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MARKET SIGHTLINES

First Quarter Comes to an End: Inflation is Raging

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The first quarter has ended. Market volatility is up, with the tragic war in Ukraine and continued pandemic-driven supply/demand imbalances driving inflation higher. In this week's Sight|Lines, we review where we are with inflation, including forward-looking market measures and official views.

LATEST READINGS

As mentioned, pandemic-driven supply/demand imbalances and the Ukraine war are putting upward pressure on prices. For example, gasoline prices have risen about 20% since Russia's invasion of Ukraine, oil prices are up about 13.6%, and natural gas prices have risen around 6.6%. Since energy is an essential input to most businesses, higher operating costs, and the potential for higher prices for these goods and services, are likely coming. As it relates to oil supply/demand imbalances, the Energy Information Administration (EIA) forecasts oil markets to balance out next year, as global fuel production is anticipated to rise faster than consumption.

So, what are some of the latest readings? The consumer price index (CPI) and core CPI are up 7.9% and 6.4%, respectively, over the year ended February 2022. Strikingly, the producer price index (PPI) and core PPI are up 10.0% and 6.6%, respectively, over that same period. Finally, the Federal Reserve (Fed) focuses on the personal consumption expenditures price index (PCE). The PCE and core PCE are up 6.4% and 5.4%, respectively, over the year ended February 2022. By all of these measures, inflation is running hot.

THE FED IS RESPONDING

In June of 2021, Fed Chair Jerome Powell said this about inflation: "As these transitory supply effects abate, inflation is expected to drop back toward our longer-run goal, and the median inflation projection falls from 3.4% this year (2021) to 2.1% next year (2022) and 2.2% in 2023." The Fed, and many other market analysts who aligned with its view, were wrong. Inflation has not been "transitory." In the press conference following the last monetary policy meeting, Powell said that "inflation is likely to take longer to return to our price stability goal than previously expected." Clearly, the Fed now understands that inflation is a problem and is shifting policy accordingly. It stopped security purchases and signaled plans for quantitative tightening. It hiked the fed funds rate 25 basis points (bps) to a range of 0.25%-0.50% at the March meeting and signaled another six 25-bps hikes this year (150 bps total). Today, the market is pricing in another 200 bps of tightening this year, which would bring the fed funds rate to 2.25%-2.50%, a level last seen in December 2018. In recent days, Chair Powell has signaled willingness for a 50-bps rate hike at one of the upcoming Fed meetings.

FORWARD-LOOKING MEASURES

The Fed also publishes a Summary of Economic Projections (SEP). In this publication the Fed forecasts inflation, as measured by core PCE, to be 4.1% in 2022 and 2.6% in 2023. Clearly, the Fed believes its policy shift will bring inflation under control. Market measures tell a slightly different story. The 5-year and 10-year break-even inflation rates sit at 3.5% and 2.9%, respectively, both well above the Fed's 2% target. Also, the 5-year break-even inflation rate five years from now is 2.3%, still elevated. Figure 1 shows a similar result. This chart presents the implied 1-year inflation rate over the coming years. The punchline? Market participants expect inflation to remain well above the Fed's 2% target until 2027.

Figure 1. Inflation Breakevens

Time Period	Implied Inflation Rate
One year from now	3.3%
Two Years	2.9%
Three Years	2.5%
Four Years	3.0%
Five Years	1.4%
Six Years	2.4%
Seven Years	2.3%
Eight Years	2.5%
Nine Years	2.7%

Source: Stifel Investment Strategy via Bloomberg, as of March 31, 2022.

IS A RECESSION LOOMING?

With the Fed acting quickly and substantially to hike rates and slow the economy to rein in inflation, investors are asking: Is a recession looming? One common signal of a potential economic downturn is the shape of the yield curve. The curve will flatten dramatically, or even invert when short-term rates rise in response to anticipated Fed hikes, and long-term, rates stay steady or even fall, in anticipation that the Fed will have to lower rates again to respond to a recession. Currently, the 2-10 Treasury spread, a popular measure of yield curve slope, has fallen to 0.05% and even briefly inverted earlier in the week. In past cycles, when the 2-10 Treasury spread falls below 0%, we experience a recession 13 months later on average. Students of the yield curve are a little concerned. We include yield data in our recession dashboard, 13 metrics we use to gauge recession risk. Currently, five are showing "caution," and eight are still signaling expansion. None are yet signaling recession.

WHEN IT COMES TO INFLATION, THERE'S AN "ELEPHANT IN THE ROOM."

In the wake of the pandemic, the Fed dropped rates to near zero and purchased securities to expand its balance sheet from $4.16 trillion to $8.96 trillion. Congress approved, and Presidents Trump and Biden signed five fiscal stimulus packages totaling $5.5 trillion in spending. M2, a popular measure of money supply, rose from $15.5 trillion before the pandemic to $21.7 trillion as of February. So, the "elephant in the room?" Some economists would say, simply, that more money chasing the same goods and services must translate to higher inflation.

CONCLUSION

With the first quarter ending, this is a good time to look back at inflation, a key market driver, and look forward to where we go from here. Market measures and experts are both signaling elevated inflation for 2022, but then a path back toward normal later this year and into 2023. But the “elephant in the room,” historic levels of monetary and fiscal support and an elevated money supply, and higher commodity prices may put the prospect of calming inflation at risk. We will continue our inflation analysis and provide updates to clients regularly.

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