

Don't Fear Inflation

There's a lot to like about the U.S. economy's performance. It just completed the strongest quarterly growth rate in four years, the job market is rocking, corporations are enjoying record profits, stock prices are up and consumer confidence remains elevated. Indeed, the party is going so well that the Federal Reserve is taking away the punch bowl. Well, not entirely. It is emptying the bowl little by little, leaving enough punch behind to keep the partygoers in a festive mood. After seven quarter-point increases in the span of 2 ½ years, short-term interest rates are still historically low, resting in a range of 1.75-2.00 percent. The Fed plans to keep nudging rates higher on a gradual path, penciling in two more increases this year and three more in 2019.

But even after those increases, short-term rates will just about be matching the inflation rate, which is hardly restrictive enough to spoil the party. Indeed, in the almost sixty years prior to the last recession, the Fed has kept its benchmark federal funds rate above inflation by an average of 2.0 percent. Only when it pushes real rates up to about 4.0 percent or higher does policy start to bite into growth. By historical standards, therefore, there is still a ways to go before the punch bowl is completely removed. Does this mean the central bank has free rein to push rates up to 5 ½ or 6 percent before it does genuine harm to the economy?

Not likely. The Fed moves more aggressively when it thinks inflation is about to break out. Inflation is creeping up, with the consumer price index reaching a six-year high of 2.9 percent in June. But that's about as high as it will get, as the transitory forces pushing it up will soon fade and fundamental pressures for an inflation breakout are not gaining traction. Indeed, the economy is poised to cool over the second half of the year, defusing demand pressures, and tame wage growth is keeping cost pressures in check. Moreover, while the Fed is nudging short-term rates higher, long-term rates are lagging behind. If bond investors thought that an inflation breakout was in the cards, eroding the purchasing power of their fixed-income payments, they would be driving up long-term yields much more aggressively. Heightened trade tensions complicate things even more. Higher tariffs add to inflation, but they also stymie growth. This tradeoff is symbolic of the many headwinds and tailwinds that will be buffeting the economic landscape over the balance of the year and next.

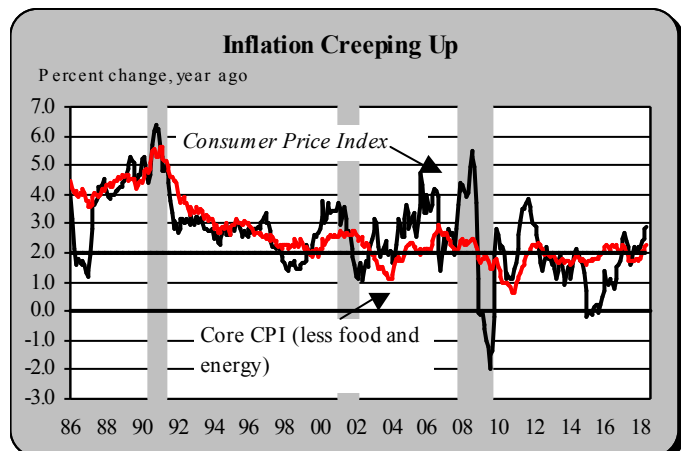
Bond Vigilantes Stay Calm

Where are the bond vigilantes? Not so long ago the circumstances similar to what we are seeing today would have brought the posse out in force. Inflation just hit a six-year high, the economy is

booming, the jobless rate is hovering near the lowest level since the 1960s, the government is running an ever-expanding budget deficit and the nation is generating more output than it is capable of producing. Taken together, this would appear to be a potent mix riling up bond investors fearful that the purchasing power of their fixed income payments will be eroded by runaway inflation. To be reimbursed for that erosion risk, the bond vigilantes would ordinarily demand more compensation, driving bond yields higher. As well, they would urge – and expect – the central bank to join in the anti-inflation fight by stepping more aggressively on the monetary brakes.

But instead of pouring out of the woodworks with fire in their eyes, the vigilantes have been remarkably subdued, seemingly content with the existing inflation and policy backdrop. To be sure, long-term rates have backed up significantly since last fall, with the bellwether 10-year Treasury yield increasing by more than 70 basis points from early September. But after hitting a high of 3.11 percent in the middle of May, the yield has since receded to about 2.85 percent, roughly where it stood in the first week of February. Paradoxically, even as the yield trended lower, inflationary underpinnings grew stronger. The economy just delivered the strongest growth rate in four years in the second quarter, the labor market has tightened further, gasoline prices have increased and a budding trade war threatens to hike tariffs on a broad swath of goods purchased by households and businesses. Not surprisingly, actual inflation is ticking up.

In June, the consumer price index stood 2.9 percent higher than a year-earlier, up from a 2.1 percent pace at the start of the year. Much of that upward thrust has come from climbing energy prices,



but even excluding often-volatile food and energy items, the inflation rate is moving higher. In June, the core CPI increased 2.3 percent from a year earlier, matching the strongest annual inflation rate since the recession. Despite the headlines, tariffs have not been much of a factor yet, as the volume of goods subjected to the tax prior to June carries a negligible weight in the consumer price index. That could change going forward if the Trump administration follows through with its threat to include nearly all the \$500 billion in goods imported from China as well as on automotive imports from Europe and Japan.

