Weighing the Week Ahead: Inflation on the Horizon?
July 10, 2018
by Jeff Miller
of NewArc Investments, Inc.

The economic calendar is a light one, and many regular participants are on vacation. The most important data include PPI, CPI, and JOLTS, the best read on a tightening labor market. I expect pundits to put these pieces together and wonder:

Is inflation finally on the horizon?

Last Week Recap

In my last edition of WTWA I took a cue from the cover of Barron’s and asked whether we should be worried about 2020. That was a reasonable guess and it allowed me to generalize about the switch from imminent worries to long-term ones. At the beginning of the week, pundits referred directly to Barron’s. There were also new stories with similar themes.

The media focus on fear is always with us, as the Visual Capitalist illustrates.
Mike Williams sounds a similar note before turning to the trade war issue.

I mean it sounds terrifying when you read some of the rhetoric, but what can they “actually” do?

The bluff and bluster will go the way of Brexit, Chinese Yuan devaluation fears (Acts I, II, II, IV, V, VI and VII), Ebola outbreaks, the outrage at the Border (I mean the Janet Reno version – not the current remake), and everything else that was previously going to throw the globe into the pits of hell.

So, before we squirm out onto the ledge let’s think through this for just a moment: Why can’t China impose “countervailing tariffs?”

He does the math, analyzes the currency threats, and explains why massive bond sales are unlikely.

[Jeff – My long-term concerns about trade are greater than Mike’s, but he helps to provide a context and ring-fence the investment effects].

The Story in One Chart
I always start my personal review of the week by looking at a great chart. This week let’s look at the futures chart from Investing.com. Since futures trade outside normal market hours, you can see the overnight effects. The “N” tags are points where there was significant news. The interactive chart lets you see the specific news and add technical indicators of your choice. Futures have a different lead month on a quarterly cycle. Right now, trading is in September futures. The value differs a bit from the S&P 500 index value. The futures owner does not collect dividends but earns interest on the funds not used for actual stock purchases. There is an active arbitrage between these values.

The market was up 0.88%. The week’s trading range was about 2%, consistent with the last few weeks. I summarize actual and implied volatility each week in our Indicator Snapshot section below. Volatility is back into the long-term range.

The News
Each week I break down events into good and bad. For our purposes, “good” has two components. The news must be market friendly and better than expectations. I avoid using my personal preferences in evaluating news – and you should, too!

When relevant, I include expectations (E) and the prior reading (P).

**New Deal Democrat’s weekly summary** covers the high-frequency data that are important, but often missed by investors. It is time-consuming to track down and analyze all these indicators, so many just skip it. His post includes both coincident and long-term indicators, so I always watch it. He also has a nice conclusion each week for those who need the Cliff Notes. This week he notes a deterioration in the long-term forecast:

> The longer term forecast, however, led by real M1, the yield curve, the credit spread, purchase mortgage applications, and now one financial conditions index, continues to deteriorate. The first three are all very close to downgrades. About a month ago the deterioration was enough to downgrade the forecast from positive to neutral. *IF* this trend continues, it is within the range of reasonable possibility that the forecast turns negative within the next month.

**The Good**

- **Factory orders** for May increased 0.4% (E -0.2 P -0.4).
- **The trade balance for May was -$43.1B.** This may not sound like good news, but it was better than E -$46.3B and P -$46.1B.
- **Trucking growth** shows continuing strength. Steven Hansen (GEI) looks at both the ATA and the CASS index. He compares the methods and provides helpful interpretation. Tucked inside the good news is incipient wage pressure in the short term. Here is a table from the CASS report.

<table>
<thead>
<tr>
<th></th>
<th>May 2018</th>
<th>Year-over-year change</th>
<th>Month-to-month change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shipments</td>
<td>1.307</td>
<td>11.9%</td>
<td>5.9%</td>
</tr>
<tr>
<td>Expenditures</td>
<td>2.875</td>
<td>17.3%</td>
<td>4.9%</td>
</tr>
</tbody>
</table>

- **ISM indices – both manufacturing and services were strong.**
  - Manufacturing was 60.2 (E 58.5 P 58.7) Bespoke has charts, analysis, and quotations from respondents.
Services was 59.1 (E 58.3 P 58.6)

 Auto and truck sales increased, but many are concerned about the effect of tariffs.

