MORNING BRIEFING
February 23, 2017

Swamp Waters

See the collection of the individual charts linked below.

(1) Declaration of reconciliation. (2) No gabbing aloud allowed. (3) With or without dynamic scoring, "revenue-neutral" tax reform plans look like tax cut plans. (4) Trump plan omits revenue gained from border adjustment and revenues lost from ACA repeal. (5) Hard to estimate impact of deregulation and infrastructure spending in budget projections. (6) Guns and butter, again? (7) Why are analysts so bullish on profit margins? (8) Jackie explains the ins and outs of Pentagon spending. (9) Increasing defense outlays in three steps could trip sequestration. (10) Europe will have to spend more on weapons, which is why the stocks of defense companies are flying high.

US Tax Policy: Lots To Reconcile. Yesterday, Melissa and I discussed the legislative reconciliation process in Congress, which was enacted by the Congressional Budget Act of 1974. It is likely to be used to fast-track Trump's health care and tax reform plans since it allows the Senate to pass bills with a simple majority of 51 votes and prohibits filibusters, which can only be stopped with 60 votes. The only problem is that just one plan of this complexity (affecting spending, revenues, and the debt) can be passed per fiscal year under the rules. The administration along with congressional Republican leaders, who have majorities in both houses of Congress, seem to favor prioritizing health reform and getting it done before the end of September. They will also work on tax reform, aiming to pass it during the coming fiscal year, possibly making it retroactive to 2017.

Trump's team—led by Gary Cohen, the director of the National Economic Council—will have to move fast to reconcile the administration's plan with the "A Better Way" proposed by congressional GOP leaders, specifically House Speaker Paul Ryan (R-WI) and House Ways and Means Chairman Kevin Brady (R-TX). Melissa and I found two useful analyses, conducted last fall by the Tax Policy Center (TPC), of the House GOP tax plan and Trump's plan. We focused on "Table 2" in both studies; these two tables summarize the estimated effects of each plan on tax revenues. Let's take a deep dive into these murky waters, focusing on the impact over the next 10 years, i.e., from 2016-2026:

(1) *Bottom line.* Before any macroeconomic feedback effects from the tax breaks are taken into account, the GOP blueprint would cost $3.101 trillion in lost tax revenues, while Trump's agenda would cost nearly twice that at $6.150 trillion. So the bottom line is that neither proposal to cut taxes "pays for itself" outright by reducing or eliminating tax deductions and exemptions. The key assumption in both plans is that the expected future benefit of faster economic growth, stimulated by lower tax rates, will offset the lost revenue. In other words, "dynamic scoring," which is based on the Laffer Curve, plausibly promises that lower tax rates will lift growth and tax revenues. However, two alternative econometric models used by the Tax Policy Center to estimate the "macro feedback" effects still show sizable shortfalls in revenues resulting from the tax cuts.

(2) *Personal income*. On the individual income and payroll tax side, Trump's bottom line would cost $3.343 trillion, while the GOP plan would cost $2.023 trillion over the 10-year period. There's a lot of minutiae behind the $1.320 trillion difference. However, on a line-item basis, the intent of both plans is actually quite close. Rather, it seems to be the scale of the reforms that is adding up to the differences.

The GOP plan includes a net tax gain for the government of $1.908 trillion for the repeal of itemized deductions (other than charitable contributions and mortgage interest deductions), according to the TPC's estimates. Trump's tax agenda includes a cap on itemized deductions for high-income earners at a net tax gain to the government of $559 billion.

Further, Trump's proposals at the time of the October 2016 TPC analysis included special treatment for business income—altogether amounting to a revenues loss of $1.544 trillion. Trump already has wavered on this aspect of his plan. The TPC analysis included the repeal of taxes related to the Affordable Care Act in the GOP's blueprint, costing $803.1 billion. That will certainly need to be included in Trump's plan, especially if ACA repeal-and-replace will precede enacting the tax agenda.

(3) *Corporate income tax.* The hit to corporate income-tax revenues on the GOP side, at $891 billion, is much less than Trump's $2.633 trillion lost revenues. A "border adjustment tax" on imports is expected to raise $1.180 trillion in revenues in the GOP plan. A big unknown is whether Trump would include border adjustments in the next version of his tax agenda. House Ways and Means Chairman Kevin Brady recently claimed that his border tax will happen. The proposed reduction in the corporate statutory tax rate from 35% to 15% under Trump would cost $2.355 trillion, but $1.845 trillion at the lower 20% rate in the GOP blueprint (including the offsetting repeal of the corporate AMT).

