INVESTMENT BRIEF

Q4 2021

Strategic Investment Group®

"Transitory" or "Severe Threat"

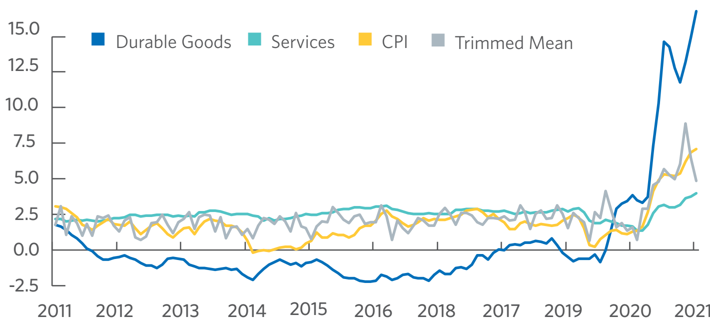
The Fed has grown increasingly hawkish following several months of sustained increases in inflation. When price pressures first emerged early last year, the Fed characterized them as "transitory." By December, when inflation hit 40-year highs, the Fed deemed it a "severe threat."

Markets face a key question. Will the Fed be able to dampen inflationary pressure without undermining the high asset valuations and debt levels that have been built up over a prolonged period of easy financial conditions? Much hinges on the pace and persistence of price increases, the Fed's response to them, and, crucially, whether the experience of high inflation becomes embedded in expectations. In this quarter's Special Topic, we explore recent inflation dynamics and consider the implications of tighter policies.

EXHIBIT 1:

U.S. Inflation Hits 40-Year Highs

Sources: Bureau of Labor Statistics. Percent change from a year ago.



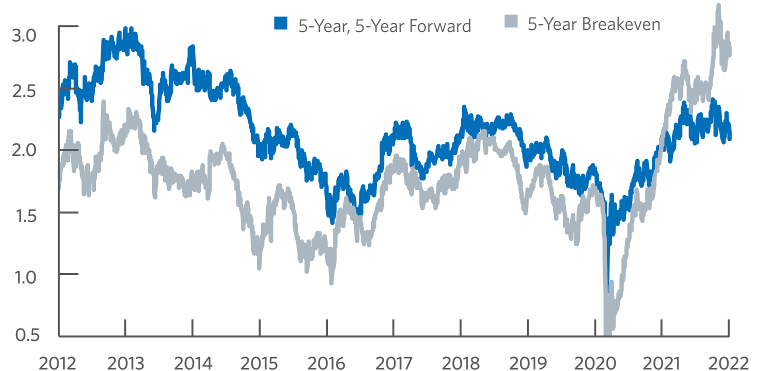
Inflation Dynamics

The jump in inflation has a number of noteworthy features. First, durable goods prices, which had been in a long secular decline relative to services, spiked 17% (yoy) in December (Exhibit 1). This jump reflects an equally dramatic shift in consumption patterns from services to durable goods since the pandemic. Real consumer spending on durables is 21% higher than its pre-pandemic peak, while real spending on services has not yet recouped pre-pandemic levels. The shift in consumption coupled with Covid-induced supply chain disruptions have resulted in some eye-popping price increases, including a 37% increase in the prices of used cars and trucks. Second, price pressures appear widespread and cannot be attributed to transitory shortages in used cars or other heavily demanded items. The trimmed mean measure of inflation that nets out such outliers was up 4.9% (yoy) in December and there is evidence of price pressures, notably in the form of higher wages, in the service sector notwithstanding the shift in consumption away from services. Moreover, commodity prices are way up. Gasoline prices in the U.S. rose by nearly 50% last year. Third, the labor market is tight and in flux. Unit labor costs rose 6.3% (yoy) through the third quarter of 2021. Job openings are near record levels (10.6 million) even though there are 3.6 million fewer people in the workforce than before the pandemic. The quits rate of 3% of total employment is at record levels. The risk of a wage price spiral is mounting.

EXHIBIT 2:

Market-Based Inflation Expectations

Sources: FRED. Inflation expectations measured by the difference between the yield on U.S. Treasuries and TIPS.



Inertia and Expectations

Inertia is the essential feature of inflation dynamics and the relative stability of expectations lies at the heart of inflation inertia. Expectations informed by past experience become self-fulfilling as they are embedded in contracts that affect future inflation outcomes. The most pernicious manifestation of this dynamic takes the form of contracts indexed to inflation. Such contracts, like the one concluded last year between John Deere and the UAW, automatically push inflation forward, making it even harder to break the cycle.

So far, market-based measures of inflation expectations are up significantly but remain relatively contained. In mid-January, market-based measures suggested expectations that inflation would average 2.8% over the next five years, and moderate substantially in the subsequent five years (Exhibit 2). By these measures, the bond market had faith that the Fed would be able to contain inflation without hurting the recovery or making high asset valuations and public and private sector debt levels untenable. Survey data, however, paint a more worrisome picture. The expectations of professional forecasters are for much higher inflation than suggested by the market. Consumer expectations are higher still. By these survey-based measures, the Fed has fallen behind the curve, and faces a difficult task of re-anchoring expectations to relative price stability.

The realization of the "severe threat" is not inevitable. Although price pressures are broad based, supply bottlenecks coupled with the dramatic shift in consumption are major pieces of the inflation puzzle. An easing of bottlenecks, a normalization of consumption patterns, and a retrenchment of the massive monetary and fiscal stimulus provided in the wake of the pandemic would do much to relieve inflationary pressure and preserve expectations for a modest near-term increase in inflation. Nevertheless, with yields still quite low and inflation rising, we retain a solid duration underweight.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.

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