The collapse in mining capex also pulled down inventories, but the hit is now over...

...The drag on Q4 inventories will be technical; rising oil prices will pull down the valuation adjustment.

Chainstore sales growth is rebounding strongly, though the dollar's rebound will be a drag again.

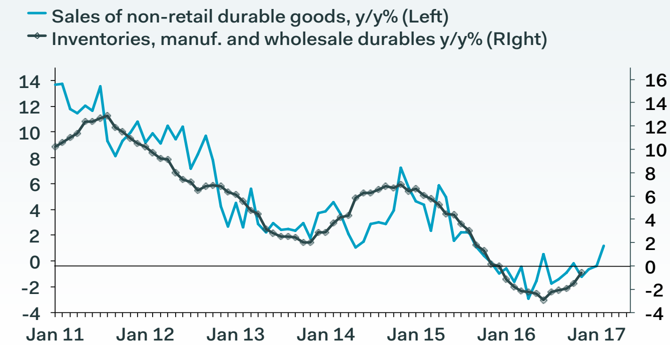
The Core Inventory Cycle is Turning, but Q4 Data Likely Won't Show it

For some time now we have argued that the collapse in capital spending in the oil sector was the source of most of the softening of activity in the manufacturing and wholesaling sectors last year. Investment in mining structures and equipment fell by some 67% from its peak in mid-2014 through the third quarter of last year, which likely will prove to be the floor. That's equivalent to 0.7% of GDP, and most of the hit was borne by the domestic supply chain.

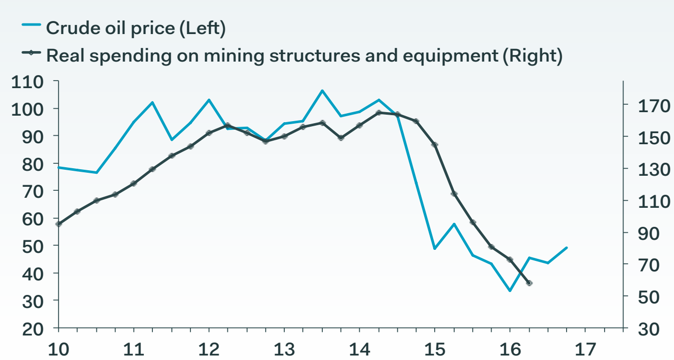
The obvious focus of attention has been on the capital spending data, but the damage is also very evident in the inventory numbers too. Capex fell very suddenly and very sharply, leaving manufacturers and wholesalers stuck with excess inventory. The build-up in inventory of durable goods was rapid, as our chart above shows, but it was no bigger than implied by the prior slowdown in sales; the underlying problem simply was that sales collapsed.

The picture now looks very different, following the rebound in oil prices and the 67% jump in the number of U.S. oil rigs in operation, since May's low. *Orders for non-defense capital equipment, ex-aircraft, bottomed out last summer and are now trending gently higher, and inventories of durable goods are beginning to rise.* The *level* of capex in the mining business will not return to the 2014 peaks for the foreseeable future—there's just too much oil supply for prices to rise to anything like $100—but the *rate of change* is in the process of swinging from alarming declines to substantial increases, and inventories are following.

