MAY 15, 2020

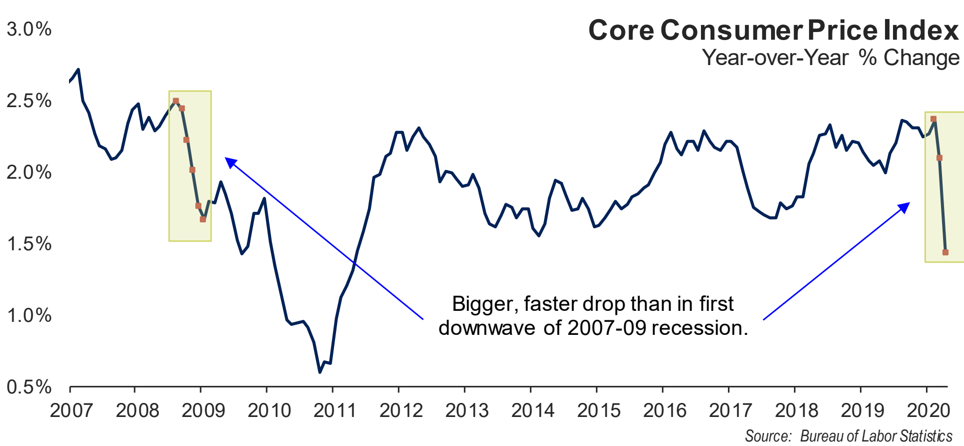
ECONOMIC WEEKLY

Sales and Inflation Retreated in April

Two words keep popping up in descriptions of the economic damage resulting from the COVID-19 lockdown. The first, "temporary," is already stretched weeks beyond its original intent. The second, "unprecedented," is reconfirmed by every economic release since March retail sales in mid-April. The latest demonstration of the power of suddenly idling 40% of the economy came from April's CPI and retail sales reports.

As Jim Vogel writes in *The Weekly Report*, April's biggest ever CPI drop reflects a 21st Century response to a medieval problem. A plague hit, customers disappeared, and computer algorithms slashed prices. The CPI report is packed with price changes — mostly down, but a few up — bigger than ever before in a month. In some cases, in fact, bigger than the previous record year-on-year change.

The below chart of core prices illustrates the magnitude of the drop in March and April. In two months, core inflation has plunged 93bp, 10bp more than the 83bp drop between August 2008 and January 2009. That decline started after nine months of recession and spanned nearly half a year. In the first two months of the lockdown recession, it has been surpassed.



Refining the core

In April, the core CPI, excluding food and energy, fell 45bp, the most ever in a single month. The closest antecedent in the past 50 years was a 25bp drop in July, 1980, but that was at a time when the annual core inflation rate was 13% and large month-to-month swings were more common. The 45bp drop in April came when core inflation was running at about 2.4%.

Food at home — as opposed to restaurant and school food — jumped 2.58%. The last time it rose that much in a month was February 1974. The last time it rose that much in a year was 2014. An argument can be made that we should focus on all items less energy rather than less food and energy. People need to eat, but during

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ECONOMICS

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lockdown they don't need to drive. Besides, and more important from an economics or trading perspective, since the early '80s, food prices did not contribute random volatility the way energy has. In April, the CPI ex-energy fell 0.16%, not as spectacular as the drop in the core, but nevertheless the most since December 1982.

To really understand price movements, however, housing should be eliminated, too. The way housing is measured, it takes months for price changes to show up. For starters, the Bureau of Labor Statistics doesn't actually measure house price inflation, they measure rents of houses equivalent to the cross section of owned homes in an urban area. Rents follow house prices, but the lag is significant because renters tend to lock rents with 1-2 year leases. Also, the BLS does not measure rents in all urban areas at once. They sample a sixth of the country monthly, rotating from one group of cities to the next until the cycle repeats six months later. The result is a smoothed series lagging years behind actual changes in prices.

