INFLATION BURNING DOWN THE HOUSE? WATCH OUT FED, YOU MIGHT GET WHAT YOU'RE AFTER

May 2021

Recent inflation statistics demand continued monitoring, but a surge in recent numbers can be partially explained by certain transitory components upon closer examination. We're not ready to jump to any conclusions, but we will be paying close attention to upcoming Federal Reserve (Fed) communications for any clues about potential changes in monetary policy.

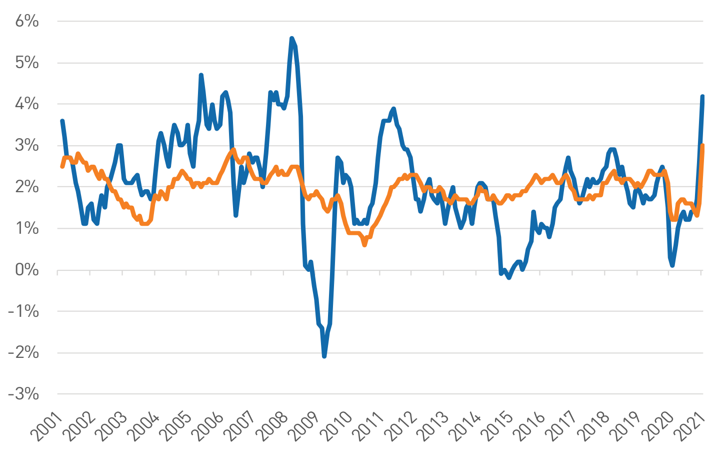
Expectations for higher levels of inflation have been steadily building over the last couple of quarters as the economic recovery continued to progress. Monetary and fiscal policy support proved to be successful in stemming the steep downturn last year, but with policymakers indicating continued accommodation, worries have grown that too much support may push inflation to elevated levels. This concern has been amplified recently as the economy continues to reopen and an increasingly vaccinated populace appears eager to make up for 2020's sacrificed consumption. Given we are approaching the one-year anniversary of the most severe economic disruptions, it is not surprising to see sharp jumps in inflation readings now that last year's figures are rolling out of the year-over-year calculations (the "base effects").

The April consumer price index (CPI) report was expected to illustrate this dynamic and it did not disappoint, as readings for the month printed at levels that hadn't been seen in many years. The headline figure of 4.2% was the highest year-over-year figure since 2008, while the less volatile core (ex-food and energy) measure rose 3.0%, which was a figure not seen since the mid 1990's (Figure 1). These statistics were well above consensus expectations, exacerbated by both supply chain issues as well as a more robust reopening impact than expected. However, when taking a deeper look at the components of the April report, the sectors that had the largest influence in the monthly figure were used cars, airfare, hotel lodging and auto rentals, which collectively contributed the bulk of the core measure's monthly increase (Figure 2). Given the supply and demand imbalances unique to these sectors, it is reasonable to expect this will be a temporary surge that will normalize later this year as supply constraints ease. It is also worth noting prices in many of the reopening and travel-related categories remain below pre-crisis levels, so these increases are reflective of a healthy return to pre-pandemic levels.

We believe this is all consistent with the transitory narrative the Fed has been forecasting related to inflation; however, it does warrant attention given the degree of the upside surprise, as well as the anecdotal stories of input

Figure 1. CPI vs. Core CPI

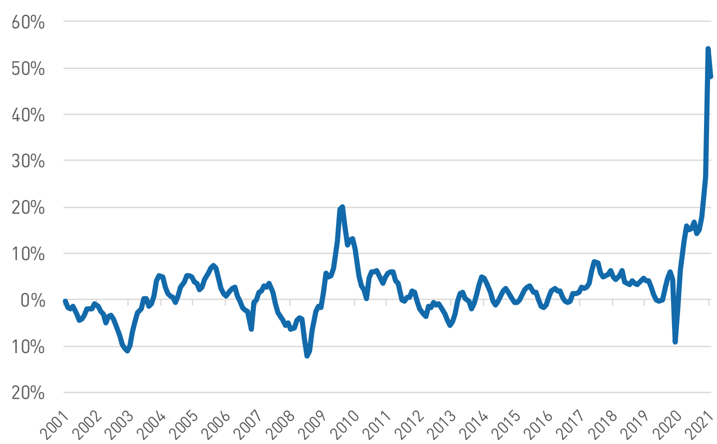
Both headline and core CPI figures have moved to post-financial crisis highs.



As of 04/30/21. Source: Bloomberg L.P.

Figure 2. Manheim Used Vehicle Value Index, year over year

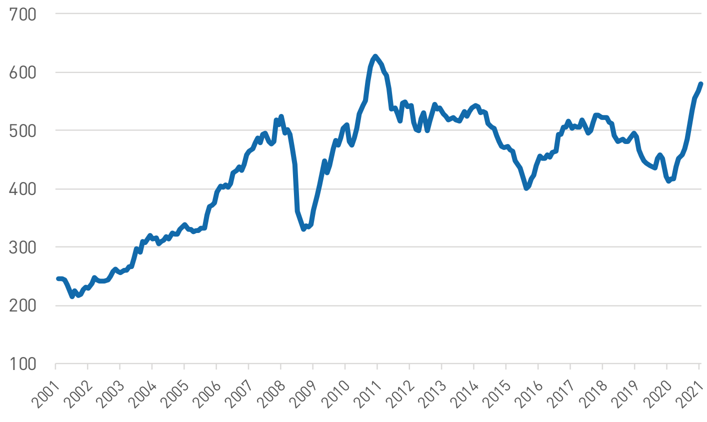
Used vehicle prices have soared as the availability of new cars has declined due to a semiconductor shortage.



