March 01, 2018

Economics Group

Special Commentary

Sarah House, Economist
sarah.house@wellsfargo.com • (704) 410-3282
Ariana Vaisey, Economic Analyst
ariana.b.vaisey@wellsfargo.com • (704) 410-1309

Inflation Outlook: Green Shoots or a False Spring?

Executive Summary

Low inflation has kept the Fed on a restrained path of tightening so far this cycle. Recent inflation data, however, have reinforced our view that price pressures are picking up. Core readings of both the Consumer Price Index (CPI) and PCE deflator posted solid gains to start the year. Alternative measures of core inflation have also perked up, while input costs—including labor—are rising. Notably, markets have started to come around to the prospects for higher inflation, fueled by bets that fiscal stimulus at this late stage of the economic cycle will finally lead to a breakout in inflation.

We still expect the pickup will remain orderly, however. Core inflation tends to adjust slowly around its longer-term trend, while structural headwinds that have weighed on inflation are not suddenly disappearing. Profit margins also look historically high economy-wide, suggesting at least some scope for businesses to absorb higher input costs, although this need not be the case if productivity improves. While the recently-passed tax plan will support household spending, inflation will likely be contained by stronger capital spending boosting productivity and lower tax rates helping firms absorb rising labor costs. We look for the PCE deflator to reach 2 percent as soon as the second quarter, with core inflation rising to 2.0 percent by the fourth quarter. The clearer upward trend should be enough for the Fed to move forward with further policy tightening, but shouldn't be so extreme for the FOMC to significantly ratchet up the pace of rate increases.

Core inflation tends to adjust slowly around its longer-term trend.

Turning Up

Inflation has once again started the year strong. The 0.5 percent rise in CPI matched the upper end of the range of monthly increases in recent years. More telling was the 0.3 percent rise in core CPI. That brought the three-month trend up to a 2.9 percent annualized rate, which is the strongest pace in more than six years (Figure 1). Core PCE inflation also started the year with an above-trend 0.3 percent increase and has risen at a 2.1 percent clip over the past three months.

Inflation has once again started the year strong.

Figure 1

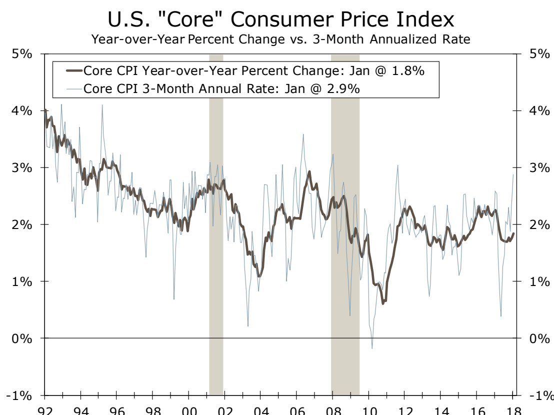
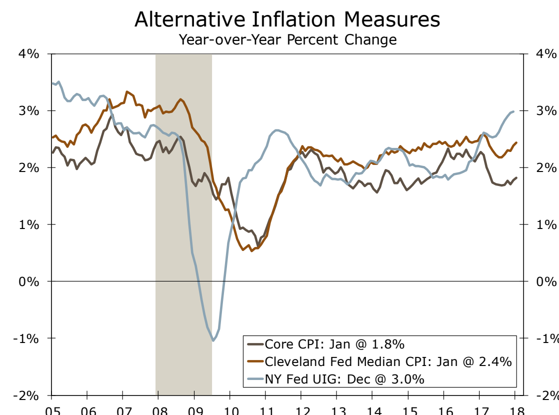


Figure 2



Source: U.S. Dept. of Labor, Federal Reserve System and Wells Fargo Securities

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

The increase in core CPI was particularly impressive given that the latest seasonal adjustment factors from the Bureau of Labor Statistics appear to do a better job controlling for the tendency for firms to raise prices in the first few months of the year. That said, January still tends to see the strongest monthly increases in core CPI even after the new seasonal factors. The most recent reading was also boosted by an uncharacteristically large rise in apparel prices—one of the most volatile components of the core index, which suggests high potential for payback over the next month or two.

