Current Economic Conditions

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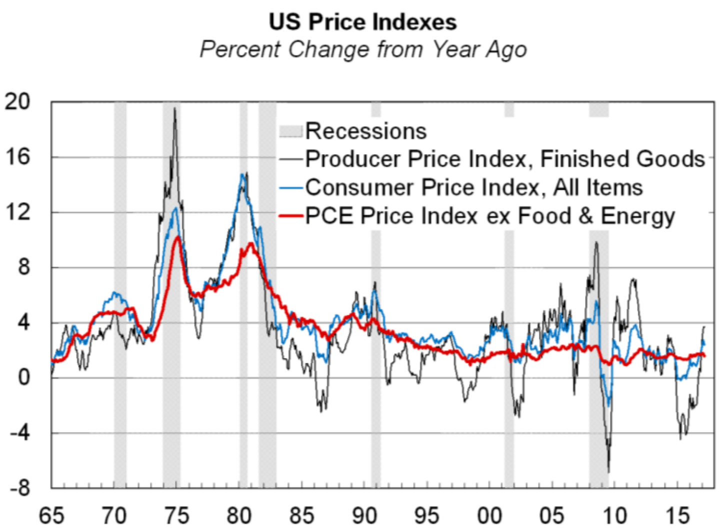
IS INFLATION PICKING UP OR FADING?

The U.S. Producer Price Index for Final Demand, the headline measure of producer (i.e., wholesale) prices in the economy, was up 2.5% year-over-year in April. This marked the highest rate of producer price inflation since February 2012. The Producer Price Index for Finished Goods, the headline measure until services were added to the PPI in 2014, was up 3.9% year-over-year in April, the biggest increase since January 2012. Much of the apparent surge in inflation is due to a rebound in the price of crude oil from the 12-year low hit in January 2016. The PPI for Final Demand less Food, Energy, and Trade Services, regarded by many analysts as a better measure of underlying producer price pressures, was up 2.1% year-over-year, and the PPI for Finished Goods less Food and Energy was up just 1.9%. But while these increases were much lower than for the broader PPIs, they were still the biggest increases for these series since August 2014 and September 2015, respectively. Producer prices seem to confirm the fears of inflation hawks that years of extremely low interest rates and "quantitative easing" would ultimately cause inflation to rise undesirably.

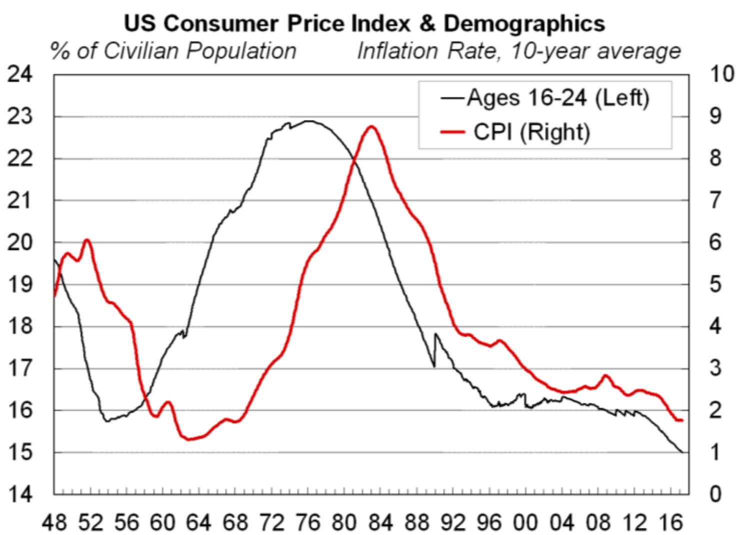


The Consumer Price Index paints a very different picture, however. The broadest CPI was up 2.2% year-over-year in April, down significantly from February's 2.7% increase. The CPI less Food and Energy was up just 1.9%, the lowest "core" inflation rate since August 2015. Declining CPI inflation suggests that the Federal Reserve's favorite measures of inflation, the year-over-year (12-month) percent change in Personal Consumption Expenditures Price Indexes, total and excluding food and energy, will also recede when reported later this month. The year-over-year change in the total PCE price index rose above the Fed's 2% target in February, but fell back to 1.8% in March. Core PCE inflation stood at 1.6% in March and hasn't been above 2% since early 2012. Consumer prices seem to bolster the arguments of inflation doves who want the Fed to raise interest rates and shrink their balance sheet very slowly, if at all.

