First Trust
Monday Morning OUTLOOK
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Where's The Inflation?

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So far this year, the Plow Horse US economy has accelerated a little bit from 2010-2012, the S&P 500 is up 16%, interest rates have risen, and gold is off 17%. As our readers know, this is exactly what we've been forecasting.

Despite this success, we have had one big miss: inflation. Consumer prices – including food and energy – are up a mere 1.1% from a year ago. We've never been in the hyperinflation camp – that's why we've been bearish on gold these past few years – but, we never expected such benign inflation.

We think gold had priced in 10% to 12% inflation, and we expected 3 or 4 or 5%, that's why we were bearish on the yellow metal. And, at the same time we thought the Federal Reserve's forecast of 1.5 to 2% inflation was too low. So, even though we have been right on gold, our inflation estimates have been too high – just like the Fed's.

The "hyper-inflationistas" have been overly focused on the size of the Fed's balance sheet, failing to recognize that it's mostly due to a surge in excess bank reserves. The M2 measure of money has continued to grow around 6% per year, well below the growth in the monetary base, Quantitative easing has not only been unnecessary but has also made monetary policy more opaque, leading some to falsely expect hyperinflation.

Despite this, our model of Fed policy, which compares the federal funds rate to nominal GDP growth, says the Fed is easy. A federal funds rate of essentially zero is well below the 3.5% nominal GDP growth rate (real GDP growth plus inflation). This should generate rising inflation and we think inflation is right now at a crucial inflection point.

We expect to look back in a few years and see that the present low readings were the lowest inflation would get. And we also believe it will become apparent that weak monetary velocity is the reason for current low inflation.

The expansion of government over the past several years, both in measurable terms like spending relative to GDP as well as hard to measure ways, such as the regulatory costs of Obamacare, are suppressing the economy's potential growth in a way that slows the circulation of money. As a result, for any given amount of money, we get less nominal GDP, including less real growth and less inflation.

Another issue might be the Fed's decision to pay banks interest on excess reserves. This new policy was implemented in late 2008. It could mean that a low federal funds rate is not as "stimulative" as the historical record suggests it should be.

Yet another issue may be simple "inflation inertia." It sometimes takes many years for loose money to generate higher inflation, especially when the public trusts the Fed to keep inflation low. For example, back in the 1950s, the federal funds rate averaged about 2% even as nominal GDP growth averaged 6 - 7%. But with the Bretton-Woods monetary system's gold peg firmly entrenched, inflation averaged 2.2% for the decade. It wasn't until the late 1960s that inflation became a problem.

If a similar pattern holds, we can expect inflation to rise from the current low, but not accelerate rapidly anytime soon.

However, in the end a price will be paid. Once unacceptably high inflation arrives, the same inertia helping hold inflation down will keep it up, so the Fed will have to tighten even more than it wants to wrestle inflation back down.

If Chairman Bernanke soon retires, he will get high marks for keeping inflation low, but his successor will have some problems to clear up. In other words, even though inflation has remained low, we don't expect it to stay that way for long.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-13 / 7:30 am	Initial Claims – June 8	346K	**345K**		346K
7:30 am	Retail Sales – May	+0.4%	**+0.7%**		+0.1%
7:30 am	Retail Sales Ex-Auto – May	+0.3%	**+0.4%**		-0.2%
7:30 am	Import Prices – May	+0.0%	**+0.0%**		-0.5%
7:30 am	Export Prices – May	-0.2%	**-0.2%**		-0.7%
9:00 am	Business Inventories – Apr	+0.3%	**+0.3%**		+0.0%
6-14 / 7:30 am	PPI – May	+0.1%	**+0.2%**		-0.7%
7:30 am	"Core" PPI – May	+0.1%	**+0.1%**		+0.1%
8:15 am	Industrial Production – May	+0.2%	**+0.1%**		-0.5%
8:15 am	Capacity Utilization – May	77.8%	**77.8%**		77.8%
8:55 am	U. Mich Consumer Sentiment- Jun	84.5	**84.7**		84.5