Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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The Inflation/Employment Puzzle

Mother Nature upended the economic landscape during the late summer months, as Hurricanes Harvey and Irma wreaked havoc along the Gulf Coast. The humanitarian toll, of course, was the most troubling consequence of the storms; millions of Americans endured severe property damage, if not outright destruction, while countless others either perished or suffered bodily harm. As was the case following Hurricanes Katrina and Sandy, the emotional and financial scars from the latest storms will take years to mend. While the economy also took a hit, the impact should be temporary and the recovery easier than that facing the unfortunate victims of the weather-related devastation.

The cost to the economy in terms of lost sales, output and worker hours will not be known for some time. Private and government statisticians will probably not have a full reckoning until next year. From our lens, the storms took a meaningful bite out of the economy's growth rate in the third quarter, perhaps lowering it from a pre-hurricane consensus forecast of 2.7 percent to about 2.0 percent, with all of the damage inflicted in August and September. No doubt, some of the lost activity will never be recovered. A haircut not taken in late August is unlikely to be replaced by two visits to the barber in September. Likewise, a restaurant customer is not likely to replace a lost meal with two trips to a favorite eating place

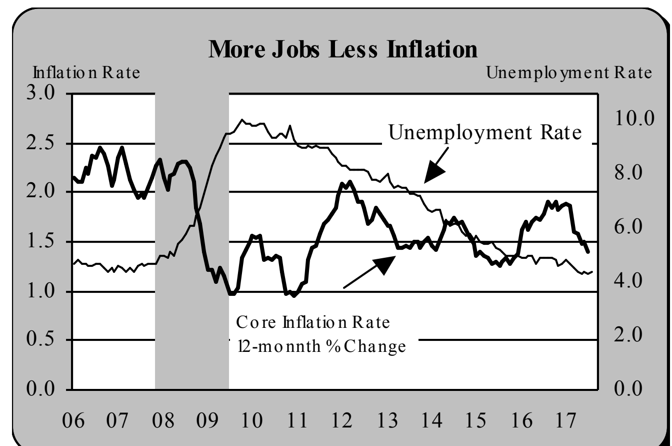
But the vast majority of lost sales and output will be made up in coming months. The rebuilding efforts, in turn, will add muscle to the economy's growth rate in the fourth quarter, boosting the demand for construction materials and workers as well as for goods and services from an array of related industries supporting the rebuilding process. Even the auto industry, which has seen sales languish this year, will get a boost as owners replace the estimated half-million vehicles wiped out by the hurricanes. It remains to be seen if the rebound from the weather-related setback is strong enough for the Federal Reserve to pull the rate-trigger in December, fulfilling its planned three hikes this year. Assuming that growth does accelerate, the Fed will still need evidence that inflation is moving higher to justify an increase. Despite the recent inflation lift from a temporary storm-induced spike in gasoline prices, that prospect remains more of a hope than reality.

Hawks Versus Doves

When the minutes of the Federal Reserve's September 19-20 policy-setting committee is released three weeks after the meeting, expect to see much discussion about why inflation has remained persistently low in the face of an ever-tightening job market. The issue has been a major point of contention between Fed officials that want to keep rates low and those favoring preemptive rate increases to stave off an inflation flareup down the road. The inflation hawks believe that it is only a matter of time before the tight labor market stokes wage and price inflation. Their view is based on a time-honored relationship, known popularly as the Phillips Curve, in which inflation rises as the unemployment rate declines and vice versa when unemployment increases.

The doves, however, argue that the historical pattern has broken down. They point to the fact that inflation has not only failed to increase in the face of declining unemployment, but has actually receded in recent months, almost a year after the jobless rate has fallen to a level widely considered to be consistent with full employment. That rate, which the Federal Reserve pegs at 4.6-4.8 percent, was initially hit in October 2016; in August, the jobless rate stood at 4.4 percent. Yet core inflation, as measured by the Fed's preferred gauge - the personal consumption deflator excluding food and energy prices - has fallen from an annual rate of 1.9 percent last October to 1.4 percent this summer. The rate has remained below the Fed's inflation target of 2 percent in every month since April 2012.

The doves believe that continuing to raise rates in a misguided attempt to stifle future inflation only risks choking off the recovery. Their view, supported by some notable Fed officials, is that inflation may have been driven permanently lower due to forces that are not fully understood and, hence, there is little harm in letting the economy run hotter for a while longer. Some also believe there is still considerable slack in the labor market despite the low unemployment rate, which does not capture the millions of workers who dropped out of the workforce but might want a job.



