Reflections on the Economy and Inflation

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis takes a look at the overall U.S. economy and comes away cautiously optimistic, including for the stock market.

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Bob Weir, CFA: Director of Research

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Reflections on the Economy and Inflation

Despite all the action in the equity market, there is not much going on in the economy that is visible. Concurrent data suggest that the economy continues to plod along at something like a 2% annual growth rate, which has been the norm since mid-2009. Industrial production and business investment continue to be lackluster, while construction expands slowly.

Confidence, however, is definitely up, as the chart below shows.

The equity market is up some 12% since just before the November elections. This strongly suggests that the market expects business-friendly policies (e.g., tax reform plus regulatory relief) to emerge from the Trump administration this year. Trump's executive orders so far have been impressive, but a lot of good news has been priced in, so further gains likely will require confirmation that policies put in place are, indeed, of the business friendly variety.

The type and timing of tax reform are crucial issues, however, and they are still in flux. If tax cuts are postponed until next year, this could pose a serious risk to the economy this year, since it will give everyone a reason to postpone new investment, realization of gains, and income until next year — in a manner similar to what happened when the initial Reagan tax cuts were (mistakenly) phased in over a number of years and the economy immediately slumped.

If Trump is going to cut taxes, he needs to do it ASAP and/or reassure the market and the public that the cuts will be retroactive to the beginning of this year. Alvin Rabushka has some interesting observations along these lines here.

It is disturbing, meanwhile, that Trump seems to be pushing hard for some type of "border adjustable" tax regime. That appeals to him, presumably, since it would allow him to tax imports and incentivize exports, and that, in turn, would supposedly reduce the trade deficit.

Unfortunately, that is a dumb thing to want to do; economics teaches us that there is nothing wrong with a trade deficit, since it is always accompanied by a capital surplus (if foreigners want to buy our financial assets instead of our goods and services there is nothing at all wrong with that).

Fortunately, it looks like many economists, as well as Republican lawmakers, are unconvinced that switching to a border-tax regime makes sense, if for no other reason than that it would result in a massive change in the rules of the game for many companies, and that could be quite disruptive. Why overhaul the whole tax system when a few simple adjustments to the current one (which admittedly could be improved) could do the trick?

A lot of sensible people I know would much rather see the current system get a few stimulative tweaks, such as reducing marginal tax rates on income, capital gains, and businesses, limiting deductions and subsidies, and slashing regulatory burdens. Those easy-to-implement measures would incentivize work, investment, and capital formation, and that, in turn, would help everyone, not just exporters. Let us hope simplicity wins out over complexity.

Core inflation has been running around 2% for a long time, but recently we have seen headline inflation move above the 2% level, thus effectively putting a stake through the heart of the deflation demon. With today's January CPI release, we now see that underlying inflation pressures are beginning to exceed 2% per year. The headline CPI in January rose by much more than expected (0.6% vs. 0.3%), while both the core and ex-energy CPI rose by 0.3%.

Over the past six months, the overall CPI is up at a 3.6% annualized rate, while the core CPI is up 2.5% annualized, and the ex-energy CPI is up 2.1% annualized. This is not enough to warrant a red alert at the Fed (energy still seems to be the major culprit), but it almost certainly means the FOMC will be raising rates sooner rather than later, and by more than the market expects, rather than less.

At the very least inflation is set to become a key focus for the market in the months to come. If it looks like the Fed is falling behind the inflation curve (i.e., raising rates by too little, too late), that could be as disruptive to the economy as a failure to implement meaningful tax reform.

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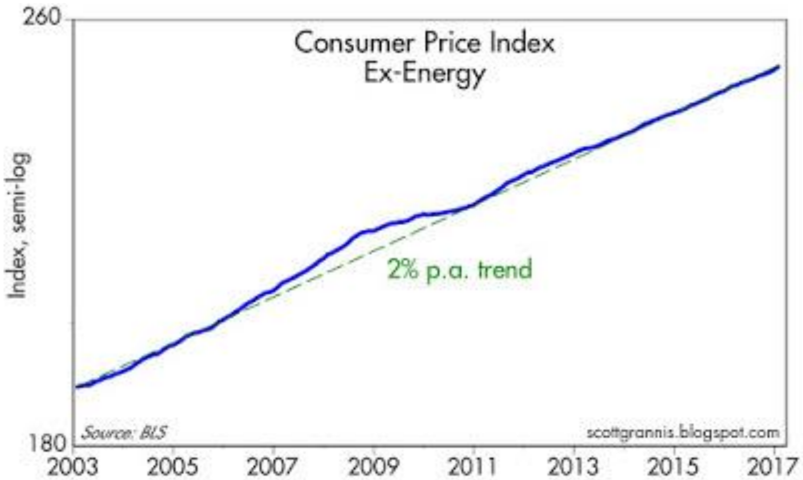
I have been featuring the following chart for a while, and the story has not changed: abstracting from volatile energy prices, inflation at the consumer level has been averaging very close to 2% a year for more than a decade.

