Weekly Economic Recap & Comment

Week Ended October 12, 2018

The world's financial markets turned turbulent this week, as investors finally seemed to notice our warnings about rising inflation and higher interest rates. Interestingly, however, the panic hit just as multiple reports pointed to a late-summer easing in inflation. Most important, the ***September consumer price index (CPI)*** rose only mildly by a seasonally-adjusted 0.1%, after gaining 0.2% in both August and July. Excluding the volatile food and energy components, the ***September "core" CPI*** also rose just 0.1%, as it did in the previous month. The overall CPI in September was up 2.3% year-over-year, compared with its most recent peak annual gain of 2.9% in mid-summer. The annual gain in the core CPI stood at 2.2%, down from its mid-summer high of 2.4%. All the same, we still think today's strong economic growth is creating significant investment risk. Because of the continued growth, we do expect higher corporate profits and a rebound in stock prices in the near term, so we are maintaining a significant exposure to equities for the time being (in our strategies that include them). However, we can't ignore the fact that the economy is now growing so fast that it is outrunning its resource base and keeping inflation risks high. With demand rising faster than supply in a wide range of industries, we think price pressures will keep intensifying. We still think broad, long-standing factors such as population aging and new technologies will ultimately limit how bad inflation will get, but excess demand is creating a near-term chance that the Federal Reserve may hike interest rates more aggressively than investors currently expect, or that rising costs will eventually short-circuit the economic expansion. There are also yellow flags in the government policy environment, such as risky posturing in national security and international trade disputes. Finally, stocks are trading at high valuations, making them vulnerable to selling. Taking these risks into account, we recently started to cut our exposure to stocks and other risky assets, especially in our strategies that aim to be more conservative. If the data keeps coming in like it has been, we expect to cut risk further in the coming months.

Other data this week suggested price pressures at the producer level have already started gaining strength again. The ***September producer price index (PPI)*** rose by a seasonally-adjusted 0.2%, after a fall of 0.1% in August and a flat performance in July. Excluding the food and energy categories, the ***September "core" PPI*** also rose 0.2%, after falling 0.1% in the previous month and rising just 0.1% in the month before that. On a year-over-year basis, overall PPI inflation has now eased to 3.2% from 3.9% in August and 4.5% in July, while core PPI inflation has eased to 2.4% from its recent high of 2.8% in June. The problem is that those annual increases are still higher than the gains in the CPI and core CPI. Businesses are still seeing their costs rise faster than the prices they charge to consumers. Unless companies can boost their workers' productivity enough to offset that difference, they will have to accept lower profits, boost consumer prices, or both. In any case, the impact could be negative for the financial markets.

Fortunately, the international sector is providing a modest brake on inflation, at least for the time being. ***September import prices*** rose by a seasonally-adjusted 0.5%, but that increase came after revised declines of 0.4% in August and 0.1% in July. The rise in September also stemmed entirely from energy costs. ***September import prices excluding fuels*** were unchanged, following three straight months of declines. Compared with September 2017, overall import prices were up 3.5%, but nonfuel import prices were up just 0.6%. The virtual stagnation in import prices seems to come largely from this year's surge in the value of the dollar. In our view, the strong dollar will continue to retard import prices and help limit any acceleration in overall inflation, but the impact could eventually be offset if the administration raises its protectionist import tariffs or applies them to more foreign products.

As we've explained previously, a lot of today's domestic inflation pressure is coming from the tight labor market. Companies are creating lots of new jobs, unemployment has fallen to very low levels, and wages are rising in response. In the most recent data on the demand for labor, ***initial jobless claims in the week ended October 6*** rose by a seasonally-adjusted 7,000 to 214,000, and the four-week moving average of claims rose to 210,000. However, those figures were still among the lowest in decades. With initial applications for unemployment benefits so minimal, it's clear that layoffs remain low, and/or jobs are so plentiful that those who do get laid off rarely bother to apply for benefits.

With the demand for labor so strong, workers feel extremely secure and confident, but optimism can still fluctuate from month to month. As evidence of that, the University of Michigan this week reported that its ***preliminary October consumer sentiment index*** edged down a bit to 99.0 from 100.1 in September. All the same, the reading for early October was still above the final August reading of 96.2, and it was still one of the strongest readings since the early 2000s. With people that confident, we think consumer spending will keep boosting the economy for at least a while yet.

Rising demand and increased production continue to eat into resource inventories, but stockpiles can still fluctuate. In data on the energy sector, ***commercial crude oil inventories in the week ended October 6*** rose by 5.987 million barrels to a total of 409.951 million barrels. Crude stockpiles have now risen for three straight weeks, and inventories now stand at their highest level since early August. However, stockpiles are still a significant 4.7% below their five-year moving average (an industry benchmark that suggests supply and demand are in balance). Just as important, it appears that producers are now finding it much harder to boost output than in the recent past. The data showed ***domestic crude oil production in the week ended October 6*** rose to a new record high of 11.200 million barrels per day, but that was only slightly above the range it was in all summer. Against a backdrop of continued economic growth and rising usage around the world, we think stagnating U.S. production should help keep inventories in check and put additional upward pressure on prices. We are therefore maintaining our exposure to broad commodity funds in our more aggressive portfolios.

Patrick Fearon, CFA
Chief Investment Officer

Upcoming U.S. Data

Date	ET	Release	For	Consensus Forecast	Prior
15-Oct	8:30	Retail Sales	Sep	NA	0.10%
15-Oct	8:30	Retail Sales ex-auto	Sep	NA	0.30%
15-Oct	8:30	Empire Manufacturing	Oct	NA	NA
15-Oct	10:00	Business Inventories	Aug	NA	0.60%
16-Oct	9:15	Industrial Production	Sep	NA	0.40%
16-Oct	9:15	Capacity Utilization	Sep	NA	78.10%
16-Oct	10:00	JOLTS - Job Openings	Aug	NA	6.939M
16-Oct	10:00	NAHB Housing Market Index	Oct	NA	67
16-Oct	16:00	Net Long-Term TIC Flows	Jul	NA	$74.8B
17-Oct	7:00	MBA Mortgage Applications Index	13-Oct	NA	-1.70%
17-Oct	8:30	Housing Starts	Sep	NA	1282K
17-Oct	8:30	Building Permits	Sep	NA	1229K
17-Oct	10:30	Crude Inventories	13-Oct	NA	+5.99M
17-Oct	14:00	FOMC Minutes	Sep	NA	NA
18-Oct	8:30	Initial Claims	13-Oct	NA	NA
18-Oct	8:30	Continuing Claims	6-Oct	NA	1660K
18-Oct	8:30	Philadelphia Fed	Oct	NA	22.9
18-Oct	10:00	Leading Indicators	Sep	NA	0.40%
18-Oct	10:30	Natural Gas Inventories	13-Oct	NA	+90 bcf
Oct 19	10:00	Existing Home Sales	Sep	NA	5.34M

Source: Briefing.com

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