There are other signs of inflation strengthening beyond just the latest monthly CPI and PCE readings.

There are other signs of inflation strengthening beyond just the latest monthly CPI and PCE deflator readings. A number of alternative measures of core inflation have turned higher in recent months. The Atlanta Fed's Sticky CPI, which excludes items that change prices frequently (e.g., apparel), is also rising at nearly a 3 percent annualized pace over the past three months. Even "sticky" prices can experience shocks from time to time, as last year's drop in wireless services showed, but the Cleveland Fed's Median CPI has picked up more sharply in recent months than the traditional core CPI (Figure 2). Meanwhile, the newest addition to the Fed's club of alternative inflation measures, the New York Fed's Underlying Inflation Gauge, is rising at the fastest pace since 2006. The UIG incorporates a broader range of price measures than sub-indexes from the CPI and PCE deflator and includes an array of macro and financial variables.

Businesses are also reporting prices rising at a faster pace (Figure 3). Higher commodity prices have driven the prices paid component of the ISM manufacturing index to nearly a seven-year high, but non-manufacturers have similarly reported rising input costs. Small businesses have also stepped up the pace of price increases over the past year.

Figure 3

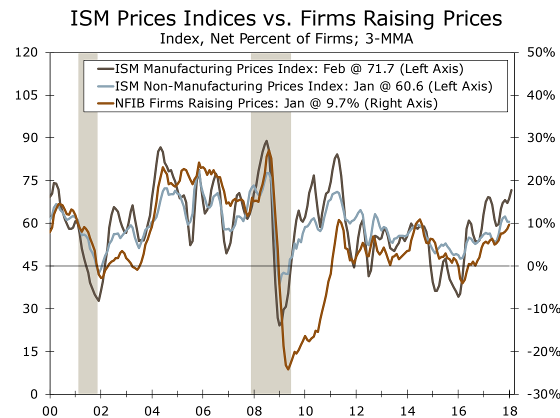
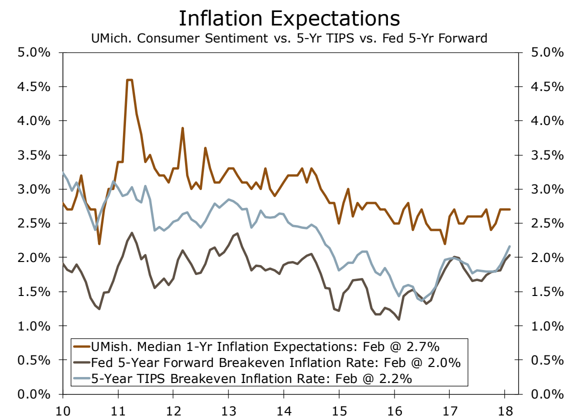


Figure 4



Source: ISM, NFIB, University of Michigan, Bloomberg LP and Wells Fargo Securities

Importantly for inflation's near-term prospects, inflation expectations are starting to move higher. Market-based measures have climbed roughly 20 basis points since the start of the year, putting them near the top of the range that has prevailed since commodity prices swooned (Figure 4). Consumer expectations have been more stable in recent years, but short-term views on inflation have similarly risen to the upper end of their recent channel.

The widening signs of higher inflation come as the U.S. economy is finally firing on all cylinders.

More Inflation to Come

The widening signs of higher inflation come as the U.S. economy is finally firing on all cylinders. Labor costs have picked up in recent months according to both the Employment Cost Index and monthly average hourly earnings (Figure 5). Even though the relationship between labor market slack and earnings growth has weakened in recent decades, we expect labor costs will continue to rise with the unemployment rate a half-point below estimates of full employment and employers increasingly citing difficulty finding workers (Figure 6).

