Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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The Low Inflation Puzzle

As the second half of the year gets underway, the economy is entering the ninth year of recovery from the Great Recession. But don't uncork the champagne, as this anniversary has as many critics as celebrants. True, the upturn has been durable, lasting longer than eight of the eleven postwar expansions. But it is also the weakest, in terms of growth, than any of the previous eleven. What's more, the harsh 2007-2009 downturn left scars that are still restraining household and business behavior.

Still, time has powerful healing properties and a record 80 consecutive months of job growth has recouped all of the jobs lost during the recession – and added 5.5 million more to boot. The unemployment rate has been driven down to a sixteen-year low of 4.3 percent from a peak of 10 percent; indeed, the news cycle is filled more by businesses complaining about a shortage of workers than by workers complaining about a lack of jobs. The steadily improving job market underpins the Federal Reserve's decision on June 14 to hike its short-term policy rate for the second time this year, believing it has successfully met one of its primary objectives: achieving maximum employment. What's more, the Fed expects to increase rates one more time this year and three more in 2018.

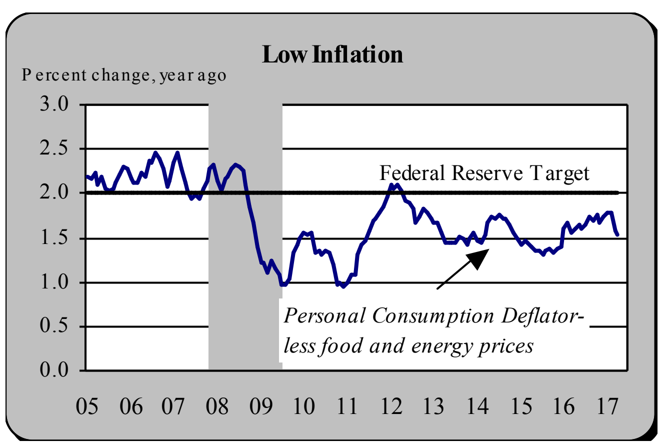
But the best-laid plans often go awry, and there are reasons to suspect that things may not fall into place as neatly as the Fed expects. Keep in mind that the central bank has a dual mandate: to achieve maximum employment in a stable price environment, which, since 2012, has been officially defined as a 2 percent inflation rate. In contrast to the success on the employment side of the mandate, the inflation effort has been an abysmal failure. Since April 2012, the Fed's preferred inflation gauge has been running below that 2 percent threshold in every month. To some, including bond investors, the stubbornly low inflation means that there is no reason for the Fed to keep increasing rates and risk bringing an end to the recovery. However, Fed officials focus more on future than current inflation; their view is that the ever-tightening labor market will spark higher wages and bring inflation up to the 2 percent target in the medium term. They had a similar view in 2015 and 2016, but their aggressive strategy for rate hikes in those years was thwarted by missed inflation calls as well as other unforeseen factors. The way things look now, their ambitious plans for this year and next will probably have to be scaled back as well.

Going the Wrong Way

The June 14 quarter-point rate hike by the Fed was the second this year and the fourth since it started the process of bringing interest rates up to normal levels. The process began with the first quarter-point increase in December 2015, seven years after the Fed drove its policy rate down to near zero as part of its effort to combat the financial crisis and lift the economy out of the Great Recession. The central bank stuck to its zero rate policy through the first seven years of recovery for a variety of reasons, including the fact that the recovery itself was the weakest on record, making it vulnerable to a series of shocks, both homegrown and from overseas, that threatened to derail it.

But the threat of deflation also haunted the Fed throughout the period, particularly since the global economy remained mired in recession well after the U.S. started to recover. Only when Europe and other developed economies regained their footing and the U.S. job market tightened up did the Fed feel confident that the deflationary pull had eased. Indeed, the Fed's preferred inflation gauge, which hovered precariously around 1 percent during the first two recovery years, finally started to climb in 2011 and briefly hit the 2 percent mark in early 2012. At that point, the Fed needed to wait for the job market – where unemployment was still sky-high at 8.5 percent – to catch up before feeling confident its dual mandate had been met.

In the years that followed, the job-creating engine revved up and the unemployment rate plunged. But inflation did not follow the time-honored pattern of moving higher as the job market tightened. Instead, that brief climb to 2 percent in the core-inflation rate, which excludes volatile food and energy items, was just that – brief, lasting four months. Since early 2012, the Fed's inflation measure has never hit that target again. Worse, the trend recently has moved in the opposite direction, slipping to 1.5 percent in April. Other price measures, such as the consumer price



index, have mirrored that trend; from January through May, the core consumer price index has slowed by 0.6 percentage points.

