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MARKET SIGHT LINES

Tracking Recovery: Higher Inflation

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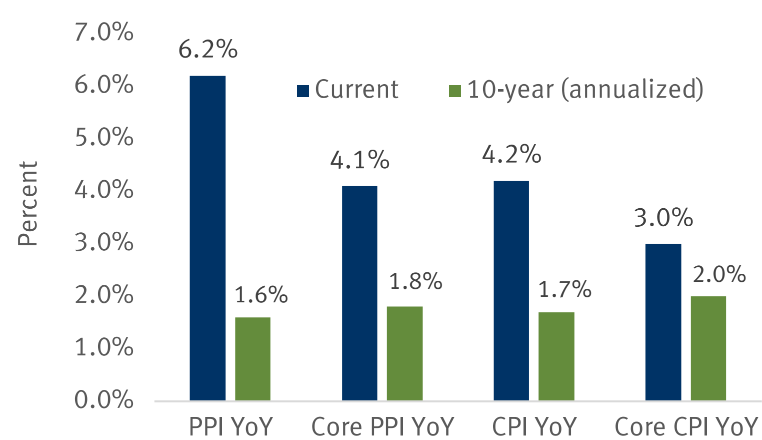
This year we've been writing about recovery, as the effects of easy monetary policy and historically large fiscal stimulus kick in and help us recover from the shutdowns of the coronavirus pandemic. Along the way, we've talked a lot about inflation, and we've all known higher inflation was coming. Now that some signals of higher inflation are upon us, it quickly begs the question: How much is too much? When we get to "too much," our buying power begins to erode, and the Federal Reserve (Fed) will likely tighten monetary policy, slowing the recovery and weakening a foundation for higher asset prices.

In this latest Sight|Lines, we review some recent inflation measures to understand what they may mean as we consider history, the current environment, and the future.

Current Inflation Readings

Let's start with recent inflation readings. Exhibit 1 presents several measures. Published by the Bureau of Labor Statistics (BLS), the producer price index (PPI) seeks to measure changes of costs over time from the viewpoint of industries that make the products, or domestic production. This week we learned that PPI rose 6.2% in April from a year ago, driven much by service demand, specifically transportation and warehousing. Core PPI, which excludes food and energy, rose 4.1%. Higher costs for production quite often get passed on to the consumer, driving up prices for them.

Exhibit 1. Inflation Measures



Source: Stifel Investment Strategy, data via Bloomberg as of May 13, 2021

The consumer experience is measured by the BLS consumer price index (CPI), designed to measure price changes in consumer goods and services, including things like food, energy, transportation, and healthcare. This week we also learned that CPI was up 4.2% in April from a year ago, driven by big increases in gasoline (49.6%), fuel oil (37.3%), and used cars and trucks (21%). The effects of the reopening were also evident, as airfares and hotels were up 10.2% and 7.6%, respectively. Core CPI, which also removes volatile segments like food and energy, rose 3%. Both measures of CPI were above expectations.

Recent History of Inflation

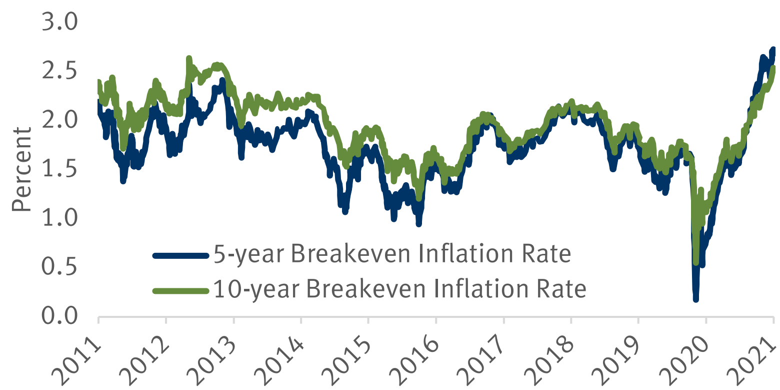
The Fed has historically targeted inflation at 2%. Last year, the Fed announced a revised policy framework in which its inflation goal is an *average* inflation target of 2% over the long run. This suggests that the Fed will allow inflation to run above 2% for a period of time in order to offset periods when it was lower. Inflation measures have been running well below 2% throughout the pandemic. So, what do these recent "prints" tell us about cumulative inflation looking back in time? When we look at the inflation that has actually occurred over the last 10 years through April, we see that CPI is up 1.7% on an annualized basis. Over that period, core CPI is up 2.0% (annualized), PPI has risen 1.6% (annualized), and core PPI has grown 1.8% (annualized).

So if the Fed is looking at the 10-year period, for example, there is certainly more room to tolerate higher inflation for a while.

Views on Future Inflation

Many years ago, the U.S. Treasury began issuing Inflation-protected securities (TIPs), securities designed to help protect investors from inflation by indexing principal and interest payments by the rate of inflation. Secondary market pricing on these securities is driven by investors' views of *future* inflation.

Exhibit 2. Inflation Breakeven Rate



Source: Stifel Investment Strategy, data via Bloomberg as of May 13, 2021

By comparing the pricing of these securities to the pricing of nominal bonds not indexed to inflation, we can infer the future "breakeven" inflation rate embedded in the TIPs pricing. Exhibit 2 shows how the breakeven CPI implied by TIPs has changed over time for the next five and 10 years. We see that investors' inflation expectations have been rising, and now inflation is expected to run at 2.7% for the next five years and 2.5% for the next 10 years.

Fed Messaging

The Fed has often mentioned "symmetric" inflation, meaning a rate that can run above the 2% target to make up for periods below 2%. Another term the Fed and others are using is "transitory." With the pandemic shutdown, supply chains shut down. As we reopen the economy and supply chains restart, bottlenecks will appear, temporarily driving prices higher. Fed Chair Jerome Powell said during his April press conference that "it seems unlikely, frankly, that we would see inflation moving up in a persistent way that would actually move inflation expectations up while there's still significant slack in the labor market…" So, the increase is expected to be "transitory." The Fed is signaling a willingness to be patient with higher inflation and the intention to keep its policy intact.

Investment Implications

Our work on topics like inflation influences our investment guidance. Our guidance has included suggesting an overweight to TIPs as a hedge against higher inflation. We have also suggested considering an overweight to commodities, which should benefit from pricing increases triggered by supply chain bottlenecks, for example. And in the equity work we do for our Stifel Choice portfolios, we're intentionally focused on semiconductors, which we believe will be in great demand as the reopenings continue.

Conclusion

Many agree that higher inflation is coming, and recently we've seen a jump that begs the question: How much is too much? Well, we know, even with this recent jump, that inflation has run below the Fed's 2% target over the last 10 years. We also know that the Fed is ready to tolerate higher "symmetric" inflation and expects it to be "transitory." And investors are expecting inflation to run 2.5% over the next 10 years.

We will continue to monitor inflation and its potential impact on production costs, consumer prices, and Fed policy.

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