



MORNING BRIEFING

September 6, 2018

Inflation, Where Art Thou?

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

(1) Technology is inherently deflationary. (2) The Gig Economy's low-fee freelancers are disrupting lots of services businesses. (3) No-fees ETFs and brokerage accounts. (4) How inflationary would tariffs on Chinese imports be for the US consumer? (5) Record-high profit margins could absorb some cost increases. (6) Productivity could be making a comeback. (7) Regional and national prices-paid indexes up sharply since 2015, but looking topmy recently. (8) No sign of inflationary pressure in CPI goods excluding food and energy. (9) CPI services inflation boosted by rent increases, which are starting to slow.

US Inflation I: Disruptive Technologies. Much has been written about industries that have raised wages because they've had a tough time finding employees. Home building, trucking, and lawn maintenance are three of many examples. Seems no one wants to drive a truck anymore (perhaps because autonomous trucks may arrive in the not-so-distant future), and tighter immigration policy has left businesses scrambling to fill seasonal positions.

Despite these inflationary pressures, July's seasonally adjusted CPI was 2.0% (saar), using a three-month percentage change ([Fig. 1](#)). When food and energy are excluded, the figure rises to just 2.3% ([Fig. 2](#)). As we've noted before, technology has unleashed some awfully strong deflationary forces exerting downward pressure on both wage and price inflation; one such force is the little guy's improved ability to compete locally and globally via the Internet. Here's a look at some recent examples of technology's outsized impact on prices:

(1) *Services go online.* Sites like Upwork, Fiverr, and Freelancer.com list the services of folks willing to write, market, make videos, and create computer programs, among other work. More than 48 million people have registered globally on websites facilitating the sale of their labor. The bad news for workers in developed nations is that those in emerging economies will work for extremely low wages. Outsourcing to emerging markets, once mostly the scourge of just US manufacturing workers and telemarketers, is now hitting college-educated workers.

An 8/31 [article](#) in *The Atlantic* brought the issue to our attention: "On Fiverr, one of the most popular of these platforms, you'll find offers for someone who will write an e-book 'on any topic'; a person who will perform 'a Voiceover as Bernie Sanders'; someone who will write your Tinder profile for you, and someone who will design a logo for your real-estate company. The people selling this labor live in Nigeria, Mexico, the United Kingdom, and Bangladesh, respectively. Each of them charge \$5 for these tasks."

While these websites purport to exist to make freelancing easier for both the worker and the employer, they're also helping buyers find labor at the lowest cost anywhere on Earth. Underdeveloped countries like Malaysia and Nigeria are training citizens to use the online platforms, helping their workers to compete on the global stage.

(Notably, only 5% of services on Fiverr actually cost \$5; “Fiverr Pro” lists workers, vetted by Fiverr, who typically charge more, e.g., \$375 and up for logo designers. That said, every \$375 designer knows there’s a worker somewhere in the world willing to do the job a heck of a lot cheaper.)

(2) *More pressure on services.* The WSJ’s David Pierce put together a guilt-ridden [article](#) on Monday about all the services he enjoys at insanely low costs despite the harm it may do to workers’ wages or to Mother Earth. On his list: MealPal, a lunch subscription service where restaurants offer one dish each day at \$6.39, even though the normal cost may be 50% more for those buying at the restaurant. Uber Pool gets Pierce a lower price for a ride even if no one else gets in the car. MoviePass provides a movie a day for under \$10 a month. Amazon’s Prime offers free, two-day shipping—and few frequent users likely fret over the environmental impact. Those willing to listen to a commercial or two can hear the world’s music for free at Spotify.

Only companies with products we can absolutely not live without—like Amazon and Netflix—have pricing power. Everyone else may find their pricing is in a downward spiral, certainly not an environment that’s conducive to rising wages.

(3) *Lower fees in financials.* The introduction of ETFs and index funds long have put pricing pressure on the asset management industry. However, the pricing war among index fund and ETF providers hit a new low last month: zero fees. Fidelity is offering retail investors equity index mutual funds covering the US and international markets that don’t charge a fee and have no minimum required investment. The funds are Fidelity Zero Total Market Index Fund and the Fidelity Zero International Index Fund.

In their first month, investors poured almost \$1 billion into the two index funds, a 9/4 Bloomberg [article](#) reported. The hope is investors will also buy other Fidelity funds that do charge a fee. So far, no other firms have matched Fidelity’s ultimate race to the bottom.

