



The Federal Reserve Refines Its 2% Inflation Target

A fair amount of talk exists about expectations for future inflation in the wake of large-scale monetary and fiscal policy efforts due to the COVID-19 recession. Market based indicators for the future presently point to an expectation below 2%, while survey based measures may indicate expectations are a notch higher. As far as the future is concerned, many factors to include eventual growth outcomes, demographics, technology and potential structural policy changes will determine where the broad price level ends up. In the short term, it is fair to say that we have a status quo subdued environment for prices given the near term realities and constraints on growth and employment.

The stock market and the companies that make it up operate in an environment where specific industries and businesses have varying production cost curves and competitive landscapes, as well as differing levels of end demand for products and services. In general, if prices begin to run too hot, companies may begin to experience higher input costs with an inability to pass on higher prices for their own goods to customers. Conversely, if prices are too low or if they even begin to fall, companies may have a harder time covering their existing fixed cost structures. Both situations can negatively impact profits and then likely company stock prices. The Federal Reserve, which operates under a stable prices mandate, “targets” a moderate level of inflation around 2%. This is consistent with this dynamic, where prices running too high or too low would likely coincide with deteriorating environments for markets, businesses and consumers.

What has happened in recent years with consumer prices? The chart below is the year-over-year plot of the Core Personal Consumption Expenditures Price Index since 2015. It clearly shows that for a brief period in 2018, core inflation did reach 2%, only to subsequently fall and, in fact, it has averaged out nearer to 1.7% over this 5-year period, which is “below” the target. Recently, the Federal Reserve has indicated a move to an “average inflation target”. Put simply, it seems to be indicating that if we are to ultimately reflate the economy to a place where the price level exceeds this 2% level, then the Federal Reserve may not act quickly to tamp prices down and instead may view the longer run average coming in at a 2% level as the new target. It is a willingness from a policy standpoint to accept a slightly higher level of prices in the economy rationalized by the fact that we have sustained a below target price level since the Global Financial Crisis ended.

There are a myriad of views on this type of complicated policy topic, which naturally drive the different Bull versus Bear arguments. The issues around the debate will not likely settle in the near term and implications for the markets and our economic backdrop will likely play out over the next several years. Where there is disagreement there is also likely a reasonably strong consensus to thread the needle and to end up with a market environment that is neither running “too hot” or “too cold”.

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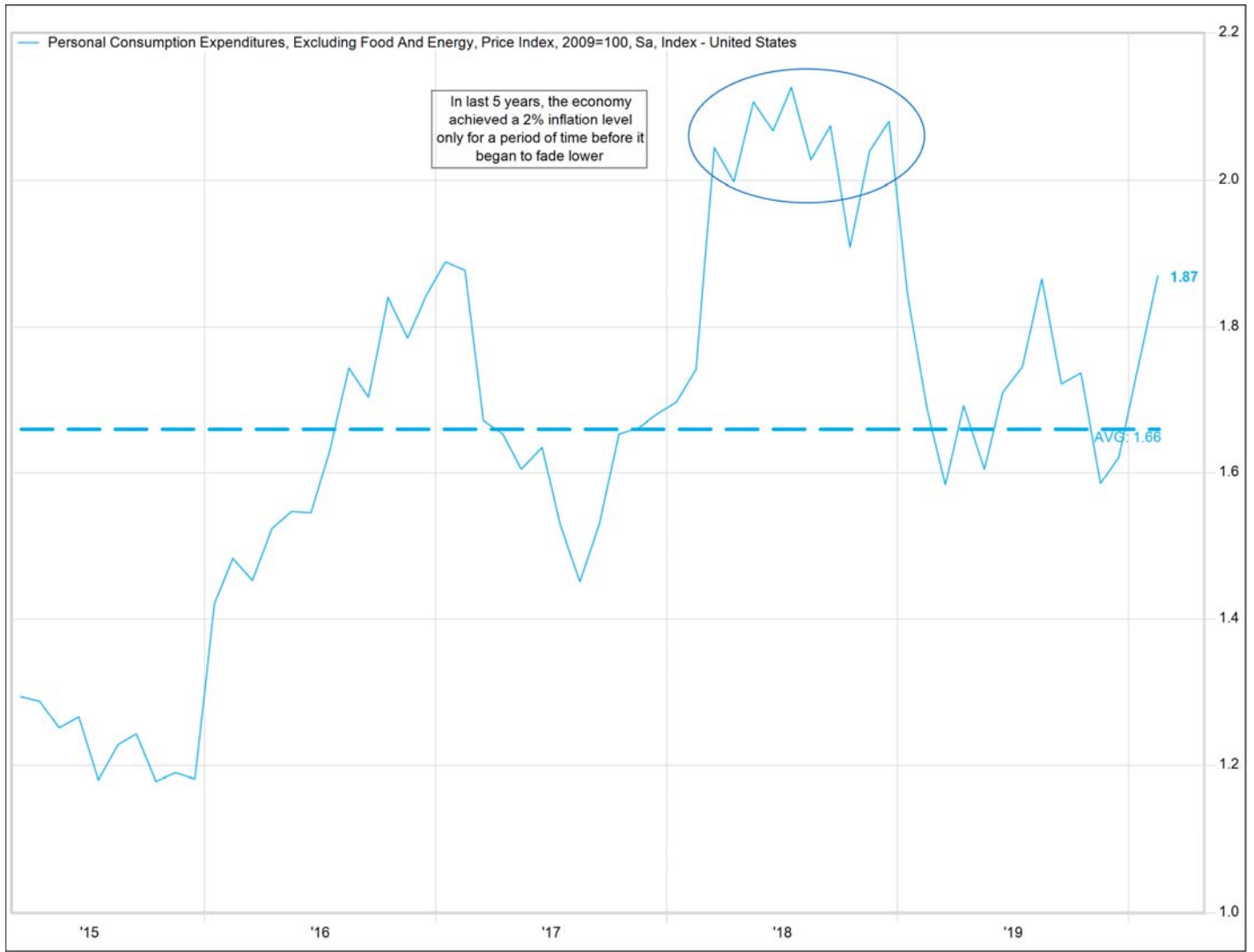
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