GREAT EXPECTATIONS: THE FEDERAL RESERVE, INFLATION, AND POLITICS

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"I went home, with new matter for my thoughts, though with no relief from the old." Charles Dickens's novel, "Great Expectations" (Chapter 48)

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OVERVIEW

A deluge of money printing and ardent yield repression by leading central banks of course are not the only important potential sources of inflation. Assorted marketplace guides proclaim a variety of opinions regarding relevant inflationary factors and their relationships and consequences. And everyone knows that economic, political, and social conditions, programs, and challenges differ, often significantly, between countries.

Central banking mandates and interpretations regarding them are not precisely the same. Central banks do not have an easy job. In his story "A Christmas Carol" (Stave 3), Charles Dickens states: "it is always the person not in the predicament who knows what ought to have been done in it, and would unquestionably have done it too".

However, all the bankers preach devotion to their mandate. The Federal Reserve Board, European Central Bank, Bank of England, Bank of Japan, Bank of Canada, and the Swedish central bank for the past several years have shared a faith and proclaimed a gospel that achieving and sustaining about two percent inflation is a "good" goal. Thus many leading global central banks believe "too low" inflation (and of course deflation) is "not good" or is "bad".

Central banking decisions, actions, and rhetoric around the globe have become increasingly interdependent since the eruption of the international economic disaster of 2007-09. Banking captains nobly stress their willingness to do whatever it takes and whatever they must, frequently pointing to their beloved toolkit of monetary measures. Thus they embarked on highly accommodative monetary policies such as yield repression and gigantic money printing and generously provided forward guidance. Yet despite their long-running and devoted odyssey aimed at achieving and sustaining the praiseworthy target of two percent inflation, the armada of central banks thus far has failed in its inflationary quest. Their great expectations have not generated great results.

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Since inflation (including too low inflation and deflation) concerns and wordplay are so significant for current marketplace analysis and trends, it pays to select and assess variables indicating whether a sufficient and sustained quantity of inflation is appearing or may soon do so. Observers can differ in their choices and viewpoints.

"Inflation", however defined and measured, may appear earlier in one nation or region than another. Moreover, just because some or sufficient inflation (or deflation) emerges in one territory, they need not do so elsewhere. In any case, let's focus on America. Not only does the United States play a crucial role on the world economic and political stage, but so does the Federal Reserve Board. Stock, interest rate, currency, and commodity marketplaces avidly monitor Fed statements, signals, and behavior. Finally, America nowadays apparently is (however slowly) showing signs of being a key leader in international GDP growth.

AMERICA: INFLATIONARY "FACTS" AND FACTORS

In the opening lines of Charles Dickens's novel "Hard Times", a speaker in a schoolroom stresses "Now what I want is, Facts. Facts alone are wanted in life. Plant nothing else, and root out everything else. You can only form the lines of reasoning animals upon Facts: nothing else will ever be of any service to them."

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As they have so often, the Federal Reserve enlightened audiences regarding their determination to "take into account a wide range of information" and to be "informed by incoming data" (Press Release, 3/16/16). Better to pay attention to facts (data, evidence, statistics, and so forth) than fiction, right? The bottom line is this revered and widely-watched luminary has no extraordinary insight into economic phenomena. Like novelists, politicians, and other cultural players, central bankers and other economists create and tell stories about their world.

Despite their attention to facts, it has been difficult for economists to explain "inflation". The Economic Adviser and Head of Research of the Bank for International Settlements declared: "Economists are still struggling to figure out the full story on inflation." ("Where's the inflation, Mr Shin?" Interview with Hyun Song Shin, Frankfurter Allgemeine Zeitung; 12/27/15).

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According to the Fed's March 2016 "Economic projections" (central tendency), US personal consumption expenditure ("PCE") inflation in calendar 2016 will be about 1.3 percent (down from its projection in December 2015 of about 1.5pc), well below the two percent inflation target. However, the Fed predicts 2017's PCE central tendency range at 1.7 to 2.0pc, with 2018's 1.9-2.0pc. The midpoint of the central tendency range for the Federal Funds rate at year end calendar 2016 is about 1.2 percent, for 2017 at 2.0pc, and for 2018 at 2.9pc.

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In today's interconnected global economy, deflationary factors such as technological advances, "too many workers for most jobs" (pressure on wages), bad debt, and the crash in commodities prices can keep inflation depressed in advanced nations such as America. Slumps in stock marketplaces and "flights to quality" in (and low yields of) debt instruments such as the US Treasury 10 year note encourage most observers to worry little about inflation's return. America's strong dollar probably also has helped to subdue US inflation.

For the American perspective, many widely-monitored benchmarks generally indicate very low inflation. However, there are assorted hints that such minimal inflation will not persist indefinitely in America (and perhaps elsewhere).

