

Executive Highlights

1. **Draghi, China, Japan Blink.** ECB President Mario Draghi just "blocked" Chairman Yellen and the Fed from taking a rate hike. That's why the stock market took off today. **Draghi, China, and Japan all hinted or announced that they would be using forms of quantitative easing in the fourth quarter to try and boost economic growth.** That will push their currencies lower of course - which is going to be troublesome for the dollar. A move by Yellen and company would push the dollar through the roof.
2. **Existing Home Sales Improve in September.** Existing home sales rose by 4.7% (second highest since the recession) to an annualized rate of 5.55 million a year, which is higher than the 5.3 million unit rate posted last month.
3. **Low Fuel Prices Help Airlines Post Profits.** United and Southwest both posted significant profits in the third quarter. In fact, United posted a record profit due primarily to positive fuel benefits. Low fuel prices helped contribute about \$1.19 billion to profits. Although profits were strong, revenue was down 2.4% and passenger revenue was down 3.8%.
4. **Puerto Rican Meltdown.** Puerto Rico lost its edge when it lost the tax breaks it could offer to companies to do business on the island. Short of simply dumping billions into rescuing the PR economy (and that may yet be necessary) there will be attempts to allow PR to declare bankruptcy so they can get some protection from the courts.
5. **Spanish Job Data Helps Incumbent Party -** The signs of an economic recovery had been noted in Spain a year or so ago, but the pace has been slow and many analysts asserted that it was too late to do the current government much good. It now appears that Rajoy may be getting some boost from the economic gains at precisely the right time.
6. **Syria War Conspiracy Activity Goes Into Overdrive.** The US, Russia, Saudi Arabia, and Turkey will meet in Vienna to discuss the Syrian War situation. They will also discuss early elections in Syria - which all believe will re-elect 50 year old Assad. That will also make it impossible for millions of migrants in Europe to return to Syria.
7. **Diesel Prices Could Fall Further.** There are forecasts coming out that suggest that diesel prices are ***likely at near term highs*** - they will fall lower as refiners end their fall maintenance schedules. Southwest earnings were up 83% because of lower fuel prices - others will benefit as well. We highlight a few of the winners and losers from lower fuel prices.
8. **Class 8 Truck Orders Show us Something Worrisome.** Class 8 truck orders were down 22% year-over-year in September. This was a sharp drop-off in purchase activity and below the 20,000 unit replacement rate required to keep net assets on the road neutral. In other words, something is amiss in the trucking sector and orders are falling off.
9. **Patricia to Lash Mexico.** There is a significant hurricane moving along the Mexican West coast that is expected to make a hard right turn and move inland. It is supposed to cross the Mexico border on Friday afternoon ***as a major hurricane***. Flooding, wind damage, and possible tornados will cause extensive damage in the region if it maintains its strength.

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Domestic Economic Issues

- Draghi, China, Japan Blink.** Here's what we need to know: whether he meant it or not, ECB President Mario Draghi just "blocked" Chairman Yellen and the Fed from taking a rate hike. That's why the stock market took off today. **Draghi, China, and Japan all hinted or announced that they would be using forms of quantitative easing in the fourth quarter to try and boost economic growth.** They would all pump additional money into their economies to try and get the velocity of money increasing. That will push their currencies lower of course - which is going to be troublesome for the dollar.

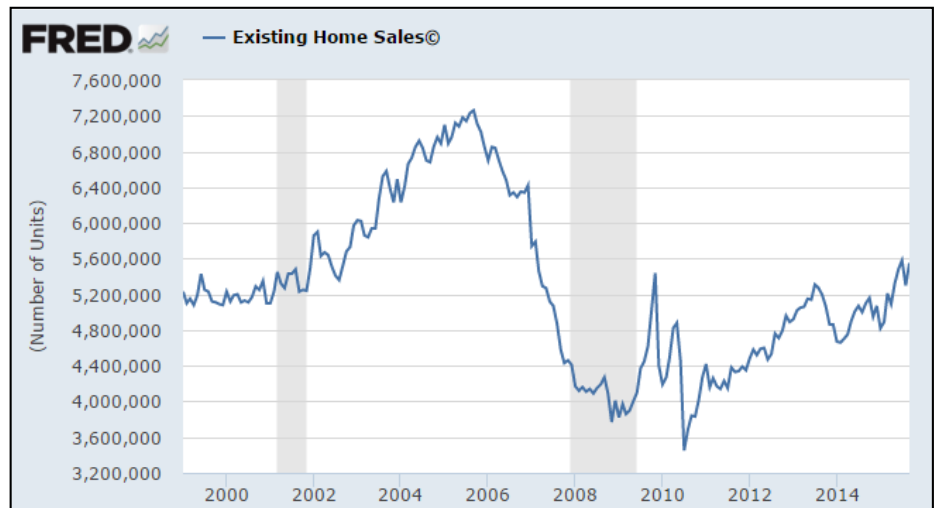
Here's why it blocks the Fed from moving on interest rates. Given the moves by China, Japan, and the European Union, the dollar will strengthen. **If Yellen and company were to make a move further to raise interest rates, the US dollar would surge to ridiculous levels against most foreign currencies.** Commodities would tank, petroleum would dive, many smaller emerging markets would likely face incredible credit problems and some would face credit default risk.

