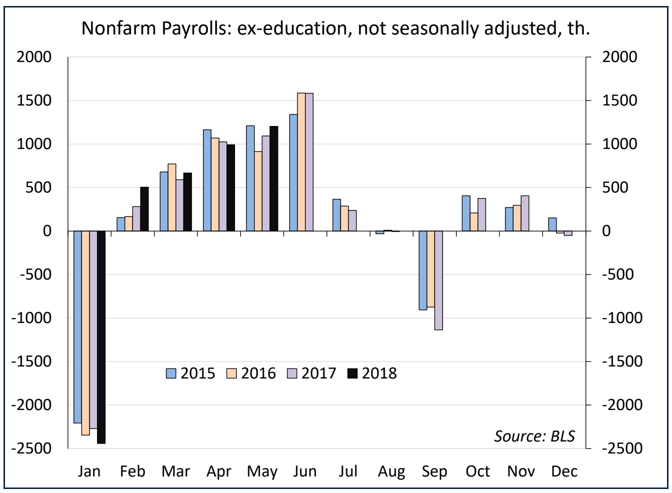


There is an argument for letting the labor market run. Faster wage growth would facilitate a reallocation of labor, further reduce underemployment, increase productivity growth, and create incentives for in-house worker training, fundamentally transforming the economy (as we saw in the late 1990s). For the Fed the key questions are whether firms will be able to pass higher costs along and what the risks are of not acting sooner.

	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
5/04/18	1.84	2.03	2.24	2.51	2.63	2.78	2.95	3.12	1.195	1.354	109.16	1.285	7209.62	2663.42	24262.51
5/25/18	1.91	2.09	2.32	2.55	2.71	2.90	3.06	3.20	1.167	1.332	109.35	1.297	7433.85	2721.33	24753.09
6/01/18	1.91	2.10	2.27	2.48	2.61	2.75	2.90	3.05	1.165	1.335	109.56	1.296	7546.94	2734.62	24635.21

Recent Economic Data and Outlook

The holiday-shortened week included some key economic data releases, but geopolitical developments and trade policy were more important factors. Concerns about Italy led to a drop in share prices worldwide on Tuesday – bond yields fell and the dollar rallied – but the initial reaction appeared overdone and the market bounced back on Wednesday. Increased trade conflict with our allies hit the stock market again on Thursday. Friday's employment figures (for May) were on the strong side of expectations, consistent with further Fed tightening.



The White House let lapse the **Steel and Aluminum Tariff Exemptions** for Canada, Mexico, and the European Union, inviting retaliatory tariffs against U.S. exports.

The Fed's **Beige Book** reported that *"economic activity expanded moderately in late April and early May with few shifts in the pattern of growth."* Manufacturing *"shifted into higher gear with more than half of the districts reporting a pickup in industrial activity and a third classified activity as 'strong.'"* By contrast, *"consumer spending was soft."* Non-auto retail sales growth *"moderated somewhat"* and auto sales were *"flat."* Labor market conditions remained tight across the country, and contacts continued to report difficulty filling positions across skill levels. Many firms responded to talent shortages by *"increasing wages as well as the generosity of their compensation packages."* In the aggregate, however, "wage increases remained modest in most districts."

The May **Employment Report** was stronger than anticipated. Nonfarm payrolls rose by 223,000, with a +15,000 net upward revision to March and April. That left the three-month average at 179,000, roughly the same pace as in 2017 (we need a little less than 100,000 per month to absorb new entrants into the job market). The unemployment rate fell to 3.8% (3.755% before rounding), vs. 4.3% a year ago. The broad measure (U-6), which includes discouraged workers and involuntary part-time workers, fell to 7.6% (vs. 8.4% a year ago). Average hourly earnings rose 0.3% (+2.7% y/y) – the three-month average was up 2.6% y/y (+2.7% for nonsupervisory workers).

Real GDP rose at a 2.2% annual rate in the 2nd estimate for 1Q18 (vs. +2.3% in the advance estimate). Consumer spending growth rose at a 1.0% (vs. +1.1%). Business fixed investment rose 9.2% (vs. 6.1%), with strength concentrated in structures (energy extraction) and intellectual property products – not in business equipment. Inventories and net exports made smaller contributions than in the advance estimate.

Personal Income rose 0.3% in April (+3.8%), with private-sector wages and salaries up 0.4% (+4.9% y/y). Disposable income rose 0.4% (+3.9% y/y), up 0.2% (+1.9% y/y) adjusting for inflation. **Personal Spending** rose 0.6% (+4.7% y/y), boosted partly by a 4.7% rise in gasoline expenditures (+15.8% y/y). Adjusted for inflation, spending rose 0.4% (+2.7% y/y). The **PCE Price Index** rose 0.2% (+2.7% y/y), up 0.2% ex-food & energy (+0.157% before rounding, up 1.8% y/y – vs. the Fed's goal of 2.0%).

