ECONOMIC OUTLOOK
REGIONS
June 2017

The Curious Case Of The Missing Inflation . . .

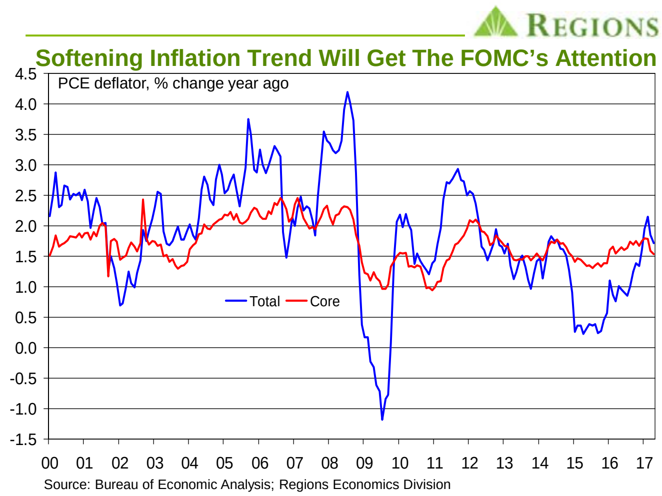
The May employment came as quite a jolt. With a net gain of just 138,000 jobs, growth in total nonfarm employment fell well short of expectations. Average hourly earnings posted another tepid increase, rising by just 0.2 percent. Sure, the unemployment rate fell to 4.3 percent, a rate last seen in May 2001, but this looks a lot better if you ignore the fact that lower jobless rate was solely due to a better than 400,000 person decline in the labor force.

Still, we've characterized the May employment as a big whiff that actually means very little, as it is riddled with distortions that make the seasonally adjusted data of very little use. As our regular readers know, we place great emphasis on analyzing the trends in the not seasonally adjusted data as a more reliable gauge of the economy's health. Doing so in the case of the employment data shows that over the past 12 months the U.S. economy has added 2.223 million jobs, or, an average of 185,000 per month, a rate more than sufficient to soak up the remaining labor market slack.

We see the underlying trends in the labor market as being healthy and a very noisy May employment report does not change that. We suspect the FOMC will come to the same conclusion and look past that May report. What is of more concern to the FOMC, however, is the deceleration in both headline and core inflation over the past three months. To be sure, the recent data on inflation are yet another example of a data series turning course after having seemingly settled into a trend, which has been one of the, for lack of a better term, hallmarks of the current expansion. In this instance, however, these twists and turns could have meaningful implications for the course of monetary policy.

After all, one of the foundations of the FOMC messaging a faster pace of Fed funds rate hikes in 2017 has been their confidence that inflation is firming and on course to hit their 2.0 percent target rate. From mid-2016 through early-2017, the inflation data gave backing to the FOMC's view, and while one could have argued, as many did, that rising headline inflation was purely a function of patterns in energy prices and therefore not sustainable, core inflation was also firming, which bolstered the FOMC's case.

In the fast paced and fun world of economic data, however, things can turn in an instant, or, in this case, three months, with inflation having reversed course over this span. The deceleration in inflation is apparent in both the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE) deflator, the latter of which is the FOMC's preferred gauge of inflation. Headline inflation as measured by the PCE deflator slowed from 2.1 percent in February to 1.7 percent in April, and while much of this can be attributed to patterns in energy prices, what is less clear cut is the source of the deceleration in core inflation. As measured by the PCE deflator, core inflation slowed from 1.8 percent in February to 1.5 percent in April, the lowest since December 2015.



After having for some time expressed confidence that inflation was moving to their 2.0 percent target rate, at least some FOMC members are now expressing concern over the recent deceleration. For instance, in a recent speech Federal Reserve Governor Lael Brainard noted that "soft" inflation, should it persist, could lead her to reassess her views on the appropriate path of monetary policy even as the outlook for global economic growth improves and the U.S. economy continues to grow at a steady rate. Even before the deceleration in inflation became apparent in the data, Minneapolis Fed President Neel Kashkari, at present a voting member of the FOMC, had expressed reservations about the prospects of the FOMC's inflation target being hit, leading him to cast the sole dissenting vote for the 25-basis point funds rate hike approved at the March FOMC meeting. Others, however, such as Philadelphia Fed President Patrick Harker, also a voting member of the FOMC, have dismissed the slowdown in inflation as being transitory and thus having no bearing on monetary policy.

