Is higher inflation here to stay?

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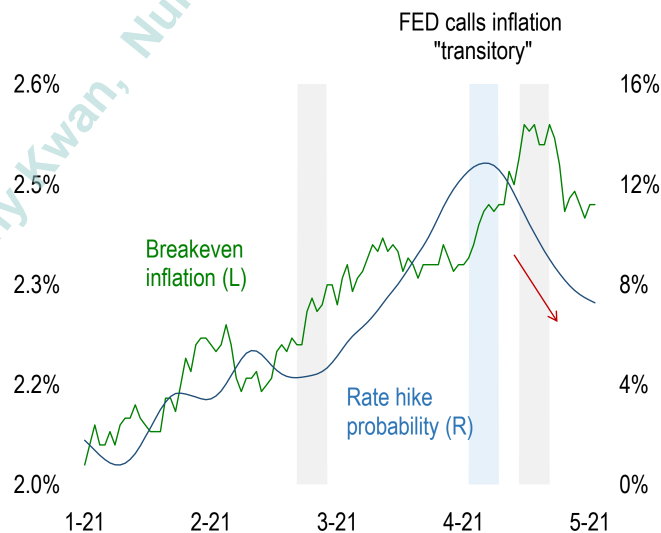
Consumer price inflation in the United States soared in April, beating market expectations and rising well above the Federal Reserve's 2% target. In this special report, we explore the factors behind the surge in US inflation, and the likelihood that the US will experience a sustained period of elevated price growth.

CPI inflation in the US jumped to 4.2% YoY in April, its highest level in 13 years and exceeding market expectations by 0.6 points – an exceptionally high prediction error. The positive inflation surprise caused a 2% equity market sell-off, as investors worried of a 1970s-type 'hawkish squeeze', in which tighter Fed policy derails the economic recovery.

In the three weeks following the CPI release, Fed officials have gone to great lengths to emphasize the 'transitory' nature of the inflation shock. Fed vice-chair Richard Clarida, for instance, emphasized the role of base effects in boosting the April figure, while pointing to well anchored inflation expectations. Fed communication eased concerns over a hiking cycle, while improving overall risk sentiment and reducing market's long-term inflation beliefs (F1).

F1: Fed guidance still holds sway
Breakeven inflation vs. rate hike probability



Note: Chart displays 10Y breakeven inflation against the market-implied probability of an FOMC rate hike by December 2021.Source: CME, Macrobond; Numera calculations.

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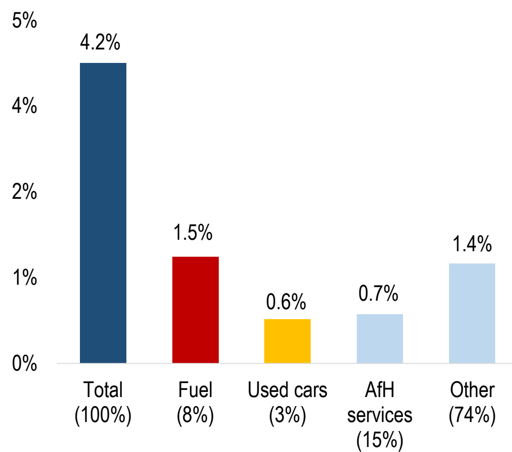
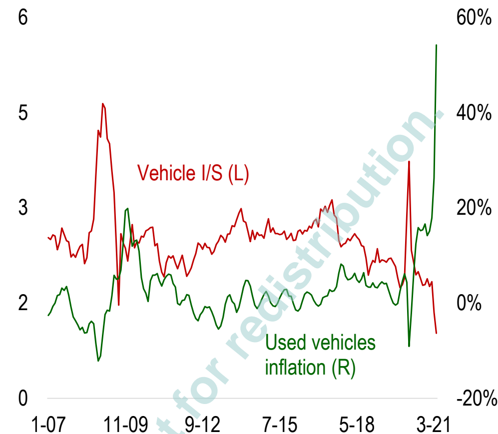
F2: Fuel, used cars driving inflation spike
CPI inflation breakdown - April 2021 (YoY)



Note: Chart breaks down sectoral contribution to CPI inflation in April 2021. The relative weighting of each sector in the CPI basket are showed in brackets. Source: BLS.

F3: Supply shortages amplifying inflation
Vehicle I/S ratio vs used vehicles inflation



Note: Chart compares year-over-year inflation for used vehicles to the inventory-to-sales ratio for motor vehicles. Source: US Census Bureau, Manheim Consulting.

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But is the Fed correct in expecting a temporary spike in prices? Underlying the Fed's inflation view is the fact that much of the April surge reflects either an easy comparison with April 2020, or temporary supply shortages for highly cyclical goods-producing sectors. We can see this in F2 above, which breaks down the contribution of selected CPI categories to the generalized increase in prices. Half of the April result stemmed from fuels and used cars, two sections that account for only 11% of private consumption.

