US Watch

FED'S "PATIENCE" BEING TESTED

Steven Blitz

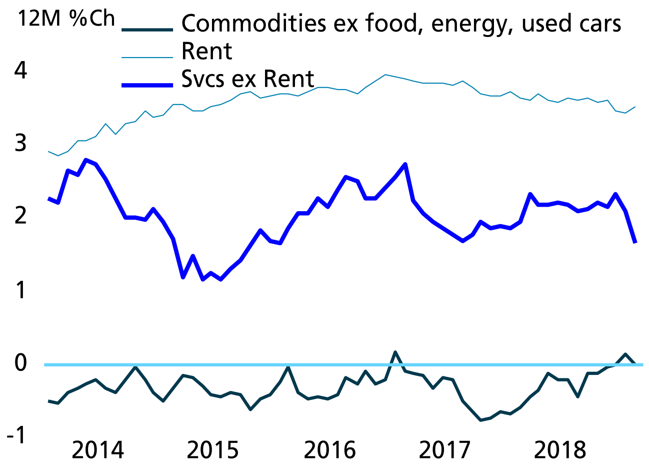
- **Disinflationary trends evident in CPI data**
- **Interplay of equities and household wealth slows retail spending**
- **Pull-forward of end of QT tells us their patience for disinflation is short**

The February CPI report will surely test the patience of the Fed's "Patience", the recent watchword for their current policy rationale. The pronouncements on patience tie to low inflation giving them the latitude to wait on policy action and watch how the economy develops – meaning no rush to hike rates. Behind this policy is the notion of an expanding economy that keeps expanding and they want to make sure that expansion continues. The unasked question is how patient will the FOMC be in the face of growing disinflationary trends aided by softening economic activity? Our guess is not very long -- this is why they pulled forward the timing of when balance sheet reduction (QT) ends.

US price inflation is about services, problematic because service inflation (insurance and rent, mostly) doesn't engender increased production as does, for example, goods inflation. Higher service prices often act more like a tax on earnings. In any event, service price inflation (excluding rent) is softening on a YoY basis and goods inflation (ex food, energy, used cars) is likely to have peaked as well (see chart below).

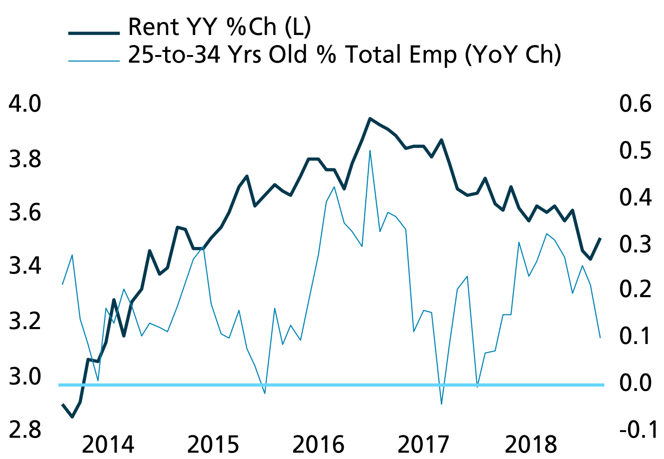
Rent inflation has been slowly abating since the end of 2016. The drop in the YoY increase in 25-to-34 year-olds in the workforce, a key push for rising rents is diminishing (chart below).

Inflation Breaking Down?



