RAYMOND JAMES
Economic Research
Published by Raymond James & Associates

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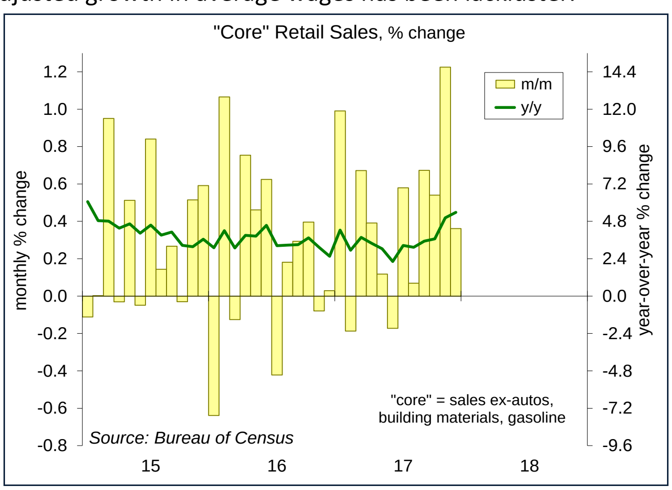
Weekly Economic Monitor

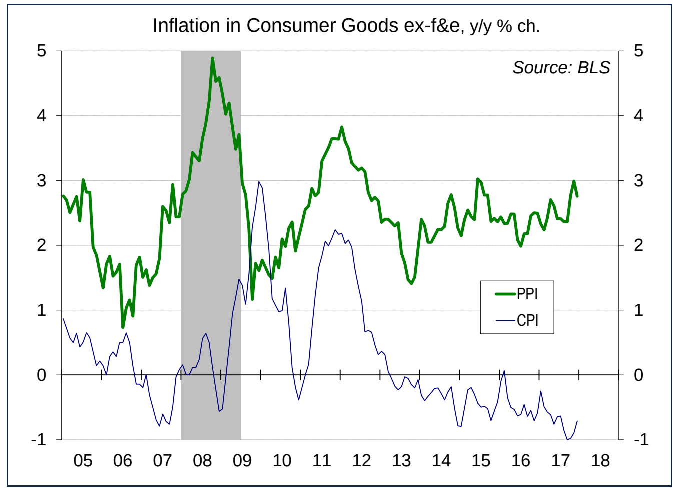
Raising the Stakes

Retail sales figures for December showed a relatively strong trend in 4Q17, although part of that reflects a rebound from hurricane effects in 3Q17. Core CPI inflation was a bit higher than anticipated in December, but that doesn't mean that the low inflation trend is over. However, eighteen states raised their minimum wages in January, and some expect this to flow through to higher prices. Perhaps. The market odds of a March rate hike by the Fed are rising (over 80% on Friday), but stock market investors are not too concerned. If the Fed is raising rates because the economy is strengthening, well, that's a good thing. But what if that's a mistake?

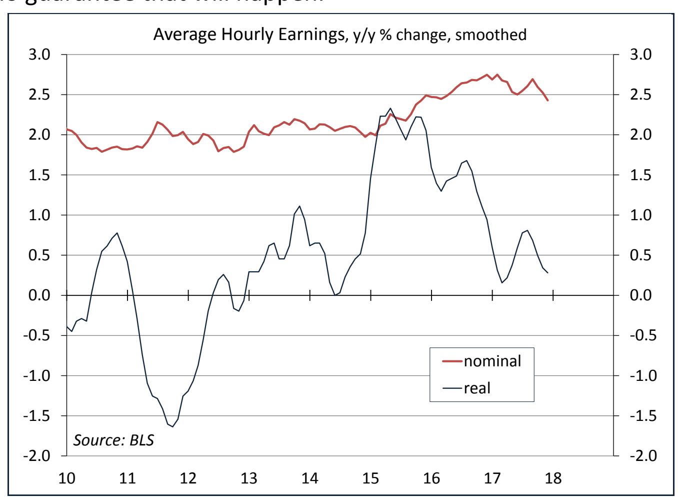
Retail sales exhibited a weakening trend through the first eight months of 2017 – not a sharp drop, more of a gentle slowing. Results for the final four months of the year were much stronger. This raises a number of possibilities. Consumer spending growth is often uneven across months and quarters. So, the 2017 pattern could simply be the normal variation around a moderate trend. We know that no matter their personal financial situation, consumers will spend during the holiday season. On the other hand, the consumer could be really picking up steam at this point, reflecting increased confidence about their ability to find jobs. Job growth, while expected to slow somewhat, has been supportive, but inflation-adjusted growth in average wages has been lackluster.



