

The Fed's inflation target is within reach

Rampant inflation is unlikely despite policy rhetoric

There have been false dawns before, but a combination of solid economic momentum, a tight labour market, higher commodity prices and a stable dollar should help the Fed to finally reach its inflation target after falling short for most of the past decade. Politics could add an additional boost to inflation, but the Fed has hinted that it would be willing to tolerate inflation overshooting the target temporarily.



“We are not trying to engineer an overshoot of inflation, not to compensate for past undershoots. Two percent is our objective but it is a symmetric objective.”

Janet Yellen

The headline inflation rate in the US accelerated to 2.7% YoY in February, the highest level since 2012. With the oil price more than 40% higher than a year ago, the annual rate was boosted by a low base

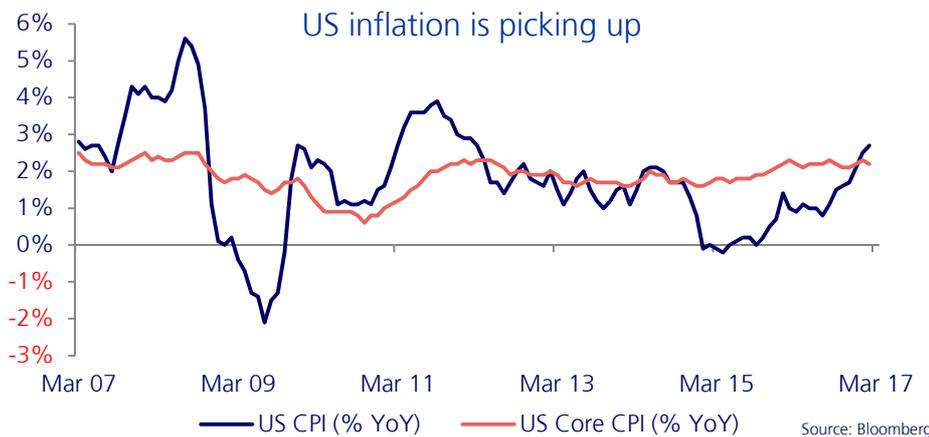
comparison as energy prices bottomed in February 2016. Transportation represents about 15% of the basket that forms the basis of the US Consumer Price Index (CPI) and is highly correlated with the oil price, which usually makes it the most volatile part of headline inflation. Having been a drag on inflation until September last year, transportation has increasingly added to the overall price pressure in recent months and became the second largest contributor to

inflation in February, adding 1 percentage point. However, with the energy price base effect peaking in February, the contribution from transportation and other energy-related items to inflation is expected to fade if oil prices remain close to their current levels. Headline inflation should therefore moderate over the course of the year.

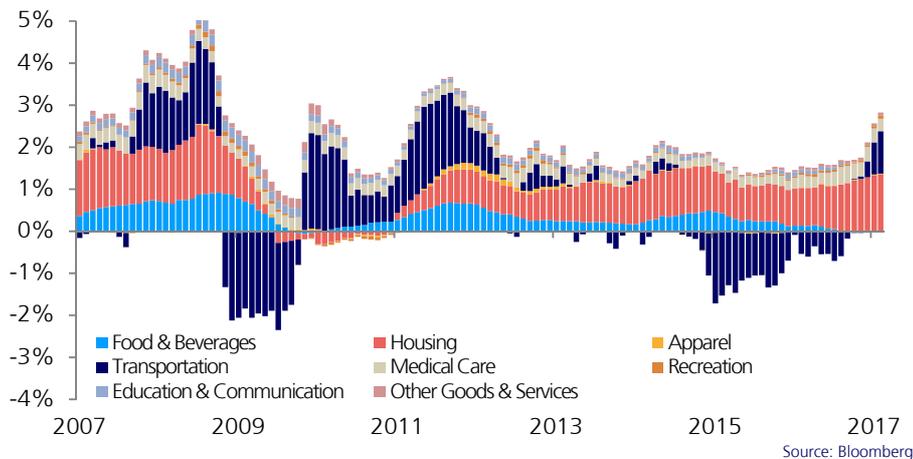
Housing lifts core inflation

While the energy boost to the inflation rate is expected to disappear relatively soon, core components will continue to push prices up. Service inflation, representing the lion's share in core inflation measures, has steadily been grinding higher in recent years. Housing and healthcare are key components of both Core CPI and the Core PCE price index, with the latter putting more weight on healthcare costs while housing is the single most important basket item to measure CPI.

