Inflation

The fear of inflation, and resulting interest rate hikes by the Fed caught up to stocks this past week. On the front page of Thursday's WSJ: **Fed Flags Rate Hike Earlier Than It Expected** Signal of tightening by late 2023 comes as the economy recovers and inflation heats up. Friday's front page included: **U.S. Stirs Global Inflation Fears** America's recovery ripples through prices, currencies, forcing rate hikes in some nations. Then came this from the front page of Saturday's WSJ:

Rate-Hike Worries Send Dow To Worst Week Since October

BY PAUL VIGNA AND CAITLIN OSTROFF

U.S. stocks retreated Friday to send the Dow Jones Industrial Average to its worst week in nearly eight months, as traders warily eyed the Federal Reserve for hints of where monetary policy is headed.

Policy makers had signaled Wednesday that they expect to raise interest rates by late 2023, sooner than they had previously anticipated. Sentiment waned again on Friday after Federal Reserve Bank of St. Louis president James Bullard said on CNBC that he expects the first rate increase even sooner, in late 2022.

The Fed has faced more inflation than it expected, and policy makers need to be nimble, he added. ...

The Dow industrials fell 1.6% Friday, or 533.37 points, to 33290.08. For the week, the blue-chip index lost 3.45%, its worst since the week ended Oct. 30. ...

Mr. Bullard doesn’t currently have a vote on the rate-setting Federal Open Market Committee, and he was the first official to weigh in after this past week’s meeting. Seven of 18 Fed officials expect one or more increases next year. ...

The Cboe Volatility Index, known as Wall Street’s “fear gauge,” climbed to its highest level in weeks. ...

The Fed’s signals Wednesday had already started to take the steam out of a recent rally in stocks linked to a broad economic recovery, leading to a retreat in banking and energy shares this week. ...

Gold futures fell 0.3%, adding to their losses from Thursday, when they suffered their largest drop in over 10 months. For the week, gold fell 5.8%, its worst one-week performance since the week ended March 13, 2020. ...

The latest from Friday's Global Investment Strategy:

Don’t Sweat US Inflation…Just Yet

Look Who’s Talking

The Fed jolted markets on Wednesday after the FOMC signaled it may raise rates twice in 2023. Back in March, the Fed projected no hikes until 2024.

Seven of 18 committee members expected lift-off as early as 2022, up from four in March. Only five participants expected the Fed to start raising rates in 2024 or later, down from 11 previously.

The Fed acknowledged recent upward inflation surprises by lifting its forecast of core PCE inflation to 3.4% for 2021 compared with the March projection of 2.4%.

These forecast revisions bring the Fed closer to market expectations, although the latter are proving to be a moving target. Going into the FOMC meeting, the OIS curve was pricing in 85 bps of rate tightening by the end of 2023. At present, the market is pricing in about 105 bps of tightening.

At his press conference, Chair Powell acknowledged that FOMC members had discussed scaling back asset purchases. “You can think of this meeting as the ‘talking about talking about’ meeting,” he said. A rate hike in 2023 would imply the start of tapering early next year.

The key question for investors is whether this week’s FOMC meeting marks the first of many hawkish surprises from the Fed. We do not think it does. As Chair Powell himself noted, the dot-plot is “not a great forecaster of future rate moves,” before adding that “Lift-off is well into the future.”

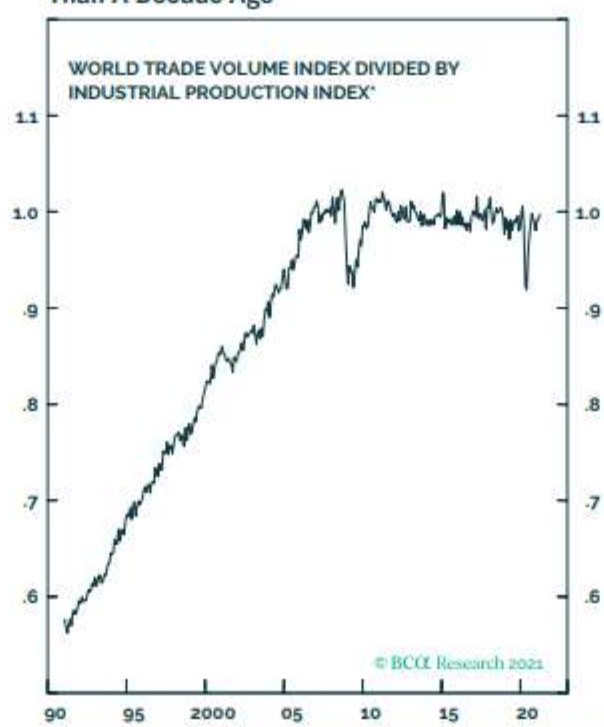
Ultimately, a major monetary tightening cycle would require that inflation remain stubbornly high. As we discuss below, while there are good reasons to think that the US economy will eventually overheat, the current bout of inflation is indeed likely to be “transitory.” This implies that bond yields are unlikely to rise into restrictive territory anytime soon, which should provide continued support to stocks. (The 10-year Treasury yield fell to 1.45% on Friday, for its 5th straight weekly decline. However, our view is that this is primarily the result of risk-off within the markets, and does not herald lower rates in the future.)

