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INFLATION 2022

Supply Catches Up to Demand

Inflation in the U.S. and around the world has risen to levels beyond what most market participants were expecting at the beginning of the year. Headline consumer prices in the U.S. are up 6.8% year-over-year at the end of November which are levels the economy has not seen since the early 1980's. Stripping out the volatile food and energy components, core inflation was 4.9%, a rate which is prompting the Federal Reserve to accelerate its reduction of monthly bond purchases so it is in a better position to battle any longer-term inflationary pressures.

Root Causes

The inflation experienced in 2021 was primarily a byproduct of various supply restrictions caused by the pandemic. The shuttering of the global economy in the spring of 2020 was accompanied by massive government income replacement schemes and business continuity initiatives. While production slowed to a crawl as workers were not going to factories, home-bound consumers naturally shifted their purchases from services to goods. With demand exceeding supply, shortages began to drive up the price of many products. Subsequent waves of Covid-19 delayed the rebound in services spending while additional fiscal relief measures earlier this year worsened the overall supply/demand imbalance in goods.

Supply chain constraints are likely to extend into next year as the Omicron variant of Covid-19 may further delay recovery in services and continue to skew consumer purchases towards goods. Any virus induced hesitancy on the part of production workers coming to their jobs could put further pressure on supply chains that are already stretched.

The Worst is Likely Over

Before the emergence of the Omicron variant, the global economy was exhibiting signs of a peak in supply chain bottlenecks which would likely lead to a peak in the inflation rates. According to the national and regional purchasing managers surveys in the U.S., production is beginning to exceed new orders and there is a slight improvement in delivery times and a reduction in prices paid. While anecdotal, there are reports of easing congestion at the two main west coast Ports of Los Angeles and Long Beach. The quicker goods can get off ships and onto shelves or into warehouses, the faster inflation rates can recede.

A recent example of the economics of supply-side inflation can be seen in the auto industry where demand for cars has increased during the pandemic, while the supply of new automobiles is greatly constrained by the severe shortage of semiconductor chips, which are largely produced in Asia. This has caused sharp increases in car prices, which along with the shortage of inventory, have begun to crimp demand. The semiconductor manufacturing industry, seeing the price of semis for automobiles move higher and under some pressure from governments, began to repurpose their factories away from chips made for phones and computers to those used in cars. Increased chip supply is allowing global auto manufacturers to ramp up production which should begin to alleviate price pressures moving into 2022.

What Could Cause Inflation to Persist

By their very nature, supply constraints tend to be temporary in a globally competitive economy. Accordingly, the development of persistent, or secular, inflation should be more a function of demand growth driven by continually rising incomes.

The last great inflation of the 1970's was largely fueled by the ability of powerful unions to negotiate cost of living wage adjustments. This perpetuated a wage/price spiral by putting additional money in consumer pockets which allowed businesses to consistently pass along higher wages and other input prices to the ultimate consumer.

Another byproduct of the pandemic is a trend that some are dubbing "the Great Resignation." The post-World War II baby boom generation started hitting retirement age at the turn of the century with labor force participation rates beginning a natural descent which the pandemic increased dramatically last year. The participation rate is recovering, but there may have been an acceleration of retirements in this demographic group which may have permanently reduced the economy's labor supply.

To the extent that a tight labor supply becomes more permanent, wages would need to increase to attract workers. Mitigating factors to this possible rebirth of a long dormant wage/price spiral would be both the greatly reduced bargaining power of American unions and the push for businesses to invest in productivity-enhancing technology and software to offset rising labor costs.

Market Signals of Peak Price Pressures

Apart from wage pressures, the most significant cost for businesses and consumers is energy. While some of the sharp year-to-date increase in prices across the energy complex was a rebound from last year's recession-induced depths, prices continued to climb to ever higher levels throughout the summer and early fall. The outbreak of the Omicron wave and some jawboning by governments around the world has caused a roughly 15%-20% decline in energy prices in the U.S. which should help reduce year-over-year CPI rates over the coming months.

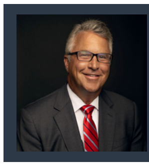
Dollar strength over much of 2021 should have been a bigger factor this year in dampening import and overall commodity prices, but the global economic rebound and supply constraints delayed this historical effect. In addition to energy, commodity prices are generally showing signs of peaking as global growth naturally slows from this year's sharp policy enhanced rebound. This is currently reflected in a notable decline in the breakeven inflation rates signaled by the difference in yield between treasuries and like maturity inflation protected securities.

The pandemic may have dealt globalization a damaging blow as a longer-term disinflationary force with economies scrambling to reshore their supply chains. But technological advancements in productivity, and the demographics of an aging population in most developed market economies, should continue to prevent a persistent outbreak of inflation. This is especially true now that many central banks around the world are beginning to contemplate incremental withdrawal from extreme monetary ease.

What This Means for Investors

Central banks are being forced to react to the magnitude of global inflation, but so far, the moves can be best categorized as a slight removal of excessive ease. While the Fed officially retired the term "transitory," there is strong evidence that inflation rates should begin to fall with authorities hesitant to react too aggressively to price increases that are already beginning to mute demand.

Monetary policy remains generally supportive of markets with negative real yields continuing to drive cash into equities and other high returning assets. Fiscal policy will no longer be a tailwind to the economy and markets, but consumers seem ready to have the torch passed from the government to businesses as the primary support to their spending. The failure to date to pass another fiscal initiative in Washington will delay any onerous corporate tax increase, therefore allowing businesses to maintain their healthy profit margins.



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