Can you see the dilemma that the Fed is in? Even if the US economy were to continue to show us signs that it could be doing O.K., the Fed really is in a trick bag over its options on movement. **The unfortunate truth emerging is that it needed to move about six months ago, and it didn't.** We would have been over the trauma by now and the market would be recovering from any sluggishness that move would have created.

Now, the world's economic systems are so inter-twined that it is difficult for us to not create or be impacted by ripple effects from any number of directions. And, as a chess match, it's like playing against two different opponents.

- Existing Home Sales Improve in September.** Existing home sales rose by 4.7% (second highest since the recession) to an annualized rate of 5.55 million a year, which is higher than the 5.3 million unit rate posted last month. Ironically, July's annualized rate was slightly higher at 5.58 million a year and was the highest since 2007. Still, we'll take the progress.

The flip side of this equation is the national home inventory report. We have seen home inventories slip over the last three months, falling from 5.5 months of inventory on hand to about 4.7.



So, in the latest new home starts data that we reported out earlier, we saw that single family homes had been lagging a bit. **This news (that inventories are falling and existing home sales are up) could lead to some improvements in home construction activity over the next few months.** Granted, we are hitting the slow period for housing. But, at least many of the fundamentals are lining up.

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Details in the report showed that first time home buyers were about 28% of existing home sales - it should be about 40%. Therefore, something isn't working in the programs that the administration has introduced to try and get people into first time mortgages.

The biggest change, however, in the housing sector appears to be the altered attitude of the millennial. For years it has been noted this generation has not been acting as those that came before. They have been slow to start families, settle into careers or to buy homes. The truth is most are not living in their parent's basements but they are living in multi-family units and not buying starter homes. **All of a sudden it appears the older members of this cohort – those in their very early 30s – are getting with the program.** There is also evidence that sellers are getting closer to the prices they wanted to get and are more willing to sell. It may be a bit premature to assert that housing has fully recovered from the debacle of a few years ago but it is much healthier than it once was.

- **Low Fuel Prices Help Airlines Post Profits.** United and Southwest both posted significant profits in the third quarter. In fact, United posted a record profit due primarily to positive fuel benefits. Low fuel prices helped contribute about \$1.19 billion to profits. Although profits were strong, revenue was down 2.4% and passenger revenue was down 3.8%.

Southwest airlines also **posted record profits of \$584 million, this was a 63% year-over-year increase in net income.** When we compare Q3 of 2014, lower fuel prices contributed about \$300 million to profits.

We don't always think about the positive benefits of fuel beyond the consumer and prices at the pump. But, **there is a strong tailwind that airlines and others can pick up from lower fuel prices that is really unrivaled from any other type of event.** It is such an incredibly important factor for operating costs. And, it works the other way when fuel prices spike as we saw in 2008 when a number of regional carriers didn't survive the fuel price surge.

- **Are We Gigging or Not?** - If you are following any of the trendy reports that have been developing over the last few years you have been exposed to the concept of giganomics. This is a concept that has suffered from way too much media exposure without much deep analysis. For example nobody really knows what it means. The notion is that people are moving from job to job the way a musician moves from gig to gig. It is based on the idea of a portable skill that can be transferred from one employer to another with little demand for additional training. **Many assumed that only those who would classify themselves as self-employed would consider themselves part of the gig economy and it has been noted the rate of self-employment has been on the decline in recent years.** How can there be fewer people described as self-employed and more people engaged in the gig economy. The issue is the definition.

