

The Return of Inflation

Welcome back old friend. It's been a while – close to two decades in fact – that a familiar feature of the economic landscape has been missing: inflation. To be sure, many, if not most, households would disagree with that assertion, noting that prices on the basket of goods and services they typically purchase have been steadily rising. Technically, they would be correct; the core consumer price index, which excludes volatile food and energy prices, has never declined for a full year going back to 1955. But price increases since the turn of the century have been particularly mild, averaging 2 percent a year and just 1.8 percent since the end of the recession.

That's a far cry from what we have seen in the past. From 1982 through 2000, inflation averaged 4.0 percent a year. Even that seems tame compared to what occurred during the hyper-inflation years of the mid-1970s through the early 1980s when prices soared at a 9 percent pace, including double-digit increases in about half of those years. Those earlier years, of course, are not remembered fondly. From 1975-1985, unemployment averaged 7.6 percent, hitting a post-war high of 10.8 percent in 1982, and interest rates were sky-high, with the 30-year fixed rate on mortgages reaching an astronomical 18.5 percent in 1981.

Those high-inflation years combined with erratic monetary policies did not sit well with stock investors. It was not until late 1982 that the Dow Jones Industrial Average broke decisively above the peak level reached in October of 1968—a fourteen-year period of essentially stagnant stock prices. Not coincidentally, that breakout occurred shortly after the new Fed chairman, Paul Volcker, vowed to finally break the back of inflation. Under his auspices, the central bank adopted a painfully tight monetary policy that sent the economy into a deep recession in the early 1980s and retained a vigilant anti-inflation stance throughout the decade. Subsequent Fed regimes mostly adhered to this policy, recognizing that it was imperative to rebuild confidence in the central bank's inflation-fighting credentials and to quash inflationary expectations on Main Street and Wall Street. Their efforts, reinforced by other influences such as technology, globalization and the "Amazon" effect, were a huge success, ushering in the tame inflation of the past two decades. But in the eyes of many, the quest to conquer the inflation dragon has been too successful, and a little more of the old inflation vigor is both welcomed and long overdue. How the Fed navigates policy as inflation picks up will have a critical bearing on the economy.

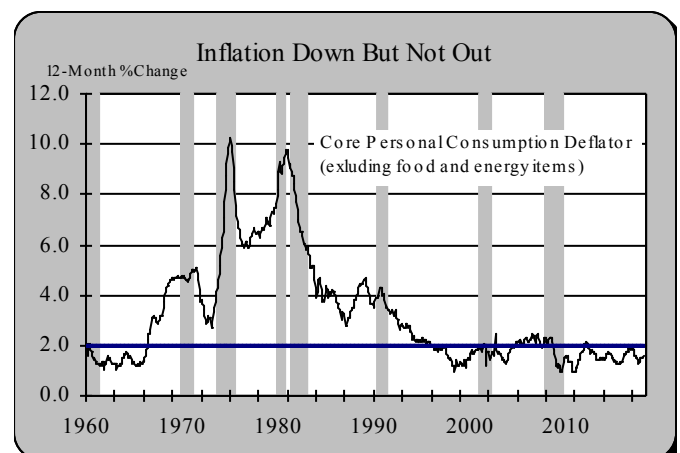
Conquering A New Demon

As damaging as high inflation is to the economy, just the opposite – deflation – poses an even greater threat. In a deflationary

environment – a sustained, broad-based decline in prices – several influences are set in motion that can send the economy into a pernicious downward spiral. Households, anticipating lower prices, hold back spending and hoard liquid assets. Businesses, in turn, are forced to liquidate inventories that can't be sold, thus reinforcing the downward pull on prices. They also cut back on orders for new goods, prompting cutbacks along the supply chain that includes laying off workers or slashing salaries. That, in turn, leaves less money in the hands of consumers, resulting in weaker demand, which sustains the vicious cycle.

That self-reinforcing series of events is usually associated with depressions or a sustained period of anemic growth. Importantly, it is extremely difficult to reverse, particularly if a deflationary mindset becomes firmly entrenched with households and businesses. Japan has struggled to emerge from a deflationary quagmire since the early 1990s despite muscular government efforts to turn things around. In the U.S. a deflation threat came later, ignited by the Great Recession and financial crisis that amplified the longer-term disinflationary trends already under way. More than one year after the end of the recession, the inflation rate was still falling to dangerously low levels. In late 2010, the annual rate tumbled to 0.6 percent, the closest to zero than any time in the post war period.

Needless to say, policy makers were getting nervous. For the first time ever, the Federal Reserve established an inflation target in 2012, setting it at 2 percent. But unlike earlier decades, the object was to lift inflation *up* to the target, not bring it down from elevated heights. The task has been challenging to say the least. Despite a turbo-charged infusion of monetary stimulus – reducing



short-term interest rates to near zero and purchasing more than \$4 trillion of Treasury and mortgage-backed securities – the Fed’s preferred inflation gauge (the core personal consumption deflator) has not hit 2 percent since April 2012.

