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Special Report

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Inflation Expectations & Currency Risks Shouldn't Derail Fed Hikes

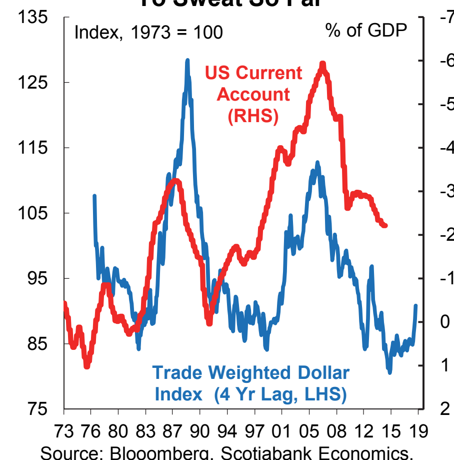
- **A broad variety of measures for inflation expectations and currency risks still support Fed rate hikes by mid-year.**

Growth in the US economy, the likely move considerably closer to full employment accompanied by a somewhat firmer picture for wage growth into early 2016, and financial market froth particularly in bonds all support policy tightening by the Federal Reserve sooner rather than later in our view. In this note, we address two additional sources of uncertainty: currency markets and inflation readings.

EURUSD Risks Alone Won't Stop The Fed In Its Tracks

The Federal Reserve outlook is susceptible to currency risks, but so far the USD on a real effective exchange rate basis is up by a fairly modest 13% since its low in mid-2011 and the effects on the current account position of the US economy will be spread over up to four years given historical correlations (chart 1). Thus far what we have witnessed is not enough to re-write the outlook for the Federal Reserve.

Chart 1 **USD Move Is Nothing To Sweat So Far**

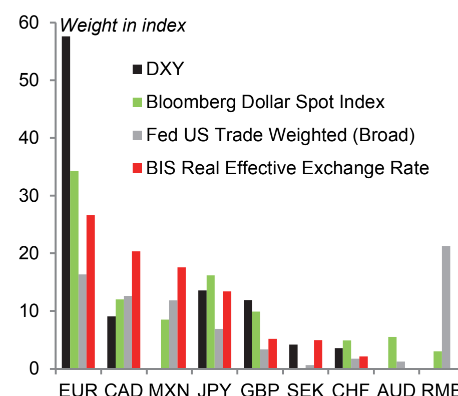


Source: Blooomberg, Scotiabank Economics.

Should the EURUSD cross move downward toward parity, then the effects on the USD and Fed policy need to be judged in terms of the overall trade-weighted currency basket — not one single cross. The Euro carries about a 27% weight in the Bank for International Settlements' (BIS) real effective exchange rate for the US, and a 16% weight in the Federal Reserve's broad trade-weighted USD that former Chairman Bernanke has referred to in the past, while other indices are too narrow in scope (chart 2). Put another way, at least three-quarters of a broad basket of exchange rates versus the USD is affected by crosses other than the EURUSD.

Chart 2

Dollar Indices -- Country Weights



Source: Scotiabank Economics, Bank of International Settlements, Federal Reserve,

With the Chinese renminbi roughly pegged versus the USD and thus little affected by ECB actions, this part of the cross is neutral to the USD risks. Presumably the foreign currency halves of crosses like USDJPY or USDCAD or GBPUSD that matter to US trade would be driven mostly by factors other than ECB action. Within reason, we therefore do not view our Fed call as being overwhelmingly at risk by what the ECB may or may not do. We need a much bigger movement in the REER than what has been observed to date in order to cause more material effects on the current account balance of the US economy. What we treat more seriously is domestic inflation risks that are the focus of the rest of this paper.

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A Balanced Approach To Inflation Expectations

Will softer US inflation readings nevertheless knock the Fed off course and delay policy rate hikes?

The key in this regard is to survey a variety of measures of inflation expectations. Forget the obsession with volatile near-term inflation readings that are bound to continue to follow gas prices lower in the short-term. Instead, look to what these metrics for inflation expectations are telling us by way of how price pressures are expected to pan out over time. While all of them have their pitfalls, on balance they point to reasonably resilient longer-run price pressures that support the Fed's tendency to look through near-term price readings.

