

Economics Group

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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.

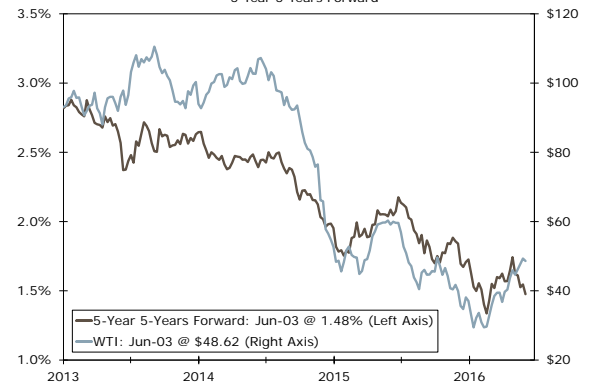
Consumer inflation expectations have been even less responsive to the rebound in commodity prices and the recent pickup in inflation. Despite the highly visible rise in gasoline prices the past three months, short-term inflation expectations hit a five-and-a-half year low in May, while longer-term expectations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

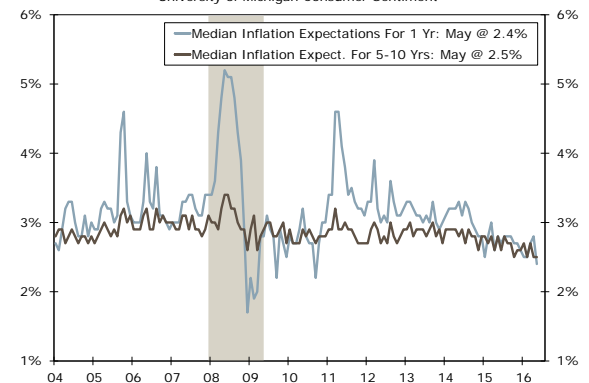
However, in other episodes in which oil prices collapsed outside of an economic expansion (1985-86, 1993-94, 1997-98) long-term inflation expectations never fully recovered until oil hit a new record high (bottom chart). With the double-digit inflation rates of the 1970s and early 1980s fading further 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.

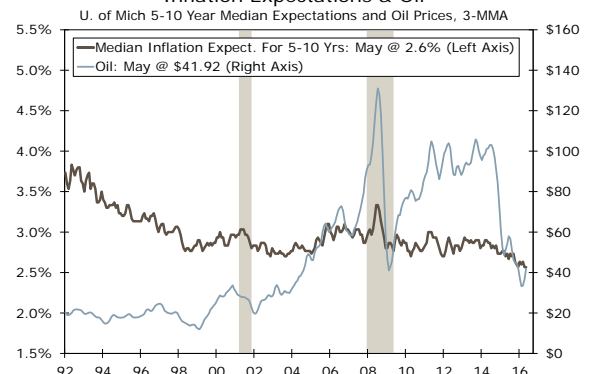
TIPS Inflation Compensation & WTI Oil Price
5-Year 5-Years Forward



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



Inflation Expectations & Oil



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