Higher inflation here to stay

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Higher inflation is here, probably to stay for this cycle. The Federal Reserve's projections of modest interest rate increases prior to the CPI report on February 14 could be changed to indicate a faster path to higher rates.

Will reports of elevated inflation mean that rates are going higher, sooner?

Inflation reported in the core CPI and the headline CPI on Wednesday February 14 was not a message of love for Valentine's Day. It was a wake-up call.

The so-called goldilocks scenario called for rates to rise slowly, at 25 basis points per meeting, with a target of 2 to 2.50% for the Fed Funds rate by end of 2018 or into 2019. Rates were forecast to reach 3 percent by the end of 2020.

Now, with CPI growth of 0.5 percent in one month and 2.1 percent on an annual basis, all that moderation talk is being replaced by speculation about how far and how fast rates might have to go. The Fed controls short-term rates but the market controls the 10-year note rate, which jumped to 2.90 percent immediately after the report. And if inflation is already over 2 percent and headed higher, how can investors feel good about earning just 2.9 percent investing for a decade? They might start to demand a much more significant premium as compensation for the risk.

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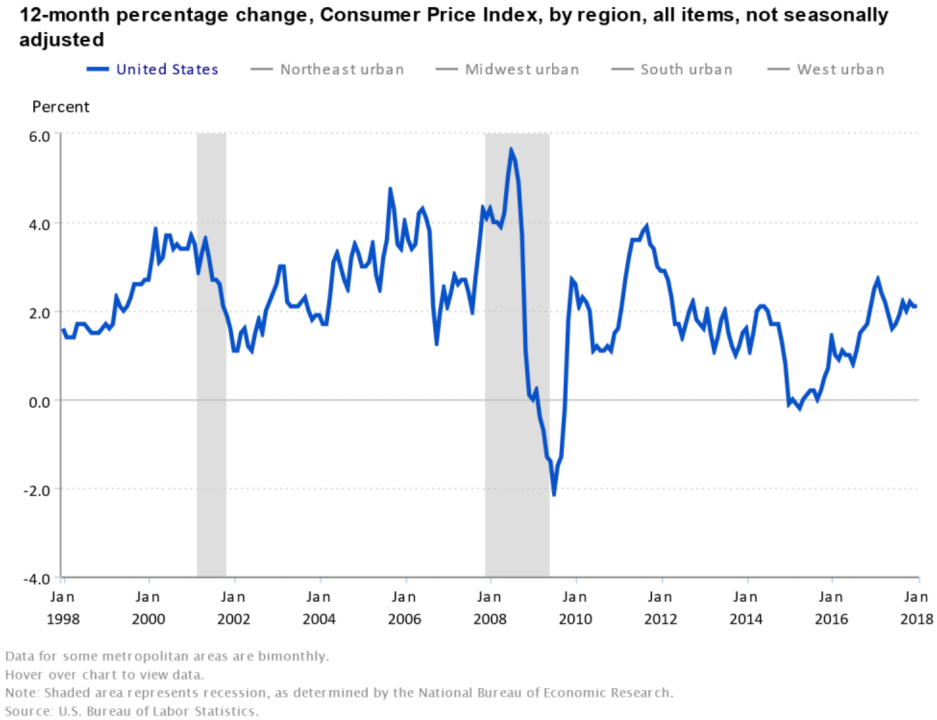

Rising inflation is a normal development for a U.S. economy that is growing steadily with unemployment near record low levels. One could even argue that the tax cuts agreed to late last year will push the economy into overheated territory and lead to rates much higher — even 4 percent on the 10-year note. But many market participants have only known low inflation and lower rates.

The Federal Reserve tends to be a follower, not a leader. The economy gets stronger, the inflation rate increases, and the Fed is forced to move into action but only after a delay.

If the Fed stays true to the past, inflation could move substantially above the Fed target of 2 percent before the Fed would increase rates high enough to have an impact. By then the next recession would be just around the corner, perhaps in early 2019.

So what are market watchers saying about the Fed's likely course of action?

Fed watchers will probably wait until March 21 to see what the Fed open market committee reports on the results of their meeting. Prior to this, the Fed signaled that three moves higher were coming in 2018. The latest inflation number guarantees at least a 25 bps move higher at the March meeting and opens up the chance of a 50 bps move. This would be a significant departure from the "slow and steady" approach taken until now.

Other than a 50 bps move, a key indicator to watch for in the media release after the March meeting is a change to anticipating four increases in 2018, rather than three.

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But even if the Fed sticks with their previous guidance of 3 increases, they will keep hiking rates into 2019 or the next recession.

We don't know how high interest rates have to go before they start to affect the economy. Decisions to buy houses, invest in new businesses and buy shares on the stock market are all affected by an increase in interest rates on government bonds and borrowing rates for consumers and businesses. Much higher debt loads for consumers and businesses today mean that modest interest rate increases could have an immediate effect on risk appetite.

Expect more volatility before 2018 is over.

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