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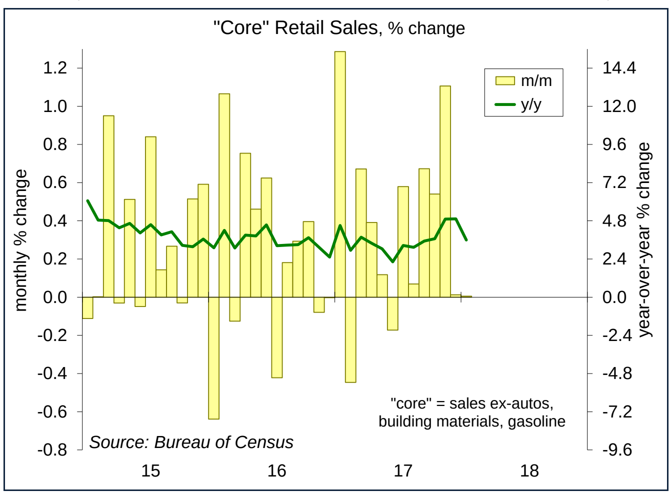
Weekly Economic Monitor

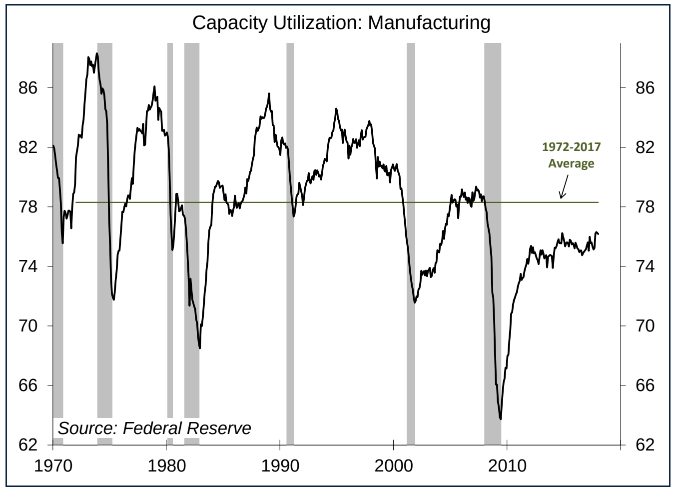
Inflation Fears Are Overdone (again)

Recent stock market volatility was partly blamed on fear that inflation will soon "take off." Simple supply and demand arguments would suggest that pressure on resource markets (labor mostly, but also raw materials) would lead inflation higher. Many of us old-timers remember the Great Inflation of the 1970s and early 1980s. However, such fears are overblown – at least for the foreseeable future. Still, there are plenty of other things for market participants to worry about.

Retail sales results for January were weaker than expected and figures for November and December were revised a bit lower. None of that should be too worrisome. Seasonal adjustment can be tricky, but adjusted retail sales figures normally move in fits and starts. A moderate slowdown in consumer spending growth would not be unusual following a strong 4Q17 (which partly reflected a rebound from a soft 3Q17). Similarly, industrial production was softer than expected in January, but that followed a strong showing in the fourth quarter (which also reflected a rebound from a soft 3Q17).



The inflation of the 1970s and 1980s is typically blamed on the oil shocks. However, the mechanism driving inflation was different than it is now. The government began indexing Social Security to the Consumer Price Index in the early 1970s. The unions saw that as a great idea and many incorporated it in their labor contracts. So, a sharp rise in oil prices boosted the CPI, which lifted union wages, and non-union wages followed. Inflation became embedded in the labor market. You needed a recession in the early 1980s to wring inflation expectations out of the system. Over 25% of private-sector jobs were union jobs in the early 1970s. We had 424 work stoppages in 1974 and averaged 289 per year in the 1970s. In 2017, 6.5% of private-sector jobs were union. We had seven work stoppages last year, the second lowest on record (we had five in 2009).



The 1970s also experienced bottleneck pressures in production. High levels of capacity utilization were associated with rising costs of goods. The rule of thumb was that anything above 85% would add significantly to inflation. Coincidentally, these episodes hit at about the same time as the oil shocks. In recent years, capacity utilization has been below its long-term average. Firms are not struggling to keep up with demand.

