When it comes to inflation, the Federal Reserve is aiming for a sweet spot. The Fed believes a modest 2% inflation rate is ideal for achieving its dual mandate of price stability and full employment and will help to promote rising wages and growing corporate profits. Traditionally, the Fed has used its benchmark interest rate (the federal funds rate) as a means of achieving its target, increasing rates to keep rising inflation in check and decreasing rates to spur inflation or employment.

However, despite historically low interest rates and increasingly favorable economic conditions, inflation has remained persistently below the Fed’s 2% target for nearly six years — and it’s not clear why. While stubbornly low inflation would have been cause for alarm in the past, few seem to be worried. In remarks made in October 2017, Federal Reserve Chair Janet Yellen called low inflation the “biggest surprise in the U.S. economy,” but said she does not believe it will persist much longer. With other economic indicators headed in a positive direction, the Fed has indicated its intention to continue to raise rates in order to achieve equilibrium between the federal funds and inflation rates and wind down its quantitative easing program.

**A Growing Economy**

Based on the current level of traditional economic indicators, the U.S. appears to be in a favorable position. The gross domestic product (GDP) has generally been on the rise since the end of 2015, increasing by 3.2% in the third quarter of 2017 and 3.1% the second.

Meanwhile, the country’s unemployment rate has been under 5% — effectively “full employment” — since April 2016. In December 2017, the Bureau of Labor Statistics reported a 4.1% unemployment rate, the lowest since 2001.

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1. “FAQs,” The Federal Reserve
3. Yellen Wonders if Fed Inflation Credibility Dented on Her Watch, Bloomberg, October 26, 2017
4. Bureau of Economic Analysis, November 29, 2017
Despite this, inflation remains below (and, at times, well below) the Fed’s 2% annual target, as measured by the price index for personal consumption expenditures (PCE). In November 2017, the core PCE index (less food and energy) rose 1.5% year-over-year, a slight increase over October’s 1.4% year-over-year gain and well below target.

Our Perspective

We believe the current framework for evaluating inflation may not account for certain economic trends that could explain why inflation has remained low. These trends include:

Disruptive Business Models

From clothing to lodging to cell phones, today’s consumers can often purchase products that are as good as (or better than) the ones they already have for the same — or possibly even lower — prices. New companies are disrupting old business models by offering consumers alternative options that are more convenient and more affordable. E-commerce giants like Amazon are leading a new era of online retail that provides consumers with low-cost options and puts pressure on traditional retailers. More than 300 retailers filed for bankruptcy in the first half of 2017 alone, a 31% increase from 2016.6 Airbnb is having a similar effect in the hospitality and travel industry, which has long been dominated by large hotel chains.

Technology and Globalization

Technological advancements have made manufacturing much more efficient, allowing companies to improve the quality of their products without increasing prices. While increases in product quality and decreases in price have benefited consumers, automation and new access to competitive job markets overseas have had a significant impact on wages. Employment may be up, but wage growth has remained under 4% since early 2008.7

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6 “Retail Bloodbath Continues,” CNNMoney, June 13, 2017
7 Wage Growth Tracker, Federal Reserve Bank of Atlanta
Changes in the Workforce
In the U.S., there’s been a significant shift from manufacturing to service jobs over the past four decades. Consider that in 1970, nearly 18 million Americans worked in manufacturing. By the end of 2017, that number had fallen to about 12.5 million.8

Exhibit 4. U.S. Manufacturing Jobs

Additionally, the relationship between employers and employees has been transformed by technology, giving rise to the “gig economy,” in which more people are likely to work freelance or contract jobs facilitated by companies like Uber or Taskrabbit. There has also been a decline in job security and stability. A recent study by LinkedIn revealed that the number of companies people worked at in their first five years out of college has doubled in the past two decades. For example, people who graduated in the late 1980s averaged 1.6 jobs, while those who graduated in the early 2000s averaged 2.9 jobs.9

The Strength or Weakness of the Dollar
Foreign exchange rates come into play as well. The strength — or weakness — of the U.S. dollar compared to the currency of other countries can impact U.S. inflation. In the recent past the U.S. has benefited from a multiyear rally in the dollar. This strength has meant imports cost less to manufacturers and consumers alike, helping to keep a lid on inflation. Since 2017, the dollar’s strength has faded somewhat. If persistent, this could contribute to higher inflation in the future.

Recalibrate Your Inflation Expectations
Our modern economy may not look or behave like economies of the past. Add in the Fed’s unprecedented participation in the markets since the last recession and it’s not surprising that we’re witnessing unexpected economic behavior.

That said, we don’t think the current low-inflation environment is a cause for alarm in the short term. At its December 2017 meeting, the Fed raised short-term interest rates for the third time in a year, as expected. The Fed noted the U.S. economy was doing well and increased its growth estimates for the next few years on expectations that tax cuts will boost the economy. They still project inflation to rise to 2% by 2019. The Fed also projects at least another three rate hikes in 2018, though the market is anticipating only two. Such increases are important, as they preserve the Fed’s ability to respond to a potential downturn by ratcheting rates back as needed.

Exhibit 5. U.S. Dollar per Euro (GDP Weighted History)

Exhibit 6. U.S. Federal Funds Target Rate

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8 Bureau of Labor Statistics
9 “Will This Year’s College Grads Job Hop More Than Previous Grads?,” LinkedIn, April 2016
With the recent passage of the Tax Cuts and Jobs Act significantly reducing corporate tax rates, the U.S. economy will likely benefit from an increase in spending among corporations and consumers alike through increased capital expenditures and hiring. All things being equal, this should lead to somewhat higher inflation by 2019.

When it comes to the current economy, we're in uncharted territory to some extent. Navigating it may require a new way of thinking about how we approach age-old concepts, including inflation. However, if inflation is the best leading indicator of recessions, it would appear we have a ways to go.