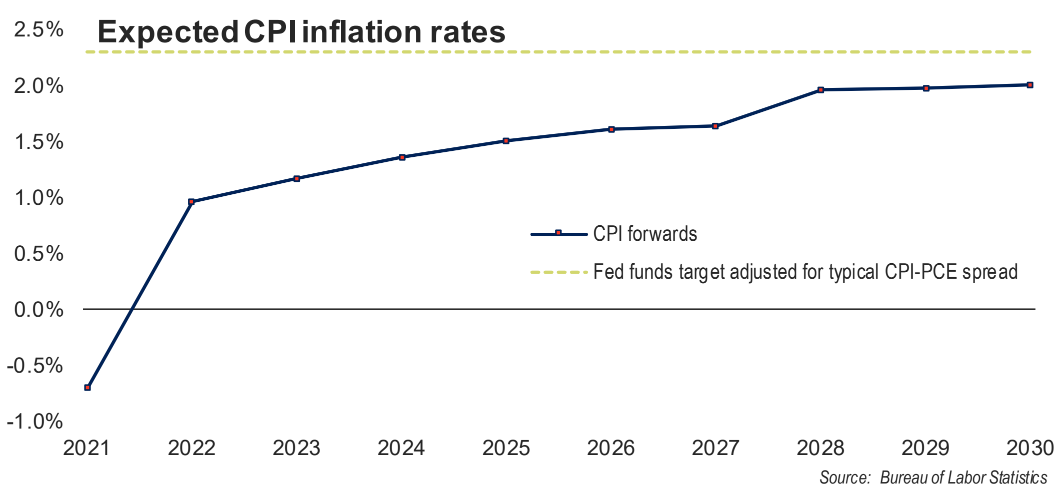
Note: we are not suggesting the CPI ex-housing and energy is a more accurate reflection of inflation than the core, but that it is a better guide to the underlying direction of price movements.

In April, the CPI ex-housing and energy fell 0.16%, the most since the financial crisis. More importantly, the six-month change peaked last September. It was losing steam for months before the COVID lockdowns began. Last year's economic slowdown created pre-existing weakness in the inflation trend that has exacerbated this year's weakness. For more on the current state of inflation, be sure to read the "Inflation Lab" update in *The Weekly Report*.

Market still has faith inflation will rise

Traders still expect 2% inflation, but not for a very long time. Average expected inflation over the next decade is 1.7%, about the middle of the range since it plunged to 0.55% in mid-March and partially rebounded with the passage of the CARES Act in April.

CPI forwards tell the story.[1] Traders expect deflation next year and roughly 1% inflation in 2022. They expect inflation will approach 2% in 2028, but will not actually get there until 2030.



[1] Those who prefer to use CPI breakevens, rest assured they show the same thing. Think of these as each annual inflation rate stacked into the familiar 5-year and 10-year breakeven rates.

The fact inflation is expected to rise to 2% at all is both remarkable and a relief. European markets are priced for perpetual sub-1% inflation. As long as traders think inflation can return to 2%, the yield curve is more likely to have a positive slope, which encourages lending. It also means the Fed has a shot at actually achieving its policy target.

Still, even if inflation actually follows this path, the odds of the Fed achieving 2% inflation in the long run will be close to zero. The economy will be overdue for recession by then, after all, and — as we are seeing now — inflation falls in recessions.

At the moment, there is no need for nuance in the Fed's policy approach. FOMC participants care about just two things right now, easing as much as possible and thinking up ways to ease more without resorting to negative rates. Inflation expectations do not factor into their immediate COVID response. Very low inflation expectations will affect Fed policy down the road, when a shade of nuance returns.

