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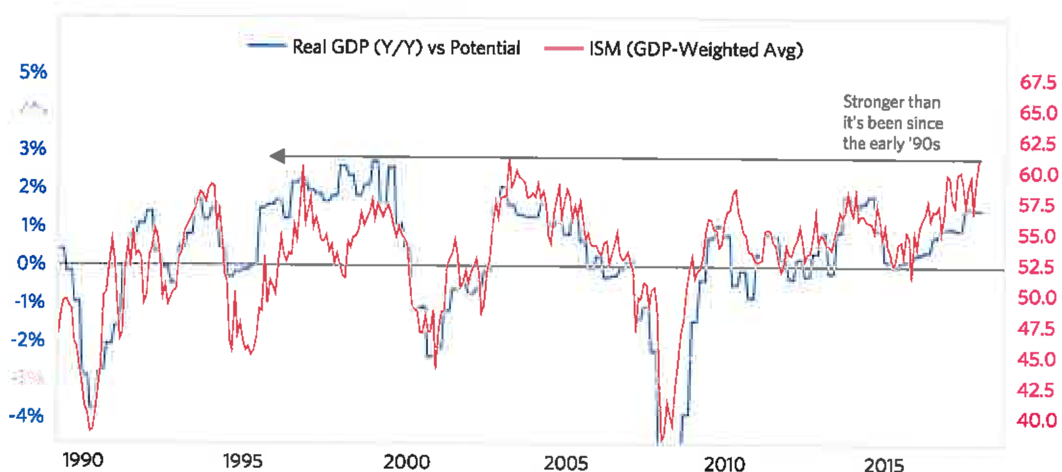
(203) 226-3030

Jason Rotenberg
Matthew Karasz

US Strength Tilts the Odds toward More Tightening and Asset Price Weakness

This week's economic stats show considerable strength at a time in the cycle when strength is likely to prompt tightening, limiting the economic upside while weighing on asset prices. The ISM business surveys, our first and most reliable read on activity through September, show businesses boosting production about as quickly as at any point since the early '90s, and they're planning to meet this demand by expanding hiring at a comparably fast pace. This strength is a consequence of how stimulative conditions have been on a backward-looking basis, and will fade to some extent as some of these supports—like the fiscal stimulus—peak and then decline. Nevertheless, financial conditions remain supportive for households to increase borrowing and spending, and businesses are reinforcing the expansion through strong income and investment growth. The market reaction to Wednesday's strong stats was consistent with this strength, as US bond yields drifted 10bps higher over the course of the day following the strong morning releases, the dollar rose, and equities were roughly flat. Looking ahead, growth is likely to be strong enough to push unemployment past 40-year lows, and inflation is likely to move modestly higher than the Fed's target, due in part to cyclical strength as well as other drivers like increased tariffs. As it is, we think it is more likely than not that the Fed will react to these conditions with more tightening than discounted, and any positive growth surprises will only tilt the odds further toward tightening.

The first chart below shows just how strong the US economy has been. The ISM survey, which provides a timely and reliable read on the US economy, suggests growth is stronger than it's been at any point since the early '90s.



