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## Weekly Market Flash

### Inflation, Economists and the Rest of Us

September 22, 2017

Where's the inflation? That question has lurked behind most of the major headline stories about macroeconomic trends this year. Jobless rate falls to 4.3 percent. Where's the inflation? GDP growth revised up to 3 percent. Where's the inflation? The Fed has an official dual mandate of promoting price stability and the maximum level of employment achievable in a stable price environment. By all available measures, our central bank policymakers would appear to be living up to their mandate in spades. Inflation has remained subdued for pretty much the entire run of the recovery that began in 2009. Over the same time, unemployment has come crashing down from a post-recession high of 10 percent to the gentle undulations of 4 percent and change from month to month. And therein lies the problem, or rather the riddle that neither the Fed nor the rest of us can answer convincingly: why hasn't a robust jobs recovery reignited inflation?

#### Math, Models and Markets

Those of us who do not hold Ph.D. degrees in economics from the nation's most prestigious universities at least have one advantage over those maven economists on the Fed Open Market Committee: we can freely speculate about the perplexing absence of inflation. Here at MVF we have our own views, largely proceeding from the larger issue of long term growth that has been the central subject of our in-depth research for much of the past three years. The catalysts that drive growth over successive business cycles – productivity and labor force participation – have both chronically underperformed for many years. Quite simply, we may have reached a point of diminishing returns on the commercial innovations that powered a historically unique run of growth through the middle and mid-late portion of the last century. Without that growth, we shouldn't expect wages and prices to do as they did before.

Which is fine for us to say, because – see above – we are not doctorate-level trained economists. But Janet Yellen is, and so are most of her colleagues. And unlike us, they do not have the freedom to brainstorm and speculate about what's keeping inflation from showing up. All they have are models. Models with months, quarters and years of data providing quantitative insights into the relationship between the labor market and consumer prices. Models written in beautiful mathematical formulations, the legacy of giants who inhabited the “freshwater” (University of Chicago) and “salt water” (MIT and Harvard University) centers of economic research in the years after the Second World War. Models premised on the hyper-rational choices of economic actors, models that do not actively incorporate variables about capital and financial markets but that assume that money is just “there.”

#### Follow the Dots...Not

The models say that a higher uptrend in inflation is consistent with where the labor market is. Accordingly, the “dot plot” predictions by FOMC members continue to assume one more rate hike this year (most likely December) and three more next year. This despite the fact that the core personal consumption expenditure (PCE) rate that the Fed uses as its inflation gauge remains, at 1.4 percent, well below the Fed's 2 percent target. Fixed income markets, though, continue to largely ignore FOMC dots (despite some of the usual post-event spasms after Wednesday's press release). There remain about 100 basis points of difference between what the Fed thinks is a “normal” long term trend for the Fed funds rate (closer to 3 percent) and what the bond market thinks (closer to 2 percent).

In a nutshell, the bond market, and analysts such as ourselves, look at inflation trends and say, why rush? The Fed says, because the models say we have to act. If the models are right, there could be some very nasty shocks in fixed income markets that spill over into risk assets like equities. But for the rest of us, with our parlor game speculations about how the relationship between prices and jobs today may simply not be as statistically robust as it used to be, it is difficult indeed to spot the hard evidence supporting a major bout of inflation on the horizon.

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