Inflation: A Long-Term Risk Rather Than A Short-Term Problem

There are plenty of reasons to worry that US inflation will eventually move persistently higher. ... many of the structural factors that have suppressed inflation over the past 40 years are reversing direction:

- Globalization is in retreat: The ratio of global trade-to-manufacturing output has been flat for over a decade (**Chart 2**). Looking out, the ratio could even decline as more companies shift production back home in order to gain greater control over unruly global supply chains.
- Baby boomers are leaving the labor force en masse. As a group, baby boomers control more than half of US wealth (**Chart 3**). They will continue to run down their wealth once they retire. However, since they will no longer be working, they will no longer contribute to national output. Continued spending against a backdrop of diminished production could be inflationary.
- Despite a pandemic-induced bounce, underlying productivity growth remains disappointing (**Chart 4**). Slow productivity growth could cause aggregate supply to fall short of aggregate demand.
- Social stability is in peril, as exemplified by the recent dramatic increase in the US homicide rate. In

CHART 2
Globalization Plateaued More Than A Decade Ago

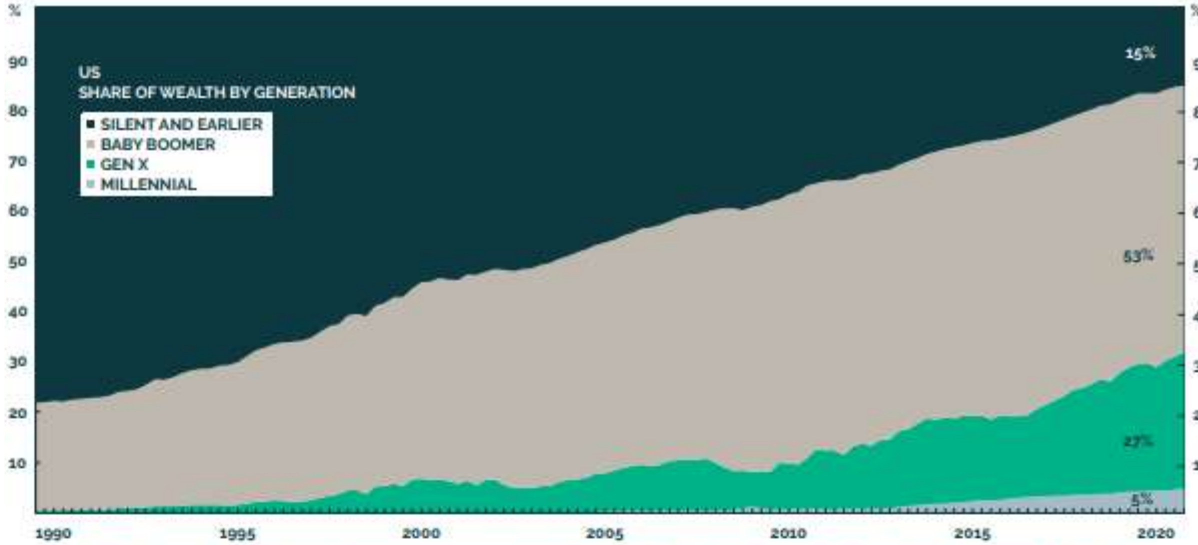


* SOURCE: CPB NETHERLANDS BUREAU FOR ECONOMIC POLICY ANALYSIS.

the past, social instability and higher inflation have gone hand in hand (**Chart 5**).

