Market Update

Economic News

February 13, 2019

The January CPI report is out this morning and is mostly inline with expectations (more on that below) which will buttress the Fed's recent dovish turn, and keep any rate hikes off the table through at least the first half of 2019, if not longer. One of the factors cited in the January FOMC statement and in other post-meeting Fed speak is that a pause in rate hikes is prudent given the docile inflation readings and this latest CPI report supports that argument. Meanwhile, stocks rallied yesterday as a tentative agreement to fund the government through September was approved by congressional conferees. The deal provides a modest $1.375 billion for 55 miles of fencing along the border. The president hasn't okayed the deal, and it still has to pass both congressional chambers before going to his desk, so while the market is treating it as a fait accompli a few hurdles remain before the Friday deadline. The risk-on tone from the funding deal combined with talk that the Trump White House is intent on getting to yes on a trade deal with China and that combination put pressure on Treasuries. Despite the risk-on news, however, Treasuries managed to hang in pretty well due to other issues that continue to lurk like the slowing global growth story, the approaching Brexit deadline, and early complaints from taxpayers that average tax refunds are running 8% behind last year. Consumers expecting hefty tax cut-inspired refunds are learning the hard way about changes to withholding schedules and that has the potential to slice into expected consumption for the next couple months.

January's CPI numbers met most expectations with core CPI gaining 0.2% for the fifth straight month while year-over-year it printed at 2.2% matching the December rate but above the 2.1% expectation. The Fed's preferred inflation measure, core PCE, tends to trail core CPI by 30bps so the 2.2% core CPI implies a 1.9% core PCE. As we mentioned above, the goldilocks-like numbers allow the Fed to remain patient with rate hikes likely off the table through at least June, if not longer.

Combing through the details of the core CPI number, Owners Equivalent Rent and the other housing-related inputs were once again the key categories driving what modest core-inflation there is increasing 0.2% vs. 0.3% the prior three months. With nearly 42% weighting in the index housing-related expenses have been driving core rate increases for more than a year (for example, core CPI ex-shelter was 1.4% YoY). If overall housing activity continues to moderate the monthly gains in the housing-related items seem likely to moderate further.

As for headline CPI the 0.0% print came in under the 0.1% expectation but the reading in December was revised from –0.1% to 0.0% somewhat offsetting the lower-than-expected January reading. Year-over-year CPI was 1.6% versus 1.5% expected but down from 1.9% in December as a large 0.5% January 2018 print rolled off the calculations. The 1.6% YoY reading is the lowest since June 2017 and is further confirmation that a late-cycle spike in inflation due to 50-year low unemployment continues to remain elusive.

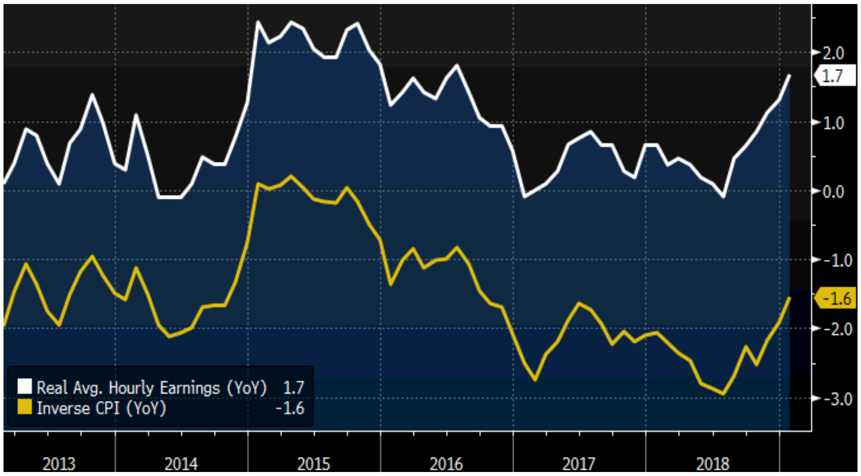
In another release today, gains in real average hourly earnings could support a case for continued solid spending by consumers. Real average hourly earnings increased 1.7% year-over-year versus an upwardly revised 1.3% pace in December. The 1.7% pace was the largest since July 2016 when inflation dipped giving a pop to real earnings. As was the case then, the drop in overall inflation provided the majority of the boost to real earnings this time but it's a boost nonetheless.

The +1.7% YoY gain in real spending power should allow consumers to continue spending at levels that keep GDP growing above 2.0% for 2019. The question is whether the late-year market volatility and ongoing political dysfunction will undermine confidence and force consumers to shut wallets and tighten purse strings. Recent confidence readings, both consumer and business, have declined adding a dose of concern in this area.

For example, the latest NFIB small business optimism index fell to 101.2, the lowest level since November 2016, and essentially repealing the post-Trump election bump. While the index remains above its long-run average of 98, the speed of the decline is troubling. The three-month average has fallen the fastest since December 2008 and uncertainty among small business owners is the fifth highest in the 45-year history of the series. With a rebound in stocks, an approved government funding deal, and a potential trade deal with China, the elements of a rebound are present but those issues have to be settled affirmatively otherwise confidence will continue to struggle.

With a Fed firmly in pause mode, global developed markets firmly in slowdown mode, and domestic consumer and business sectors experiencing lapses in confidence, the Treasury market is likely to remain range-bound with the short-end tied to the Fed's pause in rate hikes, while the long-end remains range-bound as well given slowing global growth and inflation pressures. The flat 2yr-10yr curve (currently 17bps) is not likely to go inverted if, and until, the Fed hikes again, but it's not likely to steepen much either given the moderating growth and inflation outlooks.

Real Average Earnings Gain on Waning Inflation



Real average hourly wages (YoY) have staged a nice rebound in the last few months as the white line in the graph illustrates. The real wage series takes earnings data from the monthly jobs report and nets out inflation to derive a measure of actual, or real, earnings. Also in the chart is the inverse of CPI which makes it easier to see the directional relationship between inflation and real earnings. It highlights the fact that while workers are seeing moderate wage gains (latest 3.2% YoY) another factor is the recent decline in CPI, driven in large measure by oil price declines. In sum, it paints an improving picture for consumer spending power. Now if only confidence readings will improve.

Agency Indications— FNMA/FHLMC Callable

Maturity (yrs)	2 Year	3 Year	4 Year	5 Year	10 Year	15 Year
0.25	2.69	2.80	2.92	3.03	3.45	3.71
0.50	2.66	2.78	2.90	3.00	3.40	3.66
1.00	2.63	2.74	2.85	2.95	3.33	3.58
2.00	-	2.58	2.71	2.83	3.27	3.47
3.00	-	-	-	-	3.14	3.37
4.00	-	-	-	-	3.03	3.29
5.00	-	-	-	-	2.93	3.22
10.00	-	-	-	-	-	NA