Of course, a lot of the production of consumer goods has been moved outside of the U.S. over the last few decades. As a consequence, we see much smaller inventory swings domestically, and low and relatively stable inflation. The Federal Reserve does not respond to exchange rates, but does need to take into account the inflationary implications of movements in the dollar. Yet, the relationship between the dollar and import prices appears to be disconnected. Over the last year, we've seen a pickup in inflation in imported raw materials (which is more reflective of a strengthening global economy than a softer dollar), but very little inflation in finished goods (capital equipment, autos, and other consumer goods).

Over the last year, the tight labor market has not generated the kind of wage inflation seen in previous periods of prosperity. The likely explanation is that wage bargaining power has shifted dramatically toward firms. Union membership is low. Large firms have much greater power in setting labor compensation.

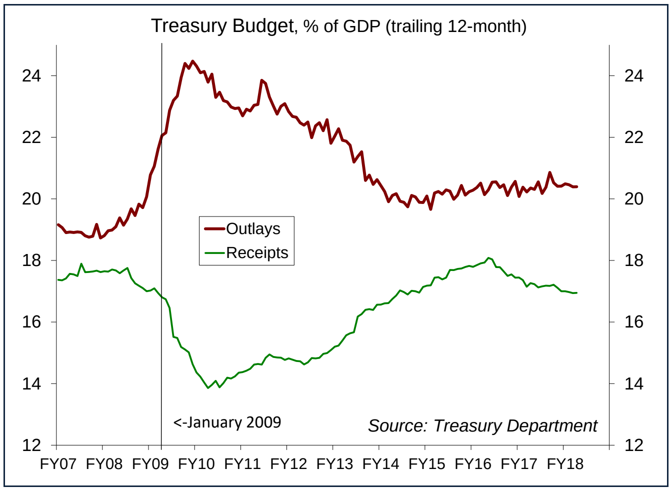
The Fed still views inflation as being driven primarily by two factors: inflation expectations and the labor market. The central bank will continue to monitor market-based and survey-based expectations of inflation, but many Fed officials will grow increasingly anxious about the job market.

On balance, the available data still suggest that inflation is unlikely to be much of a problem over the next couple of years. Increased government borrowing, on the other hand, is likely to have a bigger impact on the bond market.

	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
1/19/18	1.44	1.62	1.79	2.06	2.20	2.45	2.64	2.91	1.224	1.386	110.56	1.246	7336.38	2810.30	26071.72
2/09/18	1.55	1.73	1.89	2.05	2.26	2.52	2.83	3.14	1.223	1.379	108.44	1.260	6874.49	2619.55	24190.90
2/16/18	1.61	1.83	1.98	2.19	2.38	2.63	2.87	3.13	1.240	1.401	106.30	1.255	7260.79	2732.22	25219.31

Recent Economic Data and Outlook

The key economic reports (retail sales, industrial production, and single-family building permits) were all softer than expected and the Consumer Price Index (which isn't known for surprises) rose more than anticipated, but the stock market ignored that.



Retail Sales fell 0.3% in January (+3.6% y/y), unchanged ex-autos (+4.3% y/y). November and December data were revised down. Auto sales fell 1.3% (+1.5% y/y). Gasoline sales rose 1.6% (+9.0% y/y). Ex-autos, building materials, and gasoline, sales were unchanged for the second consecutive month (+3.6% y/y, and on track for a much slower pace than in 4Q17).

Industrial Production fell 0.1% in January (+3.7% y/y). Unseasonably cold temperatures continued to contribute to the output of utilities (up 0.6%, following +4.6% in December). Mining dipped 1.0%, reflecting a 1.4% decline in oil and gas well drilling (-11.7% since July). Manufacturing output edged up 0.1% (vs. flat in December, +2.0% y/y), with auto production up 0.6% (+1.4% y/y). Ex-autos, factory output was flat (+1.8% y/y).

Building Permits jumped 7.4% (±1.2%) in January, to a 1.396 million seasonally adjusted annual rate (+7.4% y/y), reflecting the usual volatility in multi-family permits. Single-family permits, the key figure in the report, slipped 1.7% (+7.4% y/y), which likely reflected poor weather. **Housing Starts** surged 9.7% (±16.8%), with single-family up 3.7% (+7.6% y/y).