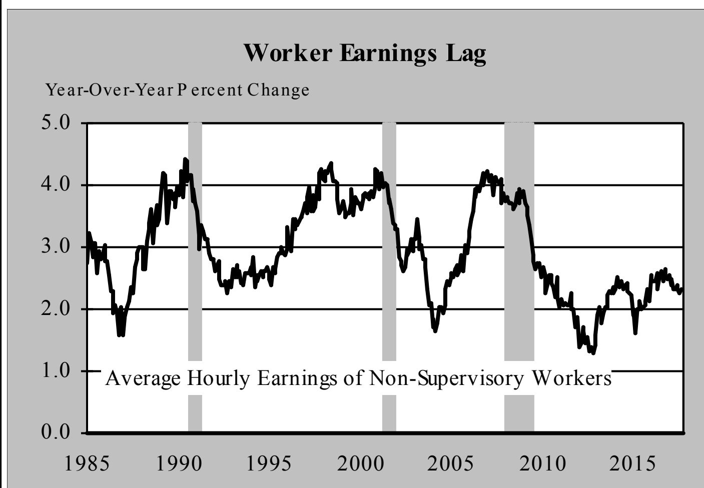
The hawks, however, assert that inflation's rise to the 2 percent target is just being temporarily delayed by some transitory factors, such as declining prices on cell phone plans. They are concerned that maintaining ultralow rates for too long is sowing the seeds of even more virulent inflation that will require harsher growth-killing interest rate increases later on.

No Wage Inflation

At this point, it is a toss-up as to whether the Fed will pull the rate trigger in December. As noted, the hurricanes are distorting the economic data, making it difficult to interpret the fundamental trends in growth and inflation at least through October. Still, by the December meeting, the noise in the data will have mostly subsided and the Fed should have a better sense of where the economy stands. One thing is clear: the Fed is strongly committed to normalizing monetary policy by unwinding the extraordinary measures taken to lift the economy out of the Great Recession and financial crisis. At the September meeting it announced that beginning in October it would start reducing its massive $4.2 trillion portfolio of securities accumulated since the depths of the recession in 2008.

The balance sheet reduction had been telegraphed well in advance and came as no surprise to the financial markets. The process is intended to be gradual and predictable and designed to have a minimal impact on the markets. But predicting the timing of the next Fed rate increase is more of a challenge because the main sticking point - too-low inflation - remains a divisive influence among policy makers. At the core of the dispute is whether the historical trade-off between low unemployment and inflation is still relevant, given the breakdown in the relationship in recent years.

Perhaps the first place to look for answers is labor costs, which have been unusually restrained throughout the recovery. For the past 5 months, the annual increase in worker earnings has been stuck at 2.5 percent; that's slightly higher than earlier in the recovery but well below the roundly 4.0 percent increases seen at this late stage of the last three business cycles. Historically, wage and price inflation go hand-in-hand, as labor costs are the biggest expense of employers. The more workers get paid and assuming their productivity does not increase, the more companies need to lift prices to protect profits. Not coincidentally, the 2.5 percent increase in workers earnings less 1.1 percent trend productivity growth since the recession translates into a 1.4 percent inflation rate, which is virtually spot-on with the current rate.



A Truck Full of Reasons

The biggest puzzle is why wage inflation has not gained traction in the face of an ever-tightening job market. While there are many theories, all have their critics. The argument that the 4.4 percent unemployment rate overstates the tightness in the labor market because it doesn't count workers on the sidelines has some credibility. But it also flies in the face of widespread labor shortages reported by a growing number of companies. Both arguments may be valid, as the dichotomy may simply be that the sidelined workers do not have the skills demanded by employers.

Evolving demographics could also explain the sluggish wage growth. The workforce is aging, and retiring baby boomers, who are in their peak earning years, are being replaced by younger workers who are less well compensated. This compositional change is dragging down the growth in average wages for all workers. Indeed, another measure compiled by the Federal Reserve Bank of Atlanta that tracks wages for the same worker over a twelve month period shows that earnings have increased by a more robust 3.5 percent through August, a full percentage point higher than for average wages.

Finally, with inflation remaining low, worker paychecks are going a longer way. Hence, while nominal wage growth has been stuck at 2.5 percent over the past five months, the annual growth rate in real wages has doubled, from 0.3 percent to 0.6 percent. If, in fact, workers expect inflation to stay low or even recede further, they would conceivably be more content with slimmer wage increases than if inflation was taking a bigger bite out of their purchasing power. One Fed official strongly believes that declining inflation expectations has tilted the inflation trend lower.

Danger Zone

To be sure, there is nothing inherently wrong with a 1.5 percent inflation rate that remains stable in the face of a tightening labor market. However, that happy confluence is not likely to persist. One danger is that the persistence of low inflation will drive inflation expectations lower and cause a change in spending behavior. Consumers would then withhold purchases in anticipation of lower prices, which not only lowers growth but heightens the risk that a deflationary spiral would gain traction. With interest rates still historically low, the Fed would have little ammunition to fight that threat. This prospect, of course, argues for a continued easy policy until inflation and inflation expectations show clear signs of increasing.

