Financial Market Weekly

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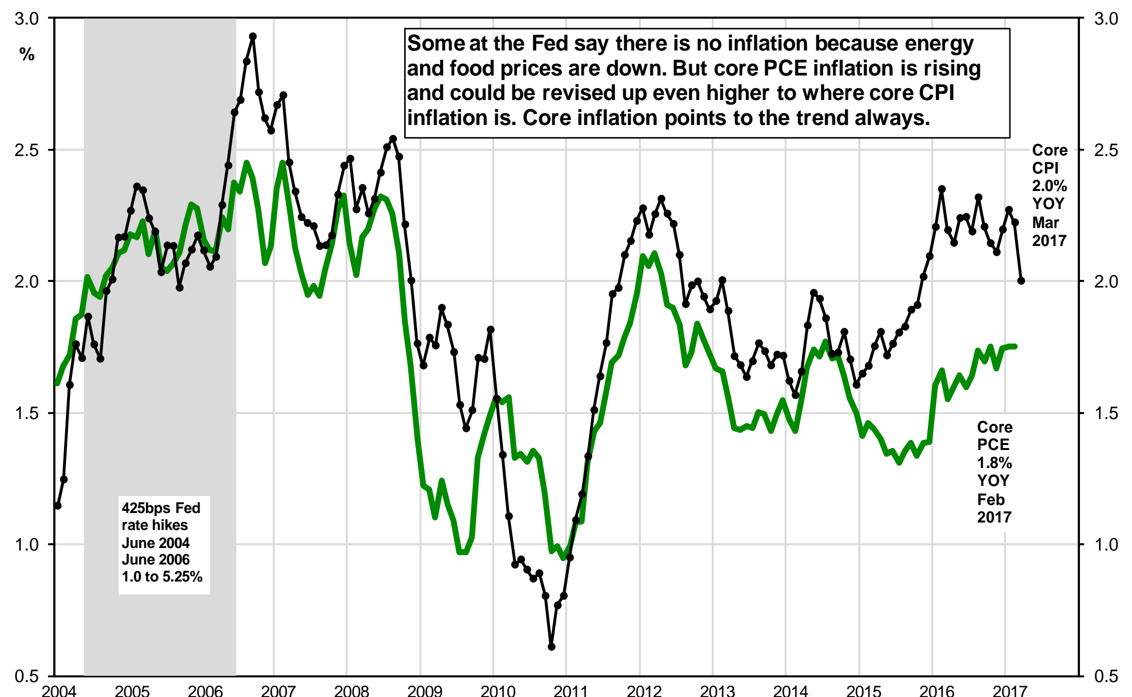
NOT MY INFLATION

Before we go off-message, in some other direction, this week's topic is meant to be all about the wrong inflation indicator the Fed is using. They like PCE inflation, which doesn't move much. The babyboom's social security benefits are indexed to CPI inflation. If the Fed was using CPI inflation as their preferred measure of inflation, inflation, like the 4.5% unemployment rate, would have met their objective already. And when they meet both objectives interest rates should be normal. Should be normal except they came up with a new reason to justify rates not going to be at 3% "normal" levels until the end of 2019. Wait for it. The delay in rates normalization being not inflation especially (it's close enough), and certainly not the too-low 4.5% unemployment rate, the delay is something to do with the zero natural rate of interest that used to be 2% in the Taylor Rule. Why is the natural rate thought to be zero now and not 2%? They have some theoretical models along with the observation that if interest rates were actually low enough, then investment spending would be much, much stronger. They never stopped to think apparently that the level of interest rates might lose its effect on companies' investment decision-making over time:



PCE inflation 2.1% YOY (February)
Core PCE 1.8% YOY
CPI inflation 2.7% YOY (February
Core CPI 2.2% YOY

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especially when the cost of borrowing to invest is left down at zero since December 2008. Business spending on equipment and R&D looks fully recovered to us and then some. We aren't going to see "more investment" in this economic expansion, we would wager.

But we digress, it was bound to happen, and this week we will look at the difference between CPI and PCE inflation, and look at the longer-run track record of PCE inflation. First, is Not My Inflation. When Greenspan switched inflation measures for the Committee, if not the rest of the world way back in February 2000, only a cynic would say it was to show the markets that see, there isn't an inflation problem out there. In the year 2000, CPI inflation was 3.4% and PCE inflation was 2.5%, a pretty big difference of 0.9 percentage point. (And don't ask about the differences in core inflation that Fed Chair Yellen all of a sudden likes: core PCE inflation which never moves much generally, up or down, we will get to that later.)

