First Trust
Monday Morning OUTLOOK
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Inflation Now and Later

The Federal Reserve believes with all its heart that inflation only occurs in economies that are producing at or above their potential. As a result, with unemployment above "normal" and growth below "trend," the Fed sees little threat of inflation. As far as the Fed is concerned, any increase in commodity prices is temporary and any increase in consumer prices due to commodities (like energy) is transitory.

We wish we could be as sanguine about inflation as the Fed, but we heard all the same arguments back in the 1970s. The Fed was wrong then, and we think it is making the same mistake(s) today.

In the first five months of 2011, the overall consumer price index (CPI) is up 5.1% at an annual rate. In the last seven months of 2010, it grew at just a 2.3% annual rate. So, as the rest of 2011 unfolds, we think the year-ago comparisons are very likely to increase – pushing the CPI from its current 3.4% year-over-year rise to above 4%, possibly even 4.5%, by year end.

Interestingly, about one-quarter of the consumer price index has nothing to do with actual consumer purchases. As a proxy for housing costs, the government uses "owners' equivalent rent," – an estimate of what a homeowner would charge themselves for rent if they had to rent the same house. Ignoring this part of the consumer price index – which is up just 1% in the past year – shows consumer prices (outside of the rental cost of homes) are *already* up 4.2% versus a year ago.

The Fed thinks this number is a red herring and Americans should focus on a different measure. "Core" inflation, which excludes food and energy, is up only 1.5% versus a year ago. But it's accelerating – up at a 2.1% annual rate in the past six months and an even faster 2.5% rate in the past three months. And this is happening even though the government's measure of housing costs (which is included in "core" inflation) is so low. But everyone we know that rents a home or apartment is talking about their landlords raising rents. When this data seeps into the government's numbers, core inflation will get a boost.

The Fed certainly looks like it's heading toward re-learning some of the lessons of the 1970s, which we previously had hoped it had learned for good. The key lesson is, as Milton Friedman said, that "inflation is always and everywhere a monetary phenomenon."

Regardless of how much slack there is in the labor market, if the Fed increases the money supply faster than the growth in the demand for money, inflation will result. The Fed has been keeping the federal funds rate near zero in an environment where nominal GDP has been growing at around a 4% annual rate. That is an unsustainable policy if policymakers want stable prices.

To be clear, we do not think the US is doomed to re-live double-digit inflation. It could happen (if the Fed holds rates this low for several years), but we don't think that's going to happen.

Around the middle of next year, we believe the Fed is finally going to start lifting short term rates. They will have a long way to go before rates are back to neutral (close to nominal GDP growth rates). Both inflation and longer-term interest rates are likely to rise, but, eventually, after a long series of rate hikes, inflation will be brought to heel.

The only fear we have is that the Fed waits too long and then must get so aggressive with rate hikes that the economy is threatened. But, this threat is still a long way off. We aren't ignoring it, but we think it is not something that should influence medium-term investment decisions today. Despite the Fed's mistake, we remain bullish about the US economy and equity markets.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-21 / 9:00 am	Existing Home Sales - May	4.800 Mil	**4.850 Mil**		5.050 Mil
6-23 / 7:30 am	Initial Claims - Jun 18	415K	**415K**		414K
9:00 am	New Home Sales - May	0.310 Mil	**0.333 Mil**		0.323 Mil
6-24 / 7:30 am	Durable Goods - May	+1.5%	**+1.7%**		-3.6%
7:30 am	Durable Goods (Ex-Trans) - May	+0.9%	**+1.0%**		-0.6%
7:30 am	Q1 GDP Third Report	+1.9%	**+2.2%**		+1.8%
7:30 am	Q1 GDP Chain Price Index	+1.9%	**+1.9%**		+1.9%