It remains to be seen whether this slowdown will persist, but whether or not it does has implications for monetary policy. While the FOMC will almost surely opt for a 25-basis point hike in the Fed funds rate at this month's meeting, the path forward after June now looks more uncertain than had been the case. Additionally, the FOMC's plans (not yet formalized) to begin paring down the Federal Reserve's $4.5 trillion balance sheet could be scuttled if inflation does not once again reverse course.

Keep in mind that in conjunction with this month's meeting the FOMC will release their updated economic projections, including a refreshed "dot plot" that lays out the implied path of the funds rate given expectations of economic growth, inflation, and unemployment. While we think that at this point the FOMC will

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continue to message a total of three 25-basis point hikes in the Fed funds rate in 2017, we are a bit less confident that this scenario will play out. It is worth noting that the FOMC's implied path of the funds rate has not been conditioned on potential changes to fiscal or regulatory policy that could potentially alter the economy's growth trajectory. That implied path of the funds rate, however, is conditioned on inflation moving as anticipated by the Committee, which means the inflation data take on added significance over the next few months.

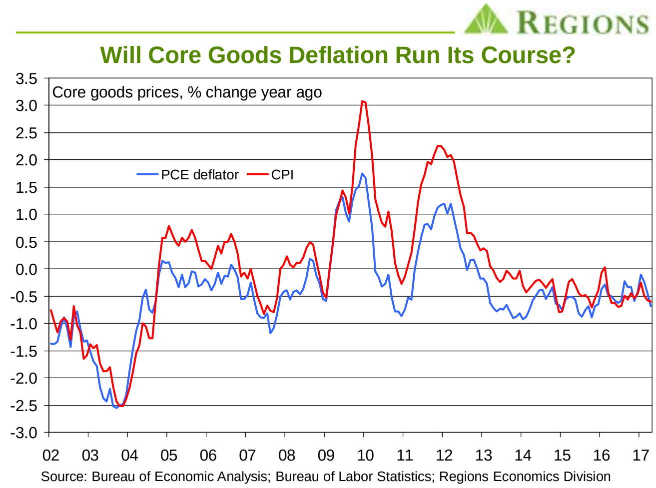
At least some of the factors that have contributed to the deceleration in inflation over the past few months do indeed appear to be transitory in nature. For instance, the cell phone world has been rocked by that "can you hear me now?" guy switching sides, and cell phone service prices have declined sharply since February, falling 7.0 percent alone in the month of March. Okay, it's not all about that "can you hear me now?" guy, as a new methodology for quality adjustments was implemented this year which, in conjunction with heightened competition amongst providers, has led to the sharp decline in prices for service plans. These lower prices have taken roughly two-tenths of a percent off of the core CPI over the past three months. But, prices will eventually level off and the recent declines will wash from the data, thus supporting firmer core inflation.

Apparel prices have been notably volatile over the past several months, rising sharply in January and February then falling sharply in March and April. While a relatively small component of core inflation – just under four percent of the core CPI, for instance – the swings in apparel prices have been so pronounced that they have had an impact on measured core inflation. This isn't to say that apparel prices will suddenly become more well behaved, but to the extent this volatility is impacting measured core inflation, it should be less of a concern to policy makers.

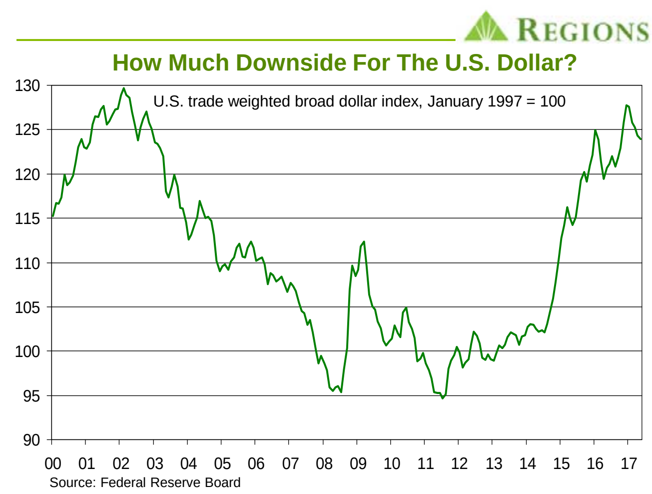
Another likely support for inflation over coming months is health care, which is the largest single component of core PCE services. Prices for health care services have been accelerating over the past several months after having risen by just 0.6 percent in 2015 and 1.2 percent in 2016, as measured in the PCE deflator. Though not nearly as pronounced, health care costs as measured in the CPI have exhibited similar patterns. It should be noted that the PCE measures health care costs on the basis of revenue collected by service providers while the CPI measures out of pocket costs to consumers. Either way, however, health care prices have been firming, and going forward should add to measured inflation.