First, the extremely lax monetary policies of the Fed and its central banking friends such as the European Central Bank and Bank of Japan probably will continue for a long time. The Fed indeed concluded its quantitative easing program many months ago. Yet that cessation does not ensure that the effects of Fed money printing have ended, or that those inflationary consequences will not become stronger (in interaction with other variables) as time passes. The Fed (3/15/16) became more dovish again. Besides, the ECB and Bank of Japan are printing mountains of money. The European Central Bank met 3/10/16 and expanded its easing scheme. The Bank of Japan (3/15/16) remained highly accommodative. At end February 2016, "China central bank unleashes $106bn to boost growth despite G20 warning" (Financial Times, 3/1/16, p1).

Moreover, US federal deficit spending, though it currently is less substantial than during the global economic crisis, likely will increase. In addition, the broad real-trade weighted dollar ("TWD") probably established an important high recently. Also, the S+P 500 and commodity prices, notably petroleum, have rallied from their first quarter 2016 depths. Housing prices continue to creep higher. Finally, some economic indicators that on their surface have not indicated or sparked inflation concerns with the passage of time nevertheless may do so.

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US consumer prices have been low. Upward wage pressures appear modest.

The US Consumer Price Index in February 2016 rose only 1.0 percent over the last 12 months (CPI-U, all items; Bureau of Labor Statistics, Table 1; 3/16/16). However, "shelter", which is thirty-three percent of the index, jumped up 3.3pc year-on-year. Energy, which is about 6.7pc of the CPI, tumbled about 12.5pc year-on-year. But what if energy (especially oil) prices, even if they do not spike, manage to sustain their advance from their early 2016 lows?

Real average hourly earnings increased only 1.2 percent year-on-year in February 2016, with average weekly earnings up only .6pc year-on-year (BLS, Table A-1; 3/16/16). Gurus debate the strength of the relationship between wages and unemployment (and notions such as the output gap and other statistics). The Fed's Economic Projections put the longer run unemployment rate range (central tendency) at 4.7-5.0pc. The ranges for calendar 2016 (4.6-4.8pc) and 2017 (4.5-4.7pc) are a bit less than this long run view. So upward wage pressures, especially if other inflation indicators point the same way, arguably may become at least slightly more significant over the next year or two.

US money supply (M2) grew 5.7 percent (seasonally adjusted annual rate) in the 12 months from February 2015 to February 2016 (Fed, H.6; 3/17/16). Money supply expansion has not inflamed inflation fears in recent years. But that does not mean this situation will remain unchanged.

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"What connexion can there have been between many people in the innumerable histories of this world who from opposite sides of great gulfs have, nevertheless, been very curiously brought together!" "Bleak House" (Chapter 16), by Charles Dickens

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Not only is the United States linked to other territories around the globe. Assorted stock, interest rate, currency, and commodity marketplaces intertwine in various and sometimes changing fashions. In mid-2015, after an awesome bull advance lasting several years, OECD (advanced nation) stock marketplaces such as the S+P 500 joined in the terrifying bear move of commodities and emerging marketplace stocks. The broad real US trade-weighted dollar's sharp climb from its September 2014 level connected closely with the bearish commodity and stock travels.

Marketplace audiences therefore should highlight the similar first quarter 2016 timing of the high in the TWD, important lows in the S+P 500 and many other key stock marketplaces, the yield bottom in the US Treasury 10 year note, and troughs in the broad GSCI (and the petroleum complex).

The price increases in commodities and the S+P 500 since their first quarter 2016 depths may not produce a boost for inflation "in general". Those price advances may not be sustained. Yet the jumps in commodities and stocks thus far probably are substantial enough to signal growing potential for rising inflation rates. The US dollar depreciation and the increase in US government

note yields also warn of an increasing likelihood of at least a modest increase in American inflation measures.

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Suppose marketplace participants generally are not terribly fearful of economic collapse. Then low interest rate yields (particularly negative ones) eventually can spark and sustain hunts for "good (sufficient) returns" outside the realm of high-quality (especially government) debt securities. Some sailors will voyage into and begin buying within the promised land of stocks (especially allegedly investment grade ones), high-yield corporate debt, or commodities.

For commodities "in general", use the S&P broad Goldman Sachs Commodity Index ("GSCI") as a weathervane. Given the very large share of petroleum within the GSCI, oil price trends and OPEC policy are particularly important for GSCI levels and trends.

Recall the broad GSCI's lofty summits at 762 (4/11 and 5/2/11) and 673 (6/23/14). The broad GSCI achieved a notable low on 1/20/16 at 268, a 64.8 percent dive from its spring 2011 peak and 60.2pc under its June 2014 elevation. It thereafter ascended, attaining around 341 on 3/18/16, a 27.2 percent climb.

