MARS CAPITAL PARTNERS

Weekly Macro Review

w/c 22 October 2018

Key Themes

Fed speakers addressed whether it is time for a pause in interest rate increases given current market volatility, some weaker earnings outlook going into 2019 and weaker housing/auto sales. Fed outlook was always for more ‘moderate’ growth going into 2019, especially as fiscal stimulus waned. Unless employment and inflation indicators turn lower than forecasts, Fed unlikely to change course. Yet, the probabilities for another rate hike in Dec have fallen over the last week.

Most data this week pointed to continued strength in US economy, but some ongoing weakness in housing and weaker private investment figures in the GDP report. Chicago Fed National Activity Index has the economy still expanding above the historical average. Prelim PMI’s for Oct indicated improved momentum, especially in the domestic economy, but ‘export activity stagnating’. Durable goods remained strong on the back of defense and non-defense transport manufacturing – ex transport, new orders grew by a much small 0.1%. US Q3 GDP growth slowed somewhat – weakness in net export growth and private fixed investment was offset by growth in inventories and continued growth in personal consumption expenditure. Of note was the slowdown in the growth of the core PCE price index for Q3 – slowing from +2.2% in Q2 to +1.6% in Q3 (annualised rates of growth).

Weakness in some Eurozone data appears to be persisting, with the notable slow-down in Eurozone and German prelim PMI’s. Watching for confirmation in ‘hard data’. For example, Eurozone and German industrial production (reported two weeks ago for Aug) showed declines had stabilized.

The ECB kept rates on hold – no change to policy measures. Draghi see’s current European data reflecting ‘weaker momentum, not a downturn’ and weakness likely to be transitory.

Japan prelim manufacturing PMI showed a solid improvement, especially with new export orders growing for the first time since May.

The Bank of Canada increased its overnight rate to 1.75%.

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US Data - Chicago Fed National Activity Index (Sep), Richmond Fed Manufacturing Index (Oct), Prelim Composite PMI (Oct), Durable Goods Orders (Sep), Kansas City Manufacturing Index (Oct), Pending Home Sales (Sep), GDP Q3

US Fed Speeches –Bostic, Kashkari, Kaplan, Mester

Europe - German Prelim Composite PMI (Oct), Eurozone Composite PMI (Oct), ECB Rates Decision, ECB Draghi Speech

Japan – Prelim Manufacturing PMI (Oct)

United Kingdom – Brexit

Canada – BoC Interest Rate Decision and Statement

Australia – Auction Clearance Rates for the weekend of 27 Oct 2018

Trade – US-China trade negotiations, NAFTA/USMCA, US-Japan trade negotiations, Section 232 Car and Truck Imports, US-Europe trade negotiations.

US Data

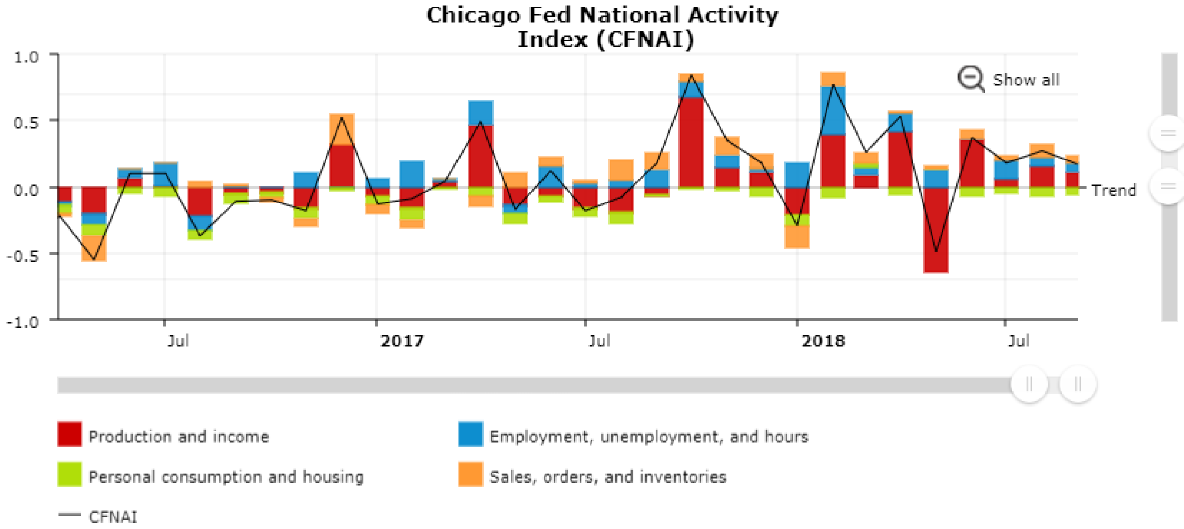
Chicago Fed National Activity Index (CFNAI) (Sep)

The Chicago Fed National Activity Index was lower in Sep;

Sep 0.17 versus Aug 0.27

Readings above zero are associated with the economy growing above the historical average.

The overall trend has been slower expansion throughout 2018;



On the sub-indexes;

Production and Income; growth slowed; Sep 0.11 versus Aug 0.16

Employment, unemployment and hours was mostly unchanged; Sep 0.07 versus Aug 0.06

Personal Consumption and Housing continued to grow at below the long-term average; Sep -0.05 versus Aug -0.06

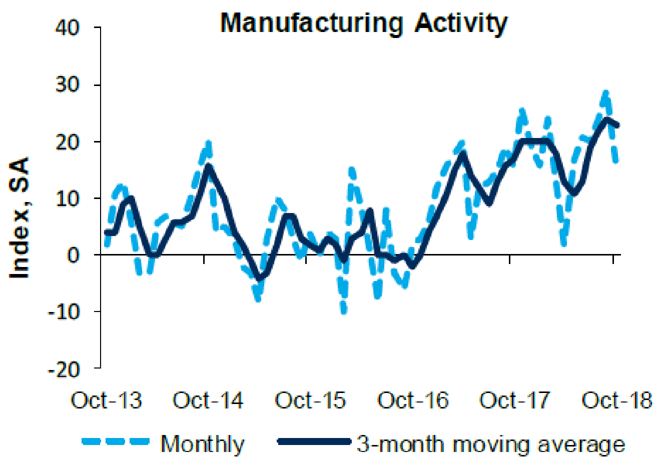
Sales, Orders and Inventories slowed; Sep 0.5 versus Aug 1.0

https://www.chicagofed.org/research/data/cfnai/current-data

Richmond Fed Manufacturing Activity Survey (Oct)

