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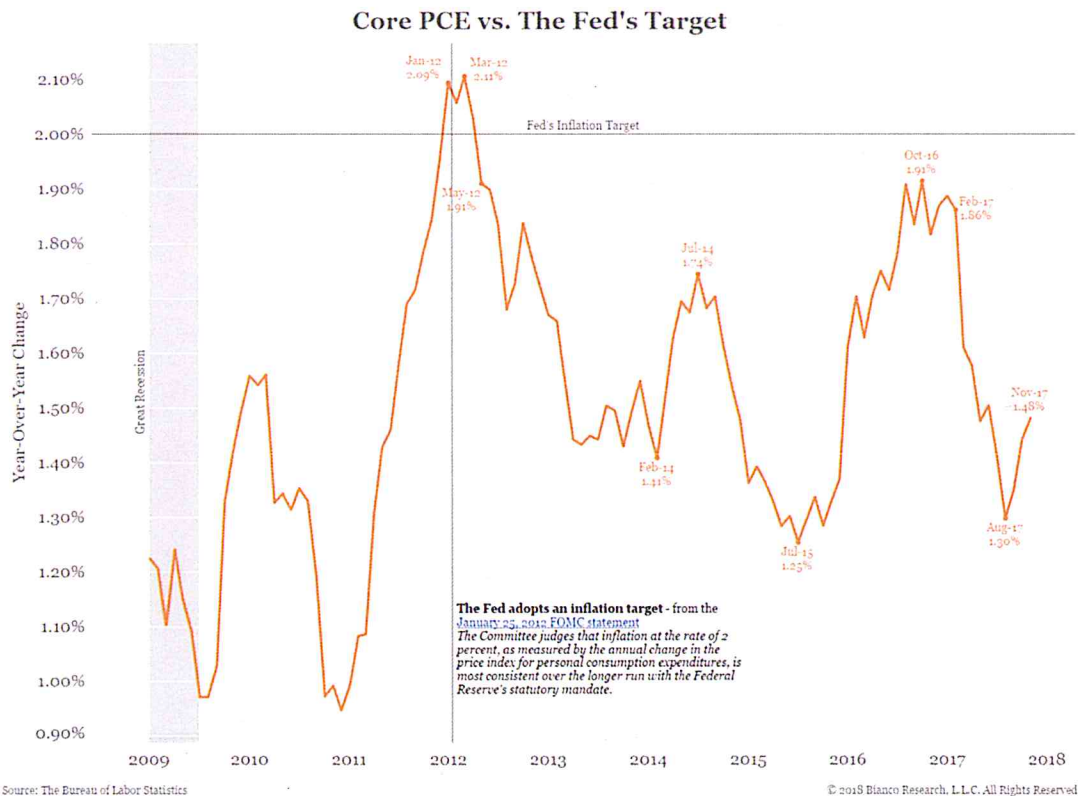
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Greg Cater Sr. and Greg Cater Jr.
Inflation Versus Interest Rates
 2/2/18

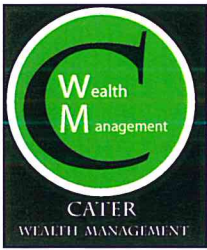
The Fed's interest rate target is 2% based on the PCE. January 23rd 2012 FOMC Statement:

“The committee judges that inflation at the rate of 2% as measured by the annual change in the Price Index for Personal Consumption Expenditures (PCE) is most consistent over the longer run with the Federal Reserve's statutory mandate.”

Janet Yellen has gone further and said she favors the “Core PCE”. Core PCE excludes food and energy because of their volatility. On January 23rd, 2012, when the Fed established the 2% target, core PCE was between 2% and 2.1%. It remained above 2% for one quarter, and has been running below ever since. The Current reading, Dec 2017, is 1.5%. Headline PCE, the actual target, is currently 1.7%, down from 1.8% at the beginning of the year.



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Jim Bianco in a Bloomberg article on Feb 1st, 2018 stated: “The Fed’s inability to create inflation has flummoxed Chair Janet Yellen, who led the last meeting of her tenure on Wednesday.” As the following two citations show, the “data-dependent” Fed chief was reduced to words like “guess”, “expect”, and “believe”.

On Oct 15, 2017, she said:

“My best guess is that these soft readings will not persist, and with the ongoing strengthening of labor markets, I expect inflation to move higher next year.”

