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ECONOMIC TALKING POINTS

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Don't take the latest inflation scare too seriously.
Weaker retail sales show consumers are turning more cautious.

The first real tremors of inflation have arrived and it has been unnerving for many investors and consumers. That angst is hardly a surprise. An entire generation of Americans have become accustomed to a world of miniscule price increases and low interest rates. Even for those who have been around a lot longer, the last couple of years felt as if the current business cycle was frozen in time. Year after year the economy displayed the same consistent pattern: GDP growth hovered between 2% to 3%, unemployment kept sliding, corporate profits remained robust, stock prices routinely marched higher and consumer prices behaved with unusual modesty.

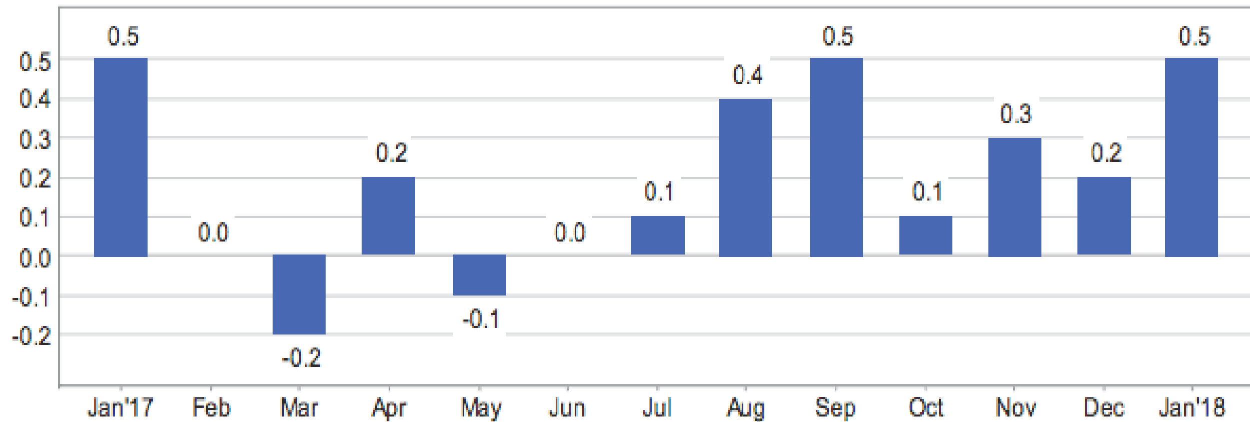
However in the last several weeks, anticipation began to build that the underlying forces that determine the ups and down of a business cycles would soon reassert themselves as inflation breaks out of its long slumber.

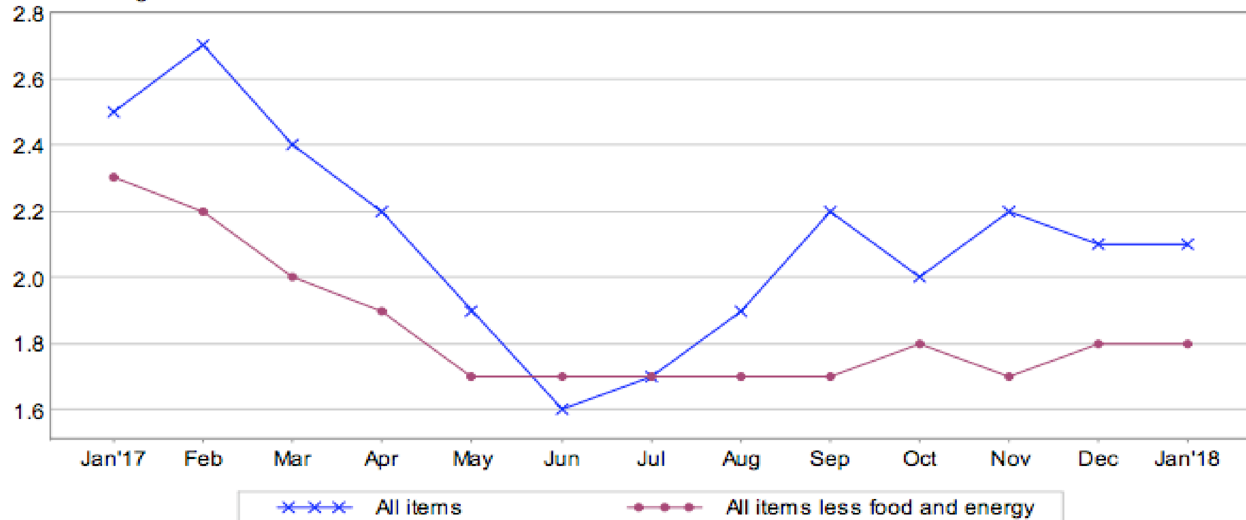
After all, the economic pot had already been on a mild boil when it entered the New Year. If you then add a stimulative $1.5 trillion tax cut, plus a budget busting increase in fiscal spending the rest of FY 2018 and 2019, throw in an additional $1.5 trillion in infrastructure spending and finally top it all off with some recent inelegant comments by Treasury Secretary Sterven Mnuchin that the US favors a weaker dollar --- what came next cannot be shocking. All the ingredients were in place for prices and interest rates to increase.

