Reading the Signals on Inflation

Do recent headlines on increasing prices of certain raw materials and consumer goods presage a coming acceleration in inflation? Here, we provide some needed context.

Featured Contributor

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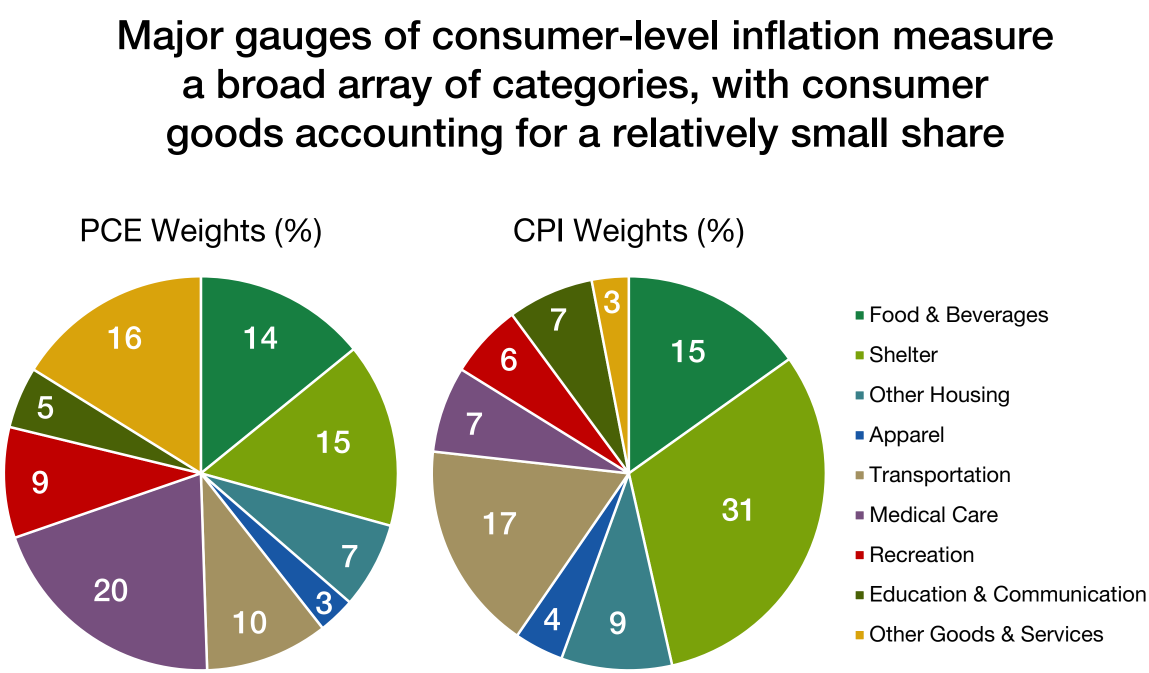
Figure 1. History Shows There's Much More to Inflation than Prices of Consumer Goods



Source: Haver Analytics, SG Cross Asset Research/Economics. Based on historical data from a research report issued in June 2014. PCE = U.S. Personal Consumption Expenditure Price Index. CPI = U.S. Consumer Price Index. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment

Reading the Signals

Economic activity is surging in the United States as vaccination rates rise and more areas of the economy reopen. With this positive news, however, comes concern of inflation. Enormous pent-up demand for goods and services, fueled by historic levels of stimulus, may not be met with sufficient supply, as many businesses are still recovering from the pandemic shock. While markets have anticipated some of these pressures—seen via rising inflation expectations and U.S. Treasury yields—explosive price movements in supply-impaired areas like lumber raise the question: Could the market be underappreciating the possibility of a sustained rise in inflation? At the same time, investors are mindful of larger structural trends, such as globalization and innovation, that have kept inflation low for decades despite prior bouts of inflation concerns.

While "this time is different" may be viewed as a hubristic cliché that tempts fate to say, "Hold my beer," the fact remains that today's circumstances are without historical parallels. Never have we experienced such a reversal in consumer demand, from depressed levels because of the pandemic, to a rapid resurgence as stimulus and vaccine effects are felt. Moreover, the U.S. Federal Reserve (Fed) has indicated a substantial shift in its approach to inflation. With limited history to guide us, investors are right to wonder what they can truly expect, and how worried they should be.

