

FFTW Weekly Commentary

FOR PROFESSIONAL INVESTORS

Are Domestic Forces Strong Enough to Push Inflation Higher Even Without Fiscal Policy? (A: Yes)

April 17, 2017

Key takeaways

- Upside risks to inflation have decreased as a result of US political developments during the first quarter
- However, US economic developments lead us to believe inflation will rise independent of fiscal policy
- Domestic price pressures are building for a number of reasons, including labor market capacity constraints, the recovery in commodity prices, and above trend GDP growth

Full commentary

Developments over the first quarter have prompted us to dial back our assessment of inflation risks somewhat. The odds of a sharp move higher in prices from tariffs must be lowered, while we remain confident that a tightening labor market will push up domestically-generated core inflation in the medium term.

The odds of corporate tax reform, aggressive fiscal stimulus and disruptive protectionist measures have receded, as the administration failed to win sufficient backing in the House and balked at the prospects of triggering retaliatory measures on trade. Risks remain that the administration will attempt to weaken the integrity and independence of the Federal Reserve (Fed) and policy-making apparatus in general. In the meantime the US economy continues to grow faster than potential and generate healthy job creation, while the dollar has retreated and crude prices are showing renewed strength.

We see room for market-implied inflation expectations (i.e., breakeven inflation rates - BEIs) to rise from here, even if the more extreme inflation outcomes are now a little less likely. We anticipate renewed widening in 10-year BEIs from 1.89% at time of writing to 2.15%. The trade is supported by:

- The Trump administration's policy agenda of immigration controls, fiscal expansion and protectionism, which raises inflation risks;
- Ongoing asset allocation flows into the asset class;
- A gradualist approach to monetary policy normalization, with the central bank tolerating a modest overshoot of inflation - though it will resist the temptation to let inflation 'run hot';
- The economy is close to or at full employment, putting upward pressure on wage inflation; and
- Background core consumer price index (CPI) inflation of 2.20% year-over-year, which we anticipate will rise towards 2.25% - 2.50% by late 2017.

Our estimate of increasing core CPI is based on strengthening US economic data. Recent data suggest the labor market is pushing up against supply constraints. The Atlanta Fed's Wage Tracker index has indicated upside wage pressures for some time, corroborating other leading indicators (such as 'shortage of skilled workers', 'jobs easy to get' surveys, as well as the 'quits' rate). Over the last year, average hourly earnings have also begun to rise. The overall picture is one of a labor market that is finally hitting up against capacity constraints, which is eliciting a price response.

The inflation picture is also encouraging. Together with a recovery in commodity prices, higher wages are contributing to pipeline inflation pressure, which is already reflected in Final Demand Producer Price Index (PPI) and the Institute of Supply Management (ISM) Manufacturing survey of Prices Paid. In addition, most measures of core inflation have demonstrated gains over the last 18 months.

By Cedric Scholtes
Head of Global Rates & Primary US
TIPS Portfolio Manager
cedric.scholtes@fftw.com



This week's market developments



Monday, April 10

- Italy Industrial Production growth increased to 1.0% m.o.m. (s.a.)

Tuesday, April 11

- UK CPI growth decreased to 0.4% m.o.m. for March
- UK PPI Output growth increased to 0.4% m.o.m. for March
- Eurozone Industrial Production growth decreased to -0.3% m.o.m. (s.a.) for February
- Japan Machine Orders growth increased to 1.5% m.o.m. for February

Wednesday, April 12

- US Import Price Index growth decreased to -0.2% m.o.m. for March

Thursday, April 13

- US PPI Final Demand growth decreased to 0.1% m.o.m. for March
- University of Michigan Sentiment Index (prelim estimate) increased to 98.0 for April

Friday, April 14

- US CPI growth decreased to -0.3% m.o.m. for March
- US Retail Sales Advance growth decreased to -0.2% m.o.m. for March

Source: Bloomberg, as of April 17, 2017

Core Personal Consumption Expenditures (PCE), at 1.8% year-over-year in February 2017, rose slightly faster than the FOMC's forecast, and looks set to be at its 2.0% target by late 2017. Furthermore, the treatment of administered medical costs, which has been influenced by ObamaCare, has been a transitory headwind for core PCE. Core CPI, meanwhile, is running at 2.0% year-over-year, but we note that the trend in services inflation is upwards, meaning that inflation is no longer only supported by rising shelter costs. That is very encouraging, and confirms that domestic price pressures are building.

We forecast that the US economy will grow at 2.10% in 2017 and 2.0% in 2018, depending on the net fiscal boost delivered by the Trump administration. These forecasts remain highly tentative at this stage, given the uncertainties on fiscal policy, monetary policy response, trade policy and the currency. Nevertheless, these 2017 and 2018 forecasts represent growth rates that are above our 1.5% estimate of trend growth, and would therefore further reduce unemployment and drive up domestically-generated inflation. We anticipate that PCE inflation should reach 2.0% by the end of 2017 and 2.25% by the end of 2018. The risks to our view are that the US dollar moves sharply higher, the Federal Open Market Committee (FOMC) turns unduly hawkish, or the economy suffers an external shock.



Next week's market developments

Monday, April 17

- US Empire Manufacturing is expected to decrease to 15.0 for April

Tuesday, April 18

- US Housing Starts are expected to decrease to 1,250,000 for March
- US Industrial Production growth is expected to increase to 0.4% m.o.m. for March

Wednesday, April 19

- Eurozone CPI growth is expected to increase to 0.8% m.o.m. for March
- US Import Price Index growth is expected to decrease to -0.2% m.o.m. for March

Thursday, April 20

- Eurozone Consumer Confidence (Advance estimate) is expected to increase to -4.8 for April
- US Leading Index growth is expected to decrease to 0.2% m.o.m. for March

Friday, April 21

- Japan Tertiary Industry Index growth is expected to increase to 0.3% m.o.m. for February
- Markit Eurozone Manufacturing PMI growth (prelim estimate) is expected to decrease to 56.0 for April
- Markit Eurozone Services PMI growth (prelim estimate) is expected to remain at 56.0 for April
- UK Retail Sales Ex Auto, Fuel is expected to decrease to -0.5% m.o.m. for March
- Markit US Manufacturing PMI growth (prelim estimate) is expected to increase to 53.5 for April
- Markit US Services PMI growth (prelim estimate) is expected to increase to 53.4 for April
- US Existing Home Sales are expected to increase to 5,600,000 for March

Source: Bloomberg, as of April 17, 2017



Charts of the Week Atlanta Fed Wage Tracker and Average Hourly Earnings for Production & Non-Supervisory Workers Core & Services Inflation Measures



Sources: Bloomberg, BLS, Federal Reserve Bank of Atlanta as of March 31, 2017



Sources: Bloomberg, BLS, as of February 28, 2017



Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on June 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	March 15, 2017	0.75% - 1.00%	0.96%	May 3, 2017
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	April 27, 2017
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.05%	April 27, 2017
BoE	-25 basis points	August 4, 2016	0.25%	0.35%	May 11, 2017

Sources: Bloomberg, as of April 17, 2017

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