The **Consumer Price Index** rose 0.5% in January (+2.1%), up 0.3% (+0.349% before rounding) ex-food and energy (+1.7% y/y). Food rose 0.2 (+1.6% y/y), with a continued split between food at home (+1.0% y/y) and away from home (+2.5% y/y). Gasoline rose 5.7% (+3.2% before seasonal adjustment, and +8.5% y/y). Cold temperatures contributed to a 9.5% jump in the price index for fuel oil (+22.5% y/y). Apparel rose 1.7% (-0.7% y/y), which likely reflects a rebound from heavier discounting during the holiday shopping period.

Real Hourly Earnings fell 0.2% in January (+0.8% y/y). For production workers, real hourly earnings fell 0.5% (+0.1%), implying little fuel for consumer spending growth.

The **Producer Price Index** rose 0.4% in January (+2.7% y/y), up 0.4% ex-food, energy, and trade services (+2.5% y/y). Pipeline gauges showed a further build-up of inflationary pressure at the earlier stages of production. Ex-food & energy, unprocessed intermediate goods rose 8.2% y/y, with processed intermediate goods up 3.7% y/y. Intermediate services rose 2.9% y/y.

Import Prices rose 1.0% in January (+3.6% y/y), led by higher prices of petroleum (+4.3% m/m, +20.9% y/y) and natural gas (+20.7% m/m, +16.2% y/y). The index of imported food, feeds, and beverages rose 0.8% (+3.1% y/y). Ex-food & fuels, import prices rose 0.5% (+1.8% y/y), with industrial supplies and materials up 1.8% (+9.3% y/y). The price index for imported automobiles rose 0.5% (+0.6% y/y). Capital goods edged up 0.1% (+0.9% y/y), while consumer goods were flat (-0.2% y/y).

Homebuilder Sentiment held steady at 72 in February.

Treasury reported a $49.2 billion **Budget Surplus** for January (vs. $51.3 billion a year ago). For the first four months of FY18, revenues rose 4.2% y/y, while outlays rose 5.1% y/y.

Economic Outlook (1Q18): around 3.0% GDP growth, likely to be boosted by lower imports (which surged in 4Q17).

Employment: Job growth has remained strong, but the pace should decline as the job market continues to tighten.

Consumers: Job and wage growth remain moderately supportive. Fourth quarter improvement partly reflects a rebound from the third quarter's hurricane effects.

Manufacturing: Sentiment surveys remain strong and orders have been improving. Factory output is rebounding from a soft 3Q. An improving global outlook has supported export growth.

Housing/Construction: Job growth has been supportive. Monthly figures are often erratic and supply constraints remain, but the underlying trends are relatively strong.

Prices: Core inflation has continued to trend below the Fed's 2% target, partly reflecting a "one-off" plunge in wireless telecom services. Wage pressures are moderate.

Interest Rates: The Fed remains in tightening mode, and is expected to continue gradually raising short-term rates, but personnel changes add uncertainty. Balance sheet reduction has begun and should not be disruptive for the markets.

