First Trust
Monday Morning OUTLOOK

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Inflation Creeping Up

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The past several years have made many investors complacent about inflation. That complacency served bond bulls well. The more than 35-year bull market in bonds finished with the ten-year Treasury yield at 1.36% in July. But things are changing.

Inflation is already accelerating. The Consumer Price Index rose 2.1% in 2016, a sharp acceleration from the meager 0.7% gain in 2015. Today, figures on the Fed's preferred inflation measure – the PCE index – showed an increase of 0.2% in December, which means consumption prices were up 1.6% in 2016 versus only 0.6% in 2015.

If price gains average 0.2% per month in the next two months, then by February the PCE index will show a gain of 2.0% versus a year ago, putting inflation right at the Fed's target.

The threat of even higher inflation should be taken seriously whether your economic philosophy is conservative or liberal.

The M2 measure of the money supply – currency, checking accounts, savings accounts, small time deposits, and retail money funds – grew 7.1% in 2016, an acceleration from 5.7% the prior year. Banks have reduced excess reserves in the system by participating in repurchase agreements with the Fed and holding more bonds. However, there are still nearly $2 trillion in excess reserves in the banking system.

Unless the Fed removes those reserves, the money supply (M2), which Milton Friedman taught us to watch, will likely grow faster and boost inflation even more. Meanwhile, more rate hikes may encourage banks to lend more, boosting the money supply.

Any policy shifts that help stimulate real economic growth, like tax cuts, reducing regulations, cutting spending, or replacing Obamacare, can help hold off inflation over the next couple of years. Inflation is too much money chasing too few goods. So, more real growth helps hold down inflation.

Average hourly earnings increased 2.9% in 2016, the fastest pace for any calendar year since 2008. This is the kind of "cost-push" inflation which helps Keynesians and the Fed justify rate hikes and tighter monetary policy.

None of this means Jimmy Carter-style double-digit inflation is around the corner; it isn't. But after several years of a strange quiet on the inflation front, look for inflation to be in a higher 2.5 to 3% range by the end of 2017, with potentially more to come in 2018.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-30 / 7:30 am	Personal Income – Dec	+0.4%	**+0.4%**	+0.3%	0.1%
7:30 am	Personal Spending – Dec	+0.5%	**+0.5%**	+0.5%	+0.2%
1-31 / 8:45 am	Chicago PMI – Jan	55.0	**56.4**		53.9
9:00 am	Consumer Confidence – Jan	112.8	**113.1**		113.7
2-1 / 9:00 am	ISM Index – Jan	55.0	**55.1**		54.5
9:00 am	Construction Spending – Dec	+0.2%	**+0.2%**		+0.9%
afternoon	Total Car/Truck Sales – Jan	17.5 Mil	**17.3 Mil**		18.3 Mil
afternoon	Domestic Car/Truck Sales – Jan	14.0 Mil	**13.5 Mil**		14.2 Mil
2-2 / 7:30 am	Initial Claims – Jan 28	250K	**251K**		259K
7:30 am	Q4 Non-Farm Productivity	+1.0%	**+0.6%**		+3.1%
7:30 am	Q4 Unit Labor Costs	+1.9%	**+1.9%**		+0.7%
2-3 / 7:30 am	Non-Farm Payrolls - Jan	175K	**162K**		156K
7:30 am	Private Payrolls – Jan	170K	**154K**		144K
7:30 am	Manufacturing Payrolls – Jan	4K	**3K**		17K
7:30 am	Unemployment Rate – Jan	4.7%	**4.7%**		4.7%
7:30 am	Average Hourly Earnings – Jan	+0.3%	**+0.3%**		+0.4%
7:30 am	Average Weekly Hours - Jan	34.3	**34.4**		34.3
9:00 am	ISM Non Mfg Index – Jan	57.0	**57.2**		56.6
9:00 am	Factory Orders – Dec	+0.8%	**+1.0%**		-2.4%