



MORNING BRIEFING

January 8, 2020

Will Inflation Make a Comeback in 2020?

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

(1) Another 2%+ quarter for real GDP. (2) Good news and not-so-good news in trade. (3) Purchasing managers are upbeat in services, still depressed in manufacturing. (4) No growth in factory orders. (5) Truck and rail traffic are on the weak side. (6) Auto sales are cruising at the same speed. (7) Employment indicators still showing a strong labor market. (8) Big issue in 2020: Will rising wage inflation boost price inflation? (9) More wage inflation in services than in goods industries. (10) Competitive pressures should keep a lid on price inflation and stimulate productivity.

US Economy I: Running on Five Cylinders. US real GDP is on track to have grown by 2.3% (saar) during Q4-2019 following gains of 3.1%, 2.0%, and 2.1% during Q1, Q2, and Q3 last year ([Fig. 1](#)). That's actually quite impressive a performance given that manufacturing—one of the economy's main cylinders—is still sputtering. The average increase in real GDP during the 15 quarters since Q1-2016 has been 2.4%. On a y/y basis, real GDP has been growing around 2.0% since 2010 ([Fig. 2](#)). Let's look under the economy's hood:

(1) *Trade.* The Q4 estimate is the latest from the Atlanta Fed's [GDPNow](#) model as of 1/7, unchanged from the 1/3 estimate of 2.3% (saar), as the narrowing of November's real trade deficit was offset by declines in the nowcasts of both Q4 real personal consumption expenditures and Q4 real gross private domestic investment growth. The narrowing in November's real trade deficit was mostly attributable to a 1.3% m/m drop in real merchandise imports, which may be a sign of domestic economic weakness ([Fig. 3](#)). There's no evidence that the drop in imports was offset by an increase in domestic production. Both the exports and imports components of the M-PMI survey remained below 50.0 during December, at 47.3 and 48.8 ([Fig. 4](#)).

(2) *Purchasing managers surveys.* Also yesterday, we learned that the US NM-PMI rose to 55.0 during December ([Fig. 5](#)). That same month, the M-PMI dropped to 47.2, the lowest since June 2009. This suggests that so far the growth recession in manufacturing isn't spilling over

into the services economy.

(3) *Factory orders*. The weakness in manufacturing was confirmed by the release yesterday of factory orders, which fell 1.5% y/y during November with durables down 3.8% and nondurables up only 0.9% ([Fig. 6](#)).

(4) *Truck and rail traffic*. Also on the weak side last November was the ATA truck tonnage index, which fell 3.5% m/m and 2.1% y/y ([Fig. 7](#)). However, it remains in a volatile range in record-high territory. Then again, medium-weight and heavy-weight truck sales dropped 12.3% m/m during November but recovered some of that loss with a 7.6% m/m gain during December ([Fig. 8](#)).

Not surprisingly, there is a good correlation between the y/y growth rate in manufacturing production and the comparable growth rates in both the trucking index and railcar loadings ([Fig. 9](#)). The former was down 1.2% during November, while the trucking index (using the three-month average of the series) was up only 1.2% and railcar loadings were down 6.9% during the final week of 2019, based on the 26-week average.

(5) *Auto sales*. There is a relatively tight fit between sales and railcar loadings of motor vehicles ([Fig. 10](#)). The former has stalled around 17.0 million (saar) for the past two years, while the latter has been on a modest downward trend, falling 3.7% y/y through the 12/28/19 week based on the 26-week average.

(6) *Employment*. The good news is that the labor market remains strong. The four-week average of initial unemployment claims did rise to 233,250 during the last week of 2019, but that remains near recent cyclical lows ([Fig. 11](#)). This series is highly correlated with the percentage of respondents in the consumer confidence survey who say that jobs are hard to get. Only 13.1% said so during December. Also in December, while the M-PMI employment index dropped to 45.1, the NM-PMI employment index remained high at 55.2 ([Fig. 12](#)). Manufacturing accounts for only 8% of payroll employment.