Ignoring this risks being caught by surprise over the course of the next year into 2016 when — as we think — US headline inflation will probably begin to spike higher. On headline, this will be partly caused by a reset on year-ago base effects that are currently comparing gas prices to higher levels in the past but by year-end into 2016 will be comparing to currently low levels. On core, there is a higher likelihood that lower gasoline prices will free up incomes to spend on other things and thus gradually reflate core prices over time than the opposite effect of lower gasoline prices feeding through core CPI by way of spillover effects on transportation and other costs.

If this is right, then it will cause an abrupt shift in the level and shape of the Treasury curve in response to inflation data and an FOMC that will focus on lagged effects of monetary policy into a
6-18 month forward environment. We think this is the approach the Federal Reserve's FOMC will take on January 28th and more so at the March FOMC meeting in support of hikes by or around mid-year.

1. Market-Based Measures Of Inflation Expectations

Among the possible market-based measures, we sample two of them that have fallen significantly, are difficult to read, and do not signal deflation risk.

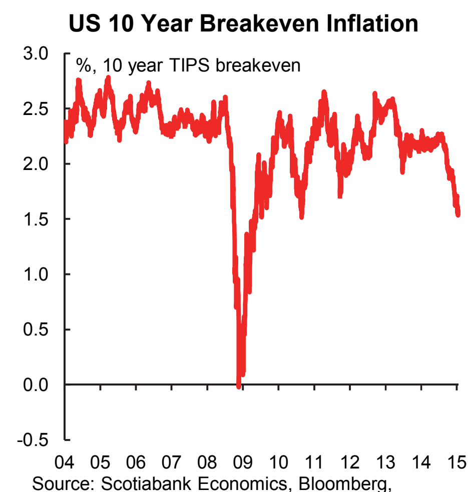
One is the simple 10 year breakeven rate on Treasury Inflation Protected Securities (chart 3). It has fallen sharply from about 2.28% last July to 1.57% now which is the lowest since 2010. This might be taken to mean that markets have backed off inflation expectations. A problem, however, is that this measure can encapsulate several things and not just what the market thinks about true inflation rates over the longer term but also liquidity distortions when safehaven flows disproportionately flow into nominal Treasuries relative to TIPS as well as inflation risk premia. Many would argue that some of the decline is due to truly lower inflation expectations but that much of it is driven by these other factors such that the decline exaggerates true market sentiment toward long-run price pressures.

Enter an alternate measure — the five year forward inflation swap (chart 4). This measure is less susceptible to the non-inflation distortions that affect 10 year TIPS breakevens and was proposed in a Federal Reserve working paper just going into the global crisis (here). It has also fallen fairly sharply from about 2.5% last summer to 1.75% now.

2. What Forecasters Expect

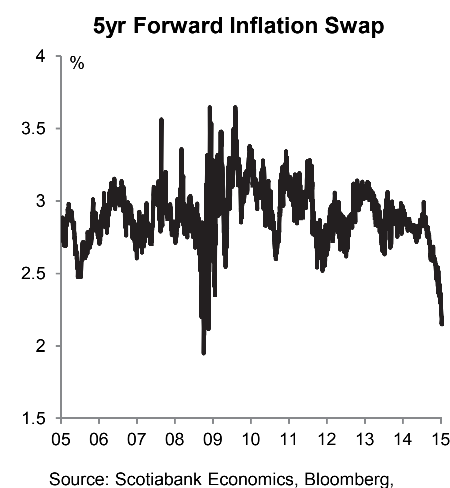
Market opinions are useful, but there's no evidence that markets necessarily get it more right than any other way of formulating expectations. What do

Chart 3



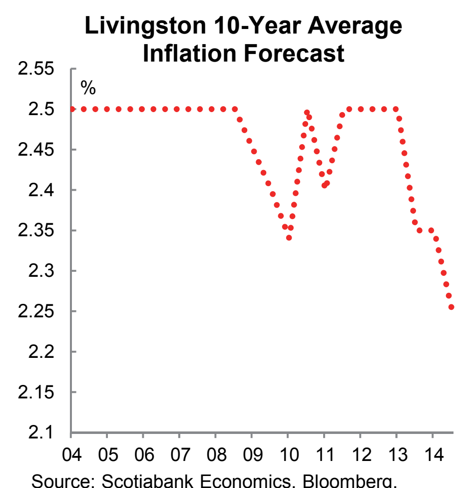
Source: Scotiabank Economics, Bloomberg,

