Private Bank

Global Strategy Bulletin

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COVID Distortions Boost Inflation. The Long-Term is Less Troubling

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- **The US CPI rose 4.2% over the past year, with 0.8 percent growth in just April.**
- **The monthly increase was the largest single monthly increase in 40 years, and the yearly increase exceeds anything seen since the middle of the great recession.**
- **We have highlighted this coming increase in headline inflation for months, and have over weighted Treasury Inflation Protected Securities by 2 percentage points to receive compensation in our GIC level 3 portfolios.**
- **After shortages in goods owing to COVID-driven shifts in consumption patterns, services prices should rebound next. Yet in sharp contrast to more strident inflation hawks, we see most of this inflation as a normalization rather than a permanent acceleration. We look at two-year annualized inflation and see figures roughly in line with Fed targets, and see growth signs in the details of today's CPI print.**
- **Most price increases cut consumer power, but there is one exception, and that is used vehicle prices, which surged by 10% in April, driving nearly ½ of the entire monthly increase in prices. Instead of cutting consumer power, higher used vehicle prices means higher trade in values, and coupled with very favorable lending terms for new vehicles, means we will likely see a strong summer of vehicle selling which will likely reinforce the business cycle expansion.**

When the details tell more than the headline

The April CPI was substantially higher than expected at 0.8% month-to-month versus 0.2% consensus, or 4.2% year-to-year. This is in line with our expectations that the middle of this year would see very high inflation figures. The world economy is highly distorted by COVID-driven shifts in consumption expenditures resulting in supply bottlenecks.

We have over weighted TIPS in the GIC allocation by 2 percentage points in the level 3 portfolio (see figure 1). While we expected strong CPI figures, we are not inflation hawks, and see the bulk of these figures as a rebound surge rather than a signal of much stronger and lasting inflation to come (see figure 2). The Federal Reserve will have a difficult communication challenge ahead as the US shifts further into expansion. With the relatively mild employment figure for April, high inflation and soaring economic growth in the first quarter there is a lot to digest.

We view the GDP figure as the most telling about the direction of the economy versus the lack luster employment and high inflation figures for April. We see strong growth that is coming out of the recovery as the US economy reopens and transitory factors in inflation and employment. But the same three data points could be used to tell a far more pessimistic story, of already tight labor and soaring inflation. We caution against this reading and see the details of the reports as more important than the headlines for charting the future path of the economy.

On the inflation side we see the bulk of the increase as temporary, and something to that could be anticipated due to "base" effects from a plunge in prices a year ago. There is a lot baked into the future price path already based on what happened in 2020. That said, looking at 2-year changes we can look over the top of the pandemic to see how inflation is shaping up away from impact of the pandemic. So away from the base effects impact of April 2020, we can see headline inflation is up 2.2% annualized from April 2019.

Figure 1: US TIPS total return and CPI Inflation

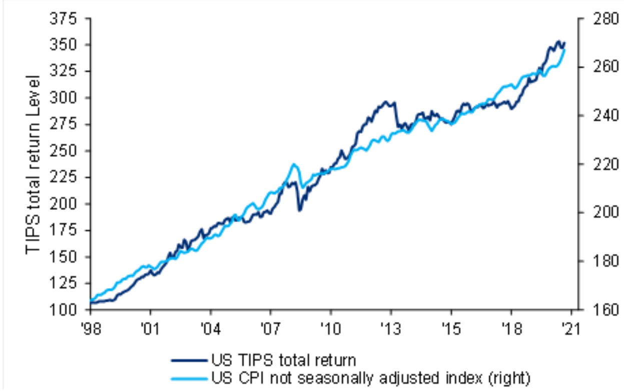
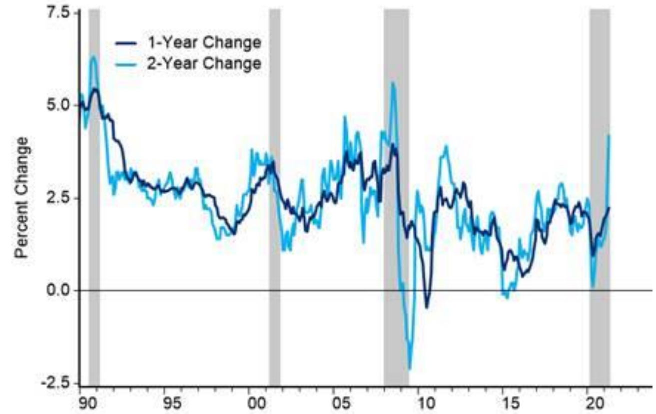


Figure 2: Headline CPI



Source: Haver Analytics as of May 12, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. Grey shaded areas represent recessions.

