LPL RESEARCH

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INFLATION INSIGHT
BREAKING DOWN THE MINUTES

John Lynch *Chief Investment Strategist, LPL Financial*
Barry Gilbert, PhD, CFA *Asset Allocation Strategist, LPL Financial*

KEY TAKEAWAYS

The minutes from the Fed's September policy meeting show a lively debate around inflation.

Most Fed meeting participants believed inflation will continue to push toward the Fed's 2% target, but there were growing concerns that structural factors may keep inflation lower.

Economic growth has been steady and labor markets are largely healthy, leaving inflation as the key determinant of the Fed rate hike path over the next year.

The recently released minutes from the Federal Reserve's (Fed) September policy meeting, along with the Consumer Price Index (CPI) and Producer Price Index (PPI) data, have kept the markets focused on inflation. Inflation is half of the Fed's "dual mandate" to maximize sustainable employment and keep inflation low and stable. These two mandates often conflict and usually require a balancing act. Getting to maximum employment usually implies that the Fed should be more accommodative; keeping a lid on inflation implies that it should be more restrictive.

Looking at the current situation, there's little debate that we are at least near, if not over, maximum sustainable employment. But given stubbornly below-target inflation—which Fed Chair Janet Yellen described over the weekend as the "biggest surprise" in the economy in 2017—is it really necessary to tighten the reins? That's the key question that will be driving Fed policy for the rest of 2017 and into 2018.

BREAKING DOWN THE MINUTES: ALL, MANY, SOME, A FEW

So what's the Fed thinking about the issue right now, and what will Fed officials be watching? There are some important insights in last week's release of the minutes from the September meeting. The minutes provide a much more thorough picture of the policy meeting than the brief statement that is released right after the conclusion of the meeting. The policy statement is just a terse overview of the Fed's evaluation of the economy and its policy decision. The minutes, released three weeks after the conclusion of each meeting, are a more extended account of the meeting with a full overview of the discussion. (Complete transcripts of the meetings are released five years later. Some sensitive material is redacted, but even painful attempts at humor are retained.)

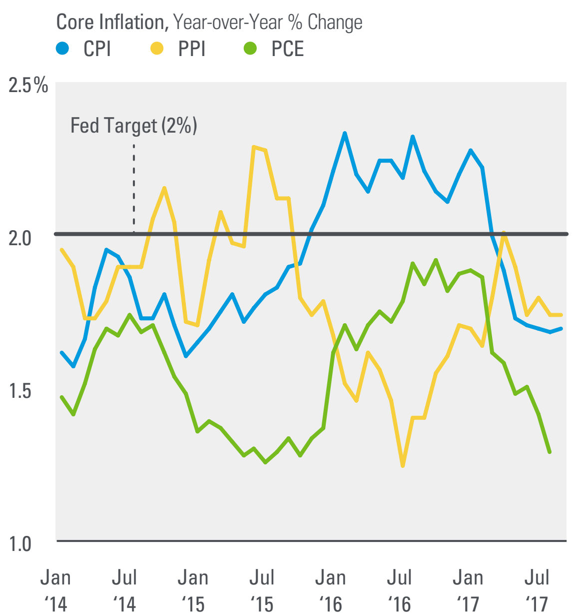
The minutes capture the key areas of debate during the meeting and present the weight behind different positions by loosely characterizing how many members advanced each point of view, using words like "all," "many," "some," and "a few." The September minutes reveal a lively debate around inflation and highlight how inflation may be the key driver of Fed policy over the next year.

IT'S ALL ABOUT INFLATION

Committee members were unanimous that there should be no additional rate hike at the September meeting. The key debate was whether to maintain guidance for an additional rate hike by the end of the year, with participants' views largely turning on their inflation assessment:

> *Many participants expressed concern that the low inflation readings this year might reflect [more than] transitory factors … A few of these participants thought that no further increases in the federal funds rate was called for in the near term … Some other participants, however, were more worried about upside risks to inflation.*

1 THE FED FOCUSES ON PCE, WHICH HAS REMAINED STUBBORNLY BELOW 2%



Source: LPL Research, U.S. Bureau of Labor Statistics, Federal Reserve 10/13/17

CPI - Consumer Price Index; PPI - Producer Price Index; PCE - Personal Consumption Expenditure Price Index

Performance is historical, and no guarantee of future results.

Earlier in the year, as inflation fell, the Fed's initial response was that the decline was largely driven by transitory factors. Clearly, that argument has lost ground. Nevertheless, while "most" participants broadly recognized that low inflation was not simply due to transitory factors, there were only a "few" who were sufficiently alarmed to advocate slowing the prospective path of rate hikes, and there were still some who saw greater risk that inflation would rise.

