First Trust
Monday Morning OUTLOOK
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Inflation and The Fed

We believe inflation is still, and always will be, a monetary phenomenon. It is defined as "too much money chasing too few goods and services" – but that doesn't mean every period of higher inflation is going to look exactly the same.

Today's case for higher inflation is easy to understand. The M2 measure of the money supply is up about 25% from a year ago, the fastest year-to-year growth in the post-World War II era. And while measures of overall economic activity such as real GDP and industrial production are still down from a year ago (pre-COVID), Americans' disposable incomes are substantially higher, boosted by massive payments from the federal government with more "stimulus" on the way.

Right now, the consumer price index is up only 1.7% from a year ago. But, this year-ago comparison is set to soar to 2.5%, or higher, as we drop off the big declines in prices we saw during February - April 2020. The extent of this increase will likely be held back by the government's measure of housing inflation (which only focuses on rental values, not home prices). Excluding rents, inflation will be more like 3.0% this year, and will likely move up by about another percentage point in 2022.

Producer prices are already up 2.8% from a year ago, with much faster growth in prices further up the production pipeline.

Does this mean we are heading back to double-digit inflation, bell-bottoms, disco balls, and the return of Jimmy Carter-style stagflation?

We think we are a long way from that. As Mark Twain once said, "History doesn't repeat, but it often rhymes." In the 1970s, if the Fed would have fought inflation harder early on, we would have never seen it hit double-digits. As a result, for now, we are thinking more of the late 1980s, not the 1970s.

Consumer prices rose only 1.1% in 1986 as oil prices collapsed, but then it revived in 1987, rising above 4.0% by late Summer. To fight this rise in inflation, the Fed raised short-term interest rates by about 140 basis points, to about 7.3% from 5.9% towards the end of 1986.

As the 10-year bond yield rose in 1987, the stock market took it on the chin and crashed in October. Alan Greenspan responded by providing as much liquidity as needed to restore confidence in the financial markets, and had the Fed cut short-term rates through early 1988. The money supply didn't soar, but short-term interest rates were lower than the trend in nominal GDP growth (real GDP growth plus inflation), signaling loose monetary policy.

Once the smoke cleared from the stock market crash, the Fed found itself behind in the inflation-fight. Inflation jumped to 5.4% in 1989, before Iraq invaded Kuwait, and then higher oil prices from the war pushed it to 6.3% after the invasion.

As a result, the Fed eventually lifted short-term rates to almost 10.0% to get inflation under control. The result was the tight-money-induced recession of 1990-91, which some still wrongly blame on the Iraqi invasion.

We don't know if the late-1980s pattern is the one we're about to follow. What we do know is that just like with the stock market crash of 1987, the Fed has demoted inflation as its top concern and pushed COVID recovery to the top of its list. Letting M2 growth rise to 25%, and holding rates at basically zero, in spite of an economic recovery, is the proof.

The biggest question is how quickly the Fed turns its attention to inflation as it builds and how far will they go to fight it. In the 1970s, it was double-digit inflation, in the 1980s, it was 5% to 6% inflation.

Either way, this Fed has made it clear that it will remain easy through 2022. As are result, we remain bullish on the economy and stocks, but cautious on bonds as inflation picks up. We all need to wait until 2023 to see what history we rhyme.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-15 / 7:30 am	Empire State Mfg Survey - Mar	14.5	**15.0**	17.4	12.1
3-16 / 7:30 am	Retail Sales – Feb	-0.5%	**-0.5%**		+5.3%
7:30 am	Retail Sales Ex-Auto – Feb	+0.1%	**+0.7%**		+5.9%
7:30 am	Import Prices – Feb	+1.1%	**+1.2%**		+1.4%
7:30 am	Export Prices – Feb	+1.0%	**+0.8%**		+2.5%
8:15 am	Industrial Production – Feb	+0.4%	**+0.2%**		+0.9%
8:15 am	Capacity Utilization – Feb	75.5%	**75.7%**		75.6%
9:00 am	Business Inventories – Jan	+0.3%	**+0.3%**		+0.9%
3-17 / 7:30 am	Housing Starts – Feb	1.555 Mil	**1.538 Mil**		1.580 Mil
3-18 / 7:30 am	Initial Claims – Mar 14	700K	**720K**		712K
7:30 am	Philly Fed Survey – Mar	24.0	**25.7**		23.1