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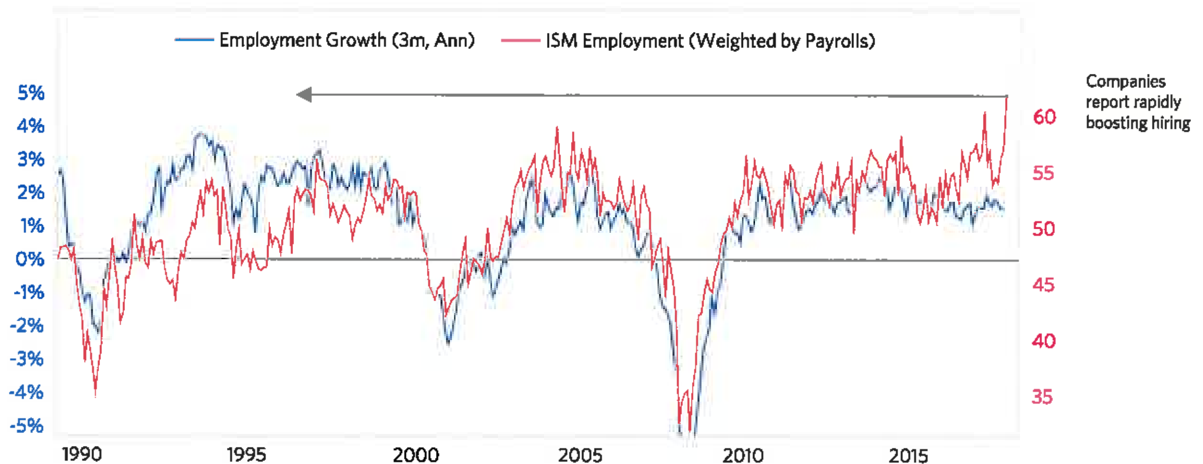
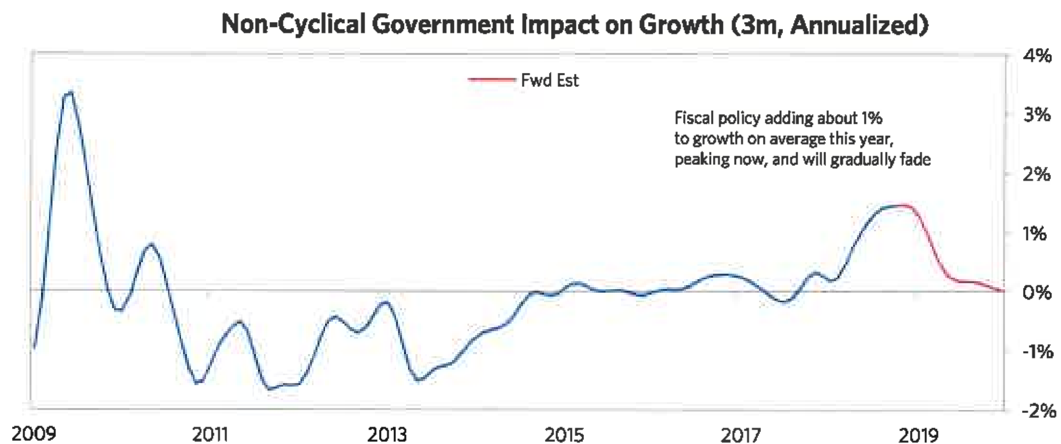
In response to this strong demand, businesses have also been reinforcing the expansion through increased hiring and investment, and the latest surveys suggest that they're continuing to do so. As the chart below shows, businesses report boosting hiring more quickly than at any point since 1990.



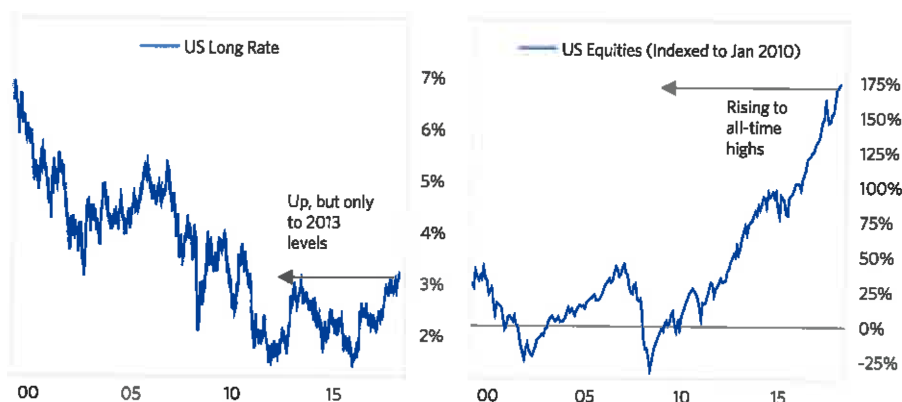
This strength is a consequence of how stimulative conditions have been on a backward-looking basis, and we expect some of this strength to fade as some of these supports—like the fiscal stimulus—peak and then decline. The chart below shows our rough estimate of the impact of the fiscal easing on growth over time. While there is no precision to the timing shown below, we think that fiscal policy will add about 1% to GDP growth over the course of this year (with a peak impact about now), and that this support will then gradually fade over the course of next year. This will slow the expansion to some extent, but without other drivers isn't likely to be enough to derail it.

