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Will This Bull Ever Tire?
Part 2—The Threat of Rising Inflation

Inflation indices are tasked with the job of establishing an overall price level for goods and services that can be tracked over time. Consumers do not need an index to tell them what their wallet is already telling them – prices go up over time. The speed at which prices rise will dictate the effect inflation will have on the market.

Perhaps the most well-known measurement of inflation is the Consumer Price Index (CPI). However, there is another useful gauge for inflation and that is the Personal Consumption Expenditure index (PCE). The goal of these indices is to boil inflation measurements down to a single number that can represent overall price trends. Although much ado has been made over which inflation gauge may be best, both of the indices show inflation trends that vary by sector in the short run but come close to merging in the long run.

Figure 1. Comparison of CPI and PCE price levels. (1997-April 2017)
Source: Bureau of Labor Statistics

As Table 1 below demonstrates, the makeup of these indices is quite different.

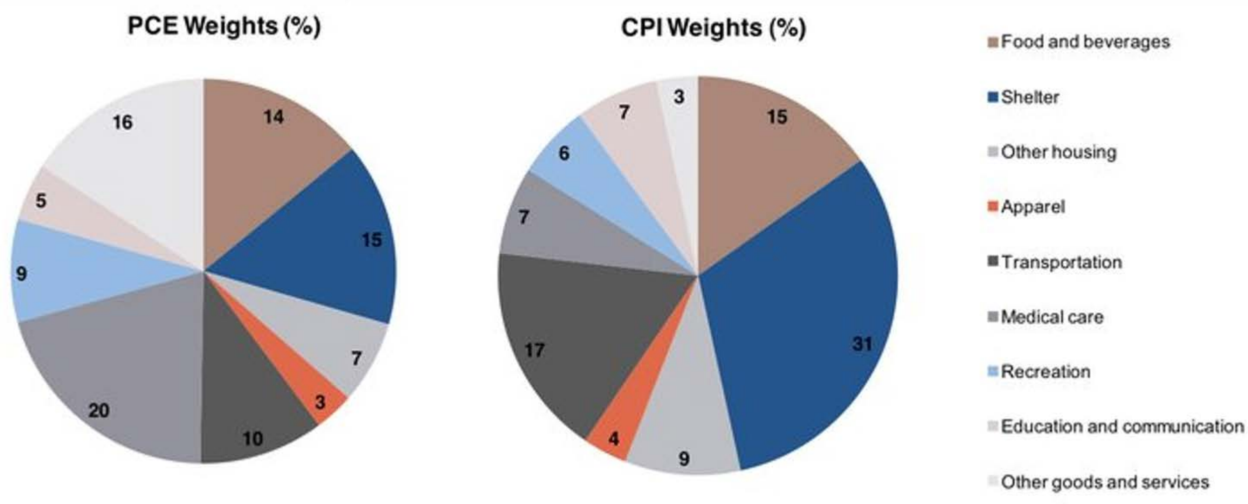

Table 1. Components of PCE vs CPI.
Source: Haver Analytics, SG Cross Asset Research

Consumers do not need an index to tell them what their wallet is already telling them.

Why is this discussion relevant to today's markets and economic outlook?

As the market continues to consolidate, investors need to be aware of which holdings are most sensitive to inflation. Certainly, fixed income and those sectors of the market with inelastic pricing will bear watching closely if inflation consistently overshoots the 2% target artificially set by the Federal Reserve.

Going back to Economics 101, consumer spending is influenced by anticipated prices going up or down. Up until this point, there has been more talk about deflation than inflation. When deflationary forces are prevalent, the consumer will wait to spend money, believing that goods and services will be cheaper tomorrow. In an inflationary environment, the opposite is true. Spending happens more rapidly to avoid prices increases over time. On a brighter note, with inflation, debt becomes less of some burden as older, more valuable dollars get repaid with newer, less valuable dollars. This phenomenon can help to ease an over-leveraged economy.

As you can see, it will be important for companies to be able to raise prices when and if inflation accelerates. Companies must possess pricing power so they can pass on price increases as they occur. If they cannot pass these on to the end customer, profit margins and earnings will be compressed, causing earnings to fall and stocks to reprice to lower earnings expectations. Inflation that eats into stock market earnings could be an impediment to this long-running bull market.

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