LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

October 15 2018

BENIGN INFLATION READINGS SUPPORT FED'S GRADUAL APPROACH

John Lynch *Chief Investment Strategist, LPL Financial*
Barry Gilbert, PhD, CFA *Asset Allocation Strategist, LPL Financial*

KEY TAKEAWAYS

Markets are growing increasingly sensitive to any inflation data that may put Fed rate hikes on an accelerated path.

While inflation has normalized to near the Fed's target of 2%, there are few signs of added pricing pressures appearing.

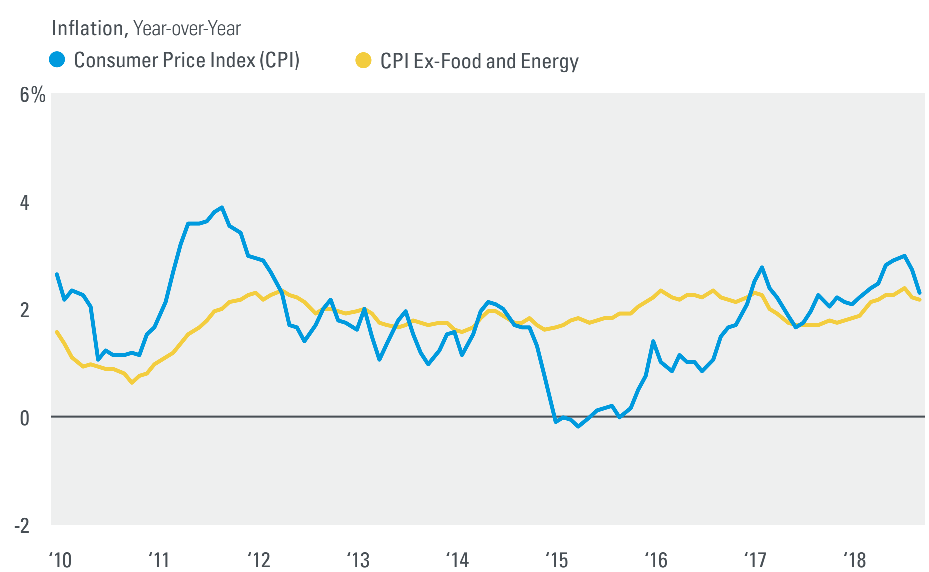
Fed policy, as reflected in dollar strength, is one of the main reasons inflation has remained contained despite accelerating economic growth.

Several new readings on inflation last week confirmed that price pressures remain manageable, supporting a continued gradual path of rate hikes for the Federal Reserve (Fed). With the unemployment rate near multi-decade lows and the economy growing well above the median Fed longer-term consensus rate of 1.8%, markets are growing increasingly sensitive to any inflation data that may put Fed rate hikes on an accelerated path. While inflation has normalized to near the Fed's target of 2%, there are few signs of added pricing pressures appearing. We attribute this to the Fed's gradual approach to tightening, which is likely contributing to overall inflation remaining well contained. The risk of inflation breaking to the upside, potentially fueled by factors such as economic growth, labor scarcity, and trade policy, needs to be monitored. However, recent inflation readings provide few signs that the economy is overheating.

HEADLINE INFLATION FALLS BELOW EXPECTATIONS

The Consumer Price Index (CPI), the most well-known inflation reading, increased 2.3% year over year in September, below expectations of 2.4% [Figure 1]. The "core" reading of CPI, which excludes volatile food and energy prices, grew slower than expected at 2.2%, only somewhat below the cycle high of 2.4%

