MORNING BRIEFING
August 14, 2017

Inflation: Ghost Stories

See the collection of the individual charts linked below.

(1) Hurricane season. (2) More storms than usual. (3) Latest count: 57 panic attacks. (4) Stock market could have a melt-up if a nuclear meltdown is averted. (5) Calendar and numericalogical curses for stocks. (6) The Bay of a Pig Scenario. (7) Latest round of disinflation just temporary or more of the same secular trend? (8) Yellen is still waiting for Phillips to show up. (9) Sticky inflation running around 2.0%. (10) Lots of price indicators. (11) Movie review: "The Big Sick" (+).

Strategy: Panic Season. It's time to prepare for a hurricane. I'm talking about the weather, not the stock market. I'm still a stock market forecaster, not a weather forecaster. My backup career in case this one doesn't work is movie reviewer. I rely on the National Oceanic and Atmospheric Administration (NOAA) in the US Commerce Department for long-term weather projections. In an 8/9 news release, the agency warned:

"Today NOAA issued the scheduled update for its 2017 hurricane season outlook. Forecasters are now predicting a higher likelihood of an above-normal season, and they increased the predicted number of named storms and major hurricanes. The season has the potential to be extremely active, and could be the most active since 2010.

"Forecasters now say there is a 60-percent chance of an above-normal season (compared to the May prediction of 45 percent chance), with 14-19 named storms (increased from the May predicted range of 11-17) and 2-5 major hurricanes (increased from the May predicted range of 2-4). A prediction for 5-9 hurricanes remains unchanged from the initial May outlook."

So batten down the hatches! Stock investors may have started to do so last week in reaction to worsening tensions between the US and North Korea. The S&P 500 lost 1.4%, putting it 1.6% below the 2480.91 record high on August 7 (*Fig. 1*). That's still a minor storm, and isn't big enough to add to our list of corrections (when the S&P 500 is down 10%-20%), but we are adding it to our list of panic attacks since the start of the current bull market (*Fig. 2*). There have been 57 of them now including the latest one. (See our *S&P 500 Panic Attacks Since 2009*.) They've all been selloffs triggered by frightening events that turned out to be false alarms, and were followed by relief rallies to new cyclical highs and then new record highs since March 28, 2013.

I suspect that the latest panic attack could last a while longer, but will probably set the stage for a powerful relief rally, perhaps even a melt-up. The relief should be that the latest panic attack didn't cause a (nuclear) meltdown. Last week's selloff occurred mostly during Thursday after President Donald Trump, on Tuesday, threatened to hit North Korea with "fire and fury" if the country's regime doesn't cease and desist with their nuclear arms program and their war-mongering. Consider the following:

(1) *VIX.* The S&P 500 VIX woke up from its summertime siesta, rising from 9.93 on Monday to 16.04 on Thursday (*Fig. 3*). Admittedly, that's not much of a panic reaction for the S&P 500, especially since the South Korea MSCI stock price index (in local currency) dropped 3.5% last week, though it is still up

21.3% y/y (*Fig. 4*).

(2) *The worst month*. It's still early in the stock market's often-stormy fall season. A week ago Friday in *Barron's*, Randy Forsyth noted, "Since 1950, however, August has been the worst month for the Dow Jones Industrial Average, according to the Stock Trader's Almanac edited by Jeffrey A. Hirsch. And, in a note written along with Christopher Mistal, Augusts in years after presidential elections have been especially treacherous." Our data for the S&P 500 since 1928 show that September has been the worst month for this index (*Fig. 5*).

(3) *Unlucky 7.* In his column this week, Randy relates, "And, for reasons possibly mystical, years ending in 7 have been particularly treacherous during this period. In Leuthold's Green Book (as the firm's widely read monthly publication for clients is popularly called), Ramsey reproduces charts of stock prices for years ending in 7, going all the way back to 1887, and darned if they all don't have some sort of swoon around this time of year."

As an amateur numerologist, I'm surprised since seven is considered to be a lucky number. In addition, there are seven seas, seven continents, seven colors in a rainbow, seven notes on a musical scale, seven days in a week, and the Seven Wonders of the World. In the movies, the good guys were the protagonists in "The Seven Samurai" and "The Magnificent Seven."