Being self-employed is not the same as being in a gig economy. The fact that one is not self-employed does not preclude one from being in the gig economy. The pattern for many with transferable skills is the ability to job hop. The skill is in demand and is easily transferred so people in this category jump quickly from job to job according to who pays them more or offers some other advantage. **They are not self-employed – they are full time or part time workers on a permanent basis until they are not.**

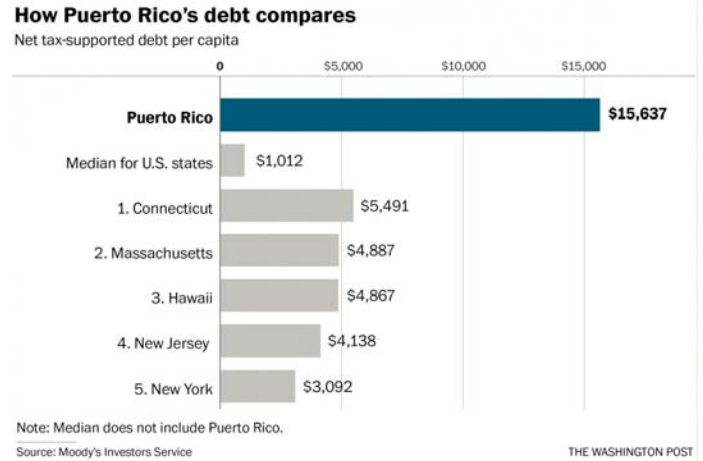
The arrival of the gig economy has been linked to the portability of health care. In past years the number one incentive to stay at a given job was the fear of losing the benefits that came with the job and today most of these benefits are no longer connected to the job but are carried from job to job by the employed. The rate of self-employment may be falling but gigs are still getting to be more common options for the employed.

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Global Economic Issues

- Puerto Rican Meltdown** – As Europe was contending with the Greek mess the US was facing its very own version of that financial collapse in Puerto Rico and for much the same reason. Greece borrowed to the hilt to maintain a social system it could not come close to maintaining while PR built a similar system on the back of its manufacturing and pharmaceutical sectors. **Greece lost its leverage when the Cold War ended and Puerto Rico lost its edge when it lost the tax breaks it could offer to companies to do business on the island.** Both Greece and PR started to circle the drain almost immediately. As Puerto Rico staggered under the weight of massive debt the US hastened to assert it had no intention of bailing the commonwealth out. What could it say when Europe was getting suggestions from the US that demanded a hardball attitude towards the Syriza government. Now the US has been forced to admit that it has to do something to bail PR out unless it wants a total disaster on its hands. Those who have been watching Puerto Rico assert that a humanitarian disaster is not only possible but imminent. The country is going to have to choose to pay creditors or keep vital services intact. It will be impossible to pay pensions or even maintain security for the airport. The commonwealth is beyond broke.

Short of simply dumping billions into rescuing the PR economy (and that may yet be necessary) there will be attempts to allow PR to declare bankruptcy so they can get some protection from the courts. The states in the US do not have this option but Puerto Rico is not a state and that creates a different set of rules. There are also calls for tax credits and other incentives to get people back to work. The labor force participation rate is substantially lower than that in the US as a whole and this is at the root of the crisis. The opportunities are just not there and fears of an exodus have grown substantially. This is what has been happening in Europe as millions of Greeks and Spaniards have left the country looking for work. These are the young and the skilled and they would have been the future of the country. This the same for PR and many of those who leave will not come back. That leaves a population that is largely unskilled and/or elderly.



There is ferocious opposition to this move as many in Congress want to have nothing to do with what feels like a bailout. What differentiates Puerto Rico from Greece is that poor decisions were made by successive Greek governments who assumed they would always be able to borrow more. The collapse in Puerto Rico was due to US government decisions to pull tax breaks that had fueled the expansion of the pharma business as well as manufacturing. Without those breaks the business community tended to abandon the region and head back to the US

Geopolitical Risk Assessment

- Syria War Conspiracy Activity Goes Into Overdrive.** So here's what happened today:
 - Qatar announced that it would join Saudi Arabia and Turkey in fighting against Assad (essentially the Russians).

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- Over the past couple of days, Assad physically joined Putin in Moscow for a meeting - the first time he has been out of the country since the war broke out.
- Vienna will host a delegation including the United States, Turkey, Saudi Arabia, and Russia to discuss the war in Syria. That alone is interesting. No Israel, Iran, Iraq, Jordan, etc.
- And the last little bit of news was that Putin and Assad have agreed that elections will need to be held quickly to establish the "people's leader".