One-Off Depressants

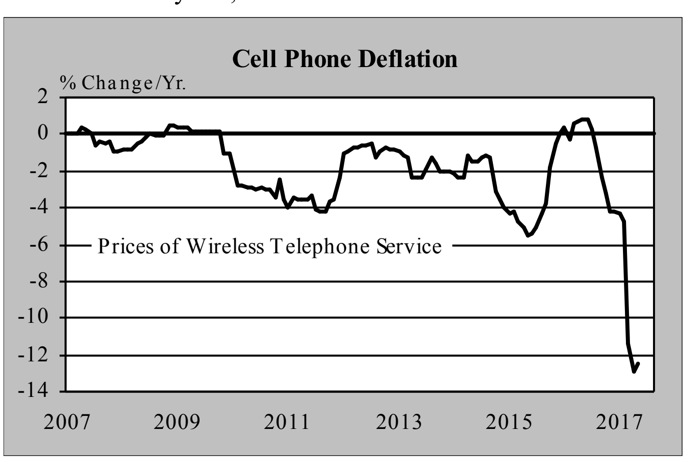
To be sure, the Fed was aware of the deceleration in inflation before hiking rates on June 14 and promised to "monitor inflation developments closely" as it pursues its policy goals. Still, the central bank does not appear to be overly concerned, claiming that certain "one-off" factors are mainly responsible for the recent inflation setback. Two in particular caught the Fed's eye: an astonishing free-fall in prices of cell phone plans and, to a lesser extent, the slowdown in prescription drug prices. The plunge in wireless service plans alone – reflecting the addition of free minutes by telephone carriers as part of an intense price war – lowered the inflation rate by 0.2 percent, an impact that is much greater than their contribution to the overall price index.

The Fed believes that once these one-off factors fizzle out, the inflation rate will move up to its 2 percent target over the medium term. But two-thirds of the decline in the inflation rate this year has been due to more fundamental factors, and the prospect that they will undergo an abrupt reversal is not very good. For one, core goods (i.e. excluding volatile food and energy items) remain in deflationary territory, as their prices have continued to decline every month this year and are down nearly 1 percent from a year ago. This persistent decline reflects a global oversupply of goods that will not dissipate soon as there is still a vast amount of spare capacity in the global goods market. Even in the U.S. where the recovery is the longest, industrial capacity is fully 3.3 percent below its long-term average.

The only reason inflation is positive is because prices of services – which account for more than 60 percent of all output in the U.S. – continue to rise. But even here, the inflation pace is slowing, and the slowdown reaches well beyond cell phone plans. The biggest thrust behind the rise in service prices in recent years has been housing costs, particularly the ever-spiraling cost of renting a home or apartment. However, after doubling between 2011 and 2015, the annual increases in rents leveled off last year and actually declined this year, dragging down the inflation rate. The downward pull is set to continue.

Housing Costs Easing

Indeed, since rents and other housing costs comprise more than 50 percent of total service prices, they have an important bearing on the direction inflation will take. Not surprisingly, the upward climb in rents in recent years, which far exceeded the increase in incomes, sowed the seeds for the eventual easing now unfolding. For one, developers lured by the profits in the rental market embarked on an apartment building boom that, in time-honored fashion, has resulted in an oversupply of rental units. For another, more millennials are turning away from rentals, perhaps priced out of many markets, and becoming first-time homebuyers.



With mortgage rates hovering near historic lows and the solid job market lifting incomes, the shift from renting to home buying is likely to continue, extending the time it takes for the oversupply of rental properties to unwind and reinforcing the downward pull on rents. The easing of rental price increases along with the moderation in medical services, recreation and transportation prices, combined with the sharp decline in wireless service plans, strongly suggest that inflation will remain stubbornly below the Fed's 2 percent target, both this year and next.

But what about the wage inflation that a tightening job market is supposed to ignite, prompting businesses to pass on higher labor costs to consumer? Clearly, that classic wage-price inflation dynamic is far from happening. For a variety of debatable reasons, the steep fall in the unemployment rate has not spurred an acceleration of wage growth; if anything, the average 2.5 percent increase in worker pay in effect over the past several years combined with 1 percent productivity growth is consistent with a 1.5 percent inflation rate, which is about where we are now.

High Hopes

That's not to say that things won't change in coming months. The Federal Reserve is clinging to the belief that tightening labor market conditions will underpin a pick-up in inflation over the medium term, particularly once the aforementioned "one-off" price declines run their course. That may well occur if the competition for workers continues to heat up and their bargaining power increases. However, given the lack of response so far with the unemployment rate at a sixteen-year low, the trigger point may not be reached until joblessness falls to under 4 percent, something not seen since December 2000.