Employment showed continuing solid growth

- Payroll jobs increased a net 213K with upward revisions of 40K in prior months (E 195K P upwardly adjusted to 244K)
- ADP private jobs increased 177K, down from an upwardly revised 189K and in line with expectations.
- Even the higher unemployment rate had a positive aspect. (NYT)

...It’s a sign that the hot job market is succeeding at pulling people off the sidelines and into the work force. It’s easy to imagine people who have become disengaged from the
work force who, in this tightening job market, are more likely than they were a few years ago to see help wanted signs everywhere, or to have friends and acquaintances urge them to start working.

It is the opposite of the trend from 2010 to 2012, when the unemployment rate was falling but simultaneously millions of Americans gave up even looking for work.

- Initial jobless claims were 231K versus expectations of 225K, but the overall level remains at record lows.

The WSJ chart pack always covers the key results. I am selecting the depiction of various unemployment measures. As we can see, all have improved together. The idea that there is some deception about the overall economy is silly. The differences among the measures are evident through the entire history. It is nice to see more people attracted into the work force, but I doubt we will ever again see the 2000 levels.

![Broader Measures](chart)

**The Bad**

- **Construction spending increased only 0.4%** (E 0.6 P downwardly revised 0.9)
- **Hourly earnings increased only 0.2%** (E and P of 0.3%).
- **North Korea negotiations.** (Washington Post). Sec. Pompeo had an upbeat report on his meetings, but the Korea Central News Agency contradicted the report.

   Pyongyang crushed that appraisal, saying the United States had betrayed the spirit of the
June 12 Singapore summit between President Trump and North Korean leader Kim Jong Un. “The U.S. side came up only with its unilateral and gangster-like demand for denuclearization,” the statement said.

The Ugly

“Deepfake” videos. The Pew Research Center reports that 70% of Americans are exhausted by the news. People turn to videos as an easy alternative to reading. But what if the video could be edited to deceive watchers about the actual statements. Deb Riechmann (AP and Chicago Tribune) explains the technology and warns about the potential for election disinformation.

The Week Ahead

We would all like to know the direction of the market in advance. Good luck with that! Second best is planning what to look for and how to react.

The Calendar

The calendar is modest. Inflation data and the JOLTS report are the highlights. The trade story will continue to play out, of course, with more stories aimed at documenting the impacts.

Briefing.com has a good U.S. economic calendar for the week (and many other good features which I monitor each day). Here are the main U.S. releases.

<table>
<thead>
<tr>
<th>Week of July 09 - July 13</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Date</strong></td>
</tr>
<tr>
<td>Jul 09</td>
</tr>
<tr>
<td>Jul 10</td>
</tr>
<tr>
<td>Jul 10</td>
</tr>
<tr>
<td>Jul 11</td>
</tr>
<tr>
<td>Jul 11</td>
</tr>
<tr>
<td>Jul 11</td>
</tr>
<tr>
<td>Jul 11</td>
</tr>
<tr>
<td>Jul 11</td>
</tr>
<tr>
<td>Jul 12</td>
</tr>
<tr>
<td>Jul 12</td>
</tr>
<tr>
<td>Jul 12</td>
</tr>
<tr>
<td>Jul 12</td>
</tr>
<tr>
<td>Jul 12</td>
</tr>
<tr>
<td>Jul 13</td>
</tr>
<tr>
<td>Jul 13</td>
</tr>
<tr>
<td>Jul 13</td>
</tr>
<tr>
<td>Jul 13</td>
</tr>
<tr>
<td>Jul 13</td>
</tr>
</tbody>
</table>
Next Week’s Theme

This is rather light week for economic reports. The PPI, CPI and JOLTS reports invite the punditry to take a hard look at the labor market, increasing wage pressure, and overall inflation rates. I expect many to be asking:

Is inflation on the horizon? Should we be worried?

This popular subject has a very wide range of controversial viewpoints. As always, each of these has adherents. Most have a bearish tone, although they are difficult to scale carefully. Expect to hear variants of the following:

- We already have substantial inflation – much more than government measures show.
- The government keeps the CPI low to avoid paying more to Social Security recipients.
- The Fed’s money-printing will finally influence the general price level.
- My own costs – especially health care and college tuition—have risen much faster than the CPI.
- Why should prices increase at all? The Fed should have a price stability goal of no change – zero, not 2%.
- Surveys of inflation expectations continue at about 3%.
- Expectations reflected in bond prices (updated each week in the indicator snapshot) remain close to 2%.

Feel free to add in the comments any which I have missed. As usual, I have some additional observations in today’s Final Thought.

Quant Corner

We follow some regular featured sources and the best other quant news from the week.