CHART 3

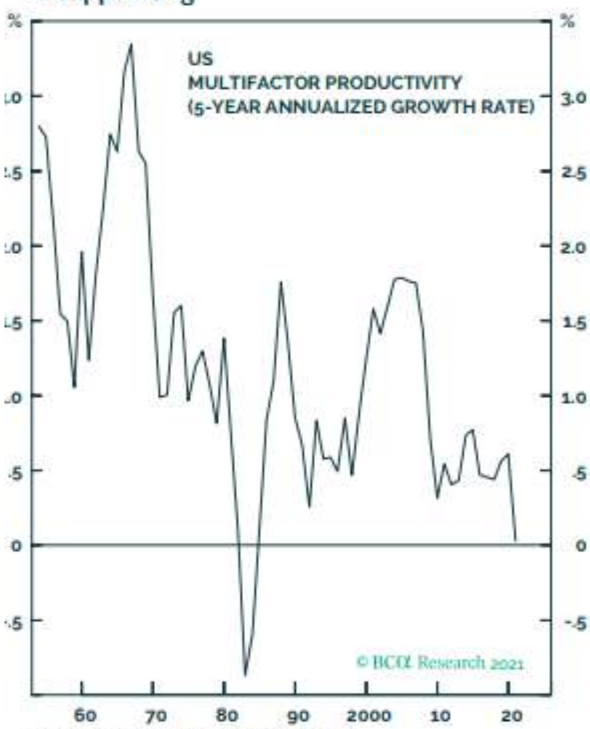
Baby Boomers Have Accumulated A Lot Of Wealth



NOTE: GENERATIONS ARE DEFINED BY BIRTH YEAR AS FOLLOWS: SILENT AND EARLIER INCLUDES THOSE BORN BEFORE 1946; BABY BOOMER INCLUDES THOSE BORN BETWEEN 1946-1964; GEN X INCLUDES THOSE BORN BETWEEN 1965-1980; AND MILLENNIAL INCLUDES THOSE BORN BETWEEN 1981-1996. THE NUMBERS IN THE CHART REFER TO THE DISTRIBUTION OF WEALTH IN Q4 2020.
SOURCE: FINANCIAL ACCOUNTS OF THE UNITED STATES.

CHART 4

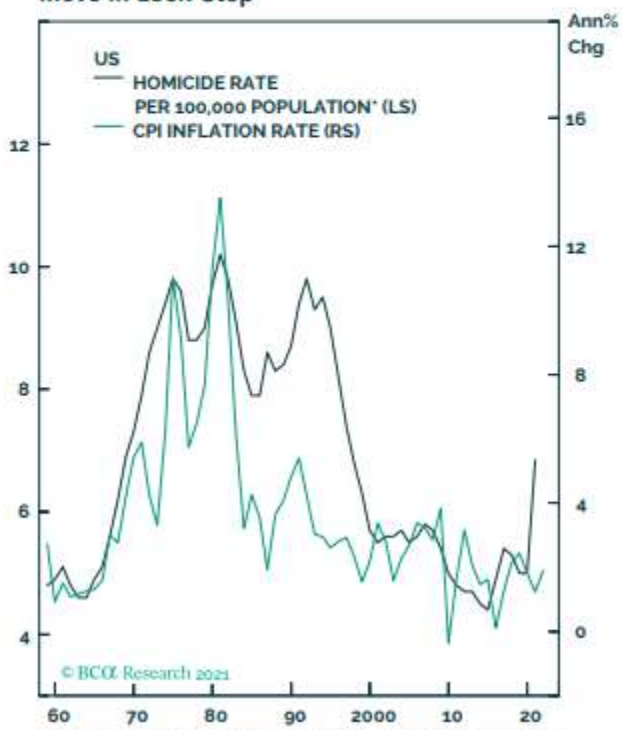
Trend Productivity Growth Has Been Disappointing



SOURCE: BUREAU OF LABOR STATISTICS.

