Global Demographics

Richard (Dick) Hokenson
rhokenson@hokenson.biz
+31 6 5518 3873

03 May 2018

The Fed's Conundrum

The total PCE deflator reached the Fed's 2% target for the first time since 2012 (see Chart 1 although the core PCE deflator did not quite reach the target (see Chart 2). While the year-ago percent change for both measures is genuine, it is very important to note that the size of the increase is exaggerated because of the low value in March of last year. The notion that this now means that price inflation will quickly become problematical is belied by the fact that monthly changes remain subdued, e.g. 0.15% for the core in March.

The conundrum for the Fed is that some firming in price inflation might occur while wage inflation remains moderate. For the last four years, the 12-month percent change ending In March for the Employment Cost Index for Wages and Salaries (ECI) has moved in a very narrow range even as the unemployment rate declined from 5.6% in the first quarter of 2015 to 4.1% today (see Chart 3). Moreover, the recent dip in the Atlanta Wage Tracker supports our view of continued moderation in wage inflation (see Chart 4).

The current consensus forecast is that somewhat higher price inflation will be accompanied by stronger wage inflation. This would create the rationale for at least two and perhaps three more increases in the federal funds rate this year. Relative to expectations, we expect wage inflation to surprise to the downside. The Janet Yellen Fed was very data dependent which resulted in a more restrained Fed. It remains to be seen how Jerome Powell will react to a scenario that deviates from the consensus.