JPMorgan Chase’s online trading fees also hit rock bottom last month. JPMorgan will offer any bank customer at least 100 free stock or exchange-traded-fund trades for a year, with no account minimums, an 8/21 WSJ [article](#) reported. “That is a sea change in pricing. The bank had charged \$24.95 for online trades as recently as last year ... The service, dubbed You Invest Trade, will be embedded in the bank’s app and website.”

The firm is hoping to attract first-time investors and customers of the bank who invest elsewhere. The move has hurt the shares of rivals like TD Ameritrade Holding and E*Trade, which charge customers \$6.96 a trade, and Charles Schwab, which charges \$4.95.

US Inflation II: Are Tariffs Inflationary? Some folks fret about the impact of Trump’s China tariffs on US inflation. Melissa and I agree that certain categories of goods, like cell phones and washing machines, may see tariff-induced rising prices, but we aren’t worried about the impact on headline inflation.

In addition to implementing worldwide tariffs of 25% on steel and 10% on aluminum, the Trump administration has imposed tariffs on \$50 billion of Chinese goods in two phases. Looking ahead, Trump has threatened to impose tariffs of up to 25% on another \$200 billion of imported Chinese goods. The President may move forward with these plans as soon as today when a public-comment period ends, according to an 8/30 [article](#) in Bloomberg. The amount of goods subject to tariffs is approaching nearly half of the \$500 billion plus in total annual US imports from China.

So why aren’t we worried about these tariffs causing inflation? One big reason is that secular forces—including aging demographics, technology innovation, and the “Amazonification” of prices—continue to

keep a lid on inflation, as we've often discussed. Additional reasons specific to China include:

(1) *Not in import prices (yet)*. The y/y changes in US import prices from China have been markedly subdued since peaking in early 2012. The measure fell below zero during early 2015. It rebounded to zero at the end of 2017, and reached 0.5% by June, easing to 0.2% in July ([Fig. 3](#)). So the tariffs that have gone into effect thus far haven't had a significant impact so far. By the way, only about 2.0% of US steel [imports](#) came directly from China during 2017. But that doesn't count the steel that is exported from China to third-party countries for further processing before being shipped to the US.

Not only have US import prices from China remained muted but so have China's domestic consumer prices. Interestingly, China's measure of producer prices paid surged 7.8% y/y during February 2017. In the latest reading, the y/y percent change fell back down to 4.6% in July, still sizable. From the start of 2017 through July, the y/y percent changes in China's consumer prices have bounced between 0.8% and 2.9% ([Fig. 4](#)). That may indicate that China's producers are hesitant to raise prices for domestic consumers as well as those abroad.

(2) *Not all trade is with China*. Estimates suggest that the impact on consumer price inflation (CPI) from the tariffs could range 0.3-0.4ppts, according to a PIMCO analysis cited in an 8/9 Bloomberg [article](#). That doesn't sound as alarming as the \$250 billion in goods possibly subject to tariffs, so why isn't the percentage point impact higher? China is the US's largest trading partner, but US imports from China account for 21.4% of total US merchandise imports, and only 2.6% of US nominal GDP ([Fig. 5](#)).

And the US can shop around. Cell phones and other household items are currently the largest category of imports to the US from China, [according](#) to the World Economic Forum. China isn't the only place in the world to buy cell phones. For example, Samsung, the South Korean electronics giant, is "now looking to fend off Chinese companies trying to dominate the market for inexpensive phones" by expanding manufacturing into India, according to an [article](#) in Tuesday's *WSJ*. The article reported that the company's new facility in India will be fully built in a New Delhi suburb by 2020. It will eventually make 120 million handsets in a year, or roughly one of every 13 phones in the world. Around 30% of those will be exported.

(3) *Absorbing the impact*. It typically takes time for the inflationary effects from tariffs, which directly impact producer prices, to indirectly flow into consumer prices. Typically, producer prices lead consumer prices as companies figure out how to handle cost increases. They must decide whether to pass price increases onto consumers without disrupting demand too much or absorb the price increases in the profit margin, and/or increase productivity.

So far, US producer prices have increased partially due to the worldwide tariffs imposed on steel and aluminum. However, as discussed below, that doesn't seem to have impacted consumer prices. Already, companies including General Motors, Boeing, and United Parcel Services have suggested that Trump's tariffs are expected to negatively impact profitability. Corporations like these may be more willing to absorb price increases given the boost to profit margins that has come from Trump's tax cuts. Despite historically low unemployment, wage inflation consistently has been subdued. If wage inflation were to pick up, then corporations might raise consumer prices. But again, that hasn't happened yet.