NYMEX crude oil (nearest futures continuation) collapsed to its important bottoms at $26.19 on 1/20/16 and $26.05 on 2/11/16. Prices spiked dramatically higher, reaching $41.20 on 3/18/16, up 58.2pc.

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Recent wordplay and action by the easy money Fed and its central banking shipmates underline not merely their determination to evade deflation and manufacture sufficient inflation. These helmsmen also have launched a campaign to arrest further declines in key global stock benchmarks in the United States and overseas, as well as to stop the broad real trade-weighted dollar ("TWD") from ascending much (if at all) beyond its January 2016 highs.

Substantial stock marketplace rallies do not necessarily demonstrate (or portend) either strong real economic growth or inflation. But such bull moves may indicate either or both of these.

Closing at around 2050 on 3/18/16, the S+P 500 remains beneath 5/20/15's 2135 peak. The nominal TWD had an interim low 5/15/15 at 112.8. However, the most recent S+P 500 settlement more than triples 3/6/09's major low at 667. It hovers more than 90 percent above the important later trough on 10/4/11's 1075 and almost 62pc over 6/4/12's 1267 low.

Following its early January/February 2016 lows at 1812 (1/20/16)/1810 (2/11/16; recall the earlier interim low on 4/11/14 at 1814), the S+P 500 motored up about 13.4pc to its 3/18/16 high at 2052.

Emerging marketplace stocks likewise have rallied in the past two months. The MSCI Emerging Stock Marketplace Index (from Morgan Stanley; "MXEF") is a key yardstick for emerging marketplace stocks "in general". Note the MXEF's low on 1/21/16 at 687 (it established a second bottom at 708 on 2/12/16, around the time of the S+P 500 and other stock marketplace lows). The MXEF thereafter has marched northward roughly twenty percent from its January 2016 low, climbing over 800.

Asset price inflation is not confined to stocks. American house prices have risen. Survey the S&P Case-Shiller national home price index. The index bottomed at 134.0 in February 2012.

December 2015's reading of 175.7 (the most recent statistic) is not distant from July 2006's Goldilocks Era 184.6 pinnacle and is up 31.1pc from the 2012 trough. Also, the national index is up about 5.5pc year-on-year relative to December 2014's 166.6.

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The broad real trade-weighted dollar ("TWD"; Federal Reserve Board, H.10) is a monthly average. The TWD made a major bottom at 80.5 in July 2011. Its recent high at 101.4 in January 2016 was a 26.0 percent bull charge from July 2011's low and a 17.1pc rally since the breakout in September 2014 (86.6) over June 2012's interim high (86.2). The TWD slipped down about one percent to February 2016's 100.5.

The nominal TWD has daily data. Its high occurred 1/20/16 at about 126.2. Note the coincidence of this summit and the lows in the broad GSCI (1/20/16), the S+P 500 (initial 1/20/16, second on 2/11/16) and emerging marketplace stocks (MXEF; 1/21/16). The nominal TWD top occurred not long before the US Treasury's important yield low on 2/11/16 at 1.53 percent.

Since then (through 3/11/16, the most recent statistics), the nominal TWD ebbed to 121.4, a 3.8pc fall.

The cross rates of various so-called commodity currencies against the US dollar have rallied over the past two months. This confirms the broad GSCI and advanced and emerging marketplace stock patterns. For example, the Canadian Dollar's low against the greenback was 1/20/16 at about 1.47; the CD rallied about 11.2pc to beneath 1.30 recently. The Mexican peso's 2/11/16 low was around 19.45; it appreciated over 11.0pc by mid-March 2016. The trough in the Russian ruble versus the US dollar was 1/21/16 at 86.0; the ruble advanced to under 68.0 (about 21.0pc) by the end of last week. The low for Brazil was 9/24/15 at 4.25. However, the real made a second low on 1/21/16 at about 4.17; it eroded a further 13.7pc from mid-January to under 3.60 recently.

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Various factors such as competitive depreciation may limit the TWD's fall, or assist renewed TWD strength. For the dollar, much depends on central banking policy and inflation levels in the US and elsewhere, as well as trends in assorted key equity, commodity, and debt domains.

However, several phenomena, which perhaps will interrelate, could cause further TWD feebleness. For example, suppose benchmark American inflation measures such as the CPI and PCE begin rising (and perhaps accelerating) from current rates, and that ongoing substantial yield repression by the Fed accompanies this increase in inflation in general. Or, what if more and more marketplace observers begin to worry more significantly about the sizeable and increasing US federal fiscal debt level? Also, deep US political divisions and strife could inspire a crisis of confidence in American political (and economic) leadership.

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The US Treasury 10 year note yield's recent trough was 2/11/16's 1.53 percent. This stands very close to its major low at 1.38pc on 7/25/12 (recall the European Central Bank President's "whatever it takes" speech on 7/26/12). The UST 10 year yield advanced significantly from its July 2012 bottom. It established a ceiling on 1/2/04 at 3.05pc (2/11/16's yield is about half that level).