It is fair to point out that as in recent years, changes in health care costs going forward will be driven far more by legislative factors than by economic, factors. This raises the question of how FOMC members should interpret changes in health care prices when assessing inflation pressures in the broader economy. As for prices of cell phone service, FOMC members likely discounted them on the way down and will just as likely discount them as the effects of these lower service prices wash through the data. And, while apparel prices may be very noisy, they are not very informative and, as such, will likely be discounted by FOMC members.

Informative or not, these factors should all combine to give inflation, particularly core inflation, a "better look" over coming months. That said, there are other factors of more economic significance which will be more important in setting the path for inflation but for which the outlook remains somewhat uncertain. One such factor is the behavior of prices of core goods (i.e., goods excluding food and energy), which have been a persistent drag on core inflation – both CPI and PCE – over the past several years, as seen in the chart below.



As measured by the PCE deflator, core goods prices have been down year-on-year for 53 consecutive months, and as measured by the CPI have been down year-on-year in 48 of the past 49 months. To a large extent, this persistent weakness reflects the strength of the U.S. dollar over this same time period. A stronger U.S. dollar means goods imported into the U.S. are cheaper for U.S. consumers to purchase, and this has been a significant weight on core goods prices. In one of life's, or at least economics', rich ironies, over the past few years it has been expectations of a more aggressive, on both an absolute and relative basis, monetary policy stance on the part of the FOMC that have mainly fueled the strength of the U.S. dollar which, by suppressing core inflation, has put the FOMC further away from hitting their inflation target.



The U.S. dollar also saw a sizeable post-election bounce on expectations of faster growth and/or inflation in the U.S. due to what was expected to be a vastly different economic and regulatory policy landscape. That post-election bounce, has been entirely retraced as expectations for meaningful policy changes have been scaled down considerably. To be sure, should the policy landscape change in a meaningful way, that will be reflected in the exchange value of the U.S. dollar, but what could prove to be a bigger driver is an improving global growth outlook. Firmer growth abroad, particularly to the extent it leads foreign central banks to pare down the degree of monetary accommodation, would put downward pressure on the U.S. dollar. To the extent this scenario plays out, it would be a source of upward pressure on core goods prices and, in turn, be supportive of accelerating core inflation.

Of course, any discussion of core goods prices has to account for the changing retail landscape. Aside from the obvious impact on brick and mortar retail establishments, the rise of online shopping has led to intense price competition amongst sellers of goods in all venues, and this is reflected in the data on core goods prices. This is a trend far more likely to intensify than to reverse and, as such, could act as a drag on core inflation for some time to come.

And, at least in the near term, motor vehicle prices, new and used, are likely to be a drag on core inflation as has been the case in recent months. New vehicle sales are past their cyclical peak, which has led to dealers becoming more aggressive on pricing to, well, drive sales, and the string of three consecutive declines in new vehicle prices in the inflation data will likely persist. At the same time, prices for existing vehicles have been under downward pressure for some time, in part due to the strength of sales of new vehicles and more recently due to growing numbers of lease expirations. Vehicle prices, then, most likely represent a source of downward pressure on core goods prices over coming months.

Rents are a source of what, at least in our view, could be potentially significant downward pressure on core inflation in the months ahead. The rate of growth in market rents has begun to slow and will slow further going forward. As we have often noted in other forums, the backlog of multi-family units, the vast majority of which are rental apartments, under construction is at present larger than at any point since the mid-1970s. When more of these units are completed and come on the market over coming months, rents will come under downward pressure. One not insignificant offset is that rents on single family homes, which now make up a larger share of the rental housing stock than has been the case in the past, remain strong. But, while this will mitigate the impact of softening apartment rents in the inflation data, it will not totally offset it, meaning rents will be a drag on core inflation.

