Inflation Will Remain Low for Years

The US Federal Reserve was established in 1913 with three primary objectives: maximizing employment, stabilizing prices (controlling inflation), and moderating long-term interest rates. Interestingly, it took nearly 100 years from the Fed's establishment before the Federal Open Market Committee (FOMC) explicitly stated its target inflation rate. The 2% target inflation rate announced in 2012 remains in effect today, with the Fed using the Personal Consumption Expenditures excluding Food and Energy Index, or Core PCE, as its main measure of inflationary pressures. Measured quarterly to show the percent change from the year prior, the Core PCE tells us the rate at which prices for consumer goods and services are increasing or decreasing. As the below long-term chart demonstrates, Core PCE inflation has hovered reasonably close to the Fed's target for most of the past two decades.

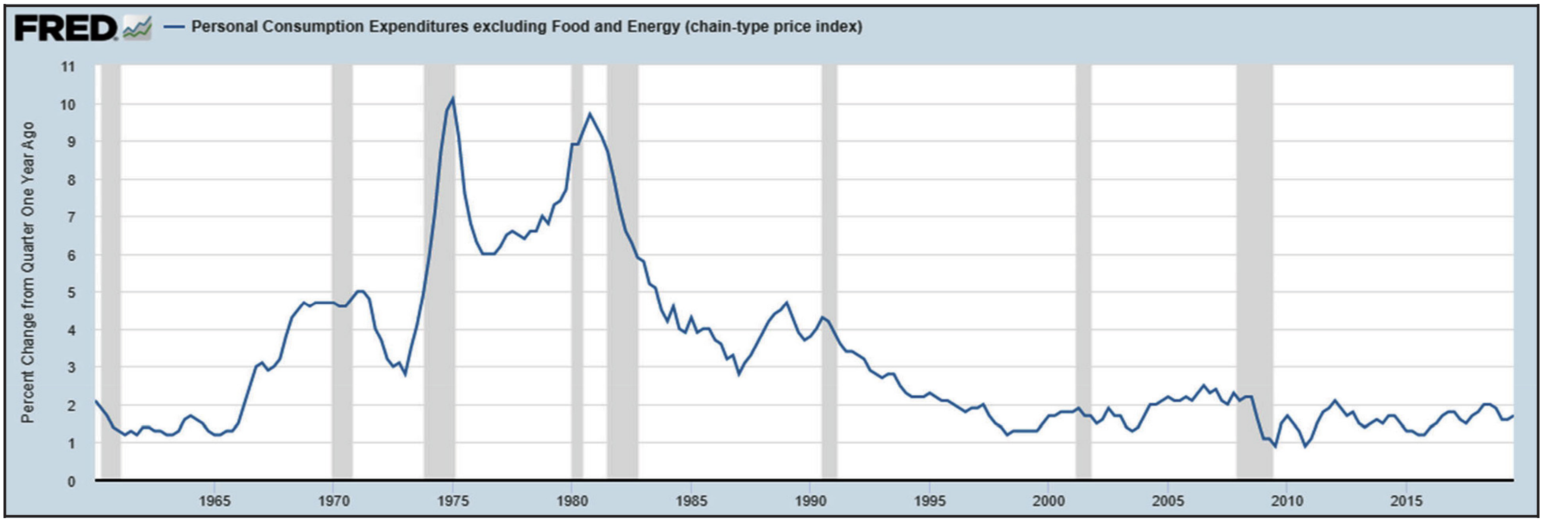

Chart data source – U.S. Bureau of economic analysis.

The first two of the Fed's three priorities – maximizing employment and controlling inflation – are commonly referred to as the Fed's "dual mandate". Economist William Phillips famously noted that these two forces are seemingly at odds with each other, a logical conclusion given that low unemployment typically correlates with rising wages. Rising wages in turn put pressure on firms to increase prices to maintain corporate profits. Furthermore, low unemployment means more workers have money to spend, therefore more demand for goods, resulting in supply versus demand upward pressure on prices. The Fed's primary tool in this balancing act is monetary policy; raising interest rates to reduce demand and slow an overheating economy or lowering rates to spur investment and hiring but potentially adding to inflationary pressures.

As noted above, the Core PCE reading has been tepid for some time now, only briefly exceeding 2% once in the past decade. During the Fed's rate-hike cycle from 2015-2018, inflation never suggested an overheating economy, prompting well-justified skepticism as to the necessity of those rate increases. Meanwhile, the unemployment rate has fallen from a high of 10% in 2009 to just 3.6%, the lowest level since 1969.

Chart data source – U.S. Bureau of economic analysis.

Despite the low unemployment, wages have been growing at a slower-than-average pace, particularly for lower-paid workers, prompting political outcry and calls for increased minimum wages. Why has the relationship between unemployment and inflation has seemingly broken down in recent years? Some point to aging global demographics, with less pressure felt from workers entering the economy at a large rate and instead more and more people being in the retired classification, where they exert less pressure on prices, with many on fixed budgets. Others say it is due to the heavy debt loads carried by nations around the world and studies have shown that high debt and lower GDP can lead to lower inflation. The cause certainly is multifaceted, but the unprecedented advances in technology and data we believe are a major factor.

Chart data source – Federal Reserve Bank of Atlanta.

Where is Inflation Headed?

One only needs to visit a shopping mall to see how the internet economy has exerted downward pressure on prices. Amazon and other e-commerce giants have put price-discovery at the fingertips of smartphone users worldwide. Advances in robotics and artificial intelligence enable internet retailers to operate at a level of efficiency never dreamed of, while virtual storefronts and just-in-time delivery have lowered traditional barriers to entry and dramatically reduced overhead costs. These breakthroughs do come at a cost – namely jobs for less-skilled workers, who are no longer needed to perform retail and warehouse tasks. But if these jobs are being eliminated, how do we have such low unemployment? The low unemployment rate only measures workers actively looking for jobs, but the labor participation rate shows that for the past two decades, many individuals have simply dropped out of the labor pool.