Failed Expectations

To be sure, while policy makers fretted over the prospect of deflation, they steadfastly believed that inflation would move up to 2 percent in every year since the target was established. One reason: Fed officials were consistently overoptimistic in their growth forecasts. But even as the economy failed to live up to expectations, the Fed remained confident in its inflation prognosis because of the ever-tightening job market. As the unemployment rate continued to fall below levels deemed consistent with stable inflation, the Fed’s conviction hardened, underscored by the belief that rising wages would put upward pressure on prices, a linkage famously captured by the so-called Phillips Curve.

To its chagrin, the relentless drop in the jobless rate failed to validate that linkage. For one, the drop in the jobless rate hardly moved the wage needle. During the first six years of the recovery, wage growth stagnated around a lackluster 2 percent pace even as the jobless rate tumbled from 10 percent to 5 percent. Finally by early 2016, the pace of wage increases picked up modestly, rising to 2.5 percent. But a further tightening of the labor market, with the unemployment rate falling to 4.1 percent this year, did little to bump up worker pay. In March, average hourly earnings of all private-sector workers increased 2.7 percent from a year earlier, hardly an improvement over the previous three years. The last time the unemployment rate fell to current levels in 2000, wages were increasing by more than 4.0 percent.

What’s more, the link between wages and prices may not be as ironclad as the Fed believes. Businesses are under intense pressure to hold the line on prices, thanks to global competition, weak productivity, the growth in the “sharing economy” (i.e., look at the impact Airbnb and Uber has had in the hospitality and taxicab industries) and heightened price transparency created by the Internet (Amazon Prime now has over 100 million members). Consumers too expect stable prices, which together with the erosion of brand loyalty, has added muscle to their bargaining power. Procter & Gamble and Unilever, two giant producers of consumer products, had to cut prices in the first quarter to retain customers.

The Worm Turns

That said, it would be overly simplistic to assume that inflation is immune to evolving economic fundamentals. While wage growth over all remains surprisingly tame given the low unemployment rate, the ever-tightening job market is starting to bear fruit. For example, a near record number of workers are voluntarily quitting their jobs for other positions, and the pay bump they obtain for switching exceeds the raises they would get for staying put. The number of job hoppers is small relative to the size of the labor force, but the pressure on companies to boost compensation because of worker shortages is growing, particularly among small businesses where the largest share since 2000 are increasing wages.

Even if rising labor costs do not fully get passed through to increased prices, other signs of inflation are proliferating. For one, oil prices—a time-honored inflation catalyst—are once again climbing at a rapid pace. Gasoline prices hit a three-year high of 2.75 a gallon

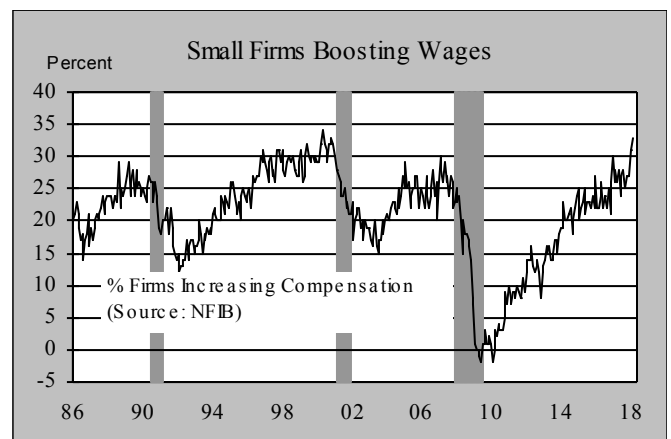
recently, thanks to OPEC production cutbacks and dwindling oil inventories. Importantly, prices on a wide range of commodities are also increasing at an accelerating clip and businesses are paying more for supplies and raw materials. The producer price index advanced at an annual rate of 3.5 percent over the last three months, feeding a pipeline that will eventually hit consumer pocketbooks. Indeed, the 2.9 percent annual increase in the core consumer price index during the first quarter was the strongest in more than a decade.

While inflation expectations still remain relatively anchored on Main Street, they are clearly gaining traction on Wall Street. The spread between the 10-year Treasury yield and the yield on 10-year Treasury Inflation-Indexed notes rose to a four-year high of 2.19 percent on April 20, indicating that the bond market is pricing in a 2.19 percent inflation rate over the next ten years. To be sure, this so-called breakeven rate should be taken with a grain of salt, as inflation is sensitive to economic setbacks and the economy is almost certain to fall into a recession at some point over the next ten years.

Gone But Not Forgotten

At the very least, the deflation threat that became close to reality a few years ago has been put on the back burner, at least for now. By all accounts, inflation is picking up and the Fed’s preferred price measure should hit the 2 percent target fairly soon. Unlike the cautious approach in recent years, the Fed may well speed up its planned rate increases this year if inflation runs higher than 2 percent and the economy outperforms expectations. Even so, the end point of the rate-hiking cycle will be much lower than the peak reached in past cycles; the Fed believes that the highest level for the federal funds rate will be 3.40 percent in 2020. That would be far below the previous cycle peak of 5.25 percent set in 2007 and lower than the end point of any previous cycle going back to 1960.