Manufacturing activity grew at a slower pace in the latest month, with the headline index of activity falling;

Oct 15 versus Sep 29



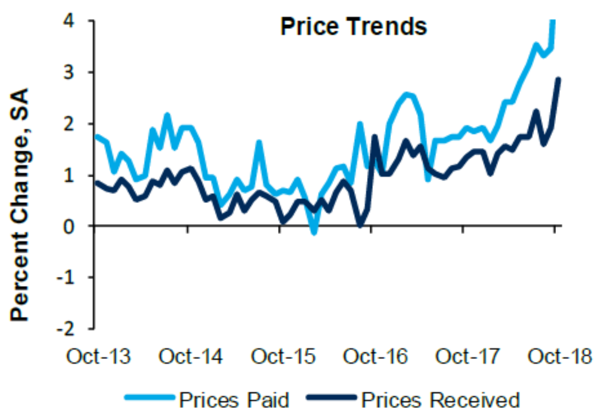
The shipments index fell the most, indicating slower growth; Oct 7 versus Sep 33. The expectations for shipments in the next six months increased.

The volume of new orders also fell from the high of the prior month (which was the second highest reading for new orders in the data history); Oct 20 versus Sep 34

The backlog of orders also fell back to more average levels.

The number of employees expanded at a faster rate; Oct 19 versus Sep 16. Growth in wages and the average workweek slowed somewhat. The availability of skills needed fell further into contraction; Oct -22 versus Sep -11.

Prices paid continued to accelerate higher. Prices received also grew at a faster pace;

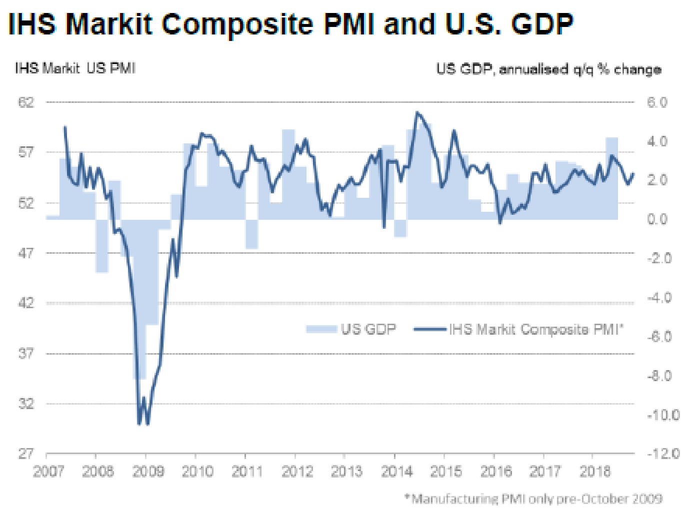


https://www.richmondfed.org/research/regional_economy/surveys_of_business_conditions/manufacturing/2018/mfg_10_23_18

US Prelim Composite PMI (Oct)

The headline preliminary composite PMI showed private sector activity expanded at a faster pace – both services and manufacturing grew at a faster pace;

Oct 54.8 versus Sep 53.9



Sources: IHS Markit, U.S. Bureau of Economic Analysis.

Prelim Services PMI

Oct 54.7 versus Sep 53.5

This result follows on from the rebound in Sep. New orders grew at a faster pace leading to further increases in backlogs of work. Employment grew at a slower pace. Costs increased at a faster pace – due to tariffs, fuel and higher borrowing costs.

Prelim Manufacturing PMI

Oct 55.9 versus Sep 55.6

Faster growth in new business and employment offset the slow-down in production growth.

Continued deterioration in vendor performance – stock shortages and demand for inputs. Reports of spikes in purchasing due to tariff uncertainty led to manufacturing supply chain pressure.

> "The domestic economy remained the main driver of demand, with exports stagnating amid growing signs of trade being subdued by tariffs".

https://www.markiteconomics.com/Survey/PressRelease.mvc/2b33e7aa54804c71a1677063ee811f10

Durable Goods – Monthly Advance Report on Manufacturers New Orders, Shipments and Inventories (Sep)

All parts of the durable goods report continued to grow in the latest month. New orders and shipments remain heavily influenced by large transport orders – for both defense and non-defense goods. Growth in durable goods new orders ex transport remains almost flat v last month.

New Orders

Continued to increase in Sep but growth was lower than Aug partly due to transport orders that were filled and shipped.

Total durable goods new orders; Sep +0.8% versus Aug +4.6%

Ex transportation; Sep +0.1% versus Aug +0.3%

The total growth in new orders of $1.9b was still mostly driven by transport new orders of +$1.8b. Within transport, the big increase came from new orders of defense aircraft and parts of +$6.3b in Sep.

Shipments

Increased at a faster rate in Sep due to slightly higher growth in shipments of transport goods.

Total durable goods shipments; Sep +1.3% versus Aug +0.9%

Ex transportation; Sep +0.3% versus Aug +0.1%

Total shipments grew by +$3.3b in Sep of which transportation was $2.9b – this was mostly non-defense aircraft and parts.

The increase in new orders for defense aircraft and parts will likely show up in shipments over the next few months.

Unfilled Orders

The change in unfilled orders remained on par with the prior month – this was mostly due to growth in unfilled orders for defense aircraft and parts

Total durable goods; Sep +0.8% versus Aug +0.9%

Ex defense; Sep +0.1% versus Aug +0.5%

Total unfilled orders increased by $9.4b in Sep, of which transport was $7.9b – within transport unfilled orders for defense aircraft and parts was $6.9b.

