THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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Enjoy the Mild Inflation for Now.
But Brace Yourself for Higher Prices Soon

Inflation has been remarkably well behaved in recent years. How much longer will that continue? Not much more. Our research shows that pressure is building on companies to raise prices.

The reason? Real (inflation-adjusted) wage are accelerating, while worker productivity remains in a stupor. This is a trend that will shortly end with an outcome of either higher consumer prices --- or much thinner corporate profits. Clearly something has to give. Absent a recession this year (only a 25% probability), the best news on inflation is behind us.

Yes, the government reported that retail prices were tame again in January. Headline CPI did not increase at all last month, continuing its flat line trend in December and November. Over the past 12 months, inflation rose 1.6%, the slowest we have seen in more than two years.

Take out food and energy and you see core CPI has been locked in 0.2% increase for each of the last five months. On a yearly basis, it has risen at a monotonous rate of between 2.1% and 2.2% since last summer.

Now for some nasty news. There are powerful forces at work that suggest inflation pressures are reawakening. Shaking up the inflation dynamics are labor costs, the single biggest expense firms carry on their books, and dismal productivity.

Real average hourly earnings (pay adjusted for inflation) in January jumped up 1.7% from a year ago, the most since July 2016. Another shot across the bow came from average weekly pay, which adjusted for prices surged 1.9% in the year, the fastest since October 2015.

Such wage hikes will soon cut into corporate earnings given that annual nonfarm productivity the last three quarter has been stuck between 1% and 1.3% a year. The only way companies can increase both profits and wages is through faster productivity growth. But to achieve that, firms have to beef up capital spending to improve operating efficiencies ---- and that is precisely what has been lacking. Given the looming economic and political uncertainties, firms chose instead to return capital back to shareholders through record stock buybacks last year.

So what does mean for the inflation outlook? The biggest imbalance in the economy right now is the supply and demand for labor. The shortage of workers has been an ongoing story for more than a year. What's new, however, is that we are at the critical threshold where the competition for labor has now pushed up wages to a level that firms cannot easily absorb.

Check out these three different measures that highlight just how tight labor market conditions have forced companies to keep raising pay to attract new employees and retain existing ones.

• Since April of last year, companies are competing with each other to fill more job vacancies than there are unemployed looking for work. That is, the ratio of job openings to unemployed has been less than 1 since last spring. Prior to April we never saw such a trend in the entire history of this series (which began in 2001).

• Reinforcing this trend has been the increase in the labor force participation rate. It rose to 63.2 in January, the highest more than five years! It indicates that rising wages and benefits are now attracting even those who have long been sitting on the sidelines out of work.

• Finally, there's the employment – population ratio, or the proportion of the American population that is at work. It now stands at 60.7%, the most we have seen in more than 10 years!

Given these labor market trends, it's no mystery why employee pay has been accelerating--- and why it will continue to do so. The question that looms large now is how much longer are companies willing to raise wages without offsetting increases in retail prices? Some have already made that decision. Producers of household staples, such as paper goods, detergents, plastic garbage bags and cleaning products have already moved to lift prices.

Others will soon face the moment of truth on operating incomes. The rationale among an increasing number companies is that as people become more secure about their jobs and income, they will be more tolerant of higher inflation. For the Federal Reserve, such a sentiment will flash a yellow warning light since it elevates the risk of a wage and price spiral later this year.

It just seems more and more improbable given the current dynamics in the labor market and low productivity, that inflation can remain quiescent much longer.

