US Inflation Outlook: The Rising Tide

FOR PROFESSIONAL INVESTORS - 28 February 2018

- US inflation and growth has brightened considerably since the start of 2018.
- Targets have lifted for both US Treasury yields and TIPS-based breakeven inflation rates.
- What are the contributing factors to the rise in US inflation and potential monetary policy response from the Federal Reserve (Fed)?

Cedric Scholtes
Co-Head of Inflation Team and Chair of the Rates Committee
cedric.scholtes@bnpparibas.com

Since January, our outlook on US growth and inflation prospects has become more constructive. We have lifted our targets for both US Treasury yields and TIPS-based breakeven inflation rates (BEI).

Looking first at growth, the additional budget measures signed in February are set to add an additional $300 billion of deficit-funded spending to the economy over the next two years, on top of the $1.5 trillion of deficits that will be created over the next decade as a result of December's 'Tax Cut and Jobs Act'. Although a portion of the budget measures represent funding for assistance to regions that were devastated by last fall's hurricanes, a significant portion of this spending package is essentially discretionary. To our mind, engaging in such fiscal largesse at a point in the economic cycle when authorities ought to be reducing rather than adding to the national debt is, frankly, irresponsible. Regardless, most analysts anticipate that these spending measures will contribute 0.5 percentage points to gross domestic product (GDP) growth in both 2018 and 2019.

In addition, growth is likely to be supported by ongoing robust business investment. Certainly, the recent corporate tax cuts, and changes to tax-expensing of capital investment have boosted firms' investment plans. Additionally, whereas much of the contribution of business investment to GDP in 2017 was concentrated in the resources and mining sectors (in response to rising commodities prices), in 2018 we expect to see increasing breadth in the distribution of investment across sectors.

Correspondingly we have raised our GDP growth forecasts for 2018 and 2019 to 2.9% and 2.5%, respectively. With trend GDP growth probably still languishing in the 1.5% to 2.0% range, this implies that we will see further compression in spare capacity in goods and labor markets. Indeed, we expect non-farm payrolls to continue growing at a pace exceeding the replacement rate, helping to drive the unemployment rate towards 3.5%. Our view is that spare capacity in the labor market will soon be exhausted, notwithstanding the failure of prime-age male participation to fully recover. As such, wages seem set to continue rising, even if we do not forecast a rapid acceleration.

With labor compensation data likely to show improvement in coming months, we expect the Federal Reserve (Fed) will grow increasingly confident in its assessment that underlying inflation is returning to target, and that the softness exhibited in core consumer price index (CPI) and personal consumption expenditures (PCE) data in 2017 reflected a mix of transitory factors (notably declines in cell-phone plan prices) and 'acyclical' factors (compression of medical care prices as a result of the Affordable Care Act).

Since January, we have received two more CPI prints (for December and January). Both data releases have revealed a gentle firming of core inflation, with strength in shelter costs (via rents and owner's equivalent rent), vehicle prices and medical care. In January, CPI was also supported by a bounce in apparel prices after several months of decline.

Consumer Price Index (month-over-month change)

