



## MORNING BRIEFING

May 1, 2018

### Fed on Course

See the [collection](#) of the individual charts linked below.

(1) Victory dance at the Fed as inflation approaches 2.0% target. (2) Three more rate hikes this year, in June, September, and December. (3) Federal funds rate hasn't exceeded core PCED inflation since March 2008. (4) No inverted yield curve in our outlook. (5) Mounting cost pressures more likely to come out of record profit margins than to push prices higher. (6) Regional surveys of "prices paid" reflecting higher commodity costs. (7) Employment Cost Index showing more of an upward trend in wage inflation than average hourly earnings. (8) Fed was right to expect reversal in transient factors that depressed inflation last year. (9) Rent inflation might have peaked, as the number of owner-occupied households has been increasing while renting ones decline.

**Inflation I: Almost Up to Fed's Target.** The bad news is that inflationary pressures are building. The good news is that Fed officials must be doing a victory dance. That's because they've been trying to boost the inflation rate closer to their 2.0% target ever since they publicly announced it at the start of 2012. The PCED core inflation rate rose to 1.9% y/y during March ([Fig. 1](#)). That's the highest since February 2017. Still, that is a tick below the 2.0% target, which was last achieved just when the FOMC first announced that target! Nevertheless, it's close enough.

Now that their mission seems to have been accomplished, Fed officials are likely to stay on their announced course of gradually tightening monetary policy. That means that they will continue to reduce the Fed's balance sheet ([Fig. 2](#)). It also means that the FOMC is likely to boost the federal funds rate by 25bps at every meeting that has a scheduled press conference with Fed Chairman Jerome Powell through the end of this year.

The federal funds rate is currently targeted at a range of 1.50%-1.75%. Rate hikes during June, September, and December of this year would bring the range up to 2.25%-2.50% by the end of the year. Melissa and I expect a couple more rate hikes in 2019 to take the range up to 2.75%-3.00% ([Fig. 3](#)).

Assuming that the inflation rate remains relatively steady around 2.0% over the rest of this year and next year, as we do, then the federal funds rate will exceed the core PCED inflation rate later this year for the first time since March 2008 ([Fig. 4](#)).

What about the 10-year Treasury bond yield? We expect that it will trade between 3.00% and 3.50% over the rest of this year through the first half of next year. In our scenario, the yield curve should remain relatively flat, but we don't expect that it will invert. The mounting supply of US Treasury debt shouldn't push the bond yield higher than we expect as long as inflation remains subdued as we expect, and as long as the Fed stays on its current well communicated course of normalizing monetary policy as we expect.

**Inflation II: Profit Margins as Cost Absorbers.** Inflationary cost pressures have been building in

recent months. Rising costs don't necessarily cause a one-to-one increase in price inflation. They can be offset by productivity. That's not a very compelling story right now since annual productivity growth has been below 1.0% on average for the past five years ([Fig. 5](#)). Debbie and I would like to believe that Trump's tax cuts will provide a magical supply-side boost to productivity. However, we will have to see it to believe it.

More likely is that some of the cost increases will come out of profit margins. The good news is that Trump's tax cuts boosted profit margins significantly ([Fig. 6](#)). There isn't any bad news in this story since the S&P 500 profit margin was at a record high of 10.3% during Q4-2017 before the tax cuts were implemented. Analysts are expecting that it will rise to 12.0% this year. It might, or it might not if corporations use some of the windfall to keep a lid on pricing in the face of both mounting costs and mounting competition.

**Inflation III: Cost Pressures Mounting.** Debbie and I are finding increasing evidence of rising costs facing businesses. Commodity prices have been rebounding since early 2016, led by the 170% rise in the price of a barrel of Brent crude oil since then. Labor cost inflation has been remarkably subdued given the tightness of the labor market, but slowly has been trending higher. Let's dive into the relevant data:

(1) *Regional surveys.* Debbie and I average survey data collected on business activity by the regional Federal Reserve Banks. The average of the five available series for prices paid rose to 45.3 in April, the highest reading since May 2011 ([Fig. 7](#)). This prices paid diffusion index (PPDI) was around zero in early 2016. The spread between the PPDI and prices received diffusion index rose to 23.1 in April, the highest since March 2012, suggesting that margin pressure has been going up since early 2016 ([Fig. 8](#)).

