



MORNING BRIEFING

November 6, 2018

All About Inflation

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

(1) Faster pay increases heighten price inflation concerns. (2) Is the Phillips curve finally in gear? (3) Tight labor market boosting productivity and real wages perhaps? (4) Wage vs price curves. (5) Inflation has been subdued for a very long time, and may remain so. (6) Disinflation remains a global trend. (7) Latest employment gains belie labor shortage fears. (8) More rapid increases in wages for goods producers aren't showing up in goods prices. (9) In services, rent inflation is looking topky thanks to multifamily house-building boom. (10) Healthcare inflation remains very low even excluding impact of government programs, which tend to keep a lid on pricing.

Inflation I: The Long View. Now that the unemployment rate is back down near or below previous cyclical lows, there is mounting concern that price inflation will soon make a comeback. That concern undoubtedly was heightened by Friday's payroll employment report showing that October's wage inflation rose to 3.1% y/y, the highest since April 2009 ([Fig. 1](#)). That's based on the average hourly earnings series for all workers, a series starting in 2006. It is up 3.2% for production and nonsupervisory workers (P&NSW), which starts in 1964.

Is the Phillips curve finally starting to work? Apparently so, but Debbie and I believe that the tight labor market may be boosting productivity growth, which would allow wages to increase without boosting price inflation. Consider the following:

(1) *The wage curve.* The Phillips *wage* curve, which posits an inverse relationship between the unemployment rate and wage inflation, may finally be making a long-awaited comeback now that the unemployment rate is the lowest since December 1969 ([Fig. 2](#)). The comeback is even more impressive using the short-term unemployment rate (for joblessness under 27 weeks), which fell last month to 2.9%, the lowest since the early 1950s ([Fig. 3](#)). The wage inflation rate for P&NSW is up from 2.2% a year ago to 3.2% last month.

(2) *The price curve.* On the other hand, the Phillips *price* curve remains broken. Price inflation is still missing in action. The core PCED rose 2.0% y/y during September ([Fig. 4](#)). Actually, this measure of inflation has been remarkably subdued for a very long time. Since the start of 1995, it has ranged between 0.9% and 2.5%. Over that same period, P&NSW wage inflation ranged between 1.2% and 4.3% ([Fig. 5](#)).

(3) *The markup curve.* The popular notion that wage costs are marked up into prices hasn't been happening since at least the mid-1990s. Debbie and I attribute that to a number of developments. Labor unions (with their union contracts including automatic cost-of-living adjustments) lost their power starting in the 1980s. Globalization increased worldwide competition (first from Germany and Japan, then from China and other emerging economies), which continues to keep a lid on inflation. In addition, the high-tech revolution of the 1990s continues to disrupt business models while providing productivity-enhancing innovations. Aging demographic trends around the world are also inherently disinflationary,

in our opinion.

Inflation II: The Global View. These disinflationary forces are global in nature. As a result, inflation remains subdued around the world. Consider the following:

(1) *G7.* The core CPI inflation rate for the G7 industrial economies has been low for a long while as well, hovering between 0.6% and 2.3% since 1997 ([Fig. 6](#)).

(2) *Eurozone and Japan.* The core CPI inflation rate in the Eurozone was just 1.1% during October, according to the flash estimate ([Fig. 7](#)). It's been under 2.0% since January 2003. Japan's core CPI inflation rate was just 0.1% during September ([Fig. 8](#)). It has been mostly hovering between zero and *minus* 1.5% since 1999!

(3) *The world.* The International Monetary Fund compiles CPI inflation rates for the advanced and emerging economies ([Fig. 9](#)). The former has been hovering around 2.0% since the late 1980s, and was 2.0% y/y during July, the latest available data. The latter has been much higher over this period. However, it fell to 3.8% y/y during April and May (near its record low of 3.6%, recorded in early 1969), before accelerating to 5.1% and 5.4%, respectively, in June and July—still relatively low levels.

Inflation III: Made in the USA. During their Q3 earnings conference calls, many company managements reported that they are experiencing inflationary cost pressures. Almost everyone agrees that the labor market is tight. Yet the latest macro data show that employment increased during October by 227,000, 250,000, and 600,000 according to the ADP, payroll, and household surveys. Furthermore, the labor force participation rate of prime-age workers (25-54 years old) rose to a cyclical high last month ([Fig. 10](#)).

Many company managements also have warned that tariffs are driving their materials costs higher, and that they may have to spend more on rerouting their supply chains if the trade war with China continues to escalate. The recent drop in oil prices might be sustainable given recent stories that Saudi Arabia, Russia, and the US are pumping oil at record rates and that global demand for oil is weakening along with the global economy. If so, cheaper oil should help to offset some of the other cost pressures.

