# After the INFLATION Intermission

Market Viewpoint: February 28, 2019

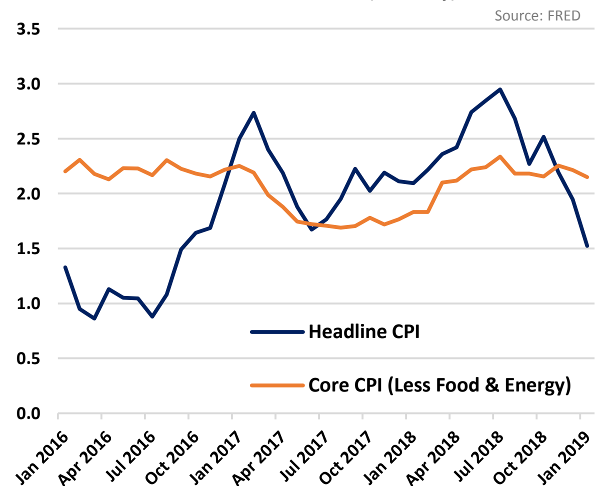
*Summary: Headline inflation has shifted into a downtrend over the past few months, largely due to a sharp decline in energy prices toward the end of 2018. The core CPI, however, shows that, aside from food and energy, inflation remains above 2%. While the Fed is going to need more than that to shift them out of their "patient" position on interest rates, MRP believes that a rebound in the price of crude oil and other commodities, as well as consumer staples and other finished goods will continue to push inflation higher throughout 2019.*

The market's recovery from 2018's fourth quarter collapse has been reinforced by the Fed's decision to pause for the moment on further rate hikes. But for all of the chatter about global growth from market pundits and the Fed itself, the pause in the tightening cycle may have had more to do with the slowdown in the inflation readings. How long the slowdown lasts and how the Fed might react to an eventual reacceleration will importantly impact the capital markets.

**Below the Headlines**

The consumer price index, which was flirting with 3% just last summer, pulled back to below 2% in December and fell to an almost 2-year low of just 1.5% in January. That has been enough to at least change the attitude of Fed Chairman Jerome Powell, who followed up the January FOMC meeting by stating the committee would be "patient" going forward. That was a dramatic change from his mood in October, when he proclaimed the Fed was "a long way" from a neutral policy on rate hikes.

The FOMC's official statement, as usual, focused on the Fed's dual mandate to "foster maximum employment and price stability", but changed the text from December's meeting to include "muted inflation pressures", indicating the committee as a whole is growing more vigilant about inflation and concerned about the decline in inflation expectations. Although some have come up with theories of Powell caving to pressure from President Trump, the reality is that some of the economic data and the rate of increase in prices seems to have softened toward the end of 2018. But the slowdown is not nearly as drastic as it seems.



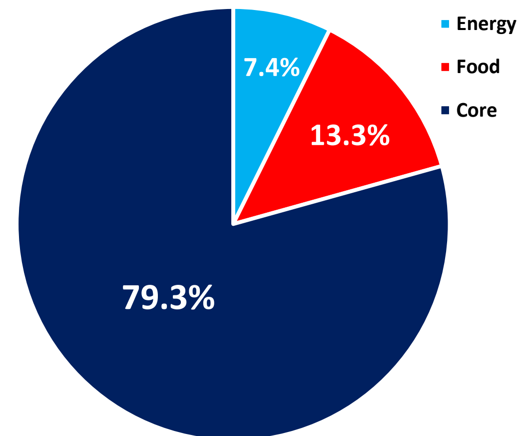

As we noted in last month's viewpoint, the core CPI (all items less food and energy) has not seen nearly as sharp of a downturn. In fact, Core CPI growth closed out the final month of 2018 at 2.2%, an above-average result for the year, and just a tenth of a percent below the July peak of 2.3%. Last month, even while headline CPI growth fell sharply, core growth remained on track at 2.1%.

