LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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TOO HIGH OR TOO LOW?

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KEY TAKEAWAYS

Signs of slowing global growth have fueled worries of tepid domestic inflation.

Consumer price growth has softened, but producer price and wage growth remain solid.

We expect consumer price inflation to pick up as global headwinds subside.

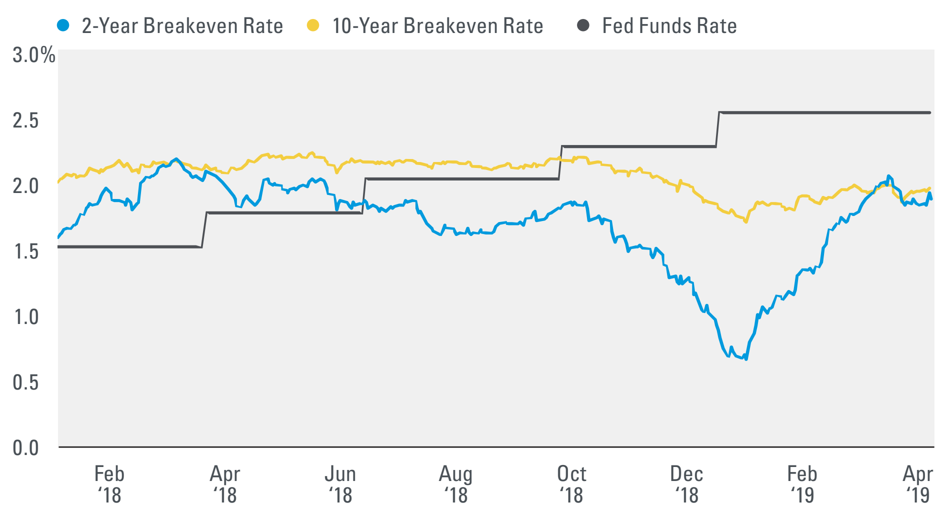
The U.S. inflation narrative has flipped. In 2018 and 2019, one of investors' prevailing worries was that inflationary pressures were increasing and the U.S. economy could start overheating under policymakers' noses.

Late in 2018, deteriorating global conditions shifted the economic landscape and fueled concerns that inflationary pressures could be too low, hinting of an impending U.S. economic slowdown. Investors have dealt with several cases of whiplash from changing narratives and policy speculation in this expansion. When that has happened, we've leaned toward data for direction. Even though investors' perception of inflation have changed, we see signs that lower inflation fears could be fleeting [Figure 1].

CONSUMER PRICES

The headline Consumer Price Index (CPI) grew 1.9% year over year in March. The core CPI index, which excludes the volatile food and energy components, rose 2% year over year through March, the lowest level in 13 months. Core data, which we prefer, show consumer price growth has progressively slowed since the U.S.-China

1 FINANCIAL MARKETS' INFLATION EXPECTATIONS FLIP



Source: LPL Research, Bloomberg 04/12/19

Breakeven interest rates are defined as the difference between the yields of nominal Treasuries and those of Treasury Inflation-Protected Securities. This difference implies market expectations for inflation rates over a certain period of time.

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trade dispute heated up in the second half of last year [Figure 2]. Consumer price inflation hasn't fallen to alarming levels, but the trend reflects the sting of lower global demand.

There are also idiosyncratic factors to consider in the most recent CPI report. Apparel prices slid the most in more than 50 years in the March CPI report, the same month as the Bureau of Labor Statistics switched its methodology for data collection in that sector. While this change only accounts for part of the weakness in recent data, it likely weighed on March's reading and could reverse in future months.

PRODUCER PRICES

As consumer price growth softens, wholesale price growth is humming along at a steady pace. The headline Producer Price Index (PPI) climbed 2.2% year over year in March, while core PPI rose 2.6%. Growth in services prices has hovered around 2.5–3% for several months, even as goods prices have slumped amid trade tensions. Services comprise approximately 80% of economic output, so as long as services price growth is sustained, it's unlikely that producer price growth will slide much further.