CHART 5

Historically, Social Unrest And Higher Inflation Move In Lock-Step



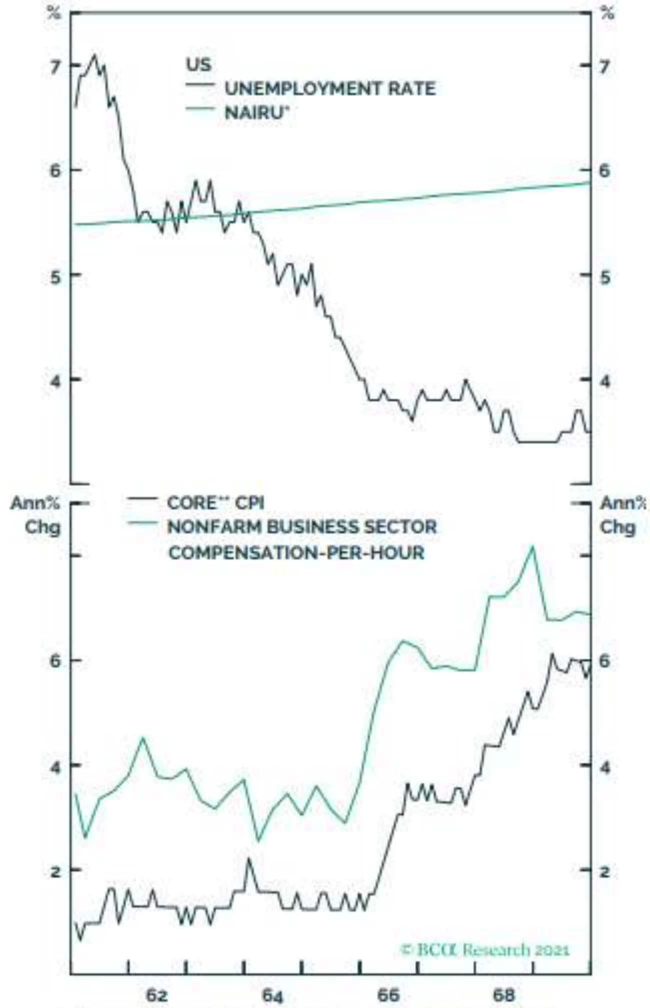
* INCLUDES MURDER AND NONNEGLIGENT MANSLAUGHTER ONLY.
SOURCE: US BUREAU OF JUSTICE STATISTICS; AND FBI UNIFORM CRIME REPORTING (2019).
SOURCE: BERNARD E. HARCOURT, ASHER, JEFF. TWITTER POST. DECEMBER 29, 2020., BJS, FBI UNIFORM CRIME REPORTING (2019), AND BCA RESEARCH.
NOTE: HARCOURT'S DATA IS USED FOR 1928-2000. BCA RESEARCH ESTIMATES USING BJS DATA ON PRISONER STATISTICS THEREAFTER.

- Perhaps most importantly, policymakers are aiming to run the economy hot. A tight labor market will lift wage growth (**Chart 6**). Not only could higher wage growth push up inflation through the usual "cost-push" channel, but by boosting labor's share of income, a tight labor market could spur aggregate demand.

Despite these structural inflationary forces, history suggests that it will take a while – perhaps another two-to-four years – for the US economy to overheat to the point that persistently higher inflation becomes a serious risk.

Consider the case of the 1960s. While the labor market reached its full employment level in 1962, it was not until 1966 – when the unemployment rate was a full two percentage points below NAIRU – that inflation finally took off (**Chart 7**).

CHART 7
Inflation Started Accelerating Quickly Only When Unemployment Reached Very Low Levels In The 1960s



* NON-ACCELERATING INFLATION RATE OF UNEMPLOYMENT. SOURCE: CONGRESSIONAL BUDGET OFFICE (CBO).
** EXCLUDING FOOD AND ENERGY.

DRY

In May, 4.4% fewer Americans were employed than in January 2020. The employment-to-population ratio for prime-aged workers stood at 77.1%, 3.4 percentage points below its pre-pandemic level (**Chart 9**).

A Labor Market Puzzle

Admittedly, if one were to ask most companies if they were finding it easy to hire suitable workers, one would hear a resounding "no." According to the National Federation of Independent Business (NFIB), 48% of firms reported difficulty in filling vacant positions in May, the highest share in the 46-year history of the survey (**Chart 10**).

Nationwide, the job openings rate reached a record high of 6% in April, up from 4.5% in January 2020. The share of workers quitting their jobs voluntarily – a measure of worker confidence – also hit a record of 2.7% (**Chart 11**).

How can we reconcile the apparent tightness in the labor market with the fact that employment is still well below where it was at the outset of the pandemic? Four explanations stand out.