That means it has less room to cut rates should some shock – such as a trade war or geopolitical event – send the economy into a recession and knock inflation back down. In the past, the Fed slashed rates by an average of 4.5 percentage points to counter a recession, ammunition that is not available with rates currently in the range of 1.50-1.75 percent. What’s more, with \$1 trillion budget deficits looming in coming years, there is little room for the government to cut taxes or increase spending to help out. Simply put, the deflation threat may have fallen off the radar screen, but if it returns we may need new weapons to combat it.



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	<u>March</u>	<u>February</u>	<u>January</u>	<u>December</u>	<u>November</u>	<u>October</u>	<u>September</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
<i>Prime Rate</i>	4.58	4.50	4.50	4.40	4.25	4.25	4.25	4.58	3.88
<i>3-Month Treasury Bill Rate</i>	1.70	1.57	1.41	1.32	1.23	1.07	1.03	1.70	0.74
<i>5-Year Treasury Note Rate</i>	2.63	2.60	2.38	2.18	2.05	1.98	1.80	2.63	1.77
<i>10-Year Treasury Note Rate</i>	2.84	2.86	2.58	2.40	2.35	2.36	2.20	2.86	2.19
<i>30-Year Treasury Bond Rate</i>	3.09	3.13	2.88	2.77	2.80	2.88	2.78	3.13	2.77
<i>Tax-Exempt Bond Yield</i>	3.89	3.82	3.56	3.43	3.56	3.61	3.53	3.90	3.43
<i>Corporate Bond Yield (AAA)</i>	3.87	3.82	3.55	3.51	3.57	3.60	3.63	4.01	3.51
<i>Conventional 30-Year Mortgage Rate</i>	4.44	4.33	4.03	3.95	3.92	3.90	3.81	4.44	3.81
								0.00	0.00
<i>Dow Jones Industrial average</i>	24582	24982	25804	24545	23558	23036	22173	25804	20685
<i>S&P 500 Index</i>	2703	2705	2790	2664	2594	2557	2493	2790	2359
<i>Dividend Yield (S&P)</i>	1.96	1.90	1.79	1.87	1.87	1.94	1.97	2.01	1.79
<i>P/E Ratio (S&P)</i>	21.3	21.9	22.8	21.7	22.0	21.7	21.3	22.8	20.9
<i>Dollar Exchange Rate (vs. Major Currencies)</i>	86.20	85.7	86.3	88.7	89.2	88.7	87.1	94.5	85.7

* Monthly Averages

ECONOMIC INDICATORS

	<u>March</u>	<u>February</u>	<u>January</u>	<u>December</u>	<u>November</u>	<u>October</u>	<u>September</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
<i>Housing Starts (In Thousands)</i>	1319	1295	1339	1207	1299	1261	1159	1339	1129
<i>New Home Sales (Thousands of Units)</i>		618	622	653	711	616	639	711	559
<i>New Home Prices (Thousands of Dollars)</i>		323	325	340	343	320	332	343	311
<i>Retail Sales (% Change Year Ago)</i>	4.5	4.1	3.8	5.1	5.9	5.0	5.0	5.9	3.0
<i>Industrial Production (% Change Year Ago)</i>	4.3	4.4	3.0	2.9	3.4	2.7	1.2	4.4	1.1
<i>Operating Rate (% of Capacity)</i>	78.0	77.7	77.1	77.3	77.1	76.8	75.7	78.0	75.7
<i>Inventory Sales Ratio (Months)</i>		1.35	1.35	1.33	1.33	1.34	1.36	1.38	1.33
<i>Real Gross Domestic Product (Annual % Change)</i>				2.9			3.2	3.2	1.2
<i>Unemployment Rate (Percent)</i>	4.1	4.1	4.1	4.1	4.1	4.1	4.2	4.5	4.1
<i>Payroll Employment (Change in Thousands)</i>	103	326	176	175	216	271	14	326	14
<i>Hourly Earnings (% Change Year Ago)</i>	2.7	2.6	2.8	2.7	2.5	2.3	2.8	2.8	2.3
<i>Personal Income (% Change Year Ago)</i>		3.7	3.8	4.3	4.0	3.5	3.1	4.3	2.4
<i>Savings Rate (Percent of Disposable Income)</i>		3.4	3.2	2.4	2.5	2.9	3.0	4.1	2.4
<i>Consumer Credit (Change in Mil. Of Dollars)</i>		10601	15594	18969	32560	20318	8596	32560	8596
<i>Consumer Prices (% Change Year Ago)</i>	2.4	2.2	2.1	2.1	2.2	2.0	2.2	2.4	1.6
<i>CPI Less Food & Energy (% Change Year Ago)</i>	2.1	1.8	1.8	1.8	1.7	1.8	1.7	2.1	1.7
<i>Wholesale Prices (% Change Year Ago)</i>	3.0	2.8	2.7	2.6	3.1	2.8	2.6	3.1	1.9

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