(4) *Macro effects*. TPC estimated what sort of positive macroeconomic feedback would occur under both scenarios using two different econometric models. On balance, the total macro changes for the GOP plan were estimated to boost revenues by a maximum of $593 billion versus Trump's at $178 billion. According to TPC, Trump's agenda cumulatively would increase debt relative to GDP by 25.4% by the end of 2026. That figure is 10.9% under the GOP blueprint (Tables 3).

Needless to say, the macro feedback effects are based on econometric models, which aren't likely to be any more accurate than the seat-of-the-pants forecasts of the economists who designed them. These models easily can be tweaked to provide results consistent with the researchers' political bias. Also, note that the TPC's analysis does not take into account the impact of Trump's fiscal initiatives beyond tax reforms, such as those related to deregulation and infrastructure stimulus. The latter in particular has a close tie-in with the tax plan, as we discussed in our 12/14 *Morning Briefing.* Both are likely to stimulate the economy along with the tax cuts.

(5) *Reform or cut?* One version of Trump's campaign pledge stated that the tax plan is to be "fully paid for" by reducing or eliminating most deductions and loopholes. But that seems unlikely. We are probably looking at tax cuts, rather than tax reform, which may or may not pay for themselves with faster economic growth. In other words, this is more about politics than econometrics. There is no serious plan to reduce government spending. On the contrary, Trump has promised not to touch the major entitlement programs while increasing defense spending, as Jackie discusses below. Sounds like "guns and butter," no?

Sector Focus: Marginally Better. With the oil recession in the rearview mirror, analysts are optimistic that S&P 500 profits will grow 10.6% over the next 12 months based on a 5.6% uptick in revenues over the same period (*Fig. 1*). The forward profit margin is expected to be 10.8% over the same period (*Fig. 2*).

Analysts expect the S&P 500's profit margin will widen from 10.2% in 2016 to 10.6% this year and 11.3% in 2018, according to Joe's data. The forward profit margin of 10.8% is higher than the 9.6% average since January 2004 and slightly below its peak of 10.9% in September 2015.

The S&P 500 sectors enjoying the most margin improvement are Energy and Financials, with Tech rounding out the group. The sharp rebound in the price of oil and years of cost-cutting during the energy recession will help the Energy sector's profit margin jump sharply as the industry recovers. The Energy sector's profit margin is forecasted to jump from 1.1% in 2016 to an estimated 6.2% in 2018 (*Fig. 3*).

The Financials sector margin is expected to balloon from 14.6% in 2016 to 17.2% in 2018 (*Fig. 4*). It marks an acceleration from the recovery that began in 2009, when the forward profit margin bottomed at 5.6%.

The improvement in Tech is interesting because the sector's margin has been slowly but gradually improving in recent years. Analysts predict that the profit margin will improve from an already lofty 19.4% in 2016 to 20.7% in 2018 (*Fig. 5*).

The S&P 500 sectors with the least improvement in profit margin are Utilities, Telecom, Consumer Staples, and Health Care. Analysts expect Health Care's profit margin, which was 10.5% last year, to remain flattish at 10.6% this year and 10.9% in 2018. While Health Care's forward profit margin of 10.6% has recovered from the 2013 low of 9.8%, that's down from an eight-year high of 10.8% in October and is expected to remain far below the 2004 level of 12.0% (*Fig. 6*). Lastly, Real Estate is the only sector expected to see profit margins shrink, partly due to expected increases in interest rates, but margins should improve as gains from real estate sales are included in the forecasts for 2017 and 2018. Analysts see the margin shrinking from 25.1% last year to 16.2% this year, and then improving a bit to 17.2% in 2018.

Industry Focus: Best Offense Is Defense. President Trump bounced back nicely from the Michael Flynn flap by appointing Lt. Gen. H. R. McMaster as National Security Advisor. It's the third, high-ranking military officer to land in a senior position on Team Trump. The other two are Defense Secretary Jim Mattis, a retired four-star general, and Homeland Security Secretary John Kelly, a retired Marine general.