Inventories

Increased after last months decline. The increase was mostly led by an increase in inventories for non-defense aircraft and parts.

Total durable goods; Sep +0.7% versus Aug -0.2%

Ex transport and Ex defense; changes in inventories were on par with the total change in inventories.

Total inventories increased by $2.8b versus a decline of $0.7b in the month prior. The big change in total inventories for the month was in non-defense aircraft and parts of +$1.2b – this will likely continue to flow through to unfilled orders/shipments in the following month/s.

Inventory changes in other durable goods categories were not as big but were in line with the change in the prior month (possibly pointing to a continued level of growth in new orders). Of note;

Computers and electronic products; inventories +0.8% versus -0.2% Aug. Annual growth in inventories is +2% running well below the total durable goods average of +4.7%.

Primary metals inventories up +10% on a year ago and fabricated metal products inventory +9% on a year ago (where as total inventories +4.7% versus a year ago).

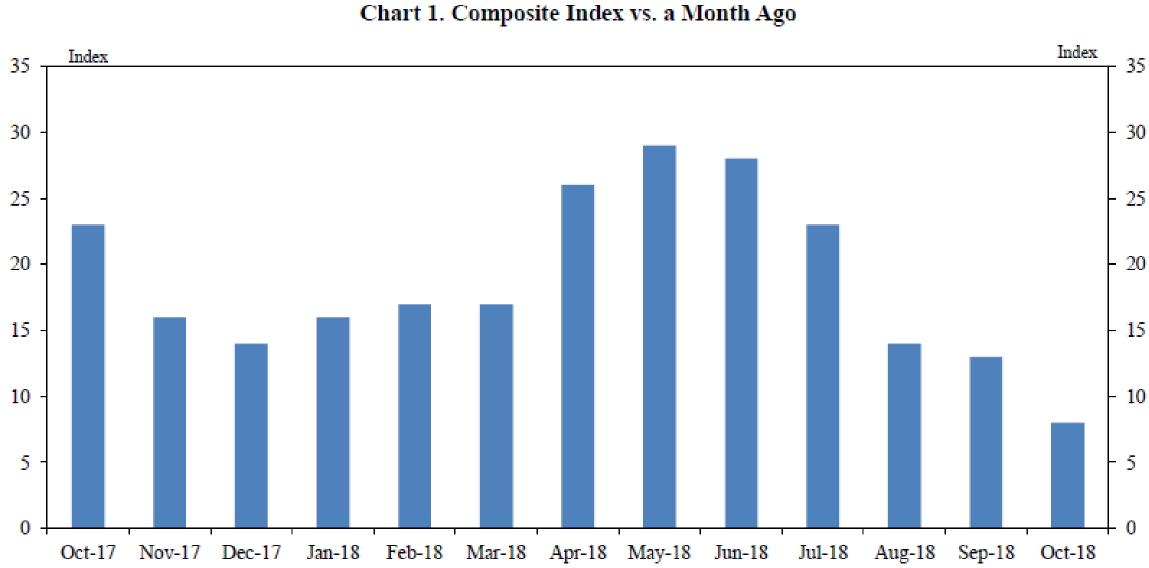
https://www.census.gov/manufacturing/m3/index.html

Kansas City Fed Manufacturing Survey (Oct)

The headline index of manufacturing activity indicated growth continued to slow in the latest month;

Oct 8 versus Sep 13

> The decline in factory growth was driven by slower expansion at durable goods plants, especially for machinery, computer and electronic products, and transportation equipment, while activity at nondurable goods plants increased.



Production and the volume of new orders grew at a slower pace. The volume of new orders peaked back in May at 38 and has slowed to a reading of 7 in Sep.

The volume of shipments grew at a faster pace.

The number of employees grew at a slightly faster pace and the average workweek remained unchanged.

Growth in price paid and prices received both slowed in Oct.

Expectations for overall manufacturing activity in six months grew at a slightly slower pace but remains elevated. Of note was the slow-down in capex – falling from 36 in Sep to 14 in Oct – the lowest reading of the last 12 months.

https://www.kansascityfed.org/~/media/files/publicat/research/indicatorsdata/mfg/2018/2018oct25-mfg.pdf?la=en

US Pending Home Sales (Oct)

According to the NAR, pending home sales leads existing home sales by a month or two.

In the latest month, pending home sales increased by +0.5% - suggesting some stabilisation to the recent declines. On an annual basis though, pending home sales declined 1%.

On a regional basis;

Northeast -0.4% in Sep and -2.7% versus year ago

Midwest +1.2% in Sep and -1.1% versus year ago

South -1.4% in Sep and +3.3% versus year ago

West +4.5% in Sep and -7.4% versus year ago.

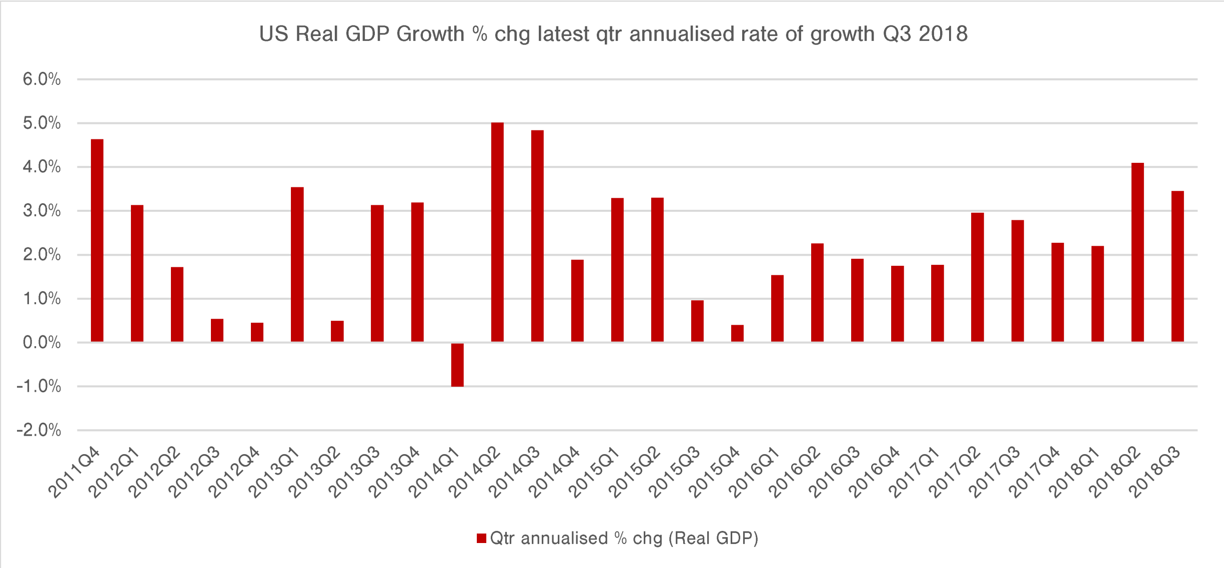
https://www.nar.realtor/research-and-statistics/housing-statistics/pending-home-sales

