PANTHEON MACROECONOMICS

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A sudden, sustained rise in core inflation in the near-term looks very unlikely...

...The Fed is tightening because it fears higher inflation in the future, given the tight labor market.

Jobless claims have hit a new all-time low as a share of the employed labor force.

Near-Term Core Inflation Risk is Modest; the Fed Fears the Future

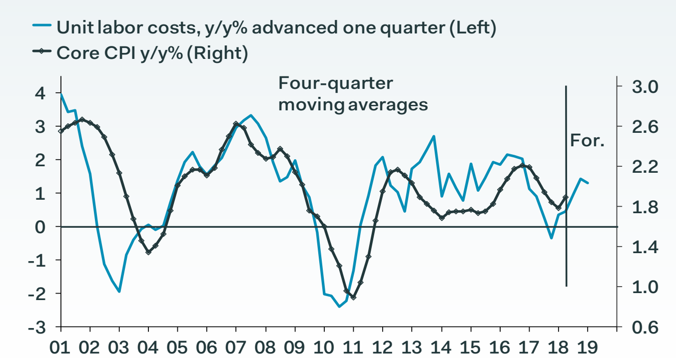
The continued modest rate of increase in unit labor costs makes it hard to worry much about the near-term outlook for core inflation. *Specific factors, such as big swings in the dollar, or broad changes in tariffs on imports, could push inflation well off the track implied by the path of unit labor costs, but for now our first chart suggests that core CPI inflation is unlikely to deliver any seriously nasty surprises over the next year.* Note that the chart shows four-quarter moving averages for the rates of increase of both unit labor costs and core CPI inflation; the former series, in particular, is wildly volatile in the short-term, and the noise can hide the signal.

Our view that the Fed will raise rates further than markets expect through next year, then, is predicated more on the idea that normalization in the face of an exceptionally tight labor market will require rates above the 2½% implied by markets at the end of next year, rather than an expectation of rampant inflation.

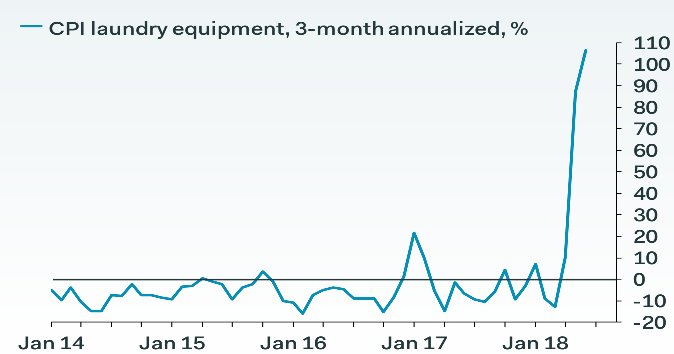
All bets on the path of inflation would be off in the event that the administration is dumb enough to apply tariffs to most imports from China, but that's not our base case. You don't need to look very hard at our second chart, which shows what has happened to prices for domestic washing machines since 20% tariffs were applied on imports in January, to appreciate that inflation would rocket, immediately, if the levies were applied to a broad range of imports.

The Fed likely would respond aggressively to a tariff-induced surge in inflation, fearing that people would be able to extract much bigger wage gains in compensation, given the tightness of the labor market. The Fed's failure to raise rates by enough to limit the surge in wage inflation in the wake of the oil shock in 1973-to-74, thereby allowing much higher core inflation to become embedded, remains a painful memory. Policymakers would be acutely aware of the risk of making the same mistake again. *This time, they would be much more willing effectively to tell the public that higher nominal wage gains would not change the fact that tariffs make*

MODEST INCREASES IN UNIT LABOR COSTS CONSTRAIN CORE CPI



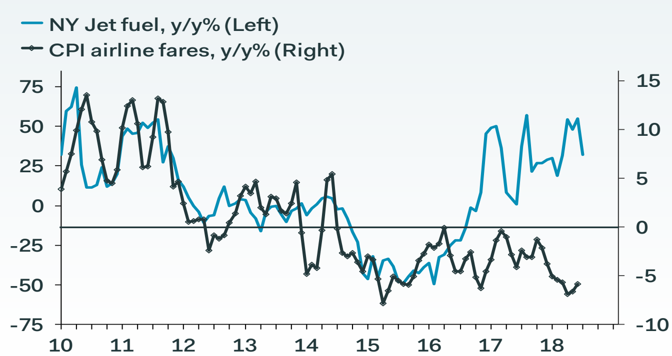
BROAD TARIFFS ON CONSUMER GOODS WOULD BE DISASTROUS



the country worse off, and that loose monetary policy cannot undo the damage.