Non-Cyclical Government Impact on Growth (3m, Annualized)

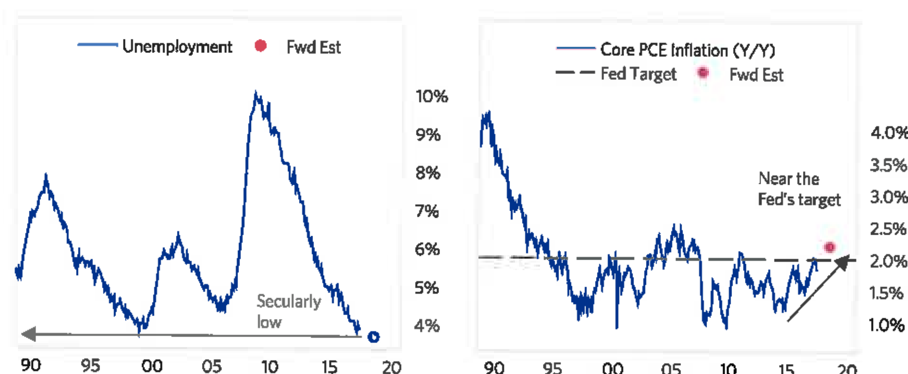


Nevertheless, as we show below, the Fed hasn't yet tightened enough either to slow growth or to push asset prices much lower. Bond yields are at multiyear highs, but remain low in absolute terms and at levels that the economy could withstand back in 2013. In addition, equity prices have been making new highs. This rise in wealth has helped to mitigate the effect of higher yields on the US economy, such that overall financial conditions are still not all that restrictive.

Given how late we are in the cycle and how strong growth remains, we'd expect to continue to see tightening market action in response to strength. This, in turn, will create a high bar for equities, as earnings will have to continue to run high enough to offset the higher discount rate and any effects that the tightening has on economic activity and profits.



The main reason we expect economic strength to increasingly lead to tightening and asset price weakness is how late we are in the economic cycle. Unemployment is already about as low as it's been in 40 years, and even if growth slows a bit, it's likely to remain high enough to tighten the labor market further. Inflation has been held at very low levels in recent years by powerful secular pressures, but as the cycle has progressed, it has also gradually been drifting higher. It's now near the Fed's target, and it is likely to pick up further given how tight the labor market is and the recent run-up in commodity prices and rise in tariffs. We'll get more information on the labor market on Friday.



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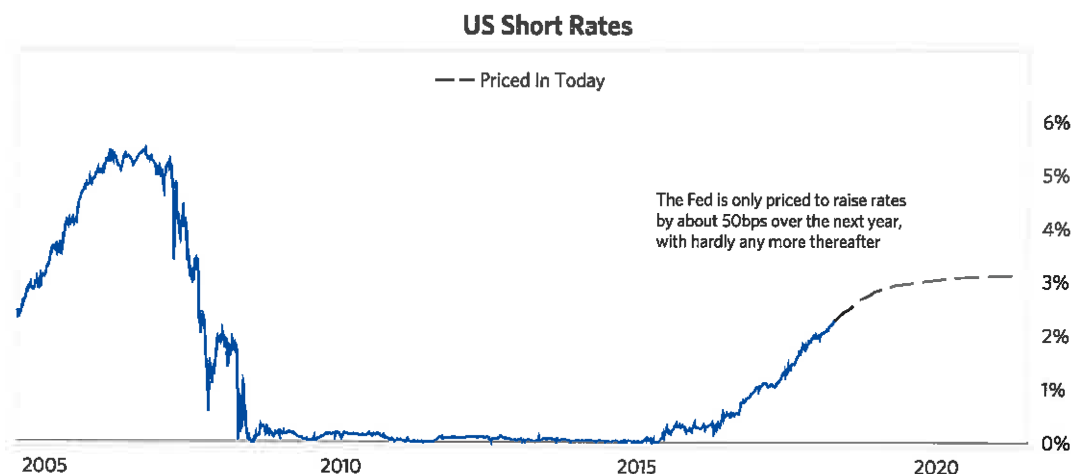
The current pricing, as the chart below shows, is for just a little bit more tightening being sufficient to keep the economy from overheating or financial excesses from eventually emerging. At this point, the tightening cycle is discounted to end in about a year with rates below 3%. We think the risks are tilted toward the Fed tightening more than discounted.



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