(4) *Bay of a Pig.* My current worst-case scenario for the North Korean Missile Crisis is that it will be like the Cuban Missile Crisis. I doubt that Lil' Kim will back down during the current one as did Nikita Khrushchev during the previous one. More likely is that the US will shoot down Kim's next test missile launch and once again threaten "fire and fury" on all of North Korea if Kim retaliates with an artillery barrage against South Korea. In this Wrath of Don scenario, the US might launch surgical strikes against North Korea's military installations. Before that happens, China is likely to get sufficiently alarmed to depose Kim in exchange for US assurances that North Korea will remain a Chinese protectorate forever, if China de-nukes the country.

This scenario could trigger a major panic attack in the stock market followed by an extraordinary relief rally. It could also be seen as a HUGE win for not only President Trump but also President Xi. In other words, a win-win scenario is possible and could easily trigger a melt-up, assuming that a meltdown is averted.

Inflation I: Pesky Disinflation. I like that Minneapolis Fed President Neel Kashkari thinks outside the box. He seems to have resisted the groupthink mentality that afflicts most FOMC participants. However, he tends to spend too much time on the lefty outside of the box for my conservative sensibilities. Nevertheless, I do agree with the following comment he made last Friday about inflation fears a few hours after July's lower-than-expected CPI was released:

"I call this—and I mean this with no disrespect—I call this a ghost story, meaning, I cannot prove to you that there's not a ghost underneath this table. I cannot prove it definitively. There may be. But there is no evidence that there is a ghost under this table. There is no evidence in any of the data that wages have this acceleration factor and are all of a sudden going to take off."

Speaking the same day, Dallas Fed President Robert Kaplan also said that the Fed can hold off on raising interest rates until inflation shows signs of picking up. Kaplan is a voting member of the FOMC. He voted to raise the federal funds rate in March and June. He sounds like he won't do it again at the September 19-20 meeting. Kashkari is also a voter, but dissented against the past two rate hikes, which otherwise were unanimously accepted.

The last public pronouncement about inflation from Fed Chair Janet Yellen occurred on Thursday, July 13 in her semi-annual monetary policy testimony to Congress: “It is premature to conclude the underlying inflation trend is falling well short of 2 percent [which is the Fed’s inflation target].” She stuck to her position, saying higher wages and prices are likely as economic slack shrinks. She acknowledged that recent readings on inflation have been lower than expected, but she attributed that to “unusual reductions in certain categories of prices.” Let’s have a closer look at some of the reductions that are deemed by Yellen to be temporary ones:

(1) *Headline & core.* Data released on Friday showed the headline and core CPI inflation rates both rose 1.7% y/y through July (*Fig. 6*). The Fed gives more weight to the PCED inflation rate, which tends to be below the CPI rate. The headline and core PCED inflation rates are available through June, and show increases of only 1.4% and 1.5% (*Fig. 7*).

(2) *Services.* Weighing down all four CPI measures was wireless telephone services, which is down 13.2% through July (*Fig. 8*). Physician services inflation dropped from a recent peak of 4.3% last August to -0.6% last month (*Fig. 9*). Airline fares are down 2.5% y/y, while hotel rates are 3.1% lower (*Fig. 10*).

(3) *Durable goods.* New car prices are basically flat y/y, while used car prices are down 4.1% (*Fig. 11*).

Melissa and I believe that powerful secular forces related to global competition, technological innovations, and aging populations are all keeping a lid on inflation, and offsetting the cyclical inflationary impact of less slack in the labor market.

Just last Thursday, Jackie noted that Marriott’s CEO warned in a recent conference call that hotel room rates are hard to raise despite high occupancy rates. That might have something to do with apps and websites like AirBNB and Trivago. Car prices may be weak because Millennials would rather take Uber everywhere than buy a new or used car. Many physicians are becoming salaried employees of health care companies, requiring that they use technology to increase their productivity.

