Weekly Commentary **February 19, 2016**

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Inflation (Surprisingly) Firm; Fed on Hold; Stocks Mark Time

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We finally had relief in the equity market, as oil prices bounced off their lows and the fear of a European banking crisis faded. But it would be quite premature to say that all is fine. Both the CPI and PPI inflation indicators came in above expectations. Core CPI in fact is running at a 2.2% annual rate, the highest in four years. To be sure, the core PCE Deflator, the preferred measure of the Fed (and most economists) is only up 1.4%. Nevertheless it is disquieting to see prices measures continue to rise in the face of collapsing energy prices.

Despite these firm inflation readings, it is extremely unlikely that the Fed will raise rates in March and the January minutes highlighted the FOMC's awareness of the volatility in the financial markets and the de facto tightening caused by the increase in risk spreads (which became far more severe in the two weeks after the Fed meeting). I also regard the recent dovish comments by St. Louis Fed President James Bullard, a long-standing hawk, significant. If he is coming to the conclusion that it is wise to wait, it is almost impossible to see how the Fed will hike. Super hawks like Richard Fisher and Charles Plosser are no longer at the Fed and Chairman Yellen is a natural dove. Furthermore Vice-Chair Fischer (although characterized as a mild hawk) keeps hear ear close to the international markets and I am sure that he, as well as other FOMC members, have heard numerous pleas from businesses as well as other central bankers to pause if not halt their tightening.

The productivity collapse appears to have continued into this quarter. January payrolls were strong and, with the recent strength emanating from jobless claims, the rest of the quarter's payrolls look to be strong. Yet GDP growth estimates for this quarter are only 2%. Recall, that 2% GDP growth would materialize, based on historical trends, if there were absolutely *no* increase in either payrolls or hours worked (which jumped in January). This new era of zero (or even negative) productivity growth is troublesome. It does keep real interest rates low, but it slows the growth of demand and most importantly brings the rise in real wages, the main indicator of the standard of living, to a halt. Furthermore, with lagging growth in the labor supply, the increase in the number of workers further tightens the labor market and forces the unemployment rate still lower. This at some point will raise wages, not due to productivity, but due to a labor shortage, further pressuring profit margins. For these reasons I am not convinced a sustained recovery in share prices is yet in the offing.
NEXT WEEK I SHALL BE TRAVELLING IN MYANMAR AND THERE WILL BE NO NEWSLETTER. COMMENTARY WILL RESUME MARCH 4, THE DAY OF THE FEBRUARY JOBS REPORT.
