Weekly Economic Commentary

February 10, 2014

The Inflation Conversation: Part 1

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Highlights

At her first public appearance as Fed chairwoman tomorrow, Janet Yellen is likely to say that inflation is in more danger of falling below the Fed's target of 2% than accelerating higher.

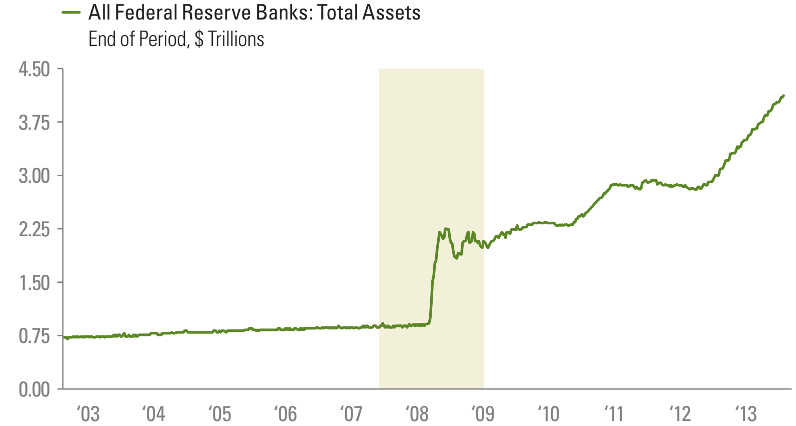
Market participants' view of inflation is similar to the Fed's view that inflation remains well contained.

Food and gasoline prices have soared over the past 30–40 years, and yet consumers (and businesses) hear every day that inflation is "well contained."

On Tuesday, February 11, 2014, Janet Yellen will make her first public appearance as chairwoman of the Federal Reserve (Fed). Yellen—who took over from Ben Bernanke on February 1, 2014—will likely "stick to the script" and continue to say that the U.S. economy and labor market are healing and that the scaling back of quantitative easing (QE) that began in December 2013 will continue, but remains data dependent.

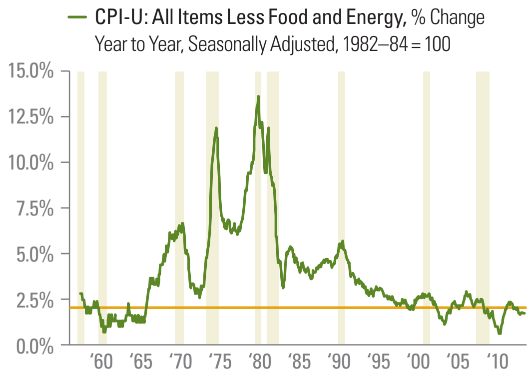
Yellen will likely get asked about the recent turmoil in financial markets, slowing growth in emerging markets, and the recent run of weaker-than-expected reports on the nation's labor market, which, in our view, have been negatively impacted by much colder and snowier-than-normal weather in December and January. Yellen will likely make it clear that there is a high hurdle for the Fed to stop or reverse tapering. Although Yellen will likely be peppered with plenty of questions about the labor market, many market participants will want to hear her views on the other side of the Fed's dual mandate—low and stable inflation.

1 The Expansion of the Fed's Balance Sheet Under Quantitative Easing Has Led to Fears of Inflation



Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 02/10/14

2 Inflation Excluding Food and Energy Has Been Decelerating for More Than 30 Years

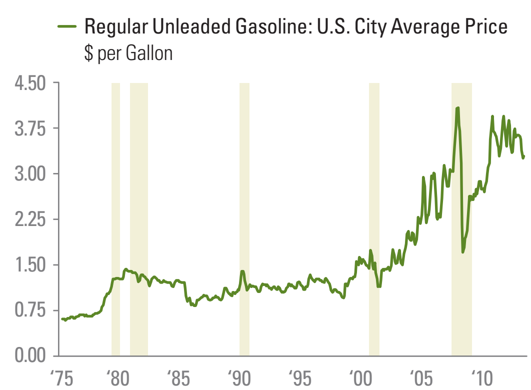


Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 02/10/14

3 The Market's Inflation Expectations Have Been "Well Contained" for Over a Decade

Source: LPL Financial Research, Haver Analytics 02/10/14

4 Gasoline Prices Have Increased Five-Fold Since the Late 1970s



Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 02/10/14

During her Senate confirmation hearings in November 2013, Yellen noted that "inflation has been running below the Federal Reserve's goal of 2% and is expected to continue to do so for some time." Yellen is viewed by market participants as favoring the "full employment" side of the Fed's dual mandate to promote full employment in the context of price stability, and is more likely to say that inflation is in danger of falling below the Fed's target of 2% than accelerating higher.

