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MACROCOSM

Inflation Fears are Over-Inflated

Thursday, February 15, 2018

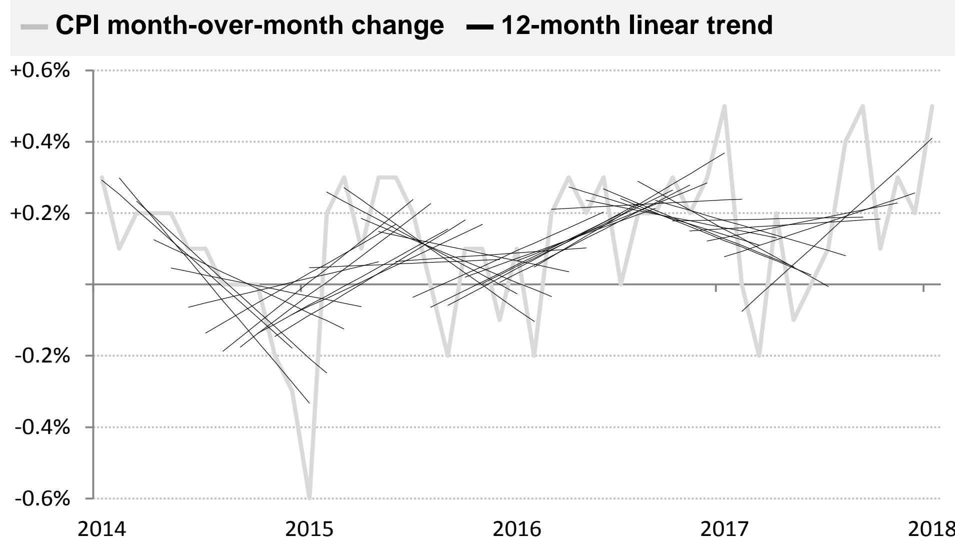
Donald Luskin

Here's the factual headline you didn't see yesterday: "CPI Falls Second Month In A Row!"

The stock market's reaction to yesterday's upside surprise in January CPI – a plunge on the news, then an even bigger recovery – should give credence to our view all along that risk of inflation hasn't been the driver in February's high-volatility correction (see, among others, "It's Just the Reflation Trade, People!" February 5, 2018 and "Inside the VIX Engine of Destruction" February 8, 2018). It's been years since we've been particularly scared about it one way or the other, arguing that all the old hand-wringing about deflation risk was overdone (see "The Deflation Hoax" January 8, 2015), and then forecasting that after Brexit and the US presidential election, slightly-too-low inflation and inflation expectations would pick up (see "2017: It's Bigger than The Donald" December 30, 2016). *So as far as we're concerned, this is all according to plan, and it's all to the good.*

- *In yesterday's CPI release, January 2018 is, at least so far, an outlier month for inflation.* It creates the impression of a strong upward change in trend (see the chart below), but so far that is contingent on this single most recent datapoint.
- On a year-over-year basis, CPI actually *fell* from its December level, as indeed it fell in December from its November level. *So this is the second month in a row that year-over-year CPI has declined.*

CPI month-over-month change — 12-month linear trend



Source: Bureau of Labor Statistics, TrendMacro calculations

Update to strategic view

US MACRO, US FED, US STOCKS, US BONDS: The stock market's quick recovery after yesterday's upside CPI surprise shows that the consensus fear of resurgent inflation hasn't been the driver of the February correction. January's CPI pop was driven mostly by energy and energy-related sectors; previously strong OER decelerated. Market-implied inflation expectations rose, but their trend remains sluggish. The forward funds rate rose, too, but we think as much in response to recovering stock markets than inflation. Powell signaled continuity of policy gradualism, but the "dot plot" could move up a bit in March, reflecting improved growth prospects. The back-up in the 10-year yield mostly reflects growth expectations embedded in the term premium, and only minimally rising inflation expectations. Fears of inflation "with a vengeance" are very much overblown.

[Strategy dashboard]