At a press briefing last Thursday, New York FRB President Bill Dudley said, “I expect inflation to also start to move higher in the medium term but probably not get all the way back to 2% on a year-over-year basis, because remember, we’ve had these very weak inflation readings for a number of months. So we’re not going to get to a year-over-year number of 2% until some of these very low readings drop out of the statistics 6 to 10 months from now.”

Inflation II: Sticky Inflation. Melissa and I wouldn’t be surprised to hear Fed officials talk more often about the Atlanta Fed’s sticky-price CPI and other measures of consumer prices that show inflation is running at 2% or higher. Let’s review:

(1) *Sticky and flexible CPI*. The Atlanta Fed’s headline sticky-price CPI rose 2.1% y/y during July, while the core rate rose 1.0% (*Fig. 12*). Two Fed economists explain that sticky prices are the ones that don’t change very often or very much. They may be less responsive to economic conditions than flexible prices, but “may do a better job of incorporating inflation expectations. Since price setters understand that it will be costly to change prices, they will want their price decisions to account for inflation over the periods between their infrequent price changes.” During July, the flexible-price CPI rose 0.8% y/y, while the core version fell 0.8% (*Fig. 13*).

(2) *Median and mean CPI.* The Cleveland Fed also calculates its own funky CPIs based on the official data. Over the last 12 months, the median CPI rose 2.1%, while the trimmed-mean CPI rose 1.9% (*Fig. 14*). Trimmed-mean inflation measures remove the most volatile monthly price changes from the

inflation calculation. The median CPI is considered to be an "extreme trim" measure.

Inflation III: Different Strokes. Melissa and I have previously observed that one of the main differences between the CPI and PCED measures of consumer prices is that the CPI, which is compiled by the Bureau of Labor Statistics (BLS), is based on surveys of consumers. The PCED, prepared by the Bureau of Economic Analysis, reflects surveys of businesses, which more accurately show what consumers are buying. So the market basket reflected in the PCED more accurately captures consumers' shopping carts.

Interestingly, over the years, the CPI has risen more than the PCED (*Fig. 15*). It has also risen faster than the nonfarm business price deflator, which is largely based on the PPI for final demand, which is also up less than the CPI.

The CPI is often used to convert measures of compensation to inflation-adjusted ones, as it measures how the prices of a basket of consumer goods change over time. As noted in a June 2017 BLS post, "the CPI might not be the most appropriate deflator to use when comparing compensation to productivity. Workers are compensated based on the value of goods and services produced, not on what they consume. Using an output price deflator, a measure of changes in prices for producers, instead of the CPI is an alternative that better aligns what is produced to the compensation that workers receive." Consider the following:

(1) Average hourly earnings for production and nonsupervisory workers has been growing faster when deflated by the PCED than the CPI (*Fig. 16*). Incredibly, the former has been rising in record-high territory since the late 1990s, while the latter remains well below its peak in the early 1970s!

(2) Nonfarm business productivity is highly correlated with real average hourly earnings using the nonfarm business deflator (*Fig. 17*).

Movie. "The Big Sick" (+) (*link*) is a funny movie about a young Pakistani-American stand-up comedian, who is also an Uber driver. He falls in love with an American girl from the South. She loves him too, but his parents insist on arranging his marriage to a Pakistani girl. Will love conquer all? It often does in the movies. In the real world, we are reminded by the violence in Charlottesville that hate remains a very destructive force in our society.

CALENDARS

US. Mon: None. **Tues:** Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.3%/0.3%/0.4%/0.5%, Business Inventories 0.4%, Empire State Manufacturing Index 9.8, Import & Export Prices 0.2%/0.2%, Housing Market Index 65, Treasury International Capital. (Bloomberg estimates)

Global. Mon: Eurozone Industrial Production -0.5%/2.8%, China Retail Sales 10.8% y/y, China Industrial Production 7.1% y/y. **Tues:** Germany GDP 0.7%q/q1.9%y/y, UK Headline & Core CPI 2.7%/2.5% y/y, Japan Industrial Production, RBA August Meeting Minutes. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index fell 1.5% last week for its worst decline in 20 weeks as it ranked 24th of the 49 markets and only seven countries rose in US dollar terms—compared to 29th a week earlier, when it edged up 0.2% as 30 countries moved higher. The AC World ex-US index underperformed the US MSCI for the first time in five weeks, suffering its worst decline in