Housing, which represents more than 40% of the CPI basket and has a significant weight in the PCE Core price index as well,



Housing and transport are the biggest CPI contributors (% YoY)



has been a relatively constant and steady source of rising inflation in the past few years. An improving economy with solid employment growth and rising wages has continuously lifted the demand for housing. At the same time, supply has been lagging. The resulting mismatch has been driving up shelter costs, the most significant factor in the housing basket, to an annual rate of 3.5% at the beginning of this year. As housing supply is only gradually picking up, shelter costs are expected to rise further in the near term, adding to inflationary pressure for both headline and core inflation. However, historically shelter costs and housing inflation have been correlated with house prices. Given that a number of national house price indicators have started to moderate recently, housing inflation may soon be peaking.

Medical care, representing roughly 8% of the CPI basket, but more than double that in the PCE Core index, constantly added between 0.2 and 0.4 percentage points to headline CPI inflation over the last decade. While the annual growth rate of medical care costs has slowed down from its recent multi-year high, the underlying demographic trend and the constantly increasing demand for healthcare services will keep pushing medical care costs higher.

Fed may tolerate inflation to overshoot
Housing and healthcare cost will keep supporting core inflation measures. The PCE Core price index, the Fed's preferred inflation measure, slowly climbed to 1.7% YoY in January and is thus still some way off the Fed's target of 2%. Given the solid pace of service inflation and the recent pickup in

both durables and non-durables prices, the PCE Core price index is expected to slowly rise over the course of the year. Nevertheless, the Fed is in no hurry to tighten monetary policy aggressively. Its latest statement contained a newly introduced emphasis on the symmetry of the inflation goal. This seems to imply that the Fed could live with a short period of inflation overshooting the 2%-target, in particular if wages keep rising at a relatively moderate pace in response to higher inflation. In fact, the Fed recently lowered its longer run expectation for the equilibrium unemployment rate to 4.7%, indicating that it thinks the labour market can tighten further before it leads to a significant acceleration of inflation rates.

Inflation expectations are receding

While the Fed is right to watch wage developments, a number of research papers show that the relationship between wage growth and inflation is broken. If anything, the causality seems to go from higher

inflation to rising wages rather than the other way round. Despite the weaker relationship, the Fed will keep a close eye on wage growth to avoid any resurrection of a wage-price spiral. It is therefore reassuring for the Fed that wage growth is not excessive so far. Interestingly, the latest NFIB small business survey signals a lower willingness to increase wages despite increasing challenges to fill open positions.

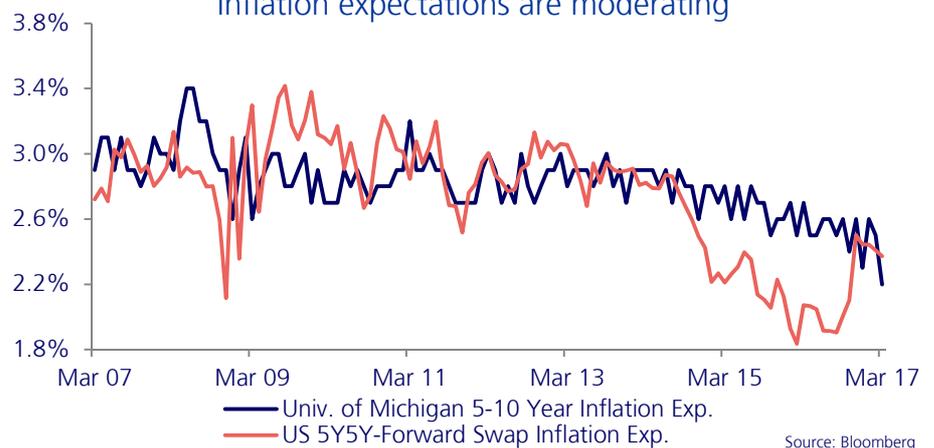
While a wage-price spiral seems a distant threat so far, the Fed will closely watch inflation expectations for any signs of a potential de-anchoring. However, survey-based measures have not yet picked up markedly. Quite the contrary, the University of Michigan's longer-term inflation expectations survey has fallen to the lowest level on record in March, underlining that rising prices are not a major worry for households.

Market-based inflation expectations have soared in the aftermath of Trump's election victory, bringing them back in line with survey-based measures. Investors are anticipating growth-enhancing and potentially inflationary policies by the new administration. Although market-based inflation measures have a relatively poor track record of forecasting actual inflation, politics may indeed have a significant impact on inflation in coming quarters.

