



MORNING BRIEFING

May 9, 2018

Cautiously Optimistic Central Bankers

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

(1) More caution than optimism. (2) Fed's Williams and Dudley wouldn't mind a brief inflation overshoot. (3) Fed's 2% inflation target is viewed as a tight range around this mean. (4) Fed officials conceding Phillips curve is flat-lining. (5) Draghi dragging his feet, saying "patience, persistence and prudence" will drive monetary policy. (6) Eurozone's economy is debatable at the ECB. (7) Eurozone's flash CPI not very bright. (8) ECB sticking with its asset-buying program for now. (9) Kuroda will tell you where inflation is going, but won't say when it will get there.

Fed: More Baby Steps. Top officials at the major central banks are signaling cautious optimism about the prospects for their economies. However, their policies and verbal guidance reflect their caution more than their optimism. That's because they don't want to upset what they perceive to be their delicate recoveries.

So long as inflation remains below the bankers' targets, Melissa and I think that they are likely to continue to reduce monetary policy accommodation at a deliberately slow and steady pace. That's particularly true for bankers at the Federal Reserve and European Central Bank (ECB). Bankers at the Bank of Japan (BOJ) are likely to maintain their ultra-easy policy while they continue waiting for Godot, i.e. higher inflation.

First, let's have a look at what the central bankers at the Fed have been up to:

(1) *Tolerating a brief inflation overshoot.* Two Fed officials, FRB-SF President John Williams and FRB-NY President Bill Dudley, recently said that they wouldn't mind seeing inflation overshoot the FOMC's 2.0% target for a while. "Fed's Williams, Dudley Stress Soft Ceiling on Inflation Goal" is the title of a 5/4 Bloomberg [article](#). Williams' views now carry more weight since he will become a permanent voter on the FOMC when he replaces Dudley at the FRB-NY in June, as we discussed in our 4/10 [Morning Briefing](#).

Bloomberg quoted Williams stating in a 5/4 CNBC [interview](#) that: "I am personally comfortable with the fact that inflation may overshoot that 2.0% for a while." He added: "The central bank's emphasis on a 'symmetric' target 'is a signal to say that inflation will sometimes be above, sometimes below, but on average at 2 percent,'" reported Bloomberg. The soon-to-be FRB-NY president reiterated that he thinks of 2.0% as the "mid-point" of expected inflation.

Williams thus confirmed our analysis of the [minutes](#) of the FOMC's March 20-21 meeting. In our 4/16 [Morning Briefing](#), we wrote: "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." Only if inflation should rise "much faster than expected

and stay consistently above 2.0%” would the FOMC consider a “slightly” faster pace of interest-rate increases.

Furthermore, the FOMC used the word “symmetric” twice to describe the Fed’s inflation goal in its 5/2 [statement](#) rather than just one time in the 3/21 statement. To us, that emphasizes that the FOMC would be just fine with an overshoot of the inflation target, as long as it isn’t too much for too long.

(2) *Aiming for persistent 2% inflation.* The FOMC held rates steady at its May meeting, as was widely expected. However, the May FOMC statement featured another notable change from the March statement: The phrase “near-term” was dropped. “Since the fall of 2016, the Fed statement had said: ‘near-term risks to the outlook appear roughly balanced.’ In the new statement ... the Fed simply said ‘risks to the outlook appear roughly balanced,’” observed a 5/3 *MarketWatch* [article](#).

Some speculate that the omission may be an attempt to side-step short-term noise from trade war talk. That’s possible. It is also possible that the Fed is simply more focused on the medium-term for the economy, especially inflation, which officials want to see persist around 2.0%.

The personal consumption expenditures deflator (PCED), one of the Fed’s preferred measures of inflation other than the core PCED, climbed to 2.0% y/y in March. The only other time it was at 2.0% or above since March 2012 was in early 2017 during January (2.0%) and February (2.2) ([Fig. 1](#)).

(3) *Losing faith in Phillips curve.* Most Fed officials seem still to believe in the inverse relationship between inflation and unemployment, i.e., the Phillips curve. Yet several important voting members, including Fed Chairman Jerome Powell, have come around to the idea that the Phillips curve has flattened, i.e., low unemployment may not spur wage or price inflation as high as in the past.

By the end of this year, Fed officials expect the unemployment rate to fall below 4.0% and inflation to nearly touch their 2.0% y/y target, according to the latest [Summary of Economic Projections](#). During April, the unemployment rate dipped below 4.0% for the first time since December 2000. But no alarm bells sounded because the average hourly earnings measure of wage inflation remained tepid, growing just 2.6% y/y, as we discussed yesterday ([Fig. 2](#)).