This Week:					*forecast*	last	last –1	comments
Monday	2/19		President's Day					markets closed
Tuesday	2/20	1:00	Treasury Note Auction					2-year notes
Wednesday	2/21	10:00	Existing Home Sales, mln.	Jan	***5.50***	5.57	5.78	January figures aren't meaningful
			% change		***-1.3***	-3.6	+5.1	strong, but with supply constraints
		11:30	FRN Auction					2-year FRNs
		1:00	Treasury Note Auction					5-year notes
		2:00	**FOMC Minutes**	1/31				any clues on the future pace?
Thursday	2/22	8:30	Jobless Claims, th.	2/17	***235***	230	223	still subject to seasonal noise
		10:00	Leading Econ Indicators	Jan	***+0.9%***	+0.7%	+0.4%	permits, ISM orders, SPX, yield curve
		1:00	Treasury Note Auction					7-year notes
Friday	2/23		no significant data					winter Olympics end
Next Week:								
Monday	2/26	10:00	New Home Sales, th.	Jan	***610***	625	686	choppy/erratic from month to month
			% change		***-2.4***	-9.3	+15.0	a relatively strong y/y trend
Tuesday	2/27	8:30	**Durable Goods Orders**	Jan	***-2.6%***	+2.8%	+1.7%	aircraft orders back to earth
			ex-transportation		***+0.3%***	+0.7%	+0.4%	moderate
			nondef cap gds ex-aircraft		***+0.3%***	-0.6%	+0.1%	a moderate trend
		8:30	Advance Econ Indicators	Jan				Jan inventory and merch trade figures
		10:00	**CB Consumer Confidence**	Feb	***122.0***	125.4	123.1	stock market impact?
Wednesday	2/28	8:30	**Real GDP (2nd estimate)**	4Q17	***+2.5%***	+3.2%	+3.1%	+2.6% in the advance estimate
			Priv. Dom. Final Purchases		***+4.4%***	+4.6%	+2.2%	+4.6% in the advance estimate
		9:45	Chicago Business Barometer	Feb	***62.0***	65.7	67.8	still strong
		10:00	**Powell Mon Pol Testimony**					to House Financial Services Committee
		10:00	Pending Home Sales Index	Jan	***NF***	+0.5%	+0.3%	subject to weather/seasonal distortions
Thursday	3/01	8:30	Jobless Claims, th.	2/24	***235***	***235***	230	holiday adjustment adds uncertainty
		8:30	Personal Income	Jan	***+0.2***	+0.4%	+0.3%	sluggish gain in aggregate wage income
			Personal Spending		***+0.2***	+0.4%	+0.8%	autos down, retail sales soft
			PCE Price Index ex-f&e		***+0.3%***	+0.2%	+0.1%	the core CPI rose 0.349%
		10:00	**Powell Mon Pol Testimony**					to Senate Banking Committee
		10:00	**ISM Manufacturing Index**	Feb	***57.8***	59.1	59.3	still strong, but likely lower
		tbd	Motor Vehicle Sales, mln	Feb	***NF***	17.0	17.8	trend is likely to remain soft
			domestically built		***NF***	13.1	13.7	weather may have been a factor
Friday	3/02	10:00	UM Consumer Sentiment	Feb	***98.5***	95.7	95.9	99.9 at mid-month

This Week…

The economic calendar is sparse and it should be a relatively dull week for the financial markets. Investors will look for clues in the minutes of the January 30-31 monetary policy meeting – but bear in mind that there will be some differences between the Powell Fed and the Yellen Fed. The economic data are not critical. The LEI should surge further in January (nearly all of the data are known and it's a published formula). The following week will be more eventful, as Fed Chair Powell is set to deliver his semi-annual monetary policy testimony to Congress.

Monday

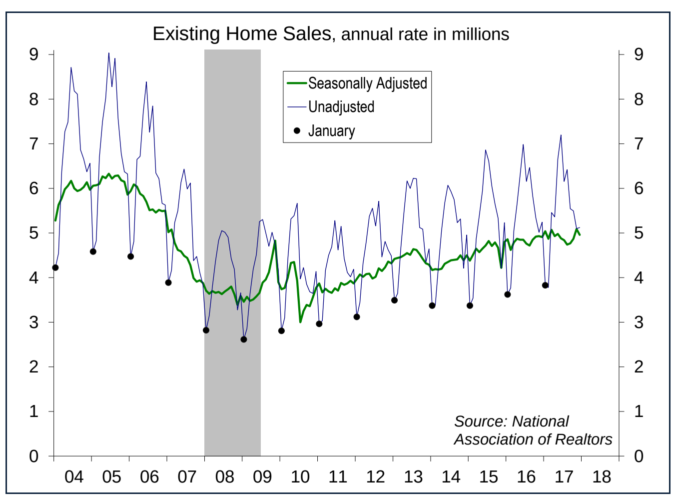
Presidents Day – Markets closed.

Tuesday

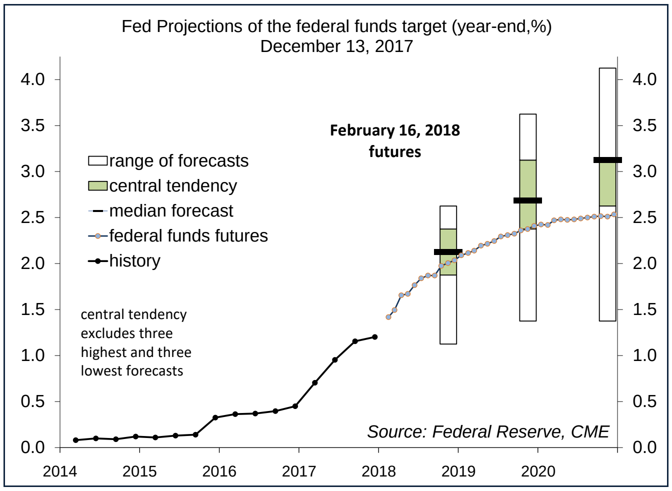
No significant data.

