**November 19, 2024**

# Morning Briefing

## On Sticky Inflation & Robust Consumers

*Check out the accompanying chart collection.*

**Executive Summary:** What if the Fed continues to cut the federal funds rate despite the strength of the economy? What's that going to do to inflation? Today, Eric explains that a second wave of high inflation isn't likely given expectations for a productivity growth boom that holds down unit labor cost inflation. But a legitimate worry is that inflation expectations could rise, keeping long-term bond yields elevated and eroding confidence in the Fed. … Also: Consumer spending has been strong, buoyed by growth in real wages as well as several sources of nonlabor income. We expect even stronger consumer spending up ahead.

**Weekly Webcast.** If you missed Monday's live webcast, you can view a replay *here*.

**US Economy I: Is 2.0% Inflation a Done Deal?** Both headline and core CPI inflation rates rose in October. Federal Reserve Chair Jerome Powell has often said the path to the Fed's 2.0% target is likely to be "bumpy," suggesting that the latest data and perhaps coming reports won't prevent the Fed from cutting interest rates further. Yet it doesn't look like one-off or transitory factors are driving inflation higher. In our opinion, there is a real risk that inflation is getting stuck above 2.0%. The bond market and federal funds rate (FFR) futures market appear to be sniffing this out.

We're not worried about a second wave of high inflation, as happened in the 1970s (*Fig. 1*). In fact, we see just 20% odds of an inflationary geopolitical shock upending the financial markets. However, there is a risk though that long-term bond yields remain elevated due to higher inflation expectations. An even bigger worry is that the Fed's credibility could be shaken if this persists for several quarters causing inflation expectations to become unanchored rising from around 2.0%-2.5% currently. That's not an expected outcome for the time being, but the risk to the financial markets is large enough that it is worth considering.

Here's how we're thinking about the inflation picture:

(1) *Supply*. Supply-side inflation largely eased by last year. The latest New York Fed's Supply Chain Pressure Index signaled easing from the pandemic snarls had faded, allowing CPI goods prices to fall ([*Fig. 2*]). China's property depression has also depressed the country's exports prices as the Chinese dumped goods in global markets to stimulate their economy.

Meanwhile, in the US, housing continues to be an issue in the CPI. October's shelter CPI increased to 4.9% y/y from 4.1% six months ago (*Fig. 3*). The index tends to be slow to pick up new lease rents inflation, which has been falling. As a result, many inflation watchers expected shelter CPI to continue disinflation. Yet it has been rising on a three-month annualized basis since July, suggesting it's unlikely to fall below 4.0% anytime soon. Arguably, this is a problem of the Fed's own making. Because interest rates were lowered to zero during the pandemic, many homeowners are reluctant to give up mortgages at rates around 3%, depressing existing home sales and boosting home prices to record highs (*Fig. 4*).

(2) *Demand*. It's an open question how much inflation would have fallen on its own without the Fed raising interest rates, given the supply-driven inflationary pressures. There's also debate over the extent by which stimulatory fiscal policy increased demand and exacerbated inflation. Regardless, economic growth has remained strong over the past two years even as inflation slowly fell toward 2.0%. Now the Fed is lowering interest rates, and the fiscal deficit may widen under Trump 2.0 as tax cuts come quicker than federal spending cuts. There may not be much more room for economic growth to accelerate without boosting inflation unless productivity growth continues to improve as we discuss below.

In fact, there's already evidence that consumer spending on goods is increasing. Real core retail sales hit a new record high in September and likely reached another record last month (*Fig. 5*).

PPI personal consumption services, which already exclude shelter, have accelerated as well, to 3.9% on a three-month annualized basis from 0.9% in September (*Fig. 6*).

(3) *Sticky prices*. CPI services less shelter, or the "supercore" CPI, increased from 4.3% in August to 4.5% y/y in October. That's two months of increases from already historically high levels. Fed Chair Powell referred to supercore inflation as possibly the best indicator of

underlying inflation in the economy back in November 2022. What's changed?