Description	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18
All Items	0.12	-0.29	0.17	-0.13	-0.02	0.11	0.40	0.55	0.11	0.39	0.15	0.54
All Items Less Food and Energy	0.21	-0.12	0.07	0.06	0.12	0.11	0.25	0.13	0.22	0.12	0.28	0.35
Food and Beverages	0.22	0.33	0.21	0.13	-0.03	0.16	0.05	0.12	0.05	0.03	0.15	0.18
Food	0.24	0.34	0.20	0.16	-0.05	0.17	0.05	0.10	0.04	0.02	0.16	0.20
Housing	0.29	0.06	0.33	0.22	0.12	0.07	0.38	0.20	0.32	0.24	0.32	0.21
Shelter	0.27	0.12	0.30	0.23	0.24	0.14	0.46	0.26	0.34	0.22	0.35	0.25
Fuels and utilities	0.74	-0.33	0.90	0.47	-0.34	-0.17	0.09	0.15	0.41	0.70	0.31	-0.22
Apparel	0.63	-0.70	-0.32	-0.82	-0.11	0.27	0.06	-0.12	-0.11	-1.28	-0.49	1.67
Transportation	-0.54	-1.44	0.10	-1.39	-0.66	-0.08	1.41	2.80	-0.48	1.89	-0.19	1.81
Private transportation	-0.69	-1.57	0.14	-1.36	-0.60	-0.11	1.54	2.98	-0.55	2.16	-0.20	1.95
New and used motor vehicles	-0.13	-0.58	-0.20	-0.06	-0.25	-0.45	-0.12	-0.36	0.06	0.61	0.85	0.25
Motor fuel	-2.89	-6.11	1.20	-6.42	-2.81	0.03	6.25	13.04	-2.48	7.23	-2.65	5.64
Motor vehicle parts and equipment	0.18	0.38	0.08	-0.43	0.09	0.11	-0.16	-0.14	-0.66	-0.52	0.36	0.41
Motor vehicle maintenance and repair	0.09	-0.07	0.20	0.08	-0.39	0.11	0.32	0.61	0.37	-0.27	0.21	0.07
Medical Care	0.10	0.14	-0.16	-0.01	0.37	0.42	0.13	-0.07	0.25	0.05	0.34	0.41
Recreation	0.60	0.02	-0.13	0.04	-0.07	0.34	0.25	0.17	-0.11	-0.05	0.07	-0.02
Education and Communication	-0.20	-1.85	-0.29	-0.03	0.01	-0.05	-0.07	0.11	0.22	0.29	0.11	0.06
Education	0.30	0.05	0.10	0.10	0.35	0.10	-0.09	0.25	0.29	0.36	0.12	0.11
Communication	-0.63	-3.47	-0.63	-0.15	-0.29	-0.20	-0.06	-0.01	0.15	0.22	0.11	-0.01
Other Goods and Services	0.12	0.02	0.99	-0.01	0.17	0.13	-0.13	0.20	0.47	0.06	-0.11	0.42

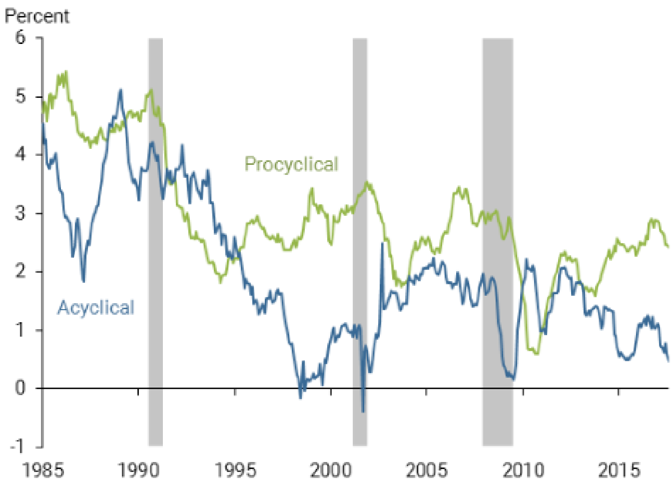
Source: Bureau of Labor Statistics, through January 2018

To a degree, the firming in shelter and vehicle categories reflects the influence of last fall's hurricanes, which damaged large numbers of residential units and cars, particularly around Houston and Florida. The evidence from prior hurricanes is that the impact on rents can be persistent.

So is the improvement in core simply due to hurricane effects? Encouragingly, it appears the answer is no. First, rents are also supported by the strength of the labor market and demographics, and the rate of household formation has in recent months appeared to have risen again.

Second, a recent paper by the San Francisco Fed confirms that when one disaggregates CPI and PCE into 'cyclical' and 'acyclical' components, one can observe that cyclical CPI components have been behaving as one would have expected – in other words, cyclical components of CPI have been rising in response to tightening market conditions.

Procyclical and acyclical core PCE inflation



Source:Federal Reserve Bank of San Francisco, "What's Down with Inflation?"; November 27, 2017

Contribution of health-care services inflation to core PCE

Source:Federal Reserve Bank of San Francisco, "What's Down with Inflation?"; November 27, 2017

Third, there is some reason to believe that medical care prices may be on the cusp of turning higher. An analysis by the San Francisco Fed indicates that softening medical care inflation resulting from the Affordable Care Act has been responsible for detracting 0.3% p.a. from PCE inflation over the last 5 years, versus the prior trend, mostly via the hospital care category. While CPI only considers out of pocket costs, rather than fees paid by MediCare and MedicAid programs, government administered pricing schedules still have an influence on medical costs captured by CPI. Looking ahead, although rising healthcare costs remain a key concern for the public purse, there is evidence that the federal government has relaxed constraints on reimbursement rates, and that medical care inflation may at least partially recover in 2018.

