FIRST BANKERS' BANC SECURITIES, INC.

UPDATE

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Understanding economics and the way we measure our domestic output and the value that output represents is a difficult task. After the data is collected, we must then decipher and interpret what these numbers represent given the macroeconomic trends. Compounding the difficulties of collecting and interpreting data is the notion that the data we use to make decisions might not accurately capture the pulse of the "new economy".

Our country has transitioned from a manufacturing dominated focus towards services and the experience associated with them. The statistical measurements we use have trouble reconciling the "new economy" with what they were engineered to measure, a manufacturing based production economy. For simplicity's sake, let's take a look at two of the major statistics investors use and what they are and aren't telling us about the shape of the economy.

G.D.P.

Over the last 5.5 years the US economy has averaged just over 2% GDP growth if you average the annualized QoQ change for the preceding 22 quarters and adjust for inflation. There is a saying in sports, "You are what your record says you are." As it pertains to our economy and GDP specifically, we are a 2% type of economy. One problem with GDP as the main statistical point we use to gauge the health of the economy is that it is only a measure of production, not welfare. Rebuilding after a natural disaster boosts GDP, but we would not necessarily say people are better off than they were before the disaster. GDP measures production with no value given to the experience.

If a company produced one million tires in only one size and tread pattern, GDP would count that as production of one million tires. If the company produced one million tires but offered tires designed for different seasons and vehicles, GDP would not capture the greater variety and improved quality, it simply captures the fact that one million tires have been produced. The customer experience is enhanced through additional choice, but the bottom line still says the company produced one million tires. Something in that scenario is growing (quality or variety), but those are not tangible things that can be measured in today's calculation.

Inflation

Inflation is one of the toughest stats to understand and account for. The FOMC states in its published Longer-Run Goals, "The Committee reaffirms its judgement that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures…" Right there the FOMC tells us the measurement they prefer is the PCE (Personal Consumption Expenditures) gauge distributed by the Commerce Department. The number the market is traditionally fixated upon is the CPI (Consumer Price Index) which is released by the Labor Department. PCE tracks things Americans consume, including those they don’t directly pay for like Medicare-funded healthcare or food furnished and consumed on farms. CPI tracks prices paid on goods and services purchased by urban dwellers.

Over the last 5 years CPI has averaged 1.4% with the latest reading at 2.20%. The pace of increases has slowed since the middle of 2016, and that is a conundrum to followers of the Philips Curve theory. The theory has held true for several business cycles and generally states that as unemployment rates drop employers will offer higher wages, and those higher wages trickle down into the greater economy thereby lifting all prices. Unemployment is hovering around all-time lows and we have yet to see the reflection of meaningful wage increases materialize. PCE has averaged 1.61% over the last five years. However, after a multiyear peak in 2016 it has moved back towards its low readings near 1.30%.

The real message here is that a sustainable 2% level on CPI has not yet been achieved and the readings look even worse when utilizing the PCE. If 2.00% is the FOMC’s target and the PCE is the gauge they like to use, they are really betting on inflation materializing at some point in the future because current readings and a solid trend just aren’t there.

What could change this picture is a shift in the fiscal policy dictated by our elected officials. As Congress was unable to react swiftly to the financial crisis and waivered at impactful reforms thereafter, the FOMC became the only game in town to those looking for economic support. Through unprecedented measures they were able to reflate asset valuations across many sectors. I don’t suspect the FOMC really wants to be involved in that activity any more than they feel they have to. They have started to unwind their quantitative easing purchases and that will eventually add supply not to mention remove a very large purchaser. Tax reform and infrastructure plans are likely to add to the deficit, at least in the near term, and that will also put some supply pressure on the market. If these actions out of the legislative branch can produce some measurable inflation, that will give the FOMC cover to continue raising the overnight lending rate. The unwinding of the balance sheet might do some of the heavy lifting for them before they have a chance to act on the overnight rate. If inflation fails to materialize, then I think contemplating what an even flatter yield curve would do to the return on investment equation is a worthwhile exercise. The answer is out there somewhere, probably buried in the numbers.