“Falling Unemployment Could Pressure Fed to Move Faster on Rates” was the title of a *WSJ* [article](#) posted online Friday. We disagreed. Then we noticed that the title of the article was toned down for the 5/5 print edition of the *WSJ* to “Employment Report Could Foreshadow Fed Challenges.” That’s a more agreeable conclusion to us.

(4) *Normalizing federal funds rate toward 3%.* 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 year-end. Melissa and I expect a couple more rate hikes in 2019 to take the range up to 2.75%-3.00%, which is consistent with the latest consensus projections of the FOMC’s participants.

ECB: Draghi Minding His ‘P’s. At the ECB’s 4/26 [press conference](#), President Mario Draghi struck a cautious tone about the bank’s approach to monetary policy. “Effectively, the ECB needs more information before it can engage in a meaningful debate on the next policy move,” noted the head of European economics at BNP Paribas, [according](#) to the 4/26 *FT*. Draghi recognized that the pace of the Eurozone’s recovery had moderated. No changes were made to monetary policy (neither to interest rates nor to the bond-buying program), nor did the bank provide updated guidance.

Draghi’s tone during his April press conference mirrored his attitude on 4/20 when he told finance

ministers and central bankers that “the Eurozone’s growth cycle may have peaked” and that the ECB “would move only slowly to phase out its large monetary stimulus,” [paraphrased](#) the *WSJ*. In his own words (with our emphasis), Draghi said: “While our confidence in the inflation outlook has increased, remaining uncertainties still warrant *patience, persistence and prudence* with regard to monetary policy.” Here is some more context behind the relatively uneventful press conference:

(1) *Eurozone growth slowing?* The *WSJ* article noted that there seems to be a difference of opinion among Draghi and at least one of the 25 members on the ECB’s rate-setting-committee. Jens Weidmann recently said: “There’s no reason to see a turning point in growth—Germany’s economy is still booming.” But of course, as the president of Germany’s central bank, Weidmann is more focused on Germany’s economy than the Eurozone. (By the way, Weidmann is reportedly the favorite to succeed Draghi when his term is up in October 2019, according to a 3/19 Bloomberg [article](#).)

Draghi observed during his April press conference: “When we look at the indicators that showed significant, sharp declines, we see that ... this loss of momentum is pretty broad across countries.” During February, industrial production in the Eurozone slid for the third month in a row. There’s also been evidence of softness in the purchasing managers surveys in addition to retail sales and consumer confidence. The 4/18 *WSJ* [observed](#): “The June gathering is regarded as potentially more significant, and policy makers should by then have some sense of whether the first-quarter slowdown was temporary or lasting.”

A few days before Draghi spoke, on 4/18, Eurostat released the Eurozone’s March inflation rate, which was up 1.3% y/y. Inflation was still a distance from the ECB’s inflation [target](#) of below, but close to, 2.0%. The flash estimate of April’s CPI released on 5/3 showed 1.2% y/y. For April, the CPIs in France (1.8% y/y) and Germany (1.4) increased faster than inflation in other major Eurozone countries, while rates in Spain (1.1) and Italy (0.6) weighed on the overall Eurozone inflation statistic ([Fig. 3](#)).

(2) *No change in pace of bond buying.* It is expected that an interest-rate increase by the ECB won’t be on the table until early to mid-2019. The ECB has planned first to start unwinding its asset purchase program (APP). During March of this year, the ECB dropped its pledge to buy more bonds in the event of a future recession, [reported](#) the *FT*, signaling a shift in the bank’s “easing bias.”

Prior to that, there had been no action on the APP since October 2017, when the ECB announced a further reduction starting in January 2018 to a monthly pace of €30 billion until the end of September 2018, “or beyond, if necessary.” (See our [Chronology of ECB Monetary Policy Actions](#).)

Back in December 2016, the ECB announced that it would reduce its purchases under its APP from the monthly pace of €80 billion to €60 billion, starting in April 2017 and until the end of December 2017, “or beyond, if necessary.” The monthly purchases under the APP had first been set to €80 billion starting in April 2016. Since then, the ECB’s assets have grown from €2.90 trillion to €4.55 trillion ([Fig. 4](#)).

