First Trust
Monday Morning OUTLOOK
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Inflation: What Inflation?

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Who hasn't heard forecasts of "Hyperinflation?" They've been all over the web and TV ever since the Federal Reserve started a huge expansion in its balance sheet, called Quantitative Easing, back in 2008. Among other things, these forecasts called for a dollar collapse, dire problems for the banking system and 1970s, or Weimar Republic-like, inflation.

We have consistently disagreed with these forecasts. Yes, the monetary base has expanded rapidly. But banks have held the vast majority of this QE as excess reserves. These reserves just sit at the Fed, earning 25 basis points, but other than that, gathering electronic dust. They haven't boosted inflation as feared. And we don't believe they are responsible for economic growth, or the rising stock market, either.

In economic terms, the velocity of money collapsed in the Panic of 2008 and, although there are some recent signs of a revival, it's nowhere near bouncing back to where it was before the Panic. What QE has accomplished is reducing the money multiplier in a significant way.

To be clear, even though we never expected hyper-inflation, we did expect inflation to rise more than it actually has over the past few years. We thought inflation would be at least 3% by now, maybe even 4%. And yet, the Consumer Price Index is up only 1.7% in the past year while the Fed's preferred measure, the PCE deflator, is up only 1.5%.

We still don't expect inflation to stay this low, but for a number of reasons, we now expect any move higher over the next few years to be very gradual, maybe half a point per year. This isn't enough, all by itself, to get the Fed to move rates much higher than it currently projects.

Here's why we expect only a gradual rise in inflation.

First, the Fed is fully prepared to increase the interest rate it pays on excess reserves. And while this doesn't guarantee the money supply won't expand, the Fed is also ready to use higher capital standards and Chinese-like bank rules to hold back lending, which will contain money growth and loans.

Second, real economic growth should pick up over the next couple of years to close to 3% versus the average of roughly 2% growth per year since the recovery started in 2009. This extra growth could help soak up some of the loose monetary policy.

Third, and lately the most important reason for a very gradual slog higher in inflation, is the huge headwind coming from the energy sector, where the combination of horizontal drilling and fracking is transforming production. Supply is simply booming and prices are falling. Back in 2005, the US was importing ten times as much oil (petroleum and petroleum products) as it was exporting; now that ratio is down to 1.9 and headed lower. In the next few years, the US could easily become a net exporter of petroleum.

These forces are creating disarray in OPEC. Saudi Arabia is willing to accept lower prices for oil, undercutting other oil exporters in the Middle East as well as Russia. West Texas Intermediate, which was $104/barrel in late June is now below $90/barrel, and probably has further to fall.

Gold is below $1,200/oz., a clear sign that inflationary fears are receding. We still think it has further to fall.

As a result, even though the Fed will start to raise short-term rates next year, the rate hikes will be gradual. We don't expect 50 basis point hikes at any single meeting anytime soon. More likely, the Fed will raise rates at one meeting and then pause at the next, in an attempt to damp volatility.

In turn, long-term rates will work their way higher, but not by leaps and bounds. We expect both equities and the 10-year Treasury yield to move higher later this year. While we look for 10-year yields to end this year below 3%, we look for something like 3.5% by the end of 2015 and 4% in 2016.

Most important for investors, is to understand that a 4% yield on the 10-year Treasury (the equivalent of a 25 price-earnings ratio) is not a headwind for the stock market. Based on next year's forecasted earnings, the S&P 500 P-E is less than 15 today. That leaves plenty of room for equities to rally.

And even if the Treasury yield goes above 4%, that's OK for equities as long as interest rates rise primarily because of improvement in real GDP growth rather than inflation.

The bottom line is that our outlook for inflation has shifted downward, but not dramatically. We still expect more inflation, just not enough to cause serious concern for at least the next couple of years. This is good news for the stock market and the economy.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-7 / 2:00 pm	Consumer Credit– Aug	$20.0 Bil	**$21.9 Bil**		$26.0 Bil
10-9 / 7:30 am	Initial Claims – Oct 4	294K	**295K**		287K
10-10 / 7:30 am	Import Prices – Sep	-0.7%	**-0.5%**		-0.9%
7:30 am	Export Prices – Sep	0.0%	**+0.2%**		-0.5%