(4) *Productivity comeback*. US manufacturers are already hard-pressed to find skilled labor in the US. Instead of raising wages to attract such labor, US producers might start to focus on increasing domestic productivity. If productivity makes a surprising comeback, then a related decrease in domestic producer prices could offset price increases abroad. US manufacturers are most likely to refocus on boosting domestic productivity if Trump succeeds in bringing manufacturing plants back to the US. In addition to the protectionist tariff measures, Trump recently has threatened to pull the US out of the World Trade

Organization (WTO). Since China entered the WTO in 2000, both manufacturing production and capacity in the US have been flat. Lots of US manufacturers moved their operations to China and didn't focus on enhancing their productivity within the US.

(5) *Deal, or no deal?* Trade talks between China and the US at the end of last month ended without any agreement. Nevertheless, it's possible that a deal will be made and the \$200 billion in incremental tariffs threatened won't be implemented or that further talks will delay them. It's also possible that some tariffs already imposed may be reversed. Moreover, the \$200 billion threat may be enough to force China to concede where it counts, like on its unfair advantages in technology.

US Inflation III: Rounding Up Inflation. Inflationary pressures have been building at the producer price level since September 2016. Cost-push inflationary pressures may have started to push consumer price inflation slightly higher. But Debbie and I don't think these measures of inflation will rise much from here. Competitive pressures should keep a lid on the CPI inflation rate. Think: "Amazonification." It's so easy for consumers to compare prices online that no seller can price its products dramatically higher than levels its global competitors have set.

While producer price inflation has risen more rapidly than consumer price inflation, producer price inflation looks like it may be topping out already. Even if producer prices continue to outpace consumer prices, as we expect they will, we aren't too concerned about corporate profitability. Profit margins have received a generous boost from Trump's tax cut, which has made more than enough room for companies to absorb some price increases. Let's round up some of the latest data supporting our relatively benign inflation outlook:

(1) *ISM surveys.* The monthly ISM survey of purchasing managers includes prices-paid indexes for manufacturing and nonmanufacturing companies ([Fig. 6](#)). The former jumped to its highest reading since April 2011 during May (79.5). That was a significant rebound from the second half of 2014 through all of 2015 when this index was below 50.0. During August, the index fell back down to 72.1, though that's still well above 50.0. The nonmanufacturing prices-paid index has been on a more muted uptrend since early 2016, rising to a recent peak of 68.0 during May. As of July, it fell back 64.5.

(2) *Regional Fed surveys.* Five of the 12 Federal Reserve district banks (FRBs) conduct monthly business surveys in their regions—Dallas, Kansas City, New York, Philly, and Richmond. All inquire about both prices paid and prices received ([Fig. 7](#)). The diffusion indexes for prices paid almost always exceed those for prices received, confirming that it isn't easy to pass costs on into prices.

As with the ISM series, there have been noticeable uptrends in both indexes for the five districts since early 2016. More recently, the series may have crested, having fallen back down in latest readings. The average of the five FRBs prices-paid indexes is highly correlated with the ISM manufacturing prices-paid index ([Fig. 8](#)).

(3) *Producer prices.* The regional average prices-paid index is also highly correlated with the PPI for final demand ([Fig. 9](#)). During July, the former was its highest since May 2011, while the latter reached its highest rate since November 2011 in June. These measures since have fallen, but remain elevated.

(4) *Consumer prices.* The average prices-paid index based on the Fed's regional surveys reflects pricing pressures in the goods sector more than in the services sector. That's evident from its high correlation with the ISM manufacturing prices-paid index and with the PPI for final demand. The recent pricing pressures evident in those three prices-paid indicators are only just starting to show up in the CPI for goods, but are not so evident when food and energy are excluded ([Fig. 10](#)).

(5) *Import prices*. Pressure from the weaker dollar, which was down -9.4% y/y through January 25, didn't show up in the CPI for goods excluding food and energy either. That's because the index of imported consumer goods excluding energy has been hovering around zero on a y/y basis since early 2017 despite the weaker dollar ([Fig. 11](#)). More recently, the trade-weighted dollar is back up 5.7% y/y through yesterday, and the index of imported consumer goods excluding food and energy remains near zero.

(6) *Services*. The cost-push inflationary pressures evident in the ISM, FRB, and PPI prices-paid indexes may relate mostly to the rise in oil prices since early 2016. On the other hand, the CPI services inflation rate is up 3.1% y/y with, and 2.9% without, energy services ([Fig. 12](#)). A major contributor to the CPI services inflation rate as well as the headline inflation rate is rent inflation. Excluding food and energy, the overall CPI is up 2.3%. But also excluding shelter lowers the inflation rate to just 1.5% ([Fig. 13](#)). Rent inflation has been declining since late 2016 as a surge in multifamily housing construction has increased the supply of rentable apartments.