Figure 5

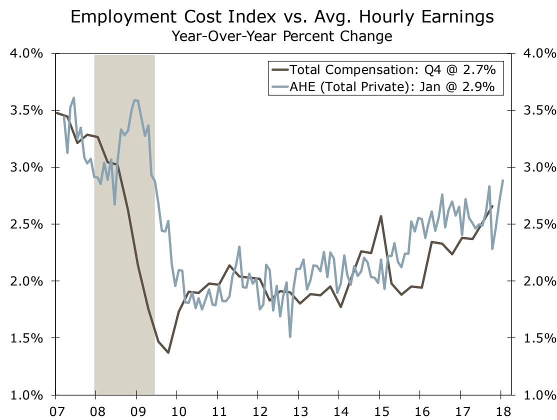
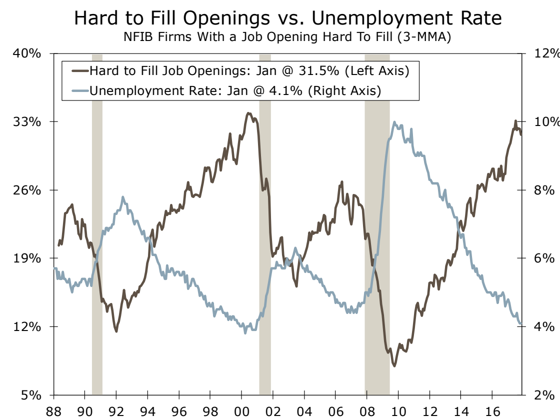


Figure 6



Source: U.S. Department of Labor, NFIB and Wells Fargo Securities

Global conditions also look more supportive of U.S. inflation at this stage of the cycle.

Global conditions also look more supportive of U.S. inflation at this stage of the cycle (Figure 7). Import prices for consumer goods are no longer declining as the dollar has weakened around 8 percent since the end of 2016. Although dollar dynamics are only a small influence on core inflation (since about two-thirds of consumer spending is on services), they typically take about a year to reach full force, meaning the downtrend in the dollar is only now beginning to impact core inflation.

At the same time, inflation has picked up globally amid stronger growth. That has put upward pressure on resource utilization around the world. After declining in 2015 and 2016, Chinese producer prices for consumer goods are rising once again (Figure 7). Stronger global demand (and more disciplined production) has also led to a rebound in commodity prices. In addition to labor, U.S. producers are seeing rising input costs for processed and unprocessed goods (Figure 8). Although cost increases for raw materials have slowed in recent months, they are no longer a source of deflation like in 2015 and 2016.

Figure 7

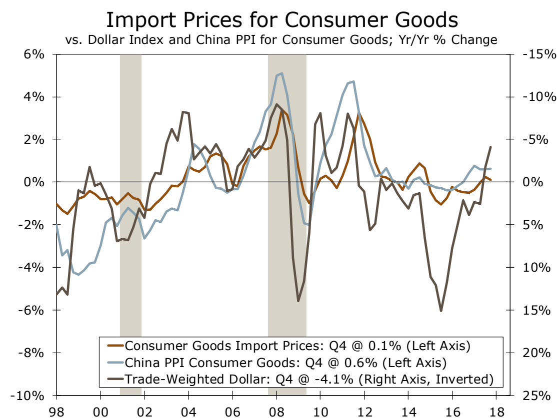
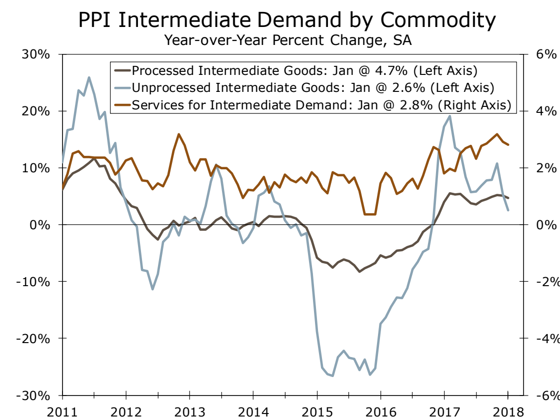


Figure 8



Source: U.S. Department of Labor, FRB, CEIC and Wells Fargo Securities

Let's Not Get Ahead of Ourselves—The Case for Orderly Reflation

We still believe the rise in inflation will remain within the Fed's comfort zone.