The trio of strong military men match Trump's unambiguously strong talk about his intention to strengthen the US military. So far, investors like what they're hearing. The S&P 500 Aerospace & Defense sector has gained 15.5% since Election Day through Tuesday's close, eclipsing the S&P 500's 10.6% return over the same period. President Trump still needs to dodge pre-existing budget caps and woo fiscally conservative Republicans before he can get the funding needed to execute his vision, but we're guessing there's a deal to be made. Here's a rundown of some of the recent developments:

(1) *Campaign promises*. When candidate Trump stumped around the country, a key promise was to strengthen the military. "In September, Trump called for adding more than 80,000 Army soldiers to get to 540,000 active-duty soldiers. He wants to boost active-duty Marines to 200,000 from current 182,000. He also wants to increase the Navy's ships from 287 to 350, and to add to the Air Force's fighter jet fleet by two dozen to 1,200 aircraft," according to a 1/27 article in the *Los Angeles Times.* "Mackenzie Eaglen, a defense analyst at the American Enterprise Institute, found that these changes could add up to $300 billion over the next four years. The Pentagon's budget request for fiscal 2017 is around $584 billion."

(2) *It's only money*. Since becoming president, Trump signed an executive order instructing the Pentagon to review the nation's military and come up with a plan to upgrade equipment, improve training, and address current and future threats. "I'm signing an executive action to begin a great rebuilding of the armed services of the United States, developing a plan for new planes, new ships, new resources and new tools for our men and women in uniform," he said at the time, according to the *LA*

Times article. “Our military strength will be questioned by no one,” he said. ”Neither will our dedication to peace.”

In response, Defense Secretary Mattis released a 1/31 a memorandum that outlines how the Department of Defense (DOD) should act on the President’s order. Phase one involves a budget amendment asking for more money in the current fiscal year to pay for “urgent warfighting readiness shortfalls across the joint force, and new requirements driven by acceleration of the campaign against ISIS.” The budget amendment request is to be delivered to the Office of Management and Budget by March 1.

Phase two involves a review to refine and improve the DOD’s fiscal 2018 budget request. “The FY 2018 [President’s Budget] request will focus on balancing the program, addressing pressing programmatic shortfalls, while continuing to rebuild readiness.” It’s to be delivered by May 1. And lastly, phase three looks at the budgets for fiscal years 2019 through 2023. It will look at the size of the military force and “determine an approach to enhancing the lethality of the joint force against high-end competitors and the effectiveness of our military against a broad spectrum of potential threats.” The plan will also include “an ambitious reform agenda” aimed at improving efficiency and taking advantage of economies of scale.

(3) *Loosening purse strings*. Total defense spending peaked in fiscal 2010 at $691.0 billion, according to a March 2015 report from the Office of the Under Secretary of Defense. Since then, spending has fallen annually to a low of $560.4 billion in fiscal 2015. President Trump has not stated how much he’s willing to spend, but Senator John McCain has proposed spending $640 billion in fiscal 2018 (*Fig. 7* and *Fig. 8*).

But before defense companies rev up production, they should wait to see if Trump can tap dance around the Budget Control Act of 2011. The Act instituted budget caps for 10 years, ending fiscal 2021, on the defense and nondefense parts of the government’s discretionary budget, explains an 8/1 article by the Center for Strategic & International Studies (CSIS). If those budget caps are exceeded, automatic, across-the-board budget cuts—a.k.a. “sequestration”—occur.

There are some major loopholes to the budget caps, including the budget for war-related funding, or Overseas Contingency Operations (OCO) funding. The Budget Control Act does not “provide a robust definition of what constitutes OCO funding. In practice, this means that OCO funding is whatever Congress enacts and the president signs into law—a loophole both Congress and the DOD have used to get around the budget caps since 2013,” the CSIS article explains. The other major exception is for military personnel funding, which is used for pay, allowances, and some benefits service members receive.

Over the years, Congress has enacted modifications to the Budget Control Act to lift the spending limits. It’s certainly possible the same could occur again, but to do so Trump will need help from across the aisle. “Legislation to lift caps on defense spending will require 60 votes in the Senate, where Republicans only hold 52 seats. Democratic leaders have thus far refused to increase money for military programs unless the increases are included for other non-defense programs, something that conservatives on Capitol Hill have opposed,” a 1/23 *MilitaryTimes* article explained.