Chart 4



Source: Scotiabank Economics, Bloomberg,

Chart 5



Source: Scotiabank Economics, Bloomberg.

professional forecasters think, subject to the same caveat? The oldest continuous survey of forecasters' expectations is produced semi-annually by the Philadelphia Fed (here). The Livingston Survey shows that the median forecast for the average inflation rate over the next ten years sits at 2.25% (chart 5). That's below the 2.35% forecast as at last June, but not by much. So the consensus of forecasters lies generally in line with the Fed's reasoning more so than what market participants believe.

Samples of forecasters' opinions are hardly in short supply but generally reinforce each other. Another measure is the Bloomberg consensus of forecasts for headline CPI and the core price deflator for total consumer expenditures (core PCE). Chart 6 shows that this measure of consensus opinions expects CPI to rebound into year-end and next year and that core PCE inflation may rise over this period. Chart 7 compares Consensus Economics Inc's consensus call for inflation to Bloomberg's fresher sampling. Scotiabank Economics' forecasts are similar in the broad directions and we are a contributor to several consensus samples. Chart 8 looks at a different measure which is the quarter-over-quarter annualized rates rather than chart 7 which looks at year-ago inflation rates. Each consensus measure has its pros and cons in terms of freshness and how inflation is measured but they all point upwards after a temporary lull in inflation pressures.

3. What Consumers Expect

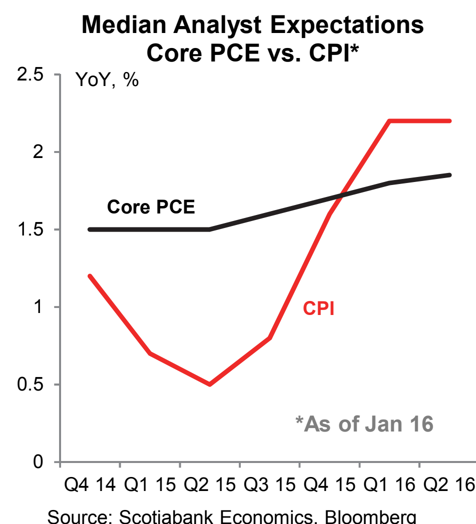
So economists differ somewhat from markets in pricing inflation risk and it remains to be seen who will be right, but what does mainstreet think? Arguably this can be the most important of all since signs of significant disinflation or outright deflation risks reflected in consumer sentiment could be a more powerful influence on broad economic activity than anything that traders and economists think.

We offer two measures starting with the Conference Board's 1 year consumer inflation expectations component to their consumer confidence measure. Well, this shows that inflation has long been parked on the moon at rates well above official measures, but the key here is to look at the changes in expectations at the margins. It may be unrealistically high and consistently so, but it has fallen only marginally since last summer and remains within a fairly stable long-run range (chart 9).

The University of Michigan's consumer sentiment gauge offers two measures of consumer inflation expectation over differing horizons. Note that this measure is more in line with reported inflation than the Conference Board's metric. The one-year forward UofM measure has fallen from about 3.25% last summer to 2.4% now and remains well above true inflation (chart 10). The UofM's 5-10 year measure asks consumers what they think will happen to prices over the next 5-10 years and as such loosely lines up with the horizon of the 5 year forward inflation swap (above). This measure is volatile within a tight range and has budged only marginally over time (chart 11).

