LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

February 5 2018

GDP, PCE, AND JOBS

John Lynch *Chief Investment Strategist, LPL Financial*
Shawn Doty *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

The latest data on GDP, inflation, and the job market continue to paint a positive picture of the U.S. economy.

The Fed's favored measure of inflation, core PCE, remains below the Fed's 2.0% target.

Wage inflation has begun to tick higher, though it remains well below the level that has typically triggered a more active Fed.

U.S. stocks and bonds were hit by inflation concerns over the past week, but what is the economic data telling us? A barrage of U.S. economic data was released over the past two weeks, including major reports such as fourth quarter gross domestic product (GDP), personal consumption expenditure (PCE) inflation, and the January employment situation report. We will discuss the impact of each individual report in more detail later, but overall the data deluge has signaled that the U.S. economy remains on stable footing. Signs of rising inflation were present in all three reports, which is one of the factors behind both stock and bond weakness over the past week. However, we would remind investors that, for now at least, inflation readings remain below the Federal Reserve's (Fed) 2.0% target, and we would need to see continued acceleration before we would expect a more aggressive path of Fed rate hikes.

GDP MISSES, BUT UNDERLYING DATA SHOWS STRONG DEMAND

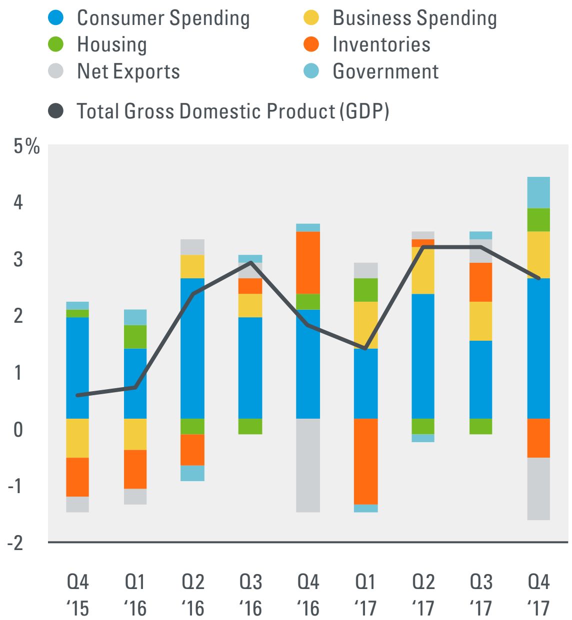
The advance release of fourth quarter GDP showed a year-over-year increase of 2.6% on an inflation-adjusted (real) basis. This was below the market's expectation of 3.0%, and also below the 3.2% reading from the prior quarter. However, the underlying data was better than the headline portrayed.

An inventory drag, possibly hurricane related following rebuilding efforts late in the third quarter, was the major reason for the shortfall versus expectations. Trade also hurt, as import growth strongly outpaced export growth and widened the trade deficit. However, the report also featured strong demand, with consumer spending (+3.8%), business equipment investment (+11.4%), and residential construction (+11.6%) all seeing strong results [Figure 1]. Government spending, which hasn't been a major driver of GDP in recent years, also grew by 3.0% during the quarter, which is the best since 2015. Removing the impact of inventories and trade (a measure referred to as final sales, based on annualized data), growth would have come in at a solid 4.3%.

For the full year of 2017, GDP rose 2.3%, roughly in line with the expansion average, and we expect the impact of the new tax law may help push the pace up closer to 3.0% in 2018.