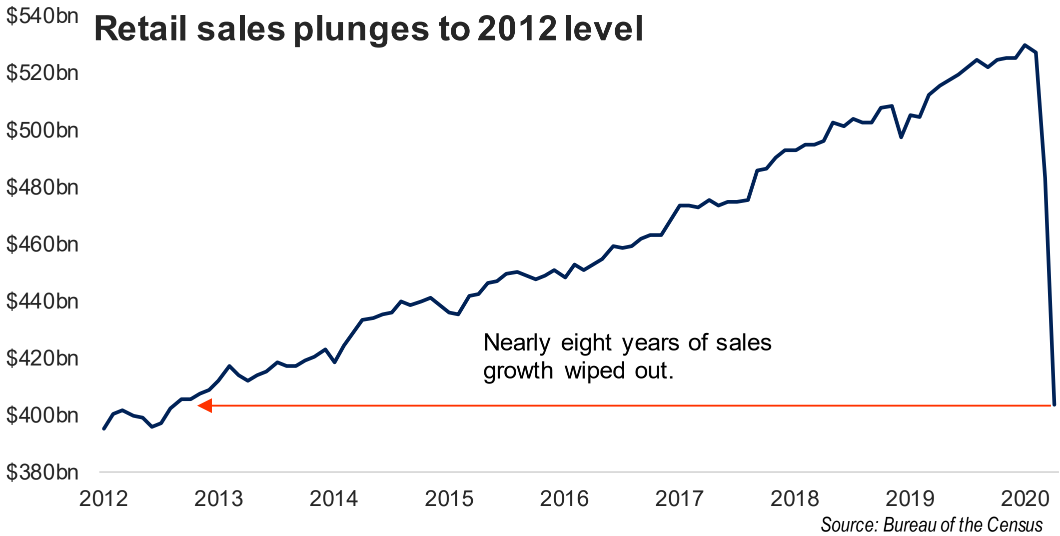
1. Very low inflation expectations will delay Fed tightening. The FOMC is committed to keeping the fed funds rate unchanged until the economy is "well on the road" to maximum employment and 2% inflation. At the moment, that implies the first hike in 2028.

2. The FOMC is likely to roll out forward guidance if the recovery is sluggish. Prolonged low inflation expectations will make it possible to promise to stay on the zero lower bound longer.

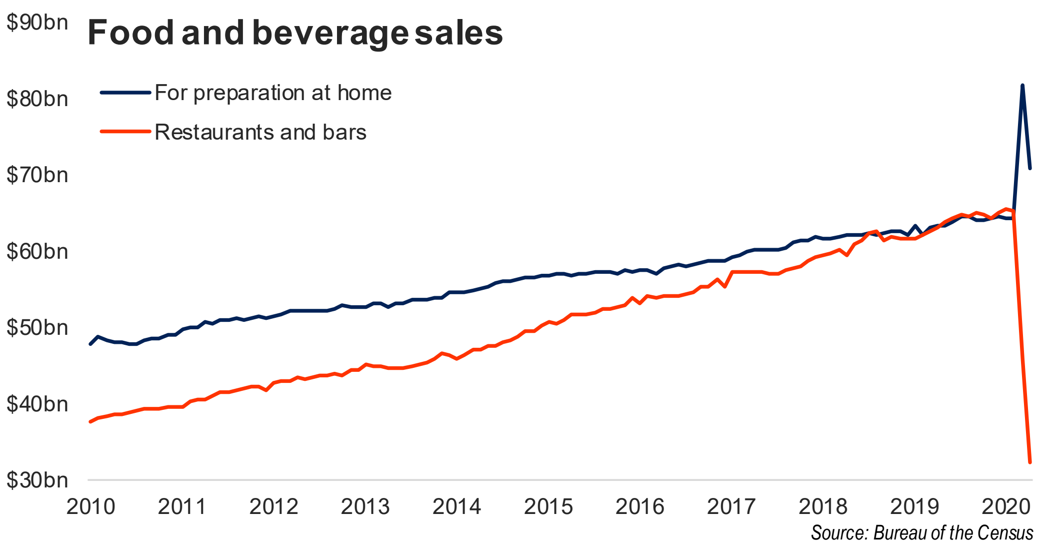
"Poor" retail sales

The CPI provided plenty of hints of where we'd see retail weakness in April, but did nothing to prepare for the magnitude of the drop. Our favorite reaction so far, from a strategist on CNBC, is a clip titled "Markets Will Look Past Poor April Retail Sales Numbers." We'll spare you the link.