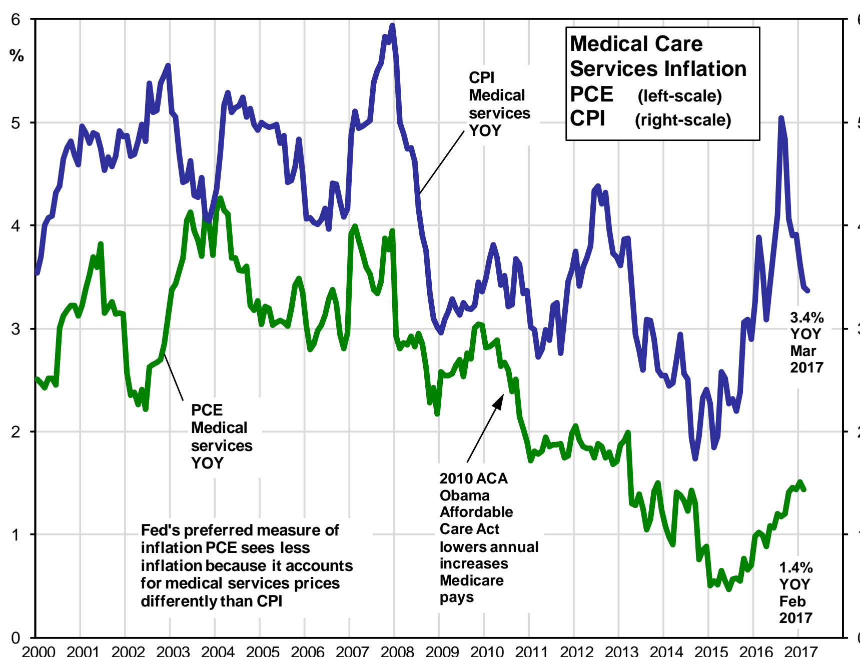
So what accounts for the difference in core consumer inflation, CPI higher versus PCE lower. Well, PCE inflation gets revised as the text box here from February 2000 says is one of the strong points it has going for it. Okay, then let's see when we get the annual benchmark revision to real GDP this year on July 28, or more strictly the personal income report a day later. The problem with core PCE inflation is that the trend is obviously different than it was in 2004-06 when the Fed "found" inflation and was raising interest rates. That's right, core PCE inflation and core CPI inflation were pretty close for once in indicating an "inflation problem." Now of course, core CPI has been above 2.0%, the Fed's target, for over a year (ignore this month: March, please for now), while core PCE has come up short.

Why is core PCE less than core CPI inflation. Maybe there is something else to blame Obamacare for if you are looking for more reasons. Obamacare has held down medical

Fed drops CPI and shifts to PCE inflation in February 2000
[PCE finds less inflation in America.]

In past Monetary Policy Reports to the Congress, the FOMC has framed its inflation forecasts in terms of the consumer price index. The chain-type price index for PCE draws extensively on data from the consumer price index but, while not entirely free of measurement problems, has several advantages relative to the CPI. The PCE chain-type index is constructed from a formula that reflects the changing composition of spending and thereby avoids some of the upward bias associated with the fixed-weight nature of the CPI. In addition, the weights are based on a more comprehensive measure of expenditures. Finally, historical data used in the PCE price index can be revised to account for newly available information and for improvements in measurement techniques, including those that affect source data from the CPI; the result is a more consistent series over time. This switch in presentation notwithstanding, the FOMC will continue to rely on a variety of aggregate price measures, as well as other information on prices and costs, in assessing the path of inflation.

Inflation in the year 2000
CPI 3.4% PCE 2.5% Diff +0.9
Core 2.4% Core 1.7% Diff +0.7



