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Focal Point

What's next for US inflation?

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- Global growth concerns and low oil prices have been depressing inflation expectations in advanced economies. In the US, according to the Fed's own projections, core PCE inflation is likely to remain below 2% until 2018.
- However, recent data may indicate a turning point. Core inflation is increasing and the stabilization of oil prices will automatically lead to a pick-up in the energy component.
- If a rebound in expectations enters the firms' pricing decisions and workers' wage demand, this may speed up actual inflation.
- We expect CPI inflation to average 1.3% this year, with some upside risk.
- The Fed may still tolerate some temporary overshooting in inflation and stick to its cautious stance, given its stronger concern about growth as well as global economic and financial conditions.

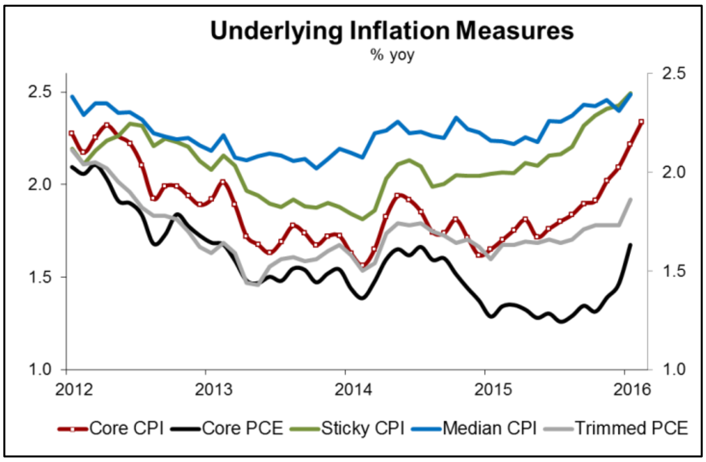
During the recent months, the evolution of US inflation has drawn a lot of attention among investors. For most of 2015, sluggish price dynamics have been quoted as one of the main factors behind the Fed's delayed increase in policy rates. Moreover, falling inflation expectations amid lower oil prices have been seen as one of the key drivers of the recent market turmoil.

Survey-based measures of inflation and projections by professional forecasters have been trending down in recent months. Moreover, in the projections published after the March FOMC meeting, the Fed reaffirmed that it expects headline inflation to average below 2% in 2016 and 2017. This was one of the key reasons for maintaining its cautious monetary policy stance.

A turning point in low inflation?

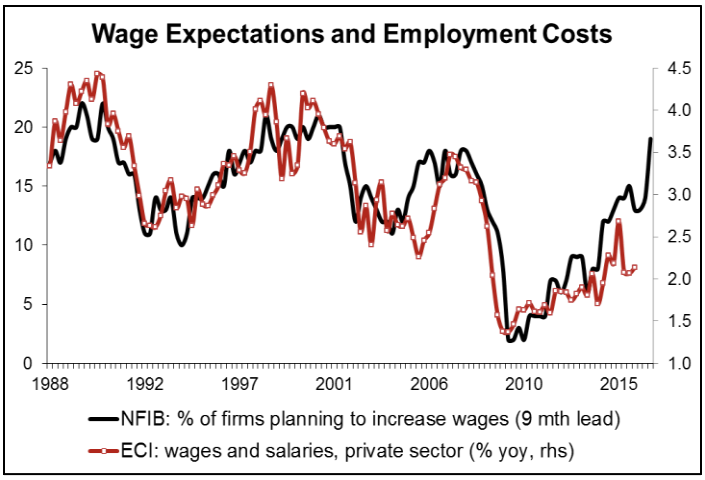
However, between the end of last year and the first months of 2016, there have been increasingly strong signs of a turnaround. After several months of relatively weak readings, all the available measures of underlying inflation have started edging up: the non-food, non-energy component of the PCE price index (the measure targeted by the Fed) has reached +1.7% yoy in February, while almost all the other measures are at or above 2%.

