Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

OCTOBER 24, 2014

BOO

"What should I be for Halloween?" The text message flashed on my smart phone while I sat in a meeting earlier this week.

"Go as inflation expectations."

My brother, a high school teacher with little interest in financial markets, shot back: "Huh?"

So I explained: "Falling inflation expectations always seem to be enough to frighten the world's most powerful central bankers into action. Try it out on your students and colleagues."

Needless to say, he ignored my advice and chose another costume.

But the point stands: as what we at Payden like to call "the Halloween FOMC meeting" approaches next week, disinflation haunts central bankers.

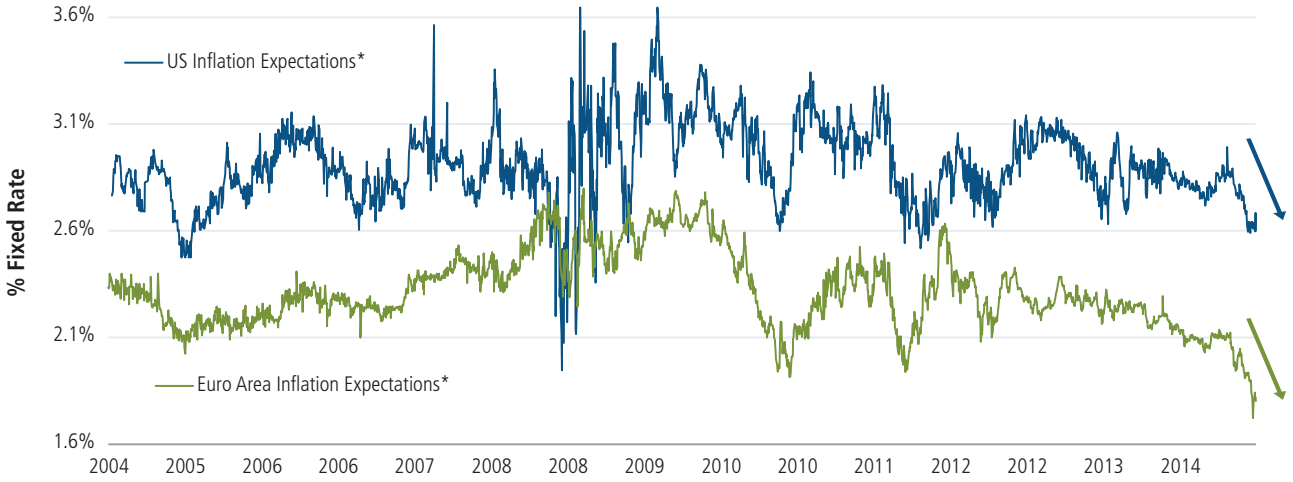
In the US this week we learned that core inflation dipped to 1.7% year-over-year in September. Since this measure produced by the Bureau of Labor Statistics tends to overstate inflation in the Fed's preferred gauge by 50 basis points, we expect central bankers to raise a few eye brows. Add to that the fact that the only major component of the index that is really "inflating" is the housing component. CPI ex food, ex energy and ex housing is up just 0.9% over the last year. Further, we don't think rising monthly rents and disinflating everything else is the inflation mix for which the Fed had hoped.

Importantly, this is not a US story. Of the 46 countries with "inflation targets" 30 are experiencing below target inflation. The vast majority of countries on Earth have inflation below 3%. But it isn't just inflation today that is low. Expectations of future inflation—a key determinant of actual future inflation in macro models employed by the world's technocrats—have also declined significantly since the summer. A quick look at inflation expectations out of the US and euro area provide plenty of "boo" for policymakers. US CPI swaps fell from 2.9% at the beginning of August to 2.6% today. Euro area CPI swaps fell from 2.1% to 1.8% over the same time period (see chart below).

Cautiously, some of our traders tell us, "Well it's just oil pushing inflation expectations lower," or "The stronger dollar only pushes inflation lower today, not in the future." To which we hastily reply: "It matters less what's behind the move than the move itself." Once ingrained, lower inflation expectations prove mighty difficult to dislodge. Japanese policymakers have wrestled with this fact for nearly two decades. But, now, it's no longer isolated to an island nation in the Pacific.

More important for investors, though, falling inflation expectations often precede monetary policy shifts. In the summer of 2010, falling inflation expectations prompted talk of QE2, which eventually arrived at the Halloween FOMC meeting. In the summer of 2011, right after QE2 ended, the Fed unveiled Operation Twist as the economy stalled, jobs disappointed and, yes, inflation expectations tumbled. In 2012, a fall in inflation expectations presaged QE3's launch and the adoption of the famous Evan's Rule (interest rates stay at zero at least until we see 6.5% unemployment, and so long as inflation stays below 2.5%).

WHAT SCARES CENTRAL BANKERS? BOO! INFLATION EXPECTATIONS HAVE DECLINED SUBSTANTIALLY IN 2014



Source: Bloomberg

**As a proxy for long-term inflation expectations, we plot 5-year 5-year CPI swaps denominated in EUR and USD. A 5-year 5-year CPI swap is a derivative trade where one party agrees to pay a fixed rate, receiving the floating future inflation rate for five years, starting five years in the future.*

So what's different in 2014? In our view the US economy in particular is in much better shape. We've experienced nearly four years of steady job growth. That said, global growth, trade, and inflation look worse. Perhaps the data are not enough to drag down the US economy but the impact on US inflation is worth noting. As the world's foremost inflation-targeting central bank, global disinflation and falling inflation expectations will not go unnoticed by the Fed: whether they choose to acknowledge the backdrop at the meeting next week or prefer to ignore it and hope for a revival by the December meeting is another question.

Long telegraphed to end at the October meeting, prolonging QE3 is perhaps a low risk, easy commitment that would prove the central bank really is data dependent and worried about both sides of the dual mandate. At the very least, acknowledgement of persistently low US and global inflation could jump off the page in the 900+ word post-meeting policy statement. Any hints of an imminent move toward tighter policy should be absent--an important departure from market expectations/worries of just a few weeks ago.

As we approach the "Halloween FOMC meeting," watch out for central bankers frightened by inflation expectations.

Boo.