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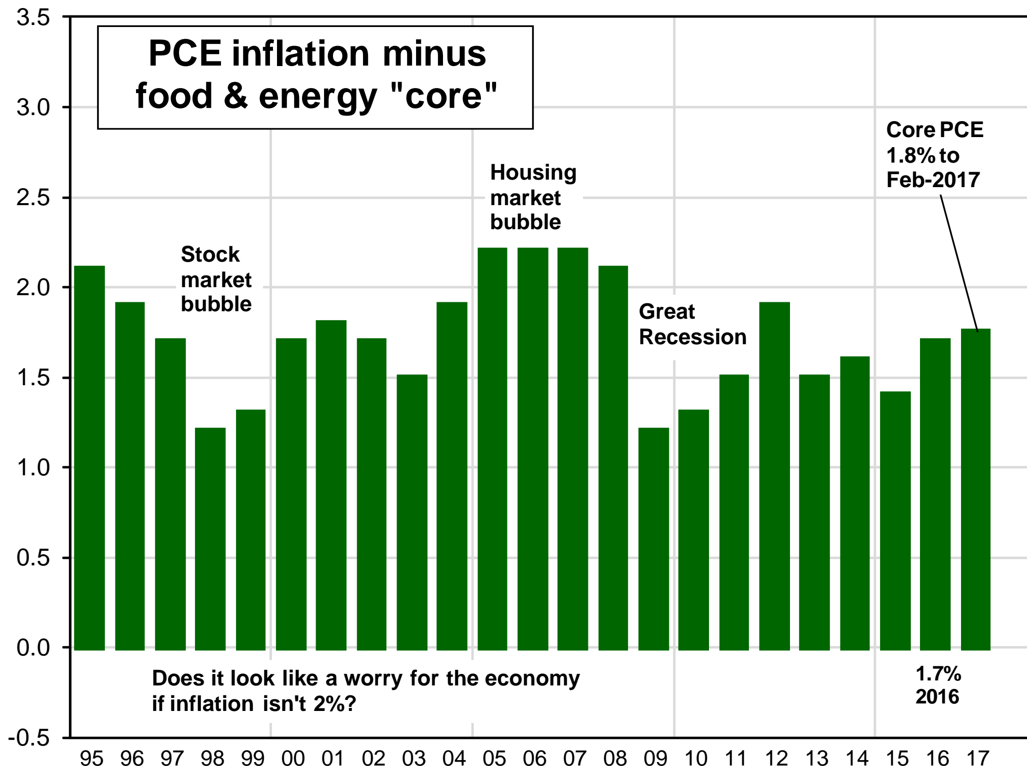
costs as measured in the PCE inflation index. CPI medical care services measures the costs that consumers pay out of pocket so it basically does not include medical care services paid by Medicare. Medical care services inflation in PCE inflation is much slower at 1.4% YOY in February (4.1% for medical services in CPI), and medical care services had a gigantic weight in core PCE of nearly 20% versus a weight of just 8% in core CPI goods and services. Do you spend 20% of your non-food and energy expenditures on health care services? We hope not. This distortion in health care inflation is the major reason core PCE inflation of 1.8% YOY in February has not hurdled the Fed's 2% target.

Despite all that has been written about "inflation," it hasn't gone very high or very low for two decades.



Conclusion: The Fed's preferred inflation measure is fatally flawed. Core PCE inflation is 1.8% YOY short of the Fed's target. If their preferred inflation saw medical care services prices running at a faster CPI measured pace of 3.4%, then core PCE inflation would be an on-target 2.2%. And there is still a chance that core PCE inflation will be revised higher this year as well when the annual GDP benchmark revision comes out on July 28 this year. Back in 2005, both CPI and PCE inflation indicated interest rates should be normal. Now CPI inflation is back above target while PCE inflation is lagging somewhat; we find the Fed's failure to acknowledge this finding troubling. It tells us their reasoning is bent over backwards in trying to find reasons to keep interest rates low. We don't think monetary policy has a role to play right now in the economy. The economy does not need the support of the central bank. Not when the current economic expansion enters its ninth year in July.

MARKETS OUTLOOK

	31-Mar 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
30-Yr Treasury	3.03	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10	4.20
10-Yr Note	2.40	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90	4.00
5-Yr Note	1.93	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70	3.90
2-Yr Note	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.20	3.35	3.35	3.50
3-month Libor	1.15	1.50	1.70	1.95	2.20	2.45	2.70	2.95	3.20	3.45	3.45	3.70
Federal Fund Rate	1.00	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50
2s/10s spread	115	100	95	100	95	90	75	70	60	55	55	50
Libor/funds spread	15	25	20	20	20	20	20	20	20	20	20	20

