Financial Market Weekly

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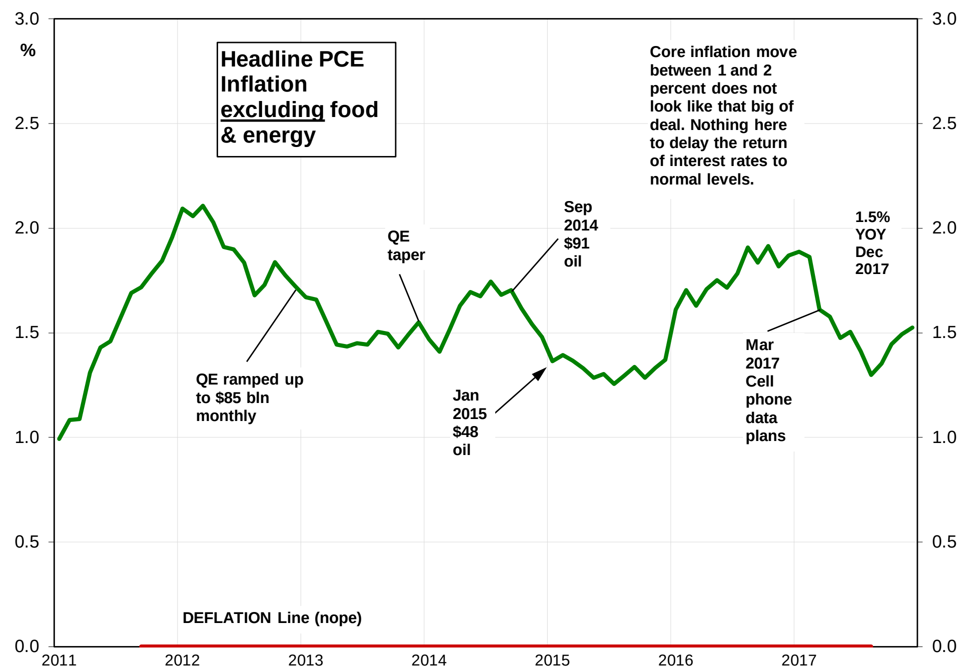
MARKET FEARS INFLATION IS HEATING UP. IS IT?

The stock market losses this year in part are due to the market's fear that inflation is heating up, the Fed may need to raise rates four times this year, not the three times they expected at their December meeting last year. Average hourly earnings rose 2.9% the last year to $25.74 an hour in the January 2018 monthly employment situation report from the BLS on Friday, February 2. 10-yr yields rose from 2.79% to as high as 2.85% on the news. Thinking wage inflation leads to price inflation.



But to get back to the question, is inflation heating up? Core PCE inflation was 1.5% in December, and may lift a few tenths to 1.8% when that cell phone data plan inflation-buster drops out of the year-on-year data upon the release of the March 2018 consumer inflation reports. (March CPI report is Wednesday, April 11 and March PCE inflation is Monday, April 30.) We aren't sure whether wage pressures can produce more inflation. The recent historical record isn't great where stronger average hourly earnings in the late 90s never led to a boost in core PCE inflation. Besides we always thought it is inflation that leads to higher wages, not the other way around that the bond market fears. But never say never. This is the tightest labor market in a generation or two or three.

Headline PCE inflation was not that short of 2 percent the last two years; 1.7% in 2017, and 1.8% in 2016. Fed officials probably make too much of the low-inflation story. It is a story. Not true. Yellen has left the building and she liked to look at core inflation less food and energy as it shows where the underlying trend is going as opposed to transitory energy or crop price effects.

It's not the easiest of tasks to explain why core PCE inflation was 1.5% in 2017 year down from 1.9% in 2016. Less than a half-percentage point. The most obvious reason was cell phone data plans that gave their users more data for free in March 2017. Inflation has been heating up a little in recent months. The monthly core inflation changes have been stronger the last several months: 0.2% increases in three of the last four months after a run of 0.1s.

Where is inflation going after the cell phone data effect washes out in March? Could core PCE inflation make it back a little above 2% like it did during the housing bubble years? Housing prices rose 3.3% this year the same pace as the last few years. Back in the mid-2000s housing bubble, this measure of prices never really increased any faster than it is today. One of the reasons PCE inflation is less than CPI inflation is that housing has a smaller weight (18%) in PCE than in CPI (43%).