US Economy II: Is Phillips Curve Working Finally? Will this be the year that price inflation finally makes a comeback? Debbie and I don't think so, though it is long overdue based on the Phillips curve model. Actually, the basic model postulates an inverse correlation between the unemployment rate and the wage inflation rate. That relationship is finally working. However, it

is widely believed that higher wage inflation should drive price inflation higher. That's not happening so far.

It will be interesting to see how the Fed reacts if wage inflation continues to move higher, as it is likely to do in Friday's employment report for December. During his 10/30 [press conference](#), Fed Chair Jerome Powell said, "So I think we would need to see a really significant move up in inflation that's persistent before we would consider raising rates to address inflation concerns." He was undoubtedly referring to the core PCED inflation rate, which remains subdued. Let's look at the latest data:

(1) *Wage inflation*. Average hourly earnings for production and nonsupervisory workers rose 3.7% y/y during November, little changed from October's 3.8%, which was the highest pace since December 2008 ([Fig. 13](#)). It is up from the most recent cyclical low of 2.2% during October 2017, when the unemployment rate was 4.1%. The unemployment rate was down to 3.5% last November, and has been at or below 4.0% since April 2018. Interestingly, the big jump in wage inflation has occurred in services rather than in goods industries ([Fig. 14](#)). Since the jobless rate fell below 4.0%, the former is up from 2.5% to 3.8% while the latter is down from 3.8% to 2.8%.

(2) *Wage inflation by industry*. Among goods-producing industries, wage inflation for production and nonsupervisory workers during November was only 2.7% in manufacturing and 2.0% in construction. However, it was 7.7% in natural resources.

There seem to be more widespread inflationary wage pressures among services-producing industries: information services (4.5), professional & business services (4.3), leisure & hospitality (4.3), retail trade (3.9), transportation & warehousing (3.9), wholesale trade (3.7), education & health (3.6), financial services (3.3), and utilities (0.0). We believe that other than in the education & health industry, competitive pressures will make it hard for services industries with the most wage pressures to pass them on to prices.

(3) *Price inflation*. Overall, there isn't a very tight fit between wage inflation and the core PCED inflation rate, which remains subdued despite the uptrend in wage inflation ([Fig. 15](#)). Furthermore, there doesn't seem to be a very tight fit between the price inflation rate in goods-producing industries and wage inflation among these industries ([Fig. 16](#)). In any case, both of them remain subdued. On the other hand, there does seem to be more pass-through of wage

pressures to prices in the services sector. We will be monitoring both closely during the coming year.

Our bet is that competitive pressures will make it hard for most industries to pass wage pressures through to prices. That could be bad news for profit margins. However, we expect that companies will use technology to boost their productivity all they can in the interest of maintaining their margins. The weekly data on forward profit margins show that the S&P 500 LargeCaps did that more successfully last year than did the S&P 400/600 SMidCaps ([Fig. 17](#)).

CALENDARS

US: Wed: ADP Employment Change 160k, Consumer Credit \$15.8b, MBA Mortgage Applications, DOE Crude Oil Inventories, Brainard. **Thurs:** Jobless Claims 221k, Williams, Clarida. (DailyFX estimates)

Global: Wed: Eurozone Economic Confidence 101.4, Germany Factory Orders 0.2%m/m/-4.7%/y/y, Japan Consumer Confidence 39.5, China CPI & PPI 4.7%/-0.4% y/y.

Thurs: Eurozone Unemployment Rate 7.5%, Germany Industrial Production 0.8%m/m/-3.6%/y/y, Germany Trade Balance €21.0b, Japan Household Spending -2.0% y/y, China New Yuan Loans ¥1250b, China Aggregate Financing, Mexico CPI 2.76% y/y, Carney. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI improved m/m in December for the first time in seven months, but was negative for the 12th time in 14 months as several sectors fell to cyclical lows. NERI improved to -7.4% in December from a 43-month low of -8.9% in November, which compares to a record high of 22.1% in March 2018. NERI improved m/m for five of the 11 sectors; that compares to four improving in November. All 11 sectors had improved m/m in May, which was the first time that had happened since January 2018. NERI was positive in December for two sectors, unchanged from November's reading and down from three from July to October. That compares to negative readings for all 11 sectors from February to April. Materials has the worst track record, with 15 months of negative NERI, followed by Industrials (14), Financials (13), and Utilities (13). Tech's NERI turned positive m/m for the first time since June, but Real Estate's negative reading was its first since April. Here are the sectors' December NERIs compared with their November readings:

Tech (2.2% in December, up from -1.0% in November), Health Care (1.5, 2.2), Real Estate (-1.4, 1.7), Consumer Staples (-4.2, -5.7), Utilities (-4.4, -0.6), Financials (-7.0, -11.5), Consumer Discretionary (-7.4, -10.4), Communication Services (-7.3 [19-month low], -7.3), Materials (-17.3, -15.6), Industrials (-18.6 [47-month low], -18.5), and Energy (-21.6, -26.9).

MSCI World & Region Net Earnings Revisions ([link](#)): Analysts' recent earnings revisions through December suggest less pessimism about profits in the US and across much of the world outside of EM Eastern Europe. The AC World ex-US MSCI's NERI was negative for a 21st month but improved to a 14-month high of -4.7% from -6.3% in November. That's up from a 33-month low of -8.4% in January 2019. The US's NERI was negative for the 13th time in 14 months, but improved to -7.7% from a 43-month low of -9.0%. It remains well below its corporate-tax-rate-cut-boosted record high of 21.8% in March 2018. Here are December's scores among the regional MSCIs: EM Asia (-1.8% in December [21-month high], up from -3.9% in November), Emerging Markets (-2.5 [21-month high], -4.3), AC World ex-US (-4.7 [14-month high], -6.3), AC World (-5.5, -7.0), EMU (-5.7, -6.3), EM Eastern Europe (-5.7 [45-month low], -3.3), Europe ex-UK (-5.7, -6.2), EM Latin America (-6.2, -7.0), EAFE (-7.0, -8.1), Europe (-7.6, -7.5), and the US (-7.7, -9.0 [43-month low]).

MSCI Countries Net Earnings Revisions ([link](#)): NERI was positive for 7/44 MSCI countries in December, up from six in November and just two during September and October, which then matched the lowest count since March 2016. That compares to 11/44 countries positive in May, which was the highest reading since October 2018. NERI improved m/m in December for 30/44 countries, the highest count since July 2018 and up from 22/44 in November. During December, NERI turned positive m/m for India for the first time in 24 months and New Zealand for the first time in eight. NERI slipped back into negative territory for Sweden. Among the countries with improving NERI in December, Greece was at a 121-month high, followed by India (71-month high), Taiwan (65), New Zealand (44), the Philippines (26), Hungary (23), Malaysia (20), and China (18). Among countries with weaker NERI m/m, Egypt was at a 96-month low, followed by the United Kingdom and Turkey (both at 68-month lows), the Netherlands (49), Poland (46), and Russia (46). The five-month positive NERI streaks for Hungary and Israel are the best among countries. South Africa's NERI has been negative for 67 straight months, followed by the negative streaks of Mexico (38 months), Denmark (29), and Germany (29). The highest NERI readings in December: Hungary (10.4%), Greece (9.8), Taiwan (6.2), New Zealand (6.0), the Philippines (3.0), Israel (1.9), and India (1.3). The weakest NERIs occurred this month in Peru (-18.2), the United Kingdom (-14.8), Finland (-13.7), Chile (-13.6), Canada (-12.3), and Egypt (-12.1, 96-month low).

US ECONOMIC INDICATORS

Merchandise Trade ([link](#)): The real merchandise trade deficit in November narrowed for the fifth time in six months, posting its smallest gap since March 2017, suggesting trade could give a boost to Q4 GDP—which would be only the second time it contributed to growth in six quarters. The real deficit narrowed to -\$75.3 billion from -\$86.3 billion in May. The October/November average monthly deficit of -\$77.1 billion is considerably below the -\$84.7 billion average monthly gap recorded during Q3. There's not much strength in the trade data, however, with both exports (-1.5%) and imports (-5.6) declining over the six-month period—with imports contracting at nearly quadruple the pace of exports. It's a sea of red for both exports and imports, with only real exports of industrial supplies & materials (5.1) and real imports of foods, feeds & beverages (2.9) in the plus column over the six-month period. Taking a look at our trade deficit with China (in nominal terms), it has narrowed steadily from -\$419.5 billion at the end of 2018 to -\$357.7 billion during the 12 months through November. Over this comparable period, US exports to China fell by \$13.2 billion—from \$120.1 billion to 106.9 billion—while US imports from China fell at five times that pace, from \$539.7 billion to \$464.5 billion, though US exports to China rose in November for the first time since spring 2018.