While global forces on balance remain disinflationary, in our opinion, what about homegrown inflationary pressures? Consider the following:

(1) *Goods vs services.* Like the core PCED inflation rate, the core CPI inflation rate has also been remarkably subdued since 1995 ([Fig. 11](#)). The latter was 2.2% during September even as P&NSW wage inflation rose to 3.2% last month. Leading the way was wage inflation in goods-producing industries, which rose to 3.8%. Yet the inflation rate for CPI goods excluding food and energy remains just below zero, as it has since 2013. Global competition and technological innovation are keeping a lid on goods inflation. So is the Amazonification of retail sales, as consumers find the lowest prices on shopping websites.

Wage inflation in services-producing industries rose to 3.1% last month, up from 2.1% a year ago. The CPI services ex-energy inflation rate was 3.0% during September, continuing to hover around this pace since 2015. Two of the major components of services inflation are rent of shelter and healthcare, which could offset each other in the next few years.

(2) *Rent.* There has been an interesting inverse relationship between the unemployment rate and the inflation rate of the CPI's rent of shelter component ([Fig. 12](#)). It accounts for 40.0% of the core CPI and 17.8% of the core PCED.

Rent inflation has actually been looking topky over the past couple of years even though more people are finding jobs and getting better wage increases, which should be boosting housing demand and rents. However, a lot of demand in recent years has been for rental units, which has stimulated a building boom in multifamily housing construction. In other words, supply may be catching up with demand. If so, then rental inflation could ease a bit over the next few years. That has already been happening to the CPI tenant rent inflation rate, which was down to 3.6% during September from a recent peak of 3.9% at the start of 2017 ([Fig. 13](#)).

Inflation IV: Unhealthy Inflation? One of the hardest-to-predict components of both the core CPI and core PCED is healthcare, which accounts for 10.9% of the former and 23.3% of the latter. The CPI component is limited to out-of-pocket expenditures by consumers, while the PCED also reflects payments made by government programs, i.e., Medicaid and Medicare.

During September, medical care inflation was 1.7% y/y for both measures ([Fig. 14](#)). In the past, the CPI medical care inflation rate usually exceeded the comparable PCED measure, as government programs restrained inflation in the hospitals and physician services components of the PCED relative to the CPI. Inflation for drug prices tends to be the same for both measures.

The above suggests that even excluding the moderating effect of government programs on healthcare pricing, inflationary pressures remain subdued in this important sector of the economy. That's a bit surprising given the aging of the Baby Boomers, who started turning 65 years old in 2011. It also is at odds with rapidly increasing healthcare insurance premiums, which account for only 1.3% of the core CPI and 1.5% of the core PCED.

At a recent meeting I had in Kansas, one of our accounts expressed concern about healthcare inflation, citing news that Medicare and Medicaid reimbursements were just increased for next year. I asked Melissa to have a look. She found that only Medicare Advantage Plans (MAP) reimbursement rates were raised, not those for Original Medicare or Medicaid. For 2019, MAP reimbursement rates will be increased 3.4%, [according](#) to Deloitte.

In 2017, one-third of the 57 million people on Medicare were enrolled in a MAP. So the inflationary effects of MAP rates are not the whole story when it comes to rising federal healthcare costs, though they are a significant part.

What about the Original Medicare rates that apply to the other two-thirds of people on Medicare? These are [fee-for-service](#) rates that vary by (highly specific) type of services rendered. Admittedly, we aren't healthcare experts. In short order, we couldn't find anything on 2019 across-the-board rate increases that would apply to Original Medicare.

CALENDARS

US. Tues: Job Openings 7.1m, Midterm Elections. **Wed:** Consumer Credit \$16.5b, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Meeting Begins. (Econoday estimates)

