Weak Inflation, Fed Policy and US Bond Yields. Bond Rally To Continue?

Given the importance of inflation to central bank policy and thus to investors, it is useful to look not only at headline growth rates of CPI but also at the components of the index and the behaviour of each component.

Housing represents 42.6% of the basket. Within that, owners' equivalent rent, not a cash flow item, is 24.6%.

Which components of CPI are rising?

- Housing is rising at 3.1% for housing, 3.3% for owners' equivalent rent.
- Transportation is rising 1.8% but mostly due to volatile gasoline prices. New vehicles are flat and used vehicles are falling (-4.2%)
- Medical care is rising at 2.7%. Hospital care is rising at 4.6%.
- Education costs are rising at 2.3%.
- Video and Audio recreation (+2.8%) all other recreation flat.

And which components are not?

- Food and Beverages are flat (+0.9%). Food at home is (-0.2%) with the inflation driven by food away from home (+2.3%).
- Apparel is deflating (-0.9%) and is generally weak.
- Communications including telephony, infotech, hardware and services are -6.3%.

A cursory look at prices in the economy reveals that apart from housing, healthcare and education, most sectors face flat

to declining prices. That the housing component is over two fifths of the CPI means that apart from housing, the CPI would be much weaker. A rough estimate is that the 1.9% headline reading would indicate that the non-housing elements were growing at just over 1%.

The Fed has now raised interest rates 4 times since 2015. It intends to raise rates once more in 2017 and 3 times in 2018, if economic data remain constructive. Later in the year, probably September, it intends to normalize its balance sheet by placing caps on reinvestment of bond interest and principal maturing. Yet at the post FOMC news conference last week, Janet Yellen contemplated the concept of raising inflation targets, which would require slowing the pace of rate hikes and balance sheet normalization. In the context of the current rate hiking cycle and the impending process of balance sheet normalization, this appears incongruous. However, in the context of price levels in the economy, ex shelter, this is not so surprising. Accepting this will mean looking at the current rate hikes and balance sheet taper in a new light.

On the fiscal side, if President Trump's infrastructure and tax plans are passed and implemented, inflation expectations might increase. In that case the treasury would miss the Fed's transfers of profits from its asset holdings which may take some of the pressure off the Fed to be too hawkish, which seems to align with the Fed contemplating higher inflation targets. This might be a cynical view that the Fed is not in fact independent of the interests of the government. If the tax cuts and infrastructure expenditure plans fail to find approval, then inflation expectations are unlikely to rise.

In sum, bond yields at longer maturities are unlikely to rise significantly.