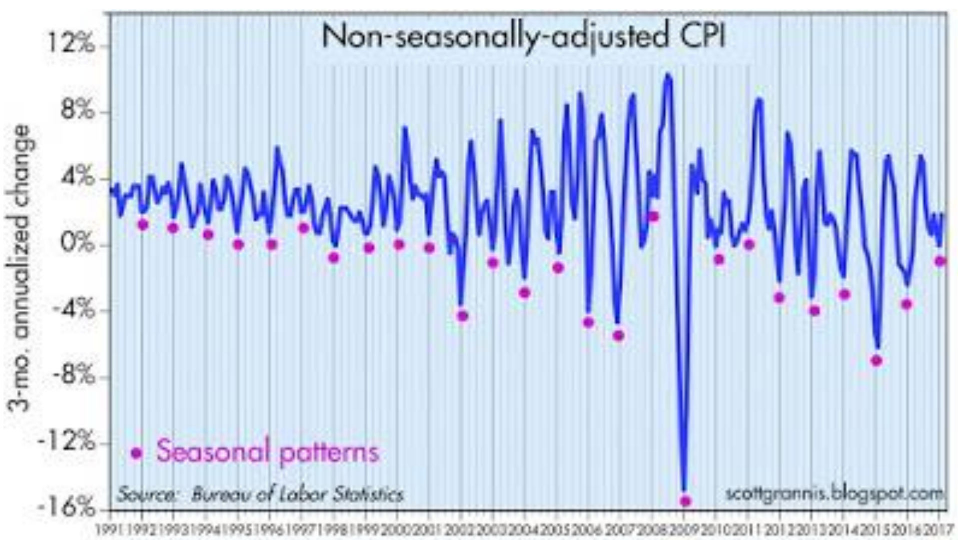


Over the past year, the CPI is up 2.5%, with energy prices (specifically, a rise in gasoline prices in January that has already been reversed in February) doing most of the work.

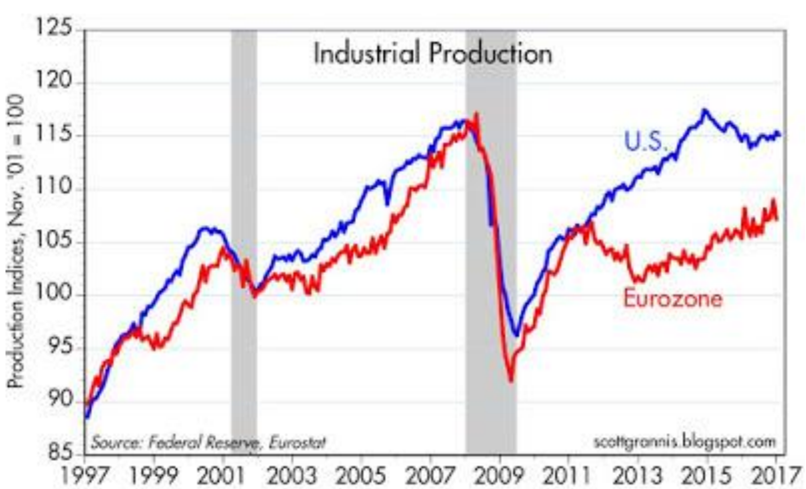
Taken together, these first two charts are not very scary. But, if recent trends continue, then it will be time to start worrying.

What happened in January was not so much that overall prices actually rose, however. What happened was that they did not stay flat or fall, as is usually the case around October-January.

The chart below illustrates that, by showing the 3-month annualized rise in the non-seasonally-adjusted CPI. The dots highlight the fact that actual inflation is almost always very low around the end of each year. The January report was an outlier; since seasonal adjustments expect price gains to be zero or negative around this time of year, a modest rise in actuality became a big jump after adjustments were applied.



Industrial production has been improving only modestly for the past year. It is encouraging that the Eurozone has been doing somewhat better, but so far it just looks like catch-up to the U.S.A.



January housing starts were down a bit, but previous months were revised upwards substantially. Given the relatively high level of builder sentiment, the trend of starts over the past year, and the ongoing rise in building permits, it is reasonable to expect residential construction to continue to contribute to growth for the foreseeable future, albeit modestly.

Industrial metals prices are up over 50% since the end of 2015, and that is impressive indeed.

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As the next chart shows, it is quite unusual for commodity prices to rise while the dollar is also rising (note that the blue line is the inverse of the dollar index).

At the very least this suggests that global economic activity has strengthened. It is also possible that rising commodity prices are symptomatic of a rising inflation trend globally. I note that gold prices are up 17% over this same period, and gold is still significantly above its long-term, inflation-adjusted average price, which I calculate to be roughly $500-$600 per ounce.

The road ahead looks promising, but there are still significant obstacles to overcome and nasty pitfalls. I think that is obvious to just about anyone, however, so I am not sure that the market is over-extended.

For now, I am in the cautiously optimistic camp, mainly because I believe the economy has a tremendous amount of upside potential that is just waiting to be tapped. I think the pessimists are under-estimating this, and under-estimating the power of supply-side tax and regulatory reforms.

I see too many articles arguing that Trump Stimulus is all about goosing spending, financed by bigger deficits—it is not. It is about unshackling the private sector and shrinking the public sector. That has not been tried for a long time, and the time to do it is ripe.

BW: See ABOUT THE AUTHOR on the next page.

ABOUT THE AUTHOR

Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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