Heartwood
Investment Management

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Investment Insight

Weekly Insight

Is the Fed being too complacent about longer-term inflation risks?

There were no surprises when the Federal Reserve announced that it was keeping interest rates on hold following its March policy meeting. What has surprised markets, though, is the Fed's more dovish assessment of economic and financial conditions, which was manifested in a meaningful downward revision to policymakers' median projection of interest rate increases for this year from four to two. And yet, this assessment comes at a time when, ironically, there appears to be an upward shift in US inflation.

Supportive conditions for US consumers

While disinflationary energy effects continue to contain US headline inflation, core inflation has been drifting higher over recent months, with the latest reading at 2.3% year-on-year in February. Admittedly, base effects are contributing to stronger numbers on an annualised basis, but nevertheless a number of factors are coming together which potentially create the conditions for stronger consumer spending and, ultimately, inflation.

It is worth noting that the buying power of the US dollar has remained unchanged over the past two years, according to the Bureau of Labour Statistics. In effect, the cost of living in the US has remained static between 2014 and 2016, despite an environment of moderate economic growth. This situation appears puzzling to both us and the market and we would question whether it can continue, given moderate wage gains, tighter employment conditions and the benefits of real disposable income gains to US consumers. Moreover, consumer confidence indicators continue to stand at healthy levels - US consumers have not yet signed up to fears of a US recession. All in all, we expect the wealth effects of lower energy costs, low inflation and low interest rates to support consumption ahead.

Why then is the Fed seeming to back away from its hitherto sanguine view of US economic prospects?

We believe the latest Fed commentary tells us that policymakers seem prepared to fall behind the bond market's pricing of future inflation and interest rate expectations. In our view, this strategy of potentially allowing US inflation to run above the medium-term target of 2% as a mechanism to counterbalance global disinflationary forces is not without risk. Fed policymakers are no doubt conscious that their counterparts in the European Central Bank and Bank of Japan are burrowing down the rabbit hole of negative interest rates. In consequence, the Fed will not want to appear too aggressive in widening the interest rate differential with other markets, thus posing more US economic risks.

In the short term, we expect the accommodative stance of central banks to continue in light of global growth and financial market developments. We expect there is enough fodder to keep investors engaged, which should support risk assets in the short term. We also note that recent economic data in the US has provided more reassurance to investors, as manufacturing surveys show signs that the downdraft appears to be slowing. All that said, the inflation question is unlikely to disappear, particularly if core inflation continues to drift higher. At some point, markets may have to reassess their view of longer-term inflation expectations, whereupon again we are likely to see a return to more volatile times.

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