Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

MAY 22, 2015

Core to the Fore

Ignore the headline consumer price index (CPI) and focus on core CPI—that's our message to investors as we head into the Memorial Day weekend in the US and celebrate the unofficial arrival of summer. A faster rate of core consumer price inflation supports our call for a rate hike sooner rather than later.

Friday's release of the Labor Department's gauge of consumer prices, the CPI, saw headline CPI fall -0.2% year-over-year in April, prompting newspaper headlines touting "deflation" in the US. But core CPI rose 0.3% in April, the biggest one-month gain in that price gauge in more than two years. And it goes beyond April. Core CPI has accelerated to start 2015, rising at a 2.6% annual rate over the first four months of the year.

On a year over year basis, core CPI is now up 1.8%, already very close to the Fed's 2.0% policy target. Doing the math, if we were to see a few more months of inflation like we saw in the April report, core CPI would breach the 1.8-2.0% target by June. If instead the core CPI post monthly sequential gains of just 0.2%, inflation will breach the all-important 2% threshold by August.

With core measures of inflation back above 2% this summer and the unemployment rate nearing 5%, why is the federal funds rate still stuck at zero? That's a great question—and one policymakers will wrestle with all summer long.

One answer is that policymakers focus on a separate gauge of prices when contemplating inflation, the core personal consumption expenditures (PCE) price index. While the CPI and PCE differ, over time they tend to move in the same direction with about a 0.3% (30 bps) difference between the two gauges. For example, a core CPI reading of 2.2% by this fall would be consistent with a core PCE reading of 1.9%--which is dead-on inside the Federal Reserve's 1.8-2.0% target range.

While we are more than happy to quibble over the differences between the two indices, we think the real takeaway for investors is that inflation is running at around a 2% rate, maybe a bit less, which is right in line with Fed goals.

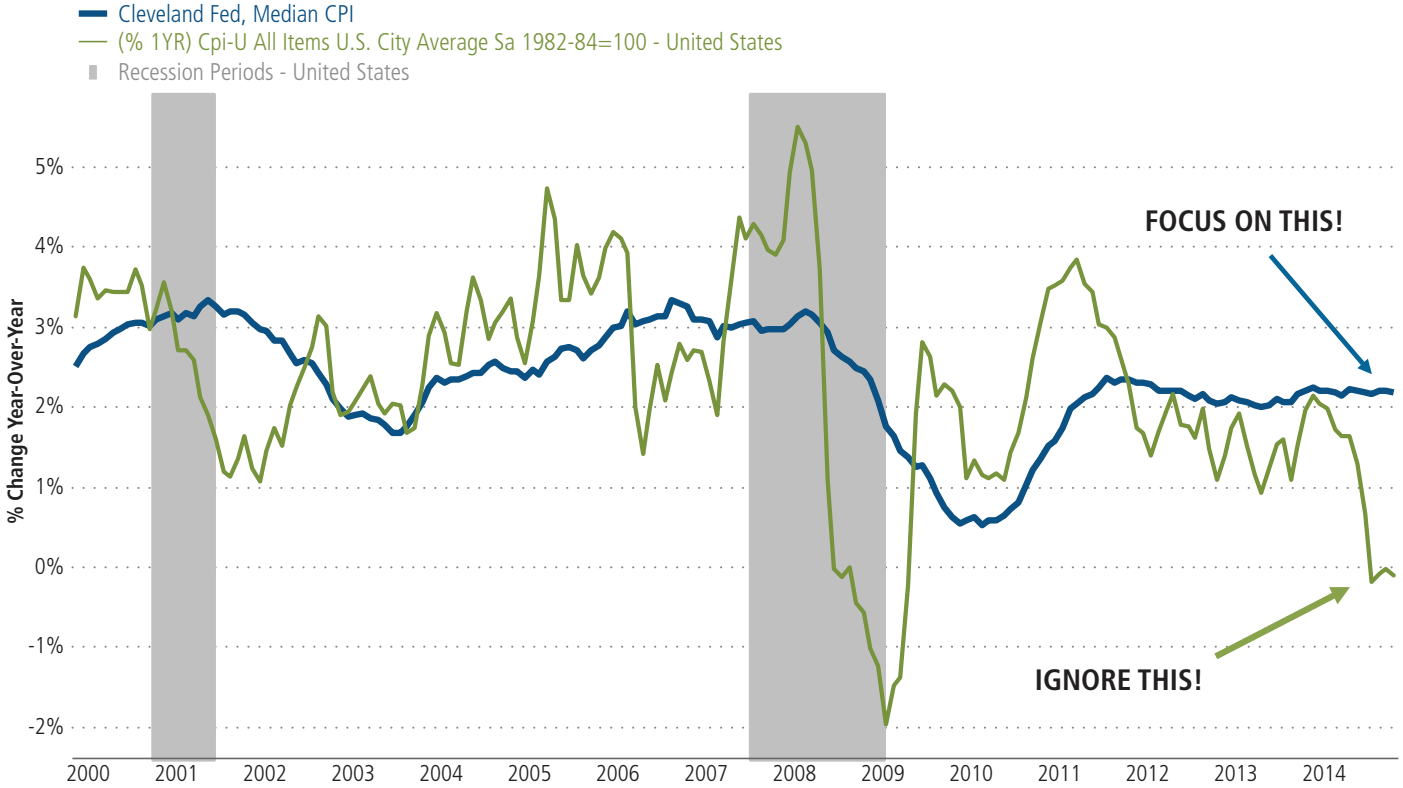
Further, Fed officials have indicated that they seek further information that shows "continued progress" in the labor market and "reasonable confidence" that inflation will return to 2% by next year. Today's CPI report should provide more confidence for that view.

Speaking in Rhode Island this afternoon Fed Chair Janet Yellen parroted the FOMC view that it "will be appropriate sometime this year to take the initial step" in hiking the federal funds rate. She "will need to see continued improvement in labor market conditions" and "be reasonably confident that inflation will move back to 2 percent over the medium term" before taking that step.

Fed officials have said that ALL FOMC meetings are on the table for the first rate hike ("liftoff"), so that includes June, July or September. The June meeting is a low probability option but we think an option nonetheless, especially after CPI reports like the one we saw this morning.

As a result, for investors, we think there is still upside risk to interest rates, whether it is 2-year yields or 10-year yields. We think complacency is widespread among bond investors. The "slow growth, no inflation, no wage growth" view is way, way too popular. If we're right in our outlook, the incoming data will seriously challenge that view and today's CPI report was a glimpse into that challenge. Two-year Treasury note yields jumped 5 basis points today in the wake of the CPI release.

Median IS the Message: While Headline CPI Jumps High, Then Low, Then High, the Median CPI (Which Strips out Outliers) Has Shown Inflation Consistently at ~2% Since 2010



Source: Bureau of Labor Statistics and Cleveland Fed

Research from the Cleveland Fed argues two important points on why to look at median measures of inflation rather than headline measures: 1) "the median CPI is useful tool for forecasting inflation. As such, it should prove useful in helping to gauge room between the near-term trend and the new inflation threshold" and 2) it doesn't exclude specific categories. "It's simply the price change in the middle of the distribution."