But let's not stop there. Employers are also struggling to hire nearly 6 million workers every month from a dwindling reservoir of unemployed or underemployed workers. So it was inevitable that wages would have to rise. And as foreign economies gain more traction, commodities were also destined to become more costly. Now combine rising wages with higher commodity costs, dismal productivity

growth and an effort by companies to protect their profit margins--- and voila!, you invariably stoke inflation.

So the latest CPI stats and the jump in average hourly earnings from the previous jobs report ought not have been a great surprise. In fact, the most intriguing aspect of this story is that inflation did not rise much more! (More on that latter point in a moment.)





Consumer prices increased 0.5% last month, which was higher than the consensus forecast of 0.3%. Over the last 13 months, the 0.5% jump was also seen in September and ironically in January of 2017. But it never tracked above that figure. What drove inflation higher last month were price increases for gasoline (up 5.7% vs. down 0.8% in December), fuel oil (a jump of 9.5% vs. 0.9%), apparel (up 1.7%, vs. absolute declines the three previous months), computer software and accessories (up 2.9% vs. a decline of 1.2$%).

If we remove the volatile food and energy components, then core CPI rose 0.3% for the month, which was also above the 0.2% analysts has expected.

But neither gauge of inflation has changed when viewed over the past year: annual headline CPI rose at 2.1%, the same pace as December's, with core holding as well as at 1.8%. And let's not let's not forget that both CPI and core were markedly higher early last year. Headline CPI topped out at 2.7% in February 2017 and core at 2.3% the month before (January 2017) --- before both slid down the rest of the year.

So what conclusions should we construe from these numbers?

Our assessment is that inflation will creep higher on a monthly basis simply because US and foreign economies are in a simultaneous upswing thereby heating up the competition for labor and commodities. Remember, the unemployment rates for the key world economies have been in free fall:

- US jobless rate is at a 17-yr. low,
- Canada saw it plunge to the lowest level in more than 40 years
- Japan's joblessness is the smallest rate in 24 years
- Europe's unemployment rate is the least in a decade .

But here's the key! We do not expect to see inflation surge to levels that call for a much more aggressive monetary policy in any of these regions. That is because globalization and technology have fundamentally altered the dynamics that drive inflation. The US is now so deeply integrated into the world economy that price competition from global suppliers will prevent any serious outbreak in prices.

Moreover, the growing use of disruptive technologies has already dramatically altered how consumers and businesses behave around the world. Nearly half the planet's population, 3.8 billion people, now have access to the Internet and this has changed how commerce is conducted at the consumer as well as B-to-B level.

So while we do expect consumer prices will edge up to 3% the next two years it's unlikely to advance past 4%. Inflation as a whole is in secular decline. By that we mean the forces that in the past have led to a sharp run-up in prices late in the business cycle have been muted by structural changes in the global economy. Economies are thus able to grow for longer stretches of time with relatively modest inflation. This marked departure from how inflation has performed in past cycles is not something unique to the US. We are noticing a combination of stronger economic activity and comparatively low inflation throughout the developed economies.

What are the implications for monetary policy?

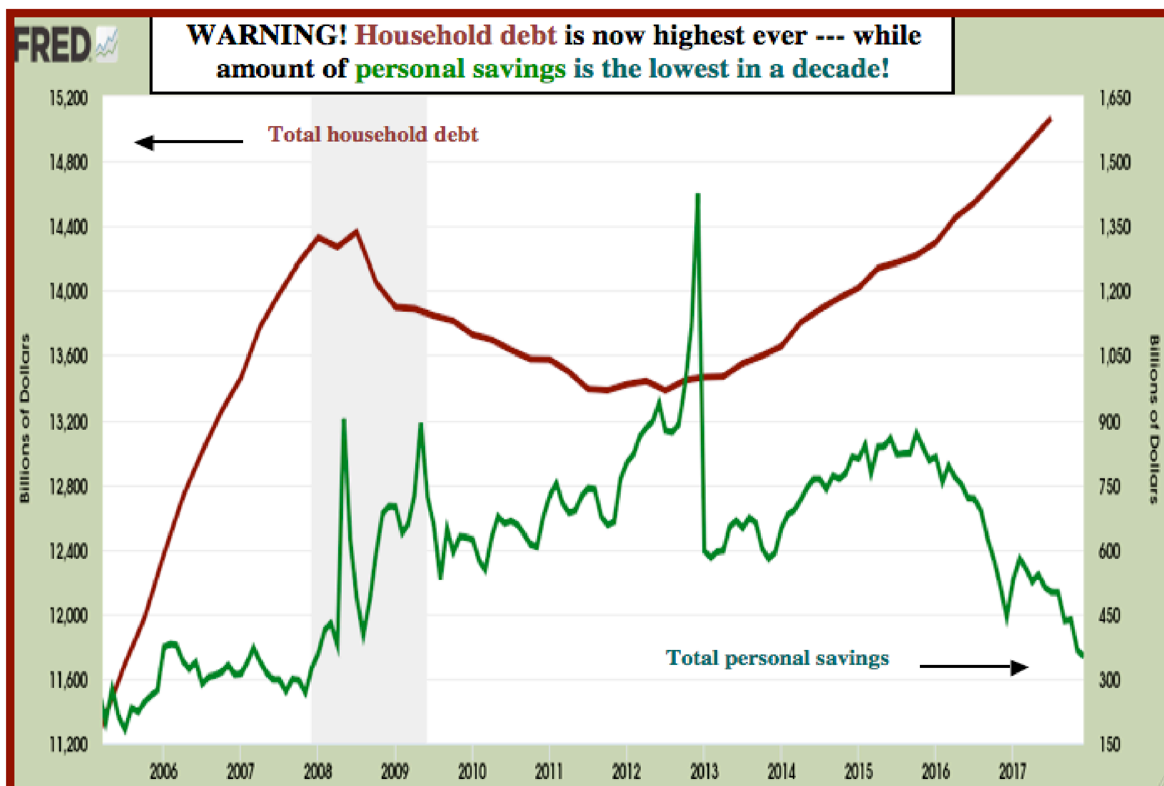
We expect the Fed's new chairman, Jay Powell, and the rest of the FOMC will agree to raise the fed funds rate another 25 basis points next month, but still hold to the plan for three rate hikes this year and one or two in 2019. The drop in the equity prices and higher market interest rates have already raised the cost of capital and that should keep the economy from overheating and prevent a more forceful tightening in monetary policy.

