LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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INFLATION IN-DEPTH

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KEY TAKEAWAYS

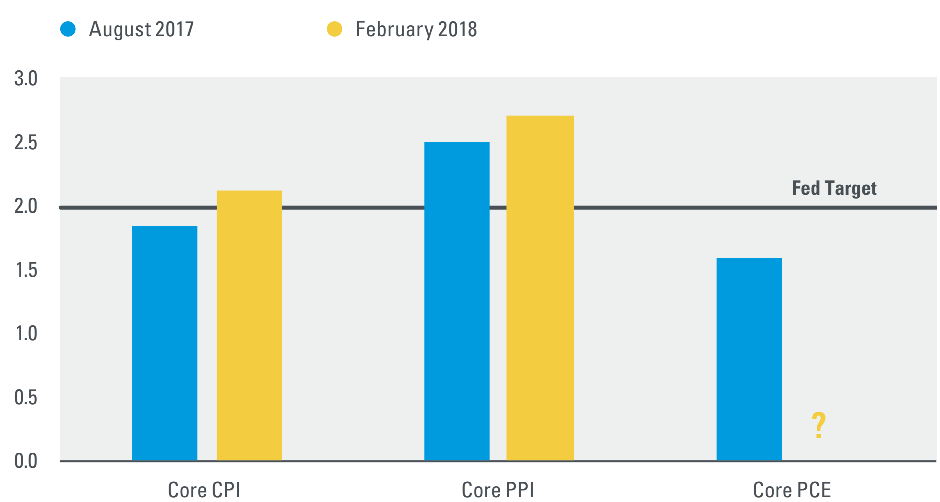
CPI and PPI moved higher in March, but inflation remains manageable.

Core PCE, the Fed's favored inflation measure, remains below the Fed's 2% target.

Inflation at current levels, even if sustained over the next few months, could result in a total of three Fed rate hikes in 2018.

Producer and consumer prices moved higher in March, but both remain manageable. Inflation has been a major topic for financial markets in 2018, with concerns initially sparked by a January wage growth number that exceeded expectations. Wage growth cooled somewhat in February and March, though it currently stands at 2.7% year over year, which remains toward the top of its post-financial crisis range. While faster wage growth is a good thing for workers, wages are one of the largest expenses for employers; and a strong move higher could lead companies to pass higher wage expenses on to consumers, potentially fueling inflation and causing the Federal Reserve (Fed) to become more aggressive with rate hikes. However, this domino effect hasn't happened so far. The latest readings for the Producer Price Index (PPI) and the Consumer Price Index (CPI) were released last week, and both moved higher, but remain at manageable levels. Perhaps more importantly for the Fed, core personal consumption expenditures (PCE)—the Fed's preferred inflation measure—remained well below the Fed's 2% target in February. March data (which will be released on April 30), would need to move significantly higher to even approach the Fed's 2% target [Figure 1].

1 CORE PPI AND CPI EXCEEDED 2% IN MARCH, BUT PCE WOULD HAVE TO JUMP SIGNIFICANTLY TO HIT FED TARGET



Sources: LPL Research, Bloomberg 04/16/18

CPI – Consumer Price Index; PPI – Producer Price Index; PCE – Personal Consumption Expenditures

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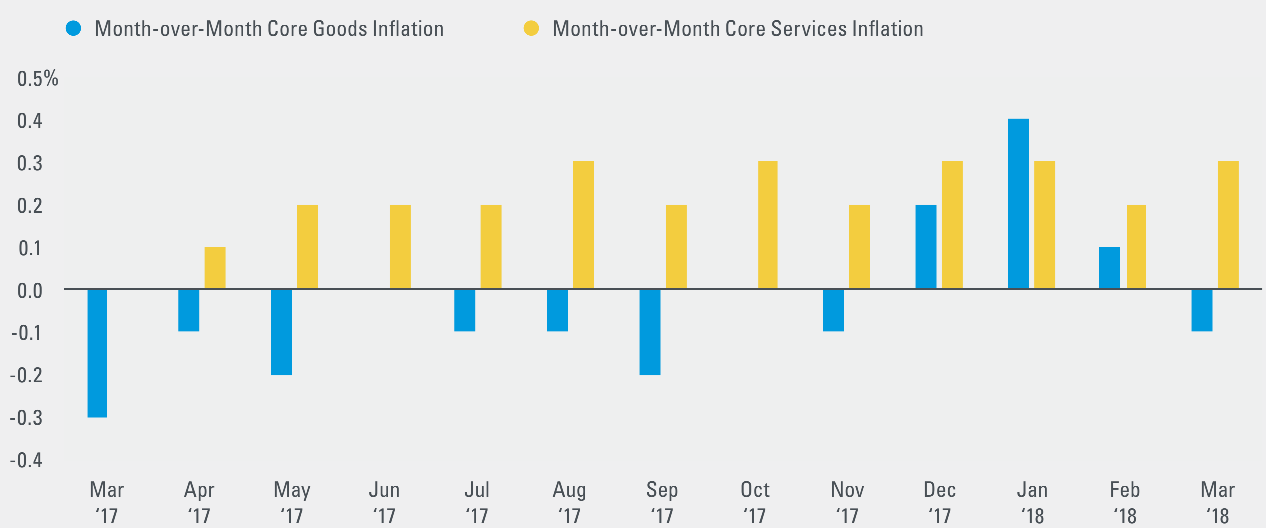
WHAT'S DRIVING CPI?

