

ECONOMIC VIEWPOINT



Is the Threat of Inflation Already Scaring the United States?

Part 2: Inflation Expectations in the United States – Households and Forecasters

The sustained growth of the U.S. economy is now putting greater pressure on production capacities, including within the job market. That should also have an impact on inflation. Several price indexes have been on the upswing since the beginning of 2018. It is time to ask whether U.S. households and businesses are really noticing these price hikes and whether they have adjusted their expectations as to future inflation.

In this second part, we see that after declining for several years, household expectations are now back up to levels compatible with the objectives of the Federal Reserve (Fed). That means recent pressures, also seen with businesses, have served to normalize the situation. It remains to be seen whether changing economic circumstances and increasing protectionist measures will make a difference.

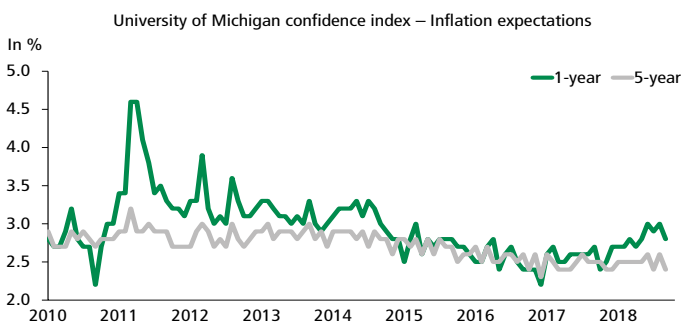
Household Expectations

The confidence indexes are our best sources of information about short- and medium-term inflation expectations for households.

The University of Michigan confidence index indicates that price increase expectations have been generally stable (graph 1). Sharper variations in 1-year expectations at the start of the decade were mainly reflective of gas prices. The relationship between short-term expectations and prices at the pump started

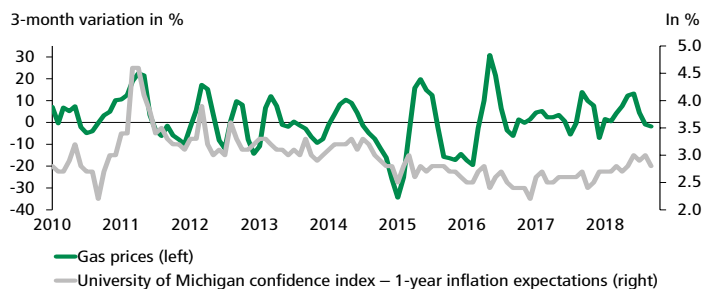
easing off in 2013, however (graph 2). Gas price movements did not trigger so many changes in household expectations, while, as we saw in [part 1](#) of this analysis, there is still a very strong correlation between gas prices and businesses, and even between gas prices and the bond market. That split may be partly due to several factors, including the fact that e-commerce makes more information available about a greater number of prices (whereas, before, displays at service stations were almost the only sources of readily available information on prices),

GRAPH 1
Household inflation expectations are still stable



Sources: Philadelphia Federal Reserve and Desjardins, Economic Studies

GRAPH 2
One-year expectations are now reacting less vigorously to gas price fluctuations



Sources: Energy Information Administration, University of Michigan and Desjardins, Economic Studies

François Dupuis, Vice-President and Chief Economist • Francis Généreux, Senior Economist

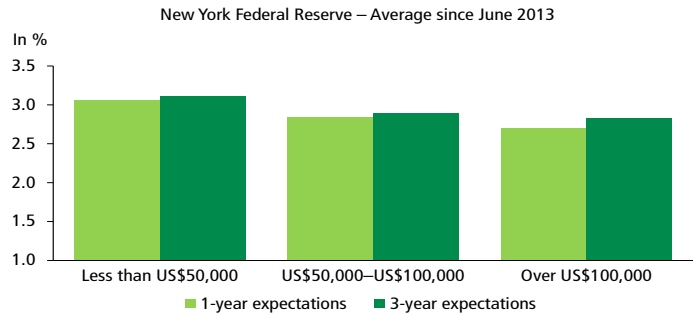
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and also the availability of vehicles that consume less energy. Household confidence is also less dependent on gas price fluctuations than it was before.