While cyclical pressures are certainly building, we still believe the rise in inflation will remain within the Fed's comfort zone. To start, the aforementioned increase in commodity prices has cooled of late, suggesting that input price pressures for raw materials may ease in the coming quarters. Second, the secular trends of e-commerce growth and historically low health care inflation that have made reaching the Fed's 2 percent target more difficult in this expansion aren't going

away overnight.[1] Although the effects of e-commerce look to be concentrated on a fairly small share of goods, the penetration of online sales has picked up. Health care inflation has edged up in recent months, but this juggernaut of core PCE (23 percent) is still likely to remain below its long-term trend given an aging population and pressure on the reimbursement rates of government health care programs.

It is not fully clear the extent to which the Tax Cuts and Jobs Act will raise supply versus demand.

Admittedly, fiscal stimulus at this stage of the expansion, where the output gap has likely closed, stands to fuel inflation further. Yet it is not fully clear the extent to which the Tax Cuts and Jobs Act will shift supply versus demand. The effect on inflation will depend on how companies spend—or don't spend—the windfall from lower tax rates. Stronger capital spending, whether from the tax changes or more favorable growth backdrop in general, stands to boost labor productivity. Stronger productivity in turn would reduce the need for companies to raise prices as the labor market tightens by helping to hold unit costs in check (Figure 9). Even without a pickup in productivity, lower tax rates could limit inflation by reducing the need for firms to raise price as input costs increase. Margins, proxied by corporate profits' share of GDP, remain at historically high levels, suggesting firms have some scope to absorb rising input costs (Figure 10).

Figure 9

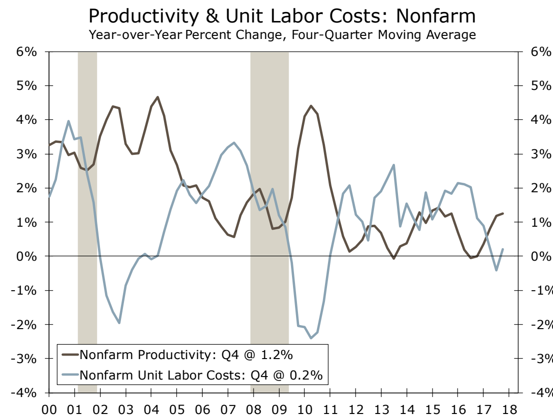
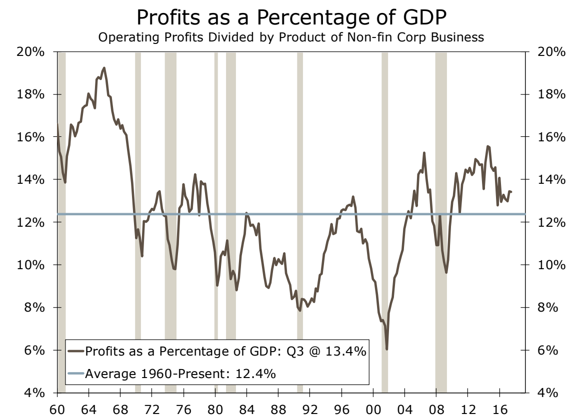


Figure 10



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities

It is likely we will see some combination of these dynamics. Growing labor scarcity points to firms paying workers more and labor costs rising. However, our expectation for capital spending to strengthen this year well ahead of hours worked should lead to a pickup in productivity growth. In addition, we suspect firms will absorb higher input costs to some extent. As illustrated in Figure 10, it is not uncommon for margins to decline as the expansion matures, but lower tax rates this year should reduce the near-term pressure and could limit the pickup in inflation even as demand strengthens.

Inflation is slow to break away from its recent trend even as the economy changes.

Reflation is also likely to be restrained by the fact that inflation is highly correlated with recent prior values. In other words, inflation is slow to break away from its recent trend even as the economy changes. Such slow movement can feed into inflation expectations and affect businesses' price plans and workers' wage demands. While market measures of long-term inflation expectations improved over the past three months, they remain below the levels registered in the first half of the expansion. At the same time, consumers' long-run inflation expectations remain near historic lows.