1 INFLATION REMAINS NEAR THE FED'S 2% TARGET



Source: LPL Research, U.S. Bureau of Labor Statistics 10/12/18

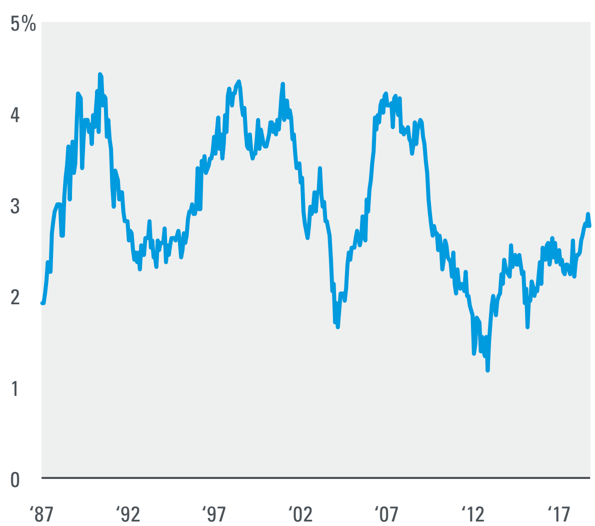
LPL Financial

recorded in July. Prices mirrored that of the core Personal Consumption Expenditures (PCE) index, the Fed's preferred consumer inflation measure, which rose 2% year over year through September. Core PCE tends to increase at a slower pace than core CPI. Despite the downside surprise, inflation readings of near to above 2% are unlikely to deter the Fed from its current path. Because of this, the readings were reassuring to markets, helping to dampen recent volatility as fears that inflationary pressure would start pushing up both short-term and long-term rates subsided.

Investors were also monitoring the Producer Price Index (PPI) this week. PPI measures prices at the wholesale level and includes unfinished goods used in the supply chain. While not as well-known as CPI, PPI is an important leading indicator for consumer prices. PPI, year over year, came in near expectations in September. With PPI ex-food and energy running a little hotter than CPI at 2.5%, and at 2.9% excluding trade, markets will continue to watch for signs of producer prices putting added pressure on consumer price levels. However, the data showed that so far, the impact has been minimal.

2 WAGES RISING BUT WELL BELOW PRIOR CYCLE PEAKS

Average Hourly Earnings
(Production and Nonsupervisory Employees, Year-over-Year)



Source: LPL Research, U.S. Bureau of Labor Statistics 10/12/18

WAGES RISING, BUT MANAGEABLE

Wage growth has been accelerating, to the benefit of U.S. consumers [Figure 2]. However, investors have scrutinized data on wages recently to gauge the level of inflationary pressures in the economy. Wages account for about 70% of business costs, so pay growth is an important source of inflation. Average hourly earnings grew 2.8% year over year last month, in line with forecasts and down from 2.9% in August, though at the high end of the range for this economic cycle. Nevertheless, historical context is important. Wage growth remains significantly slower than the 4% growth that led to more aggressive Fed tightening in past cycles. Overall, wage growth remains in the sweet spot for the economy. Strong, steady wage growth is a positive for the economy, especially against the backdrop of an extended period of weak wage growth, as long as it does not point to the economy overheating. In line with other inflation indicators, we have certainly seen wages reflect recent economic acceleration, but in our opinion it has not reached a level that should be alarming. However, we do expect markets to continue to be sensitive to any upside surprise.

FED, DOLLAR STRENGTH KEEPING INFLATION CONTAINED

Fed policy, as reflected in dollar strength, is a primary reason why inflation has remained contained despite accelerating economic growth. The Fed raised rates three times in 2017 and has already increased rates three times in 2018 (with another hike expected in December). This policy of slow but steady removal of accommodative monetary policy has generally diverged from the policy of other major developed market central banks, which has helped to keep the dollar strong. While a strong dollar hurts U.S. exporters, as U.S. goods become more expensive abroad, it benefits the consumers who are purchasing those goods, as weaker global currencies weigh on imported goods' prices and help cap inflation. The U.S. dollar remains near a 12-month high relative to its global counterparts, which has boosted export prices this year to their fastest growth since 2011.

CONCLUSION

While inflation has generally picked up along with accelerating economic growth, it remains well contained. However, rather than giving the Fed the green light to raise rates even more slowly, we believe it's a sign of how effective the current rate hike path has been in containing inflation. We still see a number of upside inflationary risks from wages, trade policy, oil prices, and above-trend economic growth. Those risks, coupled with the potential global impact of U.S. rates and dollar, may make the Fed reluctant to change the pace of its already modest path of rate hikes. But overall, we saw little to worry about in new inflation data, and we believe that as long as the Fed continues to stay on its current path, it may be able to continue to meet its dual mandate of full employment and low and stable inflation at least through 2019. ■

RES 27652 0918 | For Public Use | Tracking #1-781931 (Exp. 10/19)