As we've demonstrated before, the PPDI series is highly correlated with the PPI for both finished goods and final demand. More importantly, it is highly correlated with the price of oil and the CRB raw industrials spot price index ([Fig. 9](#) and [Fig. 10](#)). So the prices paid diffusion index is simply telling us that commodity costs have been rising since 2016. Those higher costs won't necessarily boost prices received if the increases are absorbed in ample profit margins, as noted above.

(2) *Employment costs.* Economists and investors tend to track wage inflation by monitoring the average hourly earnings (AHE) series that is included in the monthly employment report. It has remained stalled below 3.0% on a y/y basis for about the past two years even though the unemployment rate dropped sharply over this period ([Fig. 11](#)). It was up 2.7% during March.

The Employment Cost Index for wages and salaries in private industry is showing more of an upward trend, rising from 2.0% y/y during Q1-2016 to 2.9% during Q1-2018.

Showing more wage inflation is the Atlanta Fed's Wage Growth Tracker (WGT) ([Fig. 12](#)). It was at 3.1% during March 2016, holding around that rate during March (3.2%) of this year. However, as I observe in my new [book](#), the WGT "doesn't reflect that the Baby Boomers are exiting the workforce and being replaced with lower-paid, entry-level workers, whereas the AHE does." (See Appendix 4.1: [Alternative Measures of Wages & Labor Cost](#).)

**Inflation IV: Will It Overshoot Fed's Target?** What if the PCED overshoots the FOMC's 2.0% inflation target? In our 4/16 [Morning Briefing](#), Melissa and I reviewed the [minutes](#) of the FOMC's March 20-21 meeting as follows:

"FOMC participants expect that inflation will soon rise as 'transitory' factors that had weighed on

inflation last year dissipate this year. Furthermore, the stronger economic growth is expected to push inflation up toward the FOMC's 2.0% objective, according to the minutes. But such an increase is not expected to change the FOMC's gradual course of raising interest rates. Nor would a temporarily overshoot of the inflation target." Consider the following:

(1) One of the transitory factors was a 13.2% y/y drop in the CPI for wireless telephone services during July 2017 ([Fig. 13](#)). That item is weighing less now on consumer inflation, falling 2.4% during March.

(2) The medical care services component of the PCED is another category of services that has rebounded from 1.6% last March to 2.3% this March ([Fig. 14](#)).

(3) The big downside surprise over the rest of this year and next year might be a decline in the inflation rate for tenant rent. In the PCED, this item peaked at 3.8% y/y during August 2017 ([Fig. 15](#)). It was down to 3.5% during March. Data released last week by the Census Bureau show that the pace of household formation by home owners rose to 1.22 million during the four quarters through Q1, while renter households fell 353,000 over the same period ([Fig. 16](#)). The Millennials may finally be buying homes rather than renting them.

## CALENDARS

**US. Tues:** Total & Domestic Motor Vehicle Sales 17.2mu/13.0mu, Construction Spending 0.5%, ISM & IHS Markit M-PMIs 58.7/56.5, FOMC Begins. **Wed:** ADP Employment 193k, MBA Mortgage Applications, EIA Petroleum Status Report, Treasury Refunding Announcement, FOMC Decision 1.625% (1.50%-1.75%). (*Wall Street Journal* estimates)

**Global. Tues:** UK M-PMI 54.8, Canada GDP 0.3%/m/m, Canada M-PMI, RBA Cash Rate Target 1.50%, Poloz. **Wed:** Eurozone GDP 0.4%/q/q/2.5%/y/y, Eurozone Unemployment Rate 8.5%, Eurozone, Germany, France, and Italy M-PMIs 56.0/58.1/53.4/54.5, Italy GDP 0.3%/q/q/1.5%/y/y, Japan Consumer Confidence 44.5. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings ([link](#)):** Forward earnings rose to record highs last week for all three indexes. LargeCap's forward earnings has been up in 39 of the past 40 weeks, MidCap's was higher last week for a 35th straight week (which now exceeds its prior record streak in mid-2002), and SmallCap's has been up in 33 of the past 36 weeks. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap's forward earnings rose to 20.2% y/y from 20.0% y/y, which is down slightly from a seven-year high of 20.3% in mid-March and compares to a six-year low of -1.8% in October 2015; MidCap's dropped to 22.9% from 23.1%, which compares to a seven-year high of 24.0% in mid-March and a six-year low of -1.3% in December 2015; and SmallCap's ticked down to 27.1% from 27.2%, which compares to a seven-year high of 27.7% in early April and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 20.3% and 9.7%, MidCap 19.8% and 12.1%, and SmallCap 23.3% and 17.4%.

