June 17, 2024

Morning Briefing

The Phillips Curve Ball

Check out the accompanying chart collection.

Executive Summary: The rates of unemployment and inflation aren't always inversely correlated, as the Phillips Curve model posits. Historically, they have often been; in recent times, not so much. The problem with the model is that it doesn't account for the effects of productivity growth on price inflation. … The high rates of goods inflation experienced after the pandemic proved to be transitory, as we had anticipated. Services inflation has been more persistent but is moderating too. Pulling both down are assorted disinflationary forces. … Consumer sentiment fell in early June. We're not sure why exactly but suggest some possibilities related to inflation, the labor market, and the uninspiring presidential race options.

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US Economy I: Unemployment Versus Inflation. Federal Reserve officials haven't said much about the Phillips Curve lately. In the past, like most macroeconomists, they believed that there is an inverse relationship between inflation and unemployment; that was the main message of the curve. But the negative correlation hasn't been consistently reliable for a while. Nevertheless, as recently as 2022 and 2023, it was widely believed that the Fed would have to engineer a recession, causing higher rates of unemployment, to bring inflation down.

History suggested as much: Since 1914, inflationary episodes often peaked during recessions that presumably ended them (*Fig. 1*). This pattern was especially evident since the 1960s. Before then, inflation often peaked before subsequent recessions occurred. Data since 1948 do suggest that there is an inverse correlation between the unemployment rate,

which always spikes up during recessions, and the CPI inflation rate on a y/y basis (*Fig. 2*). However, the relationship became less pronounced as inflation stayed remarkably low and subdued during the so-called Great Moderation from the mid-1980s to just before the post-pandemic inflation surge.

During the current episode, the CPI inflation rate peaked at 9.1% y/y in June 2022 and fell to 3.0% 12 months later. It has remained around 3.0% since then. Yet the unemployment rate has been at 4.0% or less for the past 30 months, from January 2022 through May 2024. In other words, there has been absolutely no Phillips Curve tradeoff: Inflation has dropped sharply, while the labor market has remained tight at full employment.

Not surprisingly, history has shown a very strong Phillips Curve effect when it comes to wage inflation; that is, there's been a very strong inverse correlation between the wage inflation rate and the unemployment rate. The data are available back to 1965 for monthly average hourly earnings and 1948 for quarterly hourly compensation (*Fig. 3* and *Fig. 4*). However, the clear outlier again has been the current experience, during which the various measures of wage inflation have moderated significantly while the unemployment rate has remained very low.

The problem with the Phillips Curve model is that it mostly ignores the effects of productivity on inflation. As Debbie and I have frequently demonstrated in the past, consumer price inflation is largely determined by the core inflation rate as determined in the labor market. This is unit labor cost (ULC) inflation, which is the yearly percent change in the ratio of hourly compensation divided by productivity (*Fig. 5*). The ULC inflation rate was down to just 0.9% y/y through Q1-2024. That clearly confirms that consumer price inflation should continue to fall.

We've also observed that there is an inverse correlation between the unemployment rate and the productivity growth cycle (*Fig. 6*). During periods of falling and low unemployment, companies respond to the tightening labor market by boosting productivity. Productivity growth tends to be depressed during periods of slack in the labor market.

Productivity growth did make an impressive comeback last year as companies scrambled to boost it in response to chronic shortages of labor. It rose 2.9% y/y through Q1-2024 (*Fig. 7*). We are expecting that productivity growth will continue to rise over the rest of the Roaring 2020s decade, boosting real economic growth and keeping a lid on inflation. The Phillips Curve is likely to remain a misleading theoretical macroeconomic model.

US Economy II: Disinflating Toward 2.0%. It has been our view since early 2022 that the high rate of durable goods inflation was transitory because it was boosted by strong demand fueled by unusual amounts of fiscal and monetary stimulus as well as by supply-chain disruptions. We expected the buying binge for durable goods to cool off and the supply-chain problems to get fixed relatively quickly. We recognized that services inflation might turn out to be more persistent, especially for rents; but we expected that services inflation would moderate over time too, though it might take longer to do so.

