



MORNING BRIEFING

October 1, 2019

Inflation Roundup

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

(1) Consumer inflation remains subdued. (2) Hard to hit 2.0% inflation target. (3) No inflation in consumer nondurable goods. (4) Medical care services has lower inflation and higher weight in PCED than CPI. (5) Rent of shelter has above-average inflation rate in both PCED and CPI, but less weight in the former. (6) Why is CPI inflation higher in US than in Eurozone and Japan? (7) Nonsensical vs sensible: CPI-adjusted wages have been stagnating for 40 years, while PCED-adjusted wages have been on solid uptrend since mid-1990s. (8) Will Brexit be postponed again?

Inflation I: Still Subdued in US. The headline and core PCED inflation rates, on a y/y basis, remained subdued during August at 1.4% and 1.8%, respectively ([Fig. 1](#)). Both are lower than the comparable inflation rates for the CPI at 1.7% and 2.4% ([Fig. 2](#)).

The Fed puts more weight on the PCED than on the CPI when determining monetary policy. Furthermore, the Fed gives more weight to the core PCED inflation rate, which has been targeted at 2.0% since January 2012. Since May 2012, it has been below that target during all but nine months. That's been one of the main rationales for the Fed's ultra-easy monetary policies from 2012-14, its gradual normalization of monetary policies from 2015-18, and its two rate cuts so far this year.

The CPI inflation rate tends to exceed the PCED inflation rate both on a headline and core basis ([Fig. 3](#) and [Fig. 4](#)). The inflation rates of both the goods and the services components of the CPI exceed those of the PCED ([Fig. 5](#) and [Fig. 6](#)). Let's see why:

(1) *Nondurable goods.* There isn't much divergence between the inflation rates for nondurable goods in the CPI and the PCED ([Fig. 7](#)). In fact, they've been nearly identical over time. During August, the former was 0.0%, while the latter was -0.2%. In the CPI, nondurable goods has a weight of 26.9%. It has a weight of 20.6% in the PCED. Nondurable goods includes energy and food.

(2) *Durable goods.* Over time, the inflation rates of durable goods in the CPI and PCED have diverged significantly ([Fig. 8](#)). Since 1990, the spread between the two has been 1.2 percentage points. During August, the former was up 0.6% y/y, while the latter was down 1.1%. In the CPI, durable goods has a weight of 9.9%. It has a weight of 10.6% in the PCED.

Drilling down, we find that the divergence in the durable goods category is fairly widespread. In recent years, the inflation rates for new vehicles, used vehicles, and furniture have tended to be higher in the CPI than in the PCED.

(3) *Medical care services.* Among services, medical care shows the biggest divergence between the CPI and PCED measures ([Fig. 9](#)). Since 1990, the gap has been 1.3 percentage points. During August, the former was up 4.3% y/y, while the latter was up 1.8%. This ongoing divergence is somewhat muted by the lower weight of medical care services in the CPI (at 7.0%) than in the PCED (at 16.9%). The

former includes only out-of-pocket expenses, while the latter includes the cost of all such outlays, including those paid for by public and private insurance plans.

(4) *Rent of shelter*. There's almost no divergence between the rent-of-shelter inflation rate in the CPI and PCED ([Fig. 10](#)). They've both been hovering around 3.5% over the past few years, making rent one of the most rapidly inflating components of consumer prices. Indeed, inflation in rent of shelter has exceeded the inflation rates of both the headline CPI and PCED much more often than not. However, rent of shelter has a much higher weight in the former, of 33.4%, than in the latter, at 15.9%. It accounts for a whopping 41.7% of the core CPI and 17.9% of the core PCED. So rent inflation has been one of the major reasons why the CPI inflation rate has been exceeding the PCED inflation rate on both a headline and core basis.

Rent of shelter includes tenant rent (with weights of 8.0% and 4.2% in the headline CPI and PCED), and owners' equivalent rent (at 24.1% and 11.6%). The latter reflects an odd concept: how much homeowners would have to pay to rent their home from themselves.

Inflation II: Still DOA in Eurozone and Japan. The US headline CPI inflation rate has been running hotter than the comparable rates in the Eurozone and Japan for quite some time. The goods components of the three measures tend to be volatile and diverge from time to time ([Fig. 11](#)). They've converged recently, with the US at 0.2% during August and the Eurozone and Japan at 0.8% and 0.3%, respectively, during August.

