



INVESTMENT UPDATE

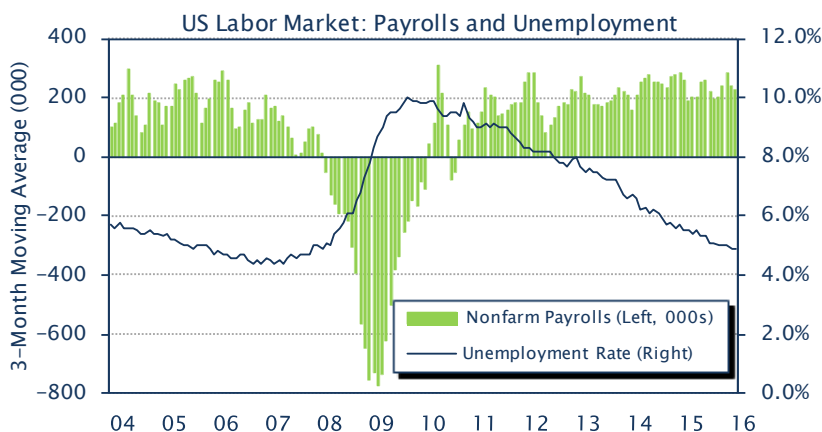
A quick economic update for this month seems to be in order, specifically focusing on the two main data series that the Federal Reserve is currently focused on for setting monetary policy— inflation and the labor markets. Of course, they're related, since the assumption that the Fed operates on is that the stronger the labor markets are, the more likely we are to get inflation.

Traditionally, inflation has been the mortal enemy of bond investors, and those of us of a "certain age" can recall quite clearly when the Fed's chief goal was to try to smother the rampage of consumer price inflation that burned bond investors. By the mid-1980s, the bond market had been decimated by the effects of decades of rising inflation, and investors were rightly wary of purchasing a fixed income security with a long maturity; anyone who had done so in the previous 40+ years had suffered losses for years on end, and could only hold on and wait for the approaching date of maturity to pull their losses back to zero. Selling before maturity would almost always mean taking a principal loss as a result of the corrosive effects of inflation on bond prices.

But in 2016, inflation fears are a piffle, a distant, far-off tale from a bygone era. In the current global economic environment, we don't have too much inflation, we have far too little of it. And central bankers all around the globe are trying like mad to make inflation go up. In Japan and in Europe deflation is a growing concern, a state of affairs much worse than inflation as consumers will delay purchases (and companies will delay investment) if they believe prices in the future will be lower than they are today. To try to counteract the resulting lack of demand, the Bank of Japan and the European Central Bank (among others) are flooding their economies with liquidity to try to en-

courage spending and discourage saving, and lowering bank lending rates to below zero to motivate banks to lend rather than sit on cash. The results, thus far, are unimpressive.

As we've discussed before, the Fed (along with most economist-types) adheres to a Philips Curve view of the world—that there is a strong inverse relationship between inflation and unemployment. Further, it believes that at some point in an economic expansion, the rate of unemployment falls so low that any further drop will cause inflation to rise at an increasing rate. This tipping point, known as the "non-accelerating



inflation rate of unemployment" (NAIRU), has intuitive appeal: once the slack in the labor market is taken up (i.e., most of the folks looking for jobs find employment), wages rise. That's because employers will have to begin offering higher wages in order to attract those who've dropped out of

the workforce, are working part-time, have retired, or have otherwise been sitting on the fence about taking a "real" job (i.e., one that doesn't involve receiving cash under the table).

The labor market in the US has been a notable bright spot in this recovery. After losing more than 8.5 million full-time jobs during the last recession, US payrolls have grown by nearly 14 million since the trough in payrolls in early 2010. As the chart on this page shows, we have been adding an average of more than 200,000 net new hires every month for the past three years. At the same time, the unemployment rate has fallen from 10% to 4.9%; the Fed's estimate of NAIRU is at 5.1%, meaning that we are now in the accelerating zone for wage increases. We would expect to see strong evidence of wage growth at this point, now that the slack has been taken out of the labor market; but like many other economic yardsticks, this one doesn't look like it's working right now. All the major