The Discussion: Consumers and Market Participants

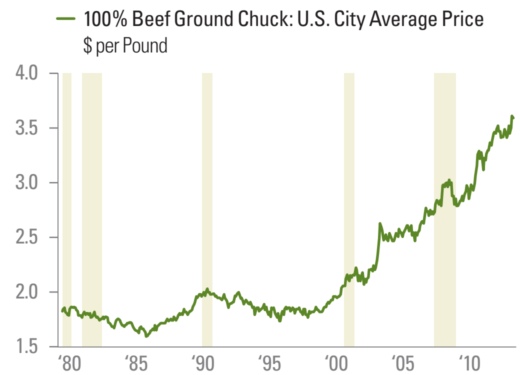
But how does that view jibe with the experience of consumers in the U.S. economy making purchases every day in grocery stores, online, and at the gas station? Most consumers would say that there is plenty of inflation, and they have the grocery and gasoline bills to prove it, but the readings on the Consumer Price Index (CPI) suggest that inflation is "well contained," as Ms. Yellen (and other Fed officials) have often noted. Many pundits and politicians however, have been saying since the Fed began its QE program in 2008 that inflation was likely to soar in response. Who is right?

Market participants' view of inflation—as measured by the difference between the yield on the 10-year Treasury note and 10-year Treasury Inflation-Protected Securities (TIPS)—is similar to the Fed's view that inflation remains well contained. In addition, recent consumer surveys (via the University of Michigan's Survey of Consumers) and professional forecasters (via the Philadelphia Fed's Survey of Professional Forecasts) reveal that inflation expectations remain well contained. The latest (January 2014) University of Michigan survey revealed that consumers expected 2.9% inflation over the next five to 10 years. This reading is taken twice a month every month, and has been in a narrow range between 2.6% and 3.0% for all but a few months over the past 16 years. Similarly, the Survey of Professional Forecasters finds that professional forecasters expect inflation to average 2.3% over the next 10 years. This group has not forecasted inflation over 2.5% since 1999.

The Discussion: Consumers and Businesses

But what about consumers and businesses (small and large) making purchases in the economy every day? Are they seeing inflation? The answer is clearly yes. For example, Figure 4 shows that in the mid-1970s, a gallon of unleaded regular gasoline cost around $0.60. Today, a gallon of gasoline costs just under $3.40. That increase represents a gain of nearly 500%, or an average increase of 4.5% per year over the past 38 years. There has been plenty of inflation at the gas pump over the past four decades. At the grocery store, a pound of beef has increased from around $1.80 per pound in 1980 to nearly $3.60 per pound today, doubling in the past 30-plus years [Figure 5]. That's inflation! Moving over to the bread aisle, the price of a loaf of bread has increased from around 50 cents in 1980 to nearly $1.40 today. Bread prices have nearly tripled in the past 30+ years, and yet consumers (and businesses) hear every day that inflation is "well contained" [Figure 6].

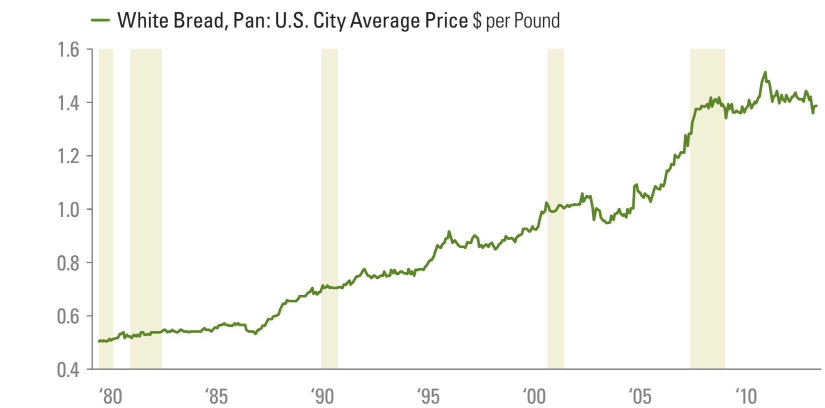
5 Beef Prices Have More Than Doubled in the Past 30 Years



Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 02/10/14

We cited just a few examples here, but we could extend the exercise well beyond the gasoline station and grocery store and find many other items that have experienced similar increases in prices in the past 30 to 40 years, including education, and of course, health care. So why the disconnect between what people see (and pay) and what policymakers tell us about inflation? How can prices for gasoline and beef and bread be so much higher, and yet, policymakers and inflation indices (such as the CPI) and even market-based measures of inflation tell us, essentially, that there is no inflation? Part of the explanation is an adjustment for quality, but of course that doesn't apply to a loaf of bread or a pound of beef. But how much we buy of each product, and importantly, definitions of terms like "inflation," "inflation rate," and "the price level," are also a part of the conversation. Stay tuned.

6 A Loaf of Bread Cost Three Times as Much Today as it Did in the Early 1980s



Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 02/10/14

This discussion is all part of the inflation conversation, a conversation that Janet Yellen may be involved in later this week with members of Congress, a conversation that we have looked at in prior editions of the *Weekly Economic Commentary* (most recently in *Inflation Situation Revisited* from March 18, 2013), and a conversation we will continue to pursue in future editions of the *Weekly Economic Commentary*. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI)—while providing a real rate of return guaranteed by the U.S. government.

INDEX DESCRIPTIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The MCSI uses telephone surveys to gather information on consumer expectations regarding the overall economy.

Philadelphia Federal Index is a regional federal-reserve-bank index measuring changes in business growth. The index is constructed from a survey of participants who voluntarily answer questions regarding the direction of change in their overall business activities. The survey is a measure of regional manufacturing growth. When the index is above 0 it indicates factory-sector growth, and when below 0 indicates contraction.

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