In the US, the services inflation rate (2.7% in August) remains much higher than in the Eurozone (1.3% in August) and Japan (0.2% in August) ([Fig. 12](#)). We suspect that the discrepancies are mostly attributable to a higher weight for rent inflation in the US than in the Eurozone and Japan.

Inflation III: Wages Still Outpacing Prices. As I discussed yesterday, the key to a happy economic outlook and a continuation of the bull market in stocks is productivity growth. I think productivity growth is starting to make a comeback as the labor market gets tighter. If so, then wages—which have been rising faster than prices since the mid-1990s—would rise at a faster clip. Faster growth of real wages likely would more than offset the supply-side slowdown in payroll employment growth. A quicker pace of productivity growth would keep a lid on inflation. Profit margins would remain at recent historical highs or even go higher. The bull market in stocks would continue as earnings moved higher.

At a meeting last week in San Francisco with one of our accounts, I was asked to explain why an 8/7/18 Pew Research Center [study](#) disputed my claim that real wages have been rising for many years. The fellow came prepared with a copy of the piece, titled “For most U.S. workers, real wages have barely budged in decades.”

Right at the top is a chart showing that the purchasing power of average hourly earnings has been flat for 40 years! Can that possibly be right? Nope, it cannot be right. It makes absolutely no sense. In fact, it's total nonsense. Consider the following:

(1) *Agreeing on wage measure*. The author of the study and I both focus on the average hourly earnings (AHE) of production and nonsupervisory workers. The series starts in January 1964, while the series for all workers is available only since March 2006. But the less comprehensive series has covered around 80%-84% of all workers and isn't as skewed by the wages of top earners.

(2) *Disagreeing on price measure*. The Pew study divided AHE by the CPI indexed to 2018 dollars. It is well known that the CPI is upwardly biased, especially compared to the PCED ([Fig. 13](#)). Since January 1964 through August of this year, the CPI is up 728% while the PCED is up 539%, both indexed to

2018.

Over this same period, AHE is up 844%. Adjusted by the CPI, AHE was \$22.90 during August, no higher than it was during late 1973, confirming Pew's alarming and depressing headline ([Fig. 14](#)). Adjusted by the PCED, the AHE was the same, but up 48% over the same period!

(3) *Making sense*. The PCED-adjusted measure of the real wage makes much more sense. It rose during the second half of the 1960s before stagnating during the 1970s as a result of two oil price shocks and during the 1980s as a result of deindustrialization. It rebounded, along with productivity growth, during the second half of the 1990s in an uptrend into record-high territory since the late 1990s that persists to this very day.

BREXIT: Update. When we last covered Brexit in detail, in our [8/29](#) and [8/28 Morning Briefings](#), Melissa and I noted that a no-deal Brexit could be the worst-case scenario for markets upon the UK's official separation from the EU. Some have said that the country's currency could crash, inflation could soar, London equities could suffer, and/or a recession in the region could ensue.

While the UK's conservative leaders are crafting a fiscal and economic policy response to prepare for a hard Brexit, the UK's leadership has said that they really don't know what the short-term impact could be to the UK's economy, [wrote](#) BBC News yesterday. While a hard Brexit remains possible, a lot of obstacles would have to be overcome first. Consider the following:

(1) *Humbug*. In a turn of the Brexit drama, Prime Minister Boris Johnson's call to suspend the UK's parliament for weeks leading up to the Brexit deadline on 10/31 was deemed unlawful by the Supreme Court over there. A hostile Parliament was ordered to get back to work last Wednesday, as *National Review* [detailed](#). (See this short [video](#) from *The Guardian* for an idea of the mood in the room.)

Prior to the suspension, Parliament passed a measure that requires a deal to be reached during the 10/17-18 EU summit or else Brexit must be further extended until at least 1/31, [reported](#) *The Guardian*. We highly doubt a deal will be reached by 10/18, as too many internal and external parties are involved for such a controversial deal to come together in short order.

(2) *Surrender act*. Johnson has mocked the UK opposition party's extension bill by coining it the "Surrender Act" or "Capitulation Act." Despite the Act, Johnson and his conservative supporters in Parliament have refused to back down from the 10/31 deadline date. Supposedly, the PM is for leaving with or without a deal at the end of next month without breaking the law.