40 weeks, a 1.6% tumble; that compared to a 0.6% gain a week earlier. All regions declined w/w, but EM Eastern Europe performed best with a decline of 0.7%, followed by EM Latin America (-0.8%), EMEA (-1.0), and EAFE (-1.6). EM Asia was the week's worst-performing region for a second week, falling 2.8% and followed by EMU (-2.3) and BRIC (-2.2). Peru (2.1) was the best-performing country, followed by Denmark (1.6), Morocco (1.1), Hungary (0.9), and the Czech Republic (0.7). Israel was the worst performer for a second week as it fell 5.2%, followed by Korea (-5.1), Pakistan (-4.8), India (-4.7), and Spain (-3.5). The US MSCI is up 9.2% ytd, with its ranking down one place w/w to 38th of the 49 markets, and continues to trail the AC World ex-US (14.7) on a ytd basis. Forty-five of the 49 markets are positive ytd, now led by Poland (39.0), Austria (38.7), Turkey (35.6), Argentina (32.6), China (31.6), Greece (30.4), and Hungary (29.2). The worst country performers ytd: Pakistan (-15.5), Russia (-13.3), Israel (-8.4), and Jordan (-0.3). EM Asia is the best-performing region ytd with a gain of 24.7%, ahead of BRIC (22.9), EMU (18.2), and EM Latin America (17.7). The worst-performing regions: EM Eastern Europe (-0.3), EMEA (4.8), and EAFE (13.8).

S&P 1500/500/400/600 Performance (*link*): All three indexes tumbled last week as LargeCap (-1.4%) and SmallCap (-2.8) had their worst decline in 20 weeks and MidCap (-2.3) registered its biggest decline in 48 weeks. At the week's end, LargeCap stood 1.6% below its August 7 record high, MidCap was 4.5% below its July 25 high, and SmallCap was 5.1% below its July 25 peak. Just one of the 33 sectors rose w/w, the lowest number since September 2016 and down from 12 rising a week earlier; LargeCap Consumer Staples was last week's sole gainer as it edged up 0.1%. Sectors falling the least w/w included MidCap Consumer Staples (-0.2), SmallCap Utilities (-0.3), LargeCap Utilities (-0.4), and MidCap Utilities (-0.5). Last week's worst performers: SmallCap Energy (-7.8), MidCap Energy (-5.9), SmallCap Financials (-4.5), and SmallCap Materials (-3.9). Nineteen of the 33 sectors are positive ytd, with LargeCap (9.0) easily beating both MidCap (3.0) and SmallCap (-0.8). Tech and Health Care dominate the biggest sector gainers ytd: LargeCap Tech (21.3), SmallCap Health Care (15.7), MidCap Health Care (15.1), SmallCap Utilities (14.3), LargeCap Health Care (13.9), and MidCap Tech (11.5). Energy and Telecom dominate the worst performers ytd: SmallCap Energy (-42.3), MidCap Energy (-34.8), MidCap Telecom (-34.4), LargeCap Energy (-15.3), and LargeCap Telecom (-10.0).

S&P 500 Sectors and Industries Performance (*link*): Just one of the 11 sectors rose last week, and six outperformed the S&P 500's 1.4% decline. This compares to four sectors rising a week earlier, when four outperformed the S&P 500's 0.2% gain. Consumer Staples was the best-performing sector as its 0.1% gain beat these outperforming sectors' declines: Utilities (-0.4%), Tech (-1.0), Health Care (-1.2), Consumer Discretionary (-1.3), and Telecom (-1.4). Energy (-2.9) was the worst-performing sector for a second week, followed by Financials (-2.7), Materials (-2.1), Real Estate (-1.9), and Industrials (-1.6). So far in 2017, nine of the 11 sectors are higher, but only four have outperformed the S&P 500's 9.0% gain. The best performers in 2017 to date: Tech (21.3), Health Care (13.9), Consumer Discretionary (10.3), and Utilities (10.2). The seven sectors underperforming the S&P 500 ytd: Energy (-15.3), Telecom (-10.0), Real Estate (3.7), Financials (5.9), Consumer Staples (6.5), Materials (7.2), and Industrials (7.6).