US Q3 GDP Growth

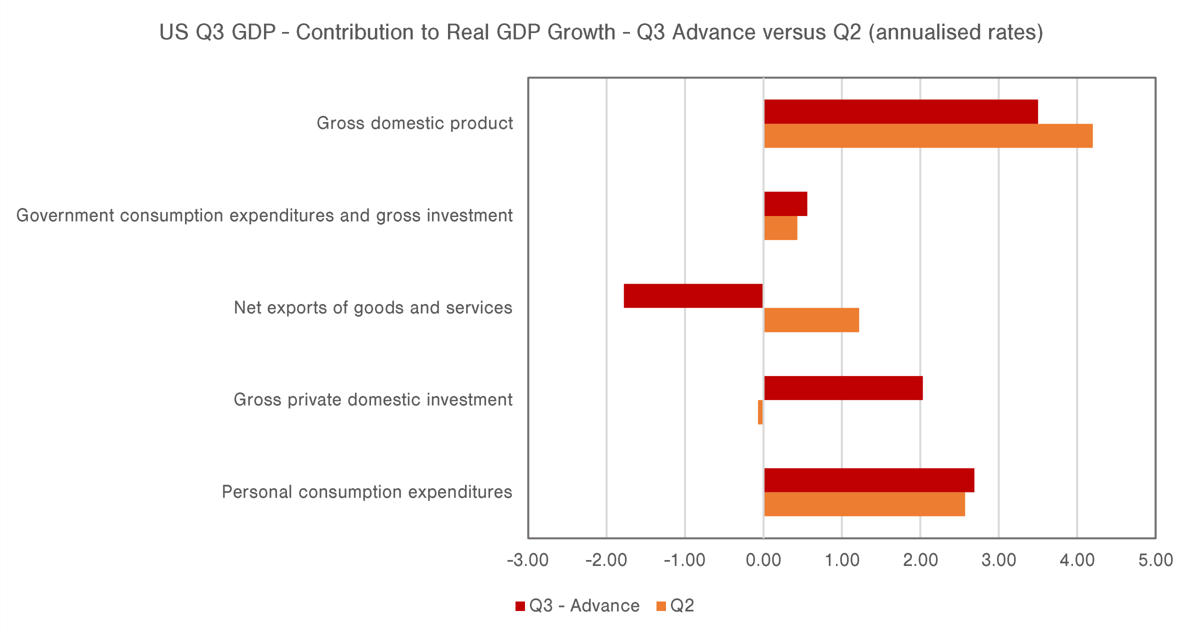
On an annualised basis, US real GDP growth for Q3 slowed slightly versus the quarter prior.

In the latest quarter weakness in private fixed investment and net exports were offset by a higher contribution to growth from inventories and continued strength in personal consumption expenditure.

Q3 2018 +3.5% versus Q2 +4.1% (annualised rates)

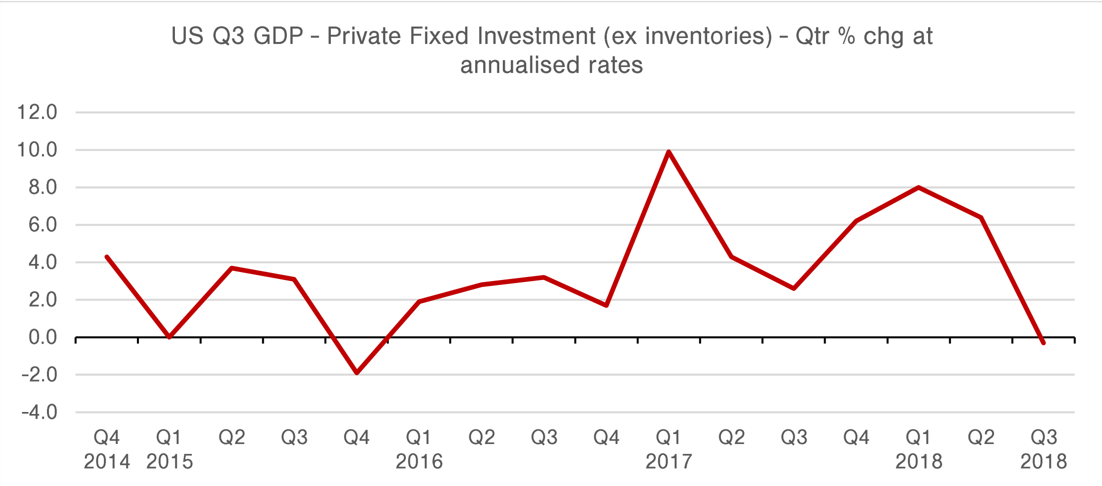


Growth slowed slightly in the latest quarter mostly due to net exports which detracted from growth in Q3. This was offset by some degree by faster growth across personal consumption expenditure, gross private investment (inventories) and government consumption expenditure and gross investment;



Personal Consumption Expenditure – made a slightly larger contribution to growth in Q3 versus Q2. The annualised growth in Q3 was 4% - the strongest result since Q4 2014. Both goods and services contributed to the acceleration in PCE growth in Q3.

