Louisiana Corporate Credit Union
ECONOMIC & FINANCIAL DIGEST
3500 N. Causeway, Suite 1510 • Metairie, Louisiana 70002 • (800) 421-7030 • www.lacorp.com
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The Inflation Puzzle

As advertised, the U.S. economy is slowing from the deceptively robust 3.2 percent annual rate in the first quarter. But the first-quarter's headline strength derived primarily from two unsustainable sources – inventories and trade. Both will be a drag on growth in the second quarter, more than offsetting a pickup in the economy's main growth drivers, consumer spending and business investment. In other words, the headline slowdown now underway masks an actual strengthening in the economy's core underpinnings.

Despite this improvement, there is growing pressure on the Federal Reserve to cut interest rates. Indeed, the financial markets are pricing in a 70 percent chance that the central bank will cut interest rates before the end of the year, a significant increase from just a month ago. What accounts for this disconnect? After all, the economy is poised to enter the longest expansion ever on a relatively firm footing, the labor market continues to run hot, household and business confidence remains elevated and asset prices are climbing. This confluence of events so late in a business cycle is a time-honored catalyst for the Fed to start putting the brakes on growth, raising interest rates instead of lowering them.

But this is not your grandfather's expansion. In the past, the backdrop described above would have stoked higher inflation, making the Fed's decision to curb growth fairly obvious. Not only is inflation quiescent this time, it is actually falling, undercutting the prime reason to restrain growth. What's more, the U.S. economy has become more interconnected with the rest of the world, which complicates Fed decisions in numerous ways. For example, the rising tide of protectionism between the U.S. and its trading partners, resulting in higher tariffs and other trade barriers, stifles growth even as it lifts inflation. If the Fed reacts to one, it risks amplifying the other problem, causing confusion over policy and wild gyrations in the financial markets. This complicated set of forces is exposing a rift among Fed officials, pitting those who want to stay patient with the current policy against those who want to move more aggressively to combat falling inflation. The latter seem to be gaining the upper hand.

Is It Transitory?

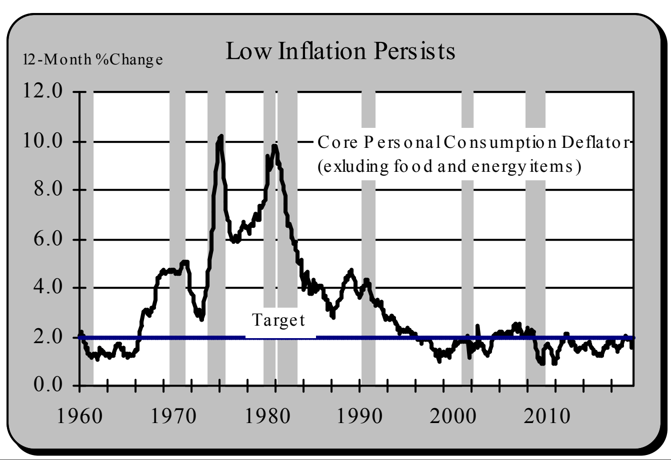
Except for a brief period last year, the Federal Reserve has consistently failed to meet the 2 percent inflation target that it formally adopted in April 2012. This elusive goal has become even harder to reach this year. After touching 2.0 percent four times in 2018, the last in December, the Fed's preferred inflation gauge – the core personal consumption deflator, which excludes volatile food and energy prices – has slipped down the ladder this year. In March, it rose 1.6 percent from a year earlier, the weakest annual increase in more than a year.

The backsliding has caught the central bank off guard, as it clearly thought that steady growth, declining unemployment and rising wages last year were putting inflation on a sustainable path towards 2 percent. That perception coaxed the Fed to lift interest rates four times during the year and underpinned its plan to hike two more times in 2019. But as they say, the best-laid plans often go awry, and that's certainly been the case so far this year. The Fed abandoned its rate hiking plans in January and has since become even more entrenched on the sidelines, waiting to see how the data unfolds in coming months.

For the record, most Fed officials still believe that the inflation setback this year is due to transitory forces. There is some truth to that. We estimate that about one-half of the 0.4 percent slowdown in the core PCE deflator since December has been due to lower inflation on three items – apparel, portfolio management fees and air transportation. Just as the temporary plunge in cell phone plans that dragged down inflation in 2016 was subsequently reversed, the same may happen with some or all of these three items. What's more, the Fed is eyeing other forces that may push up inflation, most notably higher tariffs recently put into effect, echoing the higher prices on imported washing machines linked to earlier tariff increases.

Not Following The Script

However, there are compelling reasons to believe that the stubbornly low inflation is more structural than transitory. Keep in mind that except for last year, inflation has mostly remained below 2 percent for more than two decades, dating back to the



1990s. This suggests that some enduring forces are keeping inflation at bay, overwhelming such time-honored inflationary catalysts as a tightening labor market and sustained economic growth, both of which have been amply present over this period.

While economists have debated this issue for some time, most agree that certain trends have become more prominent since the 1990s that, to varying degrees, explain why inflation has not responded to cyclical forces as in past cycles. These include globalization, which expands competition with lower-cost producers oversees, new technology, such as the Internet, which equips consumers with a greater ability to shop online for lower prices, and the decline in union membership, which reduces the bargaining power of workers and, hence, restrains the increase in labor costs associated with an expanding economy.

That raises the question: what's the problem? No one likes to pay higher prices so lower inflation should be welcomed, not feared. The problem is that if inflation consistently falls below the desired level set by policy makers, both Main Street and Wall Street will question the credibility of the Fed's power to reach that target. In that case, inflation expectations will also stay below the Fed's intentions, making its task of lifting inflation even harder. It's important to note that inflation expectations are viewed as the best leading indicator of future inflation since if consumers, businesses and investors expect lower (or higher) inflation, they will act in ways to bring that about. The main concern then is that inflation expectations could drift still lower, leading to even weaker inflation and, worse, bring the economy to the brink of deflation.

Pushing On A String

While most Fed officials believe that the recent downward drift in inflation is only temporary, some disagree and believe that lifting inflation has become the most challenging issue facing policymakers. The ranks of these skeptics seem to be growing, although none of them are yet calling for an immediate rate cut. One problem with lowering rates now while the economy is still growing is that it leaves policymakers with less ammunition when a recession does arrive. Historically, the Fed has lowered its short-term policy rate by at least 4 percentage points during recessions, which is more than what the Fed has in its arsenal. The federal funds rate is currently in a range of 2.25-2.50 percent, and a reduction would leave it with even fewer bullets to combat a recession.

Even if it cuts, there is no guarantee that inflation would respond. The main purpose of a rate reduction is to stoke the economy's growth engine, which generates the typical late-cycle burst in activity that ignites inflation. But prices that have historically responded to faster growth are not doing so in the current expansion. Although GDP growth has picked up from 1.3 percent in mid-2016 to 3.2 percent in the first quarter of this year, cyclically sensitive prices have hardly budged. In fact, despite a labor market that continues to churn out over 200 thousand jobs a month and wage growth that has firmed to over 3.0 percent, cyclically sensitive prices are actually rising more slowly than the 2004-2007 average of 3.0 percent.

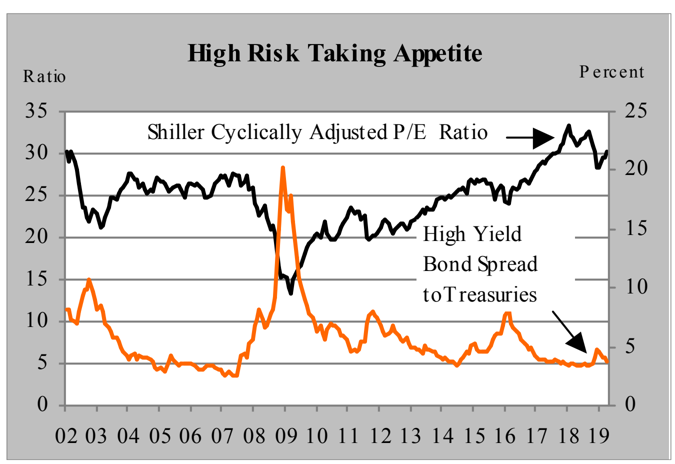
Hence, given the dampened cyclical movement in inflation, easing monetary policy might lead to more asset price inflation than consumer price inflation. If so, this ultimately could prove destabilizing to the expansion. Notwithstanding the recent setback in financial markets stemming from renewed trade tensions, equity price valuations are elevated and corporate bond spreads, including high-yield bonds, are narrow. The low interest rate environment has played a large role in boosting investors' appetite for riskier assets. Importantly, growing expectations that the Fed's next move will be to cut rates have underpinned a powerful rally in equity prices this year as well as renewed tightening in high-yield corporate bonds spreads.

Changing Expectations

So if cutting rates might be unproductive – primarily encouraging more risk taking and spurring higher asset prices — what can the Fed do to lift inflation? One approach is the one it is currently taking: stay on the sidelines and hope that the recent inflation setback is in fact transitory. If that turns out to be the case, the very forces that lifted inflation to 2.0 percent last year – a tightening labor market and sustained growth – could well do so again later this year. Most Fed officials still maintain that expectation, believing that the case for a rate cut and a rate increase are about evenly balanced.

But the longer the inflation shortfall persists, the more deeply will lowered inflation expectations become entrenched; that, in turn, will make the task of lifting inflation even more challenging down the road. Another approach, promoted by many respected economists, is to directly home in on expectations. That is, persuade households, businesses and investors to believe that the Fed is willing to let inflation rise above 2 percent for a considerable period of time to compensate for the lengthy period it fell short of that target. Rightly or wrongly, the general perception has long been that the 2 percent target is a rigid ceiling, something that would prompt the Fed to swiftly tighten policy as soon as inflation reached that level.

Fed Chairman Powell has been trying to repudiate that perception, stating that inflation could exceed 2 percent for a period of time without eliciting a tightening response. Indeed, earlier this year, the Fed announced that it was set to embark on a comprehensive review of its policy tools, with special emphasis on the merits of a "flexible inflation targeting" framework. The review is scheduled to be completed in mid-2020, but with inflation expectations still weakening, the credibility of the Fed is being increasingly undermined in the financial markets and among households and businesses. It may behoove the central bank to speed up that review before the next recession sets in, when monetary policy will have to lift both the economy and inflation out of the doldrums.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	April	March	February	January	December	November	October	12-Month Range High	12-Month Range Low
Prime Rate	5.50	5.50	5.50	5.50	5.35	5.25	5.25	5.50	4.75
3-Month Treasury Bill Rate	2.38	2.40	2.39	2.37	2.37	2.33	2.25	2.40	1.86
5-Year Treasury Note Rate	2.33	2.37	2.49	2.54	2.68	2.95	3.00	3.00	2.33
10-Year Treasury Note Rate	2.53	2.57	2.68	2.71	2.83	3.12	3.15	3.15	2.53
30-Year Treasury Bond Rate	2.94	2.98	3.02	3.04	3.10	3.36	3.34	3.36	2.94
Tax-Exempt Bond Yield	3.85	3.96	4.22	4.21	4.13	4.30	4.32	4.32	3.85
Corporate Bond Yield (AAA)	3.69	3.77	3.79	3.93	4.02	4.22	4.14	4.22	3.69
Conventional 30-Year Mortgage Rate	4.14	4.27	4.37	4.46	4.64	4.87	4.83	4.87	4.14
Dow Jones Industrial average	26402	25723	25606	24158	23806	25252	25569	26402	23806
S&P 500 Index	2904	2804	2755	2607	2567	2723	2785	2904	2567
Dividend Yield (S&P)	1.95	2.01	2.04	2.08	2.22	1.99	2.02	2.22	1.87
P/E Ratio (S&P)	19.3	18.7	18.3	17.8	16.6	18.9	18.7	21.0	16.6
Dollar Exchange Rate (vs. Major Currencies)	92.3	91.9	91.4	91.8	92.1	91.7	90.8	92.3	88.7

** Monthly Averages*

ECONOMIC INDICATORS

	April	March	February	January	December	November	October	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1235	1168	1149	1291	1142	1202	1211	1332	1142
New Home Sales (Thousands of Units)		692	662	625	562	612	552	692	552
New Home Prices (Thousands of Dollars)		303	315	304	330	309	328	330	303
Retail Sales (% Change Year Ago)	3.1	3.8	2.1	2.9	1.6	4.0	4.6	6.6	1.6
Industrial Production (% Change Year Ago)	0.9	2.3	2.7	3.6	3.8	4.1	4.1	5.4	0.9
Operating Rate (% of Capacity)	77.9	78.5	78.5	79.0	79.5	79.6	79.3	79.6	77.9
Inventory Sales Ratio (Months)		1.37	1.39	1.39	1.38	1.36	1.35	1.39	1.33
Real Gross Domestic Product (Annual % Change)		3.2			2.2			4.2	2.2
Unemployment Rate (Percent)	3.6	3.8	3.8	4.0	3.9	3.7	3.7	4.0	3.6
Payroll Employment (Change in Thousands)	263	189	56	312	227	196	277	312	56
Hourly Earnings (% Change Year Ago)	3.2	3.2	3.4	3.1	3.3	3.3	3.3	3.4	2.9
Personal Income (% Change Year Ago)		3.9	4.2	4.3	5.0	4.3	4.4	5.0	3.9
Savings Rate (Percent of Disposable Income)		6.5	7.3	7.2	7.7	6.2	6.4	7.7	6.2
Consumer Credit (Change in Blns. Of Dollars)		10.3	15.4	17.2	12.2	21.8	20.2	25.1	2.5
Consumer Prices (% Change Year Ago)	2.0	1.9	1.5	1.6	1.9	2.2	2.5	2.9	1.5
CPI Less Food & Energy (% Change Year Ago)	2.1	2.0	2.1	2.2	2.2	2.2	2.1	2.4	2.0
Wholesale Prices (% Change Year Ago)	2.3	2.2	1.8	2.0	2.5	2.6	3.2	3.4	0.3

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