Inflation Is Quite Misleading on Average

March 2019

OVERVIEW

- **More subtle than shocks to growth or interest rates, inflation is often an underappreciated risk to portfolios**
- **The Fed has established credibility in fighting excess inflation and the management of inflation expectations**
- **Even with a potentially relaxed policy approach, long-term assumptions call for muted inflation relative to full history**

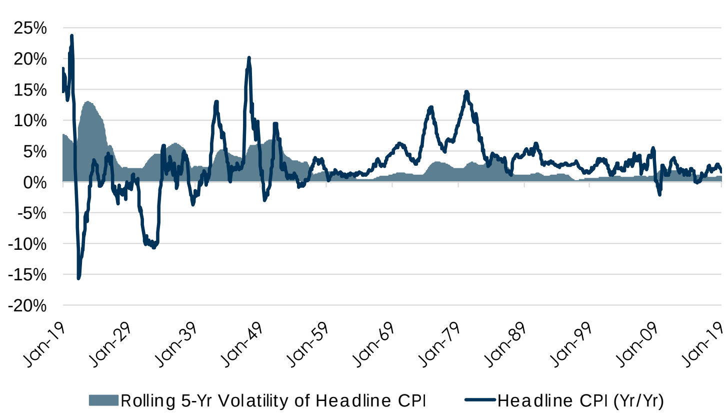
Background

After a series of financial crises early in the 20th century, there was a desire for centralized control of the U.S. monetary system. The passage of the Federal Reserve Act on December 23, 1913, created our central banking system with three primary objectives: maximizing employment, stabilizing prices, and moderating long-term interest rates. The first two, commonly referred to as the Federal Reserve's "dual mandate," share a history of interconnectedness given the economic realities of supply and demand for labor, goods and services. With stable prices, it follows that long-term interest rates should be moderate.

Measuring Inflation Can Be Complicated

The Fed's preferred gauge of inflation is the Core Personal Consumption Expenditures (PCE) Index, which strips out the volatile Food and Energy components. This series comes from the Bureau of Economic Analysis (BEA), but has history that only extends back to 1959. For this article, we have chosen to utilize the Headline Consumer Price Index (CPI), which reports the average change over time in the prices paid by consumers for a predetermined market basket of goods and services. The Bureau of Labor Statistics (BLS) has maintained monthly data for this series all the way back to early 1913, and provides detailed information covering eight major categories (housing, medical care, etc.) for the U.S. as well as distinct geographic areas. While Headline CPI is the most widely utilized statistic for reporting broad changes to the nation's cost of living, it lacks precision at the individualized level given routinely heterogeneous price fluctuations across disparate sub-components and regions.

Reported Inflation: A Century of Evolution



	100-Year History	Before Fed Accord*	After Fed Accord*	Most Recent 10-Years	ACG Long-Term Assumption
Average Headline CPI (Yr/Yr)	2.95%	1.87%	3.48%	1.57%	2.75%
Measured Volatility	4.66%	6.94%	2.81%	1.15%	2.83%

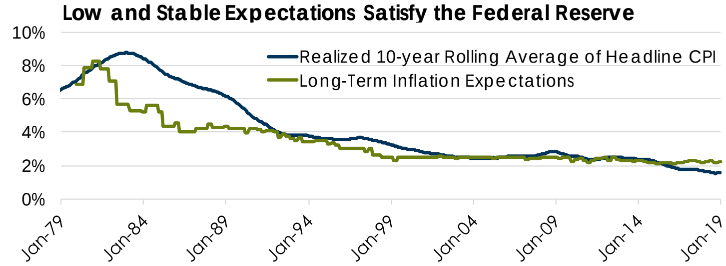
*In March 1951, the U.S. Treasury and the Federal Reserve reached an agreement to separate government debt management from monetary policy, laying the foundation for the independent modern Fed.

Source: Bureau of Labor Statistics (BLS), ACG Research

"Price Stability" Alive and Well

Inflation becomes a problem when it is unexpected or very high, with negative implications for consumers, business, and markets. Year-over-year inflation has been in secular decline for nearly four decades, since approaching the 15% level in early 1980. Most economists argue that low, steady rates of inflation are best to support long-term economic growth. Low (as opposed to zero or negative) inflation is thought to limit the severity of recessions by enabling labor markets to adjust, while minimizing the risk that a "liquidity trap" causes cash hoarding that prevents monetary policy from stabilizing the economy. As bouts of deflation have become far more rare, the volatility of inflation is at historic lows.

Low and Stable Expectations Satisfy the Federal Reserve



Source: Federal Reserve Bank of Philadelphia, BLS, ACG Research

The Fed's Approach to Inflation Targeting

Although the Fed is not required to maintain inflation within a specific range, the anchoring of inflation expectations is viewed as a measure of their success. In line with many of the world's central banks, the U.S. adopted a 2% inflation target under the leadership of former Fed Chairman Ben Bernanke in early 2012. Recent discussions have redefined this target as being "symmetric," and highlight the Fed's apparent willingness to tolerate inflation running modestly above or below target in the period immediately ahead. Particularly following instances where the Fed Funds rate has been kept fairly close to zero, a modified price-level targeting approach would allow for temporary inflation "overshoots" to ward off any deflationary expectations.

ACG's Position

The question of how to reignite inflation is something that has confused many very intelligent people following the Global Financial Crisis. Irrespective of unprecedented stimulus, the secular headwinds of technology, demographics, and global supply chain management have thus far muted the traditional late-cycle impact of tighter labor markets and building wage pressure. As recent Fed messaging has created an increasingly dovish and complacent consensus, the potential for markets to encounter an inflation surprise remains a key tail risk within portfolios. While explicit inflation hedging can be costly, we feel exposures to diversified real assets, shorter-dated fixed income, and active management provide an effective near-term defense. If long-term inflation expectations begin to trend higher, risk assets such as equities may also benefit.

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231 South Bemiston Avenue ♦ 14th Floor ♦ Saint Louis, Missouri 63105
www.acgnet.com
314.862.4848