First Trust
Monday Morning OUTLOOK

630-517-7756 • www.ftportfolios.com

May 26th, 2015

Inflation: Dormant, Not Dead

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

Last month we explained why the dreaded threat of hyperinflation hasn't materialized, and likely wouldn't materialize, in spite of the huge expansion of the Federal Reserve's balance sheet the past several years, including QE1, 2, and 3.

The April inflation report, released Friday, underscored this theme. Consumer prices rose a tepid 0.1% in April and were down 0.2% from a year ago. With the exception of the Panic of 2008 and its immediate aftermath, that year-to-year decline was the lowest reading for inflation in 60 years.

However, this doesn't mean the US is experiencing deflation, or that inflation is dead. Quite the contrary. We expect inflation to pick up over the next few years, faster and further than most investors anticipate.

To see why, just look at the details of the April report. Yes, the very same report some thought was proof that inflation would never return.

First off, inflation data has been dominated by energy prices, which are down 19.4% from a year ago. Excluding energy, consumer prices are up 1.8% in the past twelve months (the same if we exclude food *and* energy). But energy prices were not going to fall forever and have already bounced back somewhat. As a result, the underlying trend of consumer prices should move back toward the "ex-energy" measure in the year ahead – to roughly 2%, or more.

But there are other reasons to believe inflation outside the energy sector should pick up. Normally, lower energy prices, because they boost purchasing power outside of energy, lead to an increase in demand for non-energy goods and rising prices in these other sectors.

But the drop in energy prices has been so sharp, consumers appear to be taking their time deciding how to spend the windfall. At the same time, tax receipts have soared which has drained purchasing power from many consumers. This temporary dip in demand has a short-term effect on inflation measures.

But people don't work for the heck of it; they work to generate purchasing power. And the gains from lower energy prices will eventually help sales in other sectors, which should also lead to higher prices in those sectors as well. We may be seeing signs of this already. In the past three months, "core" prices are up at a 2.6% annual rate and in the past two months they are up 2.9% annualized – the fastest pace in seven years.

In addition, housing costs, which make up almost one-third of overall consumer prices, continue to gradually accelerate. These prices were up 0.3% in 2009, 0.4% in 2010, then 1.9%, 2.2%, 2.5% and 2.9% from 2011 to 2014. In the past twelve months (thru April, they're up 3%). Meanwhile, with home builders still constructing too few homes to meet population growth and scrappage rates, supply constraints should help generate even faster rent hikes in the year ahead.

The bottom line is that monetary policy is too loose. The Fed has kept short-term rates near zero for more than six years. The last time the unemployment rate was falling to 5.4% (where it is today) during an economic expansion was in August 2004 and the Fed then had short-term rates at 1.5% and heading higher. If you go by the more expansive U-6 definition of the jobless rate (also includes marginally attached and part-time workers), which is 10.8%, it was also there in May 1994, when the fed funds rate was 4.25%.

The current looseness of monetary policy will eventually generate higher inflation. It may not be hyperinflation, but it's more than many investors are prepared for.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-26 / 7:30 am	Durable Goods – Apr	-0.5%	**-1.2%**	-0.5%	+4.7%
7:30 am	Durable Goods (Ex-Trans) – Apr	+0.3%	**+0.2%**	+0.5%	+0.4%
9:00 am	New Home Sales – Apr	0.508 Mil	**0.485 Mil**	0.517 Mil	0.481 Mil
9:00 am	Consumer Confidence – May	95.0	**95.6**	95.4	95.2
5-28 / 7:30 am	Initial Claims May 23	271K	**269K**		274K
5-29 / 7:30 am	Q1 GDP Preliminary Report	-0.9%	**-0.9%**		0.2%
7:30 am	Q1 GDP Chain Price Index	-0.1%	**-0.1%**		-0.1%
8:45 am	Chicago PMI	53.0	**51.5**		52.3
9:00 am	U. Mich Consumer Sentiment- May	90.0	**89.1**		88.6