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Core PCE inflation is now following core CPI higher, and has a good deal further to rise...

...The Fed's 2% target will likely be breached by the fall, and policymakers will have to respond.

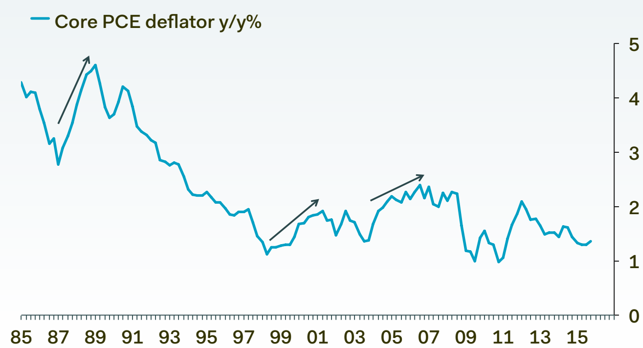
Tolerance for above-target inflation will be limited if the trend is rising strongly when 2% is reached.

Core PCE Inflation Will Breach the Target This Year, Two Years Early

When we argue that the Fed will have to respond to accelerating wages and core prices by raising rates faster than markets expect, a frequent retort is that the Fed has signalled a greater tolerance than in the past for inflation overshoots. That's true, but the story is rather more complicated than simply saying the Fed could live with core PCE inflation at, say, 2¼%, despite having a 2% target, or that wage growth would be allowed to run a bit faster than in the past. Investors taking comfort from these notions are, in our view, in severe danger of having their fingers badly burned.

The core issue here is that monetary policy decisions are taken on the basis of the Fed's projections for the *future* path of inflation, not its *current* rate. ***If policymakers were convinced that the next move in inflation would be sharply to the downside—because, say, indicators of economic activity were collapsing—then, yes, they would tolerate an above-target rate.*** They probably would *ease*, under those circumstances. But as Janet Yellen said last week, "...it's a myth that expansions die of old age"—they die because the Fed kills them—so the chances are low that inflation will breach the target with growth rolling over at the same time, *before* a substantial Fed tightening.

THE FED CAN'T ASSUME INFLATION WILL PEAK AND LEVEL OFF

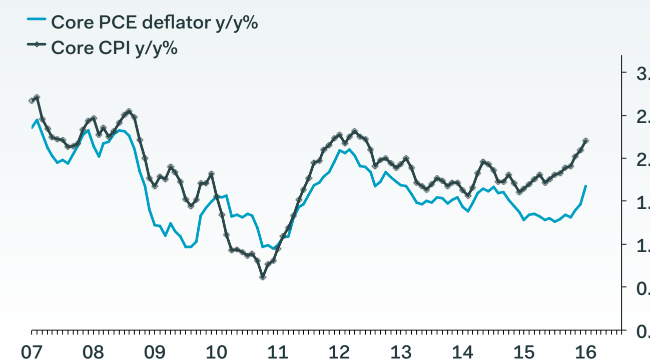


It is much more likely, in our view, that at the point core inflation and wage growth reach the Fed's targets, both will clearly be rising rapidly. Note that core PCE inflation will hit the target as soon as October—two years earlier than the Fed's current forecast—if the monthly numbers merely run in line with the average for the past three months. And, in the absence of significant prior tightening, we expect the pace of economic growth at that time to be quite strong, because the hit from falling capex in the oil sector will be over, and the household saving rate will have dropped back sharply from its recent highs.

The Fed's models, therefore, will predict that the initial breach of the inflation target will be followed rapidly by further increases, rather than a comforting levelling-off at a rate the Fed can live with indefinitely. ***If inflation overshoots when economic growth is still strong and monetary policy is still super-accommodative, the Fed's forecasts will project even higher inflation in the future, triggered by rising wage demands.*** The only plausible policy response in this scenario is to raise rates, and quickly.

