SAC
SMITH AFFILIATED CAPITAL

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Inflation Will Be Sticky, But Not Oppressive

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The economy is coming off the second strongest growth rate since 1978 in the just-completed quarter, and the powerful post-pandemic reopening boost is still unfolding. For sure, the health crisis has not vanquished entirely. Although more than 60 percent of the adult population is fully inoculated, vaccine hesitancy, emerging variants, and a rise in social interactions could still lead to an uptick of Covid infections. That's the greatest risk facing the economy, one that would undoubtedly hinder the torrid rebound in growth that is now underway.

That said, the remarkable progress towards ending the health crisis has reopened the U.S. economy, and consumers are wasting no time getting back to their old spending habits. Bars and restaurants are once again humming with customers; travel agents are feverishly booking trips for eager vacationers, hotel vacancy rates in many states are back to near normal, and fans are flocking to sporting events. Spending on these socially involved in-person activities had been put on hold since the onset of the pandemic last March, resulting in more than $2.5 trillion in excess savings that are now being used to satisfy pent-up demand. This savings windfall occurred because incomes continued to grow throughout the pandemic despite substantial job losses, thanks to generous government transfer payments, including three rounds of stimulus payments.

The combination of pent-up demand, excess savings, and a recovering job market is setting a fire under the economy, poised to deliver the most robust annual growth since 1983. But all of this reopening is happening too quickly, as the economy struggles to keep up with demand. In time-honored fashion, when too much demand overwhelms supply, prices perk up, stoking inflation. The inflation spike now underway is one sour note that tarnishes an otherwise cheerful revival even as its staying power is at the center of much controversy. Many wonder if the Federal Reserve is allowing the party to run too long and too hot, which would keep the inflation fires burning beyond a transient phase. Most Fed officials do not think so, but they moved up the timetable for a rate lift-off from the near-zero boundary at its June policy meeting and talked about when to start reining in bond purchases.

From our lens, the economy is unlikely to undergo an inflation regime shift that some fear. But after a decade of glacial price rises in the wake of the financial crisis, it is likely to experience a prolonged period of warm inflation that will hover modestly above the Fed's 2% target.

History Won't Repeat

While the debate between "inflationistas" and "relaxionistas" rages on, we find the likely outcome lies somewhere in the middle. In effect, we see three potential outcomes over the next 18 months. First, this could simply be a short-lived spike in inflation that will fade within a couple of months as reopening pressures subside. Second, this could be the onset of an overheating economy, with inflation about to spiral into a new regime à la the 1940s or 1970s. Third, this could be a bout of "sticky" inflation, which is likely to cool from its current level but remain higher than it has been over the past decade as economic and labor market activity remains on a solid multiyear trajectory. We believe the odds favor the last scenario, which wouldn't represent a proper inflation regime shift.

History shows, in the two instances, that when inflation shifted to a regime above 5%, it took multiple years and a combination of factors. In the 1940s, U.S. inflation averaged about 5%, but the period was composed of two distinct rises in prices, with multiple catalysts at play. In the first half of the decade, greater deficit spending culminated with a pre-war boom in outlays, loose monetary policy, and the lingering effects of the 40%-dollar devaluation. The greenback coming off the gold standard contributed to a multiyear surge in inflation, leading to the Emergency Price Control Act of 1942. The end of price controls in 1946-1947 then led to much higher inflation via an "unveiling of price increases that had occurred earlier" (Friedman & Schwartz, 1980) along with the post-war release of pent-up consumer demand.

In the 1970s, the move to a high-inflation regime again required a multitude of factors: the gradual politicization of the Fed, with President Richard Nixon pressuring Fed Chair Arthur Burns to maintain a loose monetary policy, the end of the gold standard in 1971, and the oil price shocks of 1973-1978 leading to unmoored inflation expectations. That vicious cycle lasted until Fed Chair Volcker stamped on the monetary brakes in the early 1980s, sending interest rates sky-high and the economy into the deepest post-war recession. It took another decade of high, though receding interest rates, to finally wring out the inflation psychology that gave heft to the self-fulfilling wage and price-setting practices of labor and businesses.