(3) *Rising trade risks.* By the way, ECB policymakers are also waiting to see how the trade spats between the US and Europe and the US and China pan out. During his April presser, Draghi warned: “If we have an increase in tariffs, increase in protectionism, there may be direct effects, trade related effects. ... They don’t seem to be substantial. However we don’t know the extent of the retaliation yet. ... What is certainly known is that these events have a profound and rapid effect on confidence, on business confidence, on exporters’ confidence generally speaking. Confidence can in turn affect the growth outlook. This is why we say there are risks.”

BOJ: Kuroda’s Long-Lasting Last Stand. Like the ECB and the Fed, the BOJ is patiently waiting for 2.0% inflation to arrive and stick around for a while. But it might have a long wait. On 4/28, in its April

[Outlook for Economic Activity and Prices](#), the BOJ ditched its ETA for reaching its inflation target. Here are the details:

(1) *How do you say “mañana” in Japanese?* In its January [Outlook for Economic Activity and Prices](#), the central bank had projected it would meet its 2.0% target for consumer price inflation by “around fiscal 2019.” Prior to letting go of a target timeframe altogether, the BOJ had pushed out that date six times, most recently until March 2020, [observed](#) the 4/27 *WSJ*. Nevertheless, the BOJ’s April report explained: “Although it is necessary to carefully examine the fact that firms’ wage- and price-setting stance has remained cautious, the momentum toward achieving the price stability target of 2 percent appears to be maintained.”

The *WSJ* recalled that the BOJ’s Governor Haruhiko Kuroda “offered a target date shortly after taking office in 2013, saying he thought inflation would hit 2% within two years.” The BOJ’s [preferred](#) measure of inflation is the CPI for all items less fresh food, or the “observed CPI.” During March, this rate increased 0.9% y/y ([Fig. 5](#)). It’s not for the BOJ’s lack of trying. Since the beginning of 2013, the BOJ’s total assets increased from ¥158 trillion to ¥535 trillion ([Fig. 6](#)).

(2) *No change until further notice.* Nevertheless, Kuroda said at his news conference: “Our policy commitment hasn’t changed at all.” He added: “There is no change in our stance that we will persistently continue aggressive easing.” Reuters [reported](#) that “Kuroda noted the omission of a target timeframe was aimed at preventing markets from betting on additional easing each time the BOJ pushed back the timing for hitting its price goal.”

CALENDARS

US. Wed: PPI-FD Total, Core, and Core Ex Trade Services 0.3%/0.2%/0.4%, Wholesale Trade Inventories 0.5%, MBA Mortgage Applications, Bostic. **Thurs:** Headline & Core CPI 2.5%/2.2% y/y, Jobless Claims 220k, Weekly Consumer Comfort Index, Treasury Budget \$88.0b, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: Japan Leading & Coincident Indexes 105.1/116.4, Japan Trade Balance ¥1017.1b. **Thurs:** China New Yuan Loans 1100b, China Aggregate Financing 1325b, China CPI & PPI 1.9%/3.4% y/y, UK Headline & Manufacturing Industrial Production 3.1%/2.9% y/y, BOE Bank Rate 0.50%, BOE Asset Purchase Target 435b, BOE Inflation Report. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—has rebounded to a new record high. Our WLI jumped 1.8% during the last week of April following a 0.5% gain the prior week, more than reversing the five-week slide from the previous record high posted during the week of March 10. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg’s Weekly Consumer Comfort Index (WCCI). Our BBB rebounded 4.6% during the two weeks ending April 28 to a new record high, as jobless claims, one of the components of our BBB, fell from 231,500 to 221,500 over the two-week period—the lowest reading since March 3, 1973. Meanwhile, the CRB raw industrial spot price index, another BBB component, remained in a volatile flat trend around recent highs, moving toward the bottom of the range in recent sessions. The WCCI slipped for the second week after reaching a cyclical high in mid-April.

S&P/Russell LargeCaps & SMidCaps ([link](#)): SmallCaps are now outperforming LargeCaps and MidCaps so far in 2018, and are closest to their January record highs. Here’s how they rank ytd through

Monday's close, along with their 2017 performance and their percentage changes since their record highs in January: S&P SmallCap 600 (3.2% ytd, 11.7% in 2017, -1.3% from record high), Russell SmallCap 2000 (2.8, 13.1, -2.0), S&P MidCap 400 (0.4, 14.5, -4.4), Russell LargeCap 1000 (0.1, 19.3, -6.7), and S&P LargeCap 500 (0.0, 19.4, -7.0). Forward revenues and earnings are at record highs now for all the S&P and Russell indexes. 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 a seven-year high of 20.9% y/y from 20.2% y/y, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to 23.0% from 22.9%, 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 increased to 27.4% from 27.1%, 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 21.3% and 9.6%, MidCap 19.7% and 12.1%, and SmallCap 24.3% and 16.7%.