You might think this is all very abstract, because core PCE inflation has been below the target for a very long time, and the Fed's forecasts show it reaching the target—only just—in the fourth quarter of 2018. But core PCE inflation jumped to 1.7% in January, and, on the Fed's own calculations, it is being held down *temporarily* by ¼-to-½% by the strong dollar and the drop in oil prices. ***In other words, core inflation ex-temporary factors is now 2-to-2.3%.*** Monetary policy works with long lags, so the Fed has to look through temporary factors. We are of the view that the Fed is now substantially behind the economy, though not behind the curve.

THIS IS WHAT TROUBLE LOOKS LIKE



We view the jump in core PCE inflation in January as the first move towards narrowing the gap with the core CPI, where the year-over-year rate has climbed to 2.2% from 1.6% over the past year. Cost compression in healthcare explains about two thirds of the gap between the two measures, but financial pressures on insurance companies and healthcare providers means that the Obamacare disinflation windfall is now over. In January, though, healthcare costs were responsible for only a small part of the 0.3% month-to-month jump in the core PCE, which was lifted, ominously, by outsized gains in a broad array of services, as well as increases in the prices of new cars, clothing and jewelry.

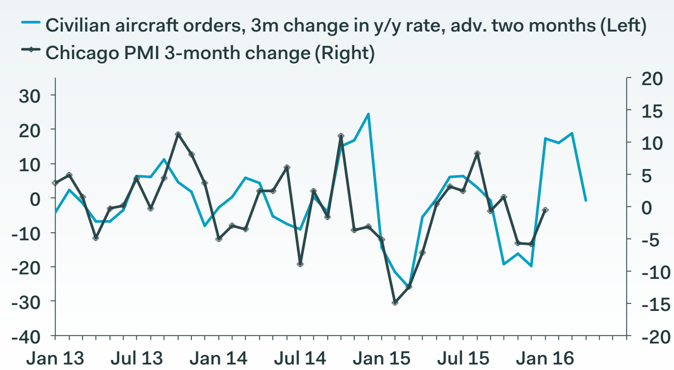
Core PCE inflation is now set to breach 2% by the fall of this year, two years earlier than the Fed's forecasts. Right now, markets think the chance of this scenario is close to zero, perhaps because stock investors are pre-occupied with the weakness of manufacturing, which is hugely over-represented in the major indexes compared to its importance to GDP and the labor market.

The Fed leadership's unwillingness explicitly to embrace what their own models presumably are telling them—growth will pick up as consumers spend the gas price windfall, wage pressures are building, and weakness in foreign economies doesn't matter much to the U.S.—is quite hard to understand. *But it will not be sustainable if wage and inflation follow the paths we expect over the next six months or so.* Sooner or later, the noises coming from inside the Fed will have to change.

Upside risk for the Chicago PMI?

The Chicago PMI has been so volatile in recent months that we can't have much confidence in our forecast for today's February number. *Most of the time, the headline index tends to move broadly in line with shifts in civilian aircraft orders—Boeing is headquartered in Chicago—but the scope for surprises is substantial in any given month.* Our chart suggests the February reading will about 10 points higher than in November, putting it at about 59, up from 55.6 in January. The consensus forecast is for a dip to 52.5.

UPSIDE RISK FOR THE CHICAGO PMI, THANKS TO BOEING?



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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, February 29

- **D: Chicago PMI (2)/9:45 EST**

The lagged effect of rising aircraft orders late last year should lift the index to **59** from 55.6. **Consensus: 52.5.**

- **D: Pending Home Sales (1)/10:00 EST**

Rising mortgage applications should lift the index by about **2%,** after a run of lackluster numbers. **Consensus: 0.5%.**

Tuesday, March 1

- **Redbook Chain Store Sales (2/27)/9:00 EST**

Sales growth is picking up, partly due to base effects, so we look for an uptick from last week's **1.2%** year-over-year.

- **D: ISM Manufacturing Survey (2)/10:00 EST**

Our reading of the regional numbers and the lagging relationship of the ISM with China's PMI suggests the index will rise to about **50** from 48.2. **Consensus: 48.5.**

- **D: Construction (1)/10:00 EST**

Spending has been inexplicably weak and a hefty rebound is overdue; we look for a **1%** jump. **Consensus: 0.4%**.