Restraints on Long-Term Rates

So, with inflation moving up, why aren't the bond vigilantes making noises? Are they just biding their time to see what happens over the next few months. Perhaps. Keep in mind that bond bears are facing powerful competing forces that are keeping long-term rates lower than might otherwise be indicated by economic and inflation fundamentals. The Federal Reserve has built up a \$4.2 trillion portfolio of government and mortgage securities, which removes a significant supply of government bonds from the market. Although it is letting its portfolio shrink gradually as it strives to normalize policy, other central banks are doing the opposite, either purchasing bonds to stimulate growth in their countries or maintaining huge portfolios to prevent a tightening of policy.

As a result, interest rates are much higher here than in other developed nations which, since the U.S. bond market has become globalized, is luring foreign funds into dollar-denominated assets, primarily Treasury securities, seeking higher returns. One byproduct of these foreign inflows is that the dollar has been strengthening relative to other currencies. That, in turn, makes foreign goods cheaper, thus suppressing inflation, even as it restrains growth by hampering exports – two additional forces that lower bond yields.

More important, bond investors may simply believe that the upward move in inflation will not be sustained over the longer haul. Indeed, the so-called breakeven rates, which measure the markets' inflation expectations over time, are pricing in lower inflation beyond this year. The spread between 5- and 10-year Treasury securities and their TIPS counterpart currently stands at 2.07 and 2.11 percent, respectively, which is well below market inflation expectations during the late stage of the previous expansion when, incidentally, the core inflation rate was actually lower than it is now. Nor is it just bond traders that are unfazed about future inflation prospects; most surveys indicate that household inflation expectations also remain well anchored. In its latest survey on household sentiment, the University of Michigan reported that 5-10 year inflation expectations slipped from 2.6 to 2.4 percent in July, remaining in the 2.4-2.6 percent range for 19 consecutive months.

Low Expectations

The benign inflation outlook among bond investors and households is not particularly surprising. Inflation has been so low for so long that only recently has the fear of deflation been extinguished. In year's past, when inflationary concerns overshadowed other worries about the economy, bond investors would have had a knee-jerk reaction to any uptick in inflation, sending long term yields abruptly higher. However, over the past two decades, inflation has ranged between 2 and 3 percent and, following the Great Recession, core inflation slipped to a postwar low of 0.7. Since the recession, market participants have been more concerned about the

central bank's ability to fight deflation than in checking inflation.

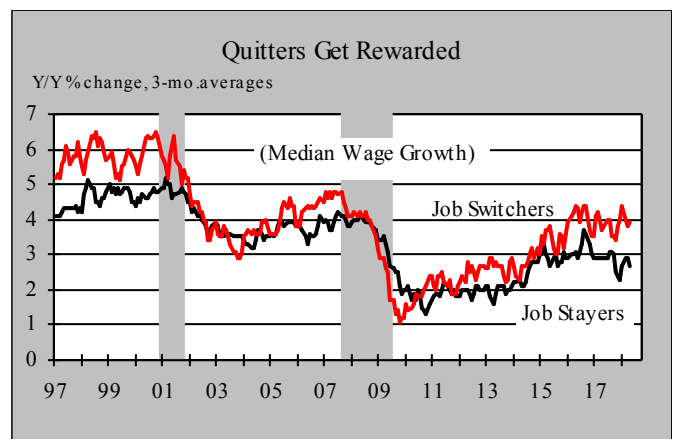
The enduring presence of low inflation has curbed household inflation expectations as well. But structural changes have also played a key role. Most important is the strong growth of e-commerce shopping, which has doubled its share of retail sales since 2011. The inflation-retarding impact of this trend is twofold. First, prices of goods purchased online are almost always lower than those bought at brick-and-mortar establishments. Second, the enhanced ability to comparison shop via the Internet drives consumers to the lowest price alternative. This transparency, in turn, stokes competitive pricing throughout the retail sector, eviscerating the pricing power of firms that would prevail in a less transparent shopping environment.

Workers Regain Bargaining Power

The bad news for households is that the restraint on pricing power forces companies to keep a lid on costs to retain profitability. Their biggest expense, of course, is labor, which amplifies the effort of employers to resist bold wage demands of workers. Indeed, real average hourly earnings have not increased at all over the past twelve months despite the historically low unemployment rate. However, as the job market continues to tighten and worker shortages become more acute, it is becoming increasingly difficult for employers to keep wages bottled up. One reason, workers are quitting their jobs at a rapid pace.

In May, the latest month available, the quit rate rose to the highest level since early 2001, indicating that workers are extremely confident about landing a new and better position elsewhere. When they move, the odds are that they will also receive a sizeable pay boost over and above what they would receive by staying put. The Federal Reserve Bank of Atlanta compiles a wage tracker that clearly shows this discrepancy. In May, the annual wage growth of quitters was more than 20 percent greater than for all workers. Relative to job stayers, the discrepancy was dramatically wider, reaching 44 percent. With more job openings than job searchers and workers quitting their jobs in droves, the pressure on companies to lift wages should only get stronger.