Pre-Covid Inflation Regime Was All About Power

In contrast, the past decade has been characterized by a low inflation regime. From 2010 to 2019, core PCE inflation averaged about 1.6%. We see three key factors underpinning this period of low inflation: weak pricing power by companies, weak bargaining power for workers; structural constraints; and a credible Fed target of 2% inflation. In terms of pricing power, the initial post-pandemic period shows companies have more of it now than at any time over the prior decade. The NFIB small-business optimism index shows 40% of firms are currently raising prices, and 43% expect to do so – both record highs. Anecdotal evidence from the Fed's Beige Book also suggests that manufacturers, builders, and transportation companies are passing on higher input costs to customers.

This rise in pricing power is affecting consumers, especially on the goods side. In June, the University of Michigan Consumer Sentiment Index reading showed spontaneous references to market prices for homes, vehicles, and household durables rising to their highest level since 1974. Importantly, though, higher inflation has led to non-inflationary endogenous demand response, with overall buying attitudes for vehicles and homes falling to their lowest level since 1982. With pent-up consumer demand rotating toward services, one would expect demand-pull inflation to strengthen in the coming months, especially as elevated savings make consumers temporarily less sensitive to higher prices. However, the evidence from goods price inflation indicates that inflationary psychology is unlikely to settle in even if the recovery is rapid.

Indeed, the financial markets are echoing household inflation perceptions. Breakeven rates, the shape of the yield curve, and forward inflation expectation rates are all priced for higher inflation than was the case earlier in the year and considerably so relative to a year ago. However, these inflation gauges are well off their peaks reached in late May and have continued to recede following the FOMC meeting in mid-June. The reflation trade that drove the bellwether 10-year Treasury yield up to a nearby peak of 1.74% in late March from under 1% at the start of the year has all but dissipated. As of early July, it had receded to under 1.50%. While frenzied short-covering by investors on the losing side of the reflation trade has clearly played a role in the reversal, that defensive activity is also a tacit admission that pandemic-related forces driving the current upsurge in inflation will soon recede.

Don't Fear Wage Inflation

Another interesting dimension of this recovery is that despite a lingering 6.8 million jobs shortfall relative to pre-Covid following June's jobs report, workers' bargaining power has increased. With multiple factors still constraining labor supply, such as virus fear, child care access and costs, and generous unemployment benefits (as a trade-off factor), companies face difficulties hiring, especially in low-wage occupations, and are having to offer higher wages to attract workers.

In May, a net 34% of small businesses increased wages, while 22% expect to do so over the next three months – both only two percentage points below their pre-Covid shares and near-record highs.

As expected, this has translated into a rise in traditional wage growth measures, with the Employment Cost Index rising 2.7% Y/Y in the first quarter – the most in 14 years. Average hourly earnings in lower-paid leisure and hospitality jobs are posting their most substantial back-to-back monthly increases since the early-1980s. Simultaneously, the New York Fed's Survey of Consumer Expectations shows median reservation wages (the lowest acceptable wage) about 3% higher than pre-pandemic and about 19% higher for low-wage workers.

The key question is: Will those wage increases feed into a consumer price and wage inflation spiral? One perspective is that companies having acquired greater pricing power will pass on labor costs to their consumers. Another is that these wage increases are largely cyclical and transitory. Once labor supply becomes less constrained and consumers start responding to higher prices by curbing their demand, businesses will lose pricing power and workers will lose bargaining power – especially in lower-wage occupations.

