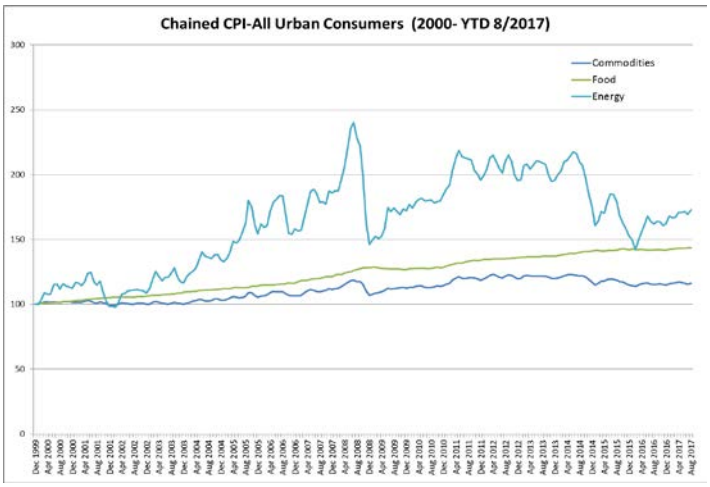
What Happened to Inflation?

October 2017

A 2017 economic conundrum is the apparent absence of inflation in the face of strong U.S. employment and improving growth abroad. A still-accommodative central bank, robust economic data and improving corporate earnings only compound the puzzle. During 2017, a number of "one-off" effects seem to have restrained the Consumer Price Index (CPI), although these expenditure categories have modest weights in the overall index so it would appear something else might be holding back prices. A review of the data and labor market conditions suggest we may be living through a deferral of inflation, not a secular adjustment toward permanent containment.

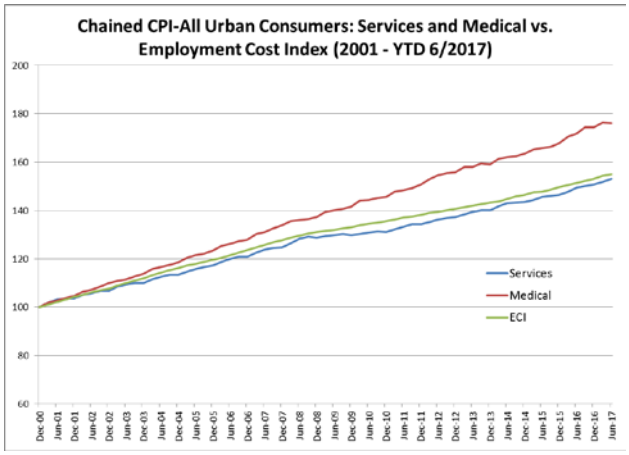
Starting with information we know generically, but perhaps have not considered in detail, "things" we buy, other than food, have not risen in price for years. The chart below shows the Chained CPI data for commodities (physical things we buy), and breaks out two components, energy and food and beverages. Food constitutes over 40% of the Commodities Index and energy commodities make up another 9.5% so it is not surprising consumers feel a bit squeezed, even though we hear goods prices are not really rising. We believe a few meaningful developments account for the absence of inflation in things. The first is the globalization process and the expansion of free trade, which moved manufacturing to low cost jurisdictions. Technology has played an important role in reducing production costs, but betterment in that factor of production is not unique to recent years. A second, more recent and likely temporary phenomenon, is the decline in energy and metals prices, which eased input costs. The last might be described as the "Amazoning" of retail. The ability to shop efficiently online has two important effects, perfect price information and margin compression. Since consumers are able to view prices online and comparison shop, prices compress toward the marginal cost of production. While this technological advancement benefits consumers and forces manufacturers, retailers and distributors to become efficient, it does not eliminate inflation. Goods prices depend on the cost of materials, labor and technology needed to produce them. Efficiency in distribution minimizes the price consumers pay above the physical cost, but cannot reduce that cost over time.



Source: Bureau of Labor Statistics

After 2008, U.S. corporations targeted efficiency improvements to reduce costs, in part by reducing employment. For years, analysts complimented corporate cost-cutting, but decried the absence of revenue growth. Discipline on the cost side and painful memories of lengthy unemployment may be responsible for the docile wage data through 2017, especially considering the low level of unemployment. Employees may not be pressing for higher wages, but they will likely be getting them soon. Services constitute about 68% of U.S. personal consumption and have a 63.75% weight in the CPI. While the CPI attempts to capture consumer consumption patterns through its surveys, people have been shifting their spending toward services for years. Key features of most services include limited price transparency, high labor content, and minimal jurisdictional mobility. Not surprisingly, service inflation exceeds goods inflation.

The graph below shows the challenge workers face as wages, reflected by the Employment Cost Index (ECI), have barely kept up with services inflation. For the older generations who have entered the high medical care consumption years, the burden has become more problematic. Some aspirational items like college tuition, certain forms of entertainment, and food away from home have comfortably exceeded reported inflation. It is surprising that wage pressures have not been more severe. In our 1Q 2017 Commentary, we discussed the unemployment rate and suggested labor market pressure may be more acute than the reported jobless rate indicated. We also cited a Federal Reserve Bank of Cleveland study that argued the Natural Rate of Unemployment should be between 5% and 6%. On October 6, 2017, the Bureau of Labor Statistics reported an unemployment rate of 4.2%. While October's number may have been distorted by the hurricanes, it is not meaningfully away from the lowest level of unemployment in the last 30 years, 3.8% in April 2000. Many small businesses like home repair services, construction, landscaping and others have struggled to find labor. Some shortages may be attributable to reduced immigration, but the larger challenge for the economy, comes from the absence of slack at a time of accelerating growth.



Source: Bureau of Labor Statistics

Analysis by Pantheon Macroeconomics shows that beginning around 2014, the increase in average hourly earnings lagged the increase in National Federation of Independent Business' (NFIB) index of unfilled job openings, advanced by nine months. That relationship had been tight since 2000. The NFIB also publishes a Small Business Optimism Index that rose after the presidential election and has remained elevated. This combination suggests small business' demand for labor will continue and even become more intense as the global macroeconomic picture improves. Any additional lift from growth oriented tax policy could make labor shortages worse, likely leading to wage pressures and higher prices.

Since the 2008 financial crisis, economic analysis, market discussions, and investment strategy considerations have involved pre and post 2008 comparisons because of the depth of the recession and the extraordinary actions of the world's central banks. Analogous to recovery from a severe injury, almost ten years after the crisis, the world appears to have the strength to stand unaided, and the therapy now runs the risk of becoming excessive. In a world of synchronous growth, supply and demand driven forces on commodities and labor should logically lean toward higher prices. Technology has done wonders for efficiency, cost reductions, and changes in consumer behavior, but it cannot fundamentally alter the laws of economics. As wage pressures build, inflation will surely be close behind.

October 15, 2017

Sources: Bureau of Labor Statistics, Pantheon Macroeconomics, National Federation of Independent Business (NFIB), and Federal Reserve Bank of Cleveland

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