In our March 7, 2022 *Morning Briefing*, Debbie and I wrote: "We are now predicting that the core PCED (personal consumption expenditures deflator) measure of inflation will peak at 7% y/y during Q2, up from 6% during Q1. Then we expect that it will moderate to 4% during Q4." On *March 16*, we opined: "Then it might decline to 3%-4% in 2023, maybe." In the November 14, 2023 *Morning Briefing*, we wrote, "In our projected scenario, the core PCED inflation rate falls to 2.0%-3.0% next year."

These projections have turned out to be quite accurate. Both durable goods and nondurable goods inflation rates proved to be relatively transitory after all, while services inflation has been more persistent but continues to moderate. The headline and core PCED inflation rates were 2.7% and 2.8% y/y in April, down from their 2022 peaks of 7.1% and 5.6% (*Fig. 8*). Goods inflation in the PCED plunged as quickly as it soared from its June 2022 peak (*Fig. 9*). Services inflation in the PCED remained relatively high at 3.9% y/y during April, but it remains on a moderating trend (*Fig. 10*).

Consider the following related disinflationary developments:

(1) *Fed projections*. The Fed's preferred PCED inflation rate will be released at the end of the month for May. The Cleveland Fed's *Inflation Nowcast* model currently has the core PCED rising 0.10% m/m and 2.6% y/y. That would put the core PCED inflation rate below the FOMC's recently updated end-of-year target of 2.8%, up from 2.6% in the committee's March Summary of Economic Projections!

Fed officials are currently projecting that the core PCED will then fall to 2.3% next year and 2.0% in 2026. We, on the other hand, expect to see 2.0% by the end of this year.

(2) *Chinese deflation*. On Friday, we learned that the US import price index for Chinese goods fell 2.0% y/y during May (*Fig. 11*). China continues to export deflation, which partly explains why US core CPI goods prices are down 1.7% y/y through May, while the US core PPI final demand remained subdued at 1.7% y/y through May. In the CPI, durable goods

inflation dropped 3.8% y/y, the lowest since March 2004 (*Fig. 12*). That undoubtedly helped to push down May's PCED inflation rate, which will be reported on June 28.

(3) *Rent inflation*. In the CPI, the three-month annualized inflation rates for rent of primary residences and owners' equivalent rent were more than one percentage point lower than the yearly percent changes (*Fig. 13*). That confirms that new lease rent inflation is below existing leases rent inflation.

(4) *Transportation services*. Among the stickiest inflation rates in the CPI have been for auto-related services. The CPI for transportation services was up 10.5% y/y though May (*Fig. 14*). Leading the way is motor vehicle insurance, which was up 20.3% in May (*Fig. 15*). It's up 7.4% in the PCED because it is adjusted for payments made on claims. Also up sharply on a y/y basis in both the CPI and PCED is auto repair & maintenance by 7.2% and 7.6% (*Fig. 16*).

We've previously observed that about 80% of retail motor vehicle sales are attributable to "light" trucks such as monster-sized trucks like Ford's F-150. These tend to be more expensive than sedans and more expensive to maintain, repair, and insure. We question whether that should be counted as an inflationary phenomenon. The CPI may need a "hedonic adjustment" to reflect that more Americans are trading up to bigger and more expensive cars.

(5) *Home insurance*. Home insurance has been another persistent source of inflationary pressure in both the CPI and PCED measures, with increases of 4.3% and 7.0% y/y through May and April (*Fig. 17*). Both rates seem to be peaking currently.

(6) *Health insurance*. The CPI includes a measure of health insurance that is extremely volatile because of the very strange way that it is calculated by the Bureau of Labor Statistics (*Fig. 18*). Much more sensible is the measure of health insurance in the PCED, which was up only 1.4% y/y through April.