But the story of inflation doesn't have to be a negative one for the economy. **One of the largest non-energy drivers of inflation in April was used vehicles, which saw record prices in the month (see figure 3). This is a sign of strong demand, but demand that will help fund the purchases of new vehicles and drive future investment and consumption. Used vehicle prices are nearly 3% of the CPI, and were up 10% (not annualized) in April, contributing 0.3 percentage points to the headline figure, or nearly ½ of the large increase. This is a strange form of inflation because it means more consumer power for another segment, not less. The strength means that new vehicles which enter into GDP will have more support as trade in values are at record levels**.

Away from rebounding energy prices and surging used vehicle prices, long term trends are not aggressive in the CPI. One of the largest segments with the most momentum and smallest short term fluctuations is in housing prices, and there the figures are actually slowing as shown by the lowest rental price increase since 2011.

Figure 3: Used Vehicle Prices in the CPI

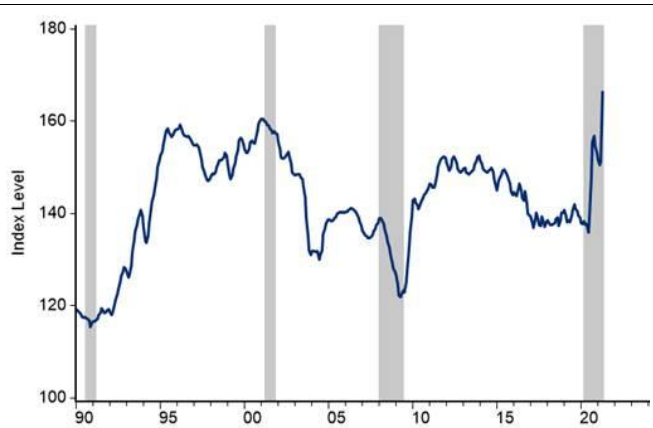
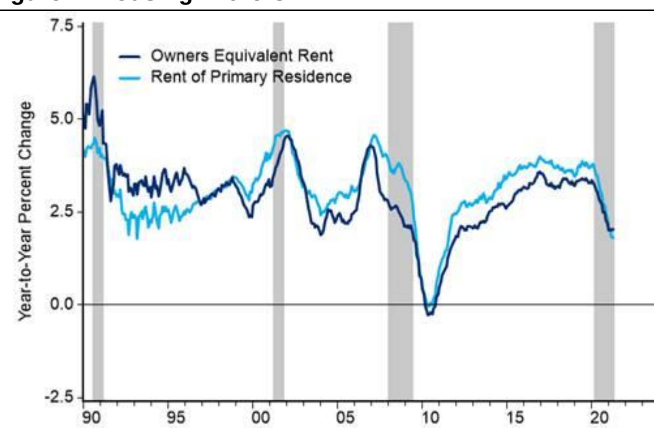


Figure 4: Housing in the CPI



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Looking forward we can see the energy impact moving out of the CPI figures, this is well illustrated in April, with the monthly change for energy prices at -0.1 percent, versus +25% year-to-year. At nearly 7% of the CPI that huge year-to-year gain accounted for 1.7 percentage points of the 4.2% headline annual gain. And yet we do not anticipate this happening again in the next year. Driving cannot recover from pandemic levels again. So while base effects will keep this high for the next few months, we can anticipate the inflation figure falling after the low base period falls out of the comparison window.

As the current base effects wane we do see another source of one-time inflation on the horizon, and that is from pandemic disrupted services. As consumers return to flying, hotels, amusement parks and restaurants there will be a period of shortage where businesses have either closed or drastically reduced capacity to cope with the pandemic. When exactly this starts will be decided by local restrictions as well as the speed an impact of the vaccine rollouts, but we definitely expect pockets of scarcity to arrive this summer, and likely not be fully resolved for at least a year.

We thus continue to see above trend inflation for some time, and simultaneously are not worried about inflation getting out of control (the country can't emerge from a generational global pandemic every year). We see the underlying trend of inflation as still relatively mild coupled with the Fed's commitment to a symmetric inflation goal and the enormous supply of untapped labor (much of it that will not return to the labor force until children are back in full time school).

As we discussed last week (Earnings and the End of Euphoria), we don't believe supply-side distortions and surging commodity prices will single-handedly generate lasting, self-reinforcing inflation.

We do not expect a sustained surge in inflation after the coming year's expected jump in prices. Price increases due to supply-side distortions and surging commodity prices will likely be transitory. We expect that the Fed will almost certainly stay true to its promise of lagging behind inflation while tightening less than in recent decades. Therefore, we expect a steeper yield curve that will most certainly benefit equities like financials, and favor certain fixed instruments, such as variable rate loans, over long-duration bonds.

We, therefore, find ourselves in general disagreement with both sides of the present "consensus" views regarding rates. Specifically, we believe that bond markets are underestimating the coming strength of the economic recovery and overestimating the intermediate rate of inflation. The net effect, in our view, is a potential yield of 2.0% for the 10-year US Treasury by year end, and 2.5% during the coming couple years of expansion.