Chart 1

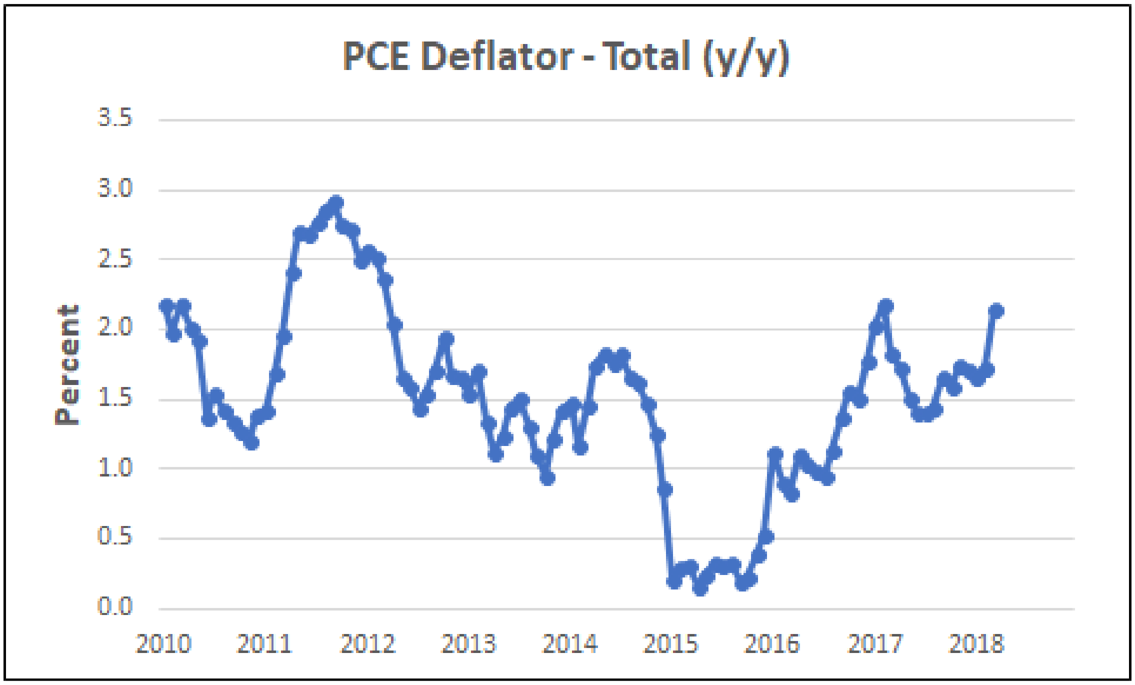

Chart 2

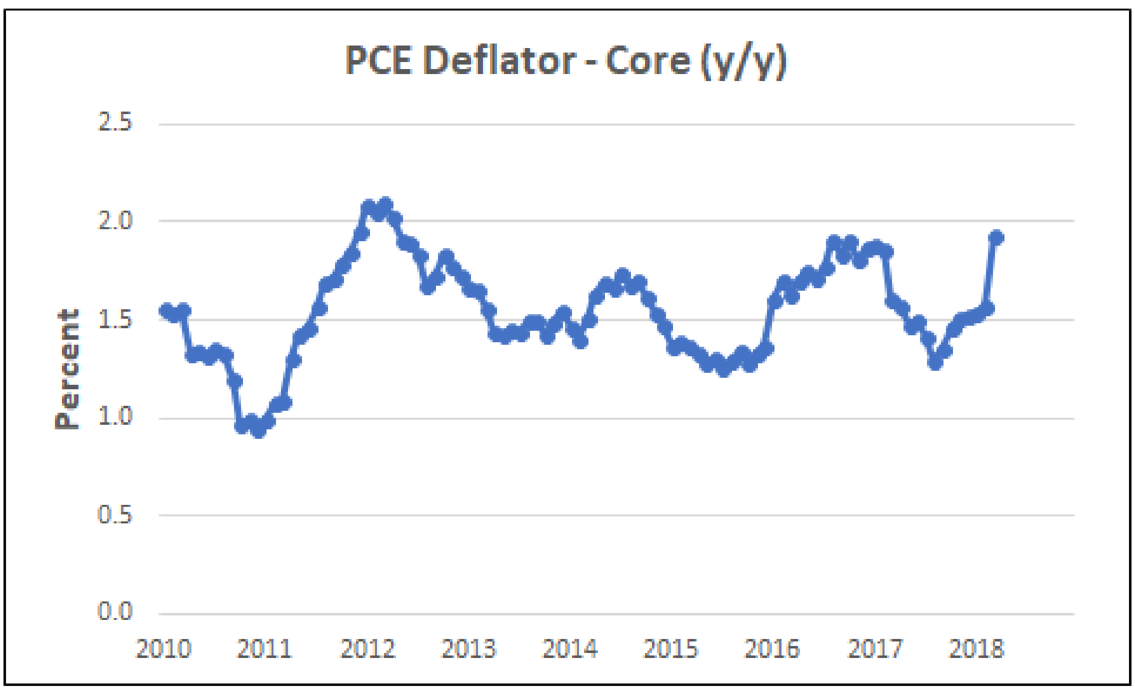

Chart 3

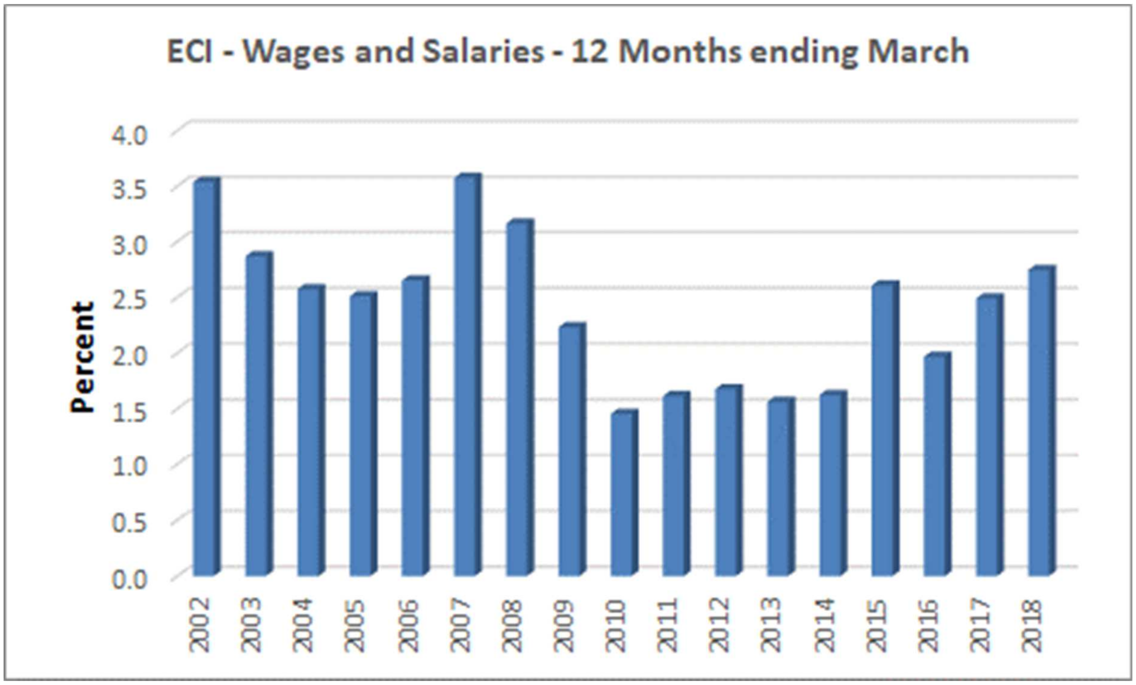

Chart 4