We understand the temptation to look past bad news, especially when things are already looking up, but there's so much wrong with this cavalier attitude. First, "poor" sales? Really? Clothing sales fell almost 90% from last April. And, what exactly should markets look past them to? China has been emerging from lockdown for two months and continues to report terrible year-on-year retail activity. Before COVID, Chinese retail sales grew 10-13% annually. After COVID, and after the lockdown, sales are still down 16.2%. For perspective, that's twice as weak as the -8.3% year-on-year sales drop reported in the US today. The chart on the next page puts the March-April retail sales into perspective. Bear in mind, it is not adjusted for inflation, which added about 15% to sales over this eight-year period.



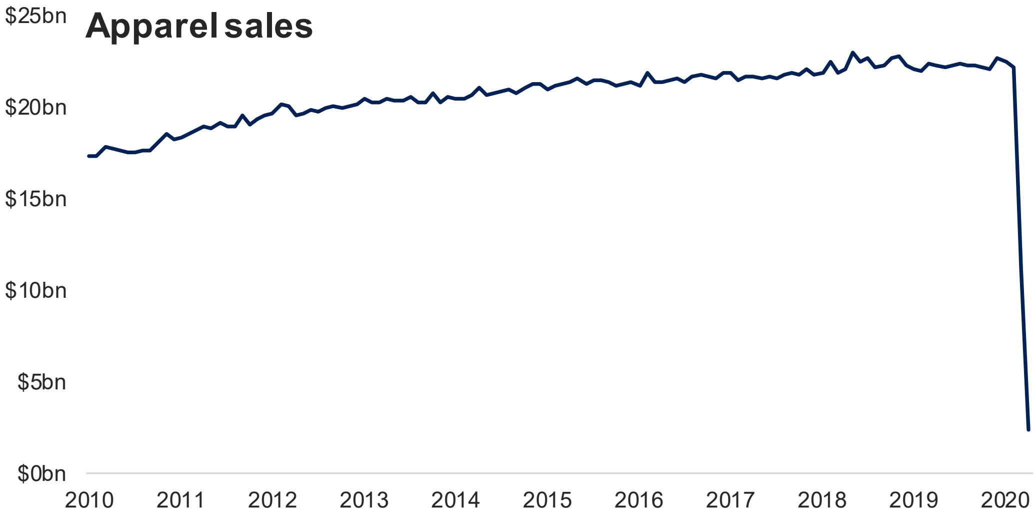
One of the best illustrations of the lockdown's impact on US households is the change in spending on food and beverages. In March, 25% of restaurant sales shifted to grocery and liquor stores. In April, restaurant sales retreated further, to half their February level, but liquor and grocery sales fell, too, by 13.1%. Total household spending on food and drink is 20% below pre-COVID levels.



There is nothing more primal in the retail sales report than eating and drinking, and total food and beverage sales in April were 20% lower than in February. Restaurants are reopening now in about two-thirds of states, combined representing about 45% of US GDP. Bear in mind, however, restaurants have been open for a couple of months now all across China, and sales are still about half what they were pre-COVID. The problem is, COVID is still lurking, even if it is spreading at a rate of just a few cases a day, customers are risk averse, and seating capacity is still restricted.

By the way, if you're wondering why food sales fell, remember grocery prices rose the most since 1974. And, if you're wondering why grocery prices rose the most in 45 years, look how elevated sales still are even after falling 13% in April.

Restaurants have received so much attention in the crisis, Secretary Mnuchin is modifying the PPP program to address their needs. They were not the hardest hit retail industry, however. Restaurant sales are down 48.7% year-on-year. Furniture sales are down 66.5%, electronics 64.8% and clothing sales are down 89.3%. There is no "weakest since" here. The apparel series dates back to 1992, when sales were about four times higher than in April.