Wage growth appears to be accelerating too. Average hourly earnings for private workers rose from 3.6% in July to 4.0% in October (*Fig. 7*). Workers suffered from cumulative inflation since the pandemic, and the labor market is tight enough to demand higher wages.

(4) *Bonds*. Breakeven inflation expectations are rising, helping to push up long-term bond yields (*Fig. 8*). Strong growth has also pushed up real rates, or those on inflation-protected TIPS. The FFR futures market sees less reason for additional rate cuts, pricing in a long-run rate of around 3.7% and less than three 25bps cuts over the coming year (*Fig. 9*).

We think further rate cuts could push up demand and see the CPI settle closer to 2.5% than 2.0%. This suggests that the current federal funds rate is currently at its "neutral" rate. It seems our view is shared by some on the Federal Open Market Committee (FOMC). Dallas Fed President Lorie Logan said this in a *speech* last Wednesday: "When I look at the available evidence, though, I see substantial signs that the neutral rate has increased in recent years, and some hints that it could be very close to where the fed funds rate is now."

(5) *Productivity*. Despite the above, we're still not worried about a second wave of inflation. That's not because we believe the neutral FFR that's neither restrictive nor stimulative is much lower than the current 4.50%-4.75%. Rather, our Roaring 2020s scenario (55% subjective probability) is rooted in our expectation that productivity growth will boost real GDP while keeping a lid on unit labor costs inflation.

Q3's productivity data was revised upward significantly over the past few years. The 20-quarter percent change at an annual rate in productivity confirms that a productivity growth boom started during Q4-2015, when it was just 0.5%, rising to 1.9% by Q3-2024 (*Fig. 10*). We are expecting to see this growth rate rise to 3.0%-4.0% during the second half of the Roaring 2020s.

(6) *External risk*. We believe geopolitical risks that could lift goods and energy prices are lower under Trump 2.0. China's stimulus efforts appear to be falling flat and failing to revive global oil demand. America's reliance on OPEC+ countries is also reduced now that it is a major net energy exporter (*Fig. 11*). Trump's deregulation push is likely to further encourage domestic oil and gas production as well.

As long as productivity growth continues to rise, we don't see inflation rebounding as it did during the 1970s; back then, productivity growth fell almost to zero by the end of the

decade.

**US Economy II: Consumers Off to the Races?** As noted above, consumer spending has been quite strong. Retail sales rose 0.4% in October after an upwardly revised 0.8% increase in September (from a preliminary increase of 0.4%), meaning real personal consumption expenditures (PCE) were stronger than the reported 2.2% (saar) in Q3 and will likely increase faster in Q4 (*Fig. 12*).

Widespread fears that the depletion of pandemic "excess savings" would slow consumer spending failed to account for several tailwinds. Strong productivity growth has supported real wage growth, while higher interest rates, rents, and dividends have boosted nonlabor income (*Fig. 13*). We expect even stronger consumer spending up ahead.

Consider the following:

(1) *Credit*. According to the New York Fed, total household debt rose to a record $17.9 trillion in Q3 (*Fig. 14*). While consumer delinquencies are rising, they've only returned to pre-pandemic levels so far and remain low relative to history (*Fig. 15*). That makes sense considering that income growth has been so strong. Consumers broadly have been able to clean up their balance sheets since the pandemic, though deleveraging as a percentage of disposable personal income stopped in Q2 (*Fig. 16*). With incomes rising at a brisk pace and low credit outstanding relative to disposable personal income, there's plenty of room for consumers to finance major purchases like homes, autos, furniture, and appliances (*Fig. 17*).

(2) *Personal savings*. A large upward revision to the personal savings rate extinguished fears that the consumer would soon tap out. However, we weren't worried about low savings in the first place, as households tend to dissave when their net worth is increasing thanks to rising home and stock prices (*Fig. 18*). Frankly, we wouldn't be surprised if the savings rate turned negative by 2026. That's because, generally speaking, Baby Boomers—who collectively own $80 trillion of US households' $154 trillion of net worth—are enjoying their retirement years and spending, many without any wage income coming in (*Fig. 19*).