But modestly faster wage growth should not stoke an inflation breakout, given the structural restraints on company pricing power and the prospective growth slowdown in coming months. For the first time in the recovery, workers will likely enjoy some real income gains at the expense of corporate profits. The good news is that tame inflation will allow the Fed to empty the punch bowl more slowly than otherwise -- and keep the party going longer.



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	<u>June</u>	<u>May</u>	<u>April</u>	<u>March</u>	<u>February</u>	<u>January</u>	<u>December</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
<i>Prime Rate</i>	4.89	4.75	4.75	4.58	4.50	4.50	4.40	4.89	4.13
<i>3-Month Treasury Bill Rate</i>	1.90	1.86	1.76	1.70	1.57	1.41	1.32	1.90	0.98
<i>5-Year Treasury Note Rate</i>	2.78	2.82	2.70	2.63	2.60	2.38	2.18	2.82	1.77
<i>10-Year Treasury Note Rate</i>	2.91	2.98	2.87	2.84	2.86	2.58	2.40	2.98	2.19
<i>30-Year Treasury Bond Rate</i>	3.05	3.13	3.07	3.09	3.13	2.88	2.77	3.13	2.77
<i>Tax-Exempt Bond Yield</i>	3.89	3.88	3.90	3.89	3.82	3.56	3.43	3.90	3.43
<i>Corporate Bond Yield (AAA)</i>	3.96	4.00	3.85	3.87	3.82	3.55	3.51	4.00	3.51
<i>Conventional 30-Year Mortgage Rate</i>	4.57	4.59	4.47	4.44	4.33	4.03	3.95	4.59	3.81
<i>Dow Jones Industrial average</i>	24790	24573	24304	24582	24982	25804	24545	25804	21318
<i>S&P 500 Index</i>	2754	2701	2654	2703	2705	2790	2664	2790	2434
<i>Dividend Yield (S&P)</i>	1.96	1.95	1.97	1.96	1.90	1.79	1.87	2.00	1.79
<i>P/E Ratio (S&P)</i>	20.70	20.6	20.1	20.2	22.0	22.8	21.7	22.8	20.1
<i>Dollar Exchange Rate (vs. Major Currencies)</i>	89.7	88.7	86.4	86.2	85.7	86.3	88.7	91.8	85.7

* Monthly Averages

ECONOMIC INDICATORS

	<u>June</u>	<u>May</u>	<u>April</u>	<u>March</u>	<u>February</u>	<u>January</u>	<u>December</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
<i>Housing Starts (In Thousands)</i>	1173	1337	1276	1327	1290	1334	1210	1337	1158
<i>New Home Sales (Thousands of Units)</i>		689	646	671	663	633	636	712	556
<i>New Home Prices (Thousands of Dollars)</i>		313	319	334	327	330	340	343	313
<i>Retail Sales (% Change Year Ago)</i>	6.6	6.5	4.8	5.1	4.5	3.9	5.3	6.6	3.5
<i>Industrial Production (% Change Year Ago)</i>	3.8	3.2	3.7	3.6	3.6	2.8	2.9	3.8	1.1
<i>Operating Rate (% of Capacity)</i>	78.0	77.7	78.2	77.5	77.2	77	77.3	78.2	75.7
<i>Inventory Sales Ratio (Months)</i>		1.34	1.35	1.35	1.36	1.36	1.35	1.39	1.34
<i>Real Gross Domestic Product (Annual % Change)</i>				2.0			2.9	3.2	1.2
<i>Unemployment Rate (Percent)</i>	4.0	3.8	3.9	4.1	4.1	4.1	4.1	4.4	3.8
<i>Payroll Employment (Change in Thousands)</i>	213	244	175	155	324	176	175	324	14
<i>Hourly Earnings (% Change Year Ago)</i>	2.7	2.7	2.6	2.6	2.6	2.8	2.7	2.8	2.3
<i>Personal Income (% Change Year Ago)</i>		4.0	3.9	3.7	3.7	3.8	4.4	4.4	2.4
<i>Savings Rate (Percent of Disposable Income)</i>		3.2	3.0	3.2	3.5	3.1	2.4	3.6	2.4
<i>Consumer Credit (Change in Mil. Of Dollars)</i>		24559	10273	8785	11195	11964	13136	31258	8596
<i>Consumer Prices (% Change Year Ago)</i>	2.3	2.2	2.5	2.4	2.2	2.1	2.1	2.5	1.6
<i>CPI Less Food & Energy (% Change Year Ago)</i>	2.9	2.8	2.1	2.1	1.8	1.8	1.8	2.9	1.7
<i>Wholesale Prices (% Change Year Ago)</i>	3.4	3.1	2.6	3.0	2.8	2.7	2.6	3.4	1.9

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