(4) *Watching margins*. Excitement over the sector might have been tempered by President Trump’s recent bargain tweetstorms. Trump tweeted in December that he was considering replacing the F-35 Joint Strike Fighter with a cheaper jet. Lockheed Martin CEO Marillyn Hewson subsequently spoke with then-President-elect Trump and released a statement saying she “assured him that I’ve heard his message loud and clear about reducing the cost of the F-35. I gave him my personal commitment to

drive the cost down aggressively."

The same scenario played out when Trump tweeted that the estimated costs for new Air Force One planes were "out of control." After meeting with Trump, Boeing CEO Dennis Muilenburg said Boeing would deliver two new jets for less than the original $4 billion price tag. Boeing will "get it done for less than that … We're going to make sure that he gets the best capability and that it's done affordably," Muilenburg said according to a 12/21 CNN article. These amended deals are potentially good for taxpayers and bad for margins.

(5) *Worldwide phenomenon?* Trump isn't just pushing the US to spend more on defense; he's also pushing fellow members of NATO to live up to their commitments and open their wallets. Most recently, Defense Secretary Mattis warned NATO that it needs to adopt plans to raise its military spending "or risk seeing America 'moderate its commitment to the alliance,'" noted a 2/15 *WSJ* article.

NATO members are supposed to spend 2% of their economic output on defense by 2024. But only the US and four other of the 28 NATO members do so—Greece, the U.K, Estonia, and Poland. To hit that goal, countries that aren't kicking in their share today would have to pony up an additional $96 billion per year, noted a 2/21 Reuters article.

European Commission President Jean-Claude Juncker would like to change what's included in the defense-spending calculation: "We want ... a broader understanding that the word 'stability' in the world means defense expenditure, human aid and development aid," he said according to the 2/21 Reuters article. The EU is the world's biggest aid donor, spending roughly $59.0 billion a year; Germany is spending $32-$42 billion on integrating more than a million refugees; France has a readiness to deploy; Spain is leading NATO's new spearhead force; and Italy is in Afghanistan.

(6) *The numbers*. After trading sideways for much of the past two years, the S&P 500 Aerospace & Defense stock index has enjoyed a sharp rally, 15.5%, since the presidential election (*Fig. 9*). The industry is expected to grow revenue by only 1.4% this year, but estimated revenue growth accelerates to 3.7% in 2018 (*Fig. 10*). The industry's forward profit margin fell from a record high 9.0% in 2014 to its present cyclical low of 7.8%. It's expected to gradually improve from 7.4% in 2016 to 7.7% this year and 8.2% next year (*Fig. 11*).

Revenue and margin improvement bodes well for earnings growth in upcoming years. Analysts anticipate that 5.3% earnings growth this year will almost double to 10.2% growth in 2018 (*Fig. 12*). That has sent the industry's forward P/E to 18.3, which isn't much higher than the broader market's P/E, but it's the highest P/E the industry has enjoyed since early 2004 (*Fig. 13*). The industry may not see much more multiple expansion, but shares may continue to improve at the same pace as earnings.

CALENDARS

US. **Thurs:** Jobless Claims 244k, FHFA House Price Index 0.4%, Kansas City Fed Manufacturing Index, Chicago Fed National Activity Index, Weekly Consumer Comfort Index, EIA Petroleum Status Report. **Fri:** New Home Sales 576k, Consumer Sentiment Index 96.0, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. **Thurs:** Germany GDP 0.4%q/q/1.7%y/y, Germany Gfk Consumer Confidence 10.1. **Fri:** Canada CPI 0.3%m/m/1.6%y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) slipped for the second week this week to 3.50 from 3.75 two weeks ago, which was the highest since early May 2015. It's the eleventh straight week above 3.00. Bullish sentiment dipped for the second week to 61.2% from 62.7% two weeks ago, which was the most bulls since December 2004. Bearish sentiment was little changed at 17.5% this week; last week it climbed from 16.7% (fewest bears since August 2015) to 17.6%. The correction count edged up to 21.3% from 20.6% the previous three weeks, which was its lowest reading since June 2014. The AAII Bull Ratio fell to 50.6% last week after climbing the previous two weeks from 48.5% to 56.4%. Bullish sentiment fell to 33.1% after rising from 31.6% to 35.8% the previous two weeks; bearish sentiment rose to 32.4% after falling from 34.2% to 27.7% the week before.