**S&P 500/400/600 Forward Valuation ([link](#)):** Last week saw forward P/E ratios tick down for all three indexes—for the first time in three weeks—but remain above their recent post-election lows. LargeCap's weekly forward P/E edged down to 16.3 from 16.4 in the prior week, and is down from 18.6 on January 26—the highest since May 2002. These recent levels are up from a post-election low of 16.0 in late March and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remain well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E eased to 16.3 from 16.4 while

remaining above its 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E has been at or below LargeCap's P/E since August for the first time since 2009. SmallCap's P/E dropped to 17.4 from 17.6, which compares to a post-election low of 17.0 in mid-March. That's well below its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed), but is comfortably above its three-year low of 15.5 in February 2016. Looking at their forward price/sales (P/S) ratios, they were lower w/w for all three indexes at levels well below January highs: LargeCap's P/S of 1.99 is down from a record high of 2.19 on January 26; MidCap's 1.28 compares to its record high of 1.40, also on January 26; and SmallCap's 0.98 is down from 1.05 then, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

**S&P 500 Sectors Quarterly Earnings Outlook** ([link](#)): With the Q1 quarterly earnings reporting season well underway, analysts have been busy adjusting their forecasts. The S&P 500's Q2-2018 EPS forecast dropped 9 cents w/w to \$38.85. That's down 0.3% since the end of Q1, but is up 6.9% ytd and 7.6% since the passage of the TCJA. The \$38.85 estimate represents a forecasted pro forma earnings gain for Q2-2018 of 19.6%, which compares to Q1-2018's blended 24.6% (which is the strongest since Q4-2010), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q1, Q2-2018 estimates are higher for three sectors, down for six, and unchanged for two. Energy's Q2 forecast has risen 5.9%, followed by the forecasts for Real Estate (up 2.5%) and Utilities (1.5). Consumer Discretionary is the biggest decliner, with its Q2-2018 forecast down 1.6% since the end of Q1, followed by Industrials (-1.5), Telecom (-1.3), Tech (-1.3), Consumer Staples (-1.2), and Financials (-0.9). The S&P 500's Q2-2018 forecasted earnings gain of 19.6% y/y would be its eighth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q2-2018—with nine rising at a double- or triple-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 19.6%. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace or better and five outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q2 relative to very low earnings a year ago, with the pace improving from Q1. Q2 is expected to mark just the third time since Q3-2011 that all 11 sectors had earnings rise y/y. The latest forecasted Q2-2018 earnings growth rates vs their blended Q1-2018 growth rates: Energy (124.9% in Q2-2018 vs 81.5% in Q1-2018), Materials (28.4, 28.9), Tech (22.0, 33.3), Financials (22.0, 29.9), S&P 500 (19.6, 24.6), Consumer Discretionary (16.4, 16.0), Industrials (15.8, 25.2), Telecom (12.9, 14.0), Consumer Staples (11.2, 12.1), Health Care (10.5, 14.5), Real Estate (2.2, 3.2), and Utilities (0.4, 12.5). On an ex-Energy basis, S&P 500 earnings are expected to rise 16.4% y/y in Q2, down from a blended 22.7% in Q1, and compare to 12.7% in Q4-2017 and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

**S&P 500 Q1 Earnings Season Monitor** ([link](#)): With nearly 55% of S&P 500 companies finished reporting earnings and revenues for Q1-2018, nearly all metrics are stronger compared to the same point during the Q4 season. If the current readings for revenue and earnings surprise and their y/y growth metrics keep up, Q1 will mark the best quarterly reporting season in seven years. Of the 274 companies in the S&P 500 that have reported, 80% exceeded industry analysts' earnings estimates by an average of 8.0%; they have averaged a y/y earnings gain of 26.0%. At the same point during the Q4-2017 reporting period, a lower percentage of companies (78%) in the S&P 500 had beaten consensus earnings estimates by a lower 4.6%, and earnings were up a lower 16.4% y/y. On the revenue side, 74% beat sales estimates so far, with results coming in 1.5% above forecast and 10.0% higher than a year earlier. At this point in the Q4 season, a higher 80% had exceeded revenue forecasts by a lower 1.2%, and sales rose a lower 9.6% y/y. Q1 earnings results are higher y/y for 88% of companies vs a lower 81% at the same point in Q4, and Q1 revenues are higher y/y for 92% vs 89% a quarter ago. These figures will continue to change as more Q1-2018 results are reported in the coming weeks. The early results on revenues are very encouraging, particularly the percentage of