Gross private domestic investment - made a positive contribution to GDP growth in the latest quarter of +2.03%pts. **This was driven entirely by a much higher contribution to growth from inventory of +2.07%pts** (highest since Q1 2015). The fixed investment component declined in Q3 by -0.3% (detracting a -0.04%pts from overall growth).

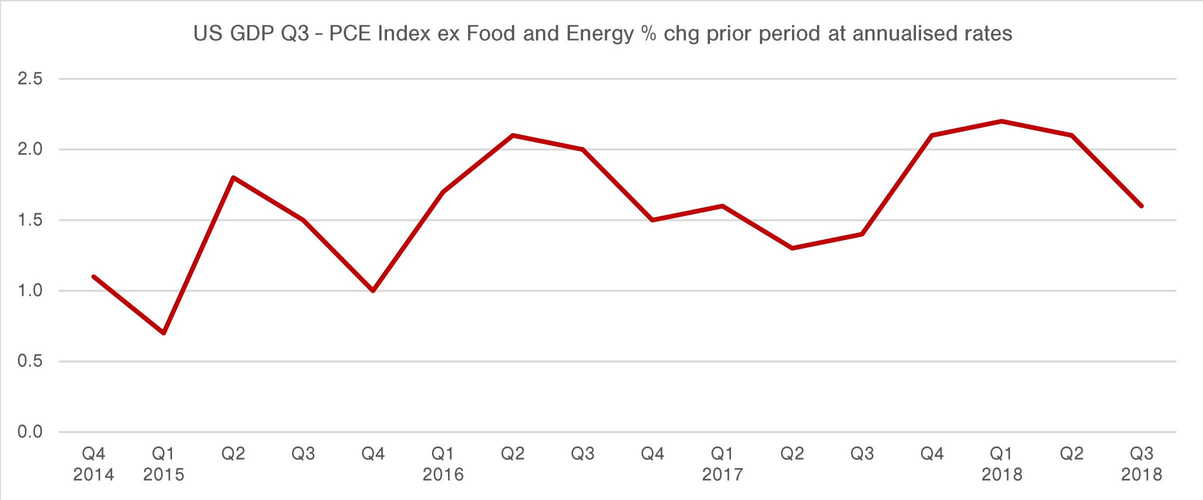


Growth either slowed or declined across most categories of private investment (versus the prior qtr). The largest declines were non-residential structures (-7.9%) and residential fixed investment (-4%). This was the third quarter in a row where residential fixed investment spending declined.

Net exports detracted from growth in the latest quarter -1.78%pts. This was the result of a decline in exports of -3.5% (at annualised rates, versus +9.3% in Q2) and an acceleration in the growth of imports to +9.1% (from -0.6% in Q2).

Government consumption and investment expenditure made a slightly higher contribution to growth in the latest quarter. The contribution of Federal spending was slightly lower which was offset by an increase in the contribution from state and local consumption and investment expenditures.

PCE Price Index – ex food and energy slowed considerably in the latest quarter to +1.6% versus +2.2% in Q2.



https://www.bea.gov/data/gdp/gross-domestic-product

US Fed Speeches

Raphael Bostic, President and CEO Atlanta Fed – Business Roundtable Louisiana 23 Oct 2018

> "one thing seems clear: there is little reason to keep our foot on the gas pedal"

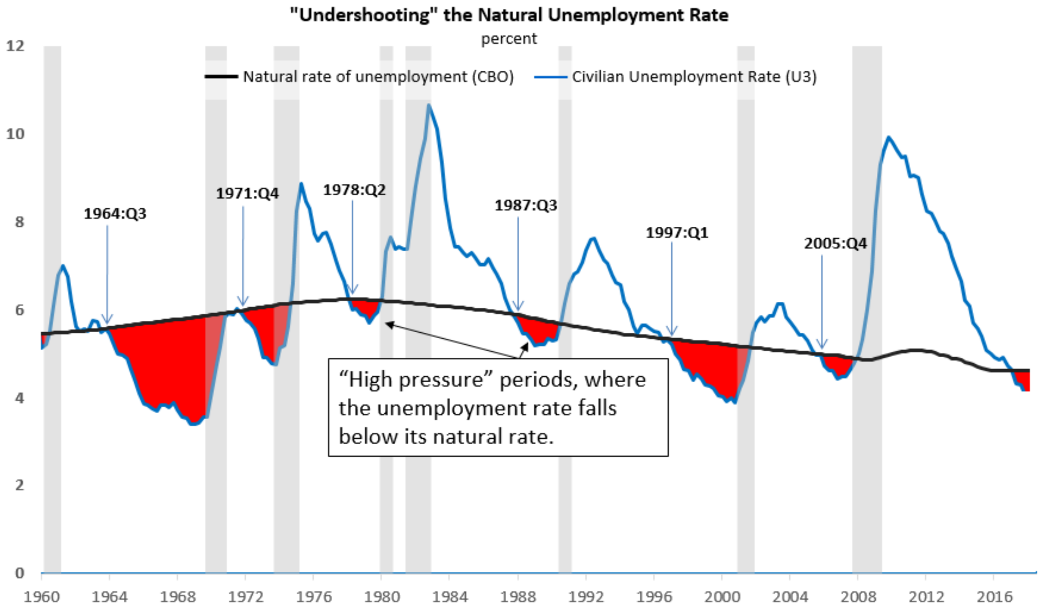
Provides a view of the Fed policy path – monetary policy has not yet reached the neutral stance. Still a few hikes away. Gradual hikes to ensure that the economy is on a sustainable path (avoiding a build-up of excesses).

Wants to avoid the 'high pressure' growth periods (growth beyond full employment). Research shows that the ST benefits of bringing under-attached workers back into the workforce during these 'high pressure' periods are not durable –

> the pain and dislocation associated with the aftermath of the subsequent recession is just as significant, if not more so.

