First Trust
Monday Morning OUTLOOK

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Resist Inflation Complacency

Some analysts and investors breathed a big sigh of relief on inflation when it was reported last week that the Consumer Price Index rose 0.3% in August versus a consensus expected 0.4%. But we think any sense of relief is premature.

First, in no way, shape, or form, is a 0.3% increase in consumer prices indicative of low inflation. Consumer prices rose at a 3.3% annual rate in August, which is still well above the Federal Reserve's 2.0% target. Yes, we are well aware that the official Fed inflation target is for the change in the PCE deflator, which always runs a little lower than the increase in the CPI, but it doesn't run anywhere close to 1.3 points lower, which is what it'd have to do for the Fed to hit the long-run 2.0% inflation target.

Second, a number of sectors had price declines in August that should not persist. For example, airline fares fell 9.1% in August and are now 17.4% below the average fares of 2019, which was pre-COVID. So, as COVID gradually recedes these prices should rise.

Third, housing rents are likely to accelerate sharply in the years ahead, including for both actual tenants as well as owners' equivalent rent, which is the rental value of homes occupied by homeowners. With the eviction moratorium in place, rents have grown unusually slowly for the past eighteen months. But, going back to the 1980s, rents tend to lag the Case-Shiller home price index by about two years. Now, with the national eviction moratorium finished, look for rents to make up for lost time. And because rents make up more than 30% of the overall CPI, anyone predicting lower inflation numbers in the future are saying other prices will fall.

Ultimately, however, it's important to recognize that inflation is still a monetary phenomenon and the M2 measure of the money supply is up about 33% since February 2020, pre-COVID. Eventually, that will translate into a substantial rise in overall spending or *nominal* GDP (real GDP growth plus inflation) and since the Fed has little to no control over real GDP growth beyond the short-term, that means higher inflation.

One way to think about it is that between the late 1950s and early 1990s, the ratio of nominal GDP to M2 hovered in a narrow range very close to 1.8. What that means is that every new dollar of M2 translated into 1.8 more dollars of spending. And if the ratio remains the same, then a 10% increase in M2 leads to a 10% increase in overall (nominal) spending.

This ratio rose in the 1990s. Interestingly, so did real GDP growth. So, the strong real growth of the 1990s was actually associated with lower inflation. Since then, the ratio of GDP to M2 has generally dropped. Immediately prior to COVID, in the last quarter of 2019, the ratio was 1.42; now it's 1.12. What this has meant is that M2 growth has not translated directly to inflation.

However, let's assume the ratio is headed back to the 1.42 that prevailed just before COVID. If nominal GDP normally grows 4% per year – 2% real GDP growth plus 2% inflation – it would take six years (so, 2027) to get back to that 1.42 ratio. But that's only if M2 doesn't grow in the interim. No change at all. More likely, M2 does grow in the interim and that additional growth feeds through directly to higher inflation.

Another way to think about it is that the ratio of nominal GDP to M2 has dropped because the velocity of money has fallen. That's the speed with which money circulates through the economy. It's hard to see velocity falling further from 1.12 because to do so means eventually going below 1, and that has not happened in any recorded history of the US.

The Fed meets this week and will be issuing its usual statement after the meeting. We don't anticipate any significant changes to monetary policy at this meeting, although we do expect a hint that the Fed will announce a tapering of quantitative easing to begin after the next meeting in early November.

However, the Fed will also be releasing a new set of economic projections as well as projections about the path of short-term interest rates. Back in June, the Fed was forecasting that inflation would be back down to roughly 2.0% in 2022. If they make a similar forecast this week, it will be a sign that it isn't taking upward inflation risk nearly as seriously as it should.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-21 / 7:30 am	Housing Starts – Aug	1.550 Mil	**1.545 Mil**		1.534 Mil
9-22 / 9:00 am	Existing Home Sales – Aug	5.880 Mil	**5.950 Mil**		5.990 Mil
9-23 / 7:30 am	Initial Claims – Sep 19	320K	**326K**		332K
9-24 / 9:00 am	New Home Sales – Aug	0.711 Mil	**0.728 Mil**		0.708 Mil