AC World ex-US MSCI (*link*): This index is up 5.6% ytd in dollar terms after rising 1.7% in 2016. In local-currency terms, the index has risen 3.8% ytd compared to its 4.1% gain for all of 2016. Local-currency forward revenues has risen 4.0% from a five-year low in March 2016, but has been more stable longer term and is down just 6.6% from its October 2014 record high. Local-currency forward earnings has performed better, with a 10.7% rise from its six-year low in March 2016, but remains 13.9% below its September 2008 record. Revenues are expected to rise 6.9% in 2017 and 4.7% in 2018 following a 0.8% decline in 2016, and earnings are expected to rise 15.3% (2017) and 9.8% (2018) after rising 2.0% (2016). Analysts are forecasting STRG of 6.4%, a 66-month high and up from a cyclical low of 2.3% in March 2016. Their STEG forecast of 13.9% is at a 47-month high, and up from their 6.3% forecast in January 2016, which was the lowest in seven years. The implied profit margin is expected to rise to 7.5% in 2017 from 6.9% in 2016 before improving to 7.8% in 2018. NERI had turned positive in January for the first time since March 2011, and improved another 0.8ppt in February to a 71-month high of 1.3% from 0.4% in January. That compares to a 51-month low of -11.3% in March 2016. The P/E edged up to 14.2 in February from 14.1 in January, which compares to a 16-month low of 12.4 in February 2016 and a six-year high of 15.3 in April 2015. The index's 12% discount to the World P/E has deepened from a 6% discount last April and is near the historical lows recorded in 2001, 2008, and early 2016.

EMU MSCI (*link*): The EMU's MSCI price index has gained 2.1% ytd in dollar terms after falling 1.2% in 2016. In euro terms, the price index is up a lower 2.2% ytd following a 1.8% decline for all of 2016. Euro-based forward revenues has improved 2.1% from its six-year low in May 2016, but remains 2.1% below its cyclical high (August 2015) and 8.7% from its record high (September 2008). Euro-based forward earnings had stalled since 2011--but is now 0.4% above its prior cyclical high in September 2015. It remains 27.6% below its record high (January 2008), but has improved 7.3% from its 23-month low in June 2016. Analysts expect revenues to rise 4.6% and 3.5% in 2017 and 2018, respectively, after falling 1.2% in 2016, but think earnings will rise 14.4% in 2017 and 10.7% in 2018 following a 0.7% decline in 2016. Forecasted STRG of 4.4% is down from a 64-month high of 4.6% in January. Forecasted STEG of 13.6% is at a 21-month high, which compares to a seven-year low of 5.6% in April 2016. STEG has been higher than LTEG (9.7%) since July after trailing it since late 2015. The forward profit margin has improved 0.8ppt to 7.0% from a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to improve to 7.0% in 2017 from 6.4% in 2016 before rising another 0.4ppt to 7.4% in 2018. NERI was positive for a third straight month in February as it improved 1.2ppts m/m to a 21-month high of 3.8% from 2.6% in January. NERI is up from a 24-month low of -13.2% in April 2016, but down from a 56-month high of 4.0% in May 2015. The P/E of 14.2 is down from a 13-year high of 16.4 in April 2015, but up from a 30-month low of 12.2 in February 2016. That represents an 11% discount to the World MSCI's P/E now, up from a record-low 25% discount during 2011. But the current reading is still well below the 1% premium during April 2015--the post-euro-inception record high.

Emerging Markets MSCI (*link*): The EM MSCI price index is up 9.7% ytd in US dollar terms after rising 8.6% in 2016. In local-currency terms, EM has gained 7.0% ytd compared to a 7.1% gain in 2016.

Local-currency forward revenues is up 2.2% from a four-year low in June to 14.0% below its November 2014 record. Local-currency forward earnings has improved 11.5% from April 2016's six-year low and is down just 8.8% from its January 2014 record. Revenues are expected to rise 9.6% in 2017 and 7.6% in 2018 following a 2.6% gain in 2016, leading to earnings gains of 16.0% (2017) and 11.4% (2018) following an 8.1% rise in 2016. Forecasted STRG of 9.5% is back on an uptrend since early 2016, but is down slightly from a four-year high of 9.6% in late January. STEG of 15.4% is the highest since May 2011 and up from a seven-year low of 6.0% in February 2016, and is above LTEG (14.2%) for the first time since July 2013. The implied profit margin is expected to improve to 6.7% in 2017 from 6.3% last year before moving even higher to 6.9% in 2018. The forward profit margin of 6.7% is more than 3ppts below its 10.3% record high (December 2007), but up from a record low of 6.0% in February 2016. NERI--negative for 72 months--improved m/m to -2.5% from -2.9% in January, which compares to a 63-month high of -1.6% in September 2016 and an 83-month low of -10.2% in March 2016. Emerging Markets' valuation has been more stable recently than that of the rest of the world. The P/E edged up to 12.0 in February from 11.9 in January, which compares to a 17-month low of 10.2 in August 2015 and a four-year high of 12.6 in April 2015. The index is trading at a 24% discount to the World MSCI P/E, up from a 10-year-low 30% discount in August 2016.