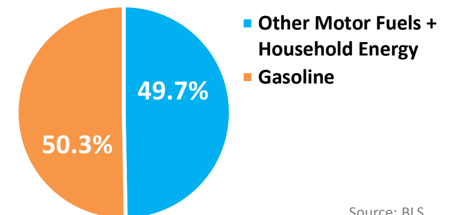
The same pattern can be seen in the producer price index (PPI) where the core figures are also strongly outperforming headline PPI. Prices for final demand goods, ex food and energy saw growth of 2.5%, compared to 2.0% in the nominal PPI, indicating some inflationary pressure still coming down the pipeline.

Joseph J. McAlinden, CFA, is the founder of McAlinden Research Partners (MRP) and its parent company, Catalpa Capital Advisors. He has 50 years of investment experience. Mr. McAlinden founded Catalpa Capital in March 2007 after leaving Morgan Stanley Investment Management where he had spent 12 years, serving first as chief investment officer and later as chief global strategist. During his 10 year tenure as chief investment officer, he was responsible for directing MSIM's daily investment activities and oversaw more than $400 billion in assets. As chief global strategist, he developed and articulated the firm's investment policy and outlook. Prior to Morgan Stanley, Mr. McAlinden held positions as chief investment officer at Dillon Read and as President & CEO of Argus Research.

## The Role of Crude

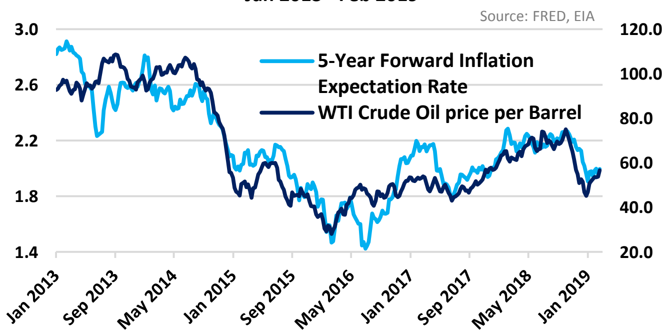
The disinflation story in the headline CPI can be largely attributed to declining energy prices – primarily the price of crude oil, notwithstanding the fact that gasoline accounts for a small share of the total CPI, as well as a more significant share of the CPI's energy index. But we think that is about to change in the coming months.



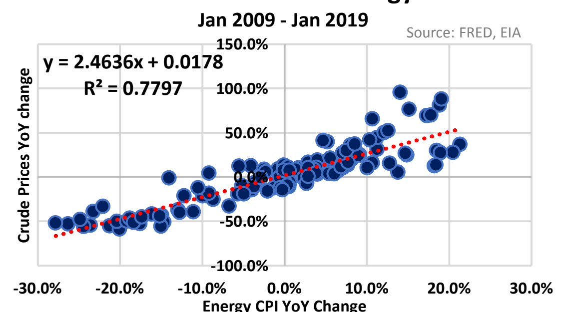

OPEC's crude oil production plummeted by nearly 1 million barrels per day (bpd) from December to 30.86 million bpd in January, marking the lowest production for the cartel since March 2015. Production is expected to dip lower yet, as OPEC members follow through on their agreement to cut 1.2 million bpd through the first half of 2019. Saudi Arabia intends to go even deeper, reducing its output in March by an additional 500,000 bpd. Outside of OPEC, a syndicate of other oil-producing nations headed by Russia is also cutting production, forming the OPEC+ alliance. Additionally, new international sanctions on Venezuela have forced the country's exports lower. Wood-Mackenzie estimates that Venezuelan production could soon fall by another 200,000 bpd.

In the US, a survey from the Federal Reserve Bank of Dallas finds that shale activity slammed on the brakes in the fourth quarter. "The business activity index—the survey's broadest measure of conditions facing Eleventh District energy firms—remained positive, but barely so, plunging from 43.3 in the third quarter to 2.3 (zero would mean that business activity from Texas energy firms was flat compared to the prior quarter) in the fourth". The index for utilization of equipment by oilfield services firms dropped sharply in the fourth quarter, down from 43 points in the third quarter to just 1.6 in the fourth – falling to the point where there was almost no growth at all quarter-on-quarter.