Healthcare inflation will be important in lifting PCE inflation potentially. Health care was rising faster in the mid-2000s (3.0 to 3.7% for years 2003-07) before the recession and Obamacare. Health care has an enormous weight: accounting for 19% of consumers' core PCE expenditures. Health care in CPI is rising about the same as PCE health care services, but it has a smaller 8.4% weight in core CPI inflation. Another reason core PCE inflation is rising less than core CPI inflation.

To conclude, market fears of an inflation outbreak are overblown. Core PCE inflation can probably make it back to where it was in the mid-2000s, 2.2%, but it is hard to see it going higher than this. Fed officials, even the hawks, probably suspect as much, so it is hard to think of the Fed funds rate going to 5.25% this cycle like it did in June 2006 during the housing bubble economy years.

Why is inflation lower in 2017?	Percent % changes		
	Dec 2016	Dec 2015	Dec 2014
	Dec 2017	Dec 2016	Dec 2015
Core PCE inflation YOY	1.5	1.9	1.4
Communication	-4.6	-1.7	-0.2
Financial services	4.9	7.4	5.0
Prescription drugs	2.8	6.3	2.5
Other durables, jewelry, books	-0.4	2.1	-2.6
Hotels	0.7	3.3	2.0
Health care	1.5	1.4	0.7
Gasoline	10.7	8.9	-20.2
Housing	3.3	3.6	3.3
Headline Inflation	1.7	1.8	0.5

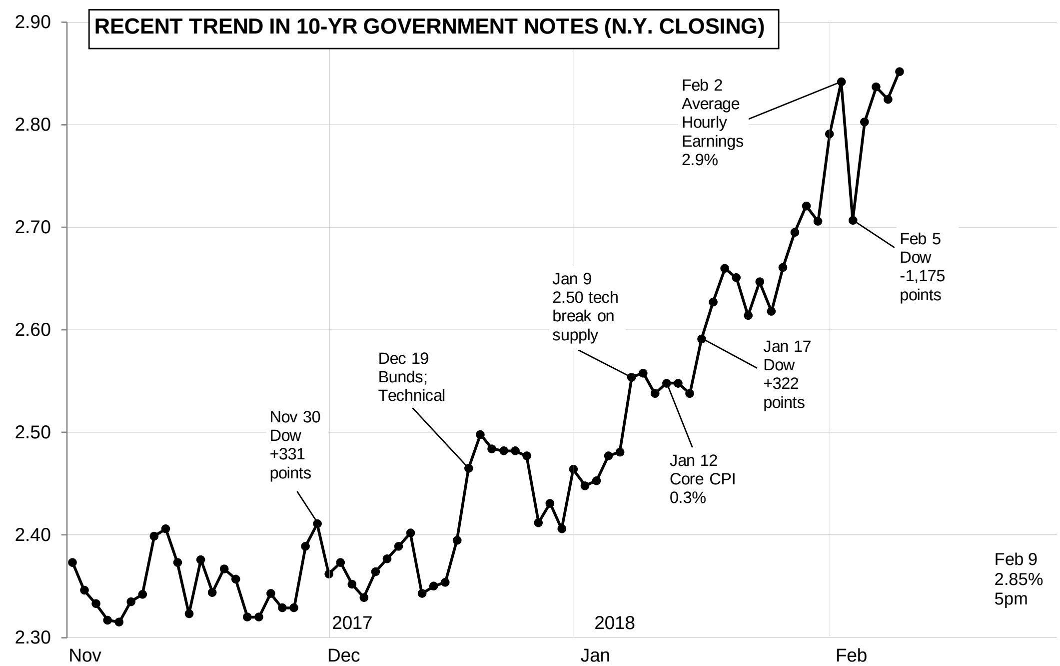
Core PCE Inflation monthly and year-on-year changes

2017	% chg	YOY	2016	% chg	YOY
Dec	0.2	1.5	Dec	0.1	1.9
Nov	0.1	1.5	Nov	0.0	1.8
Oct	0.2	1.4	Oct	0.1	1.9
Sep	0.2	1.4	Sep	0.1	1.8
Aug	0.1	1.3	Aug	0.2	1.9
Jul	0.1	1.4	Jul	0.2	1.8
Jun	0.1	1.5	Jun	0.1	1.7
May	0.1	1.5	May	0.2	1.8
Apr	0.2	1.6	Apr	0.2	1.7
Mar	-0.2	1.6	Mar	0.1	1.6
Feb	0.2	1.9	Feb	0.2	1.7
Jan	0.3	1.9	Jan	0.3	1.6