In the case of fuel, stronger road traffic and still low refinery output is allowing gasoline producers to pass on higher oil prices to consumers. Tight market conditions also caused used car prices to soar, a segment with a limited historical incidence on inflation. While strong personal income has pushed car sales 20% above their pre-COVID path, an ongoing semiconductor shortage is preventing auto manufacturers from meeting this surge in demand. As a result, the vehicle inventory-to-sales ratios has plummeted, allowing used car dealers to revise prices sharply (F3).

In the service industry, in turn, falling public health risks and improvements in mobility (see F4 below) are starting to boost demand in tourism and hospitality, allowing suppliers in these industries to normalize prices. As we can see in F2, price revisions in away-from-home industries (15% of household consumption) contributed boosted overall consumer prices by 0.7%

For now, however, rapid price growth is concentrated in 'flexible' categories such as gasoline, with still limited pricing pressures in the 'sticky' segments of the economy (industries where producers revise prices

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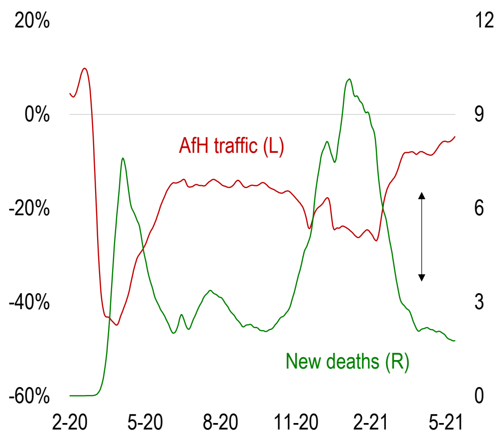
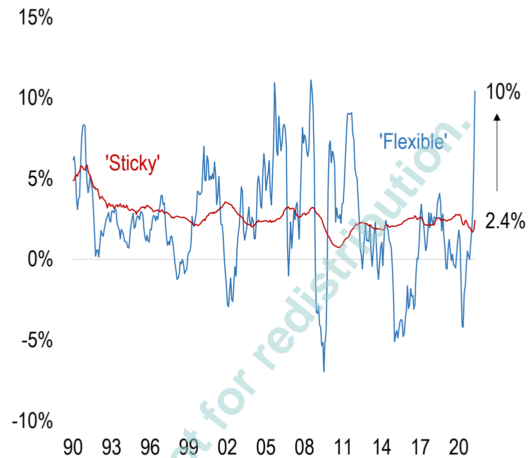
F4: Reduced health risks driving mobility
US AfH traffic vs new COVID deaths



Note: Red line show changes in US away-from-home (AfH) traffic versus Jan. 2020. Green line shows daily COVID deaths per million people. Source: ECDC, Google Mobility, Numera calculatons.

F5: Flexible categories driving inflation
Flexible and sticky price inflation (YoY %)



Note: Sticky prices correspond to industries that modify prices less frequently than every 4-5 months (the average adjustment period). Source: Atlanta Fed.

only once or twice per year). We can see this in F5 above, which compares flexible and sticky price inflation for the United States. Notice that unlike flexible categories, where prices depend primarily on demand and supply shocks, sticky inflation was virtually unchanged at 2.4% YoY.

This is of crucial importance to the inflation outlook, because unlike flexible categories, sticky-price sectors are extremely forward looking. This is because price changes in these sectors can be costly (e.g. if input prices outpace revenues), so any revisions often incorporate expectations about future inflation. Stable flexible inflation suggest expectations remain anchored, reducing the likelihood of an inflationary spiral.

Supply shortages, rising commodity prices and base effects will probably keep inflation well above 2% for the remained of the year. The most likely outcome is for PCE inflation to average 3% this year, with virtually no chance of falling short of 2%. Perhaps more importantly, near-term inflationary risk is extremely high versus the past decade, with YoY inflation potentially jumping above 6% over the next 3-6 months.

Nevertheless, anchored long-term beliefs suggest that inflationary pressures should dissipate as supply constraints lessen. Another key factor limiting the medium-term outlook are still moderate wage pressures, with median wage growth showing no discernible upward trend given still substantial job market slack (F6). Wage growth and long-term inflation expectations are two of the most accurate predictors of con-

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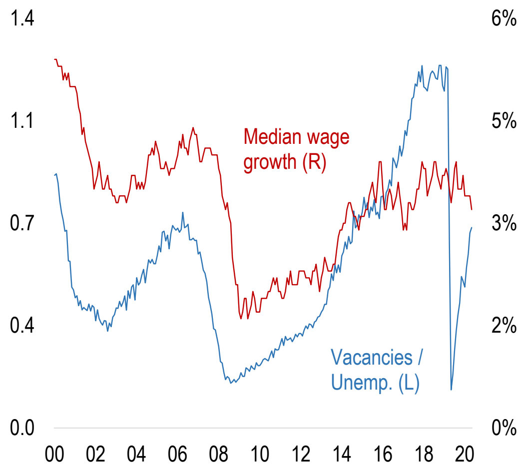
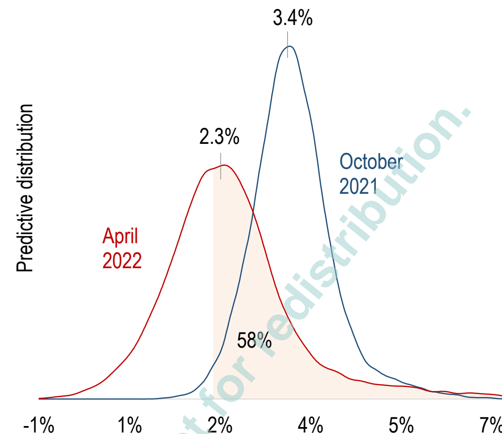
F6: Wage pressures remain modest
Market tightness vs. median wage growth