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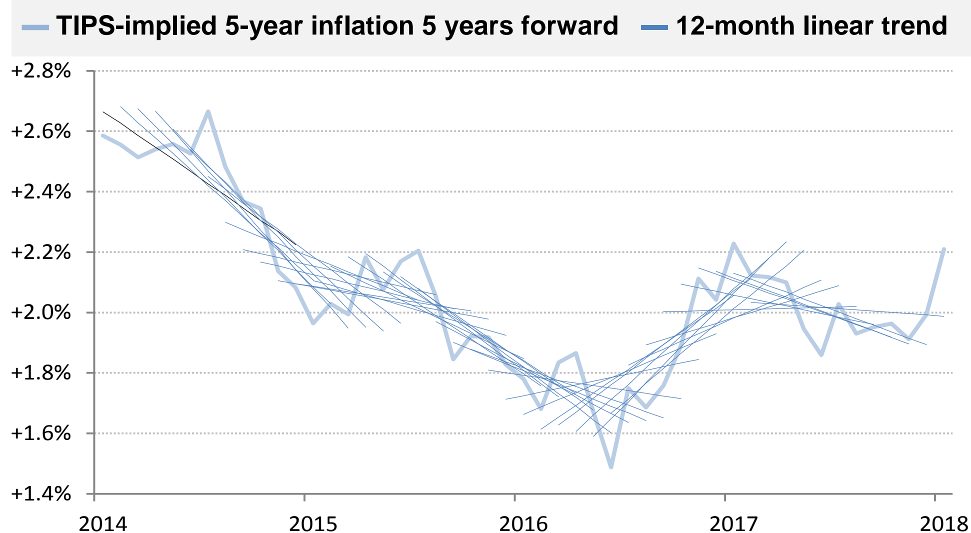
- *The higher inflation in January came across a broad front, but it was led by energy*, commodities and the energy-sensitive transportation sector (see "Data Insights: CPI/PPI" February 14, 2018). This should be no surprise, considering that oil was about the best performing asset in January – quite a victory, considering how well assets in general performed that month. But so far in February, oil has been among the weakest. *And "owner's equivalent rent" – the largest single component in CPI, and the one that has been most consistently strong over the last five years, slightly decelerated in January.*
- Other evidence of the flimsiness of this seeming steepening of the inflationary trend comes from examining changes in market-implied inflation expectations. *Today TIPS-implied 5-year inflation 5 years forward is lower than it was a year ago January, and the 12-month trend is downward-sloping* (please see the chart below).



Source: Bloomberg, TrendMacro calculations

- *Markets aren't telling us that the Fed is going to get dangerously more aggressive, either. Jerome Powell confirmed as much Tuesday in his first remarks as chair, carrying forward Janet Yellen's framework that we are not in a tightening regime, but only a normalization:* "…the Fed's approach will remain the same. …We are in the process of gradually normalizing both interest rate policy and our balance sheet with a view to extending the recovery…"
- The 1-year forward funds rate has made a new high, barely, but implies only three hikes in 2018. At 2.13%, it's less than half-a-hike above the 2.02% average "dot plot" for the funds rate in the December FOMC's Summary of Economic Projections.
- That builds in plenty of margin for the dots to move up a bit at the March FOMC. We have said that they *would* (see "On the January FOMC" January 31, 2018) – and we believe that they *should*. *A slightly higher policy rate is entirely appropriate as the economy accelerates and inflation recovers a bit – it would represent the Fed indexing the funds rate to the improving economy, not tightening. So it's easy for us to see yesterday's move higher in the forward*

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Recommended Reading

Brokers and Order Flow Leakage: Evidence from Fire Sales
Andrea Barbon, Marco Di Maggio, Francesco A. Franzoni and Augustin Landier
Swiss Finance Institute Research Paper No. 17-61
January 9, 2018

Political Connections and the Informativeness of Insider Trades
Alan D. Jagolinzer, David F. Larcker, Gaizka Ormazabal and Daniel J. Taylor
Rock Center for Corporate Governance at Stanford University Working Paper No. 222
January 17, 2018

The United States' Corporate Income Tax Rate is Now More in Line with Those Levied by Other Major Nations
Kyle Pomerleau
Tax Foundation
February 12, 2018

[Reading home]

funds rate as more reacting to the vigorous recovery in equity prices, and less the CPI data.

- The 2018 dots could move up *a lot*, and still be below 2.32%, where they were at the March FOMC *last* year – obviously, a level of policy-signaling that didn't inhibit accelerating growth or rising equity markets.
- We find it faintly ridiculous to hear attention-seeking celebrity investors like Paul Tudor Jones predicting that inflation is about to come back "with a vengeance." To be sure, if it does, that would be a problem, not least because of what the Fed would have to do. But first inflation has to come back at all. Then maybe we can worry about the vengeance thing, and right now there's just no evidence for that.
- *The back-up in the 10-year Treasury doesn't scare us in the least – we've predicted it, and we welcome it.* Since its inflection-point in early September, the nominal yield has backed up 90 bp. Only 31 bp is explained by an increase in TIPS-implied inflation expectations, leaving the majority 59 bp explained by an expanding term premium – the real rate, reflected in TIPS yields – which implies better growth expectations. If we were looking at inflation "with a vengeance," we'd see a bigger move in the inflation-compensation component, and surely growth expectations would have contracted, not expanded. *The configuration we are seeing does not imply a tightening Fed – rather, one keeping its policy posture at neutral through ongoing gradualism.*
- *It was only a year ago that everyone was celebrating "the reflation trade." All that's going on here is that the reflation trade is still on. It was a good thing a year ago, and it's still a good thing now.*

Bottom line

The stock market's quick recovery after yesterday's upside CPI surprise shows that the consensus fear of resurgent inflation hasn't been the driver of the February correction. January's CPI pop was driven mostly by energy and energy-related sectors; previously strong OER decelerated. Market-implied inflation expectations rose, but their trend remains sluggish. The forward funds rate rose, too, but we think as much in response to recovering stock markets than inflation. Powell signaled continuity of policy gradualism, but the "dot plot" could move up a bit in March, reflecting improved growth prospects. The back-up in the 10-year yield mostly reflects growth expectations embedded in the term premium, and only minimally rising inflation expectations. Fears of inflation "with a vengeance" are very much overblown.