We tend to ascribe to the latter view for two key reasons. First, the Phillips curve – the trade-off between unemployment and wages – has been historically weak since the U.S. economy entered a low-inflation regime in the early 1990s and further weakened between the Great Financial Crisis and the pandemic. Second, while the pass-through from wages to consumer price inflation tended to be firmly in place during the 1970s-1980s high-inflation regime, the dynamic nearly dissipated post-1990s. With the labor share of income still near-historical lows, it doesn't seem as though workers have permanently gained bargaining power. We believe the current dynamic reflects a one-time releveling of low wages. And it appears unlikely that companies will factor higher 2021 inflation into their wage-setting behavior in 2022 unless higher profits and stronger productivity permit them to do so.

The second key reason behind the pre-pandemic low inflation regime pertains to structural factors. In particular, we believe demographics, globalization, and technology will continue to exert downward pressure on inflation as they have over the past 25 years. Higher savings and lower spending as the U.S. population ages, ongoing technological advances, a potential productivity resurgence post-pandemic, and sustained (though slower) globalization should keep a structural lid on prices.

Fed Credibility Anchors Inflation Expectations

In August 2020, The Fed announced it was switching to a flexible average inflation-targeting (FAIT) regime. While some market participants have voiced concern that the Fed's tolerance for inflation moderately above 2% to make up for prior misses could lead to a de-anchoring of inflation expectations, most studies find evidence of even stronger anchoring around the 2% percent objective. Indeed, in the June University of Michigan Survey of Households, longer-term inflation expectations fell back, arguing in favor of still well-anchored expectations. While we admit the FAIT is new and yet untested, Fed Chair Jerome Powell has repeatedly indicated that, if necessary, the Fed would use its monetary policy tools to curb a strong and persistent rise in inflation above 2%.
Already, the Fed's June median dot plot for rate expectations moved up to two rate hikes in 2023 versus none previously.

The Fed's patience is not unlimited, and several Fed officials are already lobbying via public comments for an earlier rate lift-off and an almost immediate start to reining in Q.E. We don't believe that these dissenting voices within the Fed will gain traction on the FOMC. Still, the modest pivot at the last policy meeting, together with the more hawkish comments by the dissenters, are having a profound effect on market perceptions. Earlier in the Spring, when even Chair Powell admitted that inflation exceeded expectations, investors grew increasingly concerned that the Fed was falling behind the inflation curve. Since the last FOMC meeting, that perception shifted 180 degrees, with the Fed's inflation-fighting credibility being fully restored.

No doubt, the next few months will be challenging for the Fed as price pressures continue to build. The "Great Rotation" in spending from goods to services relieves some pressures on commodities while increasing them on services. Hotels, airlines, cruise ships, rental car companies, and other service providers catering to consumers fleeing their homes as pandemic restrictions ease are aggressively raising prices. Meanwhile, pandemic-related dislocations that have disrupted supply chains continue to restrict input availability and drive up prices of component parts. The lack of computer chips particularly constrains the auto sector, and sales of limited inventory on dealer lots are going well over MSRPs. If trying to purchase a bicycle, you would have to shell out at least double the cost of a year ago - if you are fortunate to find one.

These restraints will not fade overnight, and the Fed will likely be forced to once again move further away from its dovish stance at upcoming meetings. We suspect that Powell will announce the starting date for reducing asset purchases at the upcoming Jackson Hole Symposium in August and begin the process in 2022. We also expect the first rate hike to take place later that year. But while inflation will likely run over its 2 percent target next year, it should be receding from the peak levels reached this year and gradually slip back towards 2% later in the year and in 2023.

Slower Growth as Reopening Shock Fades

We suspect that a combination of cyclical, structural, and external forces will bring inflation down over time. The Covid reopening shock will start to fade later this year and continue to ebb in 2022. On the demand side, the expanded and enhanced unemployment benefits will expire in September, removing a major source of purchasing power for millions of unemployed and gig workers. A fraction of those recipients have built up a savings cushion that should sustain their spending habits for a while. However, most of the excess savings are concentrated among middle and upper-income households and will likely be treated as additional wealth rather than a vessel for spending.

