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The Fed plays a long game with inflation

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Inflation has jumped higher than expected — commanding headlines, worrying investors and roiling markets. What's behind the Fed's new approach?

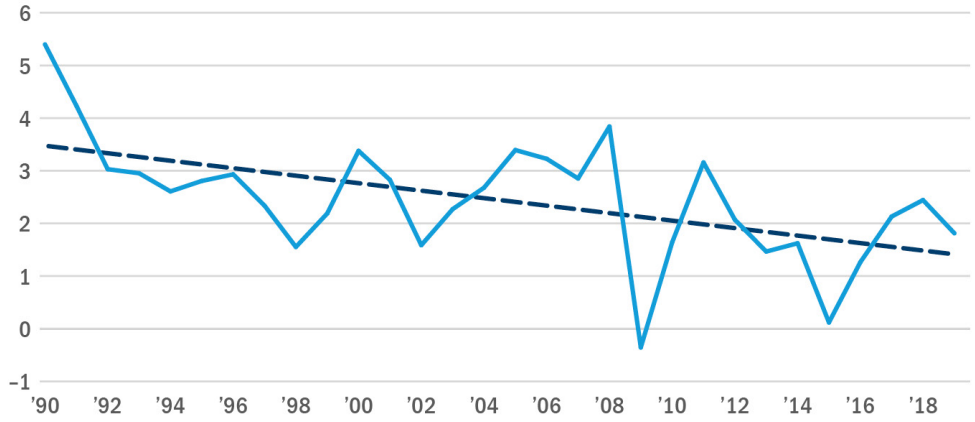
Inflation is not always a bad thing

Sustained high inflation can raise the cost of living and stunt business growth. But low and predictable levels of inflation, like what we've experienced over the past 20 years, are generally viewed as having a positive influence on supply and demand, employment and economic growth.

One reason the markets may be reacting strongly to higher inflation numbers today is the historically low inflation environment we've enjoyed since the turn of the century. For most of that time — and through two broad economic cycles — inflation has remained low and range-bound. Over the period as a whole, it has trended downward.

30 years of low and falling inflation

Consumer Price Index year-over-year, 1990-2020



Source: Columbia Threadneedle based on Macrotrends data.

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"A number of what I would call structural factors have conspired to bring inflation down across the developed market world," says Edward Al-Hussainy, Columbia Threadneedle Investments' Senior Interest Rate and Currency Analyst. "These include demographic changes, advancing technology, globalization, the evolution of services and, importantly, the actions of central banks. Any rise in inflation in this or the coming years would come off these already low levels and have to push against these growing trends."

Five key factors that have kept prices and inflation in check

Demographics	Technology	Globalization	The evolution of services	Central banks
Populations in the developed world are aging. As we age, both the velocity and the structure of our consumption changes, and it tends to skew toward services where price pressures are lower.	Technology has flattened pricing structures, making entry to industry relatively easy and concentrating market power in certain industries. It's also enabled more trade in services both within economies and across borders.	Globalization has roped in spare capacity from around the world. We no longer think of spare capacity as being a domestic issue, particularly when it comes to goods.	Services have become a larger chunk of our consumption basket and the prices within the services basket, in general, have trended down.	Central banks have been very effective at anchoring expectations, and inflation expectations tend to be one of the core drivers of inflation over the long term. That's a key factor that limits inflation volatility to the upside and downside alike.

An evolving relationship between rates and inflation

The actions of central banks, unlike the other factors, are intentional and controllable, and may be losing some of their effectiveness.

"Historically, central banks have responded to inflation levels above or below their policy objective by setting interest rates to loosen or tighten credit conditions and to stimulate demand," says Adrian Hilton, Columbia Threadneedle Investments' Head of Global Rates and Emerging Market Debt. "The understanding of the link between underlying rates and inflation, I think, is about as poor as it's been for a long time — probably worse than any point since inflation targeting took off in the late 1990s."

Since the 2008 financial crisis, central banks have struggled to meet their inflation targets to generate enough demand. "That's a problem," continues Hilton, "because if you can't create inflation with labor markets as strong as they've been, you may never get to the point where you can raise interest rates. If you can't raise rates off these rock bottom levels, then you've got a problem when the next downturn arrives — you don't have room left to cut rates to stimulate the demand you need to energize a recovery."

The U.S. Federal Reserve has responded to this problem with a new approach to inflation policy called flexible average inflation targeting (FAIT). Using this method, they hope to maintain an average target level over time. This allows for higher levels of inflation over shorter periods to run the economy "hot." This spurs growth and takes the pressure off maintaining an overly tight monetary policy.

FAIT has some segments of the market worried, because it implies a potentially more permanently inflationary path. And if the Fed is inclined to leave its foot on the accelerator longer to speed up the recovery, it probably does mean keeping rates low for longer in the near term and a more inflationary profile further out.

“The question for investors is, can the Fed hold its nerve?” adds Hilton. “The market has recently been testing the Fed’s commitment to forward guidance by starting to price in a slightly more aggressive pace of interest rate hikes than they had at the start of the year. And as we run into some of those base effects this year as the consumption recovery gathers steam and we start to see inflation moving higher, there’s going to be more and more pressure on the Fed to cool things off.”

“We know that because of base effects, supply bottlenecks and a rebound in energy prices, there’s going to be some price pressure coming to bear,” Hilton believes. “How big that is also depends on how potent the U.S. fiscal stimulus is. The extent to which stimulus can juice demand will depend somewhat on whether consumers hold onto the money rather than spend it.”

For businesses, the outlook is more muddled. “Input costs for businesses are rising, probably at the fastest pace that we’ve seen in a decade or so,” says Al-Hussainy. “The questions are, do businesses have the capacity to pass these prices onto consumers, and can they do that on a sustained basis? And to what extent does this eat into profit margins? Those answers are still unclear.”

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