On the inflation front, the CPI rose 2.1% December to December, up 1.8% excluding food and energy. The core CPI increase is not far from the Fed's 2% goal, but remember that the Fed's gauge is the PCE Price Index, which is tracking 0.4 to 0.5 percentage point below the CPI year-over-year. The Producer Price Index showed some pipeline pressures in 2017, but we don't see this as feeding through to the consumer. In fact, the CPI has continued to reflect a deflationary trend in consumer goods ex- food & energy.



More importantly, the labor market is the widest channel for inflation pressure. We should see a pickup in average hourly earnings growth in January (to be reported in the February 2 employment report, which will include annual benchmark revisions). If not offset by faster productivity growth, wage increases could be passed along to consumer prices, but there's no guarantee that will happen.

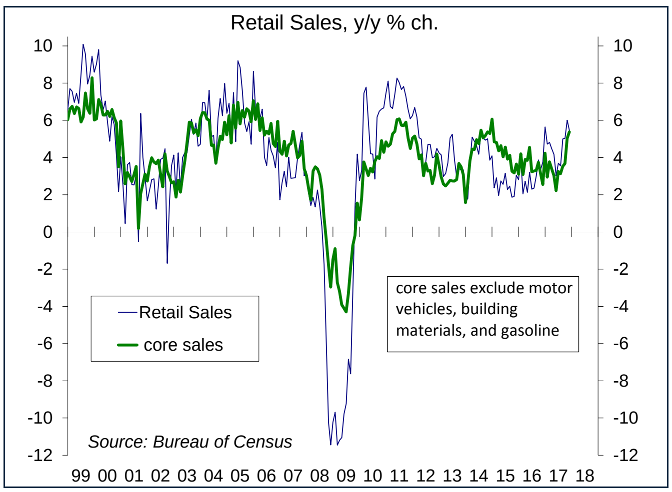


Up until now, Fed rate increases have been about "taking the foot off the gas pedal," not "hitting the brakes." Monetary policy is close to neutral and the labor market is at or near full employment. There's a good argument for the Fed to hold its fire, to facilitate a reallocation of labor toward its more efficient use. There may be more slack in the job market than we think there is. Raising rates to curb wage growth, as a means to contain consumer price inflation, could be a mistake. Conversely, the cost of waiting too long to tighten is potentially destabilizing rate increases later on, especially if accommodative policy fuels a financial bubble over the intermediate period. This is the dilemma Fed policymakers face in 2018.

	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
12/15/17	1.31	1.48	1.71	1.84	1.95	2.16	2.35	2.68	1.178	1.332	112.68	1.285	6936.58	2675.81	24651.74
1/05/18	1.39	1.58	1.80	1.96	2.06	2.29	2.47	2.81	1.204	1.356	113.18	1.240	7136.56	2743.15	25295.87
1/12/18	1.45	1.60	1.78	2.00	2.12	2.35	2.55	2.86	1.218	1.373	111.02	1.247	7258.78	2786.24	25803.19

Recent Economic Data and Outlook

Retail sales were as expected in November, but (once again) we saw upward revisions to the two previous months. The CPI was mostly in line with expectations, but investors recognize that state increases in minimum wages will add to inflation pressure, increasing the odds of Fed rate hikes (the April federal funds futures contract implies more than an 80% chance of a March 21 rate hike. Still, the stock market doesn't care.



Retail Sales rose 0.4% in December (+5.4% y/y), also up 0.4% ex-autos (+6.3% y/y). Figures for October and November were revised higher (a +11.3% annual rate 4Q17/3Q17). Motor vehicle sales rose 0.2% (+2.3% y/y). Sales of building materials and garden supplies rose 1.2% (+9.9% y/y). Gasoline sales were flat (+9.1% y/y). Ex-autos, building materials, and gasoline, sales rose 0.4% (+5.4% y/y) – an 8.1% annual rate in 4Q17 (vs. a hurricane restrained 3.1% pace in 3Q17).

Business Inventories rose 0.4% in November (+3.2% y/y), a slower pace than in 3Q17 (which implies a subtraction from 4Q17 GDP growth). Business sales (factory shipments plus wholesale and retail sales) rose 1.2% (+7.9% y/y).