- **Auto Sales (2)/Late Afternoon EST**

Auto industry observers think sales were little changed at a robust **17.5M. Consensus: 17.7M.**

Wednesday, March 2

- **Mortgage Applications (2/26)/7:00 EST**

Seasonal adjustment problems point to a modest dip in the purchase index after last week's rise to **217.9.**

- **D: ADP Employment Report (2)/8:15 EST**

Our model points to a 200K increase, after 205K in January. **Consensus: 185K.**

- **Federal Reserve Beige Book /14:00 EST**

Evidence of wage pressures spreading?

Thursday, March 3

- **D: Jobless Claims (2/27)/8:30 EST**

A modest dip to **270K** from 272K? **Consensus: 270K.**

- **Productivity and Unit Labor Costs (Q4r)/8:30 EST**

Productivity should be revised up to **-2.1%** from -3.0%, with unit labor costs down to **3.6%** from 4.5%. **Consensus: Productivity -3.2%, unit labor costs 4.7%.**

- **Factory Orders (1)/10:00 EST**

Orders should rise about **3%,** in the wake of the 4.9% rebound n durable goods orders reported last week. **Consensus: 2.1%.**

- **D: ISM Non-manufacturing Survey (2)/10:00 EST**

The January rebound in core retail sales should lift the index to about **55** from 53.5. **Consensus: 53.0.**

Friday, March 4

- **D: Employment (2)/8:30 EST**

Payrolls should rise about **180K,** constrained by the unwinding of some of the fall surge in construction jobs. The unemployment rate should be unchanged at **4.9%,** and persistent calendar quirks should hold down average hourly wages, which should be **unchanged. Consensus: Payrolls 193K, unemployment 4.9%, average earnings 0.2%.**

- **D: International Trade (1)/8:30 EST**

The advance data suggest the headline deficit will rise to **$44.0B** from $43.7B. **Consensus: $43.8B.**

THIS WEEK'S FUNDING

Monday 29	Auction: $37B 3-month, $30B 6-month bills Announcement: 4-week bills (Mar. 1)
Tuesday 1	Auction: 4-week bills Auction: $20B 1-year bills (Mar. 1)
Wednesday 2	Nothing
Thursday 3	Announcement: 3-month, 6-month bills (Mar. 7) Announcement: 3-year notes (Mar. 8) Announcement: 3-year notes (Mar. 9) Announcement: 3-year notes (Mar. 10)
Friday 4	Nothing

PANTHEON'S FINANCIAL FORECASTS

		End-month:			
	4:00pm Fir.	Mar	Jun	Sep	Dec
Fed funds target	¼-to-½	½-to-¾	¾-to-1	1¼-to-1½	1¾-to-2%
2-yr	0.80	0.90	1.25	1.75	2.25
10-yr	1.76	2.00	2.25	2.50	3.00
30-yr	2.64	2.80	3.00	3.15	3.25
Curve 10-2	96	110	100	75	75
Curve 30-2	184	190	175	140	100
S&P 500	1,948	1,900	1,925	1,925	1,950
Yen/Dollar	114.0	118	130	132	135
Dollar/Euro	1.09	1.08	1.04	1.01	1.01
Dollar/Sterling	1.39	1.39	1.38	1.40	1.42

PANTHEON'S ECONOMIC FORECASTS

GDP	Q2	3.9%	2012 year:	2.3%
	Q3	2.0%	2013 year:	2.2%
	Q4 second	*1.0%*	2014 year:	2.7%
	Q1 forecast	*2½%*	2015 year:	2.4%
	Q2 forecast	*3%*	*2016 year:*	*2½%*
	Q3 forecast	*3½%*		

CPI	January 0.0% (1.4% y/y); core 0.3% (2.2% y/y)
	June 2016 forecast: 0.8% y/y; core 2.4% y/y
	December 2016 forecast: 1.6% y/y; core 2.6% y/y

Unemployment: June 2015: 4.5%; December 2016: 4.2%.

Federal budget: FY 16 forecast: -$430B (2.3% of GDP)