There are, in addition, some transitory factors that will also be supportive for year-over-year CPI over the next few months. The collapse in cell-phone plan prices that occurred in March 2017 as providers switched to infinite data plans will fall out of the 12-month window in April, driving year-over-year core and headline inflation back up. In addition, the dollar's recent depreciation, and the strength of commodity and energy prices are likely to have some pass-through effects. Indeed, our forecasts indicate that base effects may drive headline year-over-year CPI inflation to 2.8% by July.

More recently, we have also begun, once again, to contemplate the inflationary impact of protectionist measures by the Trump administration – a theme that had faded last summer when the administration's attention was focused on repealing the Affordable Care Act and passing tax reforms. The recent announcement of tariffs on steel and aluminum imports, alongside efforts to renegotiate NAFTA, raise the specter of retaliation, which could drive up CPI via import prices. In addition, President Trump has also raised the possibility of raising the gasoline tax as a means of funding an ambitious infrastructure project. Any of these provide the prospect of a one-off increase in CPI.

Monetary Policy Developments

More recently, we have also begun, once again, to contemplate the inflationary impact of protectionist measures by the Trump administration – a theme that had faded last summer when the administration's attention was focused on repealing the Affordable Care Act and passing tax reforms. The recent announcement of tariffs on steel and aluminum imports, alongside efforts to renegotiate NAFTA, raise the specter of retaliation, which could drive up CPI via import prices. In addition, President Trump has also raised the possibility of raising the gasoline tax as a means of funding an ambitious infrastructure project. Any of these provide the prospect of a one-off increase in CPI.

- Mr. Powell made it clear that data has improved since the December forecasts. He also confirmed that additional fiscal stimulus would need to be factored into the March forecasts. Indeed, in reference to fiscal stimulus and the depreciation in the dollar, he noted that some "headwinds had turned into tailwinds."

- In line with the January FOMC minutes, he concluded that the FOMC's confidence in the inflation outlook had improved, warranting the addition of the word 'further' to the FOMC's guidance that 'gradual increases in the policy rate' are forthcoming.

- Mr. Powell stressed the need to "strike a balance between moderating an overheating economy and returning PCE inflation to target". What is interesting is that there was no mention of spare capacity in the labor market. In other words, the US economy is now judged to be well through the non-accelerating inflation rate of unemployment (NAIRU).

- He also indicated that despite February's volatility episode, financial conditions remain accommodative.

- Our conclusion is that Mr. Powell looks set to lead the committee towards additional rate hikes, with some of these hikes now required to at least partially offset the federal government's fiscal stimulus. In the author's opinion, the FOMC will raise rates by 100 bps in 2018 and 75 to 100 bps in 2019. The terminal Fed funds rate is likely to reach 3.50%, above the so-called neutral' rate, as the central bank seeks to cool an overheating economy.

Biography

Cedric Scholtes is Co-Head of the Inflation Team and Chair of the Rates Committee. He is responsible for the growth and development of Inflation Strategies, and is the lead portfolio manager for US Inflation-Linked Bond portfolios, as well as US Treasury portfolios. Cedric chairs the Rates Committee, which is composed of specialists from different fixed income product groups, who are charged with generating alpha in sovereign, derivative and inflation markets for implementation across applicable portfolios. Cedric joined FFTW, a predecessor of BNP Paribas Asset Management, in 2006 as a portfolio manager and is based in New York. Prior to joining us, Cedric worked at Goldman Sachs, the Federal Reserve Bank of New York, the Bank of England and the UK Government Economic Service. Cedric has 18 years of experience in financial markets.

More of our thoughts on the market

Listen to our webcast - US Inflation – Here to Stay or Gone Tomorrow?

The prospects for higher inflation are stronger now than at any other point in the post-crisis period. What are the sources of price pressures, how long might they persist, and how can investors prepare?

Listen to this live webcast where our speakers will cover:

- Contributors to rising inflation
- Our base case for US inflation in 2018/2019
- Risks to the upside and downside
- Implications for the US inflation-linked bond market

Listen Now

US inflation: here to stay or gone tomorrow?

Steven Friedman, Senior Economist
Cedric Scholtes, Head of US Inflation-Linked Bond Portfolios
Katie Herr, Investment Specialist
15 March 2018

Disclaimer