Source: Bureau of the Census

Bottom line

Bloomberg Economics forecasts GDP in 29 countries and now expects all will report GDP declines in 2020 with the exception of Indonesia, which has managed to avoid a significant COVID breakout, and China, whose GDP should be filed in the fiction section. Everywhere else, growth will fall. Some countries were hit hardest in the first quarter and some in the second. Still, none but China and Indonesia will recover by yearend.

COVID-19 hit the world economy like a tsunami breaking on every shore worldwide within two quarters. Economists — including America's Chief Economist, Chair Powell — have transitioned from V-shaped denial through U-shaped optimism to L-shaped resignation.

Inflation will not fall as fast as in April every month this year. In fact, we'd be surprised if it falls this fast in any month in the next decade. As for retail sales, it's not likely we'll see another one-month decline of this magnitude in our lifetimes. But we will see years of too-low inflation and too-weak sales nonetheless. There's just no way to come roaring back from a drop this deep. After the retail sales report, the Atlanta Fed revised its Q2 GDP forecast to -42.8%. That's not a bad starting place in thinking about the economic cost of the lockdowns.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

		CONSENSUS				
		PRIOR	HIGH	LOW	MEDIAN	FHN
Tuesday, May 19	Building Permits - Apr	1,353k	1,220k	750k	1,000k	**800k**
	Building Permits MoM - Apr	-6.8%	-9.6%	-44.4%	-25.9%	**-40.9%**
	Housing Starts - Apr	1,216k	1,180k	750k	929k	**800k**
	Housing Starts MoM - Apr	-22.3%	-3.0%	-38.3%	-23.6%	**-34.2%**
Thursday, May 21	Philadelphia Fed Business Outlook - May	-56.6	-25.0	-50.0	-41.0	**-30.0**
	Initial Jobless Claims - May 16	2981k	2,600k	2,100k	2,400k	**2,500k**
	Continuing Claims - May 9	22,833k	--	--	--	**25,000k**
	Markit US Manufacturing PMI - May P	36.1	45.0	35.0	38.0	**40.0**
	Markit US Services PMI - May P	26.7	39.0	29.9	32.0	**39.0**
	Leading Index - Apr	-6.7%	-1.7%	-6.9%	-5.7%	**-7.0%**
	Existing Home Sales - Apr	5.27m	5.17m	3.75m	4.30m	**4.00m**
	Existing Home Sales MoM - Apr	-8.5%	-1.9%	-28.8%	-18.4%	**-24.1%**

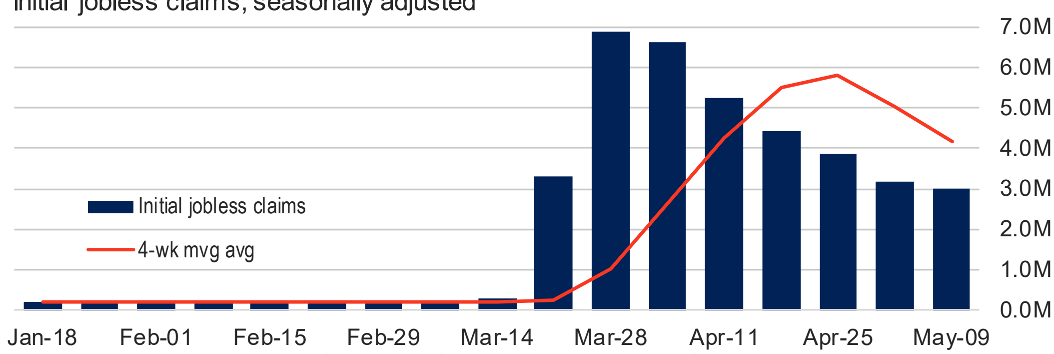
Review

Chair Powell reassured markets the FOMC will keep rates at the zero lower bound indefinitely and will not take fed funds rates into negative territory.