Wednesday

Existing Home Sales (January) – Home sales do not directly add to economic growth. There's no new construction involved. However, there is a connection to sales of home furnishings, building materials (repairs), and gardening supplies. Sales also serve as an early gauge of strength for the overall economy (see, for example, 2006-07). Rising mortgage rates ought to have a dampening effect on existing home sales, and we may also see some downward pressure on home prices (or at least, lower inflation in home prices) over the next several months. Note that existing home sales measure closings (in contrast to new home sales which measure initial transactions, such as a down payment or signed contract), and January is the low point prior to seasonal adjustment). Unadjusted sales will pick up in the spring and that will provide a better assessment of the overall strength of the housing market.

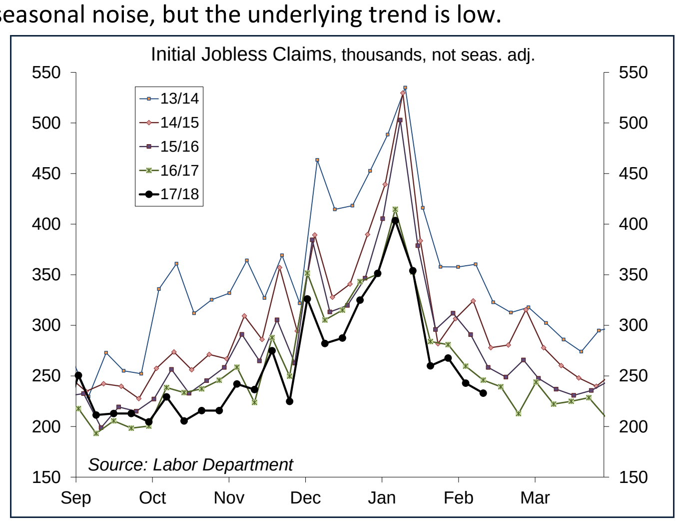


FOMC Minutes (January 30-31) – There was no press conference or revised Fed forecasts at this meeting and the wording of the policy statement was nearly the same as in the one from mid-December. Detailed minutes will be released in five years, which will clarify the transition from Yellen to Powell. Until then will have to guess. There is always some difference of opinion among senior Fed officials. Some (the hawks) are more concerned about inflation and fear falling behind the curve. Others (the doves) worry about the job market and the danger of raising short-term interest rates too soon. We're likely to see some of that debate in the FOMC minutes, but one shouldn't take it too seriously. Chair Powell will dive into more detail when he presents his semi-annual monetary policy testimony to Congress on February 28.



Thursday

Jobless Claims (week ending February 17) – The seasonal spike was narrower this year, consistent with a further strengthening in overall labor market conditions. There's always some flux in the job market. Jobs are created and destroyed (and we focus on net job gains). However, in strong times, someone newly laid off is more likely to find a new job right away (and therefore, is less likely to file a claim for unemployment insurance). Still, one wonders exactly how low the (adjusted) level of claims can go. In the near term, the weekly figures will still be subject to seasonal noise, but the underlying trend is low.



Leading Economic Indicators (January) – The LEI was originally put together by the Commerce Department, but was turned over to the Conference Board in the 1990s (budget cuts). It's a published formula and nearly all of the components are known. Hence, it's largely a question of the rounding error. Most components will make positive contributions in January, the largest from the pop in building permits, ISM new orders, the stock market (this was January), the yield curve, consumer expectations, and jobless claims.

Friday

No significant economic data.

Next Week ...

Jay Powell will present his first semi-annual monetary policy testimony to the House Financial Service Committee (Feb. 28) and the Senate Banking Committee (March 1).

Coming Events and Data Releases

March 5	ISM Non-Manufacturing Index (February)
March 7	ADP Payroll Estimate (February)
March 9	Employment Report (February)
March 13	Consumer Price Index (February)
March 14	Retail Sales (February)
March 21	FOMC Policy Decision, press conf.
March 30	Good Friday Holiday (markets closed)
May 2	FOMC Policy Decision (no press conf.)
June 13	FOMC Policy Decision, press conf.
November 6	Election Day