The **Consumer Price Index** rose 0.1% in December (+0.150% before rounding, up 2.1% y/y). Food rose 0.2% (+1.6% y/y), with a continued split between food at home (+0.9% y/y) and food away from home (+2.5% y/y). Energy fell 1.2% (+6.9% y/y), with gasoline down 2.7% (-3.3% before seasonal adjustment, and +10.7% y/y). Ex-food & energy, the CPI rose 0.3% (+0.277% before rounding, and up 1.8% y/y). Shelter costs rose 0.4% (+3.2% y/y). Ex-food, energy, and shelter, the CPI rose 0.2% in December (+0.7% y/y). Ex-food & energy, consumer goods rose 0.2% (-0.7% y/y). Non-energy services rose 0.3% (+2.6% y/y).

Real Hourly Earnings rose 0.2% in December (+0.4% y/y), also up 0.2% for production workers (+0.1% y/y).

The **Producer Price Index** fell 0.1% in December (+2.6% y/y). Food fell 0.7%, while energy was flat (+10.1% y/y). Wholesale gasoline prices fell 3.9% (-2.6% before seasonal adjustment, and +16.7% y/y). Ex-food & energy, the PPIC fell 0.1% (+2.3%), reflecting a 0.6% drop in trade services (+2.1% y/y) and a 0.4% decrease in transportation and warehousing (+1.8% y/y). Ex-food, energy, and trade services, the PPI edged up 0.1% (+2.3% y/y). Pipeline inflation indicators remained consistent with a build-up of inflationary pressure at the earlier stages of production. Ex-food & energy, unprocessed intermediate goods rose 8.2% y/y, with processed intermediate goods up 3.8% y/y. Intermediate services rose 2.9% y/y.

Import Prices edged up 0.1% in December (+3.0% y/y). Ex-food & fuels, import prices fell 0.1% (+1.4%). Ex-fuels, prices of imported industrial supplies and materials edged down 0.1%, following increased pressure in recent months (+8.1% y/y). The price index for imported capital goods was unchanged (+0.7% y/y). Prices of imported autos were unchanged (-0.3% y/y). Non-auto consumer goods fell 0.1% (+0.2% y/y).

The Index of **Small Business Optimism** fell to 104.9 in December, vs. 107.5 in November, still a very high number by historical standards. Respondents remained positive in their outlooks for the economy, but still indicated a soft trend in earnings. Plans to raise prices increased. Hiring plans and capital spending plans remained moderate.

Economic Outlook (1Q18): around 2.5% GDP growth, following 2.5-3.0% in 4Q17 (reflecting a rebound from hurricane effects, but with an expected drag from inventories and net exports).

Employment: Job growth has remained strong, but the pace should decline as the job market continues to tighten.

Consumers: Job and wage growth remain moderately supportive. Fourth quarter improvement partly reflects a rebound from the third quarter's hurricane effects.

Manufacturing: Sentiment surveys remain strong and orders have been improving. Factory output is rebounding from a soft 3Q. An improving global outlook has supported export growth.

Housing/Construction: Job growth has been supportive. Monthly figures are often erratic and supply constraints remain, but the underlying trends are relatively strong.

Prices: Core inflation has continued to trend below the Fed's 2% target, partly reflecting a "one-off" plunge in wireless telecom services. Wage pressures are moderate.

Interest Rates: The Fed remains in tightening mode, and is expected to continue gradually raising short-term rates, but personnel changes add uncertainty. Balance sheet reduction has begun and should not be disruptive for the markets.

