THOUGHT ON THE MARKET

SHOULD WE WORRY ABOUT INFLATION?

Global Financial Private Capital

SUMMARY

- The markets sold off in February on concerns that the strong economy may overheat, inflation may spike, and the Federal Reserve (Fed) may then raise interest rates more aggressively to try to combat higher inflation.
- Inflation has been below the Fed's target of 2% for years, and the Fed gave little hint in its latest report to Congress that it is prepared to raise U.S. interest rates more aggressively in 2018.
- Investors should focus on indicators such as consumer spending, economic growth as measured by Gross Domestic Product (GDP), corporate earnings results, and the Fed's monetary policy – all of which currently point to the economy's ability to digest price increases. Inflation and resulting price increases need not be significant concerns if we have a healthy and growing economy.

The markets sold off in February on concerns of runaway inflation. The fear now is that inflation will start to rise more quickly, potentially dampening growth or driving borrowing costs higher. That prospect panicked the markets in February, briefly sending stocks down more than 10% before investors recovered their nerve. The indicator that made the market react this way was the average hourly earnings for American workers, which rose 2.9% over the 12 months ending in January, the biggest increase since the economic expansion began nine years ago. This data point certainly warrants attention, but does it paint the full picture? What does it all mean and how real is the risk of runaway inflation? To answer this, we need to start with some of the basics:

What is inflation?

Inflation is a broad measure of the overall increase in the cost of living in a country. In other words, as inflation rises, each dollar buys a smaller percentage of a good or service. If the inflation rate is 2%, a basket of products that costs $100 today would cost $102 a year from now.

How do you measure inflation?

To measure the cost of living, government agencies conduct household surveys to identify a basket of commonly purchased items over time and then track the cost of purchasing this basket over time. The Fed focuses on the Personal Consumption Expenditures (PCE) inflation index in its quarterly economic projections and states its longer-run inflation goal in terms of headline PCE. The advantage of the broad index is that it approximates – even if it is imperfect – how much prices are changing for the range of items an average consumer buys.

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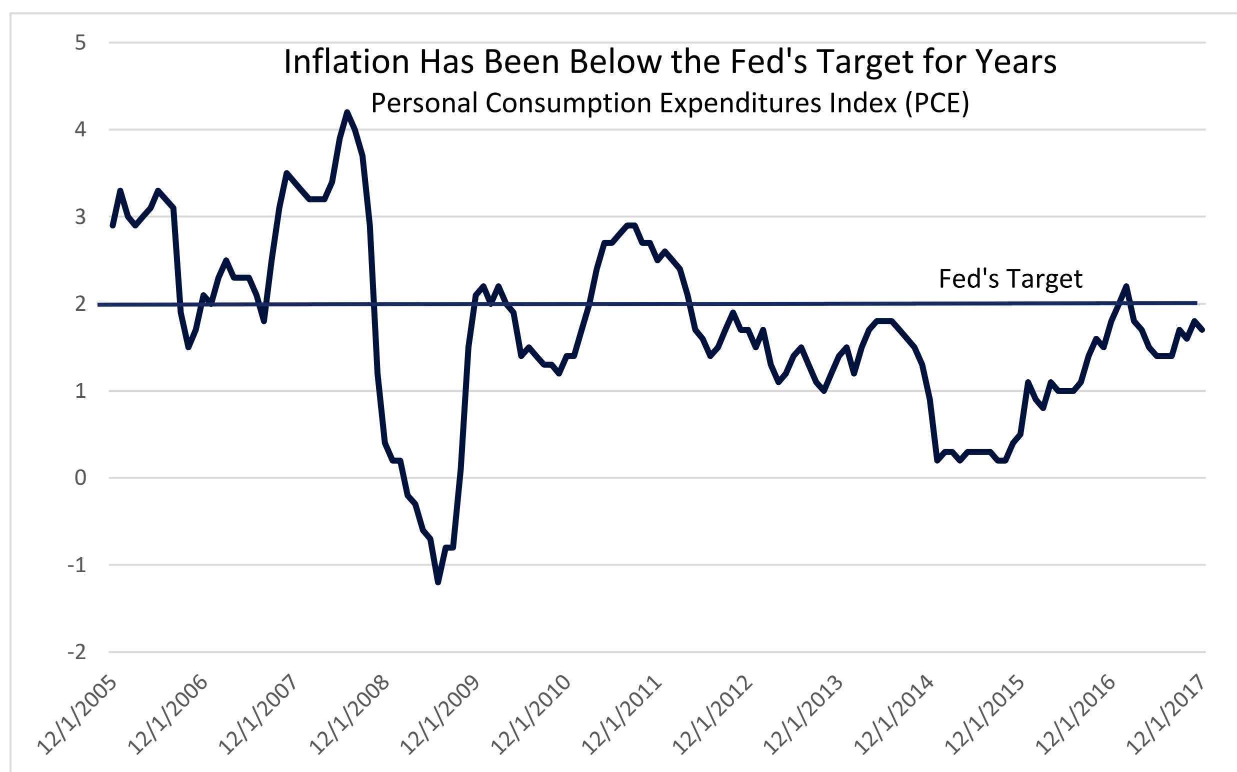
Is inflation good or bad for economic growth?

