DWS

Americas CIO View

Inflation: Sometimes it skips a generation

Thoughts on inflation during a Federal Open Market Committee (FOMC) meeting week

In our view, the threat of a sharp climb in U.S. inflation shouldn't be at the forefront of investor worries at this time. However, the drivers of inflation and their influence on near- and longer-term interest rates are important to understand to help best choose investments and build a portfolio.

We list some interesting aspects of U.S. inflation history and why we think inflation will stay near the U.S. Federal Reserve's (the Fed's) 2% target for the next few years despite a further decline in U.S. unemployment rates.

1) Low inflation is the U.S. norm. Since 1800, the average U.S. inflation rate is 1.4%. Outside of wars, U.S. inflation is 0.5% on average. Outside of wars and 1971-1982, the average is 0.0%.

2) Though short-term deviations can occur, inflation over the long term is largely under the control of monetary policy. By setting an inflation target, central banks aim to anchor people's expectations around that target and build that into their wage- and price-setting behavior and investment planning. If successful, that alone can go a long way to keeping inflation near target. Fed policymakers also adjust financial conditions in response to short-term cyclical movements in the economy, aiming not only to keep inflation near target, but also to meet the other part of their mandate, full employment.

3) In the 1800s, before the Fed, there were periods of productivity surges from agricultural advancements and industrialization causing episodes of supply-boom-driven deflation. Deflation can be damaging to an economy, because any price instability interferes with the effectiveness of price signals, crucial to market-based economies, business planning and contracts.

4) Central banks generally desire low but positive and stable inflation rates. Stable, so that it doesn't interfere with people's planning; positive so that it provides a buffer against deflation and affords central banks more room to cut real interest rates in response to economic downturns without bumping up against the effective lower bound on nominal interest rates. The Fed's current inflation target (for the price index for personal consumption expenditures) is 2%.

5) It's normal for the economic cycle to cause temporary deviations in inflation from the Fed's target. But such deviations are generally moderate and are rarely sudden jumps or plunges of several percentage points with the exception of inflationary jumps upon wars and plunges upon sharp recessions. In recent cycles, the Fed has been quite successful in preventing inflation from veering

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In a nutshell

- Low inflation is the U.S. norm
- Though short-term deviations can occur, inflation over the long term is largely under the control of monetary policy. Persistent deviation from an inflation target would represent ineffective monetary policy
- An important part of the inflation process is unit labor costs
- If inflation stays close to the Fed's target, as we expect, we don't think the Fed will "slam on the brakes"

too far from target, in part because inflation expectations have remained firmly anchored.

6) Persistent deviation from an inflation target would represent ineffective monetary policy. Generally, supply-side-shock-driven inflation – say, due to an energy-supply disruption - shouldn't be met with tighter monetary policy provided inflation expectations are not dislodged, making it unlikely that any sharp movement in inflation caused by that shock will persist.

7) An important part of the inflation process is unit labor costs. While oil is in a lot of things, labor is in everything. But realize that wage growth is not inflationary if fueled by rising productivity. Productivity-driven wage growth is prosperity.

8) If employers increase wages more than productivity justifies, they would need to pass the cost forward to customers as price hikes to maintain profits. This is difficult in a competitive economy. If such a wage-price spiral did take hold, as it did in the 1970s, it's unlikely that the Fed would tolerate such price instability. That alone makes it less likely that such a spiral would develop.

9) In the past 30 years, the highest monthly inflation spike was 6.3% in 1990. Anyone born after January 1983 hasn't experienced double-digit inflation in the U.S.

10) If inflation stays close to the Fed's target, as we expect, we don't think the Fed will "slam on the brakes" – i.e. adopt a sharply restrictive monetary policy. We do expect them to keep raising interest rates and shrinking their balance sheet into next year, but moderately, enough to move policy to a more neutral, or at most slightly restrictive stance, with the aim to bring the economy in for a "soft landing" – to cool activity enough to keep the labor market from overheating, but not enough to derail the expansion. Historically, that has been hard to do. And exactly how high the federal funds rate needs to go to achieve that is uncertain, but we suspect it's not likely to be much more than 3%.

Glossary

Deflation

Deflation is a sustained decrease in the general price level of goods and services.

Federal funds rate

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Recession

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

Unit labor costs

Unit labor costs (ULC) measure the average cost of labor per unit of output.

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