Finally, any discussion of the inflation outlook has to account for the degree of slack remaining in the economy. While most discussions of the degree of slack revolve around the labor market, we think it important to also consider the degree of slack in the industrial sector of the economy. This makes slack a global, not simply a domestic, story. For instance, as of April 2017, the latest data point available, the capacity utilization rate in the U.S. manufacturing sector stood at 75.9 percent. While this is well off of the cyclical trough of 63.7 percent as the 2007-09 recession came to an end, it is nonetheless well below the threshold, roughly 82.5 percent, typically associated with rising inflation pressures.

But, this is a global story, not merely a U.S. story. While it may be a stretch to say the world is awash in idle industrial capacity, it isn't too much of a stretch, with the broader point being this idle capacity has acted, and will continue to act, as a drag on goods prices in both the industrial and consumer sectors. To the extent it acts as a drag on prices of consumer goods, it in turn acts as a drag on core inflation. While the degree of idle industrial capacity will dissipate at a faster rate to the extent global economic growth does improve, it will be some time before producers of goods have a meaningful degree of pricing power, and this is independent of the impact of shifts in exchange rates on core goods prices.

As to the degree of labor market slack, this is a topic to which a great deal of discussion and debate has been devoted. The main questions are how close to full employment the labor market is and what are the implications for wage growth. This in turn has implications for the rate of inflation in the broader economy, at least according to many analysts. Indeed, many FOMC members believe that the economy is at or near full employment and, as such, it is only a matter of time before we see meaningful and sustained acceleration in wage growth, which in turn threatens to unleash faster inflation in the broader economy. In this view, the lagged response of economic conditions to changes in monetary policy is one reason to be pre-emptive in removing monetary accommodation before accelerating inflation is evident in the data.

As our regular readers by now know, our take on this matter is somewhat different on many fronts. First and foremost, we believe there to be considerably more slack remaining in the labor market than do many other analysts, not to mention many FOMC members. Contrary to those who argue firms are "running out of workers to hire," data on labor force flows show over six million people enter the labor force in a given month after being out of the labor force in the prior month, and this inflow has consistently exceeded the number of people exiting the labor force in a given month. We think this will be sustained for some time to come, even if the longer-term trend in labor force participation is lower, not higher. Moreover, there is still an elevated number of people who are employed but yet are underutilized.

This can take the form of people working part-time for economic reasons, or, even for those working full-time, it can take the form of a workweek that is nonetheless shorter than it otherwise would be in a tighter labor market. We have pointed to a relatively short average workweek (34.4 hours, as of May) as an underappreciated form of labor market slack. One place this comes into play is in the total wage bill of firms. While many analysts focus only on growth in average hourly earnings as a measure of how tight the labor market is, we look to a broader measure of total wage costs.

The chart on the following page shows the unemployment rate plotted against year-on-year growth in aggregate private sector wage and salary earnings. As seen in the chart, despite the sustained decline in the unemployment rate, growth in aggregate earnings remains range bound. Note that aggregate earnings is the product of the number of people working, what they make for each hour worked, and how many hours they work. Even as growth in average hourly earnings has edged higher over the past several months and even as private sector payrolls continue to rise at a healthy clip, growth in aggregate earnings has yet to break out of what for some time has been a fairly narrow range, which reflects the fact that the workweek remains well shy of where it would be in a labor market truly at or near full employment.

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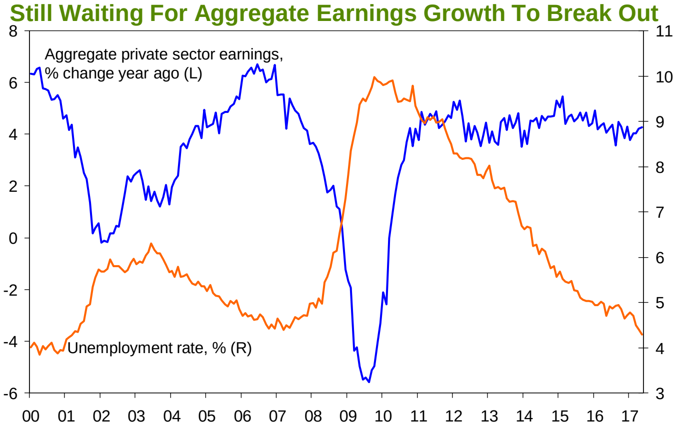
Still Waiting For Aggregate Earnings Growth To Break Out