First, unemployment benefits remain extremely generous. For most low-wage workers, benefits exceed the pay they received while employed. It is not surprising that labor shortages have been most pronounced in sectors such as leisure and hospitality where average wages are relatively low. The good news for struggling firms is that the disincentive to working will largely evaporate by September when enhanced unemployment benefits expire.

Second, lingering fears of the virus and ongoing school closures continue to depress labor force participation. ... participation rates have recovered less for mothers with young children than for other demographic groups. This problem will also fade away by the fall when schools reopen.

Third, the number of foreign workers coming to the US fell dramatically during the pandemic. State Department data show that visas dropped by 88% in the nine months between April and December of last year compared to

CHART 9

Prime-Age Employment-To-Population Ratio Remains Below Pre-Pandemic Levels

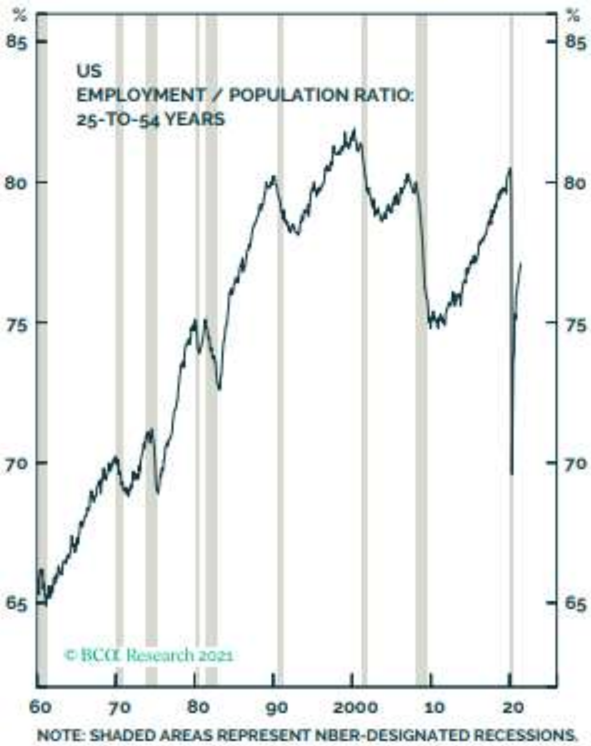


CHART 10

US Labor Market Shortages (I)

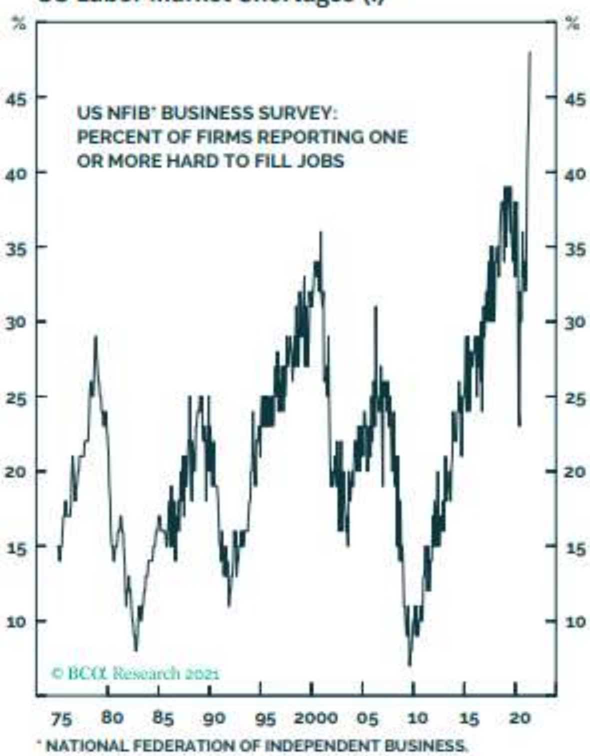
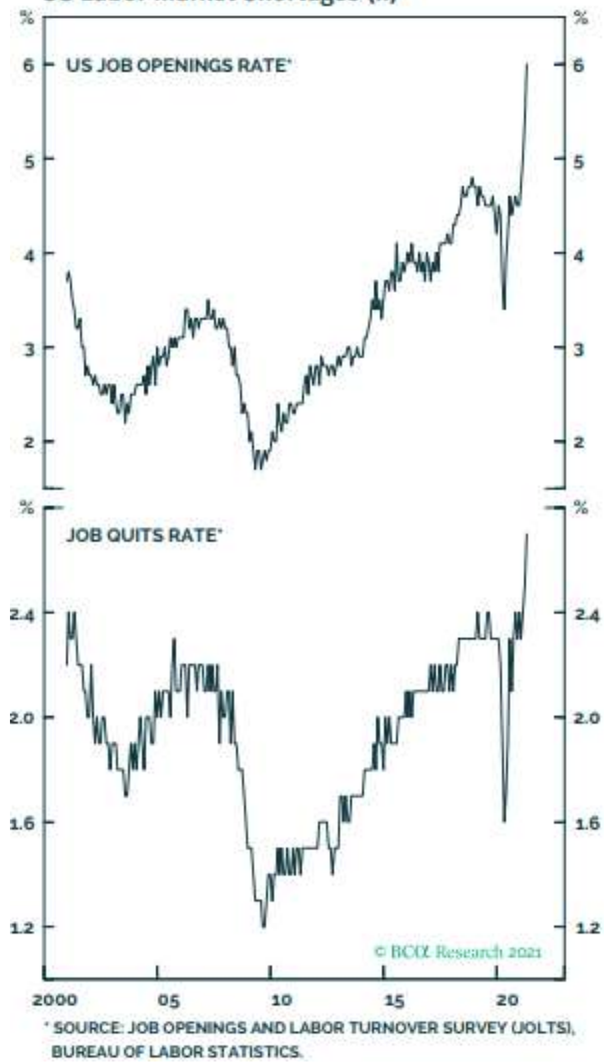