The chart below highlights the spikes in unemployment that follow the periods where unemployment falls below its 'natural rate';

A picture worth thinking about.



Sources: Bureau of Labor Statistics; Congressional Budget Office (CBO)

Believes economic growth on a strong trajectory – revised up 2018 and 2019 projections

At the same time, firms have not yet seen a persistent pick-up in demand beyond their current capability to meet that demand. Business investment to remain at a moderate pace.

> Businesses have yet to suggest that uncertainty regarding tariffs and trade policy has significantly changed their plans for employment, sales revenue, or capital spending.

On tariffs – potential for tariffs to affect cost of production and upside risk to the inflation outlook.

Bostic also makes the comment that "strength in consumer spending has been in services and non-durables, not in goods associated with long term commitments".

Minneapolis Fed President Kashkari wrote an op-ed arguing for the Fed to keep its foot on the gas pedal. Need to see more growth in the labour force (participation) and wages growth. https://www.wsj.com/articles/pause-interest-rate-hikes-to-help-the-labor-force-grow-1540507735?mod=searchresults&page=1&pos=2

Dallas Fed President Kaplan Interview (Bloomberg) – Cost input pressures (labour, steel, aluminium) weighing on corporate margins, firms "struggling" with the ability to pass on higher costs, consistent story from corporates in his region. Is this a good enough reason for a pause in rate increases? Housing and auto lending weak for last few months, not ready to say it's an indicator of overall slowing but watching it carefully. Earnings signalling weaker outlook to growth going into 2019. Changed forecast? Always thought 2018 was going to be strong based on substantial fiscal stimulus. 2019 & 2020 were always going to be more moderate in growth as fiscal stimulus wears off and still facing headwinds of aging population.

https://www.bloomberg.com/news/videos/2018-10-26/fed-s-kaplan-expects-moderation-of-growth-as-fiscal-stimulus-wanes-video

Cleveland Fed President Mester interview (CNBC) – In context of current financial market volatility; Fed looks at the medium-term horizon view of economy. Currently, market participations reassessing risk and looking to see how strong momentum in the economy really is. The current market volatility is 'natural', monitoring it, but markets behaviour orderly. Its possibly a risk to the outlook but not something that has changed her core outlook for econ. https://www.cnbc.com/video/2018/10/26/feds-mester-market-volatility-does-not-impact-my-outlook.html

Current FOMC projections for GDP & PCE inflation at the Sept 2018 meeting;

Percent

Variable	Median[1]				
	2018	2019	2020	2021	Longer run
Change in real GDP	3.1	2.5	2.0	1.8	1.8
June projection	2.8	2.4	2.0	n.a.	1.8
Unemployment rate	3.7	3.5	3.5	3.7	4.5
June projection	3.6	3.5	3.5	n.a.	4.5
PCE inflation	2.1	2.0	2.1	2.1	2.0
June projection	2.1	2.1	2.1	n.a.	2.0
Core PCE inflation[4]	2.0	2.1	2.1	2.1	
June projection	2.0	2.1	2.1	n.a.	
Memo: Projected appropriate policy path					
Federal funds rate	2.4	3.1	3.4	3.4	3.0
June projection	2.4	3.1	3.4	n.a.	2.9

https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20180926.pdf

Other news – Introduction of Ultra FICO

The launch of Ultra FICO in 2019 - designed to boost the number of approvals for credit cards, personal loans and other debt.

> Banks have spent much of the past 10 years chasing ultra-creditworthy borrowers. Yet that slice of the market, which has grown as the economy has improved, is largely tapped out.

https://www.wsj.com/articles/want-a-higher-credit-score-soon-your-cash-could-help-1540123200

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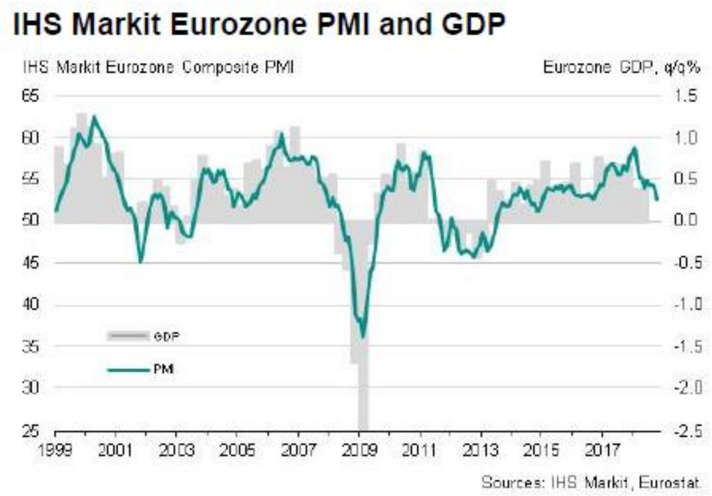
Europe

Eurozone Prelim Composite PMI (Oct)

The headline composite PMI slowed notably in the latest month – both services and manufacturing contributed to the slower level of private sector activity;

Oct 52.7 versus Sep 54.1

> "the Eurozone economy grew at the slowest rate for over two years in October as an export-led slowdown continued to broaden-out to the service sector"



Prelim Manufacturing PMI

Oct 52.1 versus Sep 53.2

Manufacturing output increased at very modest pace – the slowest since Dec 2014. New orders fell slightly for the first time since Nov 2014 – new export orders declined for the first time since June 2013.

Backlogs of orders fell for the second month. Employment growth expanded at the slowest pace in 22 months.

Input prices grew at a faster pace while output prices grew at the slowest pace in 14 months.