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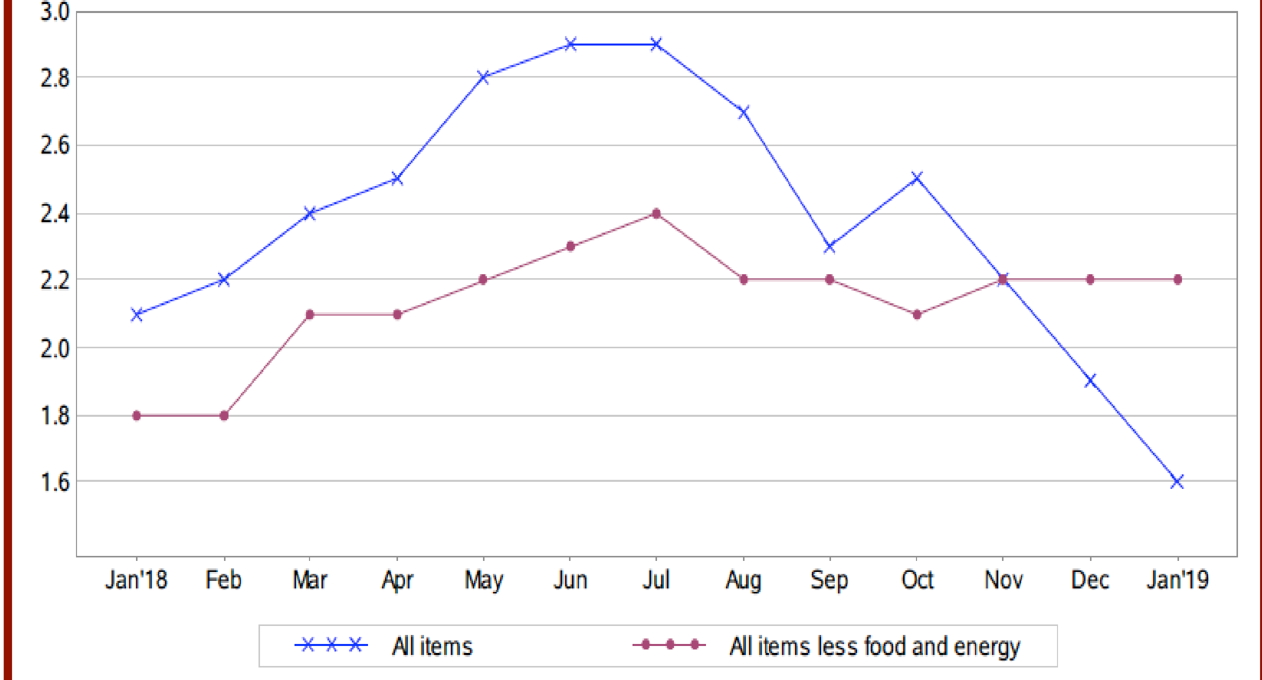
Chart **1. Ratio of job openings to unemployed seeking work**



Economic & Geopolitical Events That Can Disrupt U.S. GDP Growth

Projections are for 2019 and 2020

PROBABILITY (%)	U.S.
60	White House extends the truce and delays lifting tariffs to 25% on Chinese imports
55	Economy slows 2nd half 2019. Fed cuts rates in 2020
20	Yield curve inverts (3-month bill to 10-year Treasury note)
25	US companies significantly ramp up capital expenditures in 2019
45	U.S. economic recession to begin by 2020
	FOREIGN
70	Venezuela's Maduro regime collapses in 2019; new government takes over
85	China boosts official spending and extends credit to fend off economic downturn
45	U.S. - Chinese military clash in the South China Sea and over Taiwan
50	Saudi monarchy in turmoil in 2019. Oil prices climb sharply
55	Major clashes erupt between Israel & Lebanon's Hezbollah
65	UK decides to postpone Brexit by March, followed by a second referendum on leaving the EU
35	US and China reach a comprehensive accord on trade in 2019. Trade tensions fade

- Actual
- Forecast

United States

	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019	I 2020	II 2020	III 2020	IV 2020
Real Gross Domestic Product (GDP):												
%	2.2	4.2	3.4	2.6	2.1	2.6	2.2	2.1	1.8	1.8	1.3	1.5
Personal Consumption Expenditures:												
PCE %	0.5	3.8	3.5	2.8	1.6	2.3	2.0	2.2	1.2	2.0	1.1	1.6
Inflation, end of period, year-over-year:												
CPI %	2.4	2.9	2.3	1.9	2.2	2.5	2.5	2.7	2.5	2.4	2.4	2.1
Unemployment Rate (end of period):												
%	4.1	4.0	3.7	3.9	3.7	3.6	3.7	3.9	3.9	4.1	4.2	4.4
Non-farm Payrolls, monthly avg. thousand:												
	218	211	190	230	201	189	170	140	140	120	95	110
Treasury 10-yr Note Yield % (end of period):												
	2.74	2.85	3.06	2.76	2.85	2.95	3.00	3.15	3.25	3.40	3.30	3.15
Federal funds rate % (end of period):												
	1.63	1.88	2.13	2.38	2.63	2.63	2.63	2.63	2.38	2.38	2.13	2.13

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
US	2.6	1.6	2.2	1.8	2.5	2.9	1.6	2.2	3.1	2.4	1.5
Eurozone	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	1.8	1.8	1.7
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.3	1.2	1.4
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.1	0.9	0.7
Canada	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	2.2	2.3	2.1
India	8.4	8.6	6.7	4.9	7.4	7.9	7.1	8.2	7.2	7.0	7.2
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.3	6.0
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.4	2.3	2.2	2.4
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	1.9	1.6
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	3.0	2.8	2.9
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.3	2.0	1.9
World	4.2	3.0	2.6	2.9	3.0	2.8	2.6	3.3	3.1	2.8	2.7

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