CHART 11

US Labor Market Shortages (II)



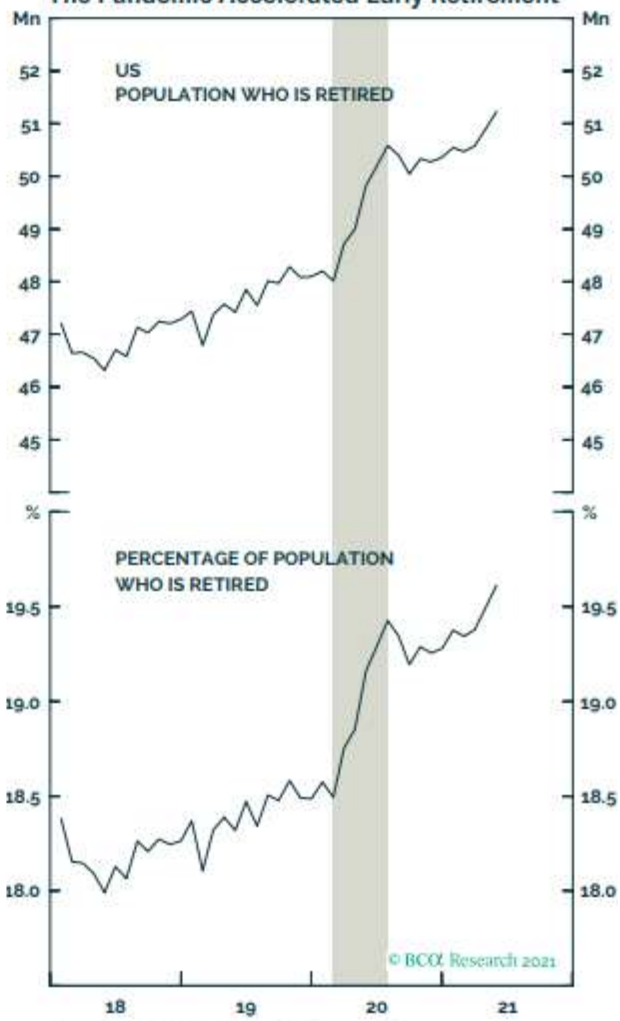
the same period in 2019. President Biden revoked President Trump's visa ban in February, which should pave the way for renewed migration to the US.

Fourth, about 1.5 million more workers retired during the pandemic than one would have expected based on the pre-pandemic trend (**Chart 15**). Most of these workers were near retirement age anyway. Thus, there will likely be a decline in new retirements over the next couple of years before the baby boomer exodus described earlier in this report resumes in earnest.