Commodities Performance (*link*): Twelve of the 24 commodities we follow rose last week as the S&P GSCI commodities index fell 0.4%, down from 14 commodities rising a week earlier, when the GSCI index fell 0.5%. Industrial metals-related commodities were among the week's strongest performers: Natural Gas (8.5%), Aluminum (7.4), Silver (5.6), Nickel (4.1), and Zinc (3.1). Last week's laggards: Unleaded Gasoline (-7.8), Sugar (-6.6), Feeder Cattle (-6.1), and Live Cattle (-5.9). Industrial metals-related commodities also dominate the best performers in 2017 so far: Aluminum (20.7), Copper (15.8), Lead (15.6), Wheat (14.5), Feeder Cattle (13.2), and Zinc (12.7). The energy-related commodities still dominate this year's laggards: Sugar (-32.3), Natural Gas (-19.2), Unleaded Gasoline (-9.2), Crude Oil (-8.8), and Brent Crude (-8.6).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 11/24 commodities, 1/9 global stock indexes, and 0/33 US stock indexes compared to 10/24, 5/9, and 8/33 rising a week earlier, respectively. Fourteen commodities trade above their 200-dmas, up from 13 a week earlier. Brent Crude and Unleaded Gasoline turned negative, and these three turned positive: Coffee, Corn, and Silver. Commodities' average spread rose w/w to 0.4% from 0.2%. Copper leads all commodities and all assets at 10.7% above its 200-dma, followed among commodities by Aluminum (9.8%), Zinc (7.3), and Nickel (5.9). Natural Gas (-4.5) performed the best of all commodities and all assets last week as it improved 7.4ppts. Sugar (-23.9) trades the lowest of all commodities, but Unleaded Gasoline (-3.8) tumbled 8.4ppts last week for the worst performance of all commodities and all assets. The global indexes trade at an average of 3.6% above their 200-dmas, down from 5.4% above in the prior week. Eight of the nine global indexes trade above their 200-dmas, unchanged from a week earlier. Chile (9.4) leads the global indexes, but Brazil had the best performance among its peers as it gained 0.5ppt to 5.7%. Canada (-2.2) trades the lowest of the global assets relative to their 200-dmas, but South Korea (6.3) performed the worst of its country peers last week, falling 3.9ppts. The US indexes trade at an average of 1.0% below their 200-dmas, with 19 of the 33 sectors above, down from a 1.4% average a week earlier, when 25 sectors were above. These six US indexes turned negative w/w: MidCap Financials, MidCap Materials, SmallCap Consumer Discretionary, SmallCap Consumer Staples, SmallCap Financials, and SmallCap Industrials. SmallCap Utilities leads all US stock indexes at 10.3% above its 200-dma, followed by LargeCap Tech (9.5) and SmallCap Health Care (7.0). LargeCap Consumer Staples (2.0) edged down 0.1ppt w/w for the smallest decrease among the US stock indexes. SmallCap Energy trades 29.9% below its 200-dma, the lowest among the US stock indexes and all assets; it also had the worst performance of the US stock indexes last week, falling 5.5ppts w/w.

S&P 500 Technical Indicators (*link*): The S&P 500 index remained in a Golden Cross last week for a 68th week (after 17 weeks in a Death Cross). The index's 50-day moving average (50-dma) relative to its 200-dma weakened for the sixth time in seven weeks, falling to a six-month low of 4.3% above its 200-dma from 4.5%. That's down from a 34-month high of 5.4% in early April and compares to a six-month low of 2.0% in early December and a 52-month low of -4.5% in March 2016. The S&P 500's 50-dma moved higher for a 38th week, but the index closed below its 50-dma for the first time since late April and only the second time since the November election. The S&P 500 weakened to 0.3% below its rising 50-dma from 1.3% above its rising 50-dma, and is down from an 11-week high of 2.5% in early June. These readings compare to a 23-week low of -1.0% in mid-April, a 38-week high of 4.8% on December 13, and a 52-month high of 6.2% in March 2016. The S&P 500 fell to an eight-month low of 4.0% above its rising 200-dma from 6.0% a week earlier, and is down from an 11-week high of 7.4% in early June. That's down from a 38-month high of 9.4% on March 1, but up from an eight-month low of -0.1% immediately before the election. The 50-dma and 200-dma both rose together for a 35th week.