Rates and Inflation at a Turning Point

Decades of falling inflation and declining real bond yields cannot be repeated (see figure 5). At the same time, as we noted on March 7 (Rates, Recovery and Resolve), history is full of short-lived rate spikes since the "Great Inflation" of the 1970s was shut down as a result of severe Fed tightening in the early 1980s. With that said, a secular *end to disinflation* seems likely.

US policy rates are zero and will most likely stay at zero for all of 2021. Yet, as we discussed in the March Quadrant From Rescue to Rescue, Fed Chair Powell and other officials have begun to downplay the significance of Fed forecasts for policy rates to stay at zero through all of 2023. They forecast a strong US economic recovery. They have not, however, forecast a path for short-term interest rates that is *consistent with that view.* In other words, the Fed is not likely to change policy until a strong, full recovery is well underway.

After such large policy steps in 2020, even a small adjustment to US monetary policy may shock financial markets. Fortunately enough, the bond market has wisely stopped taking the Fed's rate guidance literally. You can see this in figure 12 that the market has prices in a small first tightening step late in 2022, two years earlier than the Fed's infamous "dot plots". (Also, appropriately in our view, the bond market prices a lower rate than the Fed does looking several years out.)

Figure 5: US 10-Year Treasury Yield vs Annual CPI Inflation

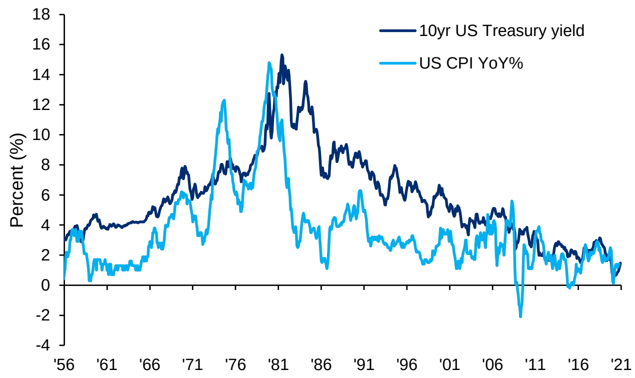
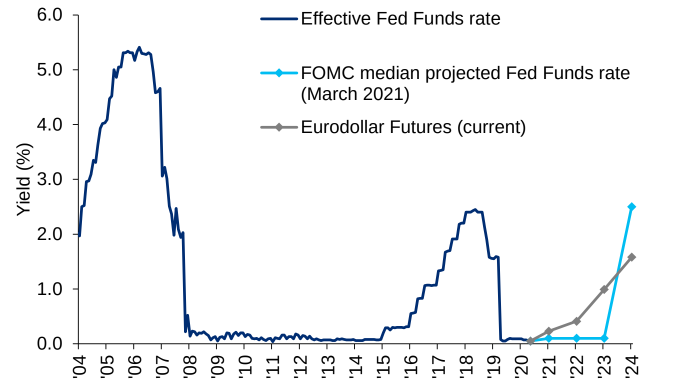
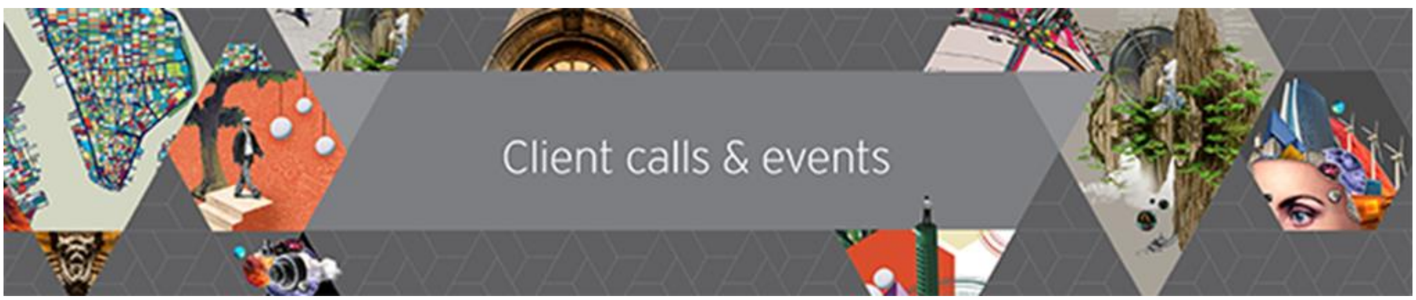


Figure 12: Market Expected Fed Funds Rate vs Actual



Source: Haver Analytics, FactSet, Federal Reserve as of May 6, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

A plausible scenario is that in a year's time, the Fed will be at the earliest stages of planning its exit from a zero interest-rate policy. This will begin first with reductions in the pace of US bond purchases made with newly minted money. If that happens, a sharp slowing in reserve creation will generate turbulence beyond US fixed income. This was last seen during the "taper tantrum" of 2013. The Fed would strongly prefer avoiding a repeat of that episode and possibly slowing the economy more than desired. However, because of the strong influence of the Fed on the appreciation of financial assets, we expect the markets will respond negatively to the change in policy direction, nonetheless.



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