Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

MARCH 4, 2014

INFLATION: THE LONG-TERM PERSPECTIVE

Yesterday we learned that the core personal consumption expenditures (PCE) measure of consumer price inflation rose just 0.1% in January. As a result, the year-over-year core PCE measure fell to 1.1%, down from 1.2% in December—the lowest year-over-year rise since March 2011.

Like her predecessor, newly-minted Fed Chair Janet Yellen labeled the factors behind low inflation as "transitory" in her February Humphrey-Hawkins testimony. Where Yellen pointed the finger at "oil prices" and "import prices," in June 2013, Bernanke attributed muted inflation to medical care anomalies.

But persistent low inflation seems to be more than "transitory." Since "Helicopter Ben" took the helm of the US Federal Reserve in 2006, US inflation averaged year-on-year increases of 1.7%. Since the FOMC officially adopted an explicit 2% target in January 2012, inflation averaged 1.5%; and since Bernanke called the persistently low level of inflation "transitory" in June 2013 it has averaged just 1.2%.

The explanation? A sluggish economy? Maybe. Slack in product and labor markets? Perhaps. A long lag (quarters, even years) between economic activity and measured inflation? Probably. But we suspect longer-term structural trends in the price index have fundamentally overwhelmed the impact of business cycle swings and monetary policy.

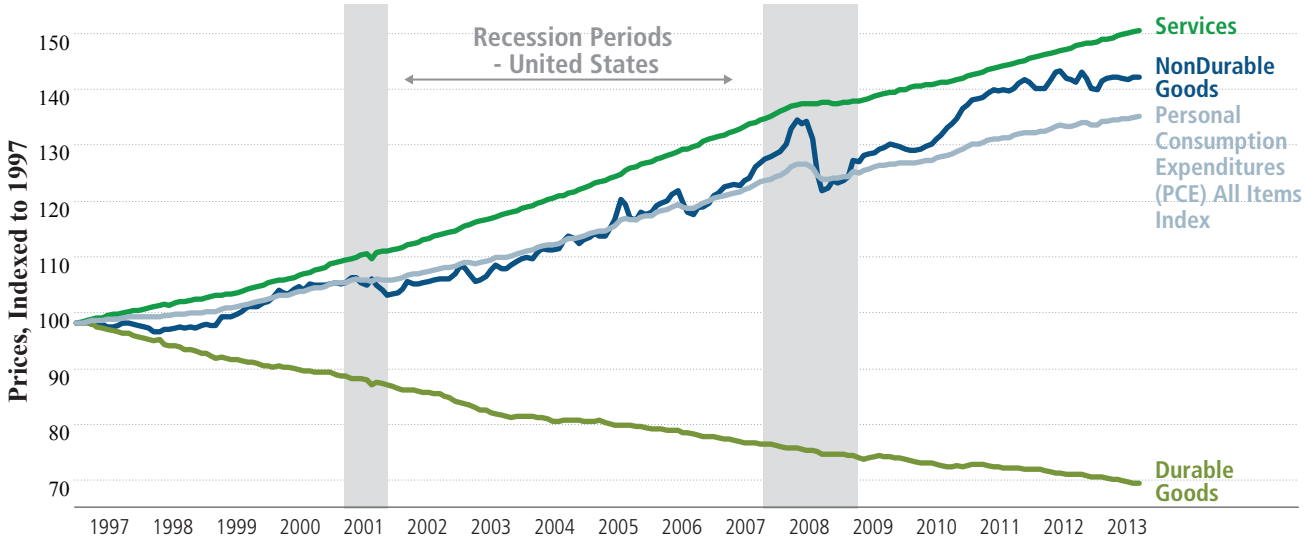
In the chart below, we divide the overall personal consumption expenditures (PCE) index into three major categories: durable goods, nondurable goods and services.

First, durable goods: these are things like washing machines, computers and automobiles, which comprise 11% of consumer expenditures. Durable goods prices have steadily fallen since 1997. In particular, the computer price index plummeted 95% over the same time period. The trend of falling prices (a good thing for consumers) should continue to weigh on the overall price index in 2014 and beyond—since price declines began, the broad downtrend has continued unabated through two recessions.

Meanwhile, spending on services, which comprises two-thirds of consumer spending, provides the counterweight to the durables "deflation" component. Services prices rose 50% since 1997 as education, housing and medical care prices increased steadily. But more and more services face automation and lower costs—think video cassette rentals. In 1991, Blockbuster video maintained inventory and employed thousands of employees in the US. In 2014, Netflix, with 3,000 employees, provides a superior service. A better service can now be furnished at lower cost to the consumer. We think the disinflationary pressures are only now beginning to ripple through the services sector. Indeed, since the recession, the average year-over-year increase in the services component slowed to just 2% from 3% during the earlier part of the decade.

THE INFLATION STORY: TRENDS THAT ARE MORE THAN "TRANSITORY"

PCE Inflation By Major Category: Durables, Nondurables, Services



Source: Bureau of Economic Anaylsis

While the two major categories above (durables and services) play tug-o-war with overall inflation, the third category of nondurable goods, bounces around the average with energy prices at the helm. As Yellen noted, the recent stabilization of oil prices has briefly tranquilized overall inflation. Looking longer-term, though, perhaps the surprise will be lower energy prices, not higher ones? Only consider the fact that rail car shipments of oil in the US breached 25-year highs (a booming supply) and the fact that miles-driven by US drivers declined for the first time in a generation (falling demand) and we can build a case for weaker energy prices.

For investors, two conclusions are worth noting: 1) Steady growth in the services component will likely keep overall measured inflation hovering just under 2%. Deflation is not an imminent risk unless one foresees falling service prices. 2) Continued soft overall inflation readings (at just 1.1% in January) suggest actual inflation will undershoot the Fed's inflation target (2%) again in 2014. If the majority of FOMC members continue to see broad labor market weakness and sluggish economic growth as the causes of soft inflation, zero fed funds will persist for longer.