The **ISM Manufacturing Index** rose to 58.7 in May, vs. 57.3 in April and 59.3 in March. Growth in new orders, production, and employment picked up. Input price pressures remained elevated. Comments from supply managers were upbeat, but showed concerns about rising input prices and steel tariffs.

The Conference Board **Consumer Confidence Index** rose to 128.0 in the advance estimate for May (vs. 125.6 in April and 127.0 in March). Job market perceptions strengthened further.

The **Bank of Canada** left short-term interest rates unchanged. The BOC noted that "developments since April further reinforce the view that higher interest rates will be warranted to keep inflation near target." However, the BOC "will take a gradual approach to policy adjustments, guided by incoming data."

Economic Outlook (2Q18): 2.5-3.0% GDP growth.

Employment: Job growth has remained strong, but the pace should slow as the job market continues to tighten.

Consumers: Real wage growth remains soft on a year-over-year basis. Credit remains easy, except at the low end.

Manufacturing: Sentiment remains strong, but the pace of improvement is likely to moderate in the near term.

Housing/Construction: Job growth has been supportive, but supply constraints and affordability remain key issues.

Prices: Core inflation is trending closer to the Fed's 2% goal. Pipeline pressures remain somewhat elevated, but are not a major threat to the consumer inflation outlook. Wage pressures are moderate, but trending gradually higher.

Interest Rates: The Fed remains in tightening mode, and is expected to continue gradually raising short-term rates. The increase in government borrowing is likely to add some upward pressure on bond yields. Balance sheet reduction is viewed as "background" and should not be disruptive for the markets.

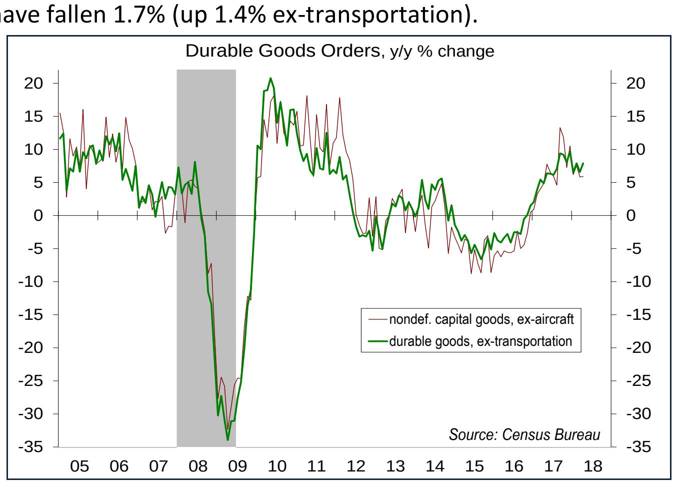
This Week:					forecast	last	last –1	comments
Monday	6/04	10:00	Factory Orders	Apr	*-0.6%*	+1.7%	+2.0%	lower aircraft orders
Tuesday	6/05	10:00	**ISM Non-Manf. Index**	May	***57.5***	56.8	58.8	moderately strong
Wednesday	6/06	8:30	NF Productivity (revised)	1Q18	*+0.6%*	+0.3%	+2.6%	+0.7% in the preliminary estimate
			Unit Labor Costs		*+2.8%*	+2.1%	+1.0%	+2.7% in the preliminary estimate
		8:30	Trade Balance, $bln	Apr	*-48.9*	-49.0	-57.7	seen about steady (down from 1Q18)
			goods only		*-69.3*	-69.5	-77.0	little changed in the advance estimate
Thursday	6/07	8:30	Jobless Claims, th.	6/02	*225*	221	235	subject to holiday-week noise
Friday	6/08		no significant data					
Next Week:								
Monday	6/11	11:30	Treasury Note Auction					3-year notes
		1:00	Treasury Note Auction					re-opened 10-year notes
Tuesday	6/12	6:00	Small Business Optimism	May	*NF*	104.8	104.7	still strong
		8:30	**Consumer Price Index**	May	***+0.2%***	+0.2%	-0.1%	seasonal adjustment tempers gasoline ↑
			year-over-year		*+2.6%*	+2.5%	+2.4%	higher y/y due mostly to gasoline
			ex-food & energy		***+0.2%***	+0.1%	+0.2%	moderate
			year-over-year		*+2.2%*	+2.1%	+2.1%	likely a bit higher
		8:30	Real Hourly Earnings	May	*+0.1%*	0.0%	+0.3%	nominal earnings rose 0.298%
			year-over-year		*0.0%*	+0.2%	+0.3%	a weak trend
		1:00	Treasury Bond Auction					30-year bonds
Wednesday	6/13	7:45	ECB Policy Decision					no change
		8:30	Producer Price Index	May	*+0.4%*	+0.1%	+0.3%	higher gasoline prices
			ex-food & energy		*+0.2%*	+0.2%	+0.3%	moderate
			ex-f, e, & trade services		*+0.3%*	+0.1%	+0.4%	choppy, but a moderate trend
		2:00	**FOMC Policy Statement**					another 25-bp increase is factored in
		2:00	**Summary of Econ Proj.**					new dot plot
		2:30	**Powell Press Conference**					looking for hints on the future pace
Thursday	6/14	8:30	Jobless Claims, th.	6/09	*225*	*225*	221	a low trend
		8:30	Import Prices	May	*NF*	+0.3%	-0.2%	higher petroleum prices
			ex-food & fuels		*NF*	+0.2%	+0.1%	a milder trend more recently
		8:30	**Retail Sales**	May	***+0.4%***	+0.3%	+0.8%	moderate
			ex-autos		***+0.5%***	+0.3%	+0.4%	higher gasoline prices
			ex- autos, bld mat, gasoline		***+0.4%***	+0.3%	+0.6%	moderate, but better in 2Q18
		10:00	Business Inventories	Apr	*+0.3%*	-0.1%	+0.6%	the advance retail figure rose 0.6%
Friday	6/15	9:15	**Industrial Production**	May	***+0.6%***	+0.7%	+0.7%	strong
			Manufacturing Output		***+0.3%***	+0.5%	0.0%	aggregate hours fell 0.3%
			Capacity Utilization		*78.4%*	78.0%	77.6%	trending higher
		10:00	UM Consumer Sentiment	m-Jun	*98.2*	98.0	98.8	seen little changed