S&P 500 Growth vs Value ([link](#)): The S&P 500 Growth index is up 4.0% ytd, well ahead of the 4.3% decline for its Value counterpart. Value is 9.8% below its January 26 record high and no longer in a correction, while Growth is down 4.4% since then. During 2017, Growth's 25.4% gain was double the 12.6% rise for Value. Growth had trailed Value in the four months following the election. Now Growth's 32.8% gain since the election is more than double the 15.9% increase logged by Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver more than double the rate of revenue growth (STRG) that Value does over the next 12 months, but forward earnings growth (STEG) is only slightly higher for Growth; specifically, 9.3% STRG and 16.6% STEG are projected for Growth, respectively, vs 4.5% and 15.4% for Value. Prior to February's selloff, Growth's P/E of 21.8 on January 26 was its highest since May 2002, while Value's 16.6 on January 3 was its highest since April 2002. Through Monday, Growth's P/E was back up to 19.4 from its 15-month low of 18.8 on April 2 and Value's 14.1 was up from a 25-month low of 13.9 on March 23. Regarding NERI, Growth's was positive in April for a 12th straight month, but dropped to 15.9% from 22.3% in March; that compares to a five-year low of -16.2% in April 2015. Value's NERI was also positive in April for a 12th month (following 33 months of negative readings), and eased sharply to 11.3% from a record high of 21.2%; that compares to a five-year low of -20.3% in April 2015. The TCJA has boosted the consensus 2018 earnings estimate and the forward profit margin for both Growth and Value. Growth's 2018 estimate has risen 7.9% vs Value's 6.9% gain. Growth's forward profit margin has jumped to a record high of 16.3% from 14.4% prior to the TCJA's passage, and Value's has risen to a 10-year high of 9.9% from 9.1%.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): "There is no question that small business is booming," said NFIB Chief Economist Bill Dunkelberg. "Consumer spending, the new tax law, and lower regulatory barriers are all supporting the surge in optimism across all small business industry sectors." April's Small Business Optimism Index (SBOI) sustained record-high levels, edging up 0.1 point to 104.8. Of the 10 components of the SBOI, four rose, three fell, and three were unchanged. Earnings trends (to -1% from -4%), capital spending plans (29 from 26), current inventory (-4 from -6), and sales expectations (21 from 20) accounted for April's uptick, with earnings trends the highest in the 45-year history of the survey. Job creation (16 from 20) eased a bit, though remained at historically high levels, according to the report, as significantly more new businesses are opening than closing, providing a major boost to new employment. Thirty-five percent of all owners reported job openings they could not fill in the current period, unchanged and tied with March 2018, July 2017, and October 2017 readings for the highest since November 2000.

JOLTS ([link](#)): Job openings in March jumped to a new record high of 6.550 million, soaring 472,000

m/m and 883,000 ytd. Meanwhile, hirings fell for the second month, by a total of 149,000, to 5.425 million—remaining volatile around October’s cyclical high of 5.609 million; separations climbed 118,000 to 5.291 million after dipping 146,000 in February. The latest hirings and separations data yielded an employment advance of 134,000 for March, nearly matching March’s payroll gain of 135,000; it was above payroll employment the previous six months. March’s job-opening rate rose from 4.2% to a new record high of 4.5%, while the quit rate was back up at its cyclical high of 2.5%. The total hires rate was unchanged at 4.1%, just below its cyclical high of 4.2%. March’s ratio of unemployed workers per job opening sank to a new record low of 1.01.

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production ([link](#)): German industrial production rebounded in March, and is only fractionally below November’s record high. The ministry noted, “The overall external environment is positive, the orders are at record levels and the business climate above average. After a quieter phase, output in the manufacturing industry should therefore pick up the pace again in the course of the year.” Germany’s headline production—which includes construction—bounced back 1.0% in March after falling two of the prior three months by a total of 1.9% from November’s record high. Excluding construction, output rebounded 1.1% to within 0.9% of November’s high. Manufacturing output followed a similar script, jumping 1.1% in March, after falling sliding 2.0% the prior three months from November’s record reading. Leading March gains were rebounds in capital (2.6%), consumer durable (1.4), and consumer nondurable (1.0) goods production; intermediate goods production fell for the third month, by 0.6% m/m and 2.5% over the period.

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