LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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DATA DELUGE BRINGS GOOD NEWS (BUT NOT TOO GOOD)

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KEY TAKEAWAYS

Economic data received over the first week of May indicated steady economic growth with only marginal risk of overheating.

The Fed continues to indicate a gradual pace of rate increases with some tolerance for inflation above target.

Job growth remains strong for the point in the cycle and should support consumer spending.

The first week of May brought a deluge of economic data, including the April jobs report, key surveys on business activity, and some important readings on inflation. Add in a Federal Reserve (Fed) policy meeting, and it's fair to say that the most important week of economic data in May is already behind us. Looking at these reports together, the economy still appears to be in an economic sweet spot, producing solid growth but not enough to cause us concern about an overly aggressive Fed. Rates will still push higher at a moderate pace and it's natural for financial conditions to tighten as we move later into the economic cycle, but as long as these are driven by steady economic growth with a minimal build-up of excesses, we expect the economic expansion to continue largely uninterrupted.

FED HOLDS STEADY

The Federal Reserve completed its third of eight scheduled two-day policy meetings on May 2, 2018. As was widely expected, the Fed maintained the fed funds target rate range at 1.50–1.75% after raising rates at its previous meeting in March. The May meeting did not include updated economic projections nor was it followed by a press conference by Fed Chair Jay Powell, so all Fed watchers were given to digest was the relatively brief policy statement.

The few changes in the statement signaled a slightly more upbeat assessment of the economy, highlighting strong growth in business fixed investment. There was also an acknowledgment that inflation was essentially at the Fed's 2% target, rather than running below it. In doing so, it characterized its inflation target as "symmetric," a new wrinkle and a reminder that running a little above the rate would not in itself be sufficient for the Fed to raise rates more quickly. Overall, the statement did little to change policy expectations. The Fed remains on track to raise rates two to three more times in 2018, with odds of a hike at the June meeting already almost fully priced in.

INFLATION MOVES CLOSE TO 2%

Earlier in the week, the Bureau of Economic Analysis released the monthly reading of personal consumption expenditure (PCE) inflation. The Fed's favored measure of inflation, the core version of this reading (which excludes volatile food and energy prices), showed an increase of 0.2% month over month, and 1.9% year over year [Figure 1], edging closer to the Fed's 2% target.

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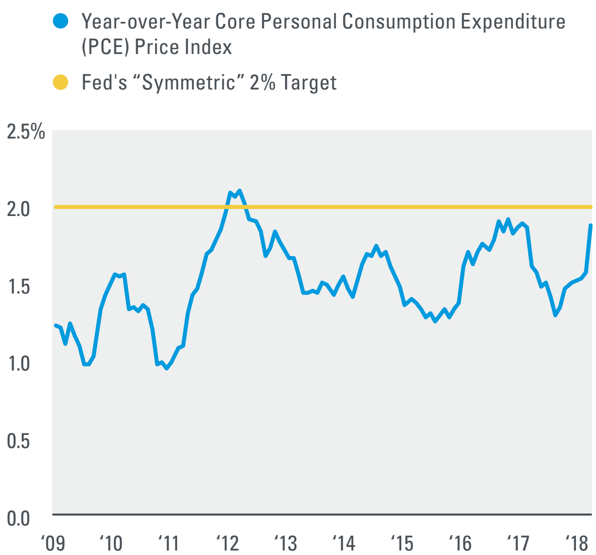
1 INFLATION APPROACHING FED'S TARGET, BUT MAY BE ALLOWED TO RUN A LITTLE HOT



Sources: LPL Research, U.S. Bureau of Economic Analysis 05/04/18

2 JOB GROWTH HAS STEADIED AND REMAINS STRONG FOR LATE EXPANSION

Sources: LPL Research, U.S. Bureau of Labor Statistics 05/04/18

The moderate increase in inflation in recent months has led to a slight increase in the market's rate hike expectations, with fed fund futures markets now evenly split between two and three additional rate hikes in 2018, for a total of three or four over the entire year. Even four hikes would only mean an average of one rate hike every other meeting, which pales in comparison to a hike at 17 consecutive meetings from 2004–2006, prior to the Great Recession. This debate between two or three more hikes will go on, but it is important to remember the bigger picture—the fed funds rate at 1.75% remains low relative to history (average is 5.25% since 1971, and 3.67% since 1985) and is unlikely to cause major problems for the economy regardless of whether we get a total of three or four hikes this year.

