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"Transitory" Inflation?

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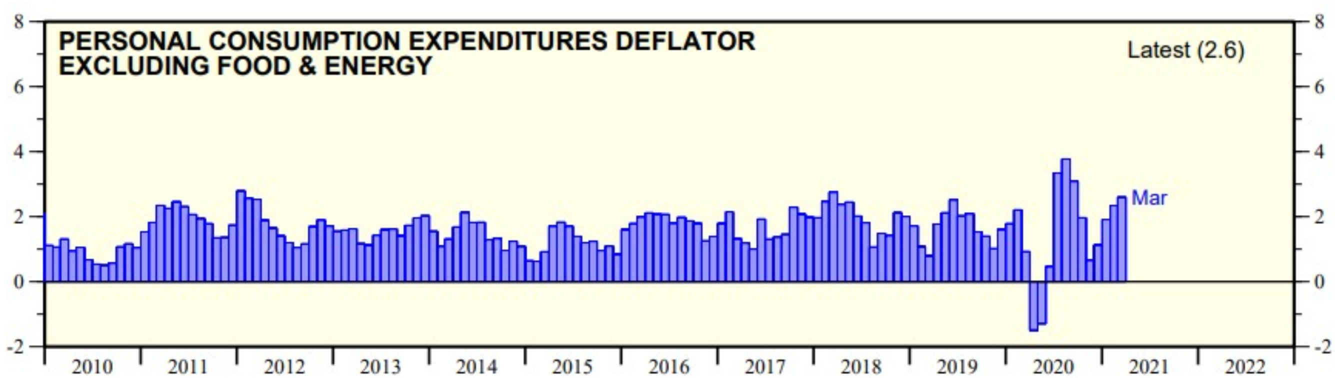
Key Takeaways

- While inflation is currently well above the 2% long-term Fed target, there are several reasons to believe that this may be a temporary phenomenon.
- Sustained inflation will not be detectable until next year at the earliest, which will allow the Fed to maintain the current monetary policy stance. In the meantime…
- We expect bond yields to only gradually rise as the economy recovers. At the same time, equity markets may be more volatile if investors pay more attention to earnings growth (as valuation multiples are challenged in a higher interest rate environment).

After the April CPI report that showed consumer prices rising 4.2% year over year, inflation has quickly climbed to the top of the list of market risks. The 10-year treasury yield has nearly doubled year to date as the economy recovers with bond market participants perhaps anticipating a sooner end to the aggressive monetary easing policy of the U.S. Federal Reserve. Equity markets have performed well so far this year as revenues and earnings have recovered, but there has been a distinct change of leadership favoring the cyclically sensitive recovery stocks over the steadier growing equities, many of whom benefited from low rates, the Work From Home trend of 2020, and the race to find treatments and a cure for Covid19.

The Importance of Sustained Increasing Demand versus Temporary Supply Constraints

Central banks in developed markets, including the Fed, have begrudgingly learned to avoid the traditional pre-emptive tightening stance normally taken whenever the bankers catch a whiff of higher inflation. They appear to better understand that entrenched inflationary pressure, the likes of which we have not seen since the 1980's, should be viewed from a policy perspective as an increase in the broad level of prices driven by excess aggregate demand in an economy. An increase in the price of certain items, particularly commodities (i.e. lumber) which are undergoing supply constraints, act more like a tax increase unless incomes increase as well. Only when monetary policymakers believe inflation is being driven primarily from a sustainable increase in demand will they begin to tighten policy. And as the following personal consumption expenditures chart shows, they aren't there yet.



Source: Bureau of Economic Analysis.

The rising inflation we are beginning to see this year is primarily a function of the year over year base effect and supply chain disruptions. The base effect is comparing prices today against prices one year ago when the economy was in the throes of the pandemic-driven recession. This effect should only be seen for the next few months as the economy began to recover strongly in the third quarter of last year. Supply chain disruptions are also very much a function of the Covid recession as certain factories closed or had to reduce production and are now only beginning to catch up with demand. An example can be seen in the automobile sector where the limited supply of important semiconductor chips has caused delays and at times stoppages in production. As economies fully reopen and production resumes, these bottlenecks should begin to dissipate and year over year price inflation should move back closer to pre-pandemic levels.

The State of the U.S. Consumer

As the Fed continues to view the current price inflation in the United States. as largely transitory and a somewhat natural byproduct of this atypical recession/recovery, one factor that can make it more entrenched is the current and continued health of the American consumer. Three stimulus checks, extended unemployment benefits, and overall lower expenses in what became a Stay at Home economy have put much money in consumers' pockets as reflected in historically high savings rates. With no more stimulus checks on the horizon and the upcoming expiration of the extended unemployment benefits, this demand driven pressure on prices should begin to decline. However, the next round of fiscal policy expansion currently being negotiated in Washington D.C. should be massive and will further stoke demand primarily in the Investment sector of the economy. Prospective tax increases at both the corporate and individual level should somewhat mute this potential demand.

In the intensely competitive global economic environment which has existed for most of this century, it has been difficult for businesses to pass along any cost increases to the ultimate consumer. This forced companies to stay very efficient and look for ways to boost productivity to protect their margins. Input cost pressures, full and partial shutdowns, and the difficulty in retaining qualified workers over the past year has further necessitated the need to remain vigilant on controllable costs. The beginning of an inflationary cycle is usually good for businesses that can boost prices faster than the increases in their all-in costs. Both the markets and the Fed will be watching to see whether businesses can sustain price increases.

Beyond the near-term economic implications of rising inflation, markets will be assessing and attempting to predict the policy response. The Fed continues to maintain they will let inflation run a little hot above their 2% target for some time. They have yet to define how hot and for how long, but they often cite that inflation was below the 2% target for such an extended period that it can stay above 2% without inflicting much economic damage.

In addition to the traditional price stability and full employment mandates, the Fed also maintains they will act to tighten only when they see evidence of a broad-based, inclusive recovery. With employment still roughly 8 million jobs below pre-pandemic levels and the prices of many Covid-hit sectors yet to fully recover, there remains a heavy bias towards monetary ease.

What We (and the Fed) are Paying Attention To

After rising steadily through most of the first quarter, the yield on the 10-year treasury has levelled somewhat and has been trading in a narrow range for the past two months. This can be a sign that the Fed is convincing bond market participants of their determination to keep rates lower for longer. It also should be remembered that unlike the 1980's when the so-called bond vigilantes aggressively sold intermediate and longer term bonds in reaction to higher inflation and the anticipation of Fed tightening, the Fed has entered this longer maturity realm as a not-for-profit purchaser and can provide sufficient support to bond prices if they so choose.

While most Fed speakers since the April CPI was released continue to stress the view that inflation is transitory, a sustained rate above 4% will test their resolve in keeping rates low into 2023 as is currently forecast. Equity markets are only 3% below their highs although concerns about rates rising further has impacted the high earnings growth sector of the market which benefits less from a cyclical economic rebound.

Bottom line, the old Wall Street adage of “Don’t fight the Fed” has never been more relevant and should continue to drive both bond and equity market participants. Inflation should slow as supply chain disruptions dissipate and year over year price increase comparisons become easier. Sustained inflation will not be detected and conceded by the Fed until next year at the earliest. Bond yields should resume their upward ascent in a recovering economy, but they should not spike sharply higher. Equity markets may be more volatile as they will be driven more by earnings as opposed to valuation multiple expansion. We do expect earnings growth to continue its sharp rebound over the coming quarters and then settle into a more normal growth pattern. With the economy growing and monetary policy remaining historically loose, it would be difficult to argue for a lower weighting to equities both in the United States and around the world.

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