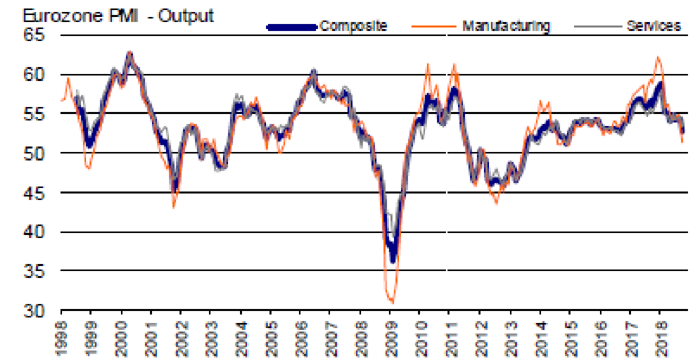
Prelim Services PMI

Oct 53.3 versus Sep 54.7

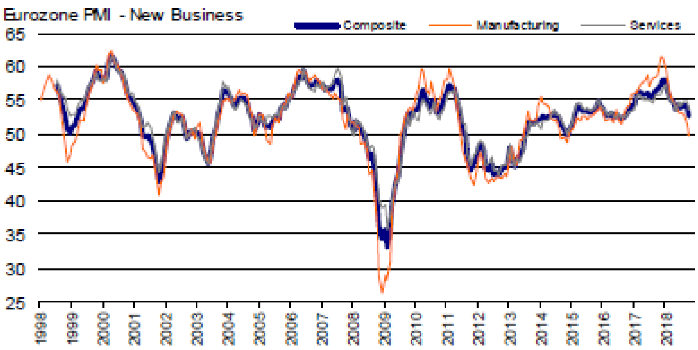
The slowdown in activity was the result of slower growth across key demand indicators; output and new orders. Employment growth slowed. Input costs and output prices both continued to increase.

Charts....

Output



New business



https://www.markiteconomics.com/Survey/PressRelease.mvc/022bdc8ac31e443a9fe7c5c9b9d1baf3

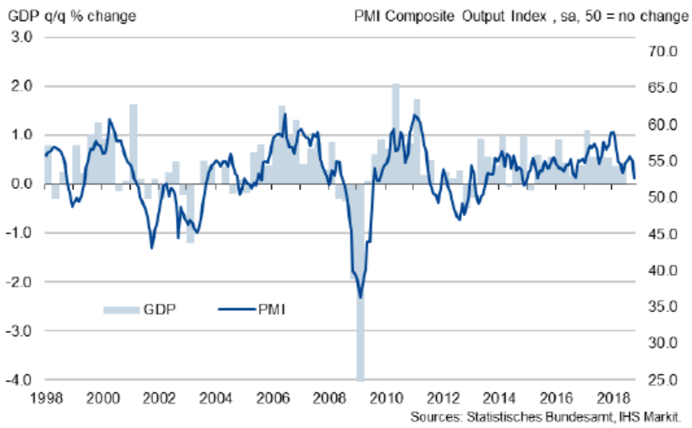
Germany Prelim Composite PMI (Oct)

The headline prelim composite PMI for Germany also slowed notably in the latest month;

Oct 52.7 versus Sep 55

The composite index is now below its long-term average of 53.4. Both manufacturing and services contributed to the slowdown in activity in the latest month;

IHS Markit Germany Flash PMI



Overall index for expected activity over the next 12 months, fell to the lowest level in four years.

Prelim Services PMI (Oct)

Oct 53.6 versus Sep 55.9

New order growth slowed to the lowest level since May

Employment grew, but at a slightly slower pace.

Prices grew at the fastest pace in over seven years.

Prelim Manufacturing PMI (Oct)

Oct 52.3 versus Sep 53.7

Output growth slowed. New orders growth fell into contraction for the first time in four years. New export orders declined for the second month in a row. Inventories also declined.

> a number of panellists commenting on fewer orders from clients in the car industry

Sentiment; the 12mth outlook in the manufacturing sector fell into pessimism for the first time in four years.

https://www.markiteconomics.com/Survey/PressRelease.mvc/0b3815d324b14f92b2307282f533c5b8

ECB – Interest Rate Decision (Oct)

Rates stayed on hold – likely to remain there through the summer of 2019 at the very least

Main refinancing operation 0%

Marginal lending facility 0.25%

Deposit facility -0.40%

Net asset purchases will remain at €15b until the end of Dec 2018. Subject to incoming data confirming the medium-term inflation outlook, net asset purchases will end then.

Principal payments from maturing securities will be reinvested for as long as necessary to maintain ‘favourable’ liquidity conditions and ample monetary accommodation.

Comments by Draghi suggest current ‘weakness’ in some data is seen as transitory;

> We're talking about a weaker momentum, not a downturn.

> Need to distinguish what is country specific from what is extended to the whole of the euro area.

> Think about the car sector in Germany. This is having quite a powerful effect for this quarter but not next quarter.

> we have no sense that we should doubt our confidence that inflation is gradually converging to our aim. But having said that, we reaffirm the fact that

our monetary policy needs to remain accommodative and a considerable degree of monetary accommodation is still needed

Cites risks relating to protectionism, vulnerabilities in emerging markets and financial market volatility as ‘prominent’. Overall risks to the euro area growth remain broadly balanced.

https://www.ecb.europa.eu/press/pr/date/2018/html/ecb.mp181025.en.html

https://www.ecb.europa.eu/press/pressconf/2018/html/ecb.is181025.en.html

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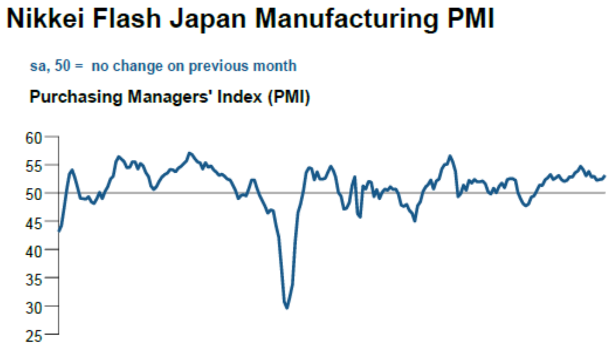
Japan

Manufacturing PMI – Prelim (Oct)

The prelim manufacturing PMI improved in the latest month, with key indicators growing at a faster pace;

Headline PMI; Oct 53.1 versus Sep 52.5



Output and new orders grew at a faster pace in the latest month. New export orders grew for the first time since May. Employment and backlogs of work also increased at a faster pace.