HEALTHY JOB MARKET BUT WITH LITTLE ADDED PRESSURE ON THE FED

The closely watched nonfarm payrolls report (released on Friday, May 4) showed the U.S. economy created fewer jobs than expected (164,000 versus 190,000), but the overall employment level ticked higher as the labor force participation rate fell to 62.8, pushing the unemployment rate to an 18-year low of 3.9%; March's initial figure was revised up by 32,000 to 135,000, basically offsetting the miss in expectations.

Job growth has slowed since its peak in 2015, but is still very healthy for this point in the economic cycle and has shown recent stabilization [Figure 2]. Wages grew 0.1% month over month in April, slightly below expectations of 0.2% growth, to put year-over-year wage growth at 2.6%, ahead of inflation but still signaling only modest signs of wage pressure.

Though the headline payrolls figure came up short, the job gains represent solid growth at this stage of the business cycle, and wage growth, while healthy, should allow the Fed to continue to pursue its policy of gradual rate hikes.

SURVEYS OF BUSINESS ACTIVITY PAST PEAK BUT STILL VERY HEALTHY

The Institute for Supply Management's (ISM) manufacturing Purchasing Managers' Index (PMI) for April dipped two points from the March reading, but at 57.3, it remains consistent with a robust manufacturing sector and above-trend economic growth. The report revealed broad-based strength, with 94% of industries reporting growth, matching the highest breadth since 2004. Markit's version of the PMI came in at a similarly solid 56.5, but in contrast to the official PMI, Market's version rose 0.9 points. Rising inflation was evident in both reports and input cost for manufacturers is an area where stronger inflationary pressures may be starting to appear.

A healthy manufacturing sector is undoubtedly positive for economic growth and is expected to stay that way for a while, given support from capital investment incentives and repatriation of overseas profits provided by the new tax law. Strong manufacturing also bodes well for corporate profits. Historically, the ISM manufacturing index has exhibited a fairly tight correlation to corporate profits, with several months of lead time. The very strong first quarter earnings season, with the S&P 500 tracking to a more than 25% year-over-year increase following strong prior PMI readings, is evidence this relationship remains in place.

LOOKING AHEAD TO THE REST OF MAY

- **May 7–11.** This week will provide further feedback on inflation, with Producer Price Index data out on Wednesday, Consumer Price Index and wage data out on Thursday, and import and export price data out on Friday.
- **Tuesday, May 15.** We'll get a read on retail sales and will be looking for signs that consumer spending is bouncing back following a lackluster first quarter.
- **Wednesday, May 16.** Industrial production data, which provides the best monthly measure of overall industrial activity, will be released.
- **Thursday, May 17.** The next report on the Conference Board's Leading Economic Index, which we continue to monitor to help gauge future economic growth prospects, comes out.
- **Wednesday, May 23.** The minutes for the Fed's May 1–2 policy meeting will be released, providing a deeper look at the Fed's current assessment of the economy and its policy implications.
- **Friday, May 25.** Durable goods orders data will be released. The headline number tends to be volatile, so watch the number that removes transportation orders. We also closely monitor non-defense capital goods orders and shipments excluding aircraft as a proxy for business investment in equipment.

CONCLUSION

With May's most important week of data behind us, the main takeaway is that the economy remains on course for steady growth in 2018 and likely into 2019. As always, there are potential threats to growth that could disrupt the economy, such as an overzealous Fed, heightened trade tensions, or meaningful further tightening in financial conditions. But for now, the economy remains on track for continued steady economic growth, supported by a rebound in consumer spending and accelerating business investment, and we maintain our baseline expectation of 2.75–3.0% GDP growth in 2018. ■

*As noted in *Outlook 2018: Return of the Business Cycle*, LPL Research projects real gross domestic product (GDP) growth of around 2.75-3% in 2018. This is in line with historical mid-cycle growth of the last 50 years. Economic growth is affected by changes to inputs such as business and consumer spending, housing, net exports, capital investments, and government spending.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing involves risk including loss of principal.

DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

INDEX DESCRIPTIONS

The Leading Economic Indicators (LEI) Index is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.