The answer is both. Let's look at how inflation impacts economic growth. The intuition goes like this: when the unemployment rate is high, there are lots of workers available for any employer that wants to hire them. As a result, employers don't need to compete for workers by paying higher wages. But, if the unemployment rate is low, companies must pay more to attract employees, driving up wages. Higher wages in turn means more money coursing through the economy, chasing finite goods and services, which creates inflation. This certainly is a simplified way at looking at inflation, and there are a lot of factors that affect inflation that are unrelated to the domestic job market. Regardless, high inflation can be dangerous. Many countries have struggled with high inflation – and in some cases hyperinflation, which is defined as 1,000% or higher inflation a year. In 2008, Zimbabwe experienced one of the worst cases of hyperinflation ever, which led to the country giving up its national currency. Venezuela is a current example of a country experiencing high inflation. However, if rising prices can have negative consequences, falling prices can as well. Negative inflation – or deflation – means the purchasing power of a currency rises over time. When prices are falling, consumers delay making purchases if they can, anticipating lower prices in the future. This means less economic activity, less income generated and lower economic growth. Japan is one country with a long period of little to no economic growth, largely because of deflation.

How much inflation do we have today?

The Fed has been targeting 2% inflation, which is low enough that the purchasing power of currencies is stable so people don't have to worry about inflation, but high enough to keep deflation at bay. Most economists now believe that low, stable and – most importantly – *predictable* inflation is good for an economy.



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In its semi-annual monetary policy report, the Fed saw broad improvement in the U.S. economy and pointed to a pickup in inflation toward the end of last year. Yet, it also stuck to its prior view that inflation is likely to hover at or below its 2% target in 2018. The 12-month rate of inflation, based on the Fed's preferred PCE index, stood at 1.7% in December. The Fed gave little hint in its latest report to Congress that it is prepared to raise U.S. interest rates more aggressively in 2018. The new Fed chairman, Jerome Powell, will expand on the bank's view when he testifies before Congress next week.

THE BOTTOM LINE

Going forward, markets will likely worry every time an inflationary data point is published, and we can expect volatility to be significantly higher in the months ahead. However, one month's wage number is hardly a definitive sign that the economy is overheating, and the fact remains that inflation is still within the Fed's target range. Moreover, investors should focus on indicators such as consumer spending, economic growth as measured by GDP, corporate earnings results, and the Federal Reserve's monetary policy – all of which currently point to the economy's ability to digest price increases. The American economy grew at a better-than-expected pace of 2.3% in 2017, an increase from 1.5% growth in 2016, driven by positive contributions from consumer spending, investment and exports. Corporate earnings remain strong, driven by tax reform. The Fed gave little hint in its latest report to Congress that it is prepared to raise interest rates more aggressively in 2018. Today, we continue to see signs of continued growth in the economy that should support some inflation and rising prices. In addition, when consumer prices rise, it also signifies greater pricing power for American businesses, helping drive higher revenue and increased sales. Inflation and its resulting price increases are not a major cause for concern if we have a healthy and growing economy. Therefore, some level of inflation is healthy and good.

Index Definitions

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses. Past performance is no indication of future performance. The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

Personal Consumption Expenditures Index: Personal consumption expenditures (PCE) is the primary measure of consumer spending on goods and services in the U.S. economy. It accounts for about two-thirds of domestic final spending, and thus it is the primary engine that drives future economic growth.

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.

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