As of 04/30/21. Source: Bloomberg

Figure 3. Commodity Research Bureau BLS/US Spot Raw Industrials Price Index

Commodity input prices have experienced a sharp rise recently as well.



As of 04/30/21. Source: Bloomberg

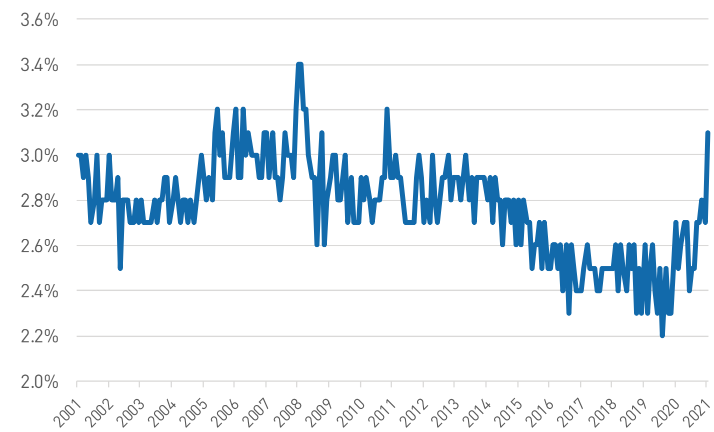
shortages and persistent bottlenecks intensifying supply chain concerns (Figure 3). How forward-looking inflation expectations evolve in the coming months will be of utmost concern to the Fed given the high levels of uncertainty related to the unique drivers of the current situation. While having expressed comfort with an inflation "overshoot" given lower-than-desired inflation following the financial crisis, the Fed will need to be mindful of its credibility should inflation expectations become untethered (Figure 4).

So far this hasn't been an issue in Treasury markets, as rates reacted by moving modestly higher immediately following the CPI release and then generally drifting lower over the following days. Similarly, breakeven rates on Treasury Inflation Protected Securities (TIPS) have retreated in recent days after steadily moving higher over most of the last year, suggesting much of the inflationary expectations were already factored into market pricing (Figure 5). Of note, the real rate on 10-year TIPS has fallen to around -0.80% after rising above -0.60% late in the first quarter, which suggests financing conditions remain highly accommodative.

Inflation measures will almost certainly remain elevated and be quite volatile in the coming months but given the unique circumstances of the current economic environment, it is important to be mindful of the underlying components of inflation for a truer picture of the overall story. When taken together with other economic data, namely the disappointing April payroll report, the Fed may have some time to remain patient. However, the Fed appears aware of the fluid nature of the current environment, as evident by this notable mention from the minutes of the April Federal Open Market Committee (FOMC) meeting: "A number of participants suggested that if the economy continued to make rapid progress towards the Committee's goals, it might be appropriate at some point in coming meetings to begin discussing a plan for adjusting the pace of asset purchases." Perhaps it is finally time to start *talking about* talking about an adjustment to monetary policy. We will continue to look for clues in Fed communications, including upcoming FOMC meeting minutes (June and July) and the Jackson Hole symposium that has recently been a forum for communicating these types of changes.

Figure 4. University of Michigan : Inflation Expectations

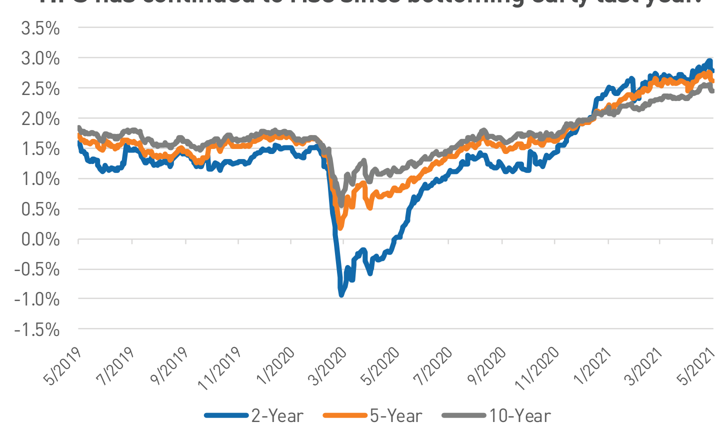
The University of Michigan expected inflation rate over the next 5-10 years is well above the Fed's long-term estimate.



As of 05/21/21. Source: Bloomberg L.P.

Figure 5. TIPS Breakeven Rates

The breakeven rate between nominal U.S. Treasuries and TIPS has continued to rise since bottoming early last year.



As of 05/21/21. Source: Bloomberg L.P.

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- **The Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.
- **The Core Consumer Price Index (Core CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services, excluding food and energy.
- **The Manheim Used Vehicle Value Index i**s recognized by financial and economic analysts as the premier indicator of pricing trends in the used vehicle market.
- **The Commodity Research Bureau BLS/US Spot Raw Industrials Price Index** is a measure of price movements of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. As such, it serves as one early indication of impending changes in business activity.

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