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FIRST Trust ADVISORS L.P.

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Monday Morning Outlook

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Don't Get Complacent About Inflation

Recent data on inflation have some analysts claiming it's no longer a threat. In the past two months, measures of consumer and producer prices that exclude food and energy – what economists call "core" inflation – have been docile. In March and April, "core" consumer prices were up at only a 1.4% annual rate, while "core" producer prices were unchanged. "Core" consumer prices are up 2.4% versus a year ago while core producer prices are up only 1.6%.

By contrast, overall inflation is rising. The consumer price index (CPI) is up 2.6% versus a year ago, and up at a 5.7% annual rate in the past three months. The producer price index (PPI) is up 3.2% versus a year ago, and up at a 12.8% rate in the past three months.

We believe those who focus too much on "core" inflation are making a fundamental mistake. The concept of "core" inflation dates back to the early 1970s when then-Fed Chairman Arthur Burns asked the Fed staff to give him inflation measures that excluded some prices that were rising faster than others.

Back then the theory was that food and energy prices were very volatile from year to year and driven by factors other than monetary policy, so ignoring those items provided a better gauge of the underlying inflation trend which could be attributed to monetary policy.

When food and energy prices are volatile both up and down – as in the period between 1987 and 1997 – focusing on "core" inflation makes sense. But for the past five years, the volatility has almost all been in one direction – and that's up.

Over the past five years, the annual growth rate of the overall CPI has been 0.8 percentage points greater than the "core" CPI, the largest gap since the mid-1970s. In this environment, instead of revealing the underlying trend, focusing on "core" inflation *conceals* the trend.

Loose money always shows up in higher inflation. But it's impossible to know beforehand which goods or services will experience the greatest price hikes and which prices will increase less. Always eliminating food and energy from inflation calculations is too blunt an instrument for discerning the underlying trend. Consumers still pay for food and energy even if these items are excluded from the "core."

There are some measures of inflation that attempt to work these problems out. One we follow is called the "trimmed mean" consumer price index, a measure calculated by the Cleveland Federal Reserve Bank. Rather than just excluding food and energy, "trimmed mean" inflation omits the 8% of items that are rising the fastest *and* the 8% that are rising the slowest (or falling the most) regardless of which items they are. This measure is up 2.8% in the past year and has been at or above 2.5% for the past 18 months.

Our view remains that inflation is already too high, is headed higher and that short-term interest rate increases will follow once the Federal Reserve gets more confident that the recent economic rebound will be sustained.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-31 / 7:30 am	Q1 GDP Preliminary	0.7%	**0.8%**		1.3%
7:30 am	Q1 GDP Chain Price Index	4.0%	**3.9%**		4.0%
7:30 am	Initial Claims - May 26	310K	**310K**		311K
9:00 am	Chicago PMI – May	54.0	**58.3**		52.9
9:00 am	Construction Spending – Apr	+0.0%	**-0.2%**		+0.2%
6-1 / 7:30 am	Non-Farm Payrolls – May	140K	**130K**		88K
7:30 am	Unemployment Rate – May	4.5%	**4.4%**		4.5%
7:30 am	Average Hourly Earnings – May	+0.3%	**+0.3%**		+0.2%
7:30 am	Average Weekly Hours – May	33.8	**33.9**		33.8
7:30 am	Manufacturing Payrolls – May	-11K	**-20K**		-19K
9:00 am	ISM Index – May	54.0	**54.5**		54.7