Risk Analysis

I have a rule for my investment clients. *Think first about your risk. Only then should you consider possible rewards.* I monitor many quantitative reports and highlight the best methods in this weekly update.

The Indicator Snapshot
Short-term trading conditions continue at highly favorable levels. Actual volatility declined dramatically in the four-day week. The VIX continues to overstate volatility. For asset managers who consider stocks versus bonds (a large group), this is an important comparison. The C-Score has declined further, but remains in rather benign territory.

**The Featured Sources:**

Bob Dieli: Business cycle analysis via the “C Score.

Georg Vrba: Business cycle indicator and market timing tools. None of Georg’s indicators signal recession.

Brian Gilmartin: All things earnings, for the overall market as well as many individual companies.

RecessionAlert: Strong quantitative indicators for both economic and market analysis.
Doug Short and Jill Mislinski: Regular updating of an array of indicators. Great charts and analysis. With the employment data, it is time for an update of the excellent “Big Four” chart.

Guest Sources:

David Templeton (HORAN) analyzes the National Income and Product Accounts (NIPA) data. He explains that these are actual IRS profits, not GAAP earnings. Importantly, he notes that peaks seem to occur about four quarters before the 12-month forward earnings estimates. This suggests continuing growth for the next year, as the chart below indicates:
Joe Wiggins (Behavioural Investment) examines whether volatility is risk. It is a great question. I have written that traders must deal with volatility, investors should embrace it, and that the VIX is a lagging indicator. We all know my position. Mr. Wiggins modestly says that his view disagrees with the majority of people he respects in the investment industry, and modestly states that it might not be sensible to take a view “contrary to people more intelligent than yourself.” While you may count me among those who generally disagree, I respect his three interesting points:

As volatility is a somewhat nebulous concept, it is worth considering what drives fluctuations in asset prices. I tend to think of three related aspects:

1) A change in the fundamental value of an asset.

2) Uncertainty over the fundamental value of an asset and our behavioural reaction to uncertainty.

3) Investors reacting to the behaviour of other investors (momentum) or anticipating how they
think other investors will behave. Markets are reflexive.

And, his insight into behavior. (I consulted Mrs. OldProf on this. She says that it is OK to use “behavior” when it is my writing, but that I must respect “behaviour” in his text. My spell-checker wants to change this. I always blame this on Bill Gates, who I once beat in a bridge match. His reaction spoke to his normal bridge-player reaction – it was not my fault!) Digging myself out of these multiple digressions (Mrs. OP says that I should quit having fun and get back to work), I strongly recommend the article.

**Insight for Traders**

Check out our weekly Stock Exchange post. We combine links to important posts about trading, themes of current interest, and ideas from our trading models. **This week** our models rebounded with a good week, adding to their long-term outperformance. The question for our trading colleagues was, “Are the Bots Winning?” As always, we highlighted ideas from trading experts as well as some of our current picks. The ratings from Felix and Oscar this week feature the DJIA. **Blue Harbinger** is our editor for this information and ringleader for the group discussion.

While the series emphasizes trading, investors might want to check it out. I have discovered that the methods reduce risk through diversity and are appropriate for a portion of an IRA allocation.

**Insight for Investors**

Investors should have a long-term horizon. They can often exploit trading volatility.

**Best of the Week**

If I had to pick a single most important source for investors to read this week it would be Isaac Pino’s Motley Fool post on *The Hidden Index Bubble*. He reviews the arguments for passive investing and analyzes the effect on the index funds. The passive investing share of investments has increased from 20% to 40% in less than ten years. His explanations are easy to understand, as are his descriptions of the consequences of this shift:

> Passive indexing, then, is in vogue in recent years. Its increasing popularity adds incrementally to the market caps of all companies in the index — but even more so to the largest ones. And this compounds over time. Ultimately, it can create distortions that will have consequences for investors.

This has a consequence that will surprise many.
Index owners are less diversified than they think. The returns are driven more by the biggest stocks than they realize.

As shown, the top five largest companies grew more on a percentage basis than the top 10, which grew more than the top 25.

<table>
<thead>
<tr>
<th>Group</th>
<th>Beginning 2017</th>
<th>Ending 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Largest five</td>
<td>11%</td>
<td>13.3%</td>
</tr>
<tr>
<td>Largest 10</td>
<td>18.9%</td>
<td>21%</td>
</tr>
<tr>
<td>Largest 25</td>
<td>29.2%</td>
<td>31.1%</td>
</tr>
</tbody>
</table>

CHART SOURCE: SEMPER AUGUSTUS INVESTMENTS GROUP’S 2017 ANNUAL LETTER.