Other Input Prices Set To Ease Just as labor shortages in a number of industries will ease later this year, some of the bottlenecks gripping the global supply chain should also diminish. The prices of various key inputs – ranging from lumber, steel, soybeans, corn, to DRAM prices – have rolled over (**Chart 16**). This suggests that producer price inflation for manufactured goods, which hit a multi-decade high of 13.5% in May – has peaked and is heading lower.

CHART 15

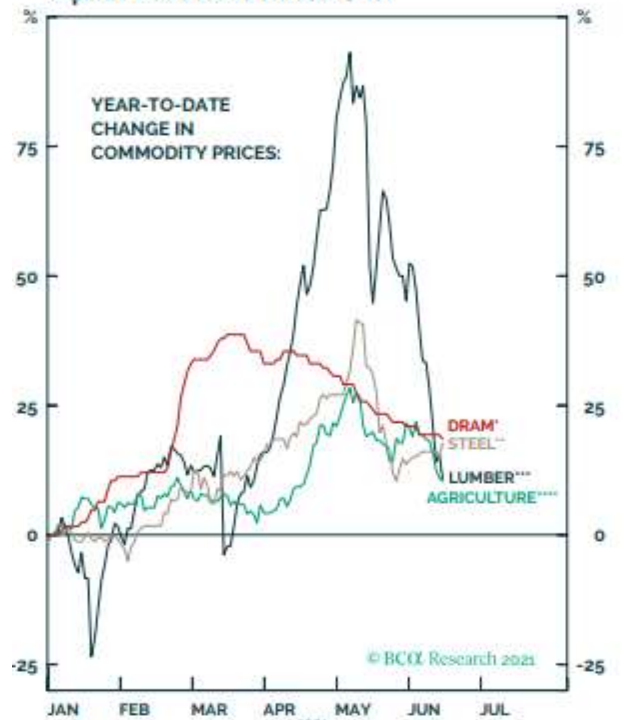
The Pandemic Accelerated Early Retirement



SOURCE: IPUMS-CPS, UNIVERSITY OF MINNESOTA.
NOTE: SHADING REPRESENTS NBER-DESIGNATED START DATE FOR RECESSION; END DATE IS A BCA ESTIMATE.

CHART 16

Input Prices Have Rolled Over



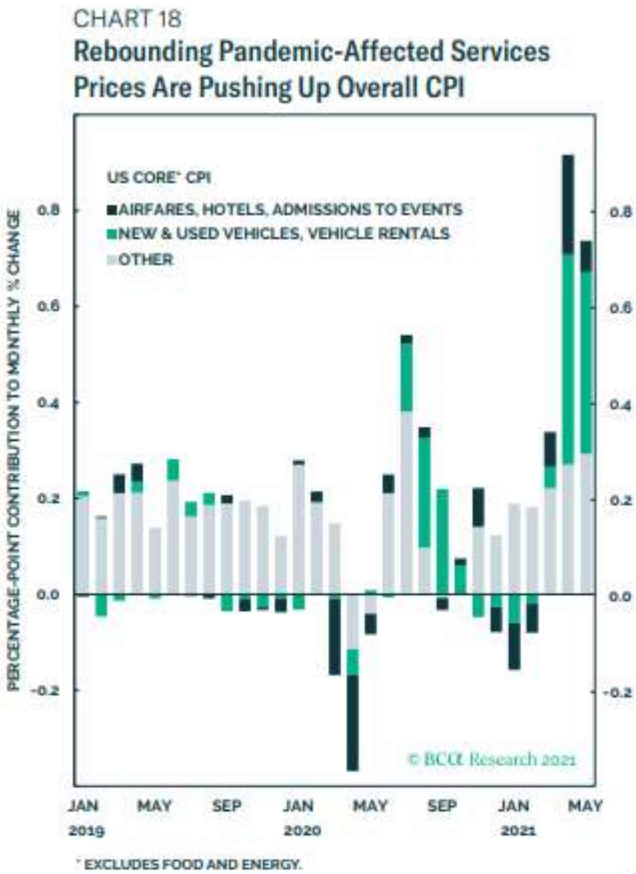
* DRAMX DDR3 1GB 128Mx8 CHIP PRICE. SOURCE: DRAMEXCHANGE.
** STEEL REBAR FUTURES PRICE. SOURCE: SHANGHAI FUTURES EXCHANGE.
*** SOURCE: CME.
**** GOLDMAN SACHS COMMODITY PRICE INDEX. INCLUDES WHEAT, CORN, SOYBEANS, COTTON, SUGAR, COFFEE, AND COCOA.
NOTE: DATA SHOWN AS PERCENT CHANGE SINCE BEGINNING OF 2021.