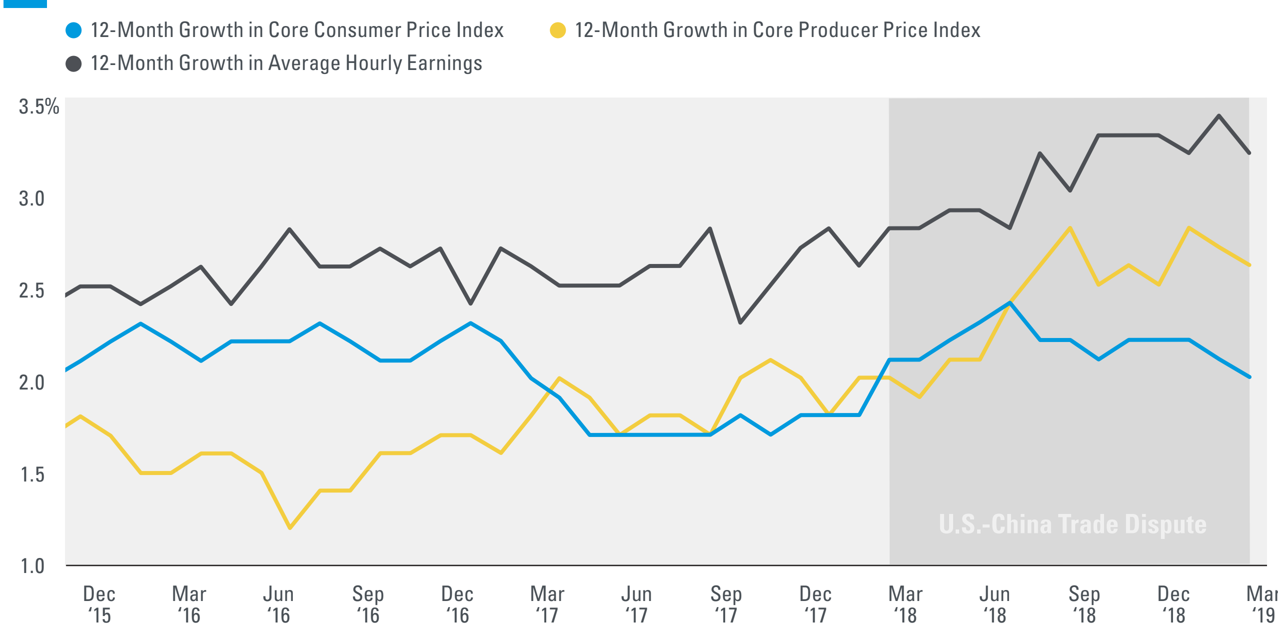
Recently, core producer price growth has exceeded core consumer price growth by the widest margin since 2012. Companies are incurring higher input costs, but they haven't raised prices at the same rate.

WAGES

Labor market strength has been one of the bright spots in the U.S. economy. Job gains have been strong, unemployment has reached a cycle low, and the labor force participation rate has ticked up recently as more of the working-age population look for employment. A tightening labor market has fueled a gradual pickup in wage growth, especially over the past several months. Average hourly earnings climbed 3.2% in March, just below the cycle-high growth of 3.4% reached in February.

Wage growth is an important inflation indicator to watch, as wages constitute about 70% of business costs. Like producer prices, wage inflation has broken away from consumer price inflation, showing us that pricing pressures may be building

2 CONSUMER PRICES BEAR THE BRUNT OF A GLOBAL SLOWDOWN



Source: LPL Research, Bureau of Labor Statistics 04/12/19 underneath the surface. We don't see evidence of an impending upside threat in wages, though. Wages historically have had to reach 4% year-over-year increases before threatening output, and we believe structural changes within the labor market will keep a long-term lid on growth.

THE FED'S VIEW

One half of the Federal Reserve's (Fed) dual mandate is promoting stable inflation. Because of this, investors have been obsessed with speculating on inflationary pressures over the past few years to gauge the Fed's next moves. The Fed takes a wide array of reports into consideration, but it has communicated that its preferred gauge for inflation has been core personal consumption expenditures (PCE), which uses a different methodology than CPI.

Core PCE climbed 1.8% in January, the 12th straight month year-over-year growth was within 25 basis points (0.25%) of the Fed's target. Based on this measure, inflation is still healthy and within the Fed's boundaries. However, the data lag by a few months.

February and March core PCE growth should slow further, according to historical patterns. Year-over-year core PCE growth has been about 25–50 basis points (0.25–0.5%) below year-over-year CPI growth in this cycle, which would equal 1.5–1.75% core PCE growth in recent months.

The Fed has recognized softening consumer inflation data, though, and made adjustments. Last month, the Fed lowered its core PCE forecast to 1.9% year-over-year growth for 2019, and policymakers have acknowledged the downside inflation risks in recent communications. The Fed has also signaled a long-term pause in rate hikes, exercising the flexibility policymakers have promised in response to slowing global growth, trade risk, and elevated uncertainty. The Fed's policy shift has helped ease monetary conditions, which should support higher inflation going forward.

CONCLUSION

The market's perception of a downside inflationary threat is mostly from a slowdown in consumer price growth, a trend we think is temporary. Producer prices and wages have steadily risen over the past few months, and we expect businesses to eventually adjust their prices as demand picks up and cost pressures increase. The lull we're seeing in consumer inflation should disappear as a resolution of trade tensions leads to a recovery in global conditions and low rates help stabilize domestic economic growth. Overall, we're expecting core CPI to increase 2.25–2.5% in 2019, with much of that pickup happening in the second half of the year. ■

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