MARKETWATCH: INFLATION; IT’S NOT ALL IN THE DATA!

Monique Frederick, CFA, FRM, Senior Portfolio Manager, Butterfield

The Cayman Islands Journal, 1 March 2017: Inflation, an ongoing rise in the general level of prices, is a metric of paramount importance in economic policy, and even more crucial in the daily lives of every single household. Who do you know who would be in favour of higher prices for essentials like food, shelter and transportation?

The Federal Reserve, analogous to other central banks, is striving for higher inflation. The medium range target for the US central bank is 2% annual inflation, but “why not aim for zero inflation?” you may wonder.

Apart from a history lesson into the genesis of a 2% inflation target, one reason for an inflation target above zero relates to the flexibility of the central bank to stabilise the economy when needed. A low inflation target, and by extension a low benchmark interest rate, leaves central banks almost helpless in the face of a recession, not leaving much room to decrease interest rates and stimulate the economy. Some may argue this premise has already been disproven as some central banks have been forced to implement negative interest rates and other unconventional policies to stimulate the economy or prevent further economic weakness.

Up to December 2016, previous data indicated a lack of inflation as measured by CPI (Consumer Price Index) figures. Some economists have rightly argued, however, that inflation has been building for a while but has not been evident in the data. The decline in oil prices for example has contributed to a low CPI number, masking the gradual rise in inflation. A more subtle form of inflation has crept into markets during the past few years, appropriate dubbed “shrinkflation”. It is a term associated with food items shrinking in size or quality while maintaining the same retail price. Chocolate treats are the most visible example of this phenomenon, with companies like Mondelez reducing the weight of its Toblerone chocolate bars in the UK as a cost saving measure to combat a rise in input costs. We have witnessed the same development with cereal and chips over the years as the weight of each box or bag has diminished. Although the price of a box of cereal has not increased, the average price per cereal puff or corn flake has undeniably risen.

To make matters worse, wage reflation has been absent from the economy. Consumers are not earning more, yet they are finding it more difficult to make ends meet. Juxtaposing rising inflation with the absence of wage growth will result in negative real earnings. It’s at this juncture where the data (the Consumer Price Index & the Personal Consumption Expenditure) and reality part ways. With central banks proclaiming a lack of inflation and seemingly more concerned about deflation, widespread criticism of the Fed’s strategy and its economic models is growing.

With the release of January’s data, the CPI is finally at a level that should give the Fed the impetus it has been waiting for. According to the report, headline inflation reached a five year high of 2.5%, buoyed by a surge in energy prices. This higher level, however, was not limited to energy prices as housing, rent and medical care costs have intensified in several locations. Despite these numbers, the Fed may allow inflation to run higher a bit longer. While Janet Yellen is seeking to stoke inflation from its current low levels, she is also of the view that the inflation target is an average number, suggesting that a period of inflation beyond 2% may be warranted.

There is still yet another factor to take into consideration: the Fed’s balance sheet has ballooned to well over four trillion and continues to expand every month. A common way of servicing this debt is to inflate your way out of it. In this case, inflation is effectively seen as a haircut on the repayment
on the debt. For that reason, coupled with Trump’s inflationary fiscal plans, higher US inflation should be expected.

Consequently, it’s highly conceivable that the Fed will not only wait a bit longer before raising rates, but will do so at a snail’s pace. Navigating this upward trajectory slowly and in small increments, could allow inflation to rise above the target, whilst sending a hawkish tone to markets. Admittedly, such rate hikes could be considered meaningless in the grand scheme of things and seen as just a path to normalisation vis-a-vis monetary tightening.

Source: Bloomberg LP

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