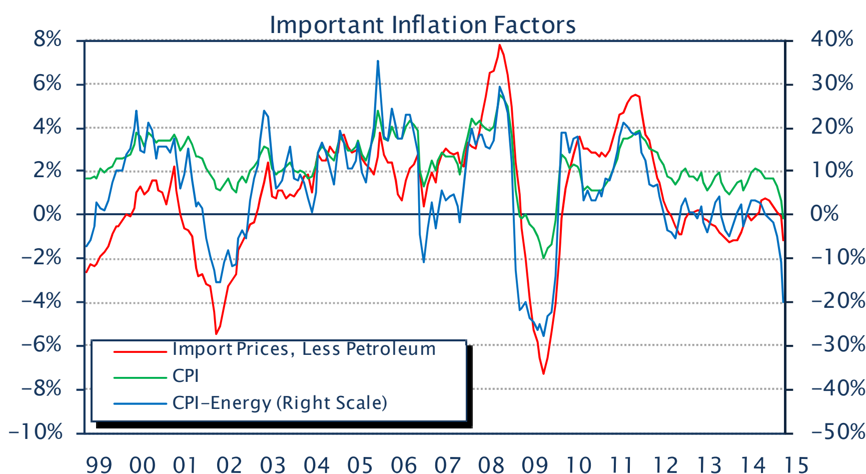
INVESTMENT UPDATE

Where is inflation? At this point in the economic cycle—more than five years since the official end of the recession here in the US—we would expect to see some upward momentum in consumer prices, as increased demand places pressure on the important factors of production. But this recovery has been anything but typical, with anemic economic growth here and abroad and excess capacity in the commodity markets keeping inflation at bay. Meanwhile, governments and policymakers continue to implement conventional and unconventional programs to spur growth and deal with the lingering after-effects of the financial crisis. In many developed economies, deflation is now more of a worry than inflation.



Here in the US, the debate is a little more even-handed, with the consensus among most economists being that inflation remains a looming danger, just below the surface. And this is nothing new. Just-released transcripts from the Federal Reserve's Open Market Committee meetings in 2009 showed that higher inflation was the chief concern for many committee members, even while the US economy was still in recession. Those concerns have only grown over the past five years, as the Fed put in place successive programs of "large-scale asset purchases"—AKA quantitative easing—buying up trillions of dollars in government debt and flooding the financial system with liquidity. Throughout this process certain "hawkish" FOMC members have continually beaten the drum, warning that all those trillions of dollars would soon result in higher inflation.

But to the surprise of many (and we'd have to put ourselves, quite honestly, into this camp), inflation has not risen over the past few years. In fact, if we look at the broadest measures of the consumer price index (CPI)—those which include the precipitous drop in energy prices over the past year—inflation is below zero now on a year-over-year basis, and at its lowest level since the financial crisis. As the chart on this page shows, much of the decline in CPI has been driven by lower energy prices, but it's also been due to the fact that the US continues to import disinflation, if not outright deflation, even if we exclude energy (note: the strong US dollar certainly helps keep all import prices low). A quick glance at most other measures of current inflation shows little pressure on a broad range of consumer prices, despite the massive injection of liquidity over the past half-decade. The Fed's main inflation gauge, core PCE (the personal consumption expenditure price index, excluding food and energy), is currently 1.3% above its level from a year ago, well below the Fed's target of 2.0%, and seemingly unable to crack out of a six-plus year range of 1%-2%.

Of course, quiescent inflation figures give the Fed ample leeway to delay the inevitable rate increases Fed critics have been demanding for years. But inflation or not, the FOMC appears determined to begin bumping up the Fed funds rate this summer; Fed Chair Janet Yellen has said as much in recent appearances. In beginning the process of raising the funds rate, the Fed can hang its hat on the fact that the labor markets have strengthened to the point that inflation is now their sole concern (keep in mind that the Fed's dual mandates are for "full" employment and stable prices). And when one looks at the evidence, there can be little argument that the US employment picture is bright, indeed.

The chart on the top of the next page shows just how strong the US labor market is right now. After losing nearly 8.5 million jobs (see the green line, using the right-hand scale) from 2007-2009, the US economy has, albeit slowly, added more than 10 million jobs over the past five years. There are more people employed today than at any time in US history, while the unemployment rate has fallen to 5.5%. Yes, the unemployment rate has been lower, but since 1970 unemployment has been above its current level more than 70% of the time.