More immediately, we expect today's CPI report, for July, to confirm that the month-to-month trend remains close to 0.2%. We see upside risks to apparel prices, which dropped unexpectedly by 0.9% in June, and airline fares, which have fallen in each of the past three months, despite rising jet fuel costs. Fares dropped at a remarkable 19.7% annualized rate in the second quarter, leaving the year-over-year rate in June at minus 5.9%, while fuel prices jumped 32% over the same period.

AIRLINES ARE UNDER PRESSURE AS COSTS AND FARES DIVERGE



This can't continue without triggering real financial distress at the major airlines, which are being squeezed—especially on the lucrative transatlantic routes—by an array of low-cost competitors. *U.S. airline CEOs have said that they expect to be able to recoup most of the hit from higher fuel prices by increasing fares, but we can see no evidence of that, yet.*

Elsewhere, keep a close watch on the lodging and used car components. Lodging costs dropped by a startling 3.7% month-to-month in June, but this followed gains totalling 6.1% over the previous three months. Lodging costs are wildly volatile, so anything can happen in any given month, but we'd be surprised to see a rebound in July.

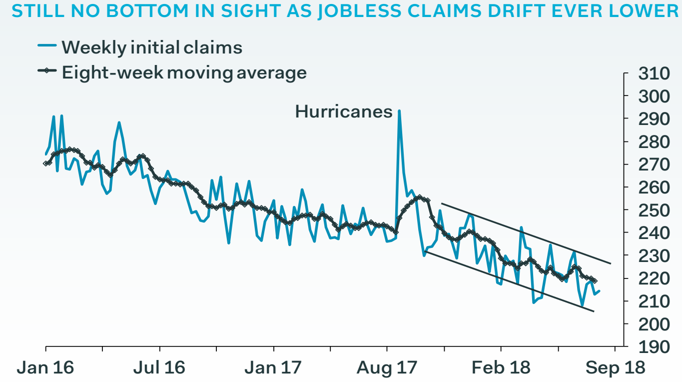
Used car prices rose sharply after the hurricanes last year, which forced hundreds of thousands of people to replace wrecked cars in a hurry. Prices then fell as demand eased back to normal, but then jumped unexpectedly by 0.7% in June. *We doubt this marks the start of a sustained revival.* Auction prices have firmed recently but they tend to lead the CPI measure by several months. Accordingly, we expect to see a renewed dip in CPI used car prices in July.

Most of the time, the off-trend movements in core CPI components are offsetting, more or less, and that's our base case for July. ***In recent years, increases of 0.1% or less have been much more common than 0.3% jumps—since January 2016, the count is 11 versus two—and while the balance is likely to start tipping in the other direction over the next year, we'd be quite surprised by a 0.3% increase in today's report.*** Note that the headline and core should move together; seasonally adjusted gasoline prices were little changed last month.

The trend in jobless claims is still falling

Yesterday's weekly jobless claims brought another milestone, with the eight-week moving average—our preferred measure of the trend—falling to a new cycle low, at 218.7K. As a share of employment, claims have never been lower, and the data extend all the way back to 1948. Presumably, the story here is that the very strong growth in the second quarter raised the bar for layoffs even higher, because firms know they will find it extremely difficult to replace people they let go in haste. *Claims likely will fall a bit further, but sustained sub-200K readings probably are too much to ask.*

STILL NO BOTTOM IN SIGHT AS JOBLESS CLAIMS DRIFT EVER LOWER



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THIS WEEK IN BRIEF

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

Monday, August 6

• **No significant data released.**

Tuesday, August 7

• **Redbook Chain Store Sales (8/4)/9:00 EDT**
Same-store sales growth jumped unexpectedly to **5.6%** year-over-year, a seven-month high, from 4.2% last week.