On March 20, Procter & Gamble, one of the largest producers of consumer staples in the world, joined a growing group of companies that are signaling price hikes for certain products. Shortages in key inputs, such as lumber and semiconductors, have contributed to rising home construction prices and fierce competition for used cars. Many employers report difficulty in hiring to meet demand.

Each of these instances is indicative of a classic supply/demand imbalance that typically leads to inflation. Put simply, until there is enough of what people want, the price rises until we reach an equilibrium—and that price-rise is inflation. When it costs us more to get something than it used to, the purchasing power of our hard-earned dollar has declined.

Only Temporary?

However, price increases in highly visible areas do not necessarily mean broad-based degradation of purchasing power, nor are those price increases necessarily persistent. For example, we may have a temporary shortage of chips, leading to a short-lived stall in vehicle production, but eventually those chips will get back to normal production, and supply will catch up to demand. So, this situation of surging prices and shortages, while alarming, is not necessarily indicative of a permanent inflationary problem. Moreover, consumer products are only one piece of the inflationary puzzle. Take a look at Figure 1 on first page which depicts the composition of two key inflation gauges: the consumer price index (CPI), which focuses on what households are buying and determines social security increases and TIPS valuations, and the personal consumption expenditure (PCE) index, which is based on a survey of what businesses are selling and is the preferred inflation metric for the Fed.

As the chart shows, housing, medical care, transportation, and even recreation play at least as much of a role in calculating inflation as consumer goods. Many current economic forecasts expect only a small impact to CPI or PCE from these expected increases. However, we can also see reasons for upward pricing-pressures in each of these other areas: housing prices and rents are rebounding sharply; vehicle prices and energy costs are rising, while a demographic shift out of urban areas may sustain these pressures; medical costs have been rising for years as Baby Boomers continue to age; and so on. Markets have clearly responded to this potential, and investors now expect inflation to run higher for the next few years than it has run for the past two decades. However, the uptick in inflation expected by markets is still relatively modest, and markets expect this trend to last only a few years.

on Inflation

Certainly, demand and supply balance out over time. We are likely to see more volatility in high-demand areas over the short term, but such imbalances are always transitory. Has something fundamentally changed to keep inflation higher? We would say the answer is "maybe." Markets can ultimately shrug off short-term phenomena, but persistent inflation has the potential to meaningfully affect asset prices, while potentially forcing the Fed to change course. The Fed's explicit shift in its approach to inflation, announced in October 2020, means that it will be slower to react to any increase in inflation, perhaps permitting price pressures to persist against a backdrop of massive fiscal spending that has the potential to fundamentally increase aggregate demand for goods and services. And finally, the pandemic has changed so many aspects of life that there may well be some unforeseen dynamics that alter the low-inflation regime we have been in for decades.

A Final Word

That said, history shows that it is difficult, if not impossible, to predict the trajectory of inflation with any degree of accuracy. What we do know is that companies and investors have been trained to believe inflation potential is limited. Markets and the economy have been set up to operate in a low-inflation world, so there are clear risks to the status quo if inflation does prove more persistent than current expectations. We also know that we are certain to see more supply/demand imbalances shooting prices higher in the coming months as demand comes surging back.

While it would be overly simplistic to extrapolate specific areas of price increases into a broader inflation trend, it would be foolhardy to ignore them, and the potential for that volatility to spill over into broader markets, or for seemingly temporary moves to become more permanent than many analysts anticipate. Investors should reasonably ask if they are being appropriately compensated for this inflation uncertainty, or how best to protect themselves. While there are no easy answers, we will explore inflation protection in the next *Market View*.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Lower-rated securities are subject to greater credit risk, default risk, and liquidity risk. Credit risk is the risk that debt issuers will become unable to make timely interest payments, and at worst, will fail to repay the principal amount. Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements. Statements concerning financial market trends are based on current market conditions, which will fluctuate.

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The **U.S. Consumer Price Index (CPI)** measures the price changes for each item in a predetermined basket of goods and services, and the inputs are weighted according to their importance to consumers.

The **U.S. Personal Consumption Expenditure price index (PCE)**, also referred to as the PCE deflator, is a United States-wide indicator of the average increase in prices for all domestic personal consumption. It is benchmarked to a base of 2009 = 100. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, the largest component of U.S. gross domestic product in the U.S. Bureau of Economic Analysis' National Income and Product Accounts report.

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