CALENDARS

US. Thurs: ADP Employment 182k, Jobless Claims 213k, Challenger Job-Cut Report, Productivity & Unit Labor Costs 3.0%/-1.0%, Factory Orders -0.7%, ISM & HIS Markit NM-PMIs 56.8/55.2, EIA Natural Gas Report, Williams. **Fri:** Nonfarm Payroll Employment Total, Private, and Manufacturing 195k/190k/21k, Unemployment Rate & Participation Rate 3.8%/62.9%, Average Hourly Earnings 0.3% m/m/2.8% y/y, Average Workweek 34.5 hrs, Baker-Hughes Rig Count, Mester, Rosengren. (Econoday estimates)

Global. Thurs: Germany Factory Orders 1.8% m/m/1.9% y/y. **Fri:** Eurozone GDP 0.4% q/q/2.2% y/y, Germany Industrial Production 0.2% m/m/2.6% y/y, Germany Trade Balance €19.5b, UK BOE/TNS Inflation Next 12 Months, Canada Employment Change & Unemployment Rate 5k/5.9%, Japan Leading & Coincident Indexes 103.5/115.7, Mexico CPI 4.95% y/y (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) climbed for the fifth week this week to 3.31—its highest reading since the final week of February—as bullish sentiment hit 60.0%. Both bullish sentiment and the correction count moved up for the fifth week, after showing little movement the previous three weeks. Bullish sentiment climbed 5.5ppts (to 60.0% from 54.5%) over the five-week period, while the correction count fell -4.8ppts (21.9 from 26.7); it was the highest reading for the former and the lowest reading for the latter since the final week of January. Nine weeks ago, bullish sentiment was at 47.1%, while the correction count was at 34.3%. Meanwhile, bearish sentiment was little changed at 18.1% this week; it has fluctuated in a narrow band between 17.6% and 18.8% the past 14 weeks. The AAI Ratio advanced for the fourth week last week to 64.1%, after falling the prior three weeks from 59.6% to 47.6%. Bearish sentiment fell from 32.1% to 24.4% over the four-week period, while bullish sentiment climbed from 29.1% to 43.5%.

S&P 500 TCJA Earnings Leaders & Laggards ([link](#)): The 2018 earnings forecast for the S&P 500 has surged 10.7% in the 37 weeks since the TCJA was signed into law on December 22. This outstanding performance has no comparison over the years since consensus earnings forecasts were first derived in 1978. The rate of change in the consensus forecasts has slowed since the Q1 earnings season as analysts appear to have fully incorporated lower tax rates into their estimates. The top sector gainers since the TCJA was passed: Energy (38.3%), Telecom (19.9), Financials (13.4), Materials (13.4), and Industrials (11.4). Consumer Staples is now the smallest gainer, with an increase of 1.3%; also underperforming the S&P 500 are Utilities (2.5), Real Estate (4.1), Consumer Discretionary (7.4),

