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MARKET SIGHT*LINES*

Has Inflation Peaked? It Depends on Who You Ask

By Michael O'Keeffe, *Chief Investment Officer*

A while back, the Federal Reserve (Fed) made the case that inflation was transitory, meaning that inflation would calm down and return to normal levels after having risen. Others argued that we would be experiencing sustained, higher inflation fueled by reopening demand, a disrupted supply chain, and a money supply that had grown too much. As we've seen sustained higher inflation since April of last year, the debate has shifted to a new question. Is inflation peaking, or not?

In this week's Sight|Lines, we summarize the arguments put forward by both sides of this inflation debate and offer our perspectives on which side might win the debate or, in other words, our inflation outlook.

THE CASE *AGAINST* PEAKING INFLATION

The case against peaking inflation starts with the tight labor market. Unemployment sits at 3.6%, and there are 5 million job openings unfilled. There are more extreme shortages in some areas, like truck drivers, that are driving wages higher. These forces may create a wage-price spiral, last seen in the 1970s, where rising wages increase disposable income, in turn raising the demand for goods and services, which pushes prices higher. Higher wages can also lead to higher production costs, putting even further upward pressure on prices. A spiral.

Increased demand and supply chain issues stemming from the pandemic have created shortages in many areas, reducing supply, which also puts upward pressure on prices. For example, the shortage in semiconductors is estimated to have impacted 169 industries in some way, even those you might not associate with semiconductors, like soap manufacturing.

The tragic Russia-Ukraine war is also being blamed for higher prices, much of that focused on the disruption of energy from Russia to Europe and other parts of the world. The war has also impacted the global supply of metals like palladium and titanium. About 35% of palladium, which is used for semiconductors, is sourced from Russia. Finally, food prices are higher, given that Russia and Ukraine collectively account for about 30% of global wheat exports and 20% of maize exports.

China's zero-Covid strategy is also creating challenges. Approximately 400 million people are under a full or partial lockdown, impacting factory output and further exacerbating supply chain issues.

Lastly, in our April 1, 2022 Sight|Lines about raging inflation, we discussed an "elephant in the room," that the big jump in money supply from supportive monetary and fiscal policy may well drive inflation higher.

THE CASE *FOR* PEAKING INFLATION

In turn, the case for peaking inflation starts with some arithmetic, or the "base effect." Industry experts and the media both report inflation by sharing how prices have changed over the last year, comparing price levels today to those 12 months ago. When prices jump dramatically, this change will be seen in the next 12 inflation reports because the "base," or the price level 12 months ago used in the annual inflation calculation, has not yet experienced the jump. This is called the "base effect." So, as the base starts to include the first big jump seen in April 2021, reported annual inflation should moderate.

A second argument for peaking inflation? Some would say it is all about the supply chain. We are starting to see glimpses of pandemic-related supply chain issues starting to ease. For example, the backlog of ships waiting to enter U.S. ports has fallen sharply to a nine-month low. The Global Supply Chain Pressure Index (GSCPI), a new index from New York Federal Reserve economists that "encompasses several indicators used to capture supply chain disruptions," is signaling that global supply chain pressures are decreasing, but still high.

When we dig into recent inflation reports, we're also seeing potential evidence of inflation relief. Used car and truck prices, which are up 35% over the last year, actually fell 3.8% in March. And core CPI, which excludes food and energy, rose 0.3%, less than consensus expectations, and mostly the result of higher housing prices.

Finally, the Fed is signaling a big policy shift with several fed funds rate hikes in 2022 and some 50-basis-point (0.5%) hikes possible at one or more meetings this year. The market is pricing in hikes totaling 2.25% this year. And, in good part due to the more aggressive Fed, forward-looking inflation measures may have peaked. For example, the 1-year breakeven inflation rate hit 6.31% on March 23 and has since fallen to 5.67%.

WHO MIGHT WIN THE DEBATE? OUR INFLATION OUTLOOK

As we evaluate the macroeconomic and market environment, uncertainty is always present. Forces are changing constantly, and the world is interconnected so that such forces may well influence economies and markets alike. Uncertainty is elevated in 2022, driven by continued pandemic risks, the tragic war in Ukraine, and a shifting Fed policy, for example. This uncertainty makes it hard to determine who might win the latest inflation debate. But our view remains that inflation has peaked and will start to fall. We see the influences of the base effect, easing supply chains, and a meaningful shift in Fed policy outweighing the effects of wage pressures, the Ukraine-Russia war, and China's current zero-Covid strategy. But, given the uncertainty in the current environment, our conviction in this view is more muted than usual.

CONCLUSION

Last year, the inflation debate asked if higher inflation was transitory. But since last year, the debate has shifted to whether inflation is peaking, or not. There are strong arguments for both sides of this new debate, and picking a winner is challenging in this uncertain environment.

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