CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

May 10, 2019

While the on-again, off-again US/China trade deal has stolen the spotlight this week, and dominated trading, April CPI is out this morning and that will have repercussions for the market and for the Fed. Overall CPI gained 0.3% for the month but below the 0.4% expectation while year-over-year it increased 2.0%, also missing by one-tenth the 2.1% expectation but that's up from 1.9% in March. The less volatile core CPI (ex-food and energy) rose 0.1% which also missed by a tenth the 0.2% forecast but the year-over-year gain matched expectations at 2.1% which is up from 2.0% in March. In summary, it's a fairly as-expected read on inflation with a slight uptick in April that halts, at least for a month, a slide that began in mid-2018 which was exacerbated by a year-end plunge in oil prices. Those prices have reversed in 2019 and that is finally being reflected in inflation readings that are beginning to edge higher. But does the report indicate inflation momentum is building enough to put thoughts of a rate cut on the back burner? And what does this portend for the Fed and for yields in general? For answers to those questions read on below.

The sudden flaring of trade tensions this week between the U.S. and China has taken the spotlight away from the April CPI report but that doesn't take away the consequences once the trade dust-up is settled one way or another. At present, stocks are repricing for the possibility that the expected trade deal falls apart, or is, at least, delayed for some unknown period of time. Pricing in the impact of tariffs rising from 10% to 25% on $200 billion in Chinese goods and new 25% tariffs on a second group of goods totaling $325 billion is ongoing as we sit here today.

Some estimates are pegging the worst case scenario of the above tariffs as wiping out the previous estimate of earnings per share growth of 5% for the S&P 500. Those are, of course, estimates but that's why you are seeing the return of volatility in stocks. Added to the earnings hit and profit margin compression s is the increase in global uncertainty from a collapse of trade talks when expectations were tilted the other way. The upshot to the sudden introduction of uncertainty in global trade negotiations is a flight-to-safety bid in Treasuries and the CPI results are likely to add to that trade.

The Fed has all but indicated that inflation trends are the number one element in determining the fate of future rate moves. While the labor market has posted month-after-month of gains with the current unemployment rate of 3.6% well below the Fed's equilibrium estimate of 4.3%, year-over-year wage gains consistently over 3%, and first quarter GDP surprising at 3.2% the Fed has stuck to it patient pause approach.

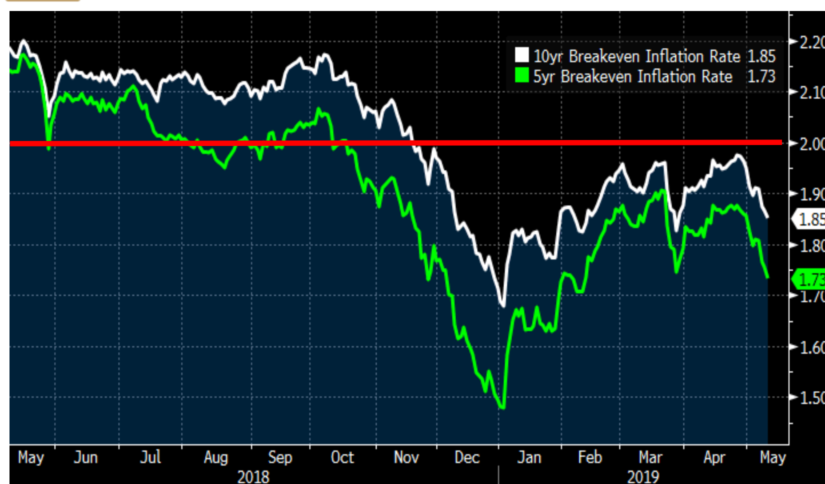
While the Fed, by almost any measure, has met the full employment part of its mandate, inflation continues to reside below the 2% target. With today's CPI release the YoY downtrend that had been in place since mid-2018 seems to have stopped with core CPI rising tentatively from 2.0% to 2.1%. The three-month average though is 1.6% annualized indicating a likely stall here, if not retreat in the next couple months. In addition, the Fed's preferred inflation measure, core PCE, is currently at 1.6% and typically runs 30bps behind core CPI. Thus, with today's release that implies a core PCE reading of 1.8% when its reported on May 31st. That would be a reversal of the downtrend that has prevailed since July 2018 but it would still be below the 2% target.

Recall too that several Fed speakers have talked of the symmetrical nature of the 2% inflation target. What that means, in theory, is they will be comfortable with inflation running a bit above 2% since it's spent the last several years under the target. If that's the case then the Fed should remain in pause mode if and when core PCE noses over 2%. Given the Fed is populated with several Phillips curve proponents (lower unemployment produces higher wages and hence potential for demand-driven inflation), we find it questionable whether they would truly be comfortable allowing inflation to move above target while unemployment is so far under their equilibrium estimate.

That being said, and even with the uptick in today's numbers, the upward trend in inflation is likely to be grudging at best. Dollar strength and Chinese yuan weakness are but two of many factors that will continue to work against any acceleration of inflationary pressures. That buys the Fed time to remain patient even if they're not really serious about the symmetrical policy stance around the 2% target.

With today's CPI numbers coming in close to expectations it indicates the nine-month downtrend in inflation may have passed but one month does not a trend make towards inflation ramping higher. Thus, we still think the Fed remains on hold throughout the balance of this year as inflation struggles to lift decisively over the 2% target. As for a rate cut, while this report hints the nine-month decline in core CPI is over it's a very tentative step. Three-month averages point towards inflation heading lower and if that happens expect rate cutting odds to start to increase again, especially if the trade dust-up unravels into a tit-for-tat escalation of tariffs and trade restrictions. In fact, odds of a December rate cut rose with this report to 64% versus 57% yesterday. So the Fed is definitely not out of the low-inflation woods with these numbers.

TIPs Inflation Estimates Dip Lower



In addition to typical Treasury securities, Treasury Inflation-Protected securities (TIPs) provide inflation compensation along with a modest coupon. The inflation payment is CPI-based and thus price fluctuations provide insight into investors' inflation expectations. Comparing yields on TIPs to similar maturity Treasuries one can tease out the inflation expectation. The graph illustrates the 5yr and 10yr inflation expectations with both showing declines in May and both well under the 2% target. This is the market saying the Fed will be hard-pressed to get inflation to and above the 2% target anytime soon. In essence, it's another sign indicating the Fed will be in pause mode for the foreseeable future.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	2.41%	-0.01%	1 Mo LIBOR	2.45%	-0.03%	FF Target Rate	2.25%-2.50%	3 Year	2.383%
6 Month	2.43%	-0.02%	3 Mo LIBOR	2.54%	-0.04%	Prime Rate	5.50%	5 Year	2.377%
2 Year	2.25%	-0.08%	6 Mo LIBOR	2.58%	-0.03%	IOER	2.35%	10 Year	2.519%
10 Year	2.44%	-0.09%	12 Mo LIBOR	2.71%	UNCH	SOFR	2.50%		