Note: Blue line tracks labour market tightness, defined as the ratio of total job openings to (adjusted) unemployment. Red line tracks YoY nominal changes in median private sector wages. Source: BLS, Atlanta Fed; Numera calculations.

F7: Inflationary pressures should ease
PCE inflation outlook (YoY %)



Note: Probability forecasts for headline PCE inflation for October 2021 and April 2022. Shaded area denotes probability of above-target inflation 12M out. source: Numera Analytics.

sumer price inflation at the 1-2 year horizon, so the fact that both remain stable greatly reduces the risk of a sustained period of 3%+ inflation (F7).

Notice from F7, however, that even if inflation decelerates, it will probably remain above the Fed's target for some time. This reflects the fact that excess demand will eventually allow service providers to increase their cost mark-ups, while lifting (but not de-anchoring) inflation expectations.

What does this mean for Fed policy?

In the past, the Fed has responded to sustained periods of higher inflation by raising short-term rates, which contain inflationary pressures by depressing growth. The Fed, however, seeks price stability alongside full employment. As a result, the current 'reflationary' regime creates a policy trade-off, since interest rate hikes to curb inflationary pressures could cripple the job market recovery.

In our view, it is unlikely the FOMC will adopt a hawkish stance even as inflation runs above 2%. Firstly, the Fed's shift to an 'average' inflation target since last summer signals a higher tolerance for inflation, especially given still low employment (F8). In fact, Powell and other Fed officials have consistently empha-

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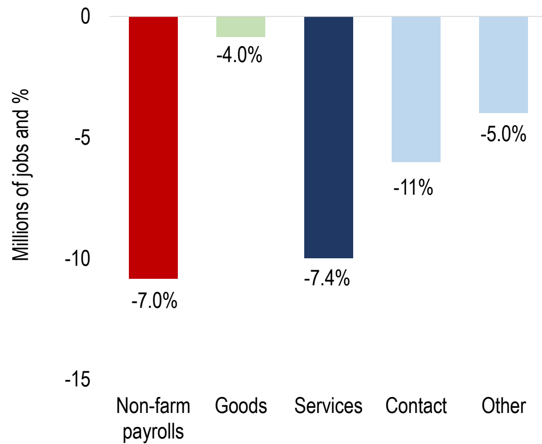
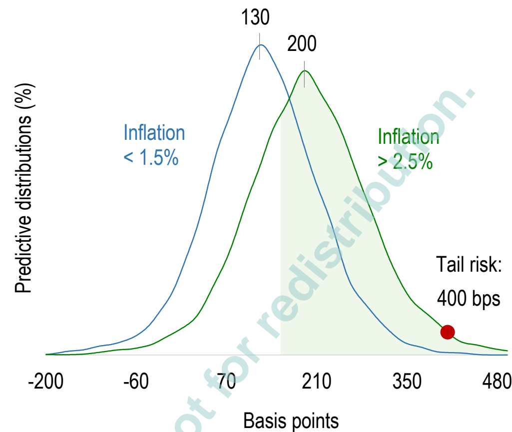
F8: Job market damage remains profound
COVID-19 employment shortfall - 05/21



Note: Chart breaks down the total employment shortfall by sector (in millions of jobs and % deviations from the pre-COVID path). Source: Numera Analytics.

F9: Huge implications for long-term rates
Conditional 10Y yield outlook - 12M out



Note: Probability forecasts for headline PCE inflation for October 2021 and April 2022. Shaded area denotes probability of above-target inflation 12M out. source: Numera Analytics.

sized their commitment to the job market recovery, which reduces the likelihood of multiple rate hikes over the next 12M (see T1 below).

Higher inflation, on the other hand, has crucial implications for long-term interest rates. Even if above-target inflation has a limited incidence on policy rate expectations, higher pricing pressures may lift 10-year Treasury yields if investors demand a higher term premium as insurance against inflationary risk.

F9 illustrates the impact of rising inflation on long-term rates. If inflation were to exceed 2.5% 12M out, the most likely outcome would be for 10Y yields to average 200 bps, and could realistically go as high as 400 bps. On the other hand, if inflation were lower than 1.5%, 10Y yields would probably fall below their current trading range.

T1: FOMC outlook Policy action	Probability forecasts (%) 11 / 21	05 / 22	11 / 22
Unchanged	63	54	45
1 hike +	37	46	55
2 hikes +	18	31	43

Note: The current Fed funds target rate is 0-25 bps. Source: Numera Analytics.

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