June 08, 2016

Economics Group

WELLS FARGO SECURITIES

Sarah House, Economist
sarah.house@wellsfargo.com • (704) 410-3282

Where's the Rebound in Inflation Expectations?

Despite oil's rebound and pickup in core inflation, inflation expectations have changed little in recent months. History and demographics suggest that the Fed appears correct in remaining cautious about a full recovery.

Inflation Expectations and the Fed: Victim of Its Own Success?

Since oil prices began to tumble in mid-2014, inflation expectations have followed suit. While a decline in short-term inflation expectations was to be expected, longer-term expectations sank right alongside oil. Yet, with oil prices recovering roughly 80 percent since earlier this year and inflation picking up, long-term inflation expectations have not changed much.

The lack of a rebound has caught the Fed's attention. As Chair Yellen noted in a speech this week, a sustained decline in expectations would raise doubts about how quickly inflation would return to the FOMC's target.

After a brief rebound in March and April that closely followed oil prices, longer-term TIPS breakevens have again headed lower (top chart). More hawkish talk from Fed officials before last Friday's payroll report may be behind the move, as it seemed clearer that the recent pickup in core inflation would be kept in check with less accommodative monetary policy. However, looking at the New York Fed's Survey of Primary Dealers for additional indications of long-term inflation expectations from market participants shows expectations for CPI inflation have remained steady in recent months.

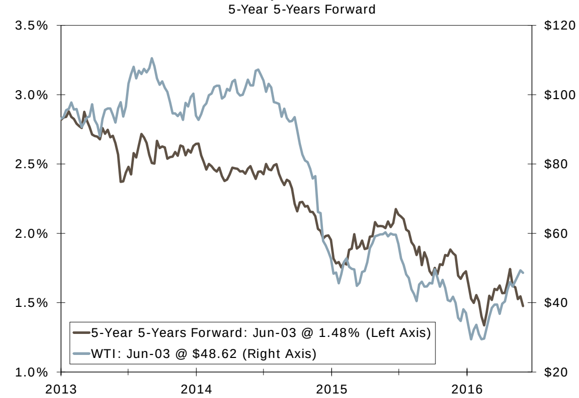
Consumer inflation expectations have been even less responsive to the rebound in commodity prices and the recent pickup in inflation. Despite the highly visible rise in gasoline prices the past three months, short-term inflation expectations hit a five-and-a-half year low in May, while longer-term expectations remained stuck at historical lows (middle chart).

The muted response to the rebound in oil and gasoline prices may just be a timing effect. After all, consumers' inflation expectations were slow to respond to the initial drop in oil in mid-2014. Once consumers see that a rebound in gasoline prices could stick around a little longer and actual inflation picks up, inflation expectations may follow suit.

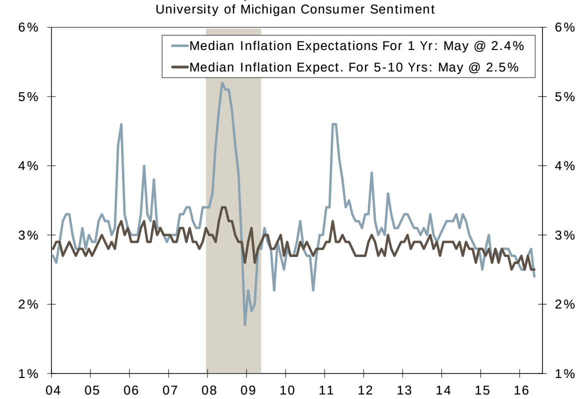
However, in other episodes in which oil prices collapsed outside of an economic expansion (1985-86, 1993-94, 1997-98) long-term inflation expectations never fully recovered until oil hit a new record high (bottom chart). With the double-digit inflation rates of the 1970s and early 1980s fading further from memory and core inflation only briefly reaching the Fed's target since the Great Recession, it may be difficult for long-term inflation expectations to fully recover back to early 2014 levels.

Demographics provide no help. Since the first of the Millennials became of working age in the mid-1990s, core PCE inflation has averaged only 1.7 percent and not exceeded 2.5 percent. As such, it is not surprising that in the New York Federal Reserve's Survey of Consumer Expectations, respondents under the age of 40 have consistently reported lower inflation expectations than their older counterparts. Fed officials may therefore be right in not taking an eventual rebound in inflation expectations as a given.

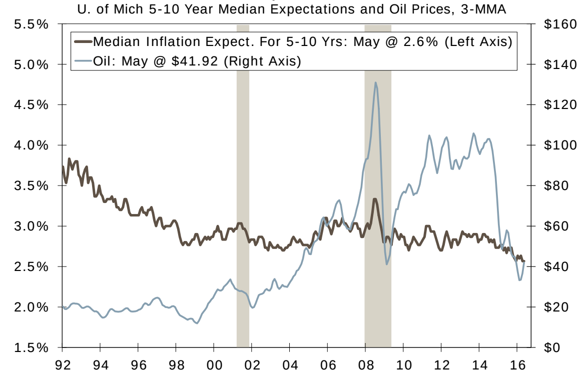
TIPS Inflation Compensation & WTI Oil Price
5-Year 5-Years Forward



Med. Inflation Expectations 1-Yr vs 5 to 10-Yr
University of Michigan Consumer Sentiment



Inflation Expectations & Oil
U. of Mich 5-10 Year Median Expectations and Oil Prices, 3-MMA



Source: Bloomberg LP, University of Michigan, Federal Reserve and Wells Fargo Securities

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Economic Analyst	(212) 214-5652	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Julianne Causey	Economic Analyst	(704) 410-3281	julianne.causey@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

WELLS FARGO SECURITIES