Inflation: Higher, but for how long?

Wealth Management

Prices—and expectations—are heading higher

Prices in the U.S. are moving higher as the economy reopens and economic activity picks up. April's Consumer Price Index (CPI) was up 4.2% from the prior year's level—well above the Fed's 2% target, and the highest reading in more than a decade. Market pricing of future inflation is also rising. The Fed gauges the market's consensus for future inflation using a measure of expected annual inflation over a five-year period starting five years in the future. This indicator is now above 2.5%, indicating that the market is pricing sustained, above-target inflation well into the next decade.

Despite these data points, the Fed—correctly, in our view—does not presently view inflation as sufficiently established to warrant policy action, and instead considers below-target inflation the greater risk in the medium term. We believe that the Fed should, and will, maintain low rates for an extended period, and that this policy is consistent with stable prices. The most likely route towards higher sustained inflation remains increased government spending, and we believe the future path of Fed policy is likely to be highly sensitive to changes in fiscal policy.

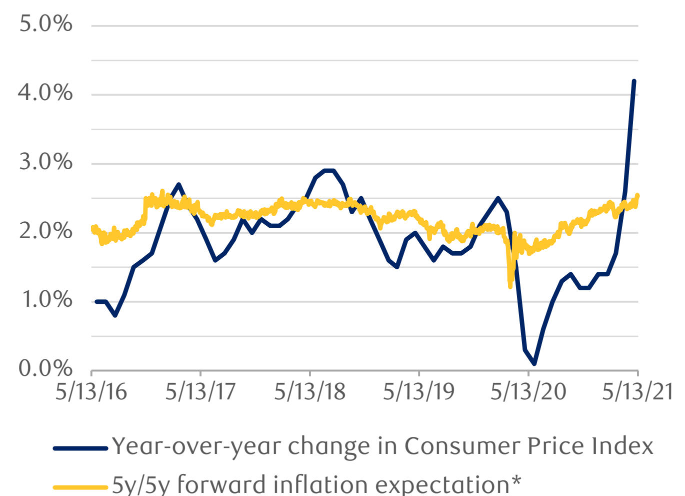
Transitory factors dominate

The Fed's sanguine view of recent above-target inflation readings is based on two core premises: first, that the drivers of above-target inflation are transitory and will not inevitably lead to higher sustained inflation; second, that if inflation becomes a problem, the Fed has a well-established policy game plan to bring it down.

There are strong reasons to believe that the Fed is correct in both of these assessments.

Consumer prices fell during the pandemic, artificially increasing 2021's inflation, which is calculated as a year-over-year change in index value. And the impact of this base effect is significant: April's 4.2% CPI reading would have been a full 1.1% lower had it been measured against the pre-pandemic price index level. Although a 3.1% increase from pre-pandemic prices would still be above the Fed's target, it's notable that fully half of the excess inflation observed in April is simply a residual impact of 2020's economic shutdown. Prices reached their pandemic nadir in May 2020, so this base effect should dissipate in the coming months.

April inflation rises sharply, expectations follow suit



* 5y/5y inflation expectation is a measure of expected inflation for a five-year period starting five years in the future

Source - RBC Wealth Management, Bloomberg

Rising commodity prices are another factor that is likely to prove transitory. Although nearly certain to pull consumer prices higher through the summer, historical data indicate that commodity price spikes of the type we are currently experiencing do not presage rising inflation rates. Empirically, slightly lower rates of future inflation are typically observed a year after commodity prices rise, because higher input costs tend to act as a tax on

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consumption, reducing consumer budgets available for other goods and services.

Spending spree?

One wild card that could impact the Fed's calculation is consumers' reaction to the economic reopening. During the pandemic, household spending slowed, leading to an additional $1.6 trillion in savings. If consumers were to turn around and spend that entire amount—over 7% of U.S. GDP—then sustained inflation would be more likely to occur. While possible, such an outcome seems improbable to us. Most of the deferred consumption was in services, not goods, and there are limits to how many restaurant meals, haircuts, and vacations a household can purchase. Recent data support the idea of a reopening surge in consumption, but what will follow is less clear. If the pandemic savings remain as savings, then the prospects for higher inflation look subdued, supporting the Fed's wait-and-see approach.