First of all, the strong downward pressure coming from the past currency appreciation is gradually fading. If, as expected, the dollar levels off and the economic outlook for emerging markets improves, import prices should first stabilize before starting to increase again.



On the domestic front, the turnaround in core inflation has been driven by several factors, some of which may prove quite long-lived. Following the recovery in home prices, shelter costs (which include rents and other housing costs and account for 41% of core CPI) have grown at over 3.0% yoy since the summer of 2015, reaching 3.3% in February. The overall demand for housing is expected to remain strong in the medium term, supporting prices and rents. Health care prices (which correspond to another 10% of core CPI) have increased by 3.5% yoy in February, after posting a 3% rise in January. Providers start to prop up prices again after the squeeze due to the coming into force of the Affordable Care act. While part of this increase could be temporary, some upward pressure would remain in place due to expected higher costs.

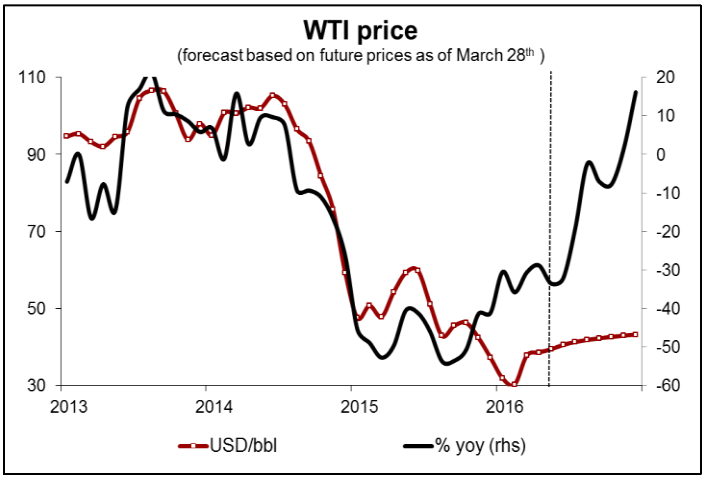
Despite the steady tightening in labor market conditions, the increase in wages and its pass-through into consumer prices has so far surprised on the downside. That said, the relatively subdued wage dynamics observed to date can largely be explained by the changing composition of the workforce; a large share of relatively high-paid workers is retiring, replaced by lower paid young workers. Yet, the participation rate remains low and the share of involuntary part time labor is still above the pre-crisis average, pointing to some slack still existing in the labor market. With the unemployment rate expected to fall from the current 4.9% to 4.6% by the end of the year, some further pressure on labor costs is likely. Indeed, surveys show that most firms expect to have to raise wages in the medium term.



Wage increases have so far mostly affected profits as firms appear unable to transfer a significan share of their higher costs onto consumers. However, the strength of domestic demand should enable them to restore margins, contributing to the increase in core inflation.

The downward push from oil prices may fade quicker than expected

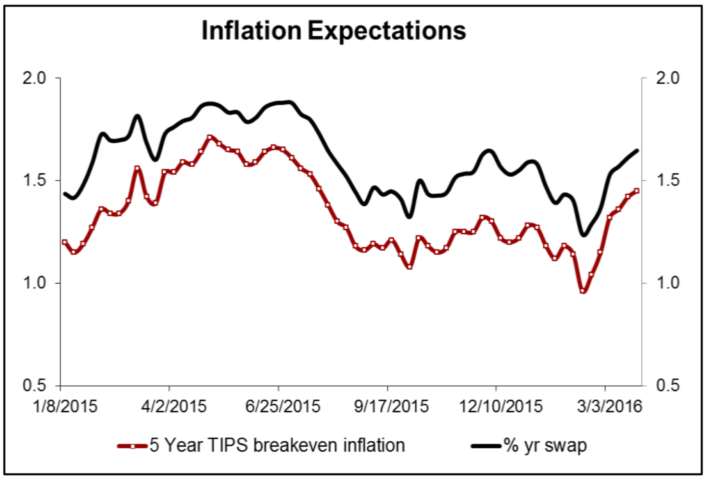
In the short-term, however, inflation dynamics will remain driven by the trend in the oil price. After the nearly 70% fall seen since the summer of 2014, prices have stabilized. This will gradually remove the strong negative contribution of the energy component to headline inflation.