Global. Tues: Eurozone, Germany, France, and Italy C-PMIs 52.7/52.7/54.3/51.0, Eurozone, Germany, France, and Italy NM-PMIs 53.3/53.6/55.6/52.0, Germany Factory Orders -0.5%/m/-2.8%/y, RBA Cash Target Rate 1.50%. **Wed:** Eurozone Retail Sales 0.1%/m/0.8%/y, Germany Industrial Production -0.1%/m/0.2%/y, Japan Leading & Coincident Indexes 103.8/114.6, Japan Machine. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell for all three of these indexes last week. That's the first simultaneous decline for the indexes since late May and the largest per-share decline w/w for LargeCap since February 2017. LargeCap's forward EPS dropped 10 cents w/w to \$175.38 and is now 0.1% below its record high a week ago. Still, that's better than the declines from the peaks for MidCap (-0.2%, last record high October 19) and SmallCap (-0.6, October 26). Forward earnings activity has been relatively strong in the past 12 months: LargeCap's and MidCap's forward earnings have risen in 48 of the past 52 weeks, and SmallCap's in 43. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016, but is looking peaky. In the latest week, the rate of change in LargeCap's forward earnings fell to 22.2% y/y from 22.6%. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's y/y change dropped to 23.0% from 23.5% a week earlier, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's dropped to 32.3% from 33.2% and is down from an eight-year high of 35.3% in early October, which compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (23.3%, 9.2%, 9.5%), MidCap (21.6, 11.7, 10.9), and SmallCap (28.6, 14.6, 12.6).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios rebounded last week from lows that were last seen before Trump's election. LargeCap's weekly forward P/E gained w/w to 15.5 from 15.2, which had been the lowest since February 2016. That compares to a six-month high of 16.8 in mid-September, a multi-year high of 18.6 on January 26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. However, last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E rose to 15.0 last week from 14.4, which had been the lowest since December 2012. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E jumped to 16.0 last week from 15.2, which was also the lowest since December 2012. That's well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). Looking at the three indexes' daily forward price/sales (P/S) ratios, all rebounded w/w from levels well below their January highs: LargeCap's P/S rose w/w to 1.94 from 1.90, which was the lowest since May 2017 and down from a record high of 2.19 on January 26; MidCap's increased to 1.19 from a post-election low of 1.16, which compares to its record high of 1.40, also on January 26; and SmallCap's surged to 0.96 from a post-election low of 0.91, 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](#)): Although Q3 earnings reports are starting to tail off, analysts are continuing to make adjustments to their Q4 forecasts. Last week, the S&P 500's blended Q3-2018 EPS forecast jumped \$1.09 w/w to \$42.17. That's up 1.1% since the end of Q2, up 11.7% ytd, and up 12.5% since the passage of the Tax Cuts and Jobs Act. The \$42.17 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 27.1%, up from 25.2% a week earlier and from 22.1% at the end of Q1. That's now the strongest since Q4-2010 and could mark the peak of the current earnings cycle. The blended Q3-2018 growth rate compares to Q2-2018's 24.9%, Q1-2018's 26.6%, Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. The S&P 500's Q3-2018 forecasted earnings gain of 27.1% y/y would be its ninth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q3-2018, with 10 at a double-digit percentage rate. That compares to all 11 positive during Q2, when nine rose at a triple- or double-percentage rate. Four sectors are expected to beat the S&P 500's blended y/y earnings gain of 27.1% during Q3, compared to four beating the S&P 500's 24.9% gain during Q2. Analysts expect Energy to

report another large profit jump in Q3 relative to very low earnings a year ago, with the pace slowing from Q2. The latest forecasted blended Q3-2018 earnings growth rates vs their Q2-2018 growth rates: Energy (116.4% in Q3-2018 vs 124.0% in Q2-2018), Financials (43.5, 27.5), Materials (29.1, 40.6), Tech (27.6, 29.0), S&P 500 (27.1, 24.9), Communication Services (24.8, 18.1), Consumer Discretionary (22.8, 21.5), Industrials (18.6, 20.2), Health Care (16.0, 18.4), Utilities (10.7, 8.7), Consumer Staples (10.0, 13.9), and Real Estate (5.4, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 23.8% y/y in Q3, above the 21.9% in Q2; that compares to 24.5% in Q1-2018, 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). Looking ahead, the Q4 estimate has risen for 3/11 sectors since the end of Q3 and dropped for 8/11. Communication Services is the best performer, with its Q4-2018 forecast rising 2.3%, ahead of Energy (1.0%) and Tech (0.2). Industrials is the biggest decliner, with its Q4-2018 forecast down 1.6% since the end of Q3, followed by Consumer Discretionary (-1.3), Real Estate (-0.7), and Materials (-0.4).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With 76% of S&P 500 companies finished reporting earnings and revenues for Q3-2018, the earnings surprise beat and y/y earnings growth are stronger compared to the same time period in Q2, but the revenue surprise and y/y revenue growth metrics have eased somewhat from Q2's stellar results. Of the 380 companies in the S&P 500 that have reported through mid-day Monday, 78% exceeded industry analysts' earnings estimates by an average of 7.0%; they have averaged a y/y earnings gain of 28.1%. On the revenue side, 60% of companies beat their Q3 sales estimates so far, with results coming in 1.6% above forecast and 9.5% higher than a year earlier. At the same point during the Q2-2018 reporting period, a higher percentage of companies (80%) in the S&P 500 had beaten consensus earnings estimates by a lower 5.2%, and earnings were up a lower 26.0% y/y. With respect to revenues, a sharply higher 73% had exceeded revenue forecasts at this point in the Q2 season by a slightly higher 1.7%, and sales rose a higher 10.2% y/y. Q3 earnings results are higher y/y for 87% of companies, vs 84% at the same point in Q2, and Q3 revenues are higher y/y for 83% vs 87% a quarter ago. These figures will continue to change as more Q3-2018 results are reported. Q3-2018 is sure to mark the ninth straight quarter of positive y/y earnings growth and among the highest-growth quarters since Q4-2010; and y/y revenue growth will be positive for a tenth straight quarter, with its pace slowing somewhat but remaining well above the historical trend. The strong results are mostly due to lower tax rates and improved business conditions, but cost pressures and global growth concerns are increasing. Furthermore, fewer companies have been reporting positive y/y revenue growth and surprises than during the Q2 reporting season.