And on Dec 13, 2017, she said:

“I’ve talked in detail about this in the past and recognize that there is uncertainty about what’s holding inflation down, but my colleagues and I continue to believe that the factors that are responsible this year for holding down inflation are likely to prove transitory.”

Phillips Curve

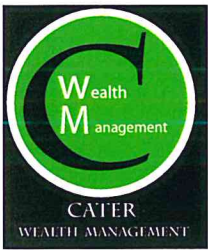
William Phillips, a New Zealand born economist, wrote a paper in 1958 titled “The Relationship Between Unemployment and Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957.” His basic idea was an inverse relationship between inflation and unemployment.

Apparently, the current Fed is “all in” when it comes to the Phillips Curve. Since the Great Financial Crisis (GFC) unemployment has fallen from double digits to 4.1%. Looking at the Core PCE chart, or any measure of inflation for that matter, it is hard to find any correlation between employment and inflation.

Interest Rates

The interest rate on a bond is a function of the issuer’s credit quality and the investor’s inflation expectation. Or in other words, how much I am willing to pay for a bond is a function of how likely I am to be paid back, and how much my money will be worth (after the effects of inflation) when I am paid back. With US Government bonds, credit quality is not a concern. The only real question is “inflation expectations.”

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Inflation expectations are just that - expectations. We currently have two ways to measure them: Market based, and Survey based. An example of the latter is the University of Michigan survey of consumers. According to James Bullard, President of the Federal Reserve Bank of St. Louis, The Michigan survey tends to overestimate inflation expectations. It is currently 2.5%.

Another Survey based measure comes from the Survey of Professional Forecasters (SPF). This survey is based on the Consumer Price Index, and the Personal Consumption Expenditure Price Index. Over the next ten years, PCE is forecasted to increase 2%; unchanged from the previous estimate three months ago.

There are two widely used Market based measures of inflation. One is tied to the market for Treasury Inflation-Protected Securities (TIPS) versus coupon Treasury Bond yields with the same maturity. Another is the Five Year-Five Years Forward Rate. Currently the 10 Year Breakeven Rate (TIPS vs coupon) is 2.1%, and the Five Year-Five Years Forward rate is 2.23%.

<u>Headline PCE</u>	<u>1.70%</u>
<u>Core PCE</u>	<u>1.50%</u>
<u>University of Mich Inflation Expectations</u>	<u>2.50%</u>
<u>Survey of Prof Forecasters (SPF)</u>	<u>2.00%</u>

<u>TIPS Breakeven</u>	<u>2.10%</u>
<u>Five Year- Five Years Forward</u>	<u>2.23%</u>

Most think inflation must go up because unemployment is 4.1%; down from double digits in '09.

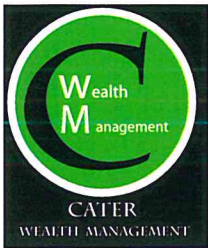
<u>Japan</u>	<u>Unemployment Rate</u>	<u>2.80%</u>	<u>Inflation Rate</u>	<u>1.0%</u>
<u>Germany</u>	<u>Unemployment Rate</u>	<u>3.60%</u>	<u>Inflation Rate</u>	<u>1.6%</u>

The developed country that has had the lowest unemployment rate historically is **Norway**.

<u>Current Inflation Rate</u>	<u>1.88%</u>
<u>Average Unemployment Rate 1997-2017</u>	<u>3.59%</u>

Interest rates, at their core, are a measure of the supply and demand for money. For interest rates to go up, either individuals or corporations must be willing and able to pay more to borrow that money. Corporate cash balances are at historic highs, and Trump's tax cuts will only add to their cash reserves. Individual savings rates are at 12 year lows, and their debt levels are at historic highs. Corporations already have the cash they need, and individuals likely can't afford to bid up the interest rate. Higher interest rates imply an increased demand for cash. I'm not sure who is going to pay up to borrow that money.

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Works Cited

All inflation projection rates: <https://fred.stlouisfed.org/>

Chart:

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Federal Reserve Quotes: <https://www.federalreserve.gov/>

Corporate Cash balances:

<https://www.spglobal.com/our-insights/US-Corporate-Cash-Reaches-19-Trillion-But-Rising-Debt-and-Tax-Reform-Pose-Risk.html>

Individual Debt and Savings Rate: <https://fred.stlouisfed.org/>

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