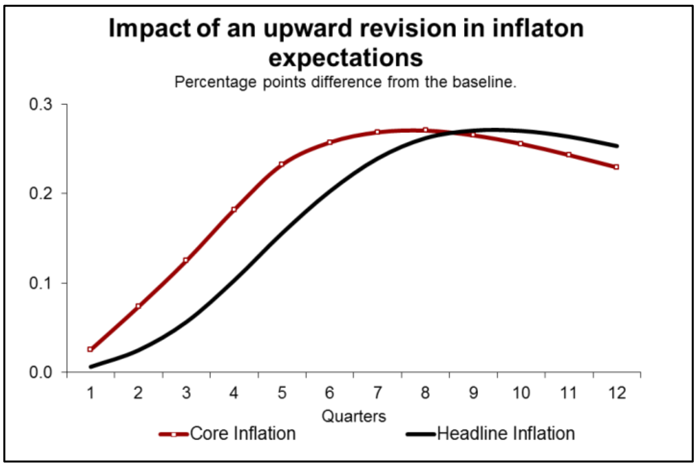
According to futures, oil prices are expected to stage a relatively mild increase, with the WTI ending the year at around 43 USD per barrel. However, in our view there is a fair chance of a steeper increase in the following months. We estimate that nearly 60% of the price fall since 2014 is due to oversupply. Therefore, any successful attempt to curb production may have a strong upward impact on prices. OPEC countries have intensified talks of a freeze in extraction and the non-official meeting scheduled for next month could deliver some concrete measures. At the same time, Iran is struggling to meet the production targets announced after the end of the international sanctions.

The consequences of a revision in expectations

Fuel prices had a prominent role in driving down expectations. The new outlook for the oil market is therefore at least partially behind the recovery in the TIPS breakeven inflation and the 5-year inflation swap rate seen since mid-February. A quicker than expected rebound, following a strong upward revision of energy prices, cannot be ruled out. This may lead to increased volatility in bond prices.



A more durable impact on actual inflation would come from higher workers' and firms' expectations, if they affect wage bargaining and pricing. February data on consumer surveys show a tentative increase. We quantify the impact of an upward revision in expectations running a simulation of the Federal Reserve FRB/US model. We assumed that within four quarters, the one-year expected inflation measured by University of Michigan survey goes back from the current 2.5% to the 3% average, seen just before the plunge in oil prices and then stabilizes.



The effect on actual inflation would be non-negligible, as both the core and headline rates would end up nearly 30 basis points higher than the baseline.

In our forecast we see CPI inflation averaging 1.3% in 2016, and reaching 2% in 2017. However, on the basis of the discussion above we see risks tilted to the upside.

The pick-up in inflation would compress real income in the short-term, reversing part of the large gain from falling oil prices seen throughout 2015. This may put a lid to the on-going increase in consumption, potentially slowing down growth.

The Fed is more concerned with growth and financial stability

Several FOMC members have recently stressed the risk of higher inflation and shown a more hawkish attitude as far as the next rate hike is concerned.

However, we think that in the end the Fed would tolerate consumer prices increasing at a slightly faster pace than expected and possibly a temporary overshooting of the 2% inflation target. As emphasized by Governor Yellen in her March 29th speech, the global economic and financial out-look remains higly volatile and prone to a growth slow-down. This constitutes a large downside risk for the US economy, as suggested by the recent signs of weakening shown by business surveys and hard data on capital spending. All these remain by far the overarching concerns for the Fed, thereby justifying the continuation of its cau-tious policy stance.

Imprint

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