Market Update

Economic News

February 14, 2020

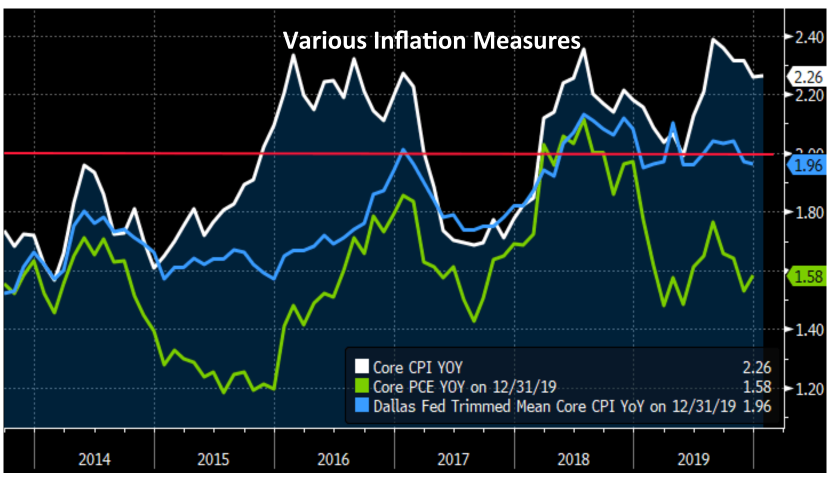
Yesterday, Treasuries easily handled a slightly-hotter-than-expected CPI release as a jump in coronavirus cases contrasted with a more upbeat scenario on Wednesday. This morning, the other first-tier report of the week is getting its due as January retail sales were just released. Coming on the heels of an upbeat December sales report, January was expected to be solid but slightly off the December pop but the results were more of a mixed bag. The 0.0% control group reading, which is a direct GDP feed, was a disappointment and widely missed the 0.3% forecast and the December print was dialed back a tenth to 0.2%. The flat January reading will weigh on first quarter consumption estimates. Meanwhile, overall sales increased 0.3% (matching expectations), while spending ex-auto and gas rose 0.4% versus 0.3% expected and 0.5% the prior month. Treasuries were higher before the report on more virus concerns and the rally is extending off the so-so retail numbers. Speaking of economic impact, first quarter GDP estimates are holding at a modest 1.6% annualized rate but that could be in for a downward adjustment if the virus impact continues to spread, and the so-so retail numbers continue. With the 10-year Treasury yield at 1.58% we are sticking with our near-term range of 1.50% to 1.68% until the virus impact starts to ebb and/or economic results accelerate.

- Meanwhile, yesterday's CPI numbers for January were a touch hotter than expected but this is probably the calm before the disinflationary storm. Dollar appreciation, falling commodity prices and weak energy prices will weigh on inflation in the coming months, likely extending the timeline for the Fed's preferred inflation gauge to return to 2%.
- CPI headline rose to 2.5% from 2.3% prior, despite a weaker-than-expected monthly change of 0.1% versus 0.2 forecast as the early innings of energy price declines influenced the headline number and those energy declines will only get more meaningful with the February numbers.
- Core CPI rose 2.3% year-on-year, which ordinarily would be consistent with core PCE inflation near 2.0%; however, over the past year, the gap between the two series widened considerably —now approaching 70 bps which implies a core PCE remaining around its current level of 1.6%.
- Within core CPI, the main driver continues to be housing costs with the shelter category (which comprises 42% of core) rising 0.3% after a modest 0.1% gain in December. The core rate ex-shelter for the past three months annualized was just 1.53% illustrating the impact increasing housing and rental costs are having on the core reading.
- As mentioned above, with the continued advance in the dollar and commodity pressures across-the-board, and further declines in energy prices expected, inflation levels are likely to fall in the coming months. That should allow the Fed to remain on the sidelines while they assess the economic impact of the coronavirus.

In other news, two top Republicans raised questions about President Trump's pick for the Federal Reserve Board of Governors, Judy Shelton, signaling potential trouble ahead for her nomination. The Senate Banking Committee held hearings yesterday and Alabama Senator Richard Shelby and Pat Toomey from Pennsylvania pressed Shelton on some of her heterodox views on the Fed, the gold standard and the U.S. dollar. Shelton was always thought a controversial pick because in the past she's challenged whether the institution should regulate the value of money and whether its mandate, as set by Congress, to pursue maximum employment and stable prices is meaningful. Her past recommendation to return to the gold standard also sets her apart from conventional economic thinking. A single Republican "no" vote on the committee is enough to block her nomination, assuming Democrats are united in opposition which is practically a given. It reminds us of Stephen Moore and Herman Cain's ill-fated attempt to pass senatorial muster.

The committee is also considering Trump's nomination of Christopher Waller for one of the two open seats on the Fed board. Waller is a much more conventional pick as he currently is the director of research at the St. Louis Fed and the chief adviser to St. Louis Fed President James Bullard. He helped develop Bullard's view that the economy is stuck in a new regime of low interest rates, low growth and low inflation. It's a stance that raised eyebrows when introduced in June 2016, but has since been vindicated, not least by three rate cuts in 2019. Unlike Shelton, Waller is expected to have a relatively easy confirmation.

Inflation Pressure Build But Soon Should Reverse



Yesterday's CPI numbers for January were a bit hotter than expected but this is probably the calm before the disinflationary storm. As the graph shows, core CPI (white line) has been above 2% for nearly two years but the Fed's preferred inflation gauge, core PCE (green line), remains well back at 1.6%. Shelter costs, which constitute over 40% of core CPI, have been driving that series while shelter gets a smaller weighting in core PCE contributing to its lower reading. All that being said, dollar appreciation, weak energy and commodity prices will weigh on inflation in the coming months, likely extending the timeline for the Fed's preferred inflation gauge to return to 2%.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	1.57%	+0.02%	1 Mo LIBOR	1.65%	-0.02%	FF Target Rate	1.50%-1.75%	3 Year	1.399%
6 Month	1.55%	-0.01%	3 Mo LIBOR	1.70%	-0.04%	Prime Rate	4.75%	5 Year	1.400%
2 Year	1.42%	+0.01%	6 Mo LIBOR	1.73%	-0.03%	IOER	1.60%	10 Year	1.527%
10 Year	1.58%	-0.01%	12 Mo LIBOR	1.81%	-0.02%	SOFR	1.57%		

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