Disinflation well established and durable

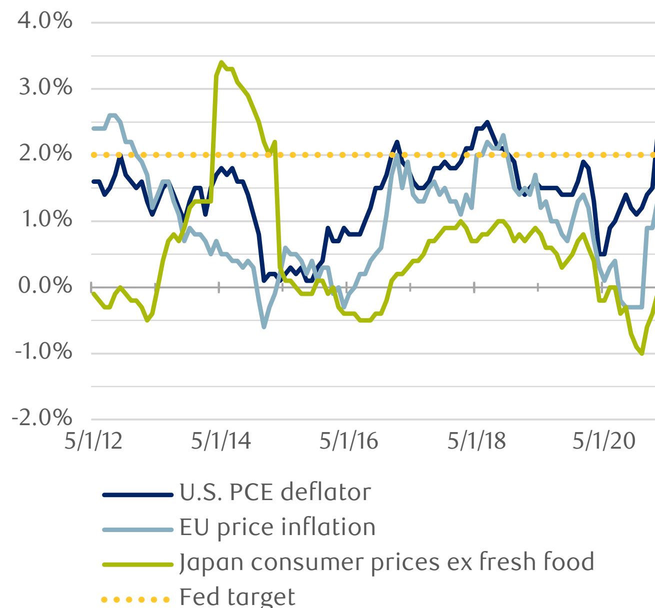
The Fed's reluctance to extrapolate from near-term inflation data is due in part to the well-established, global downtrend in inflation. There are many causes for the general restraints on higher prices: wealth disparities have pushed income towards savings-focused households and away from spenders; demographic changes have shifted the population towards slower-spending age groups; and efficiency improvements have enabled companies to provide goods at lower costs, allowing for restrained price growth with strong corporate margins. While the relative importance of these and other factors is open to debate, it seems clear that downward price pressures exist across the major developed-market economies.

Slack labor markets are another source of persistent downward price pressure. April's weak U.S. jobs report demonstrated the slow pace of hiring in one month, but a potentially more troubling sign is the difference between economic recovery and employment. In nominal dollars, U.S. GDP now exceeds its pre-pandemic level, yet that output is being created with nine million fewer employees. This significant, longer-term disconnect between labor and output makes it increasingly difficult to envision an environment where median-income households achieve sufficient wage gains to keep prices pushing higher.

All misses are not created equal

Nobel Prize-winning economist Milton Friedman famously declared that "inflation is always and everywhere a monetary phenomenon." For investors, however, that dictum is empirically untrue. Over the last decade, the Bank of Japan grew its assets from 25% to 131% of GDP,

Low inflation: A durable global phenomenon



Source - RBC Wealth Management, Bloomberg

while the Fed saw its assets rise from 18% to 36% of GDP. In both countries, however, the downward trend in consumer price inflation remained intact. Over the past nine years, only 10 monthly inflation reports have exceeded the Fed's target—the remaining 91% of inflation readings were too low by the Fed's own criteria.

These consistent inflation misses suggest that the Fed's current toolkit—at least as it has been deployed—is inadequate to create on-target inflation. This is in contrast to controlling excess inflation, where the Fed has a well-established and effective policy response. Thus, in our view, it is better for the economy in the medium term that the Fed risk a brief period of excessive inflation before applying a robust cure than that it allow disinflation or even deflation—a problem for which no cure presently exists—to become firmly established.

Fiscal in focus

The Biden administration's proposed infrastructure and families plans represent potential government spending of $4 trillion—or over 18% of U.S. GDP—over the next decade. Accordingly, we believe the Fed will increasingly focus on this legislation and the broader implementation of fiscal policy as it evaluates the appropriate pace of removing monetary accommodation. In particular, policies that tend to raise wages and overall income for middle- and lower-income households will likely increase the Fed's confidence that on-target inflation can be maintained without the current level of monetary accommodation. Absent those fiscal policy measures, we believe the Fed will incline towards a longer period of accommodation due to concern about longer-term disinflationary trends.

Conclusion

Investor surveys have revealed growing concerns about future inflation and the potential need for Fed action to offset rising prices. While recent data—most notably the April CPI report—may seem to vindicate those fears, we believe the Fed will rightly look beyond these numbers and maintain highly accommodative policy. In doing so, the central bank will be emphasizing the well-established, long-term forces pushing inflation rates lower, including the economy's ability to generate output with less labor and the resulting rise in income to households that tend to save. In our view, the forces presently pushing prices higher are largely one-time events, and similar occurrences in the past have not caused sustained inflation; we believe the Fed will not, and should not, react to a highly speculative argument on how pandemic savings might be used in the future. This conclusion is reinforced by the relative costs of a central bank mistake: higher inflation has an easy policy response, while a decade of efforts by global central banks to create sustained inflation have met with failure.

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