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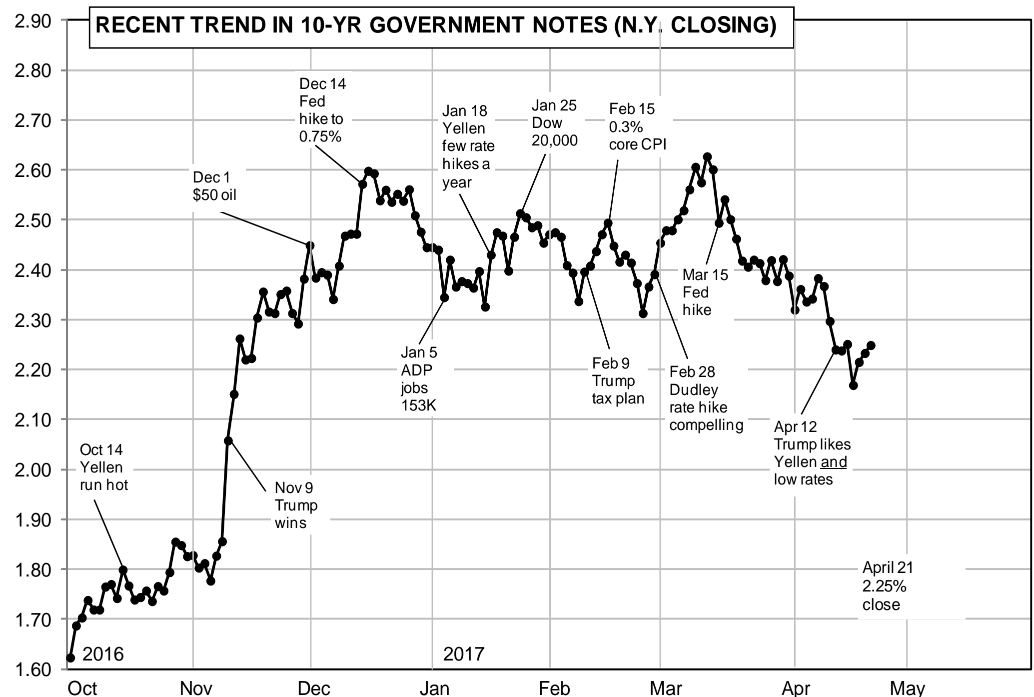
Bonds yields made a new low this week for the rally that began from 2.63% on March 14 this year. The Dow industrials fell back 113 points on Tuesday this week after Monday's 183 point rally. On Tuesday, the U.K. called early elections and European stocks fell; here in the good old USA earnings reports from Johnson & Johnson and Goldman Sachs gave stock traders an excuse to sell. 10-yr yields fell as low as 2.16% on Tuesday intraday making the total yield move from March 14 top to bottom totaling 47 bps.



FEDERAL RESERVE POLICY

The Fed meets May 2-3 to consider its monetary policy. This is a non-regularly scheduled press conference meeting so no action is expected. The median Fed forecast made at the March meeting looks for three rate hikes this year. They've done one 25 bps rate hike to 1.0%, and now have two more left to go, presumably at one of the three remaining meetings with press conferences in June, September, and December.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	19-Apr	12-Apr	5-Apr	29-Mar	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2464.638	2464.546	2464.454	2464.335	479.782
Federal agency debt securities	11.829	13.329	13.329	13.329	0.000
Mortgage-backed securities	1776.917	1781.091	1769.122	1769.118	0.000
Primary credit (Discount Window)	0.043	0.001	0.000	0.000	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	1.708	1.708	1.718	1.707	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	0.000
Central bank liquidity swaps	0.035	0.045	5.075	1.007	62.000
Federal Reserve Assets	4525.6	4530.7	4520.8	4515.7	961.7
3-month Libor %	1.16	1.16	1.15	1.15	2.82
Factors draining reserves					
Currency in circulation	1541.322	1540.933	1540.054	1536.334	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	116.567	105.528	174.644	260.357	0.000
Reserve Balances (Net Liquidity)	2256.670	2367.767	2337.776	2269.984	24.964
Treasuries within 15 days	14.058	0.460	0.460	13.559	14.955
Treasuries 16 to 90 days	46.550	59.336	59.336	46.911	31.549
Treasuries 91 days to 1 year	200.648	201.692	201.689	183.368	69.272
Treasuries over 1-yr to 5 years	1194.549	1194.562	1194.547	1216.893	170.807
Treasuries over 5-yrs to 10 years	381.191	381.007	380.988	376.236	91.863
Treasuries over 10-years	627.642	627.489	627.435	627.368	101.337

**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

Fed Vice Chair Fischer reiterated the party line in a CNBC TV interview on Friday. "Two more rate hikes this year sound about right." Thanks for that. June, September, December. Which one exactly? Growth seems slow right now looking at the 16.5 million annual rate of car sales in March relative to 18.0 million in Q4 2018, the final quarter of the Obama administration. Core CPI fell 0.1% in March, the headlines reading "first decline since January 2010," [check it, check it out for yourselves] in a report on Good Friday when the markets were closed. Core CPI falling 0.1% in March doesn't sound like inflation is advancing at a faster pace; even if the year-on-year rate is still 2.0% (exactly). Fed funds futures odds of a June Fed meeting rate hike were 44% on Friday, April 21 versus the 50/50 chance seen in the close before Good Friday. June doesn't appear very likely based on the "data" or the market's expectations. Fischer's