US Economy III: Looking for Trouble in the Labor Market. "Snap out of it!" That's what we want to tell consumers. They remain remarkably depressed, as evidenced by the sharp drop in June's preliminary Consumer Sentiment Index (CSI) to 65.6 from 69.6 in May (*Fig. 19*). The drop was led by a sharp fall in current conditions. We've previously observed that the CSI is more sensitive to inflation than is the Consumer Confidence Index, which is more sensitive to employment conditions.

As discussed above, inflation is continuing to moderate. Even the price of gasoline has been falling in recent weeks. So why is the CSI so weak?

Last week, we observed that while economists are impressed by the drop in inflation on a y/y basis, consumers are depressed that the prices they are paying for both goods and services are much higher than they were four years ago, just before the start of the pandemic (*Fig. 20*). But that shouldn't have suddenly depressed the CSI in early June.

Could the problem be in the labor market? Initial unemployment claims have been rising over the past few weeks. We think that might be related to seasonal distortions around holidays, such as Memorial Day. There are fewer job openings, but they are still relatively plentiful. The household measure of employment has been weak, but payroll employment gains have been solid so far this year.

We still favor the payroll over the household measure of employment. In May, the former was up 272,000, while the latter was down 408,000. The decline in the household measure was led by a 474,000 drop in the 20- to 24-year-old age group (*Fig. 21*). Those are mostly college kids, who typically quit their jobs at the end of the school year and start their summer jobs in June. The data are seasonally adjusted but might not have captured the changes fully this year. The 20-to 24-old age group lost 811,000 jobs since the start of the year (*Fig. 22*).

The bottom line is that we aren't sure why consumers are so depressed. It might be the awful choice we have between the two candidates currently running for the White House.

Calendars

US: Mon: Empire State Manufacturing Index -12.5; William; Harker; Cook. **Tues:** Headline & Core Retail Sales 0.3%/0.2%; Industrial Production 0.3%; Capacity Utilization 78.6%; Business Inventories 0.3%; Atlanta GDPNow 3.1%; API Weekly Crude Oil Inventories; Goolsbee; Collins. (FXStreet estimates)

Global: Mon: Italy CPI 0.2%m/m/0.8%y/y; Eurogroup Meetings ; Lagarde; Lane ; De Guindos; Ellis. **Tues:** Eurozone Headline & Core CPI 0.2%m/m/2.6%y/y & 0.4%m/m/2.9%y/y; Eurozone ZEW Economic Sentiment 47.8; Germany ZEW Economic Sentiment 49.6; Eurogroup Meetings; RBA Interest Rate Decision 4.35%; De Guindos. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index has posted gains in 23 of the past 34 weeks after trading below its prior (December 27, 2021) record high for 25 months. Last week's gain of 1.2% was its first in three weeks. The US MSCI finished the week just 0.2% below its Wednesday record high. The AC World ex-US index rose 0.9% w/w to 7.4% below its June 15, 2021 record high, and is just 1.4% below its 28-month high on May 20. EM Asia was the best performing region last week with a gain of 3.3%, followed by EM (2.3%) and the AC World ex-US. EM Latin America was the worst regional performer with a decline of 4.5% last week, followed by EMEA (-0.1), EAFE (0.6), EMU (0.6), and Europe (0.8). Among the major selected country markets that we follow, Korea performed the best last week with a gain of 5.9%, followed by Taiwan (4.6), India (3.6), Switzerland (2.5), and China (1.5). The worst country performers last week: Mexico (-10.5), Canada (-2.0), Brazil (-1.7), South Africa (-0.6), and the United Kingdom (-0.4). The 11.6% ytd gain for the MSCI United States remains well ahead of the AC World ex-US index (5.2). EM Asia jumped back ahead of the pack as the leading region ytd with a gain of 8.7%, which puts it ahead of EMU (7.8), Europe (7.1), EAFE (5.9), and the AC World ex-US. The worst performing regions so far in 2024: EM Latin America (-16.1), EMEA (-3.4), and EM (4.8). Looking at the major selected country markets that we follow, Taiwan is far and away the best ytd performer with a gain of 20.6%, followed by India (12.8), the United States (11.6), Spain (10.1), and China (7.9). The worst performing countries so far in 2024: Brazil (-19.5), Mexico (-16.2), Hong Kong (-6.5), South Africa (-6.3), and Korea (-2.9).