MSCI World & Region Net Earnings Revisions (*link*): Analysts' recent earnings revisions through February suggest rising optimism about profits across the world as all regions improved m/m except EM Eastern Europe and EM Latin America. The AC World MSCI's NERI was positive for the first time since June 2011 as it improved 0.8ppts to 0.4% from -0.4% in January. The AC World Ex-US was positive for a second month, improving 0.8ppts to 1.2% from 0.4% in January. EM Eastern Europe and Europe were positive for a fifth straight month; EAFE and EMU were positive for a third month. February's scores among the regional MSCIs: EAFE (80-month high of 4.8%, compared to 3.3% in January), EMU (21-month high of 3.8, 2.6), Europe ex-UK (76-month high of 3.6, 2.3), Europe (76-month high of 3.1, 2.8), EM Eastern Europe (2.6, 3.8 [81-month high]), AC World ex-US (71-month high of 1.3, 0.4), AC World (69-month high of 0.4, -0.4), United States (-1.5, -2.2), Emerging Markets (-2.5, -2.9), EM Asia (-2.5, -3.2), and EM Latin America (-3.5, -2.0).

MSCI Countries Net Earnings Revisions (*link*): NERI was positive for 24/44 MSCI countries in February, the most since May 2011 and up from 23/44 in January. NERI improved m/m in February for 22/44 countries, down from 30/44 improving in January. Austria's NERI was at a 128-month high in February, followed by those of Italy (127-month high), Spain (121), Australia (88), France (76), Chile (67), Sweden (57), Malaysia (53), Singapore (48), and Japan (44). On the flip-side, Mexico's was at a 21-month low, followed by those of Greece (13), New Zealand (13), India (10), and Peru (10). The 11-month positive NERI streak for Hungary is the best, followed by 10-month positive streaks for Peru, Portugal, and Russia. NERI turned positive for four countries: Argentina, Denmark, Korea, and Taiwan. NERI turned negative for three countries: Canada, Finland, and Ireland. Hungary's is the strongest recently, with positive readings in 21 of the past 22 months. Brazil's NERI has been negative for 80 straight months, followed by the negative streaks of Singapore (71), Chile (67), and Malaysia (56).

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index (*link*): "After making a cautious start to the year, the German economy is back on track," Ifo President Clemens Fuest said after business confidence in February returned to December's 33-month high. The Ifo business climate index rebounded to 111.0 after unexpectedly falling to 109.9 in January. Businesses were more optimistic about both the present and future this month. The present situation component advanced for the sixth straight month from 113.0 in August to 118.4 this month—the highest since August 2011. Meanwhile, the expectations component climbed to 104.0 after falling two of the prior three months from a cyclical high of 106.0 in October to 103.2 in January. The expectations component correlates closely with German factory orders and production; the overall index tracks exports more closely. Recent data indicate a continued pickup from the summer slowdown, as sentiment brightened in February.

Eurozone CPI (*link*): January's CPI rate matched the flash estimate of 1.8%y/y—the highest since February 2013 and increasingly close to the ECB's inflation target of just under 2.0%. That's a sharp acceleration from December's 1.1% and the eighth straight reading above zero. Of the main components, energy (to 8.1% from 2.6% y/y) recorded the highest annual rate in January—having turned positive in December for the first time since summer 2013—followed by food, alcohol & tobacco (1.8 from 1.2), services (1.2 from 1.3), and non-energy industrial goods (0.5 from 0.3). Excluding food, alcohol & tobacco, the CPI inflation rate was 0.9% y/y, matching December's pace. Of the top four Eurozone economies, inflation rates in Spain (2.9% y/y) and Germany (1.9) were above the Eurozone's 1.8%, while rates in France (1.6) and Italy (1.0) were below.

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