"Inflation: Is there a "new normal"?"

By Tommy Williams, CFP®

All eyes on inflation!

Inflation is the way economists measure changes in the prices of goods and services. The United States has enjoyed relatively low inflation for a significant period of time. Recently, the consumer price index indicated that inflation had actually moved lower in May.


Tommy Williams

Inflation is our focus because it is at the core of two very different opinions that currently are influencing markets and investors. A commentary on the Kitco Blog explained:

"One of the most important economic debates today is whether the economy will experience reflation or deflation (or low inflation) in the upcoming months. Has the recent reflation been only a temporary jump? Or has it marked the beginning of a new trend? Is the global economy accelerating or are we heading into the next recession?"

Another key factor is employment. Traditional economic theory holds when unemployment falls, inflation will rise because demand for workers will push wages higher. That hasn't happened yet in the United States even though unemployment has fallen significantly.

In fact, inflation remains stubbornly below the Federal Reserve's 2 percent target, according to data from The Economist. Regardless, the Federal Reserve believes higher inflation is ahead, so it recently raised the Fed funds rate and indicated it was preparing to shrink its balance sheet if the economy continues to grow as expected.

However, there is a group that disagrees with the Fed. They believe inflation will remain low regardless of employment levels. Barron's wrote:

"In the theoretical world, low unemployment threatens to unleash a torrent of inflation, which needs to be staved off by tighter monetary policies. Back in the real world, disruption, innovation, and competition relentlessly drive down prices while wage growth is hard to come by."

That difference of opinion was apparent in stock and bond markets in mid-June. In the bond market, yields on 10-year Treasuries moved lower after the Federal Reserve raised rates. In the U.S. stock market, the top-performing sectors were Industrials, which tend to do well when investors are optimistic about growth, and Utilities, which tend to do well when investors are worried about the future.

With an endless list of factors influencing the markets in various ways, it's difficult to predict which path our economy will take. When developing a prediction for the future of our markets, the only real evidence to examine lies within the history books. Among the many ups and downs of our economy throughout history, one trend stands tall, and it's found in the oval office. In the month following President Trump's election victory, CNBC reported:

"Donald Trump is not like any ordinary Republican president. [However,] that may prove to be a good thing for the stock market in 2017. That's because stocks have underperformed in the first year of Republican presidents most of the time, according to CFRA data. The S&P 500 has been down two-thirds of the time in the first years of all Republican presidential terms since World War II, whether it was the first or second term. That compares with big first-year gains in Democratic terms. Sam Stovall, CFRA's chief investment strategist, said the theory has been that Republicans inherited a mess made by Democrats, but instead it may be a matter of timing. 'History says be careful, that traditionally recessions have accompanied Republican administrations. Not necessarily because they do things wrong, but they probably just had bad timing,' [Stovall] said."

Regardless of the reason, the historical trend is an absolute fact. Let's hope this year breaks the cycle! In the meantime I think this is an appropriate time to remember that profound proclamation *"It's tough to make predictions, especially about the future."*

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