Retail sales posted its largest ever drop in April as consumers were on lockdown and months of social isolation didn't justify purchasing a new wardrobe, or much of anything else. US consumers said they are more concerned about their health and extended social isolation than they are about the long-term economic impact of the pandemic, according to May's preliminary consumer sentiment survey. That said, current sentiment rose, from 74.3 in April to 83.0, reflecting passage of the CARES Act and the relief checks it offered consumers. Expectations, on the other hand, continued to fall, from April's 70.1 to 67.7.

- **Another 3 million people filed for unemployment insurance last week**, well above the 2.5 million economists and equity markets were expecting. Even adjusted for a data reporting error by Connecticut, which boosted the number by 270k, claims continue to run above expectations. Since March 15 — when most businesses in the US were locked down — 36.5 million people have filed for unemployment insurance.

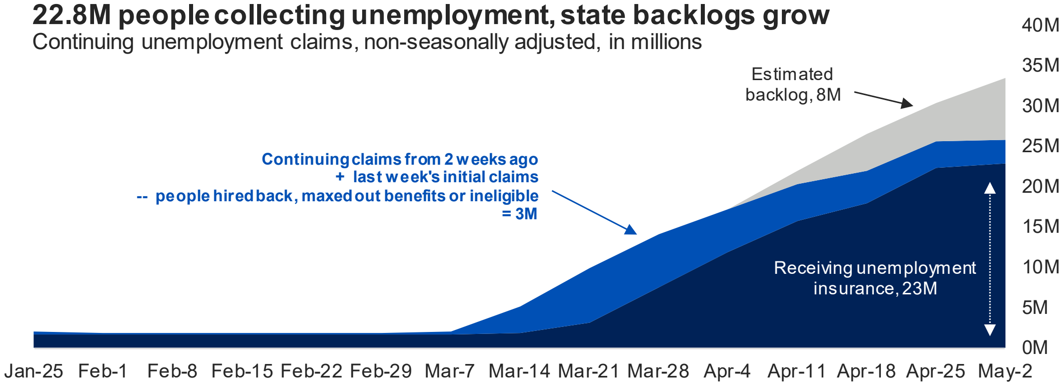
Over 36 million people filed for unemployment since mid-March
Initial jobless claims, seasonally adjusted



Source: FRED, Saint Louis Federal Reserve Bank, DOL Employment and Training Admin, FHN Financial

The total number of people collecting unemployment insurance — known as continuing claims — rose just 456k, from 22.38 million to 22.83 million. But, over 3.1 million people had filed for unemployment insurance that week and along with last week's 3 million, it means state labor offices have fallen further behind the massive numbers of people filing for unemployment insurance. Problems in California, where people must report on their employment status every two weeks to receive benefits, likely reduced the number by 1.9 million, according to **Bloomberg News**. Aside from outdated technology and overwhelmed staff delaying processing applications and delivering checks, something else is causing the bottleneck.

22.8M people collecting unemployment, state backlogs grow
Continuing unemployment claims, non-seasonally adjusted, in millions



Source: FRED, DOL, FHN Financial

According to *The Wall Street Journal*, the growing number of states quickly burning through cash from their unemployment trust funds could be contributing to the backlog. State unemployment trust funds, held at the Treasury and funded primarily by employers, are used to pay regular state unemployment benefits. "Nearly half of US states have logged double-digit percentage declines" since the end of February and concerns are growing funds may soon be depleted, as they were in the 2009 recession.

The *Journal* warns the 36.5 million unemployed from COVID is already more than double the 15.7 million unemployed people that peaked in October 2009. As the economy gradually reopens and more small businesses are unable to open, states will begin feeling pressure to restrict benefits, particularly to self-employed and other workers eligible under the CARES Act.

- **Retail Sales** posted its largest drop ever, falling 16.5% m/m and 21.6% y/y. The lockdowns erased nearly eight years of sales gains and pushed all categories, except for online and grocery store sales, into negative growth. Grocery sales fell 13.2% m/m, but that was after a 28.6% jump in March due to stockpiling. Consumers spent $57b on groceries in February, $74bn in March and $64b last month.