This Week:					*forecast*	last	last –1	comments
Monday	1/15		MLK, Jr. Holiday					markets closed
Tuesday	1/16	8:30	Empire St. Manf. Index	Jan	***NF***	18.0	19.4	erratic, but likely to remain strong
Wednesday	1/17	9:15	**Industrial Production**	Dec	***+0.1%***	+0.2%	+1.2%	a softer trend
			manufacturing output		***+0.2%***	+0.2%	+1.5%	aggregate hour reported up 0.1%
			Capacity Utilization		***77.1%***	77.1%	77.0%	steady
		10:00	Homebuilder Sentiment	Jan	***73***	74	69	still strong
		10:00	BOC Policy Decision					seen a close call (at this point)
Thursday	1/18	8:30	Jobless Claims, th.	1/13	***240***	261	250	lagged weather impact
		8:30	**Building Permits, mln.**	Dec	***1.320***	1.303	1.316	single-family strength
			% change		***+1.3***	+7.4	-3.7	multi-family volatility
			Housing Starts		***1.300***	1.297	1.256	seen little changed
			% change		***+0.2***	+3.3	+8.4	but watch for revisions
		8:30	Philadelphia Fed Index	Dec	***NF***	27.9	24.3	erratic, but likely to remain strong
		1:00	TIPS Auction					$13 billion in 10-year TIPS
Friday	1/19	10:00	UM Consumer Sentiment	m-Jan	***95.2***	95.9	96.8	still relatively strong, but likely lower
		1:00	Fed VC Quarles speaks					*Bank Regulation*
Next Week:								
Monday	1/22	9:00	IMF WEO					update on global economic outlook
Tuesday	1/23	1:00	Treasury Note Auction					2-year notes
Wednesday	1/24	10:00	Existing Home Sales, mln.	Dec	***5.65***	5.81	5.50	likely lower following strong November
			% change		***-2.7***	+5.6	+2.4	trend is strong
		11:30	FRN Auction					2-year FRNs
		1:00	Treasury Note Auction					5- year notes
Thursday	1/25	7:45	ECB Policy Decision					looking for signs of tightening timing
		8:30	Jobless Claims, th.	1/20	***250***	***240***	261	noisy, but a bit higher post-holiday
		8:30	Advance Econ Indicators	Dec				inventories and merchandise trade
		10:00	New Home Sales, th.	Dec	***675***	733	624	monthly figures are erratic
			% change		***-7.9***	+17.5	-1.7	underlying trend is strong
		10:00	Leading Econ Indicators	Dec	***+0.6%***	+0.4%	+1.2%	most components higher
		1:00	Treasury Note Auction					7-year notes
Friday	1/26	8:30	**Real GDP (advance est.)**	4Q17	***+2.5%***	+3.2%	+3.1%	drags from inventories and net exports
			Priv. Dom. Final Purchases		***+3.9%***	+2.2%	+3.3%	strong underlying demand
		8:30	Durable Goods Orders	Dec	***+2.0%***	+1.3%	-0.4%	aircraft orders higher
			ex-transportation		***+0.5%***	-0.1%	+1.3%	moderate
			nondef cap gds ex-aircraft		***+0.5%***	-0.1%	+0.8%	moderate

This Week…

The economic data reports are not expected to matter much for the financial markets. The two important releases, industrial production and residential construction are subject to seasonal noise. Inventors may be interested in what Fed Vice Chair Quarles has to say about bank regulation on Friday. The government's funding authority runs out on Friday at midnight, but lawmakers should be able to come up with another Continuing Resolution if they can't reach a broad agreement.

Monday

Martin Luther King, Jr. Holiday – Markets closed.

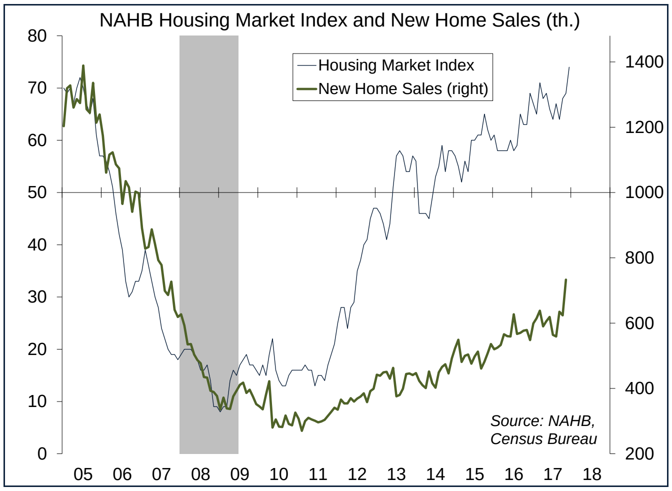
Tuesday

Empire State Manufacturing Index (January) – The Fed's regional factory sector surveys have become increasingly erratic in recent years, but the level should remain relatively strong

Wednesday

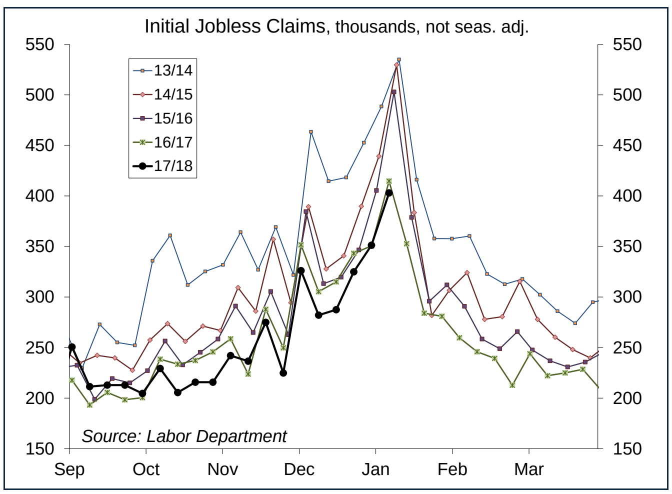
Industrial Production (December) – Improvement in factory output stalled in the spring and summer, partly reflecting the impact of the hurricanes. Manufacturing picked up sharply in the autumn (partly reflecting a rebound from hurricane effects). Aggregate hours (from the employment report) edged up just 0.1% in December, which should translate into a soft gain in factory output in December, but seasonal adjustment can be quirky in the final month of the year. Note that some of the increase over the last year is due to the energy recovery.