(3) *Hiring.* While layoffs have remained low, hiring has fallen (*Fig. 20*). We believe this is mostly due to fewer workers quitting their jobs as they settle in after a wave of job changes in the past few years. Additionally, businesses may have been reluctant to hire with so much uncertainty surrounding the election. Indeed, the NFIB Small Business survey's

uncertainty index rose to a record high recently (*Fig. 21*). We expect this measure to plummet as small business owners grow more certain and confident, which may result in more hiring. That would boost consumer confidence and incomes and likely drive even more spending.

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## Calendars

**US: Tues:** Housing Starts & Building Permits 1.34mu/1.44mu; Atlanta GDPNow 2.5%; Weekly Crude Oil Inventories. **Wed:** MBA Mortgage Application; Crude Oil Inventories & Gasoline Production; Bowman; Cook. (FXStreet estimates)

**Global: Tues:** Eurozone Headline & Core CPI 0.3%m/m/2.0%y/y & 0.2%m/m/2.7%y/y; Canada CPI 0.3%; China PBoC Prime Rate 3.10%; Buba Monthly Report; BoE MPC Treasury Committee Hearings; Mauderer; Balz; Elderson; Bailey. **Wed:** Germany PPI -0.1%; UK Headline & Core CPI 2.2%/3.1%y/y; UK PPI Input & Output 0.5%/-0.1%; UK House Price Index 2.9%y/y; ECB Financial Stability Review; Lagarde; De Guindos; Ramsden. (FXStreet estimates)

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## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): Forward earnings moved higher for just one of these three indexes during the November 15 week. LargeCap's forward earnings rose for a seventh week to a record high after falling for two straight weeks for the first time since December (when it fell for three straight weeks). LargeCap snapped its 37-week streak of record-high forward earnings during the September 13 week, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's was down for a third straight week as it dropped 0.3% w/w to 2.3% below its record high in early June 2022. SmallCap's was down for a sixth straight week to an eight-month low as it slipped 0.6% w/w to 12.5% below its mid-June 2022 record. Through the week ending November 15, LargeCap's forward earnings has soared 19.8% from its 54-week low during the week of February 1, 2023; MidCap's is 6.3% above its 55-week low during the week of March 10, 2023; and SmallCap's is 1.3% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and

the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's has improved faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.0%, 12.6%), MidCap (-0.8, 13.8), and SmallCap (-12.0, 17.7).

**S&P 500/400/600 Valuation** (*link*): Valuations fell during the November 15 week from multi-year highs a week earlier for these three indexes. LargeCap's forward P/E fell 0.4pt w/w to 21.8 from a 43-month high of 22.2. It's up 4.8pts from a seven-month low of 17.0 during the October 27, 2023 week and 6.7pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.4pt w/w to 16.4 from a 36-month high of 16.8. It's up 4.1pts from a 12-month low of 12.3 at the end of October last year and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E dropped 0.4pt w/w to 16.4 from a 40-month high of 16.7. It's up 5.8pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 24% discount to LargeCap's P/E is the lowest in six months and up from a 25-year-high 29% discount during the July 5 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 25% discount is at a 20-month low and up from a 24-year-low 34% discount during the July 5, 2024 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

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## US Economic Indicators

**NAHB Housing Market Index** (*link*): Builder sentiment increased in November for the third successive month after a significant move down in prior months. The *housing market index* (HMI) edged up 7 points in the three months ending November to a seven-month high of 46, after a four-month slide of 12 points (to 39 in August from 51 in April)—which was the lowest reading since December 2023. All three HMI components rose in November: sales expectations (+7 points to 64), traffic of prospective buyers (+3 to 32), and current sales (+2 to 49). (Any reading below 50 is considered negative.) Sales expectations is showing the most improvement in recent months, jumping 17 points from its recent low of 47 in June to 64 in November, while the traffic of prospective buyers (+7 points to 32) and current sales (+5 points to 49) components posted single-digit gains from recent lows. The November

survey indicates that the *share of builders cutting prices* was 31% in November, showing little change, hovering between 31% and 33% since July. Meanwhile, the average price reduction was 5% this month, edging down 6% last month. The percentage of builders using sales incentives ticked down to 60% this month from 62% last month.

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