



The 30,000-Foot View

Entering the third quarter, there were reasons to be anxious. Everything, from trade headlines to Federal Reserve interest rates, held the potential to cause disruptions and spark volatility. This may be what made the strength of the quarter, both in terms of the U.S. economy and asset markets, all the more impressive. The S&P 500 rose more than 8%, the U.S. economy likely grew at a pace north of 4% in real terms, and unemployment is at a multi-decade low. Not to mention all of this happening while once prominent emerging markets, including Turkey and Argentina, either watch their currencies collapse or require an International Monetary Fund bailout. It was not a pleasant backdrop everywhere, but it certainly was in the U.S.

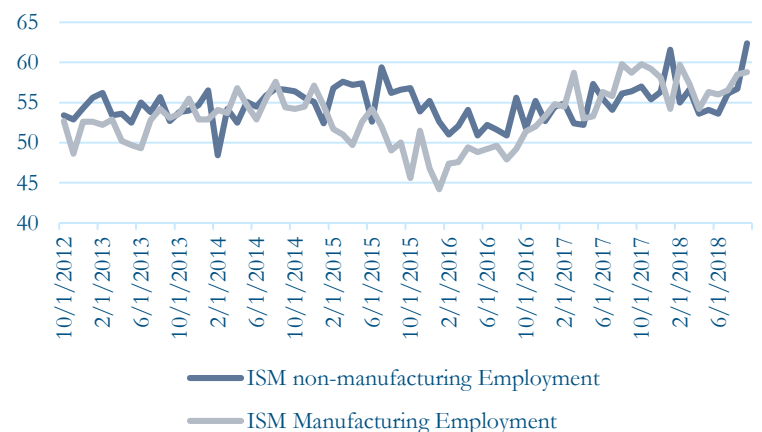
The continuation of the U.S.' economic expansion should not be a surprising development, and there are few signs of an imminent reversal of the U.S.' outsized economic fortune. The political headlines are biting and divisive but with little to no direct impact on economic fundamentals. There are certainly a few pieces of the economic puzzle to watch. Housing data, wage gains, inflation, and the ensuing Federal Reserve monetary policy could all be sources of economic volatility and downward pressure. The recent rise in longer-term bond yields is largely a symptom of a better economy but could have implications if interest rates rise further.

Atlanta Fed GDPNow Forecast



Source: Bloomberg

ISM Employment Surveys



Source: Bloomberg

Globally, the economic fundamentals are less sanguine. Instead of booming, tax reform in the U.S. has sparked a wave of U.S. dollar repatriation. Particularly in many emerging markets, this is exacerbating the pressure already felt by rising U.S. interest rates. The result has been weaker and problematic emerging market economies facing currency depreciations and selective crises. Thus far, these events have been contained and the spillover effects ring-fenced.

Italy has captured numerous headlines for critiquing the leadership within the European Union (EU) and proposing a budget that (supposedly) thumbed its nose at the leadership in Brussels. While Italian politics are always a bit entertaining, the proposed budget had a deficit similar to France and less than Spain. It makes for a headline, but there does not appear to be anything existential to the existence of the EU contained within the Italian budget.

With the U.S. economy continuing to plow ahead but the rest of the world struggling, there is plenty of fodder for both pessimists and optimists. But the data points to further growth in the U.S. and the potential for better economic data from the rest of the world.

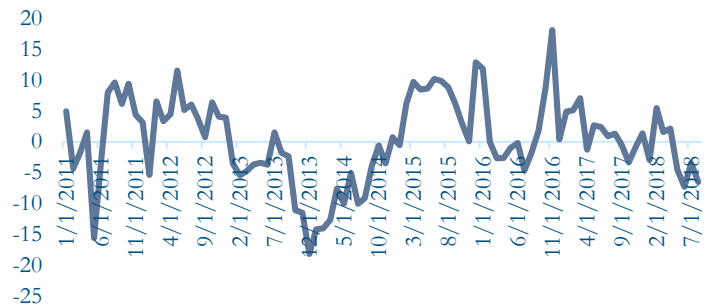
The Caveats

There are always a few caveats to an economic outlook and risks lurking in the background. For example, there is always a chance for negative spillover effects from the mostly positive tax reform. Specifically, the capping of the State and Local Tax deduction (S<) may have the effect of curbing home prices and sales in high tax municipalities and states. Increasing interest rates would be a further headwind. On the international front, Italy and China are the most prominent potential issues on the frontier. Italian yields have surged and elevated the EU break-up narrative, again. Trade rhetoric and a slowing economy have combined to once again bring fears of a hard landing in China to the forefront of debate. The Chinese Renminbi (RMB), as it has been in past years, is the transmission mechanism.

To start, there is some evidence of the potential for the combination of S< capping and higher rates to damage the U.S. housing market. The California housing market is a preview of what the S< cap and higher rates may have in store for the U.S. housing market more broadly.

While California home sales are volatile, the trend has recently turned lower. Typically, a growing economy should have growing home sales but that is not the case at this time. There are a number of reasons this may be more idiosyncratic and isolated to California and states that resemble it. Not the least of which is that home prices in California have been rising steadily. But the evidence does seem to point toward the tax law changes having a more pronounced effect. The regions with high S< deductions and mortgages over \$500,000 overlap, and are unsurprisingly concentrated in the Northeast and West, regions where housing activity has broadly slowed. Luckily, the regions with generally lower S< have not shown similar slowing dynamics, and the housing slowdown is concentrated in only a few, albeit large, pockets.