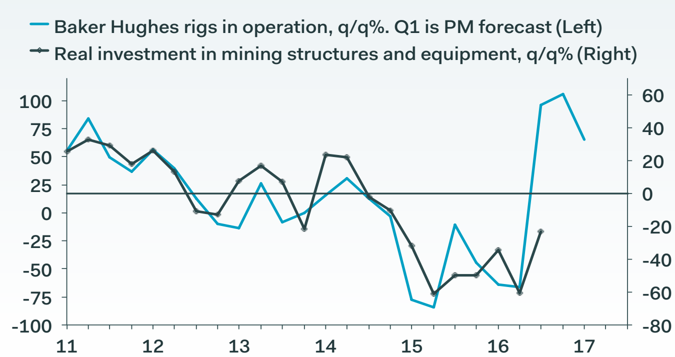
THE CAPEX CRUNCH TRIGGERED A MINI-CYCLE IN INVENTORIES



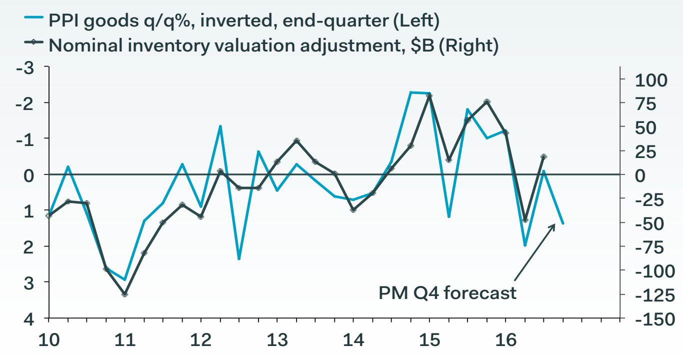
MINING INVESTMENT PROBABLY HIT BOTTOM IN Q3 LAST YEAR...



SPENDING IS SET TO REBOUND STRONGLY



THE IVA WILL BE A DRAG ON FOURTH QUARTER GROWTH



This might not be apparent in the fourth quarter inventory data in the national accounts, thanks to the rise in oil prices. The inventory numbers are subject to a valuation adjustment each quarter in order to prevent swings in prices—oil prices, mostly—from generating the appearance of windfall inventory profits or losses. These adjustments can be very large, as our chart above shows, temporarily obscuring the underlying trends in the data. The IVA moves very closely in line with PPI goods prices, which rose sharply in the fourth quarter as oil prices rebounded. ***Accordingly, we expect a hefty negative IVA for the fourth quarter, enough alone to subtract a full percentage point from headline GDP growth.***

Note that the familiar monthly inventory numbers, including today's November data from the wholesale sector, are not valuation-adjusted. The preliminary November data, released a couple of weeks ago, showed inventories of both durable and non-durable wholesale goods rose by 0.9%, generating the biggest aggregate increase in two years. No further details are provided with the advance report, so we can't be sure that the jump in durable good inventories is connected to the upturn in mining capex, but it is consistent with the idea, at the very least.

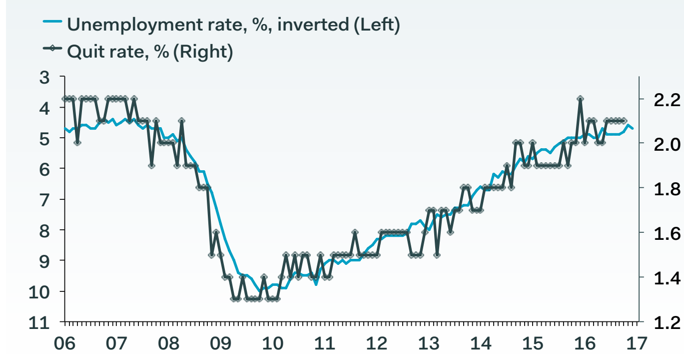
Chainstore sales growth is rebounding, for now

Today also brings the weekly chainstore sales numbers, which have taken a serious turn for the better over the past couple of months. *Partly, we think this is a lagged response to the falling value of the dollar during the first half of last year, but the combination of faster wage growth and rising employment also likely is lifting spending.* We'll find out which force is more important later this year as the lagged effect of the rise in the dollar since last October works through, but for now the data look good. ***Stronger Redbook sales will be reflected in better revenue numbers for major retailers over the next few months too.***

Finally today, our base case is that the number of job openings in the November JOLTS report will be little changed, given the broadly flat trend since early last year. But we can't rule out a renewed increase in light of the upturn in most of the private sector measures of employment. *Our composite hiring index is not a perfect indicator of the JOLTS measure, but it does suggest a degree of upside risk, at least.*

Behind the headline JOLTS number, policymakers will be on the look-out for a further increase in the quits rate, which appears to be regarded by some FOMC members, not least Chair Yellen, as a number with an almost mystical ability to capture the true state of the labor market. In fact, it's just a more volatile measure of the unemployment rate, as our final chart shows. *It tells us nothing new, but we can't ignore it, because the Fed watches it.* The chart suggests we should expect no change in the November quits rate.

THE QUITS RATE JUST MIRRORS THE UNEMPLOYMENT RATE



Please note the *U.S. Economic Monitor* will not be published on Martin Luther King, Jr. Day, Monday January 16.

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, January 9

• Consumer Credit (11)/15:00 EST
Credit growth rebounds strongly to **$24.6B** after October's below-trend $16.0B increase.

Tuesday, January 10

• Redbook Chain Store Sales (1/7)/9:00 EST
Chainstore sales growth is trending higher, but we doubt last week's **2.4%** year-over-year increase in same-store sales is sustainable; a correction seems a decent bet.