Amazingly, long-term inflation expectations of professional traders in the bond markets seem to be driven by the swings in crude prices as well. Inflation expectations in the markets are usually quantified by taking the difference between the yield-to-maturity of a conventional Treasury coupon bond and that of a Treasury Inflation-Protected Security (TIPS) bond of the same maturity term. This difference produces the breakeven inflation rate, so named because if future inflation were equal to this value, then the realized return of the conventional UST bond would be the same as for the TIPS bond. One can extract inflation expectations for the next five years beginning five years from now by using the 10-year and 5-year conventional and TIPS bonds.

But as we show in the chart above, inflation for the five-year period, beginning five years from now, seems to correlate highly with changes in the spot price of oil from two nanoseconds ago. When hedge funds were heavily shorting crude and prices were plunging in the final quarter of last year, the inflation expectations for five years from now fell alongside them. And now, with spot oil prices having rebounded since they hit their low on Christmas Eve, traders' expectations of what inflation will be in the five-year period beginning five years from now have risen accordingly.



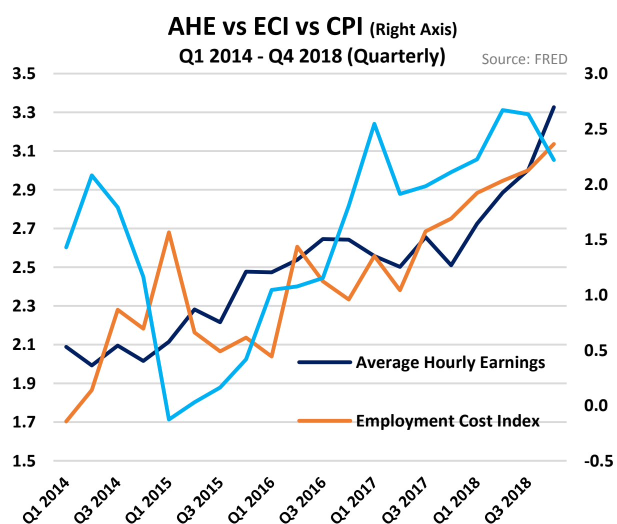
The CPI index for energy is also largely driven by fluctuations in oil's price. Due to a strong run up in energy prices last year, YoY growth in the headline data likely won't show up until we see a rebound in crude prices. And given the oil market trends highlighted above, MRP retains our long-held view that the price of WTI crude will return to a range of $60 - $80 per barrel, helping to create a rebound in headline CPI. Nonetheless, because of the base effect, the year-to-year change in crude is not likely to be positive until the fourth quarter.

**Core Pressures**

According to the Bureau of Labor Statistics, the employment-cost index, a measure of wages and benefits for civilian workers, rose a seasonally adjusted 0.7% in the final quarter of 2018. While that figure was a bit below economists' expectations, wages and salaries for all civilian workers rose 3.1% from a year earlier, the largest jump since 2008 and well above the average of the last 17 years.

Additionally, these figures follow a broader trend that has seen the 5-year moving average of growth in average hourly earnings hit its highest level since 2012. Sustained tightness in the labor market plays a large part in rising wages, but some would suggest that savings from last year's corporate tax cuts, provided by the Tax Cuts and Jobs Act, may also be helping employers invest more, increasing the efficiency of their workers.

Bloomberg reports that Americans' inflation-adjusted wages are rising at the fastest pace in more than two years. Further, when excluding food and energy prices, growth in U.S. average hourly earnings outpaced so-called core inflation by 1.3 percentage points in the 12 months through January, matching the strongest performance in eight years. Take out housing costs and inflation-adjusted wage growth was 2% -- the highest pace since 2009.