This Week…

The economic calendar is thin. Trade policy and geopolitical developments will remain key drivers for the financial markets.

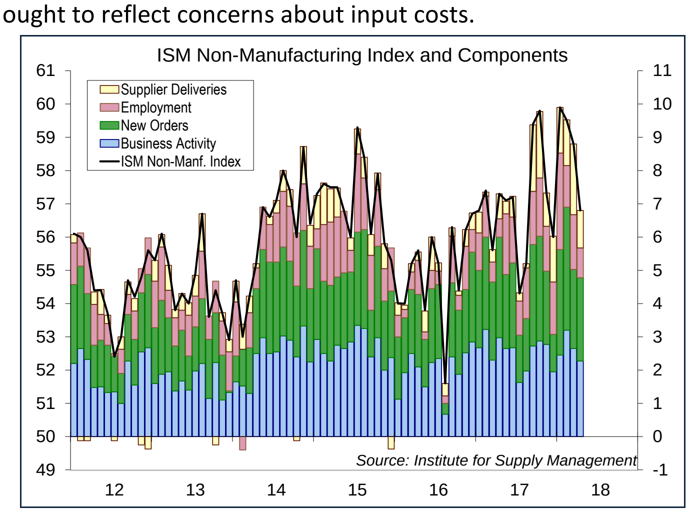
Monday

Factory Orders (April) – Durable goods orders were reported to have fallen 1.7% (up 1.4% ex-transportation).



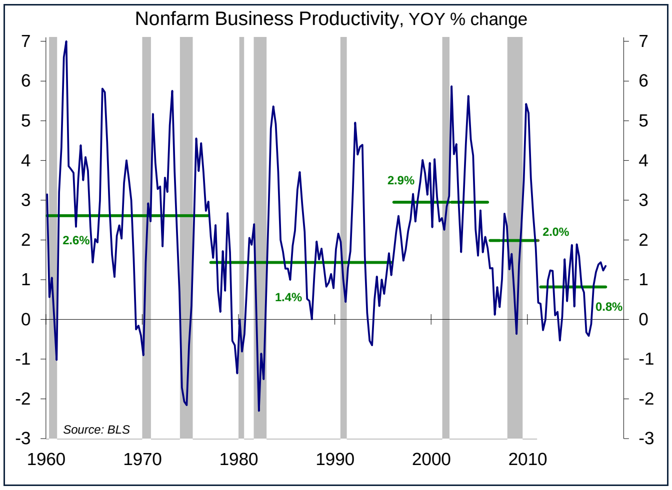
Tuesday

ISM Non-Manufacturing Index (May) – The non-manufacturing survey is likely to reflect relatively strong conditions. Watch new orders and employment. Comments from supply managers ought to reflect concerns about input costs.