MARKETS OUTLOOK

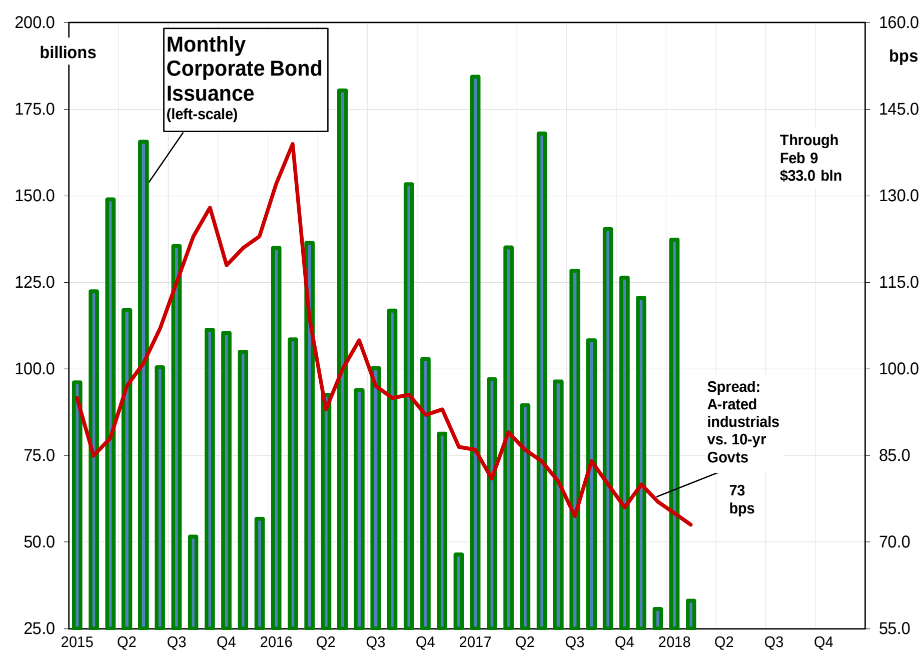
	29-Dec 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
30-Yr Treasury	2.74	2.90	3.00	3.10	3.30	3.40	3.50	3.60	3.70	3.80	3.80
10-Yr Note	2.41	2.50	2.70	2.80	3.00	3.20	3.30	3.40	3.50	3.70	3.70
5-Yr Note	2.21	2.20	2.40	2.60	2.80	3.00	3.15	3.30	3.40	3.60	3.60
2-Yr Note	1.89	1.95	2.20	2.45	2.65	2.85	3.10	3.30	3.40	3.60	3.80
3-month Libor	1.69	1.90	2.10	2.40	2.60	2.90	3.10	3.40	3.40	3.60	3.90
Fed Funds Rate	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75
2s/10s spread	52	55	50	35	35	35	20	10	10	10	(10)

Yields didn't change much at the end of the week: closing 2.85% versus 2.84% the prior week. The 1,175 point drop in stocks on Monday brought 10-yr yields to the week's low of 2.65% at the Asia opening Monday night in New York. Bonds are not rallying yet on the stock market weakness. Part of this may be due to supply fears. Congress passed a two-year budget agreement that increases spending by $400 billion.



CORPORATE BONDS: CELGENE, MCKESSON, HARLEY-DAVIDSON

Corporate offerings were $18.0 billion in the February 9 week versus $30.7 billion in the February 2 week. On Thursday, Celgene Corp. sold $4.5 billion 3s/5s/10s/30s. It priced a $1.5 billion 3.9% 10-yr (m-w +20bp) at 110 bps (Baa2/BBB+). The biopharmaceutical company will use the proceeds to finance part of its Juno acquisition. Corporate bonds (10-yr Industrials rated A2) were 73 bps above 10-yr Treasuries this week versus 71 bps last Friday.



FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	7-Feb	31-Jan	24-Jan	17-Jan	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2436.192	2436.211	2447.009	2447.009	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1760.743	1760.743	1771.054	1770.349	0.000
Primary credit (Discount Window)	0.019	0.046	0.048	0.096	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	1.715	1.715	1.714	1.715	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	0.000
Central bank liquidity swaps	0.039	0.673	0.072	0.118	62.000
Federal Reserve Assets	4468.0	4465.6	4488.5	4486.4	961.7
3-month Libor %	1.80	1.78	1.75	1.74	2.82
Factors draining reserves					
Currency in circulation	1612.559	1607.532	1606.672	1610.257	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	48.120	65.797	36.371	20.548	0.000
Reserve Balances (Net Liquidity)	2240.014	2323.217	2182.220	2234.452	24.964
Treasuries within 15 days	16.563	16.563	27.847	27.847	14.955
Treasuries 16 to 90 days	97.821	97.821	80.038	80.038	31.549
Treasuries 91 days to 1 year	297.077	297.078	317.233	317.233	69.272
Treasuries over 1-yr to 5 years	1081.307	1081.309	1083.901	1083.901	170.807
Treasuries over 5-yrs to 10 years	322.161	322.166	316.716	316.716	91.863
Treasuries over 10-years	621.263	621.274	621.273	621.273	101.337

**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

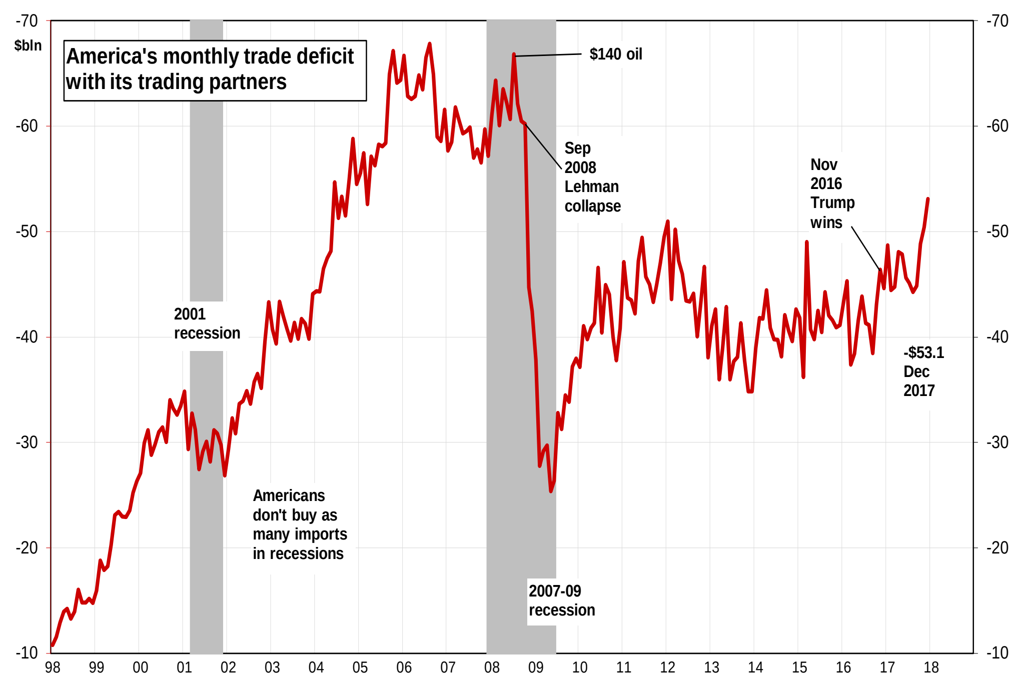
The Fed meets March 20-21 to consider its monetary policy. Fed Chair Powell was sworn in Monday morning and the Dow Jones Industrials fell 1,175 points at the end of his first day. Welcome to the job. He posted a video message on the Fed's website, modestly introducing himself, after becoming Chair. He's committed to "explaining what we're doing and why we are doing it."

The stock market fell 12.2% from the high of the year at one point on Friday, before closing over 800 points higher from the low. The decline rivals the plunge of markets back in September 2015 and February 2016, declines which caused the Fed to postpone rate hikes under Yellen. Not sure what Powell would do. On March 21. But the market odds of a rate hike are still quite high next month at 80%. Many Fed members didn't want to hike rates already for low-inflation reasons, and the decision of others will likely depend on how much stocks recover in the next several weeks.

OTHER ECONOMIC NEWS THIS WEEK

Trade deficit worsens further under Team Trump (Wednesday)

Breaking economy news. The trade balance which really means trade deficit. Try to forget stocks were up 7.7% for the year a couple of Fridays back, and now stocks are down 1.5% on the year after last night's close. Perfectly normal correction. Not to worry. Dow industrials often fall 800 points in ten minutes. All our money is invested in the stock market, but we are not concerned at all. No sir.



