U.S. INFLATION: A CASE OF HIGH ANXIETY?

Kevin Flanagan — Head of Fixed Income Strategy
02/28/2018

There is no doubt that inflation fear has reared its ugly head early in 2018, impacting the money and bond markets in rather noteworthy fashion. Some key headline-grabbing measures, such as wages and the Consumer Price Index (CPI), have come in above consensus forecasts to start the year, fueling a case of high anxiety for the fixed income arena. Naturally, the million (or should it be billion?) dollar question is: Are these heightened inflation fears warranted?

As we entered the new year, consensus forecasts for inflation were that readings at both the overall and core (ex-food and energy) levels would essentially remain unchanged. Interestingly, economists’ projections have been revised upward of late and now post slightly elevated readings. Indeed, the CPI is now expected to come in at a year-over-year rate of +2.3%, or 0.2 percentage points (pp) higher than the prior projection. The alternate measure, the personal consumption expenditures (PCE) price index, has been changed to a +1.9% increase (also up 0.2 pp), with the core PCE gauge being lifted 0.1 pp to +1.8%. The bottom line is that these revised estimates now all look for some modest increase from 2017 levels.

What about the Federal Reserve (Fed)? For now, all investors have to go by is the policy makers’ December projections. The March FOMC meeting, scheduled for March 21st, will be the Fed’s next chance to make any potential adjustments to their prior forecasts. The preferred measure is the PCE price index, and the policy makers provide projections for both the overall and core PCE gauges. The Fed’s central tendency estimate is similar to the revised market consensus, with a range of +1.7% to +1.9% for each index. It should be noted that both the economists’ and the Fed’s current PCE projections still fall below the +2.0% target laid out by the policy makers.
So, let’s take another look at the aforementioned wages and CPI numbers. Of the two upside surprises, in my opinion, the one that carries more weight for the Fed is the increase in wages. Average hourly earnings rose at an annual rate of +2.9% in January, the highest reading since 2009. This compensation measure has failed on many occasions to break above this upper bound of the range, but there seems to be a growing belief that this year will finally see an increase with a “3” handle. Such a development could make the difference, at least in the bond market’s mind, between the Fed’s projected three rate hikes for 2018 and the bond market’s newfound concern that four increases could be coming this year.

Although the overall and core CPI readings came in above consensus in January, the year-over-year gains were unchanged from the prior month’s levels. In other words, there was no uptick in inflation on an annualized basis. In fact, one could make the case that these increases won’t be replicated next month, as three outsized gains for apparel, hospital services and motor vehicle insurance were partly responsible for the end result. Odds are this development won’t be repeated, and oftentimes gains like these tend to get reversed over subsequent months.

Conclusion

Here’s a question for the reader: Do you remember the 2017 inflation scare? It happened during Q1 as well, with both the CPI and PCE measures posting their highest annualized increases since 2012. Wages were rising as well. Obviously, that scare didn’t last long, as all of these inflation gauges finished little changed on a December/December basis. For 2018 as a whole, the trend seems to be on a slightly different course, as investors might very well end up seeing some modest elevation, albeit not necessarily at a pace that should create undue stress.

Unless otherwise noted, data source is Bloomberg, as of February 14, 2018.

For standardized performance and the most recent month-end performance click here. NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.
IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com).

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.
You cannot invest directly in an index.
DEFINITIONS

**Inflation**: Characterized by rising price levels.

**Consumer Price Index (CPI)**: A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

**Personal Consumption Expenditure (PCE) Price Index**: measure of price changes in consumer goods and services in the U.S. economy.

**Federal Reserve**: The Federal Reserve System is the central banking system of the United States.

**Federal Open Market Committee (FOMC)**: The branch of the Federal Reserve Board that determines the direction of monetary policy.

**Rate Hike**: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.