Index owners are less diversified than they think. The returns are driven more by the biggest stocks than they realize.

The Big Get Bigger:
2017 S&P 500 Returns by Size of Constituents

The effect is even more pronounced in small-cap indexes.

He pulls all these effects together, leading to a question of whether there is a bubble within index
investing. This is an important topic that most investors have probably not considered.

**Stock Ideas**

Chuck Carnevale is no cheerleader. He has created tools for objective analysis, and his posts are always educational. Readers learn important analytical methods and a good stock idea as well. This week he has a warning for those who consider dividends, but not valuation. His subject this week is Roper Technologies (ROP), a company with a great record which is now fully valued.

Marc Gerstein is also a creator of excellent methods. This week he turns his screening methods to the question of REITs. His post is a lesson in suitability of the group, important criteria for evaluation, doing an honest backtest, and achieving similar results with lower volatility. And yes, there are also some specific ideas, but don’t just jump to the end of the post!

Blue Harbinger examines the business model for New Residential (NRZ), explaining the story behind the 11.2% yield. He then presents a balanced risk and reward assessment. Once again, this is a post including both education and ideas.

Homebuilders. Barron’s especially likes Toll Brothers (TOL), suffering from an “excessive decline” leaving the stock “significantly undervalued.” The company has been performing well despite the highly-publicized headwinds of higher interest rates and increased costs. [Jeff – I agree but have chosen two of their competitors.]

**Big Builders**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Toll Brothers / TOL</td>
<td>$37.00</td>
<td>$5.6</td>
<td>-23%</td>
<td>$4.38</td>
<td>$4.93</td>
<td>8.5</td>
<td>7.5</td>
<td>1.2%</td>
<td>1.3</td>
</tr>
<tr>
<td>D.R. Horton / DHI**</td>
<td>41.33</td>
<td>15.6</td>
<td>-19</td>
<td>3.85</td>
<td>4.44</td>
<td>10.7</td>
<td>9.3</td>
<td>1.2%</td>
<td>1.9</td>
</tr>
<tr>
<td>Lennar / LEN***</td>
<td>53.12</td>
<td>16.9</td>
<td>-16</td>
<td>5.42</td>
<td>6.90</td>
<td>9.8</td>
<td>7.7</td>
<td>0.3%</td>
<td>1.3</td>
</tr>
<tr>
<td>PulteGroup / PHM</td>
<td>29.17</td>
<td>8.3</td>
<td>-12</td>
<td>3.32</td>
<td>3.73</td>
<td>8.8</td>
<td>7.8</td>
<td>1.2%</td>
<td>2.0</td>
</tr>
</tbody>
</table>

*Fiscal year ends Oct; **Fiscal year ends Sept; ***Fiscal year ends Nov; E=Estimate

Source: Bloomberg

Royal Caribbean Cruises (RCL) is another Barron’s favorite this week. Once again, we have a lagging stock doing well despite worries about fuel prices and hurricanes. [Jeff – This time I agree about both the sector and the specific choice].

Stone Fox Capital likes Walgreens (WBA). They note:

Without even knowing the details of the purchase of PillPack by Amazon, analysts fought to be the first to downgrade Walgreens. Some examples of the quick analyst moves:

- BAML downgraded to Neutral with a price target of $60.
- Jefferies downgraded to Hold with a price target cut to $65 from $85.
- Baird downgraded to Neutral with a price target cut to $64 from $86.
This is quite a reaction for a company with revenue of $131B versus $100M at PillPack. Walgreens also has customer relationships and pharmacists in place, presenting a bigger challenge than other competitive moves by Amazon.

**Value Investing**

John Rekenthaler (*Morningstar*) has an interesting comparison of growth and value investing. He concludes:

> Sometimes value-stock investors will be right and will comfortably win their contest with growth buyers. Sometimes they will be wrong; then, they will comfortably lose. But sometimes, expectations will remain stable, so that neither party gains relative ground. It is during that third scenario when value investing demonstrates its true strength.

**Personal Finance**

Seeking Alpha Senior Editor Gil Weinreich has added more valuable content to his daily post. While billed as information for financial advisors, it has become popular with a general readership. He tracks the most important issues and adds provocative insights. You will not always agree with him, and that is a good reason to read him carefully. One example this week was his take on the emerging trade war. He also includes links to other key articles. I have discovered many new people to follow through Gil’s links.