S&P 500 Sectors Technical Indicators (*link*): Just one of the 11 sectors improved w/w relative to its 50-dma (Consumer Staples), and all 11 weakened relative to their 200-dmas. Four of the 11 sectors trade above their 50-day moving averages (50-dmas), down sharply from 10 a week earlier as these six sectors fell below in the latest week: Consumer Discretionary, Energy, Health Care, Industrials, Materials, and Real Estate. Energy has traded below its 50-dma in 28 of the past 29 weeks, and Consumer Staples was below for an eighth week. During mid-April, just three sectors were above their 50-dmas, which was the lowest since the election. All 11 sectors had been above their 50-dmas during mid-January, and all 11 were below the week before the election, for the first time since December 11, 2015. The longer-term picture is better: Nine of the 11 sectors were above their 200-dmas last week, unchanged from a week earlier, as Energy was below for a 23rd week and Telecom for a 21st week. Nine sectors are in a Golden Cross, with 50-dmas higher than their 200-dmas, unchanged from a week earlier and leaving Energy and Telecom still out of the club. All 11 had been in a Golden Cross during a 21-week streak that ended October 24, the longest such stretch since October 2014. Just two of the 11 sectors have rising 50-dmas, down from nine a week earlier, as Tech turned flat and these six turned down w/w: Consumer Discretionary, Industrials, Materials, Real Estate, Telecom, and Utilities. Consumer Staples' 50-dma has fallen in four of the past six weeks and Energy's fell for a 26th week. Ten sectors have rising 200-dmas, unchanged from a week earlier, as Telecom's fell for a 19th week.

US ECONOMIC INDICATORS

US CPI (*link*): The core CPI rate in July was at 1.7% for the third month and below the Fed's target rate of 2.0% y/y for the fourth month. That followed 15 months of readings above 2.0%—ranging from 2.1% to 2.3%—from December 2015 through February of this year. The three-month rate accelerated for the second month to 1.2% (saar) after no change in May, which was the lowest reading in seven years. On a monthly basis, core prices edged up 0.1% for the fourth month, after edging down 0.1% in March—which was the first monthly loss since January 2010. Costs for shelter, medical care, recreation, apparel, motor vehicle insurance, and airfares all rose during July, more than offsetting declines in prices for new vehicles, used cars & trucks, communications, and household furnishings & operations. The headline CPI ticked up 0.1% after no change in June and a 0.1% decline in May. The yearly rate inched up to 1.7% after falling the prior four months from 2.7% to 1.6%.

US PPI (*link*): The PPI for final demand posted its first decline in 11 months in July, ticking down 0.1% after no change in June. Prices for final demand goods dropped for the second time in three months, slipping 0.1% after a 0.1% increase in June and a 0.5% decrease in May, which was the biggest decline in 15 months; prices for final demand services sank 0.2% in July after advancing by the same amount in June. This was the first time since last August that prices for both final demand goods and final demand services fell together. A 1.4% dip in gasoline prices depressed final demand goods the most last month, though prices for beef & veal, utility natural gas, motor vehicles, and basic organic chemicals also declined. In contrast, the index for grains jumped 17.1%. About 60% of July's decrease in prices for final demand services was attributable to a 5.8% drop in margins for chemicals & allied products wholesaling. The yearly inflation rate for the headline series was 1.9%, slowing steadily from April's 2.5%—which was the largest increase since February 2012. The goods rate was little changed at 2.3% y/y, peaking earlier this year at a five-year high of 4.0%; the services rate eased to 1.8% y/y after accelerating to a 29-month high of 2.1% in May. The rate for the core (1.8% y/y) slowed from May's reading of 2.1%, which was the highest since May 2014, while the core ex trade services ticked down to 1.9%, below the April/May high of 2.1%.

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