

# Economic Views Brief

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## *Inflation is set to rise – but how might markets react?*

Inflation is set to rise in the months ahead, but how steeply and for how long remains to be seen. Higher prices reduce the spending power of consumers and businesses and can carry adverse consequences for financial markets as well. However, it shouldn't be overlooked that inflation is expected to rise primarily due to an expected surge in economic activity. The faster pace of price increases is also thought most likely to be temporary – lasting a few to several quarters. Along the way, higher inflation numbers could cause some market volatility, but over-time, improved economic trends are the more important consideration, in our view.

Higher inflation is typically accompanied by higher interest rates. Bond investors naturally seek to have their fixed income returns at least cover inflation, and most often, both metrics are rising due to a strengthening economic picture. However, if inflation were to remain at problematic levels beyond the next few quarters, the Federal Reserve could step-in to cool economic conditions via tighter monetary policy (i.e., higher interest rates). Fed officials have stressed in recent months their belief that the pending inflation bulge is likely to be temporary and manageable, thus requiring no material alteration in policy as they focus on the economy's return to full employment.

**Our forecast:** We forecast inflation rates to shift markedly higher over the next several months based on a confluence of factors.

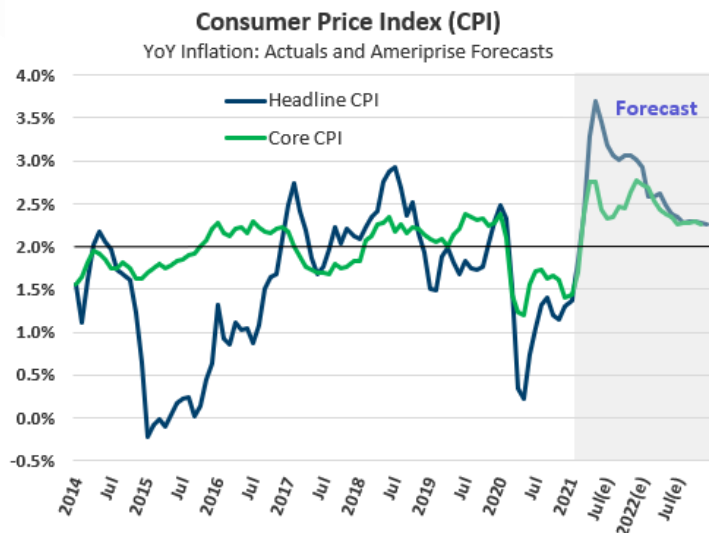
We currently expect the Consumer Price Index (CPI) to peak at +3.6% in May, when year-ago comparisons are at their lowest, and end the year at +3.0%. We believe the Core CPI rate (which excludes food and energy prices) should also accelerate to levels moderately below those of the headline Index. There could be ample room for rates to exceed our projections, however, which could provide some incremental anxiety for investors and central bankers through this period.

The chart at right is sourced from FactSet.



### Key Takeaways

- Inflation is widely expected to rise in coming months. The Consumer Price Index could approach 4.0% by May, in our view.
- Though widely expected, there is still a risk that prices could rise more strongly than anticipated or linger longer; developments financial markets may find disruptive.
- We believe there is very little risk of a “1970’s type” of experience but there could be enough to cause Fed officials to act – or at least enough that markets perceive a higher risk of Fed tightening.



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The clearest source of upward pressure on near-term inflation expectations is simple year-ago comparisons. Prices for many goods and services plunged last year as the economy shut-down. In coming months, consumer prices will be compared against those depressed year-ago levels, automatically lending a significant boost to y/y inflation measures.