• **JOLTS (6)/10:00 EDT**
The number of job openings was little changed, at **6,662K,** the fourth straight reading well above the prior trend. The quits rate was unchanged at 2.3%, after the initial estimate for May was revised down by a tenth.

• **Consumer Credit (6)/15:00 EDT**
The stock of credit rose by **$10.2B,** slowing from May's above-trend $24.3B, which likely was boosted by seasonal adjustment problems.

Wednesday, August 8

• **Mortgage Applications (8/3)/7:00 EDT**
The purchase applications index fell by 2.0% to **233.1,** a 24-week low, but note that the index usually falls in August, even though it is seasonally adjusted, badly.

Thursday, August 9

• **D: Jobless Claims (8/4)/8:30 EDT**
Claims slipped to just **213K** from 219K, and the eight-week moving average indicator of the trend dipped to a new cycle low in absolute terms and an all-time low when measured as a share of payrolls.

• **D: Producer Prices (7)/8:30 EDT**
The headline index was **unchanged,** with the core up a mere **0.1%.** Lower prices for energy—except gasoline—depressed the headline, and both measures were held down by a 0.8% drop in the "trade services" index, which captures profit margins for wholesalers and retailers. This followed a run of big increases and is not a sign that core PPI inflation is slowing; we expect it to rise through early fall, as the pass-through from rising oil prices peaks.

• **Wholesale Inventories (6)/10:00 EDT**
Inventories rose **0.1%** in June, after a 0.3% increase in May.

Friday, August 10

• **D: Consumer Prices (7)/8:30 EDT**
With gasoline prices dipping only slightly, both the headline and core indexes probably rose by **0.2%.** In the core, we look for rebounds in apparel and airline fares, and a modest increase in hotel room rates, bringing recent gyrations to an end. Used auto prices likely dropped; the 0.7% June increase is unsustainable. **Consensus: Headline 0.2%, core 0.2%.**

• **Treasury Budget (7)/14:00 EDT**
The reckons the deficit jumped to about **$75B,** from $43B in July 2017. Revenues down, spending up. **Consensus: $77B.**

THIS WEEK'S FUNDING

Monday 6	Announcement: four-week bills Auction: $51B 3-month, $45B 6-month bills
Tuesday 7	Auction: four-week bills Auction: $34B 3-year notes (settles Aug. 15)
Wednesday 8	Auction: $26B 10-year notes (settles Aug. 15)
Thursday 9	Announcement: 3-month, 6-month bills (Aug. 13) Announcement: 1-year bills (Aug. 14) Auction: $18B 30-year bonds (settles Aug. 15)
Friday 10	Nothing

PANTHEON'S FINANCIAL FORECASTS

		End-month:			
	4:00pm Thur.	**Sep**	**Dec**	**Mar**	**Jun**
Fed funds target	1¾-to-2	2-to-2¼	2¼-to-2½	2½-to-2¾	2¾-to-3
2-yr	2.65	2.70	3.00	3.20	3.30
10-yr	2.93	3.25	3.50	3.50	3.50
30-yr	3.07	3.30	3.50	3.60	3.60
Curve 10-2	28	55	50	30	20
Curve 30-2	42	60	50	40	30
S&P 500	2,854	2,875	2,900	2,850	2750
Dollar/Yen	111.1	110	110	115	115
Euro/Dollar	1.15	1.15	1.10	1.10	1.10
Sterling/Dollar	1.28	1.38	1.40	1.40	1.40

PANTHEON'S ECONOMIC FORECASTS

GDP	Q3	3.2%	2015 year:	2.6%
	Q4	2.9%	2016 year:	1.6%
	Q1	2.0%	2017 year:	2.3%
	Q2 first	*4.1%*	*2018 year:*	*3.0%*
	Q3	*3%*	*2019 year:*	*2.0%*
	Q4	*3%*		

CPI	Jun 0.1% (2.9% y/y); core 0.2% (2.3% y/y)
	Dec. 2018 forecast: 2.5% y/y; core 2.3% y/y
	Mar. 2019 forecast: 2.5% y/y; core 2.5% y/y

Unemployment: Dec. 2018: 3.6%; June 2019: 3.3%.

Federal budget: FY 18 forecast: -$750B (3.8% of GDP)