Health Care (8.1), and Tech (8.4). Higher oil prices have contributed heavily to the improvement in Energy's 2018 earnings forecast.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus-per-share forecasts for forward revenues and earnings rose to record highs again last week. As more weight is placed on the lower 2019 y/y growth expectations for revenues and earnings, their forward growth rates will continue to fall. During the latest week, however, the forward revenues growth forecast remained steady at 5.9%, and forward earnings growth edged up to 13.4% from a seven-month low of 13.3%. Forward revenues growth is little changed from an 80-month high of 6.3% at the end of February, and forward earnings growth is down from 16.9% in February, which was the highest since October 2010. Forward revenue growth of 6.3% is up 0.4ppts from 5.5% prior to the passage of the TCJA, and forward earnings growth of 13.4% is up 2.3ppts from 11.1% then. Turning to the annual revenue growth expectations, the forecasts remained steady w/w at 8.3% for 2018 and 5.1% for 2019. Looking at annual earnings growth, the 2018 forecast remained steady at 23.1%, and the 2019 forecast rose 0.1ppt to 10.3%. The forward profit margin edged up 0.1ppt to a record high of 12.4%, which is up from 11.1% prior to the passage of the TCJA in December and from a 24-month low of 10.4% in March 2016. The S&P 500 ex-Financials forward growth forecasts were steady w/w at 6.1% for revenues and 12.8% for earnings. The S&P 500 ex-Financials forward profit margin remained steady at a record high of 11.4%, and is up from 10.4% before the TCJA. Valuations were broadly higher w/w primarily due to the rise in the index's price to new record highs. The S&P 500's forward P/E rose to a 24-week high of 16.7 from 16.6, which compares to a 16-year high of 18.6 at the market's prior peak in late January and its recent low of 16.0 in early May. The S&P 500 price-to-sales ratio rose to a 30-week high of 2.11 from a 2.07, which compares to late January's record high of 2.16 and early May's low of 1.95.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenue forecasts rose w/w for 6/11 of the S&P 500 sectors, and forward earnings moved higher for 7/11. These five sectors had both measures rise w/w: Consumer Discretionary, Financials, Industrials, Real Estate, and Utilities. The per-share measures for both forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward margins are at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate. Energy's forward revenues and earnings are back on uptrends after stalling during 2016-2017, and its earnings has about tripled from its 18-year low in April 2016. Looking at last week's readings for forward revenue growth among the 11 sectors, three had a w/w improvement in their forward revenues growth forecast (Materials, Real Estate, and Tech), and three edged down (Consumer Staples, Energy, and Telecom). STEG was higher w/w for four sectors (Energy, Financials, Materials, and Real Estate) and lower for Consumer Staples and Tech. Forward P/S and P/E ratios remain below their recent highs in early 2018 for all sectors. In the latest week, nine sectors improved (all but Consumer Staples and Telecom). Energy's valuations remain elevated relative to historical levels, but are slowly returning to normal now after soaring in 2016 when revenues and earnings collapsed. Energy's P/S ratio of 1.24 compares to a record high of 1.56 in May 2016, and its P/E of 16.7 is down from a record high of 57.5 then. Due to the TCJA, higher margins are expected y/y in 2018 for all sectors but Real Estate, but that sector's forward earnings includes gains from property sales and typically improves as the year progresses. During the latest week, the forward profit margin rose 0.1ppt for Energy and fell 0.1ppt for Real Estate and Tech. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.9%), Financials (18.9), Real Estate (16.3), Telecom (14.0), Utilities (12.6), S&P 500 (12.4), Materials (11.3), Health Care (10.7), Industrials (10.3), Consumer Discretionary (8.1), Consumer Staples (7.6), and Energy (7.5). Energy's forward profit margin is near the highest level since December 2014. Among the remaining 10 sectors, all but two (Real Estate and Health Care) are at or near recent record highs.

US ECONOMIC INDICATORS

Merchandise Trade ([link](#)): The real merchandise trade deficit widened again in July, suggesting trade could be a major drag on real GDP this quarter after being a big positive contributor last quarter. July's deficit swelled for the second month, to -\$82.5 billion, after dropping sharply the prior three months from -\$85.3 billion in February to -\$75.5 billion in May. July's -\$82.5 billion gap is considerably above the average monthly deficit of -\$77.5 billion during Q2. Real exports contracted -2.3% during the two months through July, while real imports expanded 1.5%—back up at December's record high. The drop in exports over the two-month period was led by big declines in exports of consumer goods ex autos (-10.0%), capital goods ex autos (-3.8), and autos (-3.5); exports of industrial supplies & materials jumped 3.8% with food little changed. The increase in real imports was fairly widespread over the comparable period, with food (5.9), autos (3.5), consumer goods ex autos (2.1), and industrial supplies & materials (1.0) in the black and only capital goods ex autos (-1.1) in the red.

GLOBAL ECONOMIC INDICATORS

Eurozone Retail Sales ([link](#)): July retail sales remained stalled around November's record high. Sales slipped 0.2% in July after climbing four of the prior five months by 0.8%; it's only 0.4% below November's reading. July's drop was driven by declines in sales of auto fuel (-0.7%) and food, drinks, and tobacco (-0.6); spending on non-food products (0.4) rose after sinking -1.0% the prior two months. All three categories are up ytd, led by spending on automotive fuel (1.3) and food, drinks, and tobacco (1.0), while non-food products (0.2) basically broke even. July sales are available for three of the Big Four economies, with sales in Spain (to -0.9% from 0.6) and Germany (-0.4 from 0.9) contracting after expanding in June, while sales in France rose for the third straight month, by 0.4% m/m and 2.1% over the three-month period to a new record high. Meanwhile, among the Eurozone economies for which data are available, the largest decreases in retail sales were observed in Belgium (-2.1) and Portugal (-1.0); the highest increases were registered in Slovakia and Estonia (both +1.1%).

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