Source: Bureau of Labor Statistics; Regions Economics Division

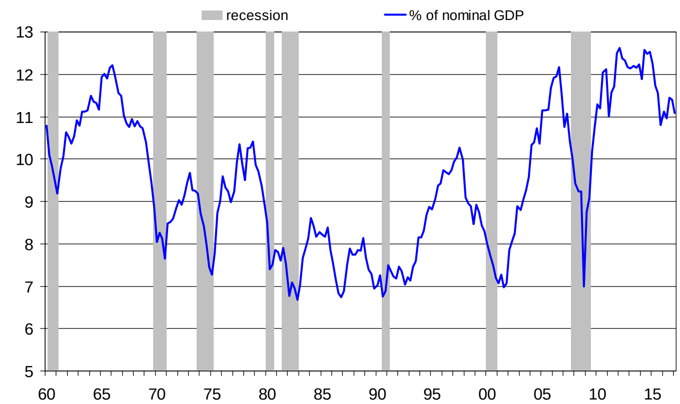
While most either overlook completely or simply discount the length of the workweek as an indicator of labor market slack, we think this to be a mistake. After all, firms think of their total wage bill, not what they pay for an hour of work, and managing hours is one way firms can hold down growth in their wage bills. Were we at full employment, growth in aggregate earnings would be running closer to 6.0 percent rather than the 4.0 to 4.5 percent range that has prevailed for some time now. To be sure, as growth in average hourly earnings firms up, growth in aggregate earnings will do the same, but will still lag as long as average weekly hours remain lower than has been the case in past cycles.

The next question is how firms respond to rising labor costs. Many analysts seem to take it as a given that firms will simply pass along higher wage costs to consumers in the form of higher output prices. We'll toss out our usual caveat that this is a more relevant question at present with a trend rate of productivity growth of less than 1.0 percent than it would be were productivity growth more in line with historical norms. That point notwithstanding, we think it is more than a bit unrealistic to assume firms can simply raise output prices to protect profit margins from higher labor costs.

Sure, that may have been a fine story back in, say, 1970 when the economy was relatively closed and manufacturing, much of it highly unionized, accounted for over 25 percent of total nonfarm employment. The economy we now have is far more open to global trade while manufacturing, much less unionized than has been the case in the past, accounts for less than nine percent of total nonfarm employment. In many, if not most, cases, producers of goods are subject to global completion, which acts as a strong drag on their ability to pass along higher costs in the form of higher output prices. We'd refer anyone unable to grasp that point to our chart showing core goods deflation.

So, at the very least, one has to make the distinction between the behavior of firms in goods producing industries and firms in service providing industries. Service providers in general do not have to face global competitors and, as such, tend to have more pricing power than goods producers. Indeed, core services prices have for some time been rising at a faster rate than overall core inflation in both the CPI and PCE data. Still, that doesn't mean service providers have unlimited pricing power and, as we've discussed above, aggregated measures of services prices will be buffeted by opposing forces over coming months, such as faster growth in health care costs and decelerating rent growth.

Before-Tax Corporate Profits



Source: Bureau of Economic Analysis; Regions Economics Division

It is also, at least in our view, an open question as to the extent to which firms will try to pass on higher costs, including labor costs, to consumers as opposed to accepting slimmer profit margins. We don't see it as an "either-or" choice, and doubt most firms see it that way either. Despite having receded from historical highs, profit margins nonetheless remain well above historical norms – it is worth noting that the near-record highs seen in the current cycle came amidst anemic revenue growth, showing the extent to which firms emphasized cost control to drive profit growth. While rising labor costs and, more recently, rising costs of commodities and other inputs to production, make it increasingly difficult for firms to preserve profit margins without faster revenue growth, their willingness and ability to push prices higher remains to be seen.

The bottom line (pun intended) is that there are many factors that will determine the path of inflation from here out, and many of these factors will be acting counter to others. What we see as the most likely outcome is that inflation will move closer to the FOMC's target rate, but is unlikely to move significantly higher than that, at least on any kind of sustained basis. And, if you can't help but think "careful what you wish for" when it comes to central bankers worrying about inflation being too low, you're not alone. After all, one day you're fretting about inflation being "only" 1.7 percent then the next day you wake up and you're South Sudan, with the world's highest rate of inflation, 476.02 percent in 2016.

