IS INFLATION MAKING A COMEBACK?

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In a noticeable turn of events, one of the key talking points for the 2017 investment landscape has been the potential return of inflation. Indeed, only a little more than a year ago, a rather different take on this topic was dominating market discussion: deflation. However, since the results of the U.S. election became known, market participants began to shift their focus to what is being referred to as the "Trump Reflation Trade."

Quite simply, the logic behind this "trade" is that fiscal stimulus will now take the baton from monetary policy and provide a newfound jolt to the economy, spurring potentially higher growth and elevated inflation readings, accordingly. For the most part, the financial markets appeared to buy into this line of reasoning, as the S&P 500 has risen +10% since Election Day while the U.S. Treasury (UST) 10-Year yield has climbed by about 65 basis points (bps) during this same time frame. Interestingly, broader commodity prices, as measured by the Thomson Reuters/CoreCommodity CRB Index, rose in the two-month period following the election to as high as +6.3% but have since reversed course and were basically unchanged as of this writing.

The most widely followed inflation gauge in the U.S. is the Consumer Price Index (CPI). This monthly report is released by the Bureau of Labor Statistics (BLS), with both the overall and core (excluding food and energy) readings receiving the most attention.

The February CPI report revealed that overall inflation rose at a year-over-year rate of +2.7%, the highest in almost five years. This compares to the 2016 low point of +0.8% in July and the outright negative readings less than two years ago. Certainly, the rebound in energy prices from the levels witnessed 12 months ago played a role in this higher-than-expected reading, but perhaps more importantly from the Federal Reserve (Fed) perspective was the core measure, CPI minus food and energy, maintaining its recent upward pattern. Indeed, core CPI rose at an annual rate of +2.2% and has now posted a reading of +2.0% or higher for 16 consecutive months.

Wage trends are another commonly watched inflation indicator, specifically the year-over-year levels for average hourly earnings (AHE). This barometer of wage performance can be found in the BLS's monthly Employment Situation report. In the February release, AHE rose at an annual rate of +2.8%, continuing to reside at levels not seen since 2009.

Even the Fed has put itself squarely into the inflation discussion, as illustrated by its "pushed-up" rate hike at the March FOMC meeting. Certainly, one of the key reasons behind this latest tightening move was the fact that inflation was on the verge of hitting the Fed's threshold of +2%. To provide some perspective, the Fed's preferred measure for inflation is the price index for personal consumption expenditures, which itself has also been on an upward trajectory, and rose to +1.9%. The last time this measure hit the Fed's target was 2012.

Conclusion

Elevated inflation expectations and actual inflation data will be watched more closely by the money and bond markets as we move forward. The turnaround in energy prices from the lows witnessed last year, the recent pullback in the U.S. dollar and less disinflation in key places such as China could all serve to support higher overall readings in the months ahead, while the recent upward trend in wages will also need to be monitored. Against this backdrop, the breakeven inflation rate, or the difference between the yield on a nominal bond (such as the U.S. Treasury 10-Year note) and an inflation-linked or real yield bond with the same maturity (such as the 10-Year U.S. Treasury Inflation-Protected Securities or TIPS), will serve as a useful guide regarding inflation expectations. As of this writing, this rate has widened out to 2.01%, an increase from the 1.20% low reached in February of last year. However, this rate is still close to the 2.07% five-year mean and well below the peak of 2.64% during this time period.

Unless otherwise noted, all data is from Bloomberg as of March 20, 2017.

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DEFINITIONS

Inflation : Characterized by rising price levels.

Deflation : The opposite of inflation, characterized by falling price levels.

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

10-year government bond yield : Yields on the 10 year government debt security.

Basis point : 1/100th of 1 percent.

Thomson Reuters/CoreCommodity CRB Index : Measures the performance of 19 commodities.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.