• Wholesale Trade (11)/10:00 EST
The advance report showed wholesale inventories rose by **0.9%,** the biggest gain in two years. Inventories of both durable and non-durable goods rose sharply, but no further details are available. **Consensus: 0.9%.**

• D: JOLTS Report (11)/10:00 EST
The number of job openings has levelled off, though the monthly data are erratic. We expect a trivial dip to **5,500K** in November from **5,534K** in October. **Consensus: 5,534K.**

Wednesday, January 11

• Mortgage Applications (1/6)/7:00 EST
The purchase applications index is beginning to soften again, now that people who wanted to lock-in as rates surged presumably have done so. Last week, it stood little changed at **234.5.** It rebounded two weeks ago, presumably because people were rushing to lock-in rates before they rise further.

Thursday, January 12

• Jobless Claims (12/10)/8:30 EST
We expect a rebound to about **260K** after last week's unexpected drop to 235K, likely driven by holiday seasonal adjustment problems. **Consensus: 255K.**

• Import Prices (12)/8:30 EST
The rebound in oil prices means that total import prices likely jumped by about **1½%. Consensus: 0.7%.**

Friday, January 13

• D: Producer Prices (12)/8:30 EST
Rebounding oil prices mean the PPI should rise about **0.5%,** with the core up **0.2%,** but trade services—profit margins—are a wildcard, having run well below trend in recent months. **Consensus: Headline 0.3%, core 0.1%.**

• D: Retail Sales (12)/8:30 EST
Total sales likely rose **0.8%,** boosted by the rebound in gasoline prices and auto sales, but we expect decent core sales too. Ex-autos, we expect a **0.6%** increase. **Consensus: Total sales 0.6%, ex-autos 0.5%.**

• Business Inventories (11)/10:00 EST
We expect a **0.6%** jump, the biggest since June last year, led by the wholesale and retail components. **Consensus: 0.4%.**

• D: Univ. Michigan Consumer Sentiment (1p)/10:00 EST
After two months of big gains since the election, we think the headline Michigan index will be little changed, at about **98. Consensus: 98.5.**

THIS WEEK'S FUNDING

Monday 9	Auction: $34B 3-month, $28B 6-month bills Announcement: 4-week bills (Jan. 10)
Tuesday 10	Auction: $24B 3-year notes (settles Jan. 17) Auction: 4-week bills
Wednesday 11	Auction: $20B 10-year notes (settles Jan. 17)
Thursday 12	Announcement: 3-month, 6-month bills (Jan. 17) Auction: $12B 30-year bonds (settles Jan. 17) Announcement: 10-year TIPS (January 19)
Friday 13	Nothing

PANTHEON'S FINANCIAL FORECASTS

		End-month:			
	4:00pm Mon.	**Mar**	**Jun**	**Sep**	**Dec**
Fed funds target	½-to-¾	¾-to-1	1-to-1¼	1¼-to-1½	1¾-to-2
2-yr	1.19	1.30	1.50	1.80	2.10
10-yr	2.37	2.70	3.00	3.25	3.50
30-yr	2.96	3.40	3.80	4.00	4.00
Curve 10-2	118	140	150	145	140
Curve 30-2	177	190	230	220	190
S&P 500	2,269	2,250	2,200	2,150	2,100
Yen/Dollar	116.1	118	120	122	124
Dollar/Euro	1.06	1.05	1.05	1.05	1.05
Dollar/Sterling	1.22	1.22	1.25	1.28	1.30

PANTHEON'S ECONOMIC FORECASTS

GDP	Q1	0.8%	2013 year:	1.7%
	Q2	1.4%	2014 year:	2.4%
	Q3	3.5%	2015 year:	2.6%
	Q4 forecast	*2%*	*2016 year:*	*1¾%*
	Q1 forecast	*3%*	*2017 year:*	*3%*
	Q2 forecast	*3%*		

CPI	Nov. 0.2% (1.7% y/y); core 0.2% (2.1% y/y)
	March 2017 forecast: 2.8% y/y; core 2.2% y/y
	June 2017 forecast: 2.7% y/y; core 2.4% y/y

Unemployment: March 2016: 4.5%; June 2017: 4.4%.

Federal budget: FY 17 forecast: -$750B (3.0% of GDP)