The trade deficit with America's trading partners was less fair and reciprocal in December widening to $53.1 billion from $50.4 billion last month. This deficit is now the widest now since the recession.

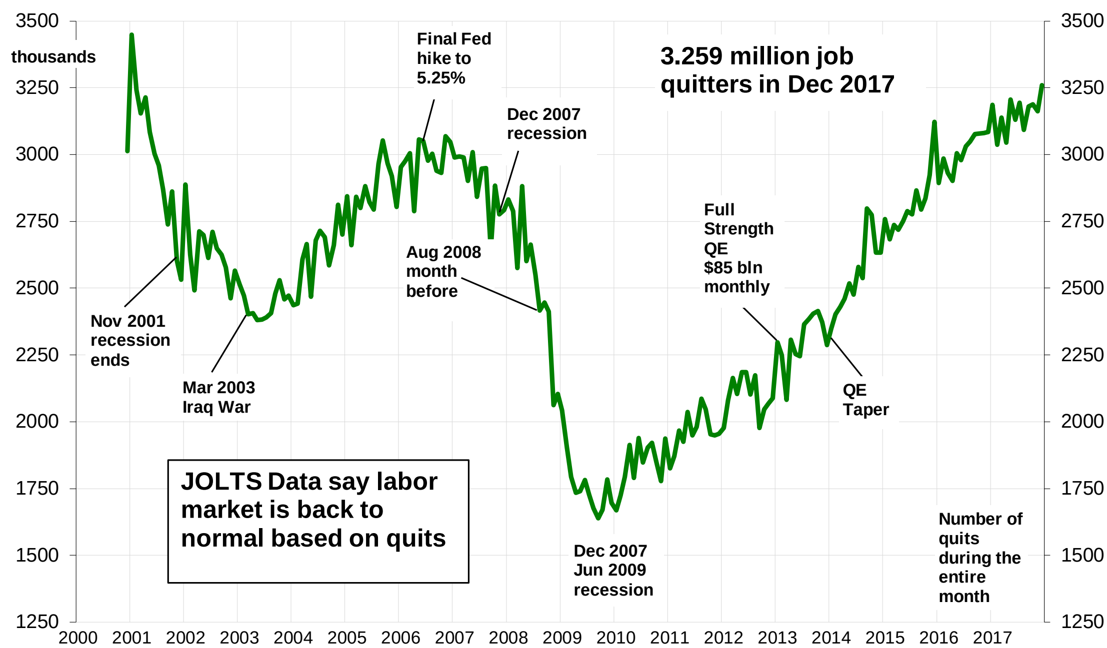
Worse than Obama's second term in office. Trump's trade team has not been able to stem the flood of imports into the country yet.

The terms of trade are not completely unfair as exports of goods jumped 2.5% to $137.5 billion in December. It's just that America's love affair with exotic foreign goods continues with imported goods rising 2.9% in December to $210.8 billion. Yes, and don't forget it is American companies assembling goods outside the country and then bringing them back in which is the problem with the trade imbalance in goods. Exports of goods rose $11.1 billion the last year, while imports rose $19.7 billion.

Net, net, world trade continues to recover from the vantage point of the U.S. with increased exports adding to growth here even if imported goods are rising even more quickly. World nations are back to trading with one another and that's a good thing as it improves the world economic growth outlook. Most of the exports strength is in petroleum-based products, although capital goods and auto exports are also part of the improvement. On the imports side, petroleum-based goods are part of it, but capital goods, and consumer goods are even stronger. The consumer goods imbalance has caught the eye of the Trump administration with $602 billion coming in last year, and just $197 billion going out. Stay tuned. Story developing. Try to keep your mind off the stock market today. It's just a healthy correction. It's just a healthy correction. It's just a healthy correction. It's just a healthy correction. It's just a healthy correction. It's just a healthy correction.

5.8 million help wanted signs still out there in the country (Wednesday)

Breaking economy news. The JOLTS data for December are out. Job openings and labor turnover survey. The news that job openings dropped is a big headfake when it comes to current labor market conditions. There are still 5.8 million help wanted signs out there in the country at the end of last year which is a very big number and a big deal. Companies are still looking for workers in one of the tightest labor markets in decades. Part of the reason for the decline in openings is the strong hiring seen recently in manufacturing and construction, so don't be fooled by the modest decline in openings today.