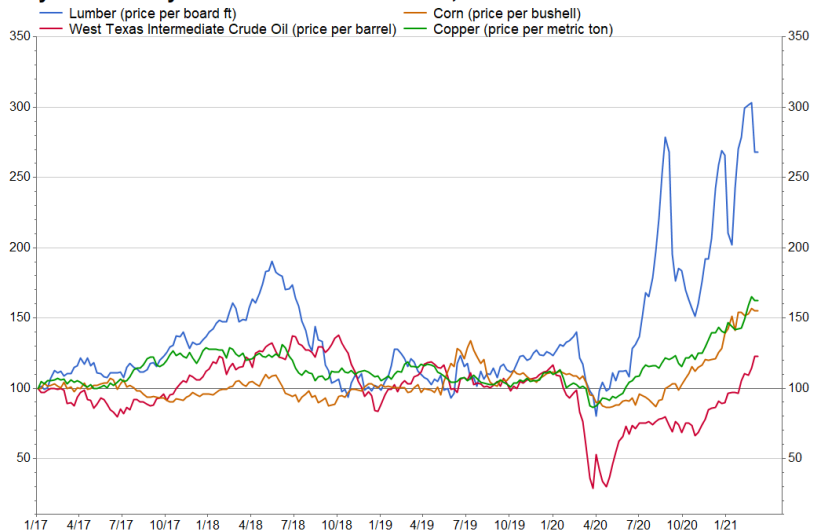
As an example, in February, the Index level of the CPI was 263.16, according to the Labor Department, representing a y/y increase of +1.7%. If the CPI were to remain unchanged at this level over the next few months (i.e., no change in aggregate consumer prices at all), the y/y rate would rise to +2.8% y/y by May simply due to the weaker year-ago comparisons. This influence should slowly subside over the second half of the year and beyond.

Aside from year-ago comparisons, the potential path of inflation is somewhat clouded by the fact that price increases are developing from a variety of sources and for a variety of reasons.

### **What else is contributing to inflation expectations?**

- A potential surge in demand that service providers appear ill-equipped to satisfy:** Restrictions on certain business activities are likely to be lifted in coming months as vaccination rates rise and virus conditions improve. Consumers in general appear to have high levels of pent-up demand for many of the socially centered activities they've been unable to enjoy over the last year. They also appear to have the financial resources to spend on these activities. However, many of the business that provide such services appear ill-prepared to handle a sudden surge in demand. For instance, the number of operating casual and fine dining restaurants has declined and those that survive have reduced staff substantially. Prices at restaurants, hotels, resorts, music venues, air travel, sporting events, and other previously restricted venues, could jump as consumers flush with cash show up at the door. It's very difficult to predict how this unprecedented situation will ultimately affect prices over the intermediate-term.
- Tight inventory levels:** Some goods also remain in tight supply. Supply chains lagged the rebound in goods demand during the second-half of 2020. For example, demand for new automobiles recovered faster than did industry production, leaving dealers with low inventory levels. The situation was recently made worse by a global shortage of semiconductors used by most manufacturers, which has led to production cuts. At a minimum, this situation is likely to result in less point-of-sale discounting until production catches-up, which could take many months.
- Higher commodity prices:** A broad range of commodities have experienced sharp price increases the last several months ([see chart at right as sourced from FactSet](#)). The price of lumber has more than doubled. Crude oil prices are now higher than their pre-pandemic levels and some industrial commodities have jumped due to the global economy's better than expected recovery. Meanwhile, agricultural products have seen higher prices due to adverse growing conditions and stronger export demand from China.
- Higher shipping costs (by sea and truck, primarily):** Shipping costs jumped in the second-half of 2020 as aggregate consumer demand returned much faster than expected. The cost of shipping goods via ocean cargo or truck jumped and prices have remained "sticky" at elevated levels since.
- Potentially higher labor costs:** In February, 36% of the jobs still missing since the pandemic set-in were based in the leisure and hospitality sector, according to the Labor Department. The sector includes such businesses as bars, restaurants, resorts, casinos, amusement parks, theaters, and hotels. As mentioned above, consumer demand for these services could recover very quickly over the next few months necessitating tremendous hiring needs which could put upward pressure on wages more broadly.

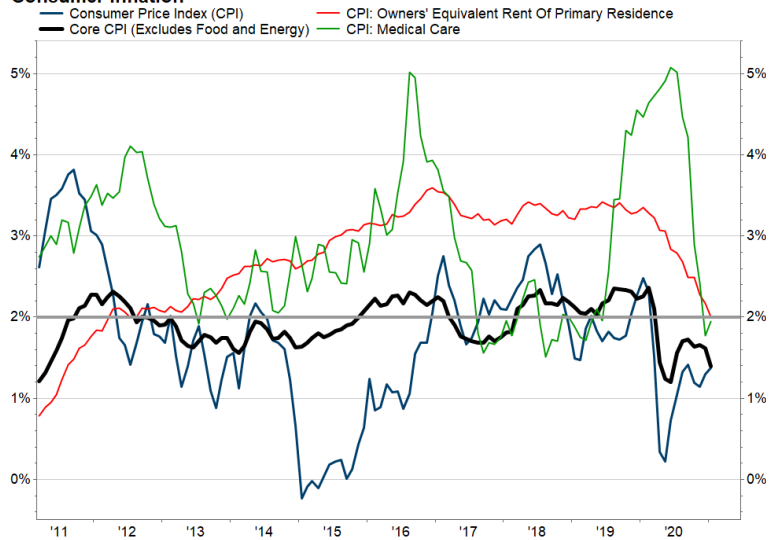
**Key Commodity Prices - Indexed to Jan. 2, 2017**