Congratulations to Tadas Viskanta, now the Director of Client Education for Ritholtz Wealth Management. He promised to maintain his high standard in his daily posts. His daily links have reached to more topics and sources, and the *Wednesday Personal Finance section* is better than ever. I am having trouble picking a favorite this week, so you should be sure to check out the full post. Gun to my head…it is still a tie. Many are considering annuities. *Mike Piper describes* a very conservative approach. Morningstar’s *Christine Benz* takes up the practical question of how expenses change in retirement. There are some other great links!

**Perspective**

Jason Zweig (*MoneyBeat*) is a leading source for individual investors. He has authored or edited several important investment books. He has a knack for combining education with entertainment as he did this week with *Ode to The Wall Street Platitude*.

His opening paragraph gives you the idea:

> Proverbs are peculiar. Heard one at a time, they sound so sage and familiar that we seldom
notice how contradictory they would be if we compared them. Somehow, “opposites attract” even as “birds of a feather flock together”; “the devil takes the hindmost,” but “haste makes waste”; “two heads are better than one,” yet “too many cooks spoil the broth.”

His application to sloganized Wall Street lore is first-rate. As I noted to a friend, anyone can find confirmation for an investment approach within this list. It must be great! Here is a small taste, but you really need to read the entire article.

You can either sleep well or eat well.  
When you get a hunch, bet a bunch.  
There’s no such thing as a free lunch.  
Don’t put all your eggs in one basket.  
Put all your eggs in one basket,  
And watch that basket!  
Bears make money, bulls make money, but pigs get slaughtered.  
When the ducks quack, feed ’em.

Watch out for…

Tired dividend growth stocks. Valuentum takes a close look at General Mills (GIS). (See also the Chuck Carnevale link above).

Dividend aristocrats are lagging the overall market this year, but Plutos suggests considering laggards in the group. His historical record shows lower volatility except for the 1994 “bond bloodbath.”


Private real estate assets. Larry Swedroe outlines the risks. His data compare listed REITs with private equity real estate. Look before buying!

Final Thoughts

It is a challenge to write about inflation, possibly the most misunderstood economic topic. Everyone is a self-professed expert, surrounded by evidence. Among the many topics greeted with popular skepticism include the following:

- Why a little inflation (the Fed’s target is 2% on the PCE index) is desirable. It provides a little cushion against slipping into deflation, which is tougher to correct. It also facilitates development of contracts, shifting of resources, and incentives for growth.
- Why there are so many different measures. Each is designed for a specific economic
• Why the CPI seems different from one’s personal experience. We focus on price increases around us, giving less attention to new bargains. Also, your personal “basket” of goods differs from the index construction.

• Why the government includes adjustments for quality and changing behavior. When a product gets better it does more, lasts longer, or is safer. Cars are a good example. Do we expect one that performs better for twice as many years to have the same cost as earlier models?

The complexity of the topic makes it open season for demagoguery and conspiracy theorists. It is more rewarding for investors to understand government policy and the likely changes. The two most important current themes are Fed policy and Trump administration policy.

1. The Fed has repeatedly expressed a desire to reach inflation of about 2% on the Personal Consumption Index. This generally runs a little “cooler” than other measures, mostly because the methodology has less emphasis on housing and a faster recognition of behavioral changes. The Fed is also not treating 2% as an instant trigger for a policy change. A range up to 2.5%, lasting for several months, is the current goal. This might mean a CPI approaching 3%.

2. Trump Administration policy has several inflationary elements, including immigration restrictions, fiscal stimulus, and tariffs. The impact of each will be gradual but significant.

Economic expansions usually end when the Fed has been too slow in controlling inflation and must embark on a policy of rapid interest rate increases. This may well happen again – but not just yet.

Excessive inflation is not imminent, but the worrying will start as soon as we see a hot number or two.

I’m more worried about:

• The Aramco IPO. The WSJ reports from a senior Aramco executive, “Everyone is almost certain it is not going to happen.” This decision would have wide-ranging impacts, most immediately on oil prices.

• A US WTO violation. The Trump Administration has not shown a high level of respect for international authorities, so an adverse decision for the US might be disregarded. The WTO provides protection against boycotts, embargoes, and other sanctions. Here is a good background piece.

I’m less worried about:

• The economy. This is a growth sweet spot which might last much longer. Valuations are attractive because of the intuitive appeal of the aging bull story.

• Earnings. Brian Gilmartin’s excellent updates on both revenue and earnings remain encouraging. The wild card will be conference calls that raise trade war worries.

© NewArc Investments, Inc.