The ISM has pegged its January Purchasing Managers' Index at 56.6%, an increase of 2.3 percentage points from the prior month's reading, reversing a downward trend in the index since this past summer. Although the raw materials component of the ISM prices index experienced a decline in prices, it was only a slight drop due to turbulence in metals markets. By sector, results were largely mixed.

February, however, may be a game-changer for inflation across multiple industries. Commodities prices have begun a strong rebound, with prices of iron ore hitting their highest levels since 2014. This, along with new wage hikes for American steelworkers, has pushed major producers including ArcelorMittal, Nucor and U.S. Steel to raise the price of steel. Along with iron, copper futures prices have rebounded to a 7-month high as inventories have begun to shrink.

Meanwhile, many companies are boosting prices for finished goods. Boeing Co. has also begun raising prices as the list prices on its lineup of commercial aircraft has increased by almost 3.9% over 2018. Much like the steel companies, a Boeing spokesman noted that the swelling prices reflect higher costs for wages, goods and services. The Wall Street Journal reported earlier this month that a number of major producers of non-discretionary household goods, including Church & Dwight, Procter & Gamble Co., Colgate-Palmolive Co. and Clorox Co., have raised prices—or pledged to do so—in response to higher costs of raw materials and transportation, as well as unfavorable foreign-currency swings. This is a significant development because price cuts have been far more common than price increases as U.S. companies were mostly reluctant to test consumers' spending power and brand loyalty.

Compounding those issues, labor markets continue to tighten. U.S. job openings (JOLTS) surged to a record high in December, suggesting a strong uptick in labor demand. We expect these strong JOLTS figures to accelerate wage growth at an even more rapid pace down the line.

The recent strength in the dollar has contributed to the weak inflation numbers as well. Foreign exchange rates are impacted by the inflation rate, but there is also a large feedback effect in which the dollar can actually influence inflation rate itself, which begs one to ask, which comes first: The chicken or the egg? In this case, since the Fed seems to have paused for now on rate hikes, a rise in inflation would cause real rates (the fed funds rate subtracted by the YoY change in the CPI) to contract. A decline in real rates would suggest weakness in the dollar and an eventual rolling over to occur.

**Market Implications**

A resumption of rising inflation would also revive the rise in bond yields seen through most of 2018. The yield on the 10-year dropped more than 50 basis points from its 2018 peak of 3.22% in the 4th quarter, down to around 2.7%. That yield is out of whack with several different measures of historical norms. As MRP has noted before, the spread between the fed funds rate and the 10-year has averaged about 100 basis points over the long term; so, the current spread between the 10-year yield and the federal funds rate is extremely thin.

While the Fed's most recent Dot Plot from December, which had forecast 2 rate hikes in 2019, has seemingly become irrelevant, the Fed's minutes from its January meeting noted that "many" on the committee were unsure what adjustments would be needed this year. But even just one rate hike would still push the Federal Funds rate to a range of 2.5% - 2.75%. Adding 100 basis points on top of that would mean a 10-year yield of 3.5% - 3.75%, still very close to the four-handle we have been anticipating. Also, the trend of nominal GDP continues to march higher, with the just-released fourth quarter numbers pushing the 5-year moving average, which closely tracks the 10-year yield, up to 4%.

Equities have enjoyed a strong rebound into 2019 and some even feel that Powell's new dovish attitude was brought on by pressure from the administration to get the stock market back on track. While that is not directly part of the Fed's mandate, it isn't completely illogical to think that Powell is considering other parts of the economy, given that inflation and employment have been well within the Fed's control over the last year. Lower levels of inflation would continue to feed the upward momentum in equity prices, but MRP's belief continues to be that a rebound in inflation will eventually redirect stocks back into a downtrend and send P/Es, which are still somewhat elevated, back toward their long-term averages.

*For MRP's research disclaimer, please go to www.mcalindenresearchparters.com/disclaimer.html*