The Fed's yield repression of the US government yield curve at times can make it challenging to spy increasing inflation (or growing fears regarding it) via looking only (or primarily) at that curve.

The vigilant Fed navigators often herald that US inflation expectations appear well-anchored. One can assess such conjectures in various ways. Trend changes in a given measure of forward inflation need not coincide closely with marketplace turns in interest rate securities such as the US Treasury 10 year note. However, the St. Louis Fed's five-year forward inflation expectation rate declined gradually from 2.84 percent on 1/15/14 to lows in first quarter 2016 (1.48pc on 1/21/16 and 1.42pc on 2/11/16). A sustained move in the St. Louis Fed's inflation expectation compass to over 2.00pc probably would attract attention (1.93pc low 9/22/11, 1.93pc trough 1/29/15, 1.93 interim top 11/6/15).

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A noteworthy trend of rising American government (and other) interest rates can occur due to various and perhaps entangled influences. For example, these may include current (or expected) inflationary pressures, substantial new US government debt supplies (growing budget deficits), net selling (less buying) by the public of US debt securities, dollar depreciation, and significant sustained falls in confidence regarding America's political (economic) leaders. Overseas economic and political trends and developments matter too.

Foreign holders of American debt instruments will be less inclined to be own them if US interest rates increase alongside US dollar depreciation. Watch for signs of reduced net foreign buying (or net selling) of US government (and other) debt securities.

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More inflation and higher interest rates may not necessarily produce or reflect substantial real GDP growth. Even if America does not get much (or sufficient) inflation in the relatively near future, or even in the medium term, people should remain alert to its emergence. And just because the Fed and other central bankers claim they will fight to avoid "too high" inflation, such assertions do not preclude such excessive inflation.

US POLITICS: BLEAK HOUSE

In Dickens's "Great Expectations", a character says: "'Ask no questions, and you'll be told no lies.'" (Chapter 2)

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Most Americans have high (or at least moderate) confidence in and trust the US Federal Reserve Board. In contrast, many Americans nowadays have rather low expectations regarding US politicians "in general". They distrust and have rather little confidence in most US political leaders. They question the willingness and ability of such representatives to work together to achieve desirable goals.

Focusing on central banks and their monetary measures aimed at achieving sufficient inflation should not cause observers to overlook political causes, including fiscal ones, of inflation and higher interest rates. And interest rates can rise for reasons other than, or in conjunction with, inflation pressures.

In any case, weak national political leadership and substantial political divisions do not guarantee rising interest rates, but they can encourage that development. They also can help to generate a weaker dollar.

The United States currently is a house divided. Income and asset inequality, immigration debates, views on health care, opinions on the appropriate size and role of government, international trade topics, climate change, and other issues inflame America's political theater. In election year 2016, as in the prior few years, there has been greater than normal partisan strife.

These ongoing significant US political divisions risk further weakness in the US dollar. Underscore the current conflict between the Republican Congress and the Democratic President. Though the American political process has a long way to go until election season 2016 concludes, partisan warfare likely will persist. The House likely will remain Republican; the President probably will be a Democrat (Hillary Clinton). Control of the Senate is a close call.

The battles within the Republican camp look likely to persist for at least a few more months. Will there be a convention fight? "Trump warns Republican elders of 'riots' if they fail to back his candidacy", headlines the Financial Times (3/17/16, p3). Although Trump has great confidence in his own talents, at present the majority of Americans apparently do not share that confidence. Suppose Donald Trump captures the Republican Presidential nomination. Imagine that he wins the Presidency. Comments from overseas leaders suggest lack of faith in Trump's abilities and policies. Such foreign attitudes are a bearish factor for the dollar.

An ability to transcend partisan divisions only via big spending (fiscal irresponsibility) does not eliminate substantial underlying political factionalism. The massive addition to future US budget deficits agreed upon by Congress and the President in late December 2015 probably will tend to push up interest rates and is a bearish factor for the dollar. (See the Congressional Budget Office's "Summary of The Budget and Economic Outlook: 2016 to 2026; 1/25/16. See also the NY Times, 12/17/15, pA29; NY Times, 12/19/15, ppA1, 13). In any event, America has a looming long run debt problem. And don't debtors tend to like inflation?

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For additional marketplace analysis, see "Hellish Falls, Divine Rallies: Commodities in Context" (3/6/16), "As the World Burns: Marketplaces and Central Banks" (2/8/16), "Japanese Yen: Currency Adventures (2007-09 Revisited)" (1/14/16), "The Curtain Rises: 2016 Marketplace Theaters" (1/4/16), "America: A House Divided" (12/7/15), and other essays.

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