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# Acyclical inflation

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## What is down must come up?


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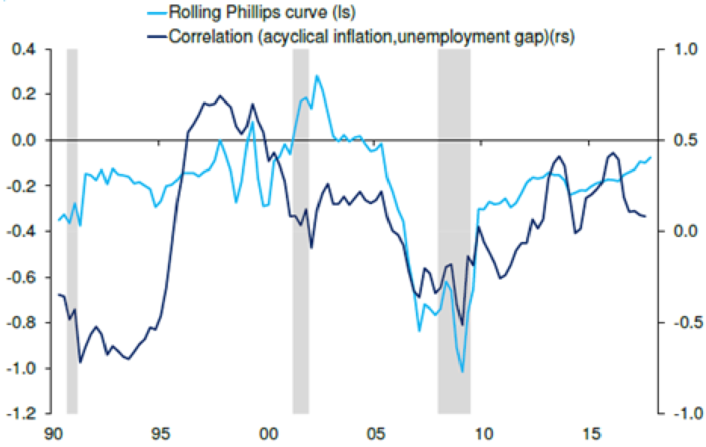
Inflation data over the past year – and especially over the past week – have highlighted a critical point. Fluctuations in inflation rates for items that are typically insensitive to the busi-ness cycle — which we refer to as acyclical, such as health care and apparel — can drive the overall inflation trajectory and lead to regime shifts in the market's inflation narrative. The plunge in wireless telephone services prices last March, followed by a string of downside surprises to other acyclical items, spawned a narrative that structural disinflationary forces would prevent inflation from rising. In the same way, recent stronger inflation data led by acyclical items may have revived the narrative that the Phillips curve is, in fact, alive and well and that risks are tilted toward inflation overshooting the Fed's target.


We take a closer look at the behavior of inflation for acyclical items over time. Our analysis has three primary conclusions. First, acyclical items are a key driver of the slope of the Phillips curve over time. The Phillips curve "works" during periods when inflation for acyclical components rises as the unemployment rate falls, and vice versa. Second, the unemployment rate must be significantly lower when acyclical inflation is low, as has recently been the case, for the Fed to hit its 2% target. Third, health care inflation and the dollar are two key drivers of acyclical inflation over time. Periods in which health care inflation is high and/or the dollar is weak, tend to be periods where the Phillips curve works.

Although acyclical inflation has been low on average over the past several years, there is building evidence that it may be on the verge of rising more sustainably. First, the sharp depreciation in the trade-weighted dollar since its recent highs in early 2017 should help lift import price inflation and provide a tailwind to acyclical inflation. Second, recent data on health care inflation has shown a sharp uptick. If this trend is sustained, acyclical inflation will rise, helping to drive core inflation higher, eventually overshooting the Fed's target as our forecast implies.

## Acyclical inflation

Shifts in the behavior of acyclical components are a key driver of the Phillips curve relationship over the time




Source: BLS, Haver Analytics and Deutsche Bank