Hence, with a good portion of savings sterilized, the economy will be facing a massive fiscal cliff next year, as three rounds of pandemic-related stimulus payments vanish, and special transfer payments cease. The CBO projects a $3 trillion deficit this fiscal year that will plunge to $1.2 trillion in fiscal 2022, which begins in October. That's a massive slice of deficit spending taken out of the economy. The reduction will also translate into less Treasury issuance, undercutting the upward pressure on yields from treasury supply. To be sure, the CBO expects that rising tax revenues from continued above-trend growth will contribute significantly to the projected narrowing of the deficit.

Finally, often forgotten in the inflation debate is that strong demand for a prolonged period tends to generate stronger supply while raising productivity. In a tight labor market constrained by a supply shortage, the competition for workers typically increases wages, which is evident in recent months. In turn, this pulls more people into the labor force, thus easing the supply shortage while also spurring companies to innovate and increase efficiency. Productivity growth has shot up over the past year, and it should continue to exceed the languid pace seen since the end of the Great Recession. Notably, while the rise in wages and productivity can lead to a surge in inflation, it is often healthy inflation because the increase in productivity permits an increase in living standards for workers. It also gives the Fed more breathing room to combat the next recession, which will inevitably return at some point in the coming years.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	6/30/2020	3/31/2021	6/30/2021	Last Quarter	Last Year
6-Mo. Bill	0.16	0.03	0.05	0.01	0.15
2-Yr. Note	0.15	0.16	0.25	-0.09	-0.03
5-Yr. Note	0.29	0.93	0.88	0.69	-1.82
10-Yr. Note	0.65	1.74	1.45	3.06	-5.94
30-Yr. Note	1.41	2.40	2.07	7.83	-13.74

Municipal Bonds	Yields (%)			Total Return (%)	
	6/30/2020	3/31/2021	6/30/2021	Last Quarter	Last Year
Barclays GO Bond Index	1.18	1.00	0.87	1.09	3.01
Barclays State GO Bond Index	1.09	0.89	0.75	1.02	2.82
Barclays Local GO Bond Index	1.27	1.12	0.98	1.16	3.19
Barclays Revenue Bond Index	1.73	1.32	1.11	1.66	4.98

Equities	Levels			US $ Terms (%)	
	6/30/2020	3/31/2021	6/30/2021	Last Quarter	Last Year
S&P 500	3100.29	3972.89	4297.5	8.55	40.77
DJIA	25812.88	32981.55	34502.51	5.08	36.34
NIKKEI (Tokyo)	22288.14	29178.8	28791.53	-1.67	27.44

Commodities	US $			Percent Change (%)	
	6/30/2020	3/31/2021	6/30/2021	Last Quarter	Last Year
COMEX Gold Active Monthly	1800.5	1713.8	1771.6	3.37	-1.61
CRB Future Com. Pr. Index*	137.9715	184.96	213.853	15.62	55.00
West Texas Intermediate Crude ($ per bbl.)	39.27	59.16	73.47	24.19	87.09

Currencies	Levels			Percent Change (%)	
	6/30/2020	3/31/2021	6/30/2021	Last Quarter	Last Year
Yen	107.93	110.72	111.11	-0.35%	-2.95%
Sterling	1.2401	1.3783	1.383	0.34%	11.52%
Euro	1.1234	1.173	1.186	1.11%	5.57%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	6/30/2020	3/31/2021	6/30/2021	Last Quarter	Last Year
German 10-Yr.Bond	-0.53	-0.41	-0.37	-0.37	-1.71
Japanese 10-Yr.+ Bond	-0.03	0.04	0.00	0.43	0.12
UK 10-Yr.+ Bond	0.06	0.77	0.66	1.98	-3.72
Emerging Market (USD)	4.67	4.05	3.85	2.99	6.34

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices

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