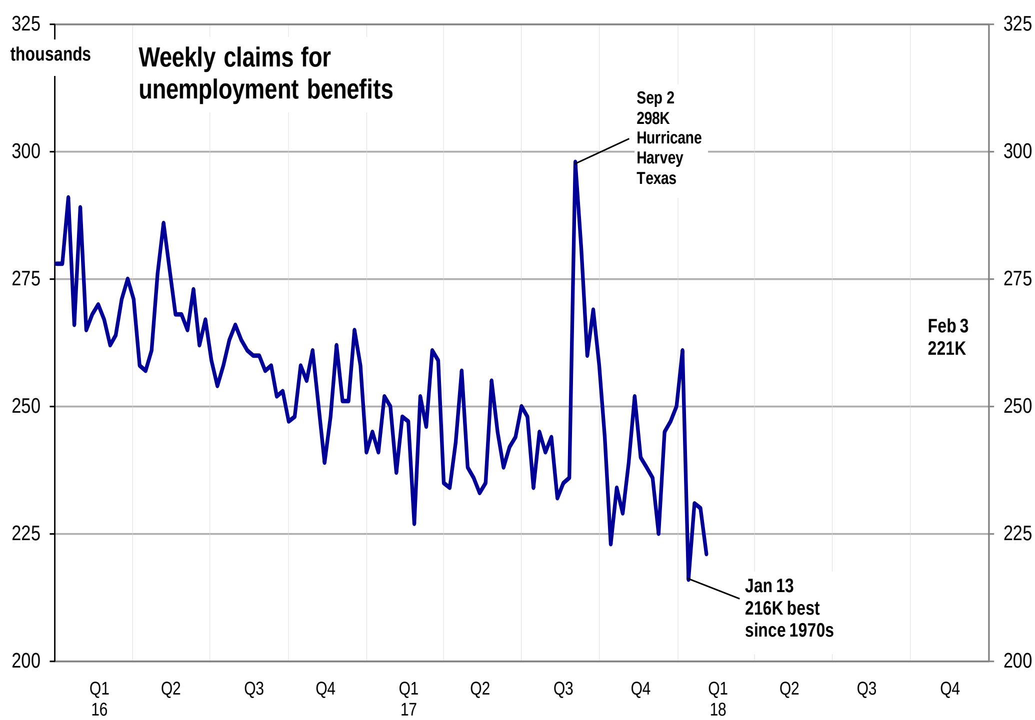
Net, net, job openings nationwide number in the millions and this highly elevated level indicates the difficulty that employers are having in trying to bring in the workers they need to make their businesses grow. Time will tell if this is the economy's Achilles heel in this long nine-year expansion that will eventually slow growth. The Tax Cuts and Jobs Act was not necessary to boost jobs in the economy that's for sure, not with 5.8 million jobs out there for the asking right now.

Fed Chair Yellen has passed the baton to Fed Chairman Powell who has learned a lot serving under Yellen the last four years. Yellen always liked the quits rate in the JOLTS data as a labor market indicator of worker confidence. You have to have a lot of confidence in your ability to find new work if you quit your job, and this month, the number of quits moved up to a new high of 3.259 million for the first time since the recession ended. You have to go all the way back to the year 2001 to find more quitters.

The data today are likely to keep the Fed on the path of gradual rate hikes this year as long as the stock market stabilizes from its death plunge the last two weeks. Labor market conditions are picture perfect today, but that can change in a hurry if worsening financial conditions and plunging markets take a toll on business confidence. Stay tuned. Story developing. The stock market is better than you think. Bet on it.

Labor market on fire while the Fed burns (Thursday)

Breaking economy news. Weekly jobless claims. No wonder companies are spending their tax cuts on their employees. It has never been more true that good help is hard to find. Any help is hard to find with jobs layoffs at lows not seen since the 70s. Companies are keeping the workers they have because once they leave, they cannot be replaced. The labor pool nationwide is nearly empty.



221K layoffs in the February 3 week is just a few thousand off the record low for this nine year expansion of 216K in the January 13 week. 216K is the lowest since the 70s. The labor market is as tight as a drum and that can only mean one thing. This economy is on a collision course with good old-fashioned wage inflation that hasn't been seen since the 1960s.

For Fed officials, it is damn the torpedoes and plunging stock prices and keep with the game plan to raise rates gradually as the economy is showing increasing signs of overheating. On the current path, interest rates won't make it to 2.75% neutral levels until the end of 2019, and two years may be too long of a time to wait. The Fed may be out of step with current economic conditions and behind the curve. Bet on it.

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