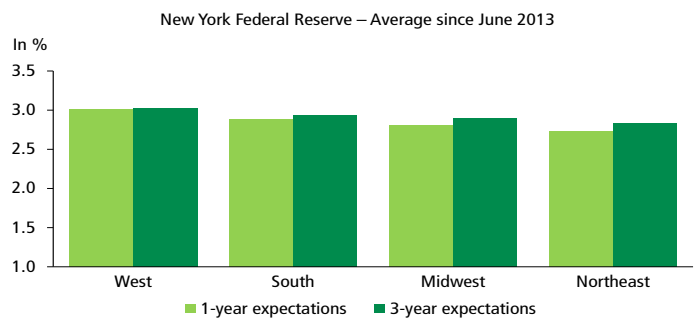
Another finding is that households have tended to overestimate the annual changes in prices in this decade (graph 3), even for the short term. The 1-year expectations taken from the Conference Board confidence survey are always about 3.5% higher than the CPI annual change. That divergence is not new; it was already noted before the financial crisis and the weak inflation that characterized the early 2010 years. The short-term expectations noted in the University of Michigan and New York Fed confidence indexes are closer to actual inflation, but they too have been overestimated during this cycle. It is as if households do not believe in the true weakness of consumer prices, or maybe they just do not see it. That also proves that there really is a solid anchoring of inflationary expectations

GRAPH 5
Inflation expectations change little based on household income



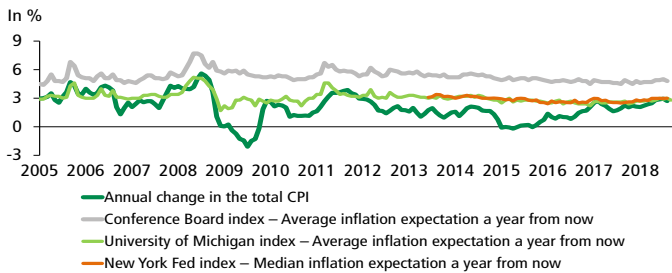
Sources: New York Federal Reserve and Desjardins, Economic Studies

GRAPH 6
The regions also have little impact



Sources: New York Federal Reserve and Desjardins, Economic Studies

GRAPH 3
Households have been overestimating inflation since the crisis

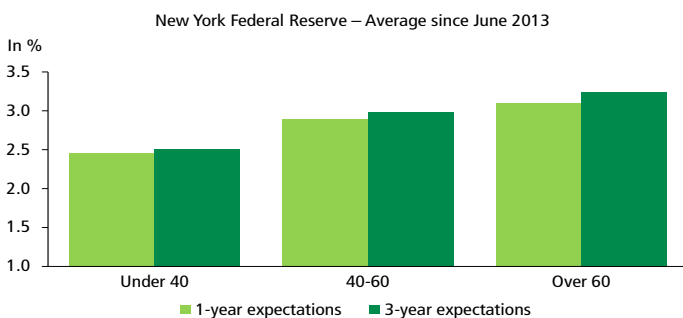


CPI: Consumer price index; Fed: Federal Reserve
Sources: Bureau of Labor Statistics, Conference Board, University of Michigan, New York Fed and Desjardins, Economic Studies

among households, even with the short-term measures.

