First Trust
Monday Morning OUTLOOK

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Inflation Ready to Rise

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One of the key excuses for the Federal Reserve to hold off raising rates again and again, and to raise them very slowly, is that inflation remains extremely low.

The consumer price index is up only 1.1% in the past year. The Fed's preferred measure of inflation – for personal consumption expenditures, or PCE – is up 1.0%. The US doesn't face deflation, but the overall inflation statistics are, and have remained, low.

But the money supply is accelerating, the jobs market looks very tight, and underneath the calm exterior, there are some green shoots of inflationary pressure.

The "core" measures of inflation, which exclude volatile food and energy prices, are not nearly as contained as overall measures. And before you say everyone has to eat and drive, realize that both food an energy prices are volatile and global in nature. They don't always reveal true underlying price pressures.

The 'core" CPI is up 2.3% in the past year, while the "core" PCE index is up 1.7%. In other words, a drop in food and energy prices has been masking underlying inflation that is already at or near the Fed's 2% target. Energy prices have stabilized and food prices will rise again. As a result, soon, overall inflation measures are going to be running higher than the Fed's target.

Just look at housing costs – a non-traded good – which makes up one-third of the CPI. Government statisticians measure this as "Rent of Shelter," which includes normal rents, hotel costs, and owners' equivalent rent (the rental value of owner-occupied homes). It's up a whopping 3.4% in the past year and has accelerated in each of the past six years.

Housing makes up a smaller share of the PCE price index, but medical care costs make up a larger share of that index. Government data show medical care costs up 4.9% in the past year, the fastest increase since 2007.

Although some (usually Keynesian) analysts are waiting for much higher growth in wages before they fear rising inflation, the fact is that wage growth is already accelerating. Average hourly earnings are up 2.6% in the past year versus a 2.0% gain only two years ago. Moreover, as a paper earlier this year from the San Francisco Fed pointed out, this acceleration is happening in spite of the retirement of relatively high-wage Baby Boomers and the re-entry into the labor force of workers with below-average skills.

But we don't think wages cause inflation – money does. Inflation is too much money chasing too few goods. The Fed has held short-term interest rates at artificially low levels for the past several years while it's expanded its balance sheet to unprecedented levels. Monetary policy has been loose.

But banks have held most of the Fed's Quantitative Easing (QE) as excess reserves. Banks have record loans on their books, but they also hold $2.2 trillion in excess reserves. Most people believe QE was, and is, temporary. So banks have been reluctant to lend it out. After all the Fed could withdraw the reserves, unwind QE, and banks would be forced to "call" their loans.

But as the Fed has postponed the process of reducing its balance sheet, banks have started to expand the M2 money supply. M2 grew roughly 6% annualized between January 2009 and December 2015. But, so far this year, from January to September, M2 has expanded at an 8.6% annualized rate. More money brings more inflation.

None of this means hyperinflation is finally on its way. In the past, inflation has taken time to build, leaving room for the Fed to respond by shrinking its balance sheet and getting back to a more normal monetary policy.

In the meantime, this will be the last year in a long while, where we see inflation below the Fed's 2% target. Look for both higher inflation and interest rates in the years ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-13 / 7:30 am	Initial Claims – Oct 8	253K	**254K**		249K
7:30 am	Import Prices – Sep	+0.1%	**+0.4%**		-0.2%
7:30 am	Export Prices – Sep	-0.1%	**0.0%**		-0.8%
10-14 / 7:30 am	Retail Sales – Sep	+0.6%	**+0.6%**		-0.3%
7:30 am	Retail Sales Ex-Auto – Sep	+0.5%	**+0.5%**		-0.1%
7:30 am	PPI – Sep	+0.2%	**+0.1%**		0.0%
7:30 am	"Core" PPI – Sep	+0.1%	**+0.1%**		+0.1%
9:00 am	Business Inventories – Aug	+0.1%	**+0.1%**		0.0%
9:00 am	U. Mich Consumer Sentiment- Oct	92.0	**91.7**		91.2