Headline CPI missed expectations on a month-over-month basis, with falling energy prices causing a -0.1% decline in the headline number versus expectations of a flat reading. However, the reading met expectations on a year-over-year basis, at 2.4%. Core measures, which exclude the impact of energy and food prices, rose 0.2% month over month, bringing the year-over-year reading to 2.1%. This was the highest level for core CPI since February 2017. We would note that even though core CPI has increased in recent months, it remains low relative to history, and at current levels may not cause a more aggressive Fed.

Figure 2 shows the seasonally adjusted month-over-month change in core goods and services within the CPI basket, and clearly illustrates that services continued to be the major driver of inflation in March. This has been the case for some time as increased wages have pressured core service prices, due in part to minimum wage increases in some areas of the country. Core goods, however, have seen a sustained decrease in price, and have been acting as a drag on overall inflation.

The chart also shows that the year-over-year increase in core inflation may have been at least partly due to an easy comparison versus March 2017. Core services inflation in March 2017 was driven lower by a steep decline in wireless telephone services (-0.7% month over month, or -11.4% year over year). Wireless service makes up just 1.8% of the CPI basket, but the price drop was large enough to catch the attention of the Fed last year, who stated the group was one of the transitory factors that were pressuring inflation lower. Year-over-year comparisons will remain easy for the next couple of months, which may allow core inflation to remain in its new higher range as we head toward the middle of the year. The Fed is well aware of these factors, which is why they generally look beyond headline numbers when making monetary policy decisions.

2 CORE SERVICES INFLATION HAS EXCEEDED CORE GOODS INFLATION IN RECENT MONTHS



Source: LPL Research, U.S. Bureau of Labor Statistics 04/16/18

Core inflation is a measure of inflation that excludes certain items that face volatile price movements.

Illustration is historical and no guarantee of future results.

WHOLESALE PRICES INCREASING

PPI, which measures wholesale prices received by producers and uses a different basket of products than CPI, also accelerated last month. Headline PPI came in at 3.0% year over year, versus a consensus expectation of 2.9%. The core reading increased to 2.7% year over year, again exceeding expectations of 2.6%. The latest core reading was the highest since November 2011, and the gains were fairly broad. Nevertheless, a few items stuck out, including cable and satellite services, outpatient medical care, airline services, and rail transportation and trucking. The trucking industry in particular has been dealing with a widely publicized driver shortage and a related increase in shipping costs for some companies and industries. It is possible that over time rising wholesale prices will be passed on to consumers, and if so higher PPI readings could start to put upward pressure on CPI. This hasn't happened at this point, but it is something we continue to watch.

Some may wonder if the threat of tariffs is having any impact on inflation so far. However, there wasn't any mention of the impact of steel and aluminum tariffs, which took effect on March 23, 2018, in the March PPI report, suggesting there was little impact. Import prices for March, which were also released last week, missed expectations slightly (+3.6% year over year versus expectation of +3.8%), and also showed few signs of tariff impact. However, the majority of announced tariffs have yet to be implemented (and whether those will be implemented at all remains in question), so we will continue to monitor developments moving forward.

CONCLUSION

Though CPI and PPI moved higher in March, the moves were moderate and do not reflect a major increase in inflation pressure. We would likely need to see a significant move higher for PCE inflation (currently at 1.6% year over year), or wage inflation nearing 4% before we would expect a more aggressive path of rate hikes from the Fed. Inflation may remain near current levels or even move moderately higher in the coming months, due to easy year-over-year comparisons as well as fading transient factors such as the sharp decrease in the wireless phone services industry this time last year. However, we don't expect it to move high enough in the near term to impact the broader economy. We continue to expect U.S. gross domestic product growth of up to 3% for the full year.* Similarly, we don't expect inflation to reach levels that will cause a more aggressive Fed in the near term, and continue to expect a total of three rate hikes in 2018. ■

IMPORTANT DISCLOSURES

*LPL Research projects real gross domestic product (GDP) growth of around 3% in 2018. This is in line with historical mid-cycle growth of the last 50 years. Economic growth is affected by changes to inputs such as business and consumer spending, housing, net exports, capital investments, and government spending.

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Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Personal consumption expenditures (PCE) is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, nondurables, and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.

INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

Core CPI is a subset of the total Consumer Price Index (CPI) that excludes the highly volatile food and energy prices. It is released by the Bureau of Labor Statistics around the middle of each month. Compare to Personal Consumption Expenditures (PCE); Core PPI; Producer Price Index (PPI).

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