California Home Sales (% Change from a Year Ago)



Source: Bloomberg

Chinese RMB



Source: Bloomberg

For China, it is all about trade. An ongoing US-China trade dispute is unequivocally negative for the Chinese economy. Currencies are the typical adjustment mechanism for trade disputes and economic slowdowns. The Chinese RMB is not an exception this time and has been steadily depreciating since late March. Movements in currencies matter for a host of reasons, and they tend to be a signal of underlying economic stress. After stating that the currency would not be used as a weapon in a trade war, Chinese officials steadied the market. But there does appear to be some renewed stress. With neither the U.S. or China backing away from the trade skirmish, watching the RMB will be critical to understanding the true stress being exerted on the Chinese economy. While there has not been a severe dislocation in the RMB, this has been a source of U.S. volatility in the past and could become one again.

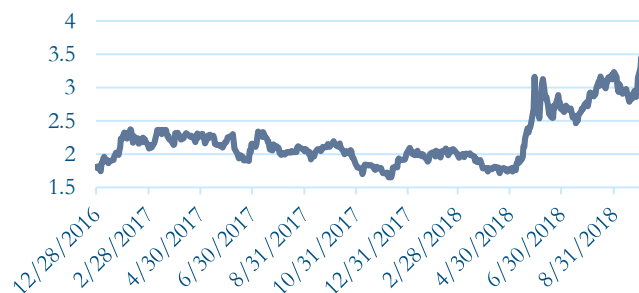
Italian politics is a train wreck, and there is a bit of "let's give it to Brussels" in its budget proposal. But it is also only a proposal, it is well within the 3% EU limit, and it is not out of the ordinary for Italy. In fact, there was some surprising constraint. Of note, the European Central Bank (ECB) has bought a tremendous amount of Italian debt during its quantitative easing program (QE). So, it may well be worth taking a step back for a minute to assess whether this is as dramatic and apocalyptic as markets are indicating. It could be that markets are testing the ECB's resolve to taper its QE program. It could be that there is genuine fear surrounding the budget deficits and Italy's ability to finance them. Italian banks have certainly taken it on the chin, and there could be more to the story if that continues. While the Italian situation is far from optimal, it does not appear to be existential for the EU, at least not yet. It bears a watching at any rate, particularly for spillover effects beyond Italian borders.

The Bright Spots

In contrast to the caveats, there are incredible bright spots. Quits are currently at the highest level since the Job Openings and Labor Turnover survey began. While it is somewhat counterintuitive, the more quits the better for the U.S. economy. At over 3.5 million job quits per month, that is more than 42 million quits per year. There are currently 156 million people employed. So, the number of quits equates to more than 25% of employees, an incredible figure.

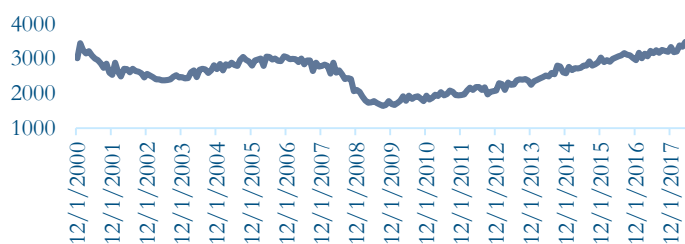
In a way, quits can also tie into wages. Until recently, wages have been a perpetual missing piece of this cycle. But the underlying dynamism of the U.S. labor market, with quits leading the way, may be changing that dynamic. How? For much of the recovery, the wage growth for job switchers was faster than the wage growth for stayers. There was an incentive for switchers and quits climbed to an all-time high. That dynamic may be changing. Wage growth for job stayers has begun to move toward that of leavers. There are a number of implications. The number of quits should begin to come under pressure as employers pay-up for talent, and this may affect the overall job creation figures as employers reassess the hiring needs. A highly dynamic labor market is a good problem.

Italian 10-Year Yields



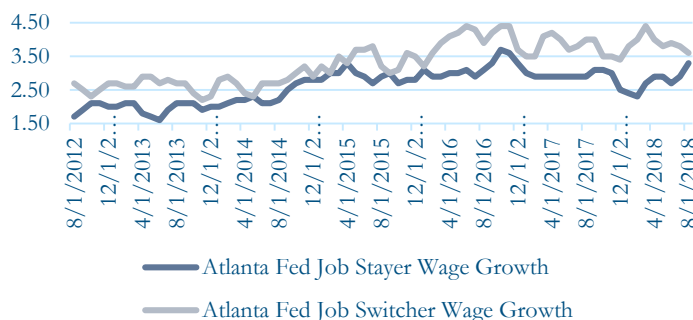
Source: Bloomberg

Quits (Monthly in Thousands)



Source: Bloomberg

Wage Growth



Source: Bloomberg

The Final Stretch

We should expect more of the same in the final stretch of 2018. Growth remains robust, labor market conditions are tight but not too tight, and it is difficult to pinpoint a reason to believe these will change dramatically between now and the end of the year. There are always unforeseen risks lurking, but the U.S. economic picture is bright otherwise. The economy should decelerate slightly from its current exceptionally quick pace of growth, but this should be a slow and steady process. International economies outside of the previously mentioned trouble areas are growing at a solid pace, but they have slowed from the torrid clip seen last year. There are reasons to pay attention, but those do not appear to be threats to the expansion. Rumors of the current economic expansion's demise are premature with a rejuvenated U.S. growth engine leading the way.

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