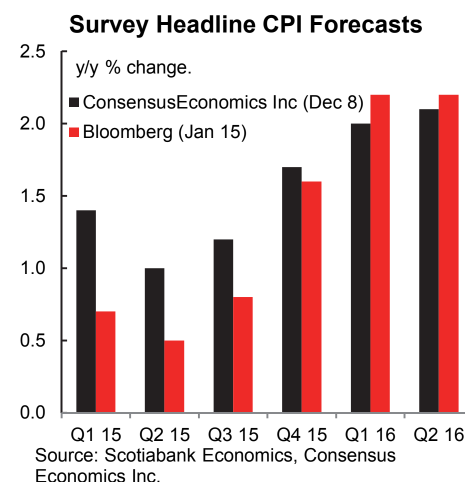
In all, forecasters and consumers are signaling less worry about inflation downsides than markets, and even the latter source of expectations is not terribly worrisome. We're going through what will mostly transpire as a relative price shock to energy prices rather than generalized economy-wide de- or dis-inflation. The mechanics of evaluating a relative price shock differ markedly from a generalized move in economy-wide prices.

Chart 6



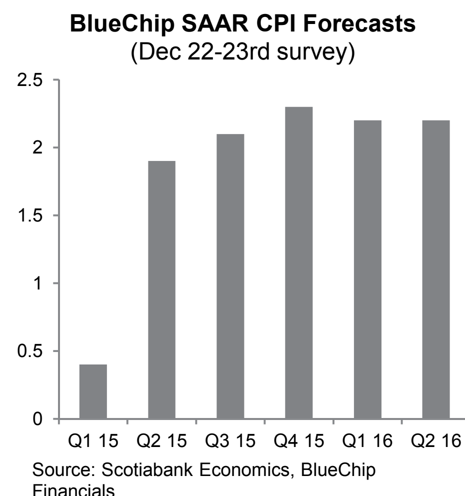
Source: Scotiabank Economics, Bloomberg

Chart 7



Source: Scotiabank Economics, Consensus Economics Inc.

Chart 8

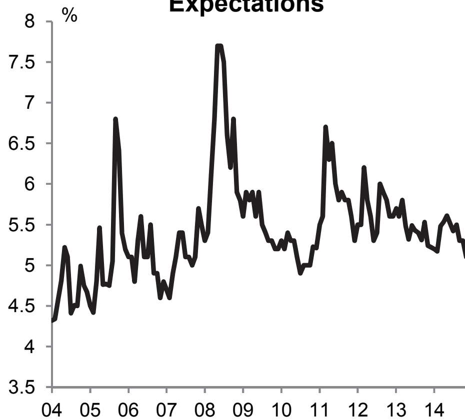


Source: Scotiabank Economics, BlueChip Financials

Fed Can't & Shouldn't Influence An Energy Price Drop

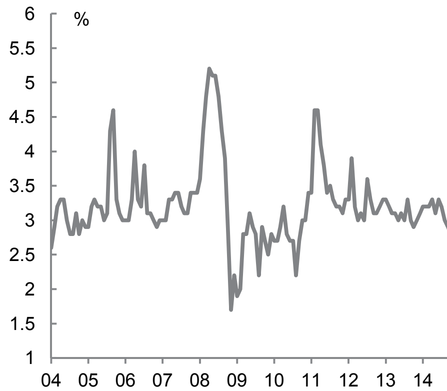
Indeed, a supply-side induced decline in energy prices — all else equal — usually carries time-limited influences on inflation and is a plus for US growth and thus should be expected to put upward pressure on growth rates and core inflation measures over time. For a central bank like the Federal Reserve to adopt a different tactic would essentially have it believing that its actions can influence oil and gas prices sustainably over time. We don't believe that they believe this to be true.

Chart 9



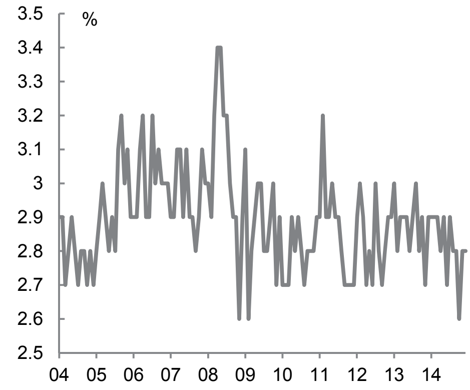
Source: Scotiabank Economics, Conference Board, Bloomberg.

Chart 10



Source: Scotiabank Economics, Bloomberg.

Chart 11



Source: Scotiabank Economics, Bloomberg.