Homebuilder Sentiment (January) – Builders were giddy in December, but we don't expect a repeat of the housing bubble.

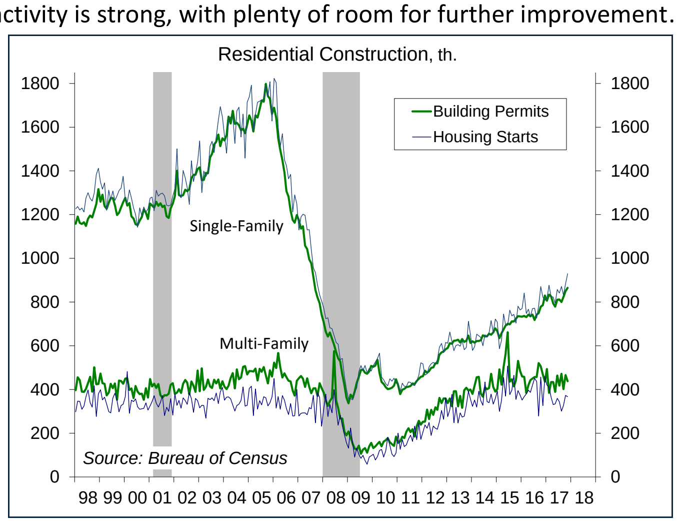


Thursday

Jobless Claims (week ending January 13) – Bad weather didn't seem to have much of an impact in the first week of the year, but strong seasonal hiring means increased seasonal layoffs.

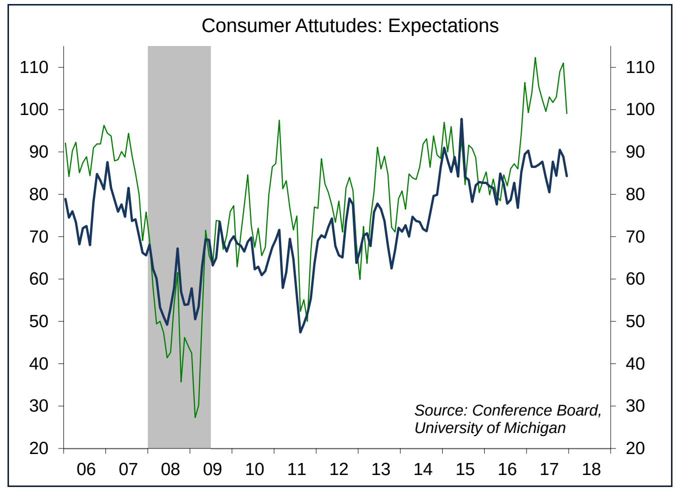


Building Permits, Housing Starts (December) – Monthly figures can be unreliable, but the trend in residential construction activity is strong, with plenty of room for further improvement.



Friday

UM Consumer Sentiment (mid-January) – Expectations, thought to be a factor in big-ticket purchases (such as a house or car) fell in December, but the decrease was well within the usual range of monthly noise in the data. Still, investors would be wise to keep an eye on these figures in early 2018.



Next Week …

The focus is expected to be on the advance GDP estimate for 4Q17. Investors put far too much emphasis on the headline figure, which will be revised. Fourth quarter GDP growth is likely to be restrained by slower inventory growth and a wider trade deficit (imports, a sign of strength, have a negative sign in the GDP calculation. Private Domestic Final Purchases (PDFP), which is GDP less net exports, the change in inventories, and government (or equivalently, consumer spending plus business fixed investment plus residential investment) should be very strong, partly reflecting a rebound from hurricane effects (PDFP rose at a 2.2% annual rate in 3Q17 (vs. GDP growth of 3.2%).

Coming Events and Data Releases

January 30	State of the Union Address
January 31	ADP Payroll Estimate (January) Employment Cost Index (4Q17) FOMC Policy Decision (no press conf.)
February 1	ISM Manufacturing Index (January)
February 2	Employment Report (January)
February 4	Super Bowl LII (Minneapolis)
February 16	Chinese New Year
February 19	Presidents Day Holiday (markets closed)
March 21	FOMC Policy Decision, press conf.
May 1-2	FOMC Policy Decision (no press conf.)
June 12-13	FOMC Policy Decision, press conf.
November 6	Election Day