US Stock Indexes (*link*): For a second straight week, investors sold the SMidCap Growth and Value indexes last week and propelled many of the LargeCap growth-style indexes to record highs. Just 17 of the 48 major US stock indexes that we follow rose, down from 20 rising a week earlier. S&P 500 LargeCap Growth was the best performer for a second straight week. The 3.7% gain for the S&P 500 LargeCap Growth index was followed by Nasdaq 100 (3.5%), Russell 1000 Growth (3.4), Russell 3000 Growth (3.3), and Nasdaq Composite (3.2). S&P 600 SmallCap Pure Value was the worst performer with a decline of 3.4%, followed by S&P 500 LargeCap Pure Value (-2.5), S&P 600 SmallCap Value (-2.4), S&P 400 MidCap Pure Value (-2.3), and S&P 600 SmallCap Equal Weight (-2.2). Looking at their ytd performances, 36 of the 48 indexes are higher so far, but that's down from 47 at the end of March. The S&P 500 LargeCap Growth index is the best performer so far in 2024 with a gain of 22.8%, ahead of Russell 1000 Growth (19.8), Russell 3000 Growth (18.1), Nasdaq Composite (17.8), and S&P 100 MegaCap (17.7). The worst performing major US stock indexes ytd: S&P 600 SmallCap Pure Value (-8.2), S&P 600 SmallCap Value (-7.6),

Dow Jones 20 Transports (-6.9), S&P 600 SmallCap Equal Weighted (-6.0), and S&P 400 MidCap Pure Value (-5.4).

S&P 500 Sectors Performance (*link*): Four of the 11 S&P 500 sectors rose last week, but Information Technology's 6.4% surge made it the best weekly performer and the only sector to outperform the S&P 500's 1.6% gain. That compares to five sectors rising a week earlier when four were ahead of the composite index's 1.3% gain. The underperformers last week: Energy (-2.3), Financials (-2.0), Consumer Staples (-1.2), Industrials (-1.0), Materials (-0.9), Health Care (-0.4), Utilities (-0.1), Consumer Discretionary (0.3), Communication Services (0.9), and Real Estate (1.2). The S&P 500 is up 13.9% ytd with 10 of the 11 sectors in positive territory, but only two ahead of the index. That's down from five sectors ahead of the index during mid-May. Information Technology is the best ytd performer, with a gain of 29.2%, ahead of Communication Services (23.6). These sectors are lagging the S&P 500 so far in 2024: Real Estate (-4.5), Consumer Discretionary (2.2), Materials (3.5), Energy (4.3), Industrials (6.0), Health Care (6.7), Consumer Staples (7.3), Financials (7.7), and Utilities (9.6).

US Economic Indicators

PPI (*link*): Both the headline and core PPIs were below expectations in May, with goods prices falling, while services prices were unchanged. *Final demand* fell 0.2% in May (vs 0.1% expected), following a 0.5% rise and a 0.1% fall the prior two months. May's yearly inflation rate was 2.2% (vs 2.5% expected), and down from 2.3% in April, which was the highest since April 2023; it was at a recent low of 0.8% in November. *Core prices* also showed signs of easing, showing no change for the month, slower than both the 0.3% increase expected and April's 0.5% gain. The yearly rate was 2.3% (vs 2.4% expected) and slower than April's 2.5%—which was the highest since last August. Excluding trade services from the core group, the rate was unchanged at 3.2% y/y—which was the highest since last April. *Final demand services* in May was unchanged, after jumping 0.6% in April, which was the biggest monthly gain since last July. Services' yearly rate edged down to 2.6% in May, after accelerating the prior four months from 1.8% in December (the lowest since January 2021) to a nine-month high of 2.8% y/y in April. *Final demand goods* fell 0.8%, the largest decline since October 2023's 1.2% shortfall, with a 7.1% drop in gasoline price accounting for nearly 60% of May's decline. Despite the fall, the yearly rate moved up for the fourth successive month, from -1.5% in January to 1.6% in May. The PPI for *personal consumption* accelerated to a 15-month high of 2.8% y/y in May, up from November's recent bottom of 0.9%, while the yearly rate for *personal consumption excluding food &*

