Four Indicators of Higher Inflation over the Near-Term

Written by: Ted Hospodar

As of March 20, 2018

The U.S. economy appears to be in the later innings of the economic cycle. Typically, at this advanced stage of the cycle, inflation pressures tend to rise as commodities and wage prices increase. We see a number of leading inflation indicators signaling that, over the near-term, inflation is headed higher, including, but not limited to, the following:

1) The New York Federal Reserve’s Underlying Inflation Gauge (UIG), which is constructed using a combination of traditional inflation measures as well as labor and financial market-related variables, has risen to its highest level in over 12 years. UIG appears to lead the Core Consumer Price Index (CPI), which excludes Food and Energy, by about 16 months with a correlation of 80%. UIG is more volatile than CPI. So even though the UIG is 3, that doesn’t mean that CPI is going to 3, but the rise in UIG over the last 6 months signals that inflation may head higher (Figure 1).

![Figure 1 - Core CPI and NY Fed UGI (16-Month Lead)](image)

2) Institute for Supply Management (ISM) Purchasing Managers’ Index (PMI) is an indicator of the economic health of the manufacturing sector based on five major indicators: new orders, inventory levels, production, supplier deliveries and the unemployment environment. ISM PMI tends to lead Core CPI by 18-24 months. The February reading registered 60.8%, an increase of 1.7% from the January reading of 59.1%. An elevated ISM PMI indicates inflation may head higher (Figure 2).

![Figure 2: Core CPI and ISM PMI (18-21 Month Lead)](image)

Source: DoubleLine, Bloomberg
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3) U.S. Average Hourly Earnings (YoY) and Atlanta Fed Wage Growth have been rising over the past couple of years, and appear to be in a long-term uptrend. The uptrend indicates that inflation may head higher (Figure 3).

4) The Citigroup Economic Surprise Index measures price surprises relative to market expectations. A positive reading means that inflation has been higher than expected and a negative reading means that inflation has been lower than expected. Recently, we saw a positive reading of 1.7 (Figure 4). Many investors are currently focused on the long-term deflationary pressures of technology advancements, and while at DoubleLine we acknowledge long-term deflationary pressures at this juncture, we additionally recognize that many investors may not be expecting near-term inflation.

Given where we are in the economic cycle and the potential for higher inflation over the coming quarters, we believe commodities offer an attractive opportunity.
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Definitions:

Citigroup Economic Surprise Index: An index that represents weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance been beating consensus. The indices are calculated daily in a rolling three-month window. The weights of economic indicators are derived from relative high-frequency spot FX impacts of 1 standard deviation data surprises. The indices also employ a time decay function to replicate the limited memory of markets.

Consumer Price Index (CPI): A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Institute for Supply Management (ISM) Manufacturing Purchasing Managers’ Index (PMI): An index made up of data from 300 manufacturing firms collected by the Institute of Supply Management (ISM). It indicates the economic health of the manufacturing sector.

Purchasing Managers’ Index (PMI): Is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Underlying Inflation Gauge (UIG): Captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data.

Atlanta Fed Wage Growth Tracker: Is a measure of the nominal wage growth of individuals. It is constructed using microdata from the Current Population Survey (CPS), and is the median percent change in the hourly wage of individuals observed 12 months apart.

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