



INVESTMENT UPDATE

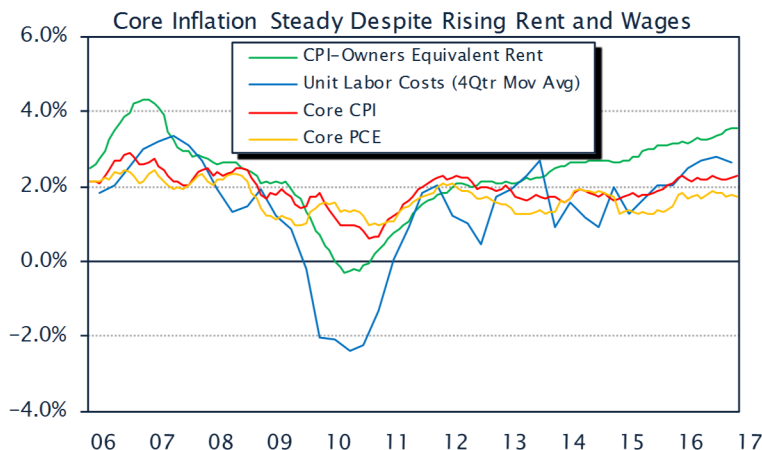
Imagine, if you can, the excitement of attending the US Monetary Policy Forum (USMPF) annual conference in New York earlier this month. The fun, the frivolity, the hijinks. Some of the best economic minds of our time gathering together to discuss the vital issues of the day: univariate autoregressive models, stochastic volatility state space algorithms, and the use of Lagrange multipliers to satisfy Kuhn–Tucker conditions in nonlinear programming. Like we said, hijinks.

In all seriousness, while much of the academic research surrounding the dismal science of economics has, over the past decades, become enamored with higher mathematics and statistics, the USMPF tries very hard to put away the slide rules and discuss the real world of economics. They are focused on actual monetary and related economic policies in the US and abroad, and the impact of those policies on people and societies. While the Forum is sponsored by the University of Chicago, it's not a group dominated by academia, but brings together practitioners, including Wall Street economists and high ranking members of the Federal Reserve; this year's keynote speaker was Stanley Fischer, Vice Chairman of the Fed's Board of Governors.

The presentation that got our attention was entitled "Deflating Inflation Expectations: The Implication of Inflation's Simple Dynamics" (authored by Cecchetti, Feroli, Hooper, Kashyap and Schoenholtz), and it provided some surprising conclusions about what's been going on with consumer price inflation over the past few years. More specifically, the authors investigated why inflation has been persistently low since the financial crisis, particularly since the Fed has tried every trick in its book to stimulate the economy and re-ignite inflation. After all, the economy has been expanding for more than eight years now, and unemployment has fallen below five percent, which is the level at which we'd expect that businesses should have to start raising wages to attract a shrinking pool of unemployed work-

ers. Yet, as the chart on this page shows, core inflation figures (both core CPI and core PCE) have remained persistently low, hovering around the 2% mark since 2011, despite wages (and housing costs) moving up.

Labor market slack and future inflation expectations are typically cited as the two most important predictors of future inflation—as noted above, when labor markets get tight, with fewer people unemployed, wages rise and companies try to start pushing through the effects of higher wages. Likewise, when inflation is expected to go up, say, because of a brighter economic outlook, actual inflation is expected to follow suit.



Not only has inflation remained stubbornly low since the financial crisis, it also remained remarkably stable during the crisis; in contrast to the Great Depression, where global economies experienced broad and persistent price deflation, most economies, including the US', experienced only a modest decline in core consumer price inflation

during the financial crises, nothing like the deflation we saw in the 1930s. The authors concluded (yes, after pulling out the calculators and constructing models) that inflation is now more like a giant supertanker than a speedboat; it moves slowly, and labor market slack has "a very limited role" in influencing the path of inflation.

What's more, the authors found that inflation expectations—arguably the single most important factor that the Fed uses in its inflation forecast—are of little value in forecasting future inflation, at least as long as expected changes in inflation are muted, as they have been in the recent years. They point out that if today's Fed had done a poor job in reining in inflation (as they did in the 1970s), and inflation expectations were subject to wild swings, then the impact of changing inflation expectations would be much more helpful in predicting

future moves in inflation; but with expectations relatively stable over recent years, it's lost its value as a forecasting tool.

If there's no empirical evidence that either labor slack or inflation expectations help determine the inflation outlook, where the heck does that leave us? In particular, if indeed inflation does not rise much when labor markets are strained, what does that mean for policy makers? Is it really true that the Fed has nothing to worry about now that unemployment has fallen below 5% and we continue to add 200,000 net new jobs every month?

During the Forum, Richmond Fed President Jeffery Lacker presented a paper outlining his thoughts on "Deflating Inflation Expectations," which threw a little cold water on the authors' findings. Lacker pointed to the parallels of the current environment to that of the early- to mid-1960s, a prolonged period of low and stable inflation, despite a tight labor market (see graphs on this page) and plenty of stimulus from the government. Lyndon Johnson's "Great Society" social programs were being put in place, and spending on the Vietnam War was moving into high gear. What followed was the great inflation of the 1970s, which caused huge dislocations in the US and world economies, forcing policymakers into taking extraordinary measures well into the 1980s to subdue inflation. He warned that some of these same ingredients are present today.

Lacker pointed to the fact that the Fed of today is much more adept than it was in the 1960's, and pointed to the mistakes it made, as well as the difficult political environment the Fed faced (citing then-Fed Chair Bill Martin's famous scolding at the hands of LBJ at his Texas ranch). Lacker gave himself and his Fed colleagues credit for taking a far more deliberate and steady approach over the past decade in dealing with the aftermath of the financial crisis, attributing the authors' relatively "steady state" inflation of today to the guidance of the Fed. Lacker's ultimate point being that if not for the Fed's responsible stewardship of the US economy, we could very well see a return to the bad old days of rampant inflation.

While it's hard to argue against Lacker's position—there's little doubt that the Fed (and other policymakers) have learned a great deal from their past mistakes—we'd be remiss if we didn't point out that there are other, larger, forces working to keep inflation low and relatively stable in the modern era. Chief among these is the changing demographics of the global economy, where low birth rates and aging populations have radically shifted consumer behavior and lowered the trajectory of economic growth for both developed countries and emerging economies. Asia, Europe, North and South America—all are seeing lower rates of GDP growth, increased savings, and lower inflation, and there's no indication that these macro factors are going to change any time soon.

Another big difference between the 2010s and the 1960s is policymakers' increased emphasis on fiscal restraint. Even before the financial crisis, governments were tightening their belts, cutting back on infrastructure and other discretionary spending in order to keep budget deficits from growing. Austerity measures among developed countries have been the overriding fiscal policy theme, as funding has been earmarked to keeping retirees' social programs solvent. Despite the rise of populism both in the US and abroad, it will be difficult to reverse this trend in any meaningful way. The 1960s and 70s are a long way back in the rear-view window.

Nevertheless, the Fed's Open Market Committee (FOMC) raised the overnight funds rate on March 15, the second hike in the past three months and the third in the past 15 months. In their

press release, the Fed admitted that it raised the funds rate even though core inflation was likely to remain fairly stable at current levels, and that monetary policy remained accommodative. In other words, the FOMC is still trying to get inflation to move up and will take its time in removing the stimulus that's currently in place (including maintaining its massive investment portfolio). It would appear that most of the FOMC agrees with Cecchetti, Feroli, et al. Inflation remains pretty well stuck, and unless policies become a lot less responsible, there's not much the Fed can do about it.