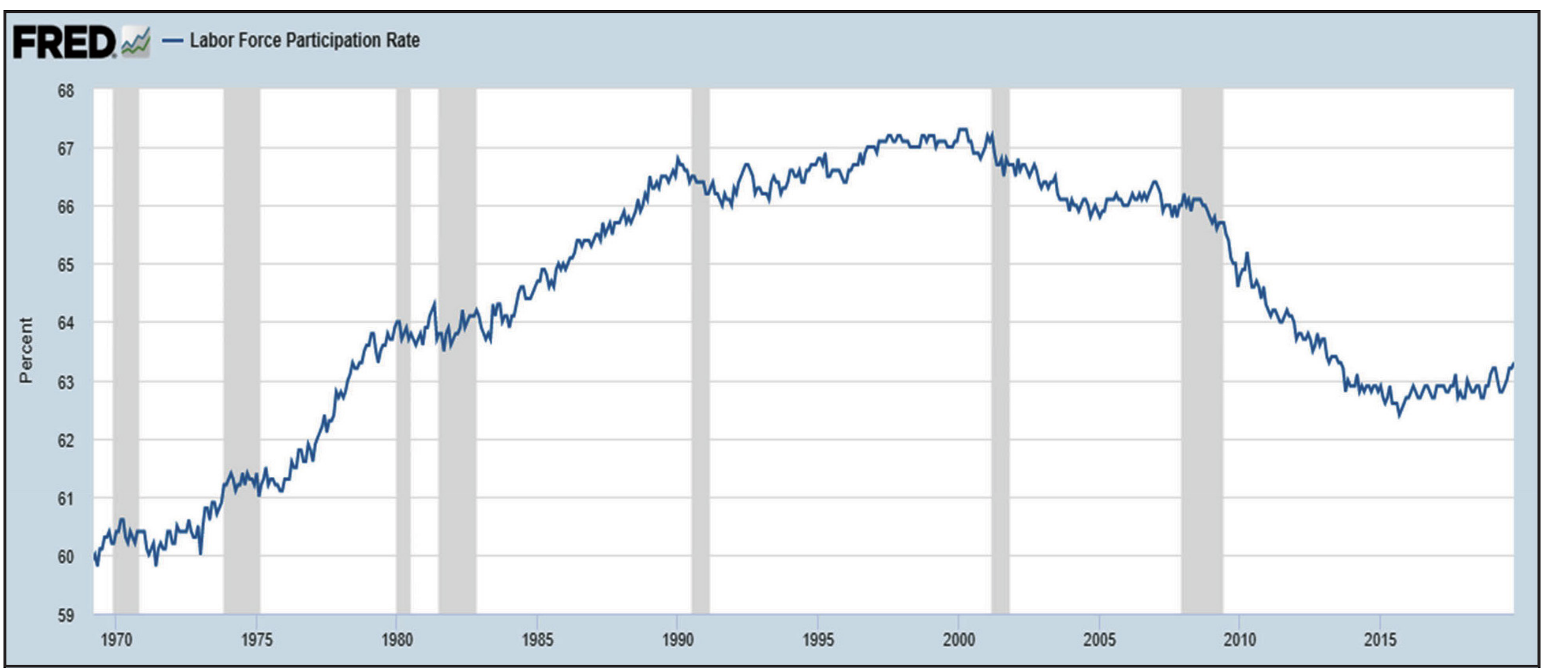

Chart Data Source – U.S. Bureau Of Labor Statistics.

This trend seems unlikely to reverse and may even accelerate in the coming years. We may only be at the early stages of the data and technology revolution. Companies are already preparing for the autonomous vehicle revolution, which promises to dramatically increase shipping efficiency but decimate employment prospects for truck drivers, of which there are 3.5 million in the US alone. Low wage service jobs, such as grocery and fast-food cashiers, are already being replaced by touchscreen kiosks. The technological revolution will also have a profound impact on input prices, as more efficient, less-wasteful design lowers the raw material cost per unit. Consider the impact of on-demand parts produced by 3D printers, or more efficient factory operations facilitated by solar power or large-scale battery technology.

For long-term investors making asset allocation decisions, correctly predicting the path of technology and inflation will be crucial. There will certainly be winners and losers in the low-inflation environment. For equity investors, brick-and-mortar retailers have been one of the first victims, with those unwilling to embrace an online presence falling to the wayside. Automakers who neglect to invest in electric vehicle research and development will likely suffer a similar fate in the coming years.

For fixed income investors, the downward price pressure means that interest rates are to some degree capped. The Fed has been handcuffed by both low inflation and a far more connected global bond market. With rates in negative territory for much of the world, domestic bond yields can only rise so much before foreign investment floods the market. The double-digit Treasury yields of the 1980s may very well be a once-in-a-lifetime event.

Alternative investments are also exposed to risk in the low-inflation environment. Commodity investors should consider replacing exposure to raw materials with indirect exposure through Master Limited Partnerships controlling the pipelines, shipping, and logistics. For investors in REITs, understanding the underlying exposure will be critical. While brick-and-mortar REITs will continue to face pressure due to e-commerce growth, opportunities have emerged for technology-exposed real estate such as datacenters and 5G cellular tower operators.

Technological progress continues to march on, and investors who do not recognize its impact on corporate and consumer behavior, consumer and producer prices, and Fed policy decisions run the risk of making long-lasting asset allocation mistakes. It certainly appears that low inflation and low interest rates will continue to be the norm for years to come.

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