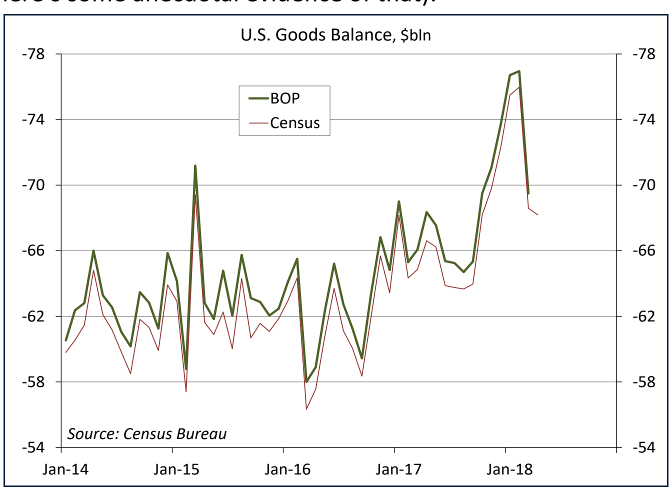


Wednesday

Nonfarm Productivity (1Q18, revised) – The estimate of nonfarm business GDP growth was revised slightly lower, implying a bit lower pace of productivity growth in the first quarter. In turn, the estimate of Unit Labor Costs, the key measure of inflation pressure in the labor market, will be slightly higher. The quarterly figures tend to be erratic, but there's no evidence of a significant improvement in output per worker.

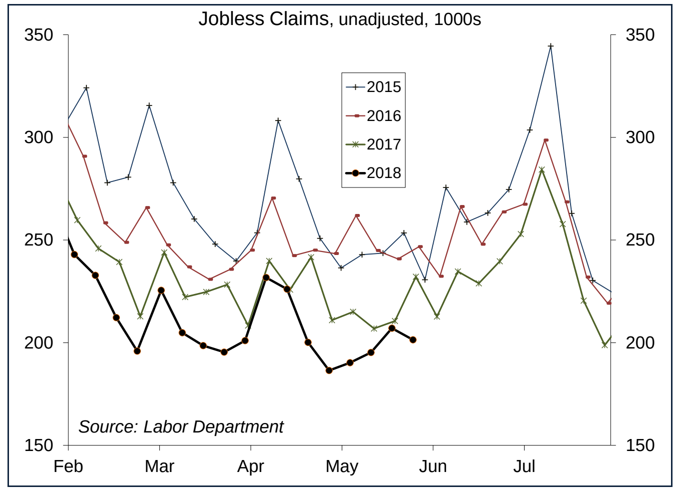


Trade Balance (April) – The advance trade figures showed little change in the merchandise trade deficit in April. The deficit ran up sharply into 1Q18. We only have one month for the second quarter (which is subject to revision), but it looks like net exports will make a positive contribution to 2Q18 GDP growth. Merchandise exports were reported to have fallen 0.5% in the advance estimate (+10.3% y/y). Merchandise imports fell 0.5% (vs. +7.4% y/y). It's unclear to what extent trade activity may have picked up in recent months as firms attempted to get ahead of possible tariffs and supply chain disruptions (and there's some anecdotal evidence of that).



Thursday

Jobless Claims (week ending June 2) – Seasonal adjustment become more difficult, following the Memorial Day holiday, largely reflecting the end of the school year. Unadjusted claims continue to trend below year-ago figures, consistent with a further tightening in overall labor market conditions.



Friday

No significant data.

Next Week …

The Federal Open Market Committee is widely expected to raise short-term interest rate another 25 basis points, bringing the federal funds target range to 1.75-2.00%. For investors, the key question is what the pace will be in the remainder of the year. We'll get a new dot plot, which the markets have tended to misinterpret. As we saw in March, the dots (the individual forecasts of senior Fed officials of the appropriate year-end federal funds rate) are likely to vary – and there's information in that dispersion. Instead, the financial press has stressed the median (middle point) of the dots. Ultimately, future Fed policy decisions will remain "data-dependent," and Chair Powell can be expected to reaffirm that in his post-meeting press conference. Powell should address the notion of "neutral" policy and whether there may be a need to move above that for a while. There's also the question of how much the Fed will tolerate inflation above 2% (which is important for reaffirming 2% as a target, rather than a ceiling).

While the May Consumer Price Index will be reported ahead of the Fed's decision, the more important data releases (Retail Sales, Industrial Production) come after. The Beige Book (based on information collected on or before May 21) noted that *"consumer spending was soft"* in late April and early May, while *"manufacturing shifted into a higher gear."*

Coming Events and Data Releases

June 19	Building Permits, Housing Starts (May)
June 27	Durable Goods Orders (May)
July 2	ISM Manufacturing Index (June)
July 4	Independence Day (markets closed)
July 6	Employment Report (June)
August 1	FOMC Policy Decision (no press conf.)
September 26	FOMC Policy Decision, press conf.
November 6	Election Day