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WHY ISN'T INFLATION HIGHER?

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KEY TAKEAWAYS

This week's FOMC meeting will offer meeting minutes, updated economic projections, and a press conference.

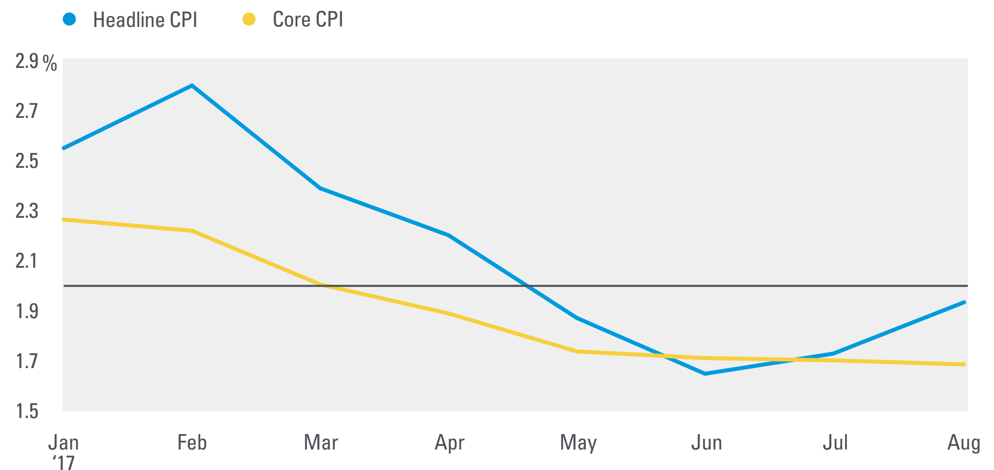
Markets will be closely watching for updates on how below-target inflation may impact the path of rate hikes.

While inflation has been trending lower in recent months, the latest CPI report shows some upward momentum.

The Federal Reserve's (Fed) next Federal Open Market Committee (FOMC) meeting will take place on Tuesday and Wednesday (September 19–20) and will be followed by the release of the FOMC policy statement on Wednesday at 2:00 p.m. ET. Along with the statement, the FOMC will release a new set of economic forecasts (gross domestic product [GDP], the unemployment rate, inflation, and fed funds projections, also known as the "dot plots"). Fed Chair Janet Yellen will also hold a press conference—the third of four in 2017—at 2:30 p.m. ET.

Markets are primarily focused on the potential for an announcement about balance sheet normalization at the September meeting, though market participants will also be watching Fed comments related to inflation and its impact on the future path of rate hikes. Rate hike expectations for the September meeting are currently at 0%, in large part due to inflation holding stubbornly below the Fed's 2% target [Figure 1]. Headline inflation did show a move higher in August, to 1.9%, which has helped increase the market's expectation for a rate hike in December 2017 (currently at 57%). However, a portion of the rise of inflation was due to increasing gasoline prices caused by refinery shutdowns related to Hurricane Harvey.

1 INFLATION HAS BEEN TRENDING BELOW THE FED'S 2% TARGET



Source: LPL Research, St. Louis Federal Reserve 09/15/17

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

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.

Headline CPI includes all items in the CPI basket, while core CPI excludes the impact of historically volatile food and energy prices.

WHY DOES INFLATION MATTER?

The Fed has been tasked by Congress to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." This is commonly known as the Fed's dual mandate. The Fed has largely been successful in the first part of its mandate, as unemployment has fallen to pre-crisis levels. As unemployment falls, labor market conditions are generally expected to tighten, pushing wages, and in turn, overall inflation higher, a relationship described by the Phillips Curve. However, despite low unemployment, this has yet to happen.

This problem has been a focus of discussion at the last few Fed meetings. The Fed lowered its expectation for year-end 2017 headline Personal Consumption Expenditure (PCE) inflation from 1.9% to 1.6% in its June meeting projections, and the July meeting minutes also displayed a healthy discussion on the topic. The impact on rate hikes was a key topic: more hawkish Fed members believed that waiting to raise rates could put the Fed behind the curve when inflation does rise, while a more dovish contingent argued that the Fed could wait until inflation starts to move higher. The July minutes also showed that members are at least somewhat divided on the reasons that inflation remains below target.