Okay, that takes more than a day, probably. But, there are reasons the FOMC, and central banks in general, fret about low inflation. To the extent the inflation rate sends signals on the underlying level of economic activity, soft inflation raises concerns. On a more practical level, persistently low inflation can turn into a self-fulfilling condition to the extent it ultimately sways expectations of households and firms – look to Japan for an extreme illustration of why this matters. Also, persistently low inflation can render a central bank's primary policy lever, short-term interest rates, of little or no value in cases where the central bank wishes to respond to adverse economic shocks by pushing nominal interest rates lower. As such, it's easy to understand why the FOMC would like to see more inflation. Just not too much more.

ECONOMIC OUTLOOK

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Q4 '16 (a)	Q1 '17 (p)	Q2 '17 (f)	Q3 '17 (f)	Q4 '17 (f)	Q1 '18 (f)	Q2 '18 (f)	Q3 '18 (f)		2015 (a)	2016 (a)	2017 (f)	2018 (f)
2.1	1.2	3.2	2.4	2.5	2.5	2.2	2.1	Real GDP[1]	2.6	1.6	2.3	2.4
3.5	0.6	2.8	2.8	2.6	2.7	2.3	2.3	Real Personal Consumption[1]	3.2	2.7	2.5	2.5
								Business Fixed Investment:				
1.7	7.0	2.0	2.8	3.1	3.9	3.5	2.6	Equipment, Software, & IP[1]	4.0	0.0	2.9	3.1
-1.9	28.3	3.9	0.7	3.2	2.3	2.0	2.4	Structures[1]	-4.4	-2.9	8.5	2.3
9.6	13.7	5.4	2.9	5.1	6.8	6.4	5.6	Residential Fixed Investment[1]	11.7	4.9	5.7	5.7
0.2	-1.1	1.2	0.9	0.7	0.8	1.0	1.0	Government Expenditures[1]	1.8	0.8	0.1	0.9
-605.0	-599.9	-610.5	-615.2	-622.1	-631.5	-641.8	-648.8	Net Exports[2]	-540.0	-563.0	-611.9	-643.6
1.248	1.242	1.214	1.224	1.260	1.289	1.313	1.342	Housing Starts, millions of units[3]	1.107	1.177	1.235	1.330
18.0	17.2	16.8	16.7	16.8	16.7	16.6	16.5	Vehicle Sales, millions of units[3]	17.4	17.5	16.9	16.5
4.7	4.7	4.4	4.4	4.3	4.3	4.2	4.2	Unemployment Rate, %[4]	5.3	4.9	4.4	4.2
1.6	1.6	1.5	1.3	1.3	1.2	1.2	1.2	Non-Farm Employment[5]	2.1	1.8	1.4	1.2
1.6	2.0	1.8	1.9	1.8	1.8	2.0	2.1	GDP Price Index[5]	1.1	1.3	1.9	2.0
1.4	2.0	1.7	1.8	1.8	1.7	2.1	2.1	PCE Deflator[5]	0.3	1.1	1.8	2.0
1.8	2.6	2.2	2.3	2.0	1.8	2.2	2.2	Consumer Price Index[5]	0.1	1.3	2.3	2.1
1.7	1.7	1.6	1.7	1.8	1.8	2.0	2.1	Core PCE Deflator[5]	1.4	1.7	1.7	2.0
2.2	2.2	2.0	1.9	2.0	1.9	2.2	2.3	Core Consumer Price Index[5]	1.8	2.2	2.0	2.2
0.42	0.67	0.92	1.15	1.38	1.41	1.63	1.64	Fed Funds Target Rate, %[4]	0.14	0.39	1.03	1.64
2.13	2.45	2.28	2.30	2.40	2.50	2.60	2.70	10-Year Treasury Note Yield, %[4]	2.14	1.84	2.36	2.65
3.84	4.17	4.02	4.04	4.16	4.28	4.40	4.46	30-Year Fixed Mortgage, %[4]	3.85	3.65	4.10	4.42
-2.4	-2.6	-2.7	-2.9	-3.0	-3.0	-3.2	-3.3	Current Account, % of GDP	-2.6	-2.6	-2.8	-3.2

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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