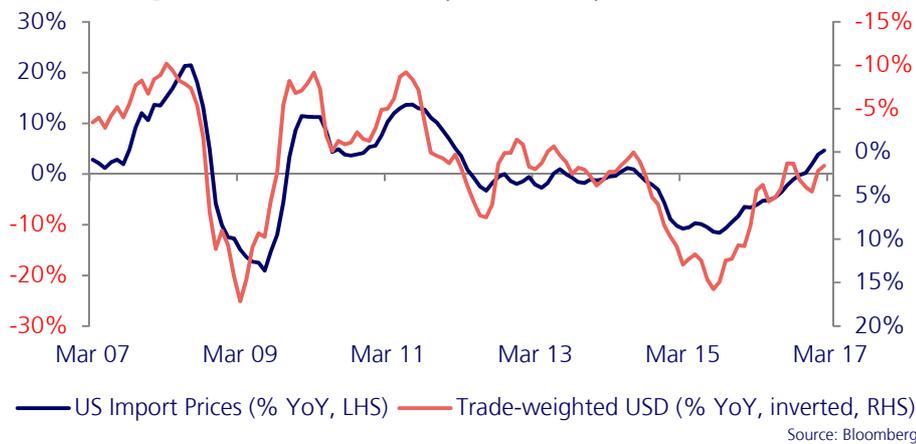
The Trump effect: taxes and tariffs could lift inflation

While currently still short on details, Trump announced plans for more fiscal spending, infrastructure investment and tax cuts for both households and companies during his election campaign and after taking office. A

Inflation expectations are moderating



A stronger dollar would dampen the impact of a border tax



fiscal stimulus when the output gap is already small would push inflation rates higher and would most likely be countered by more aggressive Fed tightening. However, as fiscal measures have not yet been debated in Congress, let alone implemented, any meaningful effect is more likely to be felt in 2018 and later.

Import tariffs or a transition to some form of a destination-based tax system with border-adjustment (BTA) as presented in Paul Ryan's corporate tax reform plan would have a direct impact on inflation. Switching to a BTA system would disallow the deduction of the cost of imported goods when calculating tax payments. Economically, the impact would be similar to imposing a tax on imports as the after-tax cost for imports would rise.

Both import tariffs and border taxes would therefore lead to higher inflation rates, although the effect would be only transitory. The amount by which inflation would rise depends on the degree of pass-through of the higher import costs, which will vary a lot between different industries. Firms in sectors with less price-sensitive customers or little substitution will find it easier to pass through the higher cost.

The total import content of the Core PCE index is estimated to be about 13%, once import costs of intermediate goods that contribute to final goods produced in the United States are taken into account. Assuming a pass-through of 70-80%, import tariffs or border taxes would have a

substantial near-term effect on inflation. However, broad-based import tariffs or a complete transition to a destination-based tax system with border adjustment seems unlikely given strong opposition from different interest groups. Any import tariffs would target specific industries. In the case of a border tax, there would most likely be sector-specific exemptions designed to mitigate the detrimental impact on the US economy.

Stronger USD would soften the impact

A key feature of a destination-based tax with border-adjustment would be to exempt export revenues from taxation. Compared to the current situation this would lead to lower input costs for US companies selling their products abroad, making them more competitive and potentially increasing the demand for US products. As the price elasticity of US imports is larger than the one for US

exports, the US trade deficit would narrow. In fact, this would be one of the Trump administration's key objectives to impose import tariffs or introduce a border tax.

An increasing demand for US products and a narrowing US trade deficit would lead to an appreciation of the dollar. A stronger dollar dampens the inflationary impact of a border tax. But again, the pass-through of a rising dollar would only partially compensate the border tax and would come with a lag. Therefore, the overall effect of import tariffs or a border tax on inflation would be positive but transitory.

Conclusion

The Fed has failed to reach its inflation target of 2% for almost every single month since the end of the recession in 2009. While economic momentum went through ebbs and flows, a strengthening dollar and a steep fall in energy prices have been headwinds for inflation. These headwinds have now faded while the economic outlook remains solid and the unemployment rate is close to its equilibrium rate. Headline inflation was boosted by the energy base effect and is likely to peak soon. Meanwhile, core inflation is expected to slowly grind higher going forward. Inflation could be further lifted by fiscal policy or new import tariffs. However, these effects would be transitory and the Fed seems willing to tolerate inflation to temporarily overshoot its target. The link between wages and inflation has been weak in recent years but the Fed will keep a close eye on the relationship as it will want to prevent the potential ignition of a wage-price spiral.

A loose relationship between wages and inflation



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