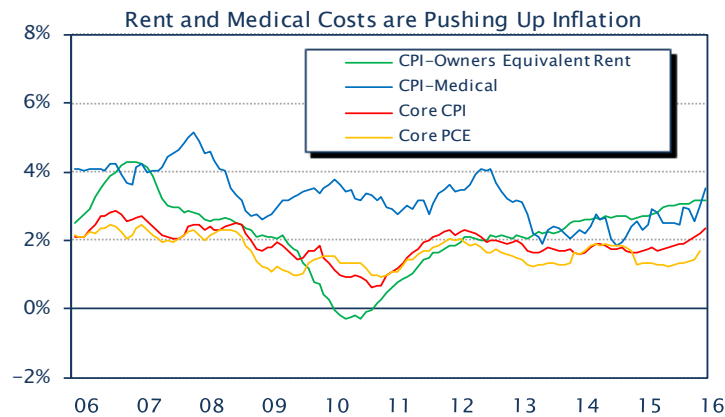
wage inflation measures—unit labor costs, the employment cost index and average hourly earnings—show little to no upward acceleration at present. The recently-released February labor report showed continued strong growth in practically every measure of US employment, yet average hourly earnings fell from the 2.5%–2.6% growth rate of the previous few months to just 2.2% on a year-over-year basis.

The lack of acceleration in overall labor costs is perplexing; one possible explanation for this is that the number of people who've dropped out of the labor force is still historically high. While this trend was already in place prior to 2007, the US labor force participation rate (the ratio of people employed to those of working age) plummeted during the financial crisis, and many of those people are still on the sidelines. The normal mechanism that should lead to increased wages hasn't kicked in (yet), as the population of folks on the margins of employment is still so plentiful that employers haven't had to raise their salaries. Another explanation, put forward by economists at the Federal Reserve Bank of Richmond, attributes the lack of acceleration in wages to the "composition effect"—that jobs lost during the recession were high-paying manufacturing and construction jobs, and job growth since then has been dominated by openings in lower-paying industries in the service sector. Thus, for the economy as a whole, wages have remained static.

Despite the lack of "cost-push" inflation from wages, there has been a notable increase over the past few months in core inflation. The core (ex-food and energy) CPI recently popped up from the 1.6% to 1.9% range that it had been stuck in since 2013, and now stands at 2.3% year over year, its highest level since the beginning of the financial crisis, and above the Fed's minimum target of 2.0%. Likewise, the core PCE (the Fed's preferred measure of inflation), which typically clocks in below core CPI, has risen over the past few months and is now at 1.7% year over year, 0.4% higher than it was six months ago.

As the chart on this page shows, there are two important components of core CPI, representing 30% of this series—owners' equivalent rent and medical expenses—which have been on the

rise over recent months, and are now at cyclical highs. Annual increases in medical expenses, after consistently outpacing most other consumer prices for decades, fell back in-line after the roll out of Obamacare, but "the bloom is off" at this point. Insurers are once again hiking rates, and prices are now increasing at an annual rate north of 3.5%. Likewise, the cost of owning a home is rising by more than 3%, the highest annual rate since mid-2007; that is, at least as measured by the folks at the Bureau of Labor Statistics. As you may recall from previous *Investment Updates*, despite representing a huge chunk of what comprises core CPI, the BLS' calculation of residential homeownership is controversial, as it doesn't directly measure mortgage payments, taxes and insurance; rather, the survey asks homeowners what they believe they could rent their homes for today, and compares that figure to previous periods to calculate the change in cost of home ownership. It's subject to distortions, and can—and does—provide some wonky results in the core CPI. This is one reason why the Fed prefers the PCE over the CPI, as core PCE measures homeowners' costs directly.



Nevertheless, the fact remains that inflation measures have taken a leg up, and that will give the Fed additional justification to "stay the course" with its plan to push up the overnight Fed funds rate "only gradually" (their words) over the coming quarters. How far, and how fast, those rate hikes will take place is, to again quote the Fed, "data dependent," and the data it will be looking for is further strengthening in the US labor markets, and whether inflation continues its upward trend of the past few months.

One final note: In its published forecasts over the past few years, the Fed has consistently overestimated both future inflation and US economic growth, and has repeatedly ratcheted down its near- and intermediate-term forecasts as new, less inflationary data has come in. So while the Fed would like to get the Fed funds rate up to something significantly above zero (it's not a very useful policy tool when it's close to zero), a forecast that includes a big bounce in growth and inflation in the coming quarters is likely to prove overly optimistic. With the rest of the world's major economies struggling to generate any real growth, it's hard to see where inflation might come from.