Now, on this last point, **many analysts believe that this is a ploy by Putin to put some legitimacy to the Assad regime - and show that he is backing the "democratically" chosen leader.** Assad is only 50 and won't likely want to live anywhere else (some theories suggested that a loss by Assad would allow him to gracefully "retire" to a safe haven like Russia or another Syrian friendly country). It would also allow Putin to put pressure back on the US, saying that whoever the new leader is would have been chosen democratically, and that Russia would step up defense activities at the request of this leader. Anyone trying to prevent this effort by Russia would be interfering in the democratically elected affairs of a sovereign nation - which violates UN doctrine.

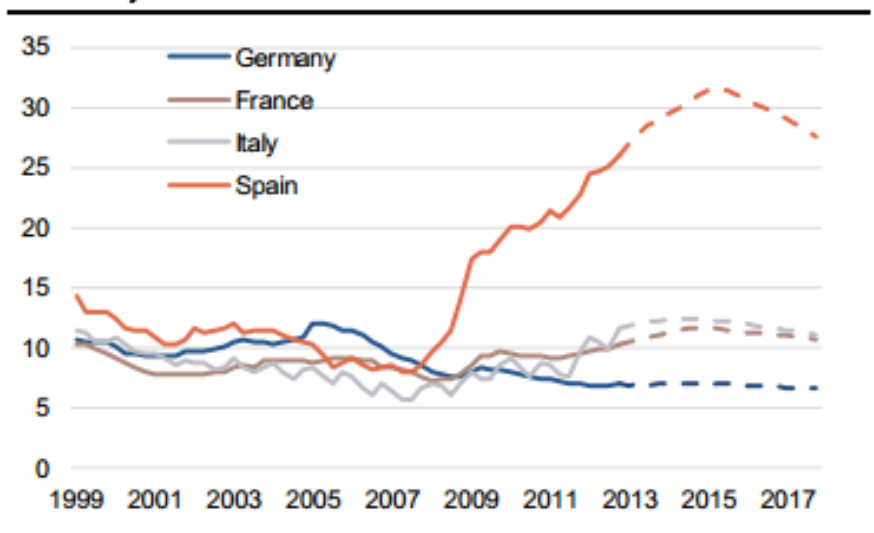
The same strategy works if Assad wins as well. Even though he might run "opposed", it would be difficult to hold safe and secure elections in which unbiased voting could be done. Who knows what an anti-Assad vote could possibly do to a citizen. It could label them for whatever the regime deems appropriate for a conspirator.

What is interesting is that the key global parties are meeting tomorrow. Russia is driving the situation, and winning - for now. One thing is for sure, there will likely be no country for migrants in Europe to return to. Authorities there need to just plan on finding permanent homes for them.

- **Spanish Job Data Helps Incumbent Party -** The signs of an economic recovery had been noted in Spain a year or so ago but the pace has been slow and many analysts asserted that it was going too late to do the current government much good. **The prevailing wisdom was that Mariano Rajoy would be credited with fixing the Spanish economy well after he left office and that another leader would be able to bask in the glow of whatever success the Spanish could pull off.** It now appears that Rajoy may be getting some boost from the economic gains at precisely the right time. The polls suggest he has been gaining popularity as each day brings slightly better news on issues that Spanish voters care about. The election is still two months out and many things can happen but the job numbers are as good as they have been in four years.

A few months ago the left in Spain was riding a "Greek" crest. It appeared that the tactics of Syriza were going to work and that Greece would manage to escape the "tyranny of austerity". In the end it was Syriza that blinked and not the Eurozone or the members of the "troika" that controlled the Greek debt. This yanked the wind out of the sails of the Spanish left and they have been plunging in

Unemployment in Spain forecast to break above 30% by 2015 (SG forecasts)



Source: Datastream, Eurostat, SG Cross Asset Research/Economics

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the polls. The Socialists never really bought into that strategy and they remain close to the Popular Party. The problem is that many in Spain remember they were in power when the crisis started and there is reluctance to rely on them again. **Not that Rajoy or Spain is out of the woods as joblessness is still at 21.2%. This is better than the 23.7% that Rajoy inherited but not by much.** Critics will point out that Spain remains far too dependent on service sector jobs and the tourist sector as a whole. The future of Spain was supposed to be in manufacturing and for a while it was. The growth of that sector has stalled and there is now more dependence on service than ever.