THE PHILLIPS CURVE

The Phillips Curve reflects the expected relationship between unemployment and inflation. If unemployment is high, economic growth is likely slow and inflation is also likely to be low. Alternatively, if unemployment is low, the economy is likely strong, and a tightening labor market may lead to wage inflation, which could help push overall levels of inflation higher.

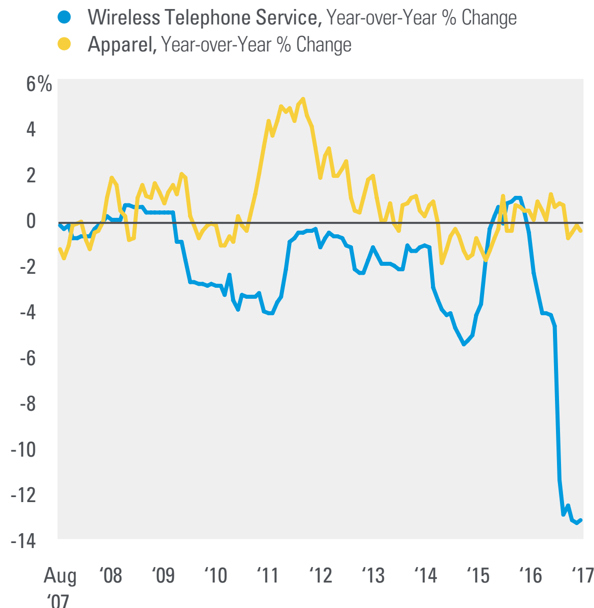
Unemployment is back to pre-recession levels, and below what the Fed considers the "natural" rate of unemployment (the amount of unemployment that would be expected even in a healthy economy due to people changing jobs or skills mismatches). Yet wage inflation and overall inflation remains low, creating a conundrum for the Fed, which has historically relied on the Phillips Curve relationship when setting monetary policy.

TEMPORARY FACTORS

A few theories on why inflation remains below target include a lower natural rate of unemployment, the possibility that we aren't using the best measure of unemployment, a changing relationship between unemployment and inflation, and technological progress driving down production costs. However, the meetings also indicated that "many participants noted that much of the recent decline in inflation had probably reflected idiosyncratic factors," or in other words, that the decline is likely temporary in nature.

Proponents of the temporary decline theory point to drags from key categories of inflation that are expected to wane over time. One category that the Fed has singled out in the past is wireless phone service, an item that makes up only 1.5% of the overall CPI basket, but has seen prices drop a significant 13.3% year over year due to an ongoing price war in the industry [Figure 2]. Another item is apparel, which makes up approximately 3% of the CPI basket, and has seen prices drop by a comparatively tame, though still impactful, 0.6% year over year. Because price drops like these aren't likely to continue forever, year-over-year comparisons should become easier over time, helping overall inflation converge toward the Fed's 2% target. If this were the case, hiking rates now may be more appropriate given that it can take time for monetary policy decisions to flow through to the real economy. If the Fed were to wait, it could end up behind the curve on rate hikes, leading to a higher risk that the economy overheats and turns toward recession.

2 OUTLIERS MAY BE HOLDING OVERALL CPI DOWN



Source: LPL Research, Bureau of Labor Statistics 09/15/17

CONCLUSION

Inflation (or the lack thereof) has been a persistent thorn in the Fed's side in 2017. So far the narrative coming out of past FOMC meetings has been that the pullback in inflation is temporary. Last week's CPI report may have helped to bolster this argument, but markets will be closely watching the Fed's September 20 statement and press conference for any signs that its view on inflation has changed, and what that might mean for the future path of rate hikes. ■

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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.

DEFINITIONS

The presidents of regional Federal Reserve banks are commonly classified as hawks or doves. Hawks generally favor tighter monetary policy, with less monetary support from the Federal Reserve. Doves are the opposite, generally favoring easing of monetary policy.

Personal consumption expenditures (PCE) is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, nondurables, and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.

London Interbank Offered Rate (Libor) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association. The Libor is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

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