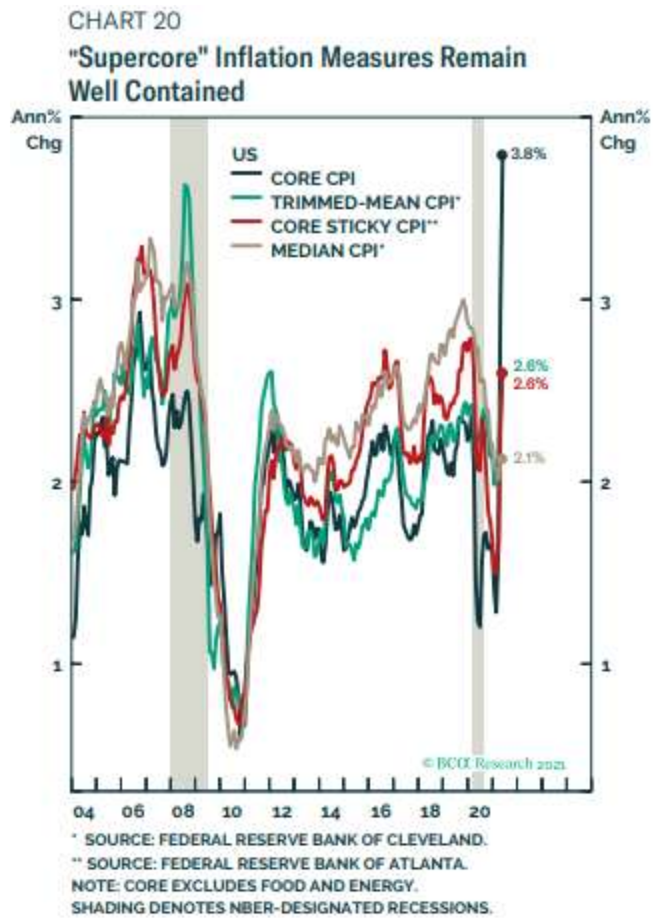
The jump in prices largely reflected one-off pandemic effects. For example, rental car companies, desperate to raise cash at the start of the pandemic, liquidated part of their fleets. Now that the US economy is reopening, they have found themselves short of vehicles. With fewer rental vehicles hitting the used car market, households flush with cash, and new vehicle production constrained by the global semiconductor shortage, both new and used car prices have soared.

Vehicle prices have essentially moved sideways since the mid-1990s. Thus, it is doubtful that the recent surge in prices represents a structural break. More likely, prices will come down as supply increases. According to a recent report from Goldman Sachs, auto production schedules already imply an almost complete return to January output levels in June.

As **Chart 18** shows, more than half of the increase in consumer prices in April and May can be explained by higher vehicle prices, along with a rebound in pandemic-affected service prices (airfares, hotels, and event admissions). Outside those sectors, the level of the CPI remains below its pre-pandemic trend.

More refined measures of underlying inflation such as the trimmed-mean CPI, median CPI, and sticky price CPI are all running well below their official core CPI counterpart (**Chart 20**).





While certain components of the CPI basket, such as residential rental payments, are likely to exhibit higher inflation in the months ahead, others such as vehicle and food prices will see lower inflation, and perhaps even outright deflation. ...

Our baseline view is that the 10-year Treasury yield will rise to about 1.9% by the end of the year. If inflation fails to come down as fast as we anticipate, bond yields would increase even more than that. ...

Our thoughts

The Trump administration's cutting taxes while increasing spending with the economy at full employment was a classic recipe for future inflation. However, last year's Covid-19 pandemic-induced recession short circuited the natural outcome. The Fed's response was to unleash a flood of liquidity, while the Biden administration has ramped up spending even more. The question isn't what lies in front of us, but when. The above analysis may be correct that the dramatic increase in inflation we are seeing is temporary, but for how long, and will the markets see any near-term reduction in inflation as what is actually temporary.

As previously shared, Keynes described the action of rational agents in a market by using an analogy of a beauty contest, in which to win you must pick what the average opinion of the judges will be: **"It is not a case of choosing those that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. ..." (Keynes, General Theory of Employment Interest and Money, 1936).**