How do we reconcile what appears to be rising inflation at the producer level with declining inflation at the consumer level? For pessimistic inflation hawks, rising producer price inflation represents inflation in the pipeline that will soon flow through to consumers. For many retailers, the combination of rising producer price inflation and falling consumer price inflation means margins are shrinking. Amazon and, more generally, the ability to search for prices online, have put downward pressure on retail prices and squeezed profit margins, continuing what Walmart started decades ago. But one shouldn't make too much of either of these explanations. Most of the increase in producer price inflation is due to a rebound in oil prices, a rebound that has already run its course. Even though producer price inflation excluding food and energy has risen to multi-year highs, the increase has been small, and much of that increase has been due to the pass-through of higher oil prices into goods prices more generally.

Once you remove the transitory impact of oil prices, the main message to be drawn from price data is that there is tremendous stability in inflation. The year-over-year increase in the PCE Price Index excluding Food and Energy has been between 1.3% and 1.8% for 57 straight months. It has been between 0.9% and 2.5% every month since January 1994, when the North American Free Trade Agreement (NAFTA) was enacted. (Before 1994, core PCE inflation hadn't fallen below 2.5% for 27 years.) The tremendous stability in inflation since 1994 has persisted even though the headline (U-3) unemployment rate has varied from 3.8% in 2000 to 10.0% in 2009, casting doubt on the Phillips Curve theory that links inflation to unemployment. A macroeconomist who remembers his microeconomic theory should realize that tight labor markets should cause real (inflation-adjusted) **wages** to accelerate, not prices of goods and services. The stability of inflation also isn't friendly to the monetarist theory of Milton Friedman, who said "inflation is always and everywhere a monetary phenomenon." The historical relationship between inflation and growth in the money supply seems to have broken down.

The Keynesians who still use the Phillips Curve and the Monetarists who think monetary policy alone determines inflation miss several things. Monetarists who believe inflation is caused by too much money chasing too few goods fail to realize that most of the money supply is now used to purchase financial assets, not goods and services. Too much money causes asset bubbles, not conventionally measured inflation. That is partly the result of the increasingly unequal distribution of income, which has boosted the income and wealth of the rich, who invest heavily in financial assets, and reduced the income and wealth of the poor, who spend most of their money on goods and services. The poor can't afford to pay higher prices for necessities. The rich can bid up the prices of financial assets and collectibles. But the most important factor missed by Keynesians and Monetarists is the important role demographics play in determining the rate of inflation. Simply put, young adults are inflationary; older people are not. Inflation surged in the 1970s when baby-boomers reached adulthood, boosting demand for motor vehicles, houses, and home furnishes, while doing little to boost supply until they were older, more experienced, and more productive. Another baby boom is unlikely, and even if one were to occur, it would take two decades to boost the inflation rate.



Given the aging of the U.S. population and its implications for inflation, it is very unlikely that inflation is going to rise significantly above current levels. That's true even with the unemployment rate below the CBO's estimate of the Natural Rate of Unemployment and still falling. It's true even if growth picks up in response to President Trump's proposed tax cuts and infrastructure spending or if those policies significantly increase the federal budget deficit; and it's true regardless of how fast the Fed raises interest rates or shrinks its balance sheet. Although the total PCE price index rose above the Fed's 2% target (for one month) in February, the Fed is likely to have a hard time keeping inflation at 2%. That's not the problem; in fact, I favor a lower inflation target. The problem is that in trying to achieve its 2% inflation target by keeping interest rates low, the Fed risks causing asset bubbles, and asset bubbles ultimately burst, often with disastrous consequences for the economy. That's a far bigger danger than any inflation rate in the 0.9-2.5% range that has prevailed since 1994. A repeat of the last decade's housing bubble is possible. House prices have risen to new record highs and are rising at about a 5.5% annual rate.

For businesses, the downside to continued low inflation is that it means that even if real growth accelerates, nominal growth will remain weak by historical standards, and it is nominal growth that is correlated with growth in corporate profits. Unless companies are in tight markets with high capacity utilization, they should not expect rising prices to significantly boost earnings growth.