Johnson's main prospect for Brexiting with or without a deal seems to be to call for a snap election with the aim of gaining a stronger conservative backing in Parliament to support what he wants to do. Johnson came out fighting, calling for a snap election last Wednesday. However, a two-thirds vote of Parliament is required to hold a snap election and has yet to be agreed upon, [reported](#) CNN. The opposition has said that it would happily hold one, but only after a no-deal Brexit is ruled out, as documented in a CNN [video](#).

Calling for a snap election is a risky move for Johnson because he could lose his seat altogether in the crossfire. In any event, Johnson may have run out of time for calling a snap election ahead of his 10/31 deadline. Parliament must be dissolved 25 days before an election, according to the CNN article. In an alternative scenario, Johnson could resign as a "Brexit martyr" and run again in the next election.

(3) *3-D chess*. "[T]o understand Boris Johnson's predicament, you need to grasp the complex and contradictory trade-offs inherent in keeping power at home while managing international negotiations

abroad,” *The Guardian* smartly [observed](#). The article added that for Johnson to “secure a deal,” he must do so in a way that will be approved by the EU, survive parliamentary scrutiny, and gain him a majority in the next general election.

Johnson’s time as PM could be cut short for other reasons too, as he faces recent allegations for improper actions that took place decades ago reminiscent of the recent “Me Too” movement in the US. Only a master at British political chess could possibly guess what happens next. Our best guess is that the Brexit deadline is extended yet again.

CALENDARS

US. Tues: ISM & IHS/Markit M-PMIs 50.0/51.0, Construction Spending, Clarida, Bullard, Bowman.
Wed: ADP Employment Change 140k, Motor Vehicle Sales, MBA Mortgage Applications. (DailyFX estimates)

Global. Tues: Eurozone Headline & Core CPI 1.0%/1.0% y/y, Eurozone, Germany, France, and Italy M-PMIs 45.6/41.4/50.3/47.9, UK M-PMI 47.0, Japan M-PMI 48.9, Canada GDP 0.0%, Australia RBA Interest Rate Decision 0.75%, Lowe. **Wed:** Eurozone Unemployment Rate 7.5%, Germany Retail Sales 0.5%*m/m*/2.9%*y/y*, Germany Unemployment Change & Unemployment Claims Rate 5k/5.0%, Germany CPI 0.0%*m/m*/1.3%*y/y*, UK GDP -0.2%*q/q*/1.2%*y/y*, Japan Jobless Rate 2.3%, Japan Tankan Survey, Japan M-PMI, Japan Housing Starts 902k. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): LargeCap’s forward earnings fell last week for the first time in eight weeks, and Midcap’s dropped for fourth time in five weeks. SmallCap’s rose for a second week, but has been mostly falling since early July. These indexes began a forward-earnings uptrend during March, but only LargeCap is still rising now. LargeCap’s forward earnings has risen during 27 of the past 33 weeks, MidCap’s 17 of the past 29 weeks, and SmallCap’s 16 of the past 27 weeks. LargeCap’s is 0.1% below its record high a week earlier, while MidCap’s and SmallCap’s are 3.3% and 9.4% below their mid-October highs. MidCap’s forward earnings is at a 14-month low now, while SmallCap’s forward earnings is near a 15-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. At their bottoms earlier in 2019, LargeCap’s forward EPS had been the most below its record high since June 2016 and MidCap’s was the lowest since May 2015. During mid-September, SmallCap’s had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap’s forward earnings was down to a 34-month low of 1.8% y/y from 1.9%. That’s down from 23.2% in September 2018, which was the highest since January 2011. MidCap’s -2.3% y/y change is down from -1.0% and is the lowest since January 2010. That compares to 24.1% in September 2018 (the highest since April 2011). SmallCap’s -8.4% y/y change is up from -9.6%, which was the lowest since December 2009. That compares to an eight-year high of 35.3% in early October. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 1.1%, 11.2%), MidCap (22.7, -4.2, 13.5), and SmallCap (22.4, -17.0, 39.5).