To get a clearer idea of what participants were looking at, Figure 1 shows three key measures of inflation. We've focused on year-over-year changes in core inflation, which exclude volatile food and energy prices. CPI and Personal Consumption Expenditure Price Index (PCE) both focus on inflation as experienced by consumers. The Fed's mandate is framed in terms of PCE, which, unlike CPI, also includes purchases that are not directly out-of-pocket (such as medical care covered by employer insurance) and tries to take into account how buying habits change in different economic environments. PPI looks at prices for all sellers of goods and services, not just final products purchased by consumers.

Both CPI and PPI have held above 2% for extended periods since the start of 2014, although they are currently lower. While PPI was hit harder by the oil-related slowdown of 2014–2016, it has largely bounced back. PCE, however, has remained stubbornly below 2% over the entire period and has not shown the same stabilization that we've seen recently in the CPI and PPI. (Note that PCE data are only through August, while PPI and CPI are through September.)

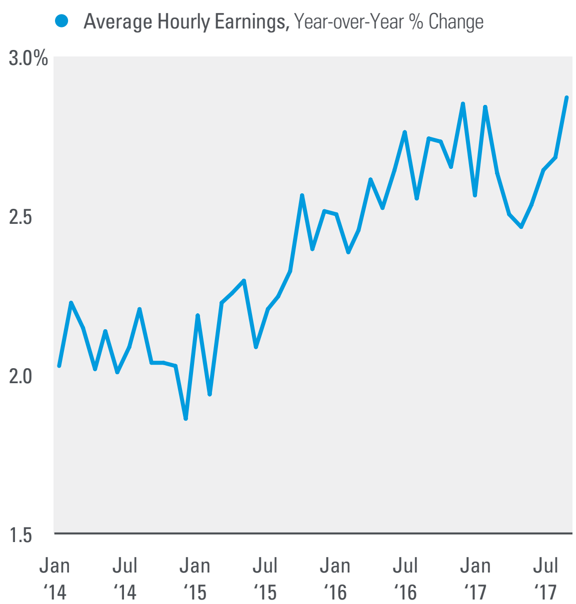
KEEP AN EYE ON WAGES

While inflation remains contained, we have had recent evidence of a modest pick-up in wage pressure after slowing into May 2017 [Figure 2].

But even with the recent acceleration, wage growth remains below what was seen at this point in previous cycles. Despite the absence of a substantial pickup in wages, there was a general consensus that wage pressures would likely continue to rise:

> *Several participants commented that the absence of broad-based upward wage pressures suggested that the sustainable rate of unemployment might be lower than they currently estimated … Most participants expected wage increases to pick up over time … A couple of participants cautioned that a broader acceleration in wages may already have begun.*

2 WAGE PRESSURE ACCELERATING BUT STILL CONTAINED



Source: LPL Research, U.S. Bureau of Labor Statistics 10/13/17

Performance is historical, and no guarantee of future results.

Some of the added wage growth in September may have been due to a disproportionate number of lower wage jobs being disrupted by Hurricanes Harvey and Irma, especially in food services. Nevertheless, the pickup in wages is consistent with an increasing scarcity of available skilled labor in some industries. Several Fed members have commented in the past that the expected relationship between lower unemployment and higher inflation, in part reflected in wage pressures, has been weak but is likely to re-establish itself.

CONCLUSION

An additional rate hike in December remains on the table as the Fed continues to try to slowly remove accommodative policy, letting the economy stand on its own two feet, while creating dry powder for future policy moves should the economy face a downturn. (Although we don't anticipate a downturn in the next year, it is a possibility given the nature of economic cycles.) Excluding some unexpected shock, inflation will be the key to whether the Fed can follow through on its projection of one additional rate hike in 2017 and three in 2018. Unlike Fed policy through much of the expansion, the Fed surprised markets in 2017 by largely executing on the expected policy path it had laid out at the end of 2016. We'll be keeping an eye on inflation data, especially PCE and wages, to determine where the Fed may be going next. Despite the internal debate, we believe that 2018 will be more like 2017 than 2010–2016, and the Fed will likely be able to follow through on its projected rate hike path. ■

IMPORTANT DISCLOSURES

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Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing involves risk, including the loss of principal.

INDEX DESCRIPTIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Producer Price Index (PPI) of the Bureau of Labor Statistics (BLS) is a series of indexes that measure the average change over time in the prices received by domestic producers of goods and services. PPIs measure price change from the perspective of the seller. The headline PPI (for finished goods) is a measure of the average price level for a fixed basket of capital and consumer goods for prices received by producers.

Personal Consumption Expenditures (PCE) is a measure of price changes in consumer goods and services, targeted towards goods and services consumed by individuals. PCE is released monthly by the Bureau of Economic Analysis (BEA).

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