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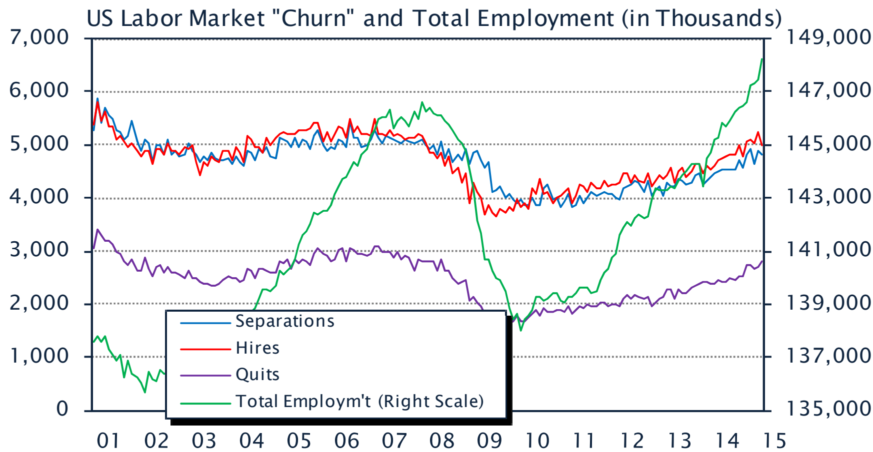
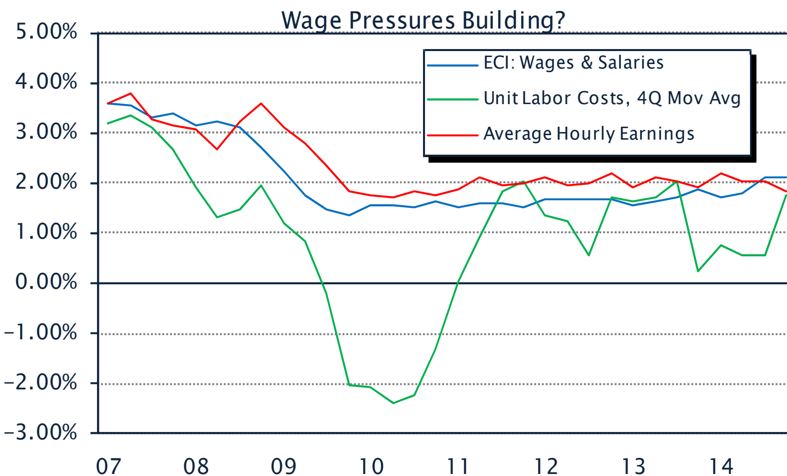
INVESTMENT UPDATE CONT.

The chart also includes additional data from the monthly JOLTS (job openings and labor turnover survey) report from the Bureau of Labor Statistics. The lines marked “separations" and "hires" show the turnover in jobs gained and lost every month; the difference between these two data points is the monthly change in nonfarm payrolls that the markets examine so closely. You'll notice that every month, four to five million people get a new job or leave their old job, an indication of just how dynamic the US labor markets are. We've also included a more obscure series from the JOLTS data—the monthly "quits" figure. This number (it, along with "layoffs and discharges," comprises "separations") is important because when it's moving up (as it is now, at a slightly accelerating pace) it indicates confidence in the job market; folks tend to not quit their job voluntarily unless they have some assurance that a new one is readily available. We are approaching the quits rate last seen during the boom of the mid-2000s, a very healthy sign for the US labor market.



Clearly, the broad-based strength in the US jobs market is weighing heavily on the Fed's collective psyche. Tightening labor markets—especially those producing good job gains across a wide range of industries—have historically been associated with rising wages, and rising wages mean that companies will try to pass those higher wage costs through to their customers, resulting in higher prices (inflation). The pressure is on the Fed, with labor markets tightening, to ramp up their *bona fides* by showing they're willing to nip inflation in the bud.



But global economic growth is in the doldrums, and commodity prices indicate that there's plenty of slack in the main factors of production; the sole source of inflation right now is likely to be coming from a tighter US labor market. The problem is, as shown in the bottom chart on this page, it's not at all clear that there's any apparent pressure on wages; any wage/salary/earnings statistic that you care to look at shows a consistent 2%-ish annual growth in US labor compensation. Unit labor costs have moved up in the past couple of months, but this is a highly volatile series that has bounced between 0.5% and 2.1% over the last three years. The employment cost index (ECI) is showing a slight upward tilt, but certainly nothing alarming.

As bond investors, our perpetual concern is rising inflation, so we appreciate the Fed's willingness to get out ahead of the curve. But as keen observers of economic trends, we have to wonder whether the fear of wage inflation is overblown. Certainly, one rate hike of ¼ of 1% isn't going to shut down the US economy, so there's little danger from the Fed moving forward this summer with a small increase in the Fed funds rate. But the global capital markets are prone to bouts of irrationality, and with the funds rate having been locked at zero for more than a half-decade, we should expect, at the least, increased volatility around this rate hike, if not sooner. And if history is any guide, the Fed won't just hike once and call it quits—that has happened only once before in the past 30+ years. Given that the rest of the world is limping along, economically speaking, we have to wonder what the combination of tighter Fed policy, removal of "forward guidance" and increased investor nervousness will do to the markets. We can’t dismiss the possibility that the cure (hiking rates) might just be worse than the disease (a little inflation).

Now, for a quick (but important) announcement. For the first time since the formation of Agincourt, we are pleased to announce that we have named four additional partners: Please join us in congratulating Ryon Acey, Erika Banks, Shannon Borum, and Catherine Temple.