Both input and output charges continued to grow at a increasing rate.

https://www.markiteconomics.com/Survey/PressRelease.mvc/858aaddd3cba49a0854410ea14a5e5bb

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United Kingdom

BREXIT

Brexit negotiations remain stalled for the moment. It has been reported that both teams were 'close' leading up to the EC meeting last week. Negotiations stalled due to the UK parliament and cabinet.

> "A difficult cabinet meeting in the previous week, followed by another just before the summit, convinced Theresa May she did not have the political support to proceed".

Some compromise may be on the table regarding a UK-wide customs backstop. Whether this is a viable short-term solution remains to be seen – as there appears to be complex implications.

Good further reading; https://www.rte.ie/news/analysis-and-comment/2018/1027/1006996-brexit-negotiation-teams/

The Times is reporting that PM May will "trigger full-scale parliamentary preparations for a 'no-deal' Brexit in 3 weeks".

https://www.thetimes.co.uk/edition/news/brexit-theresa-may-to-trigger-no-deal-planning-in-three-weeks-svwr8rhsr

This week, the European Parliament voted to confirm the relocation of the European Medicines Agency and the European Banking Authority to Amsterdam and Paris respectively (from the UK). http://europa.eu/rapid/press-release_IP-18-6207_en.htm

To recap timings; the EU has indicated it will call an emergency EC meeting at such time that there is a draft withdrawal agreement to discuss and approve. The final EC meeting in the calendar is 12-13 Dec 2018. Both sides need enough time to approve the agreement in their respective parliaments before the 29 Mar 2019 deadline.

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Canada

Bank of Canada – Interest Rate Decision (Oct)

The Bank of Canada increased its overnight rate to 1.75%. The bank rate increases to 2% and the deposit rate increases to 1.5%.

> Governing Council agrees that the policy interest rate will need to rise to a neutral stance to achieve the inflation target. In determining the appropriate pace of rate increases, Governing Council will continue to take into account how the economy is adjusting to higher interest rates, given the elevated level of household debt. In addition, we will pay close attention to global trade policy developments and their implications for the inflation outlook.

On the Canadian economy – performing close to potential, growth expected to be 2.1% this year and slowing next year. Bus investment revised up due to USMCA and recently approved LNG project in BC. Housing credit growth continues to moderate, and housing activity is stabilizing. Household vulnerabilities remain.

Inflation was lower recently, but core measures remain around the 2% target. Wage growth is moderate but expected to pick up.

https://www.bankofcanada.ca/2018/10/fad-press-release-2018-10-24/

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Australia

Auction Clearance Rates – weekend of 27-28 Oct 2018

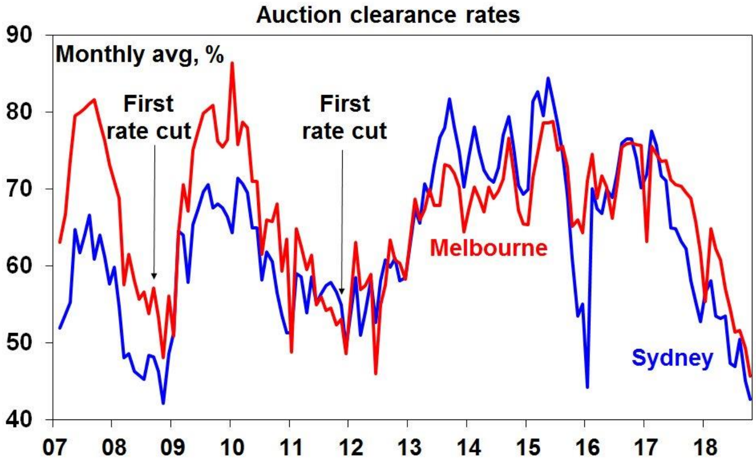
Large number of auctions were scheduled for this last weekend in Melbourne especially. Clearance rates continue to fall in the three key markets. Prelim auction results for Saturday 27 Oct 2018;

Sydney auction results: 47.9% preliminary clearance rate. Unreported rate was 25.7% (677 listed, 503 reported). Est final clearance rate is 39% to 42%. This week in 2017 CL = 55.7% 2016 = 76.5%.

Melbourne auction results yesterday: 48.5% preliminary clearance rate. Unreported rate was 29.0% (1454 listed, 1033 reported). Est final clearance rate is 38% to 41%. This wk in 2017 CL = 68.0%. 2016 = 72.8%.

Brisbane auction results yesterday: preliminary clearance rate was 44.9%. Unreported rate was 49.5% (97 listed, 49 reported). Estimated final clearance rate is 34% to 38%.

(Source; SQM Research)



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Trade

US-China Trade Negotiations

A possible fourth round of tariffs may be implemented by the US on $267b of Chinese imports after China retaliated.

It appears confirmed that Presidents Trump and Xi will meet on the sidelines of the G20 in November.

NAFTA/USMCA

U.S. officials intend to sign the agreement with Canada and Mexico at the end of November, after which it would be submitted to the U.S. Congress for approval.

The joint statement can be found on the USTR website; https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/september/joint-statement-united-states

US-Japan Trade Talks

A hearing is now scheduled to take place on 10 Dec 2018 on the negotiating objectives for a US-Japan trade agreement. Talks likely to start in Jan 2019.

https://www.federalregister.gov/documents/2018/10/26/2018-23569/request-for-comments-on-negotiating-objectives-for-a-us-japan-trade-agreement

Section 232 – Car and Truck Imports

Awaiting the outcome of the public hearings.

US-Europe Trade Talks

Official notification of the trade talks was sent to the US Congress last week (also notifying the US Congress of the intention to commence trade talks with Japan and the UK).

As noted in the announcement, the USTR will publish objectives for the negotiations at least 30 days before negotiations begin.

No formal consultation for the US-EU negotiations has been announced on the Federal Register (only for US-Japan negotiations at this stage).

https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/october/trump-administration-announces

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