The New York Fed confidence survey, with data going back to 2013, shows which types of households are the most likely to overestimate inflation. Graphs 4, 5 and 6 show the breakdown

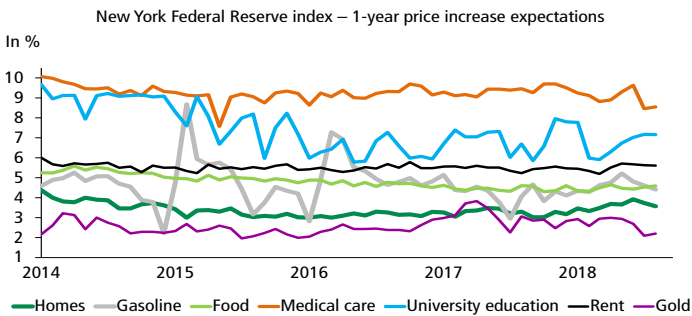
GRAPH 4
Inflation expectations are higher among older people



Sources: New York Federal Reserve and Desjardins, Economic Studies

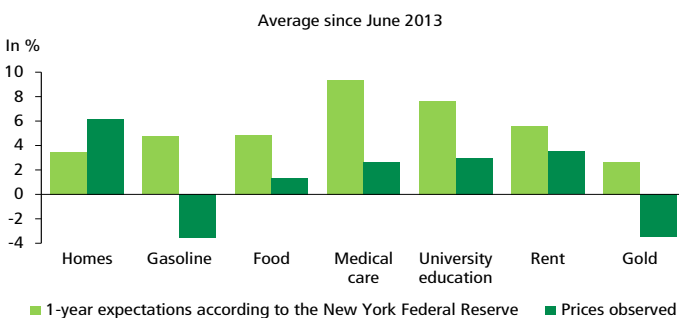
of inflation expectations since 2013 according to various age, income and location criteria. We can discern small trends; for instance, older households seem to think future inflation will be higher. There is less divergence based on income or where survey respondents live. Why do older households anticipate higher inflation? The most obvious reply to that is: habit. Older people have experienced more episodes of strong consumer price hikes in their adult lives. Younger households have the opposite reaction. The average inflation rate has been 4.1% over the past 50 years. It shrinks to 2.6% for the first 30 years, then to 2.2% for the past 20 years. The type of market basket may also differ by age, and not all goods and services are subject to the same price increases. At the same time, the perception of future inflation also changes according to the type of consumption. Still according to the New York Fed survey, households foresee much greater increases in the cost of medical care (graph 7 on page 3), which is a service that higher numbers of older people rely on. Here again, there is quite a divergence between the expectations and the actual price increases (graph 8 on page 3). That shows how fears of higher prices, and especially the consequences for people on fixed incomes like retirees, can influence perceptions.

GRAPH 7
Price increase expectations by good and service



Sources: New York Federal Reserve and Desjardins, Economic Studies

GRAPH 8
Households are overestimating price increases, except for homes



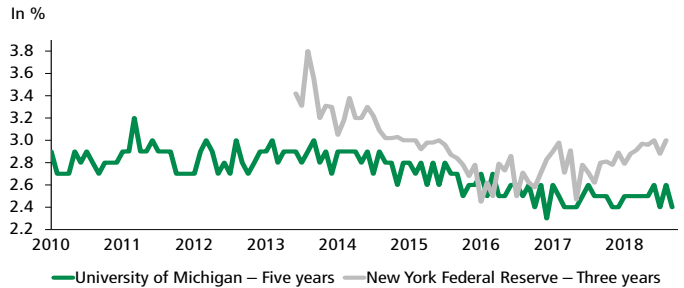
Sources: New York Federal Reserve, Bureau of Labor Statistics and Desjardins, Economic Studies

Overall, households' medium-term expectations are still firmly anchored (graph 9), but there, too, we note a downward trend towards the middle of the decade. The movement can be seen more clearly in the New York Fed's index than in the University of Michigan one, which is usually much more stable. That one has also not pointed to any notable increases over the past two years, in contrast to the other indexes, especially on the business side, and the expectations of the bond market. There are two ways of looking at this situation: either advantageous or risky. On the one hand, household expectations are still very stable which means the Fed is avoiding an upward spiral. On the other hand, this may be the result of inflation that was too weak for too long, and led to a sustained downward stall. It is still an open question, and it remains to be seen whether the higher inflationary pressures we are seeing in the U.S. economy right now will change households' perceptions.

Forecasters' Expectations

The last big category of inflation expectations that we have to analyze is that of the economists and professional forecasters. The Philadelphia Fed has been surveying those people for a long time, seeking their opinions on future price trends. Its

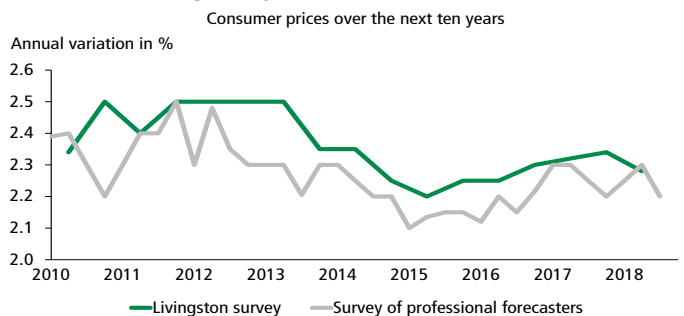
GRAPH 9
Household medium-term inflationary expectations are still well anchored



Sources: University of Michigan, New York Federal Reserve and Desjardins, Economic Studies

Livingston survey started in 1946, and its survey of professional forecasters in 1968. They both draw predictions from economists in industry, the government, banks and the academic sector. The forecasts for inflation expectations are based on the long term, i.e. ten years. Those expectations have remained generally stable since the end of the last recession, anchored between 2.0% and 2.5% (graph 10). But, as with households and businesses, there was a downward trend up to 2015–2016. Those expectations also adjusted to the weight of the weak inflation during the cycle. After that there was a modest uptick, but the very latest survey responses still point to modest expectations.

GRAPH 10
Professional forecasters' long-term inflationary expectations went down during the cycle



Sources: Philadelphia Federal Reserve and Desjardins, Economic Studies

Conclusion #1: We Have Narrowly Escaped a Downward Spiral

The continued weakness of inflation during the 2010 years led to a downward adjustment of several indicators of inflation expectations. The situation was exacerbated by the drop in oil prices. The trend was widespread and sustained enough to influence opinions as to the longer term, so that led to a slight shift in expectations. As a result, the Fed decided to keep its expansionist monetary policy for a very long time and opt for a very gradual normalization of its key rates.

That expansionist policy, an accelerated global economy, the higher costs of several commodities including oil, the improved U.S. job market and the Trump administration's economic policies have, however led to a review of inflationary expectations for most of the metrics, especially the short-term ones. We seem to have avoided a real downward spiral. A few more years of very low inflation could have stoked the downward trend and led to an even greater challenge for the Fed, which likely would have had to change its monetary policy. Now the situation has changed. The economy is growing nicely and the expectations are closer to more stable levels, compatible with the Fed leaders' targets.

Conclusion #2: Upside Risk of Higher Prices and Protectionism

Expectations have risen, but they cannot go too high! Ideally, despite the economic cycle, inflation expectations should stabilize close to current levels. Recent readings have been encouraging, and some of the pressure has been lifted in recent months. If expectations remain properly anchored, that will make life easier for the Fed, whose monetary policy can thus be a bit more accommodative, according to Jerome Powell in his Jackson Hole speech.

There are many risks, however. An overheated economy and job market could accelerate inflation and drive up short-term expectations. At this point in the cycle, upward pressure on business input costs, including labour, may prove to be a stabilizing element. In addition, the protectionist surge by the Trump administration, particularly with regard to China, could also affect prices and outlooks on inflation. Eventually, the longer-term expectations would suffer too. That would force the Fed to react. As Jerome Powell said: "I am confident that the FOMC would resolutely 'do whatever it takes' should inflation expectations drift materially up or down..."

Inflation expectations seem to be at a new crossroads. Two or three years ago, weak inflation was a threat. But now the pressures may provoke an increase that is too strong. The base scenario assumes the situation to be under control, but we will have to monitor the different indicators of inflation expectations very closely over the coming quarters.

Francis Généreux, Senior Economist