ASSET MANAGEMENT

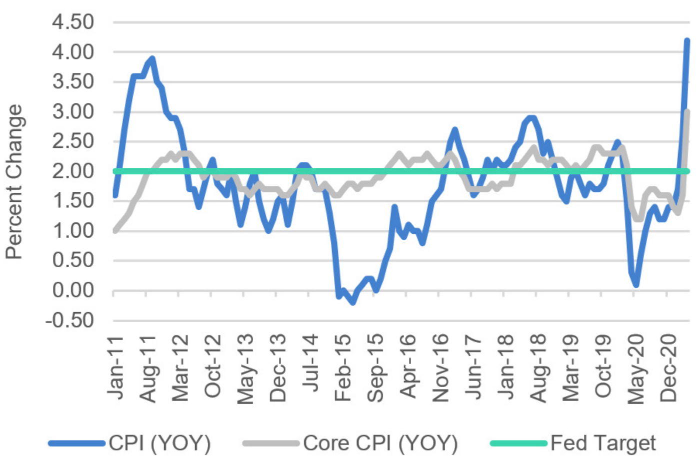
FED SPEAK: Walking an Inflation Tightrope

MAY 2021

Prepared by PMA Asset Management, LLC

In 2020, the Federal Reserve announced a new policy framework it calls flexible average inflation targeting. Since 2012, the Fed has been targeting a 2% target inflation rate. This new communication, part of the Fed's mandate to maintain price stability, was intended to clarify that the Fed seeks to maintain an average rate of inflation of 2%. Averaging 2% means inflation should sometimes be above its target. This policy guidance reflects the Fed's concern that inflation has trended below its 2% target for much of the past decade.

Inflation Has Trended Below the Fed's Target



Source: Bloomberg

There are multiple measures of inflation. The most widely known is the Consumer Price Index (CPI), which measures the change in out-of-pocket expenditures for a fixed basket of goods. There is also a Core CPI measure that excludes food and energy prices, which tend to be more volatile. The Fed's preferred measure of inflation is Personal Consumption Expenditures (PCE), which measures price changes based on actual domestic consumption. Core PCE excludes food and energy. While broadly similar, CPI and PCE utilize somewhat different baskets of goods and calculation methodologies.

Key points:

- **Temporary factors have boosted inflation in March and April**
- **CPI of 3-5% is possible in 2021**
- **The Federal Reserve remains dovish as it seeks to maximize employment**
- **Fed policy tools and global factors should keep domestic inflation well-anchored**

Inflation has grabbed headlines the past two months as month-over-month (MoM) and year-over-year (YoY) growth rates have increased. The YoY increases have been due in part to low comparisons from a year ago when the economy came to a near stop and energy prices plummeted. These calendar effects shot CPI up to 4.2% YoY in April. On a MoM and YoY basis, other factors such as supply constraints in shipping, lumber, microchips and cars have boosted inflation statistics. The Federal Reserve generally labels such factors as transitory, or temporary. Unless prices for goods and services rise more broadly and workers demand higher wages, these factors should remain transitory. The table below shows that year-to-date average hourly earnings growth remains below PCE and CPI.

Month	PCE	Core PCE	CPI	Core CPI	Average Hourly Earnings
January	0.3	0.2	0.3	0.0	0.0
February	0.2	0.1	0.4	0.1	0.3
March	0.5	0.4	0.6	0.3	-0.1
April	0.5	0.4	0.8	0.9	0.7
YTD Total	**1.5**	**1.0**	**2.1**	**1.3**	**0.9**

Why Do We Care About Inflation?

Inflation and inflation expectations impact consumers (changes in prices for goods and services), markets (asset prices), and state and local government budgets that are tied to inflation. For example, measured inflation would impact eligibility for certain Wisconsin municipalities to receive an aid payment as part of state's Expenditure Restraint Program (ERP). The higher the CPI for the 12 months ending September 30, the larger the allowable percentage increase in a municipal budget that would still qualify for an ERP aid payment.

With respect to the financial markets, if inflation were to rise in a sustainable manner, the Fed would likely raise short-term rates before 2024, when it projects to first boost the Fed Funds rate. This would increase the yield on most liquid, short-term investments. Increased inflation would also negatively impact the price of longer-term bonds and equities. In fixed income markets, inflation reduces real returns, or returns after inflation. Rising inflation expectations tend to increase long-term interest rates, which impacts bonds' market prices and income. Equity markets are also affected. Profit margins can be impacted by changes in the price of goods sold and labor input costs which may not match changes in sales prices over periods of time. This impact on margins can be beneficial as many companies have reported this year, or it can diminish margins. Market interest rates also impact equity prices since stock prices are based on the discounted present value of future earnings. A higher discount rate reduces the present value of future earnings.

Where is Inflation Headed?

This is the question markets are asking. At the Federal Reserve's March meeting, Federal Reserve Board members' median projections of PCE and Core PCE inflation in 2021 were 2.4% and 2.2%, respectively. A Bloomberg survey of economists shows expectations of PCE and Core PCE of 2.5% and 2.0%, respectively. This same survey reveals CPI is expected to be higher at 3.0% in 2021. The Fed also considers surveys and market-based expectations of future inflation as indicators of potential long-term inflation risk.

Focusing on CPI, which has already totaled 2.1% year-to-date through April, there is a distinct risk it could rise at a faster rate compared to these projections. If MoM CPI immediately returns to 0.17%—the monthly growth rate which approximates 2% annual inflation—for the remainder of the year, CPI would be about 3.3% in 2021. Under other scenarios that project inflation remaining elevated until unemployment benefits normalize in September, 2021 CPI could total 4 to 5%. Meanwhile, YoY CPI may also remain elevated due to calendar effects.

The Fed's Inflation Tightrope

Federal Reserve board members have been busy in recent weeks talking about the transitory nature of current inflation rates. The Fed believes more work is needed through low rates and asset purchases to further stimulate economic and employment growth. To this end, "Fed speak" has remained dovish as most Fed members say it is too early to talk about tapering asset purchases or raising interest rates. The Fed also knows confidence and their own credibility is critical to markets. As a result, Fed members are reminding markets they have the tools to cool inflation if it were to overheat.

Economic reports on employment, inflation and earnings growth will be closely scrutinized in the weeks ahead by the Fed, market participants and PMA investment professionals. We fully recognize the wide range of market implications that higher inflation could bring. However, we also believe that Fed has the tools to keep inflation well-anchored. At PMA, our outlook for inflation is guided by a strong and effective Fed and a recognition that the U.S. resides within a global economy where excess supply of goods and labor are widespread. This global view leads us to believe that consistently boosting U.S. inflation above 2% may be harder than some market watchers believe.