Inflation: Sometimes it skips a generation

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Thoughts on inflation during an Federal Open Market Committee (FOMC) meeting week

In our view, the threat of a sharp climb in U.S. inflation shouldn't be at the forefront of investor worries at this time. However, the drivers of inflation and their influence on near and longer-term interest rates is important to understand to help best choose investments and build a portfolio.

We list some interesting aspects of U.S. inflation history and why we think inflation stays near the U.S. Federal Reserve's (the Fed's) 2% target for the next few years despite a further decline in U.S. unemployment rates.

1) Low inflation is the U.S. norm. Since 1800, the average U.S. inflation rate is 1.4%. Outside of wars, U.S. inflation is 0.5% on average. Outside of wars and 1971-1982 the average is 0.0%.

2) Inflation over the long-term exists only because the Fed wants it to exist. The U.S. economy has a long history of good productivity trends or rising output per worker and per capita. Fortunately, chronic supply shortages have never been a problem for the U.S. economy.

3) When economic potential meets demand, the Fed engineers inflation by managing and generally increasing the money supply. In the late1800s, before the Fed, there were periods of productivity surges from agricultural advancements and industrialization causing episodes of supply boom driven deflation. It is not always possible for a change in the velocity of money to accommodate economic growth. Deflation under such conditions can be damaging to an economy, because any price instability interferes with the effectiveness of price signals, crucial to market based economies, business planning and contracts.

4) Central Banks generally desire low, but positive and stable inflation rates. Because some inflation encourages either the spending or depositing of money into productive savings. This keeps the stock of money efficiently deployed. The Fed's current inflation target is 2%.

5) It's normal for the economic cycle to cause temporary deviations in inflation from the Fed's target. But such deviations are generally moderate and are rarely sudden jumps or plunges of several percentage points with the exception of inflationary jumps upon wars and plunges upon sharp recessions. Classically, cyclical inflation affects savings vs. consumption.

6) Persistent deviation from an inflation target would represent ineffective monetary policy. Because the U.S. has never suffered chronically inadequate supply-side induced inflation, the bouts of U.S. inflation well above target for multiple years was a function of inappropriate monetary policy under tight cyclical as well as dysfunctional or irrational business conditions. Generally, supply-side shock driven inflation shouldn't be met with tighter monetary policy.

7) If there is any clear signal or definition of inflation it is unit labor costs. While oil is in a lot of things, labor is in everything. But realize that wage growth is not inflationary if fueled by rising productivity. Productivity driven wage growth is prosperity. That said, it's irrational for employers to increase employee pay more than their productivity justifies as this would reduce profits. It's more likely that if the labor supply diminishes that growth would slow.

8) If employers irrationally increase wages more than productivity justifies, they would need to pass the cost forward to customers as price hikes to maintain profits. This is difficult in a competitive economy and a big irrational risk to take. If such a wage-price spiral did take hold, as it did in the 1970s, it's unlikely that the Fed would tolerate such price instability.

9) In the past 30 years, the highest monthly inflation spike was 6.3% in 1990. Anyone born after January 1983 hasn't experienced double-digit inflation in the U.S.

10) If inflation stays contained this year, the Fed is likely to signal that hikes in 2019 are not a given as the neutral Fed Funds rate might be below 3%, probably between 2-3%. We expect a hike on Wednesday, but the next hike to be in December and then March of 2019. Pausing for several meetings after March would likely be appropriate if inflation is still near 2% and the 10yr yield not much above 3%. As hiking above 2.5% would then likely flatten the curve.

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Definitions

Deflation is the general decline in prices for goods and services occurring when the inflation rate falls below 0%. Deflation occurs naturally when the money supply of an economy is fixed. In times of deflation, the purchasing power of currency and wages are higher than they otherwise would have been.

The **federal funds** rate is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Unit labor costs (ULC) measure the average cost of labor per unit of output.

The **U.S. Federal Reserve Board**, often referred to as "the Fed", is the central bank of the United States.