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INFLATIONARY TRENDS AND OUTLOOK – ARE THERE ANY SIGNS OF A PICK-UP IN INFLATION?

As the FED has put forth an historically large effort to jump start the U.S. domestic economy through the injection of massive amounts of borrowed funds, many economists and strategists have predicted that this economic cycle will end with extremely high levels of inflation. As we approach the end of "quantitative easing" later this year we have yet to see any significant indication that inflationary rates or trends are increasing. Does this mean that the calls for significant inflation were incorrect, or is it something that will still likely occur at a later date?

Currently, both consumer prices (CPI) and producer prices (PPI) continue their flattish trends with year over year rates of approximately 2%. PPI rates are near the higher end of their two year trend, but it would be a little premature to declare this a sustainable increase. While food and energy continue to remain quite volatile, longer-term trends have done little to influence overall inflationary results. Obviously continued improvements in productivity through technology have accounted for holding price levels in line in recent years. Finally, lack of job growth and a large base of underemployed and displaced workers have helped to hold down labor costs although legislative changes to the minimum wage rate would impact the inflationary picture.

Many economists have argued that there is a strong macroeconomic correlation between the amount of money pumped into an economy and the expected cost of these funds. This is the basis for the argument that massive amounts of borrowed funds will ultimately push up prices once the economy and/or wage pressure begins to rebound. This implies that at some point the economy will return to above average historical growth and job growth trends will lessen

the pool of available job seekers and therefore push up labor costs. At this point neither of these events appears likely in the next few years.

If higher inflationary rates do not come from either labor cost push or strong economic growth, where may it come from? The obvious answers are commodity prices and/or real estate prices. On the commodity front, supply/demand imbalances may temporarily push up prices of certain commodities, but we have not observed any sustainable trends of higher prices. Real estate has also recently shown pockets of well above average price increases, primarily on the coasts and other resort type areas, but most other regions have not produced above average price increases and many areas have shown little improvement since the 2007-2009 correction known as the Great Recession.

Our conclusion continues to be that while a modest increase in inflation to the 3%-4% range, may occur, the odds of significantly higher inflation, 6% or higher annual increases, are unlikely. With regard to interest rates, if we were to see inflation blip up towards 3.5% based on a modestly better economy showing 3%+ real GDP and continued job growth, combined with a return to a more average relationship between long term interest rates and inflation, we would not be surprised to see the 10 year treasury note trading in the range of 4%-5% in the next few years vs. its current yield of 2.418%.

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