PCE and CPI

By **David Kotok** Feb 8, 2012, 8:29 AM Author's Website

"The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate." Board of Governors of the Federal Reserve System, January 25, 2012

For many years, the Fed has been discussing "core" PCE on an informal basis. Fed policy has changed. Headline PCE is now the defined target.

Jim Bianco clarified the issue. He noted that Bernanke affirmed it at his press conference by saying, "headline PCE not core PCE." To get this "iced" Jim submitted a direct request for clarification. The Fed answered: "As he noted in his news conference, this is not hitting 2% on a minute-by-minute basis, but over a 'medium term' concept."

2% headline PCE means about 2.5% headline CPI. The Consumer Price Index is a very widely used reference for financial transactions, including Social Security payments, lease adjustments, labor contracts and, of course, TIPS. Thus, the Fed has committed itself to a run rate over the medium term of about a 2.5% CPI. Former Fed Governor Frederic Mishkin is among those who have published on the spread between CPI and PCE. We discussed "Mishkin's Wedge" in some of our previous work, archived at www.cumber.com.

For the Fed, the issue ahead is to convince the markets that it will apply appropriate monetary policy to achieve its target. Inflation targeting is important. If markets believe the central bank, they act accordingly and make it easier for the central bank to achieve its goals. If central bankers fail to convince markets with actions, not just words, markets will punish without mercy and central bankers will need a long time to heal their wounds. That is now where the Fed finds itself. It has declared an inflation target; it must succeed in achieving it. Too low or too high will introduce market volatility, and it may just be vicious.

In the near term the Fed will be able to meet its goals. Treasury prices are adjusting to this outlook. The timing of Fed policy changes is still questionable, but we now know that the majority of the FOMC is committed to very low interest rates for another two years. Would an inflation flare above the Fed's target change this policy? In due time, we are likely to find out.

For now, we remain fully invested. We expect the world's central banks to remain in a simulative mode. We expect that the policy-determined interest rates will remain near zero for a while longer. We emphasize spread product, not treasuries, in our bond accounts. Moreover, we are slowly and gradually changing the duration of portfolios to a more defensive posture. There is time for us to do this. However, we also know that the zero interest rate currently prevalent around the world cannot last forever.