US ECONOMIC INDICATORS

Non-Manufacturing PMIs ([link](#)): The ISM measure shows growth in the service sector accelerated at the second fastest pace in the history of the survey, while the IHS Markit measure gained momentum. ISM's NM-PMI to (60.3 from 61.6) eased only slightly last month from September's record reading. Three of the four components of the NM-PMI slowed from September's pace, though growth remained exceptional—with both the business activity (62.5 from 65.2) and new orders (61.5 from 61.6) measures remaining above 60.0 and employment's (59.7 from 62.4) only a shade below. Meanwhile, the supplier deliveries gauge improved for the third month, from 53.0 in July to 57.5 last month. IHS Markit's NM-PMI accelerated for the first time in five months, to 54.8, after falling from a three-year high of 56.8 in May to 53.5 in September. According to the report, "The rate of growth rebounded from September's weather-related weakness, but was also buoyed by a sharp rise in new business. Capacity was often reported to have come under some strain, however, and difficulties finding suitable candidates were partly to blame for the rate of job creation easing to a nine-month low. Meanwhile, price pressures intensified, with rates of both input cost and output charge inflation accelerating."

Merchandise Trade ([link](#)): The real merchandise trade deficit widened in September for the fourth month, posting its biggest gap in the history of the series going back to 1994. (The Q3 preliminary GDP

report showed trade subtracted -1.78ppt from real economic growth last quarter, after adding 1.22ppt during Q2). September's deficit swelled to -\$87.0 billion after narrowing sharply from -\$85.3 billion in February to -\$75.5 billion in May. While both real exports and imports moved higher in September, over the past four months the former has dropped -1.7% while the latter has jumped 4.2% to a new record high. Over the past four months, the biggest decline in real exports was posted by foods, feeds & beverages (-15.3%), followed by autos (-4.5), and capital goods ex autos (-1.6); exports of industrial supplies & materials (5.3) moved higher while consumer goods (nonfood) ex autos was unchanged. Over the comparable period, real imports were up across the board, with consumer goods (nonfood) ex autos (7.6) posting the biggest gain, followed by autos (4.9), industrial supplies & materials (2.6), capital goods ex autos (2.1), and foods, feeds & beverages (0.3).

Construction Spending ([link](#)): Construction spending rose in September for the third month, to a new record high; the degree of gain, however, was negligible, as spending increases in private construction were offset by spending declines in government projects. Total spending inched up 0.1% in September after gains of 0.9% and 0.2% the prior two months. Private construction spending rose 0.3% m/m and 1.1% the past three months, to a new record high, while public construction spending dipped -0.9% after soaring 10 of the previous 12 months by 12.2%. Within private construction spending, residential investment has been volatile around cyclical highs, rising 0.6% in September after a -0.4% loss and a 0.7% gain the prior two months. Over the three-month period, multi-family construction expanded 8.2%—with most of the gain in September—while home-improvement spending climbed 2.4%; single-family construction fell for the third straight month, by a total of -1.7%. Meanwhile, nonresidential investment reached a new record high in September, climbing in nine of the past 11 months by a total of 7.4%—led by double-digit gains in lodging, office, amusement & recreation, transportation, and power structures.

Auto Sales ([link](#)): Motor vehicle sales in October reached a high for this year, as sales of domestic light trucks and imports retained their recent gains and domestic car sales posted the first back-to-back gains since the end of 2016. Total sales climbed for the second month to 17.6mu (saar) last month, after slumping to a 12-month low of 16.7mu in August. Domestic light truck sales, at 9.5mu (saar), was little changed from September's 9.6mu—which was the best sales pace since July 2005, when they were boosted by aggressive discounts. Sales of imports remained at 3.9mu (saar) last month—just shy of May's reading of 4.0mu, which was the strongest pace since August 2009. Meanwhile, domestic car sales climbed for the second month, to 4.2mu (saar), after slumping to a cyclical low of 3.8mu in August; these sales had been in a virtual freefall since peaking at 6.1mu (saar) during August 2014.

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