Manufacturing Orders & Shipments ([link](#)): Core capital goods orders and shipments remained stalled around record highs in November, lacking any momentum. Nondefense capital goods orders ex aircraft (a proxy for future business investment) rose 1.2% during the two months ending November after falling 1.3% the prior two months, while core capital goods shipments sipped 0.3% in November after a 0.7% gain and a 0.8% loss the prior two months. Meanwhile, total factory orders fell for the third time in four months, dropping 0.7% in November and 1.4% over the period. The weakness in orders is widespread, with only industrial equipment, electronic components, and furniture showing signs of life. Looking ahead, ISM's M-PMI (47.2) for December showed manufacturing activity contracted for the fifth straight month, falling at its fastest pace since June 2009 at the close of 2019.

US Non-Manufacturing PMIs ([link](#)): Both the ISM and IHS Markit surveys show non-manufacturing activity accelerated during the final months of 2019, with the former expanding at its fastest pace in four months and the latter in five months. ISM's NM-PMI appears to be on an upswing, climbing for the second time in three months, to 55.0 in December from 52.6 in September—which was the lowest reading since August 2016. (December's reading is consistent with a 2.2% increase in real GDP growth on an annualized basis.) The four components of the NM-PMI were mixed, though business activity was the standout, jumping to

57.2 in December—a roundtrip from November, when it fell from 57.0 to 51.6. Also improving was supplier deliveries (to 52.5 from 51.5), remaining on a volatile uptrend. The new orders (54.9 from 57.1) component continued to bounce around recent lows in December, though remained at a relatively high level, while the employment (55.2 from 55.5) rate held relatively steady, up from 50.4 in September. IHS Markit's NM-PMI improved the final two months of 2019, climbing from 50.6 in October to 52.8 in December, though service-sector growth remained well below that seen during early 2019. According to the report, both domestic and foreign demand contributed to the recent acceleration, with new export orders increasing for the first time since July and job creation reaching a five-month high. The missing ingredient is business confidence, which remained well below its series average at the end of 2019.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI ([link](#)): December's CPI headline rate is expected to accelerate for the second month, to 1.3% y/y, after falling to 0.7% in October (which was the lowest since November 2016). It would be the 14th consecutive month the headline rate was below 2.0%. Meanwhile, the core rate is expected to remain at 1.3%, matching April's two-year high and up from 0.9% during July and August. Looking at the main components, food, alcohol & tobacco (to 2.0% from 1.9% y/y) is expected to record the highest rate, followed by services (1.8 from 1.9)—with the former accelerating and the latter decelerating. The rate for non-energy industrial goods is forecast to remain at 0.4%. As for energy (0.2 from -3.2), the yearly rate is expected to be positive for the first time in five months, though barely.

Eurozone Retail Sales ([link](#)): Retail sales rebounded 1.0% in November, to a new record high, after slipping 0.6% over the prior two-month period. November's gain matched its best readings of 2019, which occurred during January and June. Sales were up 2.2% y/y, accelerating from October's 1.7%. Of the three major sales categories, spending on non-food products (1.4% m/m & 3.1% y/y) posted the strongest monthly and yearly gain in November, followed by food, drinks & tobacco (0.7 & 1.7); spending on automotive fuel (-1.0 & -1.4) contracted over the comparable periods. Data are available for three of the top four Eurozone economies and show German sales (2.1% m/m & 3.2% y/y) rebounded to a new record high in November, with yearly growth back above 3.0%, while retail sales in France (1.1 & 2.6) recovered to within a fraction of August's record high. Sales in Spain (0.7 & 3.0) advanced to a new cyclical high, posting only one decline during the first 11 months of 2019.

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