Source: Thomson Reuters Datastream, TS Lombard

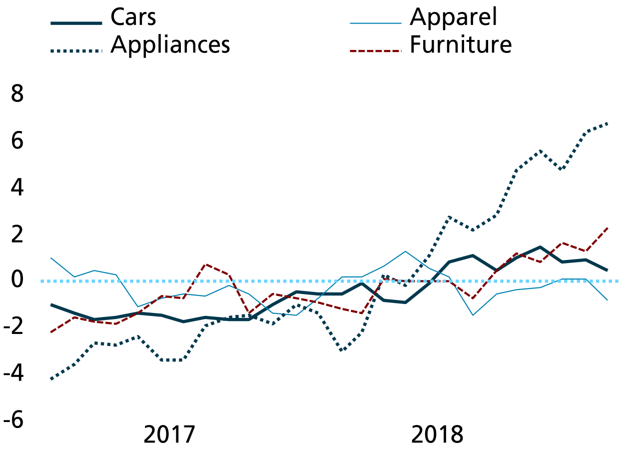
Rent vs New Entrants to the Workforce



Source: Thomson Reuters Datastream, TS Lombard

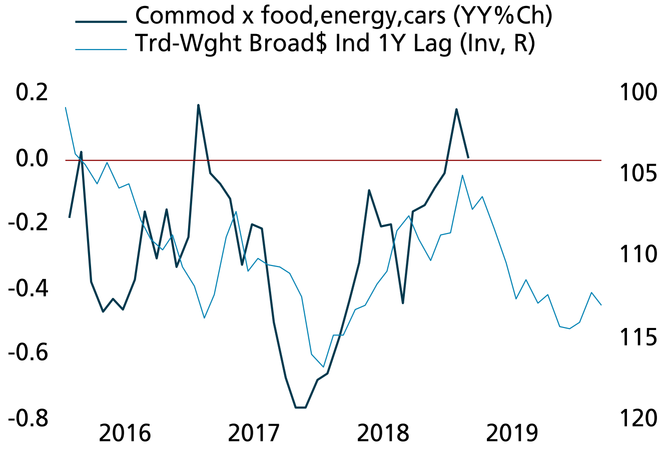
Goods inflation, as defined in the chart above, will begin to fade on a YoY basis once the one-year anniversary of Trump's tariffs has passed. This will be particularly evident in the price of appliances (chart below) and less so in furniture. The strong dollar, a knock-on result of Fed policy in combination with the doubling of the Federal budget deficit, should also prove to be a downward pull on a broad set of commodity prices in the year ahead (see chart below)

CPI for Select Items (12M Annualized %Ch)



Source: Thomson Reuters Datastream, TS Lombard

Goods Inflation Folllows the Dollar



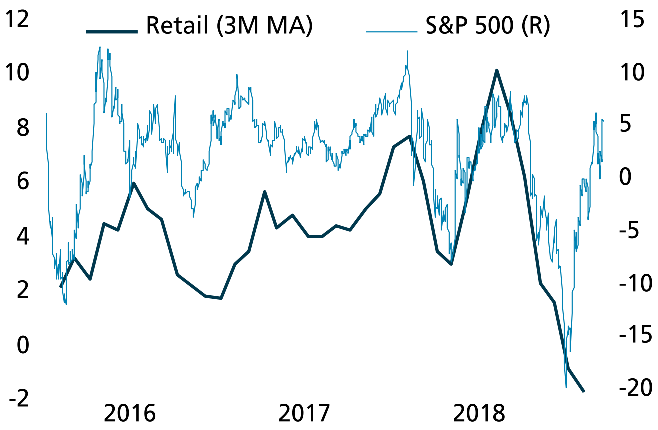
Source: Thomson Reuters Datastream, TS Lombard

The Fed is right to be patient but to the extent slower inflation reflects softening demand and, by extension, a slipping of the inflation expectations the Fed has worked so hard to keep up, we suspect their patience will wear thin rather quickly. They already showed this bias by pulling forward the timing of the end of QT. How long do they wait until they drop the funds rate 25BP?

The interplay of equity prices, household wealth, and retail sales will greatly determine the answer. The Q4 drop in equity values reduced household net worth (see chart below right), and equities have been the driver of household wealth throughout this cycle. It is far from clear that the subsequent rebound in equity prices has moved households back to spending (see chart below left). In other words, "all is forgiven" as far as the market's late 2018 swoon is concerned. Looking today at relative Treasury yields from the six month maturity out to five years, the market's inclination, like ours, is that consumer spending and inflation are on the wane.

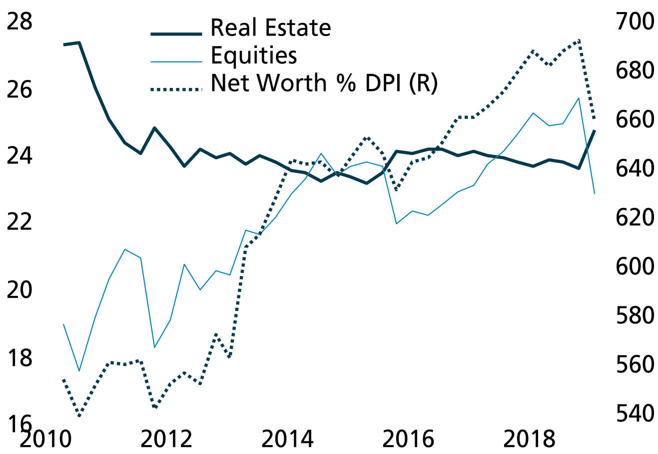
Discretionary Retail Sales* and S&P 500 (3M%Ch)

*ex cars, gasoline, food, building & garden supplies



Source: Thomson Reuters Datastream, TS Lombard

HHs: Real Estate vs Equities as % Net Worth



Source: Thomson Reuters Datastream, TS Lombard