# WEEKLY ECONOMIC COMMENTARY

### KEY TAKEAWAYS

Though recent headline readings of inflation and proposed tariffs appear threatening, other measures central to the Federal Reserve's (Fed) analysis of the pricing environment indicate less concern is warranted.

The Fed must balance mixed messages from wholesale/consumer pricing measures versus core personal consumption expenditures (PCE), as well as wage data.

Investors must not confuse price stability with runaway inflation.

Consequently, Fed policy may prove less aggressive than many investors currently fear.

#### August 13 2018

# DOES "HEADLINE" INFLATION TELL THE WHOLE STORY?

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

As the U.S. economic recovery moves into its later stages, inflation has emerged at a surprisingly slow and inconsistent rate, befuddling investors who have watched the expansion set the stage for anticipated price and wage growth. Only recently has data emerged indicating that pricing pressures have approached, and in some circumstances exceeded, target levels from monetary policymakers.

Inflation is a focal point of the Fed's evaluation of economic health when determining future monetary policy. However, the absence of inflation in the recovery has apparently stumped even the Fed, which incorporated a variety of innovative policies and quintupled the size of its balance sheet over the past decade to combat deflationary pressures. Last month, Fed Chair Jerome Powell said the risks to inflation are "roughly balanced," but added that the Fed is "slightly more worried about low inflation still," contradicting the Fed's longstanding view that the U.S. economy is more prone to overheating.

While signs of price and wage pressure have been building, we believe the overall pricing environment may not prove as threatening as many investors fear, despite solid economic growth, proposed tariffs, and the low unemployment rate. Because of this, it's conceivable that actual Fed policy may prove less onerous than current projections suggest, with potentially positive implications for investors.

## MIXED MESSAGES FROM PRICING DATA

A variety of inflation reports in recent months have displayed alarming headline numbers, only to indicate less threatening signals under the surface. A review of this data shows that the risks from the more popular wholesale and consumer measures are likely more balanced when compared with the Fed's preferred measures, core PCE and indicators of wage inflation.

For example, last week's July Producer Price Index (PPI) showed that while wholesale prices remained steady at +3.3% year over year, the core measure, which excludes the volatility in pricing of food and energy components, neared a cycle high of +2.7% year over year. Yet further analysis shows that PPI growth benefited from a jump in goods prices (+4.4% year over year) compared with a gain of just 2.6% in prices for services over the same time period. Since services comprise approximately 80% of economic output, we will have to see more pricing pressure from this critical segment of the economy before concern of a sustained pricing threat becomes justified.

### **I** LPL Financial

1

Similarly, July's Consumer Price Index (CPI) headline reading of +2.9% year over year also suggests increased pricing pressures. Further analysis of core CPI also indicates a cycle high (+2.4% year over year), which is slightly above the peak of +2.3% achieved three times (April 2012, February 2016, and August 2016) since 2008. In each of these instances, however, the forces of supply and demand caused core readings to decline below 2.0% over the ensuing 12 months. This begs the question of whether peaks in core measures are self-sustaining, or self-correcting. We'll continue to monitor this in the months and quarters ahead.

### CORE PCE AND WAGES

Another of the main inflation gauges we watch is core PCE, which is the Fed's preferred inflation measure [Figure 1]. Core PCE rose +1.9% year

#### CORE PCE SHOWS INFLATION IS MUTED COMPARED TO LAST TIGHTENING CYCLE



A tightening cycle is a period in which the federal funds rate increases.

over year in June, just below the Fed's target of 2%. We believe it's important for investors to remember that the Fed's official mandates are to ensure as full an employment situation as possible and to achieve price stability. Since the latter is assumed to be +2.0% year-over-year inflation growth, we believe the current core PCE reading must be viewed in the context of stable prices, rather than runaway inflation.

Indeed, inflation this cycle has been more muted than in previous experiences, with core PCE growth averaging +1.7% since the Fed's first rate hike in December 2015. This compares favorably with the 2.2% average reading from the Fed's last tightening cycle (from June 2004 to June 2006).

Recently, the Fed has emphasized the "symmetric" nature of the core PCE target to reassure investors that it will consider other long-term indicators of price and wage growth even if core PCE climbs above 2.0%. To us, this is the Fed's nod to other signals that inflation may not be robust enough for the current stage of the expansion.

It's also important for investors to appreciate the importance of wage growth when assessing the environment for inflation. Since wages can represent up to 70% of total business costs, it's difficult to have a sustainable pricing threat without the participation of wages. The July jobs report showed that average hourly earnings rose 2.7% over the past 12 months, while the Employment Cost Index climbed 2.8% year over year through the end of the second quarter. Considering that each of the past five recessions started with wage growth in excess of 4.0%, we believe there is ample time before inflationary wage pressures can weigh on output. To be sure, this is a curious time, given that unemployment is at a cycle low. Yet the combination of low labor force participation, mild productivity growth, globalization, and millennials replacing baby boomers in the workforce has managed to keep a lid on wage costs.

#### WEC

### **T** LPL Financial

WFC

# CONCLUSION

Though several "headline" numbers for inflation have reached cycle highs, we believe it's important for investors to look deeper into the data. While we don't want to appear dismissive of any risks that could derail this expansion, the core readings for consumer and wholesale prices appear more in line with price stability. Indeed, since inflation has been low for such a long time, it's apparent to us that too many investors are confusing the Fed's target for price stability with runaway inflation. As a result, we'll continue to monitor all pricing data but maintain our emphasis on core PCE and wage growth. Considering that these measures are more stable, we look for the Fed to maintain its gradual pace of interest rate increases and balance sheet reduction. Moreover, policymakers will also likely have to consider other factors beyond their official mandates, including trade, deficit spending, market interest rates, and currency differentials.

#### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing involves risk including loss of principal.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.

This research material has been prepared by LPL Financial LLC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial LLC is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 02965 0718 | For Client Use | Tracking #1-759486 (Exp. 08/19)



3