Even then, the expected upward pressure on wages may not materialize. In Japan and Germany, for example, wage increases are negligible despite the fact that unemployment rates in those nations are the lowest in decades. Indeed, low inflation is an even stickier issue abroad than it is in the U.S. Not coincidentally, both Germany and Japan share the same problems as the U.S.: low productivity and an aging workforce. These are critical forces restraining wages and inflation.

The good news is that the stubbornly low inflation rate should prevent the Federal Reserve from hiking interest rates too aggressively, which would stifle growth and risk sending the economy into a recession. The small quarter-point increases taken so far, including the one on June 14, only lifted short term rates to 1.00 – 1.25 percent, which is still below the inflation rate and, hence, not a growth impediment. However, the Fed is under pressure to stay ahead of the inflation curve, and that pressure will build if the economy picks up speed and the labor market continues to tighten. While growth has picked up from the tepid pace over the winter months, there is little indication that a breakout from the 2 percent trend seen throughout the recovery is about to take place. That's a recipe for a slow-go approach to policy, perhaps slower than the Fed currently plans.

KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	May	April	March	February	January	December	November	12-Month Range High	12-Month Range Low
Prime Rate	4.00	4.00	3.88	3.75	3.75	3.64	3.50	4.00	3.50
3-Month Treasury Bill Rate	0.89	0.80	0.74	0.52	0.51	0.51	0.45	0.89	0.27
5-Year Treasury Note Rate	1.84	1.82	2.01	1.90	1.92	1.96	1.60	2.01	1.07
10-Year Treasury Note Rate	2.30	2.30	2.48	2.42	2.43	2.49	2.14	2.49	1.50
30-Year Treasury Bond Rate	2.96	2.94	3.08	3.03	3.02	3.11	2.86	3.11	2.23
Tax-Exempt Bond Yield	4.02	4.05	3.95	3.91	3.80	3.82	3.59	4.05	2.83
Corporate Bond Yield (AAA)	3.85	3.87	4.01	3.95	3.92	4.06	3.86	4.06	3.28
Conventional 30-Year Mortgage Rate	4.01	4.05	4.20	4.17	4.15	4.20	3.77	4.20	3.44
								0.00	0.00
Dow Jones Industrial average	20937	20685	20823	20424	19908	19712	18697	20937	17692
S&P 500 Index	2395	2359	2367	2330	2275	2247	2165	2395	2067
Dividend Yield (S&P)	2.00	2.01	2.01	2.01	2.06	2.09	2.11	2.17	2.00
P/E Ratio (S&P)	21.0	21.2	21.1	21.8	20.9	20.6	20.5	21.8	19.5
Dollar Exchange Rate (vs. Major Currencies)	93.2	94.0	94.5	94.0	94.7	95.4	93.7	95.4	89.7

** Monthly Averages*

ECONOMIC INDICATORS

	May	April	March	February	January	December	November	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1092	1156	1189	1288	1236	1268	1149	1328	1062
New Home Sales (Thousands of Units)		569	642	607	599	548	579	642	548
New Home Prices (Thousands of Dollars)		309	319	299	317	333	318	333	234
Retail Sales (% Change Year Ago)	3.8	4.6	4.8	4.7	5.6	4.0	3.7	5.6	2.1
Industrial Production (% Change Year Ago)	2.2	2.1	1.3	0.5	0.0	0.8	-0.4	2.2	-1.5
Operating Rate (% of Capacity)	76.6	76.7	75.9	75.9	75.7	76.0	75.5	76.7	75.5
Inventory Sales Ratio (Months)		1.37	1.37	1.37	1.37	1.37	1.39	1.41	1.37
Real Gross Domestic Product (Annual % Change)			1.2			2.1		3.5	1.2
Unemployment Rate (Percent)	4.3	4.4	4.5	4.7	4.8	4.7	4.6	4.9	4.3
Payroll Employment (Change in Thousands)	138	174	50	232	216	155	164	297	43
Hourly Earnings (% Change Year Ago)	2.5	2.5	2.6	2.8	2.6	2.9	2.7	2.9	2.5
Personal Income (% Change Year Ago)		3.6	3.9	4	3.4	2.8	3	4.0	2.8
Savings Rate (Percent of Disposable Income)		5.3	5.3	5.3	5.0	4.5	4.9	6.0	4.5
Consumer Credit (Change in Mil. Of Dollars)		8197	19536	16502	11395	13636	25491	25491	8197
Consumer Prices (% Change Year Ago)	1.9	2.2	2.4	2.7	2.5	2.1	1.7	2.7	0.8
CPI Less Food & Energy (% Change Year Ago)	1.7	1.9	2.0	2.2	2.3	2.2	2.1	2.3	1.7
Wholesale Prices (% Change Year Ago)	2.4	2.5	2.3	2.2	1.6	1.6	1.3	2.5	-0.2