  Apparel fell an astonishing 78.9% m/m and 89.3% y/y. That is after falling 49.4% m/m and 49.8% y/y in March, which means Americans have gone from spending $22.1b in February to cutting it in half in March to $11.2b and finally cutting it to a tenth, or $2.4b, in April.

- **Chair Powell** spoke about the devastating impact COVID has had on the economy, praised fiscal stimulus measures Congress has taken and advocated more fiscal support, leaving the details to Congress. Powell warned the astonishing increase in fiscal spending will have a cost, but this was not the time to worry about it.

  Traders watched for clues to how Chair Powell would address last week's fed fund futures drop into negative territory. Powell reiterated statements the FOMC made during its October meeting. Quoting the October 2019 minutes, Powell said: "all" — and he emphasized all — "***all*** FOMC participants judged that negative rates did not currently appear to be an attractive monetary policy tool." He pointed out the effectiveness of negative rates has been mixed and the committee is focused on using policy tools tested and tried during the global financial crisis, all of which are proven, namely, forward guidance, large-scale asset purchases, and lending programs.

  Fed governors Richard Clarida and Lael Brainard, along with FOMC voter Neel Kashkari, favor yield curve control, where the Fed targets yields instead of a specified quantity of asset purchases. Yield curve control targets longer-term yields, such as 10-year rates at 0.0%, as the Bank of Japan implemented in 2016. In practice, it means the Fed could purchase unlimited amounts of the asset — i.e., 10-year Treasuries — needed to keep the yield on target.

  Last month, Neel Kashkari told CNBC, "Nothing is completely off the table." Joe Kernen asked, "Are you going to go below zero?" Kashkari said, "As the Fed Chairman said, 'I don't think there's much interest in going below zero.' None of us want to say no, never....Imagine, hypothetically, if the 10-year Treasury were at 0.0%. — just due to market forces — might we want to have a positively sloping yield curve, I could make that argument that might be a reason to go negative on the front-end. Not something any of us are planning for or expecting."

The Atlanta Fed's Q2 GDPNow forecast is tracking -42.8% annualized rate, down from last week's -34.9%.

Next week's big US economic releases are Wednesday's FOMC minutes and Thursday's initial jobless claims. The Philadelphia Fed Business Outlook is also due out Thursday followed by existing home sales and a webinar discussion with New York Fed President John Williams.

On the international front, Markit releases preliminary manufacturing and services PMIs Wednesday, Thursday, and Friday in Asia, Europe, and North America. On Monday, Germany releases the ZEW survey for May and Japan releases March core machine tool orders.

Preview

Note: ★ = High Impact Event
All times Eastern

Monday, May 11

- ★ 9:30pm – China:
  - CPI – Apr (Last: 4.3% y/y; Con: 3.7% y/y)

Monday, May 18

- 10:00am – US: NAHB Housing Market Index – May (Last: 30; Con: 35)

Tuesday, May 19

- 12:30am – Japan:
  - Capacity Utilization – Mar (Last: -1.8% m/m)
  - Industrial Production – Mar F (Mar P: -3.7% m/m)
  - Industrial Production – Mar F (Last: -5.2% y/y)
- ★ 4:30am – UK: Employment Report
- ★ 5:00am – Germany:
  - ZEW Survey Expectations – May (Last: 28.2)
  - ZEW Survey Current Situation – May (Last: -91.5)
- ★ 8:30am – US:
  - Housing Starts – Apr (Last: 1216k; Con: 970k)
  - Housing Starts – Apr (Last: -22.3% m/m; Con: -20.2% m/m)
  - Building Permits – Apr (Last: 1353k; Con: 1000k)
  - Building Permits – Apr (Last: -6.8% m/m; Con: -25.9% m/m)
- 10:00am – EU: ECB Chief Economist Philip Lane speaks on policy webinar.
- 9:30pm – China:
  - 5-Year Loan Prime Rate (Last: 4.65%; Con: 4.65%)
  - 1-Year Loan Prime Rate (Last: 3.85%; Con: 3.85%)
- ★ 7:50pm – Japan: Core Machine Orders – Mar (Last: 2.3% m/m)