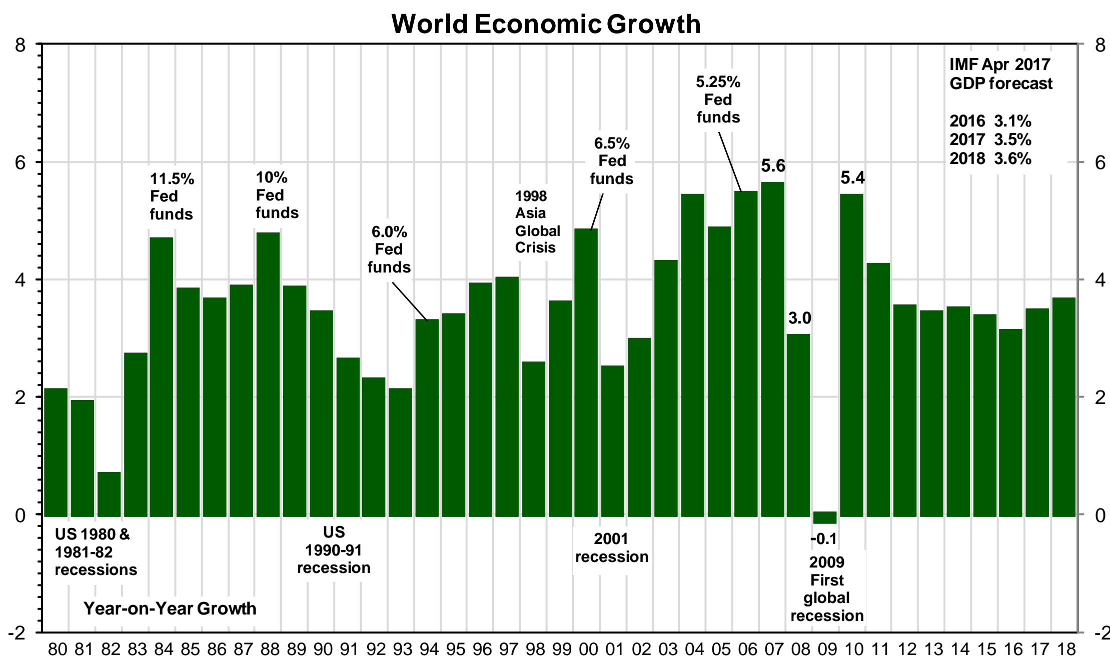
comments echo the relative optimism heard in the hallways of the IMF Spring meetings in Washington this week that have everyone attending feeling more confident about the world economy. World economic growth was revised up a tenth in 2017 to 3.5% (3.460%) in the April forecast from 3.4% (3.442%) in the October 2016 forecast. Doesn't sound like a lot to be optimistic about. Basically, Europe, U.K., and Japan are doing better than they were in October. China too.

But back to the Fed after the good-feelings about world growth this week at the IMF meetings. Again, is the June 13-14 Fed meeting a possibility for a rate hike? The market odds are low at 44% now, but could always swing back to yes, yes, yes. We view a rate hike as still possible in June. In fact, we are forecasting a rate hike looking at the table above, keeping in mind interest rate forecasts have become more like political statements. You say it and hope you can convince others it is true. The rates cycle is broken since the Fed left rates at zero for so long. The forecast is for rates to return to normal. Period. Then we'll make a new rates call from there.

IMF Forecasts for 2017

	Apr 2017	Oct 2016	Difference
World	3.5	3.4	0.1
U.S.	2.3	2.2	0.1
Euro area	1.7	1.5	0.2
Germany	1.6	1.4	0.2
France	1.4	1.3	0.1
Italy	0.8	0.9	-0.1
Spain	2.6	2.2	0.4
U.K.	2.0	1.1	0.9
Japan	1.2	0.6	0.6
China	6.6	6.2	0.4

What economic reports are left to inform Fed officials about the outlook before the next Live Meeting June 14 decision announcement date, seeing as policy is data dependent and not on a preset course? Ahead then, and it is only employment and inflation: the March PCE inflation report on Monday, May 1 (February was 2.1% PCE and 1.8% core), the April Employment report on Friday, May 5, the April PCE inflation report on Tuesday, May 30, and the May Employment report on Friday, June 2. See, the odds are low at 44% now for a June meeting hike, but there are a lot of U.S. economic data updates (4 majors) to come. A long way to go before the Fed's June 14 decision gets firmed up.



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