Mitch on the Markets

Why You May Need to Keep Your Eye on Inflation

By Mitch Zacks
Portfolio Manager

Could 2018 be the year that inflation matters again? I think the answer is likely yes.

One of the more puzzling features of 2017 was that the acceleration in global growth did not create a more substantial pickup in inflation in the second half of the year. From May through November, the consumer price index measure of inflation never rose above 1.8%, even as the economy added more than 2 million jobs in 2017 and as wage pressures grew (according to the Bureau of Labor Statistics).

I expect the softer inflation readings of last year to prove temporary. If our forecast for 2+% U.S. GDP growth in 2018 proves correct, this economic expansion will enter its tenth year and become the second longest expansion in history (according to Strategas Research). As economic expansions grow long in the tooth, history has shown that resource and labor markets tend to tighten, and that tightening can lead to upward pressure on costs and wages. Businesses are more likely to pass along those costs than absorb them, which can cause inflationary pressures to grow. Indeed, history shows us that it has not taken long before unemployment at or near 4% created stronger wage and price pressures.

Global inflation trends also seem to be firming. Purchasing manager surveys in nearly all of the world's developed economies are reporting higher prices paid and received, which points to inflation taking hold in global goods. In Europe and Japan, where inflation has been stubbornly low for years, core inflation readings are in a rising trend. It could be a product of extraordinary monetary policy measures taking hold, or perhaps a result of improving employment trends – or both (according to JP Morgan). Whatever the cause, prices are starting to firm up across the world.

So, Why is Inflation So Important?

In the post-war era, peaks in inflation have historically preceded recessions, as can be seen in the chart below.

Consumer Price Index for All Urban Consumers since 1955

Source: Federal Reserve Bank of St. Louis

Inflation can be harmful to economic growth for all sorts of reasons. In a more obvious sense, rising prices mean that consumers pay more for goods, which can potentially reduce overall spending and nudge consumers to save more. Businesses should also feel the pinch as input costs rise and sales decline.

But the tail risk of higher inflation is how the Federal Reserve and other central banks respond to it. The Federal Reserve already seems determined to tighten financial conditions given the U.S. economy at full employment and with growth accelerating, but a return of inflation at or above its 2% target could prompt the Federal Reserve to raise rates more quickly than originally planned. In this sense, we believe that higher-than-expected inflation increases the risk of policy error.

The Bottom Line: Should Investors Be Concerned about Inflation?

As the Fed raises interest rates and tightens financial conditions, it tends to compress profit margins for businesses and therefore makes business activity more susceptible to retrenchment in the event of an unexpected shock. This could be a risk that grows over the course of the year and into next.

The starting point for inflation and cost pressures, however, is currently low and wages have been plateauing for years. What's more, inflation has been below the Fed's target of 2% for the better part of five years now, so a bit of cost pressure in 2018 should not, in our opinion, spiral out of control or meaningfully force the Fed's hand (according to Bureau of Labor Statistics). For this reason, we believe that the Federal Reserve appears to be in a good position of raising interest rates gradually and as planned, with no unexpected surprises for the market.

Even still, rising inflation coupled with Fed tightening could result in volatility in the new year.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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