Higher Inflation on the Horizon, But the Fed Has Been Expecting That

With inflation picking up more momentum the past couple of months and inflation expectations beginning to move higher, we have slightly upped our forecast for this year. Headline PCE inflation is expected to run a touch above 2 percent after the first quarter, while core inflation now looks likely to reach 2 percent by the fourth quarter.

---

[1] **For a detailed discussion on these factors, see "Health Care Inflation: What's the Prognosis?" (Jan. 23) and "The Weight of the World (Wide Web) on Inflation" (Feb. 13), available on request.**

Like us, the FOMC was already anticipating inflation to move higher this year. At its December meeting, members expected both headline and core PCE inflation to reach 1.9 percent by the fourth quarter (Figure 11). We suspect the pickup in the most recent inflation data, along with the prospect for fiscal policy to further stimulate growth, will lead to FOMC members bumping up their inflation projections slightly in the March dot plot. The median projection for core PCE at the end of this year could very well rise to 2.0 percent. The move back to the Fed's long-run target would keep the Fed comfortable with raising rates further this year.

The move back to the Fed's long-run target would keep the Fed comfortable with raising rates further this year.

Will the pickup in inflation be enough to put the FOMC on a path to raise rates beyond the three rate hikes currently projected in the dot plot (Figure 12)? Traditional drivers of inflation have come under increased scrutiny amid inflation's prolonged shortfall from the Fed's target. The FOMC itself has struggled to understand the role slack and inflation expectations play in forecasting inflation, increasing the uncertainty around the best path for policy to support 2 percent inflation over the longer run.

Figure 11

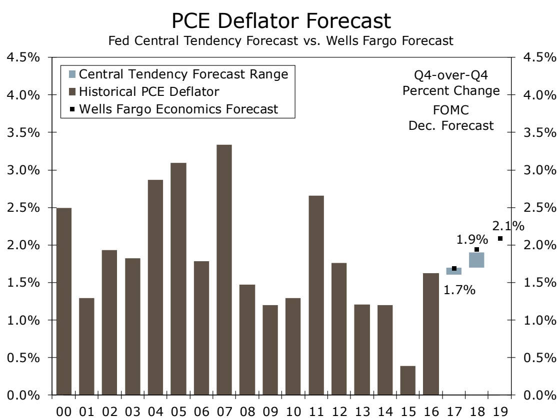
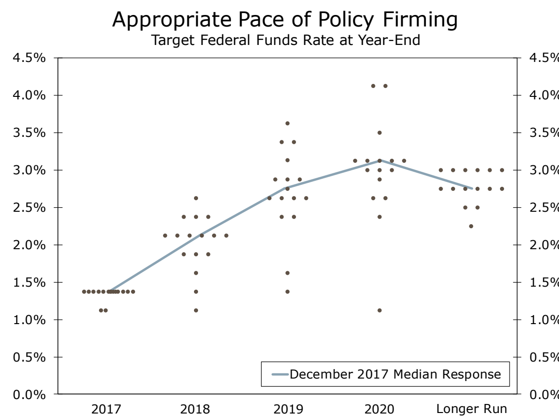


Figure 12



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities

While the timing and magnitude of the effect of resource utilization on inflation is unclear, the latest FOMC minutes reveal that almost all members still believe that the disappearance of slack will lead to higher inflation. Such conviction may lead to members anticipating, and eventually opting for, a faster pace of tightening with the growth outlook having strengthened the past few months. However, given the uncertainty around the timing and degree to which slack affects inflation, members may still be wary of upping the pace of rate hikes. Instead, the FOMC could opt for inflation to get closer to 2 percent and perhaps running higher for at time to demonstrate the FOMC's symmetric commitment to its goal, which has been a concern for some members.

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Charles Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Harry Pershing	Economic Analyst	(704) 410-3034	harry.pershing@wellsfargo.com
Hank Carmichael	Economic Analyst	(704) 410-3059	john.h.carmichael@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC. is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC. and Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2018 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. The content of this report has been approved by WFSIL a regulated person under the Act. For purposes of the U.K. Financial Conduct Authority's rules, this report constitutes impartial investment research. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE