KEY TAKEAWAYS

We believe modestly higher inflation over the next year is likely as U.S. and global growth accelerates and wage pressure rises.

However, forces such as labor force expansion and stable commodity prices should keep any larger buildup of inflationary pressure at bay.

May 22 2017

INFLATION WATCH UPDATE

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Barry Gilbert, Ph.D., CFA *Senior Economic Analyst, LPL Financial*

Over the last several months, inflation has increasingly taken center stage for Federal Reserve (Fed) watchers. While the deflation theme of early 2016 has all but disappeared, and conviction around higher but still healthy inflation ("reflation") that appeared in the months following the U.S. election has settled considerably, a largely healthy labor market is putting a spotlight on the other half of the Fed's dual mandate, low and stable inflation. We believe modestly higher inflation over the next year is likely as U.S. and global growth accelerates and wage pressure increases as the labor market tightens further. However, forces are in play that should keep any larger buildup of inflationary pressures at bay, including below-historical capacity utilization, stable commodity prices, potential for labor force expansion through a rise in the participation rate, and low inflation expectations. This week, we look at some of the factors that may impact inflation in the next year.

INFLATION IN FOCUS

The Fed's well-known "dual mandate" is to balance the often contradictory goals of maximum employment and stable prices. An "accommodative" or "dovish" Fed typically sees employment as the higher priority at a given time, whereas a "restrictive" or "hawkish" Fed typically sees controlling inflation as a higher priority. With the unemployment rate consistent with a healthy economy and job growth, while still strong, steadily slowing from its one-year peak in 2015, the Fed is becoming increasingly focused on inflation.

GROWTH GAINS A FOOTHOLD

Economic growth, both domestic and international, is at the heart of expectations for an uptick in inflation, boosted by still supportive central banks, the possibility of global fiscal stimulus and other pro-growth reforms, continued stabilization in energy markets, and the potential of the start of a virtuous cycle of rising confidence translating to increased economic activity. Although global growth remains below its historical trend, there have been signs of greater strength in the global economy. The most recent International Monetary Fund (IMF) forecasts have global growth accelerating from 3.1% in 2016 to 3.5% in 2017, with a slightly higher contribution from emerging markets (EM) than advanced economies. Thus far the global economy has managed to weather the European debt crisis, the collapse of oil prices, and slowing growth in China, although it has been difficult to create any real traction against the backdrop of these headwinds. While a policy mistake by a government or central bank always remains a possibility, the absence of a crisis could be enough to see improved confidence translate to increased growth momentum and help the global economy regain its footing.

SERVICES INFLATION HAS BEEN ABOVE 2% FOR YEARS

Inflations for services, which make up about two-thirds of consumer spending, have steadily held above the Fed's 2% inflation target for over five years, as measured by the Personal Consumption Expenditure Price Index, the Fed's preferred measure of inflation [Figure 1]. Services in general are more dependent on labor, and services inflation therefore tends to be more strongly influenced by gaps in labor supply and wages. By contrast, goods inflation, which is more influenced by commodity prices and low-cost imports, has struggled to meet the Fed's broad 2% inflation target over most of the expansion, but has raising since early 2015, helped by stabilizing energy prices.

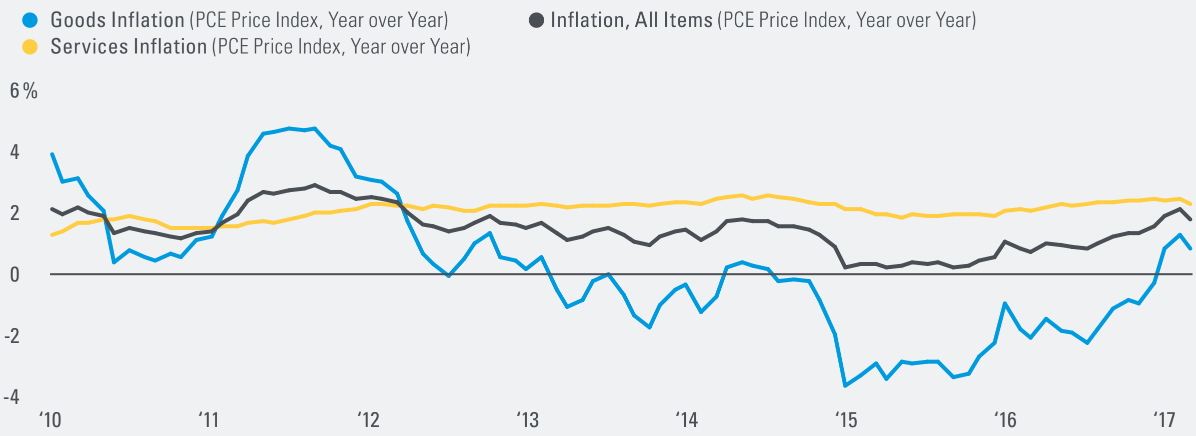
WAGE PRESSURES ARE RISING BUT APPEAR LIKELY TO BE CONTAINED

Wage pressures are considered a kind of "cost push" inflation. Wages are one of the most important input costs for any business, and wage growth can lead to higher prices as businesses try to pass costs on to consumers. After dipping in early 2015, wage growth for production and nonsupervisory employees accelerated to around 2.5% year over year in late 2015 and has largely remained there since. Prior expansions all saw nominal wage growth surge to close to 4% in the second half of the cycle, a level that contributed to the economy overheating. Wage growth should rise as the labor market tightens, but the possibility that the labor force participation rate could rise, expanding the labor force, may help limit the impact, although re-entrants may have seen skills degrade and will have a smaller impact on wage growth due to the skills gap. (See the May 8, 2017 *Weekly Economic Commentary, "Jobs Count,"* for more insight on the labor skills gap.)

COMMODITIES COULD RECEIVE SOME SUPPORT FROM GLOBAL GROWTH

Commodity prices will get some support from greater demand if global growth accelerates and if increased fiscal spending on infrastructure materializes. But lower demand from China as growth slows and its economy rebalances toward a more consumer- and service-driven model, together with technological

1 GOODS INFLATION INCREASING WHILE SERVICES HOLD STEADY



Source: LPL Research, U.S. Bureau of Economic Analysis 05/22/17

The PCE Price Index is a United States-wide indicator of the average increase in prices for all domestic personal consumption. It is benchmarked to a base of 2009 = 100. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from the largest component of the GDP in the BEA's National Income and Product Accounts: personal consumption expenditures.

developments over the last decade that have transformed energy markets, would keep prices contained. Falling inflation expectations will also decrease speculative commodity market activity that can contribute to higher prices.

SPARE CAPACITY MAY NOT BE MUCH OF A FACTOR, DESPITE APPEARANCES

If industries have spare capacity, they can ramp up production without having to make investments in capital equipment. The picture on spare capacity is mixed. Capacity utilization in manufacturing has remained largely steady throughout the expansion, but at a level significantly lower than in prior recoveries. But estimates of potential gross domestic product (GDP) growth, the rate at which the economy can expand without creating inflationary pressure, stands just below 2.0%, indicating that any further pickup in growth is likely to be accompanied by higher inflation and the impact of spare capacity in manufacturing may be limited.

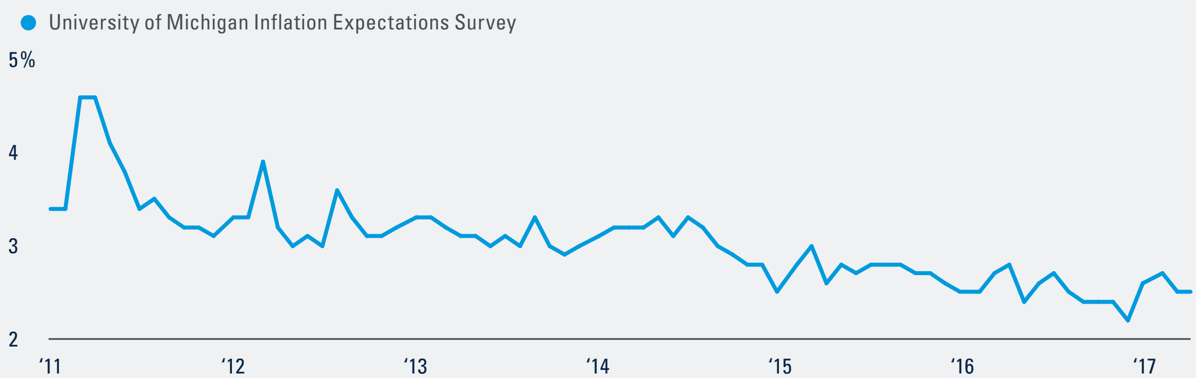
INFLATION EXPECTATIONS HAVE BEEN FALLING FOR YEARS

Surprisingly, one of the most important factors in determining inflation is… expectations of future inflation, which is determined in part by… the current inflation rate! Inflation expectations, according to the University of Michigan's monthly consumer survey, peaked post-recession in 2011 as gas prices rose sharply but have been declining since [Figure 2]. Expectations did see a small surge following the election, but even the peak value of 2.7% in February 2017 was only in the bottom fifth of all values during the current expansion. Inflation expectations remain above consensus forecasts, but a declining trend indicates it may take a meaningful pickup in realized inflation before expectations shift in a way that changes behavior.

INFLATION RISK FROM MONETARY POLICY REMAINS LOW

Extraordinarily supportive monetary policy from global central banks remains only a small risk for inflation. Monetary policy alone cannot drive inflation, and thus far the view of global central bankers that the conditions that would turn supportive policy into high inflation have not been present has been correct. But given the unprecedented level of intervention from global central banks, monetary policy may still have as yet unknown and unintended long-term consequences.

2 INFLATION EXPECTATIONS IN A DOWNWARD TREND



Source: LPL Research, University of Michigan Survey of Consumers 05/22/17

University of Michigan (UoM) Inflation Expectations Survey measures the median percentage that consumers expect the price of goods and services to change during the next 12 months.

Inflation expectations may not develop as predicted.

Should circumstances change, central banks have the tools they would need to control inflation. What's more difficult to know is whether they would also have the will.

CONCLUSION

With a meaningful decline in the unemployment rate appearing unlikely, and the economy growing near expected potential, any increase in growth would likely be accompanied by an uptick in inflation. While we expect accelerating growth to push inflation above the Fed's 2% target over the next year, there are still several forces in play that will help contain any significant move higher. Watch for the release of the minutes of the Fed's May 2–3 policy meeting on May 24 for more depth on the Fed's view of inflation following slower-than-expected growth in the first quarter. ■

DEFINITIONS

International Monetary Fund (IMF) is an international organization created for the purpose of promoting global monetary and exchange stability, facilitating the expansion and balanced growth of international trade, and assisting in the establishment of a multilateral system of payments for current transactions.

The Bureau of Economic Analysis is a division of the U.S. federal government's Department of Commerce that is responsible for the analysis and reporting of economic data used to confirm and predict economic trends and business cycles. Reports from the Bureau of Economic Analysis are the foundation upon which many economic policy decisions are made by government, and many investment decisions are made in the private sector by companies and individual investors.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

RES 5928 0517 | Tracking #1-610699 (Exp. 05/18)