companies growing revenues y/y. Q1-2018 should mark the seventh straight quarter of positive y/y earnings growth and the strongest since Q4-2010 in part due to lower tax rates.

## US ECONOMIC INDICATORS

**Personal Income & Consumption** ([link](#)): Real consumer spending was weak last quarter, but ended Q1 on an up note. March real personal consumption expenditures expanded 0.4% after declines of 0.2% and 0.1% during February and January, respectively. Real goods consumption—which posted its first quarterly decline since Q2-2011 during Q1—rebounded 0.6% in March, following declines of 0.3% and 0.6% the prior two months. Durable goods consumption jumped 1.1% in March after falling 1.8% during the first two months of the year; nondurable goods consumption climbed 0.3% in March, its first gain since November. Meanwhile, real services consumption rose for the sixth time in seven months, by 0.3% m/m and 1.4% over the period. Both real disposable income and real wages & salaries rose every month of Q1, expanding 3.4% and 2.8% (saar), respectively, last quarter. Our Earned Income Proxy, which tracks consumer spending and incomes closely, continues to set new highs, indicating that the consumer will be a major contributor to growth this quarter.

**Pending Home Sales** ([link](#)): The Pending Home Sales Index (PHSI)—measuring sales contracts for existing-home purchases—edged higher in March for the second month, but “unrelenting inventory constraints once again kept overall activity below year ago levels,” according to the National Association of Realtors. The PHSI ticked up 0.4% in March, but fell 3.0% y/y—the third straight y/y decline. Sales were below year-ago levels in three of the four regions—Northeast (-8.1% y/y), Midwest (-6.0), and the West (-2.2); sales in the South (0.3) were basically flat with a year ago. NAR’s Chief Economist Lawrence Yun noted: “Much of the country is enjoying a thriving job market, but buying a home is becoming more expensive. That is why it is an absolute necessity for there to be a large increase in new and existing homes available for sale in coming months to moderate home price growth. Otherwise, sales will remain stuck in this holding pattern and a growing share of would-be buyers—especially first-time buyers—will be left on the sidelines.”

**Regional M-PMIs** ([link](#)): Five Fed districts have now reported on manufacturing activity for April—New York, Philadelphia, Dallas, Richmond, and Kansas City—with two outliers. Growth in the Kansas City region showed a sharp acceleration this month, while Richmond’s showed a sharp deterioration. We average the composite, orders, and employment measures as data become available. The composite index (to 16.8 from 19.9) showed activity continued to expand at a solid pace, though down from February’s 24.5—which was the strongest rate since summer 2004. The Philadelphia (23.3 from 22.3) and Dallas (21.8 from 22.8) regions showed steady growth in April, while New York’s (15.8 from 22.5) growth eased. Meanwhile, Richmond’s (-3 from 15) gauge contracted for the first time since June 2016, while Kansas City’s (26 from 17) was the highest in the history of its series going back to July 2001. The new orders gauge (16.7 from 15.8) showed a slight improvement as Kansas City (37 from -1) and Dallas (27.9 from 10.3) manufacturers enjoyed a sharp acceleration in orders during April. Meanwhile, orders growth in the Richmond (-9 from 17) region turned negative after 17 months in positive territory, while orders growth slowed in both the Philly (18.4 from 35.7) and New York (9.0 from 16.8) regions—though Philly orders expanded at double the pace of New York’s. The employment measure (17.8 from 16.7) was little changed this month, though hirings by manufacturers in the Philly (27.1 from 25.6), Kansas City (unchanged at 26), and Dallas (17.8 from 11.7) regions continued to grow at a much faster pace than the Richmond and New York regions. Richmond (12 from 11) manufacturers hired at half the pace recorded earlier this year, while New York (6.0 from 9.4) factories hired at less than a third of the pace recorded at the end of last year.

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