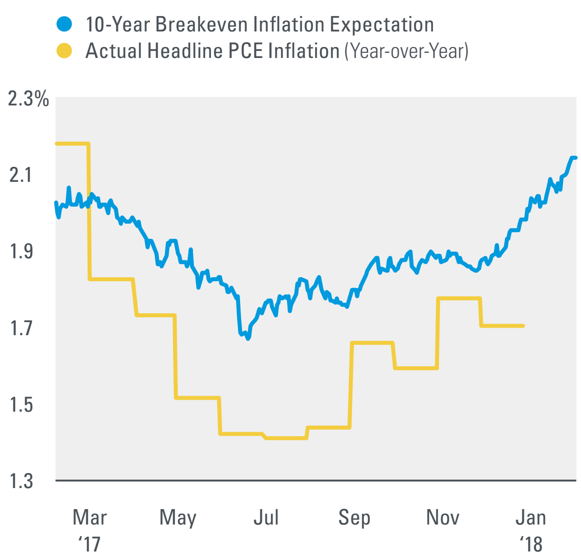
1 **FOURTH QUARTER GDP MISSED EXPECTATIONS, BUT DEMAND REMAINED ROBUST**

Contribution to Real GDP Growth by Economic Sector



Source: LPL Research, Bureau of Economic Analysis 02/02/18

2 **ACTUAL INFLATION LAGGING BEHIND EXPECTATIONS**



Source: LPL Research, Bloomberg 02/02/18

Personal consumption expenditures (PCE)

Performance is historical and is no guarantee of future results. Breakeven inflation is measured by the difference between Treasury yields and TIPS yields.

PCE INFLATION STABLE AT 1.7%

Rising inflation expectations are one factor behind the recent rise in interest rates. Below-target inflation has been a persistent headache for the Fed in recent years, but market-based inflation expectations, such as 10-year breakeven inflation (based on the difference between the 10-year Treasury yield and 10-year Treasury Inflation-Protected Security [TIPS] yield) have started to increase in recent months. However, higher expectations have yet to translate into higher actual inflation, as shown in Figure 2.

This fact was again highlighted last week with the release of PCE data. Headline PCE met expectations at 1.7% year over year, but decelerated from its November reading of 1.8%. Core PCE (which excludes volatile food and energy prices, and is the Fed's preferred measure of inflation), accelerated slightly from the previous month, but at 1.5% year over year remains well below the Fed's 2.0% target. The report was broadly seen as a step in the right direction for the Fed, but a sustained upward move in inflation may be needed before the Fed can become significantly more aggressive.

EMPLOYMENT REPORT SHOWED CONTINUED STRENGTH

The final major data release last week, and arguably the most impactful, was the January Employment Situation Report. This monthly report indicates how many jobs were created over the prior month, and also gives details on other important measures of labor market strength including the unemployment rate, the labor force participation rate, and wage growth. Wage growth is a particularly important indicator to watch in the current environment, as it is often viewed as a leading indicator of inflation. A tightening labor market typically means that there are fewer workers available, and companies have to pay more when hiring. Given that wages make up a large portion of employer expenses, a strong rise in wages can also mean an increase in overall inflation as companies raise prices in order to maintain profit margins. This chain of events has yet to unfold in the current economic expansion, though last week's employment report did finally show some signs of wage pressure.

The U.S. economy created 200,000 jobs in January, better than the 180,000 consensus expectation and above the upwardly revised 160,000 number in December (which was previously reported at 148,000), although a downgrade to November's job growth made the total revision negative. The unemployment rate remained unchanged at a multi-decade low of 4.1%, but wage pressures did finally start to show, as average hourly earnings hit an expansion high of 2.9%, well above the consensus expectation of 2.6%.

The higher than expected wage growth number helped push bond yields higher, and also led to some weakness in stocks as markets theorized that a sustained growth in wages could give the Fed more ammunition for a faster path of rate hikes. While this number definitely represents acceleration in wages, history suggests that wage growth may need to move considerably higher, toward the 4.0% range, before triggering a significantly more aggressive Fed. In addition, faster wage growth may have been impacted by an increase in the minimum wage in several states and tax-law related bonus increases, which don't necessarily reflect wage pressure from tighter labor markets. We continue to believe that the Fed may raise rates three times in 2018, though this will be an area to watch in the coming months.

CONCLUSION

The large amount of economic data released over the past few weeks shows that the U.S. economy continues to expand at a steady pace. Inflation expectations have been rising over the past few months, and the economic data, including January's employment report, are finally showing some signs that inflation may be starting to move in the right direction (for the Fed). However, actual inflation, as measured by the PCE price deflator, remains below the Fed's 2% target, and we believe that we will need to see a sustained path toward that number, or alternatively at least a stronger move in wage growth, before we are likely to see a significantly more aggressive path of Fed rate hikes. ■

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 in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

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.

Personal consumption expenditures (PCE) is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, nondurables, and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.

Treasury Inflation-Protected Securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI), while providing a real rate of return guaranteed by the U.S. government. However, a few things you need to be aware of are that the CPI might not accurately match the general inflation rate; therefore, the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPS do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.