Why such weak retail sales numbers?

As for the soft retail sales report, we have been warning clients for weeks that consumer spending will be leveling off in the coming months even with the latest tax cut. January's 0.3% drop in retail sales was thus not a surprise. The decline was led by a fall in sales of motor vehicle sales, furniture, building material, health and personal care items, sporting goods, hobby, and music purchases. Even nonstore sales, which consist of purchases via the Internet and catalogues, were flat.

Two broad factors are behind this softening in consumer expenditures. The first is based on a simple fact. Shoppers have supported this expansion for nearly nine years. We are approaching a point where consumer demand has largely been satiated. After all, how many more cell phones, autos and home electronic gadgets do households need at this juncture in the economic cycle?

More concerning is that Americans have financed most of these purchases by taking on an unprecedented amount of debt and saving far less. Total household debt now stands at a record high. That may be manageable when interest rates were historically low, but it becomes more problematic now that we're in a rising rate environment. Total household debt service in the 3rd quarter last year (latest available by the Fed) was 15.86% of disposable personal income, the highest since the second quarter of 2011! Delinquency rates on bank loans to consumers has also risen to 2.27% last fall (again, latest available), a level we have not seen in nearly four years.



At the same time, Americans have dug deep into their savings to fund shopping, The personal savings is now down to the lowest in ten years. If households chose to replenish some of their savings and/or reduce indebtedness, we will see less discretionary spending in 2018.

The second broad factor is demographics. Baby boomers have had a profound impact on the economy at every stage of their life cycle. It will be no different now that they are retiring. These boomers will continue to downsize, sell off their

possessions, move into smaller homes and show less interest in purchasing "stuff." What's especially noteworthy is that as the larger millennial generation takes center stage, they show no inclination to become the next generation of big spenders. Large college debts, skepticism over the solvency of social security, high health care costs and witnessing the painful consequences of the last financial crisis have left them with a set of values that discourages superfluous spending. ("Why buy a car when I can just Uber?")

The bottom line:

The up tick in January's inflation has to be viewed in a broader global context. It took a decade for the world economy to grow in tandem and that has finally put upward pressure on the cost of labor and commodities. But we view global competition and technological innovations as key drivers that will allow disinflation to remain in force and prevent any substantial surge in consumer prices. Aiding in that trend will also be a more cautious consumer as they begin to adjust to a higher debt burden, shrinking savings, and changing life styles.

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United States

	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019
Real Gross Domestic Product (GDP):												
%	1.2	3.1	3.2	2.6	2.4	3.2	2.5	2.5	1.9	2.2	2.0	2.4
Personal Consumption Expenditures:												
PCE %	1.9	3.3	2.2	3.8	2.4	2.8	2.4	2.4	2.2	2.1	2.3	2.7
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	2.1	2.2	2.2	2.3	2.3	2.4	2.4	2.5	2.7
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.1	4.0	3.7	3.7	3.9	4.2	4.4	4.4	4.5
Non-farm Payrolls, monthly avg. thousand:												
	166	187	128	204	190	185	160	160	150	145	140	140
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.90	3.00	3.05	3.05	3.35	3.25	3.10	3.10
Federal funds rate % (end of period):												
	0.88	1.13	1.13	1.38	1.63	1.63	1.88	2.13	2.38	2.63	2.63	2.63

GDP Growth - Global Economy

Country	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.1
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	2.4	1.7
United Kingdom	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.0	1.4
Japan	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.7	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.2	2.7	2.5
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.8	7.5	7.5
China	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.9	6.6	6.3
Brazil	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.6	1.2	2.3	2.8
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	2.5
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.4	2.4	2.7	2.8	3.0
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.5	2.1	2.0
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.5	3.4	3.2

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