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U.S. Interest Rates: Why Inflation May Be the Only Thing Going Up

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STANDISH

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Inflation in the U.S. has the potential to overshoot the Federal Reserve's ("Fed") 2% target next year, says Vincent Reinhart, chief economist at Standish, as the country's aging population is less equipped to deal with a sudden rise in demand.

"Our aging population is growing slowly and not expecting the output associated with added effort. This means now, and for a time to come, there is less headroom for demand expansion, putting inflation on a gradual uptrend toward the Fed's goal," says Reinhart.

Following the release of the July Federal Open Market Committee (FOMC) meeting minutes, Reinhart says the members of the FOMC seemed more confident about economic momentum.

"The shared view was that the U.S. economy had maneuvred over some first-half potholes and would perform going forward about as expected at the prior FOMC meeting. That earlier outlook was predicated on the expectation of FOMC participants of a rate hike or two in 2016."

However, investors should not be sanguine regarding the inevitability of another Fed rate rise this year, Reinhart adds.

While most post-meeting speakers from the FOMC wondered aloud about the low probability of action priced into futures markets, Reinhart believes this hawkish message was both "conventional and repetitive" and that the mainstream macroeconomics in the minutes followed "the Fed script of midyear."

"With policy accommodative and financial conditions supportive, aggregate demand is likely bumping along in a 2% channel. This performance is uninspiring compared with that of prior decades but is likely above that of potential output. The removal of some unusual accommodation is needed, but such action can be gradual for now. Moreover in a slowly growing economy, less cumulative tightening will ultimately be required," he says.

However, mixed rhetoric and inconclusive statements from the FOMC have left him unsure of whether the U.S. will see a rate rise before 2016 concludes.

In the July minutes, there was mention that "economic conditions would soon warrant taking another step in removing policy accommodation," yet while most FOMC members agreed labor slack was close to, or already, gone, others "continued to judge that labor utilization remained below that consistent with the FOMC's maximum employment objective."

Reinhart says the insistence of these concerns in the minutes seemed to imply these were, for a couple of participants, sufficiently compelling not to tighten in 2016. This is a surprise given that in the Summary of Economic Projections it was reported that everyone envisaged at least one rate hike in 2016.

"Some want to move, one member would have done so that day, and a couple wanted to see the whites of inflation's eyes before moving. But that does not add up to the entire group, so evidently some views were either unexpressed or unreported." Reinhart believes that not to close the loop on the discussion was a decision, rather than an omission, by Federal Reserve Chair, Janet Yellen.

Ultimately, he believes the mainstream macro story has merit and the FOMC will appropriately raise the funds rate one-quarter point in December.

"The pattern of Fed leadership, however, has been to talk that game but then grasp any reason for delay. If Yellen is flanked to her left by a couple of more assertive doves, she may be more willing to put off for tomorrow what the majority of her committee wants today," he concludes.

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