The other danger is that with the labor market close to if not at full employment, the seeds of an inflation outbreak have already been sown. Fed officials like to say that monetary policy affects the economy with a lag. That means preemptive rate increases are required now to short-circuit inflation before it becomes too virulent to contain without bringing on a recession. The Fed has a history of overstaying an easy policy, stoking an inflation upsurge that forced it to clamp down harshly on the monetary brakes. Indeed, 8 of the last 11 recessions have been preceded by catch-up rate increases that eventually stifled growth. No doubt, the economy would survive another quarter-point rate increase in December. But if the low inflation/low unemployment puzzle is not resolved soon, the risk is that policy decisions in 2018 will veer in the wrong direction with harmful consequences for the U.S. economy.

KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	August	July	June	May	April	March	February	12-Month Range High	12-Month Range Low
Prime Rate	4.25	4.25	4.13	4.00	4.00	3.88	3.75	4.25	3.50
3-Month Treasury Bill Rate	1.01	1.07	0.98	0.89	0.80	0.74	0.52	1.07	0.29
5-Year Treasury Note Rate	1.78	1.87	1.77	1.84	1.82	2.01	1.90	2.01	1.13
10-Year Treasury Note Rate	2.21	2.32	2.19	2.30	2.30	2.48	2.42	2.49	1.56
30-Year Treasury Bond Rate	2.80	2.88	2.80	2.96	2.94	3.08	3.03	3.11	2.26
Tax-Exempt Bond Yield	3.48	3.56	3.55	3.76	3.78	3.90	3.91	3.91	2.85
Corporate Bond Yield (AAA)	3.63	3.70	3.68	3.85	3.87	4.01	3.95	4.06	3.32
Conventional 30-Year Mortgage Rate	3.88	3.97	3.90	4.01	4.05	4.20	4.17	4.20	3.44
Dow Jones Industrial average	21914	21581	21318	20937	20685	20823	20424	21914	18185
S&P 500 Index	2456	2454	2434	2395	2359	2367	2330	2456	2143
Dividend Yield (S&P)	2.00	1.99	1.99	2.00	2.01	2.01	2.01	2.17	1.99
P/E Ratio (S&P)	21.2	21.2	20.9	21.4	21.2	21.1	21.8	21.8	19.9
Dollar Exchange Rate (vs. Major Currencies)	88.20	89.60	91.8	93.2	94.0	94.5	94.0	95.4	88.2

** Monthly Averages*

ECONOMIC INDICATORS

	August	July	June	May	April	March	February	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1180	1190	1217	1129	1154	1189	1288	1328	1062
New Home Sales (Thousands of Units)		571	630	618	590	638	615	638	548
New Home Prices (Thousands of Dollars)		314	312	323	311	322	298	333	234
Retail Sales (% Change Year Ago)	3.4	3.5	3.1	4.2	4.5	4.8	4.7	5.6	2.1
Industrial Production (% Change Year Ago)	1.5	2.4	2.1	2.3	2.1	1.4	0.4	2.4	-1.3
Operating Rate (% of Capacity)	76.1	76.9	76.7	76.6	76.6	75.9	75.8	76.9	75.5
Inventory Sales Ratio (Months)		1.38	1.38	1.37	1.37	1.37	1.37	1.41	1.37
Real Gross Domestic Product (Annual % Change)			3.0			1.2		3.0	1.2
Unemployment Rate (Percent)	4.4	4.3	4.4	4.3	4.4	4.5	4.7	4.9	4.3
Payroll Employment (Change in Thousands)	156	189	210	145	207	50	232	249	50
Hourly Earnings (% Change Year Ago)	2.5	2.5	2.5	2.5	2.5	2.6	2.8	2.9	2.5
Personal Income (% Change Year Ago)		2.7	2.7	3	2.9	3.4	3.4	3.4	1.5
Savings Rate (Percent of Disposable Income)		3.5	3.6	3.8	3.7	3.9	4.1	4.9	3.2
Consumer Credit (Change in Mil. Of Dollars)		18499	11827	17925	12719	14266	18713	25097	11372
Consumer Prices (% Change Year Ago)	1.9	1.7	1.6	1.9	2.2	2.4	2.7	2.7	1.1
CPI Less Food & Energy (% Change Year Ago)	1.7	1.7	1.7	1.7	1.9	2.0	2.2	2.3	1.7
Wholesale Prices (% Change Year Ago)	2.4	1.9	2.0	2.4	2.5	2.3	2.2	2.5	0.0

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