energy rose from a recent low of 2.1% in November to 2.8% in May. The former and latter reached record highs of 10.4% and 8.1%, respectively, in March 2022.

Import Prices (*link*): May import prices unexpectedly fell, posting the first decline since the end of last year, as both fuel and nonfuel prices contributed to the decline. *Import prices* dropped 0.4% after an unrevised 0.9% surge in April. *Import fuel* prices sank 2.0% in May, after increasing 4.1% in April, posting the first decline since December's 8.0% drop, led by petroleum and natural gas prices. The yearly rate rose 7.9%, the highest rate since December 2022. *Nonpetroleum* prices fell 0.3% in May, the first decline since last October, after increasing 0.7% in April—which was the largest monthly increase since March 2022's 1.2% advance. Despite the decline, prices for nonfuel imports increased 0.5% y/y, slowing from April's 0.9%—which was the largest yearly increase since December 2022.

Consumer Sentiment Index (*link*): Consumer sentiment fell 3.5 points in mid-June, which is statistically insignificant and within the margin of error, according to the report. The *consumer sentiment index* fell to a seven-month low of 65.6 this month from 69.1 in May, though is currently 31% above the trough of 50.2 posted in June 2022. The *current conditions* measure sank 7.1 points in mid-June to 62.5, the lowest since December 2022, while the *expectations* measure dipped only 1.2 points to 67.6. Overall, consumers perceive few changes in the economy from May, though did note a dip in personal finances, reflecting concerns over high prices as well as weakening incomes. *Year-ahead* expectations held at 3.3% in mid-June, above the 2.3%-3.0% range seen in the two years prior to the pandemic. Meanwhile, long-term inflation expectations ticked up from 3.0% to 3.1%—with the report noting, "the June reading should be interpreted as essentially unchanged from May." Joanne Hsu, director of the survey of consumers, notes, "Long-run inflation expectations have been remarkably stable over the past three years but remain elevated relative to the 2.2-2.6% range seen in the two years pre-pandemic."

Global Economic Indicators

Eurozone Industrial Production (*link*): Eurozone industrial production unexpectedly fell in April, after rising the prior two months. *Headline* production, which excludes construction, edged down 0.1% (vs +0.2% expected) following gains of 0.5% and 0.1% the previous two months. It started the year on a down note, sinking 2.2%. Looking at the *largest Eurozone economies*, output was a mixed bag in April, rising in France (+0.6%) and Germany (+0.3), and falling in Italy (-1.0), while Spain production was flat during the month. Compared to a

year ago, production in the overall Eurozone fell -3.0%. Germany (-3.7% y/y) posted a steep decline in production, as did Italy (-2.9), while production in both Spain (1.1) and France (1.0) increased. Among the *main industrial groups*, consumer nondurable goods (3.4%), led by pack, followed by capital goods (0.7), consumer durable goods (0.3), and energy (0.4), while intermediate goods (-0.4) output fell during the month. *Compared to a year ago*, total production fell 1.0%, with only consumer nondurable goods (0.7%) in the plus column, while capital goods (-5.3%) production posted the largest decline, followed by consumer durable goods (-3.1), intermediate good (-2.0), and energy (-1.1) output.

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