Wednesday, May 20

- 4:00am – Italy: Current Account Balance – Mar (Last: €4.783b)
- 4:00am – EU: Current Account Balance – May (Last: €40.2b)
- 4:30am – UK: Unemployment Rate – Apr (Last: 4.2%)
- 4:30am – UK:
  - CPI – Apr (Last: 1.5% y/y)
  - Core CPI – Apr (Last: 1.6% y/y)
  - PPI – Output – Apr (Last: 0.3% y/y)
- ★ 7:00am – US: MBA Mortgage Applications – May 15
- ★ 2:00pm – US: FOMC Meeting Minutes from April 28–29. The minutes will offer insight into potential discussions on negative rates, yield curve control targeting the curve's long end, and other policy tool options to help the Fed fight the current recession.

- 7:50pm – Japan:
  - Trade Balance – Apr (Last: ¥4.9b)
  - Exports – Apr (Last: -11.7% y/y)
  - Imports – Apr (Last: -5.0% y/y)
- ★ 8:30pm – Japan:
  - Jibun Bank Manufacturing PMI – May P (Last: 41.9)
  - Jibun Bank Services PMI – May P (Last: 21.5)
  - Jibun Bank Composite PMI – May P (Last: 25.8)

Thursday, May 21

- ★ 4:30am – UK:
  - Markit Manufacturing PMI – May P (Last: 32.6)
  - Markit/CIPS Services PMI – May P (Last: 13.4)
  - Markit/CIPS Composite PMI – May P (Last: 13.8)
- ★ 8:30am – US:
  - Initial Jobless Claims – May 16 (Last: 2.891m; Con: 2400)
  - Continuing Claims – May 9 (Last: 22.98m)
  - Philadelphia Fed Business Outlook – May (Last: -56.6; Con: -40.0)
- ★ 9:45am – US:
  - Markit Manufacturing PMI – May P (Last: 36.1; Con: 38.0)
  - Markit Services PMI – May P (Last: 26.7; Con: 32.0)
  - Markit Composite PMI – May P (Last: 27.0)
- ★ 10:00am – US:
  - New York Fed President John Williams takes part in video webinar hosted by the Greater Rochester Chamber of Commerce. (FOMC Voter)
  - Existing Home Sales – Apr (Last: 5.27m; Con: 4.39m)
  - Existing Home Sales – Apr (Last: -8.5% m/m; Con: -16.6% m/m)
  - Leading Index – Apr (Last: -6.7% m/m; Con: -5.7% m/m)
- 7:30pm – Japan:
  - CPI – Apr (Last: 0.4% y/y)
  - Core CPI (ex fresh food) – Apr (Last: 0.4% y/y)
  - CPI core-core (ex fresh food, energy) – Apr (Last: 0.6% y/y)

Friday, May 22

- 2:00am – UK: Retail Sales – Apr (Last: -5.1% m/m)
- ★ 3:15am – France:
  - Markit Manufacturing PMI – May P (Last: 31.5)
  - Markit Services PMI – May P (Last: 10.2)
  - Markit Composite PMI – May P (Last: 11.1)

- 3:30am – Germany:
  - Markit/BME Manufacturing PMI – May P (Last: 34.5)
  - Markit Services PMI – May P (Last: 16.2)
  - Markit/BME Composite PMI – May P (Last: 17.4)
- 4:00am – EU:
  - Markit Manufacturing PMI – May P (Last: 33.4)
  - Markit Services PMI – May P (Last: 12.0)
  - Markit Composite PMI – May P (Last: 13.6)

– Rebecca Kooshak, Economic Analyst