If Rajoy manages to get a second term he will still have his work cut out for him. The future of Spain is not secure and there will need to be a lot of assistance coming from the Eurozone.

Raw Materials – Business Threats and Opportunities

- **Diesel Prices Could Fall Further.** We were doing a project for a client last night (late), and in looking at the forecast for diesel prices we saw something that should be worrisome for certain sectors. **Retail diesel prices are currently about \$1.13 a gallon lower than they were a year ago.**

Analysts believe that as refiners get to the end of the fall maintenance period, diesel prices will fall even further as supplies increase and overall freight demand drops.

Here's some of the impact from lower diesel prices: there are, of course, winners and losers when the price of diesel is low. Among those that get hit a little bit harder than others:

- Refiners - of course. Although their input prices are lower, demand is less and the revenue per barrel is lower. It impacts earnings.
- Less-than-truckload carriers. These companies tend to do a little better when diesel prices are higher. Shippers can spread out their fuel surcharge costs with other shippers that are using the same truck. More volume typically flows to LTL when diesel prices are higher.
- Rail. Believe it or not, although rail operating costs go down when fuel prices are lower, they have a stronger value proposition when diesel prices are higher. Shippers make decisions to move to cheaper forms of transportation when the price of fuel is higher. Right now, with coal shipment volumes plummeting (regulatory pressure to convert away from coal energy production), rail companies have to rely on intermodal volumes to help "carry the load".

There is a group of businesses that benefit from this trend however. Among those:

- Airlines. Southwest's Q3 earnings were up 83% on lower fuel prices.
- Supply chain managers. Anybody running a supply chain is feeling lower total landed costs right now. Lower fuel surcharges and some lower freight rates in some sectors will push total operating costs lower.
- End consumer. End consumers will benefit in some ways from lower transportation costs.
- Farmers. We don't talk enough about the farming sector. But, lower diesel prices will help farmers significantly perform better over the next year.
- Heavy Duty Truck Manufacturing. Those auto manufacturers making the diesel-powered light duty trucks will benefit from higher sales demand - especially those selling to consumers. (Where it not for the VW scandal, we would make the same argument for consumer diesel automotive).

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Supply Chain – Business Threats and Opportunities

- Class 8 Truck Orders Show us Something Worrisome.** Ken Hoexter at Bank of America had a note out today concerning Class 8 Truck Orders (these are the big semis used most in heavy commercial applications). Most analysts keep an eye on Class 8 orders because they believe it gives them a macro data point to help identify big, broad business trends.

Here was Ken's short note on this topic:

*"Net Orders: Final Class 8 Net Orders in September were **down -22% year-over-year**, to 19,421, in-line with August's -20% decline, and slightly below preliminary expectations of 19,600. Sequentially, orders were down -4% from 20,197 in August. **Order levels this month are -3% below the 20,000 theoretical replacement level, falling below the replacement level for the first time in 2 years**". - Ken Hoexter, BAML*

We've been writing for some time about the pressures mounting for small trucking firms. We saw last night that the diesel outlook, thankfully for them, is going to see diesel prices remain low for the next year or so (barring any major geopolitical or environmental event). That will prevent many of them from going out of business. But, the drop in Class 8 truck orders is just one sign of the pressure that they are under.

We show you the DAT Trendlines data from time to time and in the last DAT update, loads looking for trucks were down 42% year-over-year. Coupled with a driver shortage issues (which forces companies to pay higher wages and offer better benefits) and higher regulatory costs (CSA, HOS, MPG requirement boosts, etc.), we are likely to see a strong exit of trucking firms from the marketplace.

As much as the administration has wanted to promote small and medium sized businesses, it is exactly these types of firms that over-aggressive regulatory activity has impacted.

Environment – Business Threats and Opportunities

- Patricia to Lash Mexico.** Many of you have interests in Mexico these days, so we want to be sure to cover events when we can that might disrupt supply chains, etc. There is a significant hurricane moving along the Mexican West coast that is expected to make a hard right turn and move inland. **It is supposed to cross the Mexico border on Friday afternoon as a major hurricane.**

Forecasters are expecting significant flooding as the major event from the storm, but strong wind damage and tornado activity is also possible.

Some of the heavy tourist areas along the West Coast and manufacturing and distribution activity is likely to get impacted as a result of Patricia. We will still have time to give you an update in tomorrow's briefing before the hurricane makes landfall. Hopefully by then it will have weakened a bit. **Current sustained winds are over 130 mph - which makes it a major hurricane.**

