First Trust
Monday Morning OUTLOOK

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The Economy, Inflation, and Interest Rates

With each passing week, the economic damage wrought by the Coronavirus and the resulting shutdowns grows larger. It's not just businesses, both small to large, feeling the pain. Educational institutions, hospitals, churches, not-for-profits, and state and local governments are all finding it hard to remain financially viable.

The US has essentially turned off broad swaths of the private sector – the ultimate and only source of income and wealth creation. Without the private sector, there is no money to pay for government, schools, healthcare, or charitable organizations. To make up for it, the US has resorted to an open-ended expansion of the Federal Reserve's balance sheet (and expanded their power) and huge increases in government borrowing and spending, the likes of which the US has never seen outside of wartime.

As in 2008, many are worried that huge increases in Quantitative Easing and money growth, along with the purchasing of debt directly from the market, will lead to much higher inflation. However, for today, that doesn't appear to be a problem. The consumer price index (CPI) fell 0.4% in March and is up only 1.5% from a year ago. This morning, West Texas Intermediate (WTI) oil was trading at $11 per barrel, the lowest level since the late 1990s, and 64% lower than its March average of $30.45. This suggests another negative number for the CPI in April.

But the drop in measured consumer prices in March was not just driven by lower energy prices. Other factors included lower prices for hotels, airline fares, and clothing. What do all these categories have in common? A massive drop in customers due to the shutdown.

Sure, hotels are cheap today, but almost no one is using them; hotel occupancy rates are down about 70% from a year ago. Yes, anyone who flies can get cheap seats, but the number of people going through TSA checkpoints is down 96% from a year ago. Clothing prices fell 2% in March as sales at clothing & accessory stores fell 50%. Who had time to buy clothes when you had to stock up on groceries and toilet paper?!?

In other words, prices for the actual items people bought in March probably did not fall as much as the CPI report suggested, and the same argument will probably apply to April, as well. Bottom line: in the near term, while it may look like deflation, that's not true for the average consumer.

As we look further out, official measures of prices will eventually turn back up. We see multiple broad forces at work on consumer price inflation, which should prevent us from lurching into either high inflation or Great-Depression-style persistent deflation.

Obviously the Fed's actions will boost various measures of the money supply. And the unusually generous unemployment benefits for many workers who have recently lost their jobs means those businesses that are trying to ramp up production will have to offer higher wages than usual to attract workers, which could feed through to higher end-prices.

However, in spite of these reasons to fear higher inflation, there is one big reason to avoid fearing hyperinflation: the demand for holding money balances, by both individuals and companies, is going sky high. The precedent of shutting down the economy will make cash King. That's the only way to survive. So, yes, the money supply will be much higher, but velocity will be much lower; people will hold cash dear.

While we think inflation measures will head back towards 2% - 2.5% in 2021, not much different than where they were immediately prior to the Coronavirus, hyperinflation is unlikely.

Interest rates will go up eventually, too, but don't expect a sharp rebound. After the Great Recession, the Fed didn't raise short-term rates again until late 2015, when the unemployment rate hit 5.0%. After the expected spike in joblessness in the next couple of months, it'll be a long time before we get back to 5.0% unemployment. Meanwhile, having witnessed two massive recessions in a row, investors will place an even larger premium on safety and risk-aversion than they have for the past decade, which will hold the 10-year yield down relative to the economic fundamentals we'll see in the eventual recovery.

We've never seen an economic shutdown like this before. The ability of people and government to panic like this changes nearly every economic calculation. For inflation, there are forces going both ways. Only time will ultimately tell.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-21 / 9:00 am	Existing Home Sales – Mar	5.250 Mil	**5.240 Mil**		5.770 Mil
4-23 / 7:30 am	Initial Claims – Apr 18	4.500 Mil	**4.941 Mil**		5.245 Mil
9:00 am	New Home Sales - Mar	0.640 Mil	**0.635 Mil**		0.765 Mil
4-24 / 7:30 am	Durable Goods – Mar	-12.0%	**-13.5%**		+1.2%
7:30 am	Durable Goods (Ex-Trans) – Mar	-6.0%	**-6.5%**		-0.6%
9:00 am	U. Mich Consumer Sentiment- Apr	67.4	**71.0**		71.0