**Less downside pressure from housing costs.** From 2014 through 2019, shelter costs (*the red-line in the chart at right as sourced from FactSet*) grew at a consistently faster rate than overall CPI. The component also carries the largest weighting within the Index, representing about 24% of headline CPI and 30% of the core. Shelter costs are measured as a function of housing rental rates in urban areas, in what's referred to as Owners' Equivalent Rent (OER).

Over the last year, the OER component of CPI has slowed sharply. When the pandemic arrived, there was a notable outward migration from city centers as workers embraced the "work-from-anywhere" model. As people moved out of cities, rents declined. Although we believe there could be further downside for this component, rental rates appear to be stabilizing in many major cities at the time of this writing, thus its containment benefit on the overall Index could wane.

**Consumer Inflation**

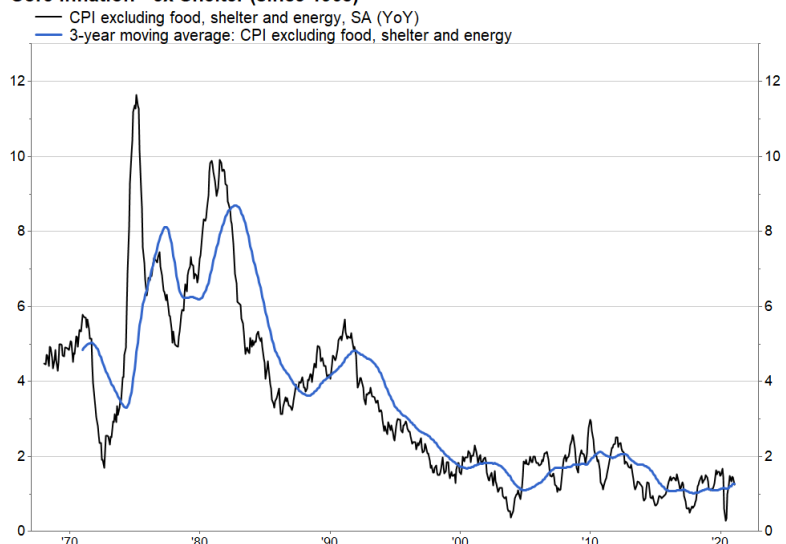


**Why are higher inflation rates expected to be temporary?** Inflation pressures in the U.S. and most other developed countries have been weak for many years. As seen in the chart at right (as sourced from FactSet), if volatile food and energy prices are removed, as well as the influence of shelter costs, prices for all other goods and services have expanded at a decelerating pace since the mid-1990's.

Economists largely attribute this to a combination of very long-term trends: demographics (slower population growth and aging societies), globalization, and advancements in technology.

Although we believe the benefit from globalization may be waning, these powerful trends should re-exert their dominant influence on broad price pressures over-time.

**Core Inflation - ex Shelter (since 1968)**



## SUMMARY AND INVESTMENT IMPLICATIONS

Inflation is widely expected to accelerate over the next several months. The faster pace of price increases is thought most likely to peak in the second quarter before slowly subsiding in the second-half of the year. Although we believe this is the most likely path, the fact that upward price pressures are emerging from various sources, as well as the unknown of how the economy ultimately reacts to a post-pandemic re-opening, provides a greater element of uncertainty, in our view. Additionally, our forecast for a CPI peak rate of +3.6% in May is currently higher than most forecasts we have seen. However, our estimates could yet be too low, and our expectation that rates slowly subside thereafter, too optimistic.

It's been a long time since financial markets have had to consider true inflation risk. Interest rates have already moved higher in anticipation of higher inflation rates, but further increases could weigh on equity market valuations, just as we believe falling interest rates contributed to rising valuation metrics in 2020. However, contained inflation impulses can also be a positive for stocks via stronger sales and earnings. Indeed, coming into the year, the Ameriprise Global Asset Allocation Committee forecast a moderation in U.S. equity market valuations, yet an offsetting increase in corporate profits, resulting in a net increase in the S&P 500 target. Please see our latest *Quarterly Capital Markets Digest* for more on the market outlook.

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