S&P 500/400/600 Valuation ([link](#)): Valuations mostly fell last week for these three S&P market-cap indexes, but remain above their three-month lows from late August. LargeCap’s forward P/E dropped 0.1pt w/w to 16.7 and is down 0.5pt from a 17-month high of 17.2 at the end of July. That compares to a five-year low of 13.9 during December and a 16-year high of 18.6 during January 2018—and of

course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E was steady w/w at 15.9. That's down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. 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. However, 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 fell 0.5pt w/w to 17.0 and is down from a 12-month high of 17.8 in mid-September. That's well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E was above back above LargeCap's P/E for a fourth week primarily due to substantially lower forward earnings for Frontier Communications. It had been below for 16 weeks—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q3 books closed, analysts cut their forecasts for the quarter at a slightly faster in the latest week. The S&P 500's Q3-2019 EPS forecast dropped 10 cents w/w to \$41.29. That represents an earnings decline of 3.2% y/y compared to the prior week's forecasted earnings drop of 3.0%. The consensus' \$41.29 estimate is down 4.0% in the 13 weeks since the start of the quarter, which compares to a 2.2% drop for Q3 over the similar 12 weeks. While the consensus Q3 EPS estimate is below our forecast of \$43.00 and is now below the \$41.45 reported for Q2, we are expecting slightly positive y/y earnings growth of 0.8%. On a pro forma basis, Q3 earnings are expected to decline 2.2% y/y, which would be the first drop in 13 quarters and compares to y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Six of the 11 sectors are expected to record positive y/y earnings growth in Q3-2019, with none rising at a double-digit percentage rate. That compares to seven positive during Q2, when three rose at a double-digit percentage rate. However, eight sectors are expected to beat the S&P 500's Q3 growth rate, up sharply from just three beating the S&P 500 during Q2. Industrials, Materials, Real Estate, and Utilities are the only sectors expected to post better (or less worse) growth on a q/q basis during Q3. On an ex-Energy basis, the consensus expects earnings to fall 0.4% y/y in Q3. That compares to ex-Energy gains of 3.9% in Q2 and 3.0% in Q1, and is well below the 14.2% y/y gain in Q4-2018. Here are the latest Q3-2019 earnings growth rates versus their Q2-2019 growth rates: Financials (4.2% in Q3-2019 versus 10.0% in Q2-2019), Real Estate (3.4, 3.1), Health Care (2.4, 10.3), Utilities (2.1, 1.1), Industrials (1.4, -9.5), Consumer Discretionary (1.4, 2.7), Consumer Staples (-0.7, 1.7), Communication Services (-0.6, 17.6), Information Technology (-7.6, -2.2), Materials (-9.8, -12.7), and Energy (-29.4, -8.9).

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): Five Fed districts have now reported on manufacturing activity for September—Philadelphia, New York, Richmond, Kansas City, and Dallas—and show activity is at a standstill. The composite (to 0.9 from 3.9) index posted its slowest activity since August 2016 with the exception of June's (-3.7) dip into negative territory. Philadelphia's composite (12.0 from 16.8) index showed activity remained at a healthy, though slower rate, while both the Dallas (1.5 from 2.7) and New York (2.0 from 4.8) composites fell back toward zero, indicating little growth in those regions. Meanwhile, Richmond's (-9.0 from 1.0) measure fell back into contractionary territory, while Kansas City's (-2.0 from -6.0) is moving toward positive territory. New orders (3.7 from 5.6) expanded at a very slow rate, one-fifth the pace of a year ago, with only the Philadelphia (24.8 from 25.8) region showing robust growth; Dallas (7.1 from 9.5) billings were subdued, while New York's (3.5 from 6.7) barely grew last month. Meanwhile, orders in the Richmond (-14.0 from 2.0) region contracted sharply, while the decline in Kansas City's (-3.0 from -16.0) narrowed to near zero. Employment (6.9 from -1.1) is expanding, with Dallas (18.8 from 5.5) and Philadelphia (15.8 from 3.6) factories hiring at considerably faster rates than in August, while New York (9.7 from -1.6) and Richmond (3.0 from -6.0) manufacturers

are hiring again after cutting payrolls for three and two months, respectively. Factories in Kansas City (-13.0 from -7.0) haven't cut jobs this aggressively since February 2016.

Regional Manufacturing Price Indexes ([link](#)): In September, the average of the New York, Philadelphia, Richmond, Kansas City, and Dallas regions' prices-paid (to 20.7 from 14.1) and prices-received measures (11.6 from 5.7) continued to bounce around recent lows, down from their 2018 peaks of 47.7 and 25.4, respectively. The regions appear to be mixed, with only the Philadelphia region showing an acceleration in both measures the past few months. In the meantime, the prices-paid and prices-received indexes in the Dallas and Kansas City regions remain on disinflationary trends, while New York's and Richmond's appear to be finding a bottom.

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