Weekly Commentary March 25, 2016

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GDP Growth Still Poor; Inflation Heats Up

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Although financial markets are closed for Good Friday, the Commerce Dept. released its final estimate of Q4 GDP growth and it was better-than-expected, up 1.4%, 4 tenths more than the previous estimate and more than a point higher than the first estimate. Looking at the big picture, this number is still horrible given the rapid growth of employment in Q4: productivity growth will likely be revised from minus 2.2% to minus 1.8%.

And with less than a week to go before the end of the first quarter, Q1 growth is not looking much better: Current estimates are about 1.5%-2.0%. To be sure, Q1 payroll growth is estimated at 650k, about 200k less than the blockbuster gains of Q4, but still high enough to produce GDP growth in the 3% to 4% range if productivity would only rise to its historical average of 2.2% per year.

As usual, next Friday's payroll report (released on April Fool's Day) will be important in shaping the Fed's view of the economy. The question is whether the participation rate will continue to rise in order to absorb the robust payroll growth with no drop in the unemployment rate. The early calls are for the unemployment rate to remain at 4.9% and hourly wages to be up 0.3%, bouncing back from the dismal 0.1% drop last month and remaining at a quiescent 2.2% year-over-year.

But how long can wage gains remain moderate if the unemployment rate continues to drop? And whatever happens to wages, we are apt to see some disturbing inflation news in the coming months. For the first time in almost a year, gasoline prices are rapidly heading upward. In fact current prices of unleaded regular have topped $2, and are now about 20% over their $1.69/gallon low reached just last month. These rising gasoline prices correspond to the recovery of crude from its low of $26 a barrel to around $40 and may give us some up 4 to 5 tenth readings on the headline (non-core) inflation, released in the middle of next month. To be sure the Fed looks at core inflation, but even that inflation measure has been firm and with rents and home prices continuing to rise, core inflation is apt to remain firm in the near future. These inflation measures will give ammunition to the hawks on the FOMC who want to "get on" with the rate hikes. Although Yellen has said that every FOMC meeting a "live" meeting, meaning the Fed can raise rates at any time, it is extremely unlikely they will move on April 27. The June 15 meeting, with 2 additional labor and inflation reports under their belts, will be more contentious. I expect that fear of another rate hike by the Fed will keep a lid on stock prices.
