Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

FEBRUARY 13, 2015

INFLATION AS A BAROMETER

For central bankers, inflation serves as a key barometer of overall economic health. So what does it mean that inflation in the US, UK, euro area and Japan are all very low?

Well, it depends.

The context in which low inflation appears matters. This week San Francisco Fed President John Williams explained to the *Financial Times* the way the FOMC is thinking right now about low inflation. John Williams is worth listening to. He served under Fed chief Janet Yellen as executive vice president and director of research during her time as President of the San Francisco Fed from 2004 to 2010.

As Williams quipped to the *FT:* "If the unemployment rate today were 8 or 9 percent and we had the inflation data we do today I would be more concerned about disinflationary pressures or downside risks to inflation. Because you have a weak labour market plus a supply shock pushing inflation down. Today there is still slack in the labour market but we have an improving labour market and one that I have high confidence will be at full strength within a year or so. That changes that whole thought process."

Back in 2010, on the eve of QE2, Fed officials worried about low inflation. But at the time the unemployment rate was above 8% and nonfarm payrolls were contracting at an average of -0.7% year-over-year. Low inflation in that context signaled economic weakness.

Today, while consumer prices are low, much of the downward pressure seems to be due to falling energy prices and a stronger dollar, which will boost household purchasing power. Better purchasing power will provide a tailwind to consumer spending. This is also true in the UK. Bank of England Governor Mark Carney remarked during the introduction of the Inflation Report this week that "two-thirds of the gap between the current inflation rate and the target" to was due to "sharp falls in food and energy prices," adding: "This is generally good news for British households."

Back in the US, President Williams also suggested that the Fed wants to downplay the precise "liftoff" date and emphasize the data-dependent nature of the rise in rates. Much like policymakers sought to downplay the precise month in which tapering would begin and instead focus on the process, we think rate hikes will proceed in a similar fashion. Investors take note: the Fed has no plan for the path of rates for years into the future. Incoming economic data will determine the path of interest rates.

In terms of the current data, central bankers this week furthered the case that low inflation--since it does not signal economic weakness as it did in 2010--will not be an impediment to a mid-year rate hike. We'll learn more next week with the release of the FOMC minutes from its January meeting.