Is the inflation genie out of the bottle?

Unless you're over 40, inflation is, in many ways, a theoretical or historical construct. Markets have had periodic wobbles over inflationary concerns, driven mainly by the huge explosion in the money supply as a consequence of QE, but the collapse in the velocity of money helps explain why that particular inflationary-chicken didn't come home to roost. (Please see our September 2020 Market Commentary for an article on this subject.)

In recent months, we have seen an increase in inflationary concerns – even if the recent falls in US bond yields would appear to suggest those concerns have eased.

Which brings us onto the latest US inflation news.

US Core CPI (which strips out the impact of food and energy and is therefore a more underlying measure the US Fed will take more notice of) came in at 3.8%. To put that into context, just two months ago it was only 1.6%.

US Core inflation annual change 1996-2021

The previous month saw a big spike, with the annual rate moving up from 1.6% to 3.0%, blowing out of the water most economists' estimate of 2.3%. The kind of big miss, to say the least, that you do not see with a normally

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non-volatile measure like Core CPI. Given all the other indications in recent weeks – such as Chinese Factory Gate Inflation at 9% and the surveys of intention to raise prices from the US NFIB Small Business federation - you would have thought that they would have learnt their lesson from that!

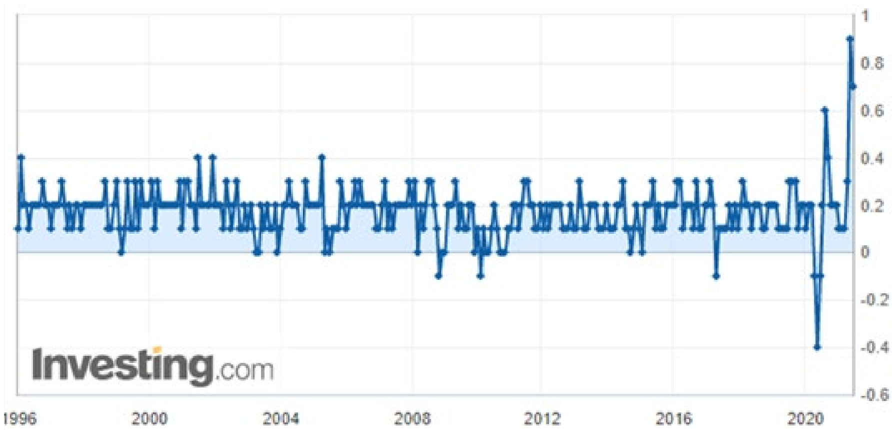
The estimate for May was for an increase from 3.0% to 3.4%; we got 3.8%

The month-on-month April 2021 increase was +0.92% over the previous month, and +3.0% over the previous year. So perhaps it was not unexpected that the estimate was off. To get the expected annual increase of +3.4% meant that the monthly change needed to go from +0.92% to +0.34%, a level of slowdown which did not feel right. And it turned out that it wasn't. What we got was another month where prices rose significantly over the previous month, in this case - +0.74%. Not as bad as April, but still an ugly number. These kinds of month-on-month increases haven't been seen since the early 1980s.

This chart below – the month-on-month change - isn't the prettiest of visuals, but it helps illustrate what's going on. Cast your eyes to 2020 – when prices fell in May, then bounced the following month – which is why the annual change is getting close to 4%. BUT now we're seen two months on the trot of historically very high levels of inflation, and these month-on-month numbers are not influenced by the weak comparisons of a year ago.

Every country calculates inflation in a different way, with the US updating their basket weights every two years (unlike the UK where it is done annually). This implies the US measure is still running on a pre-COVID view of spending patterns, with its higher allocation to transport costs, which saw a big spike in inflation. Those that seek to minimize the scale of the inflationary surge point to these factors. But the economists knew that and, in theory, should have allowed for it. The bottom line is that for two months in a row the month-on-month number has blasted through expectations.

US Core CPI month-on month change 1996-2021



Why does this matter?

You could argue that it doesn't, given how US bond yields have reacted to two months' worth of worse than expected inflation data.

To start, the annual rate of Core CPI is the highest for over 25 years, and the last time it was this high, US 10-year bond yields were 7% compared to 1.5% today.

That being said, the link between US bond yields and nominal GDP broke down after the 2008 financial crisis, and bond yields today are utterly disconnected from Nominal GDP for a variety of reasons, including, but not only, the impact of QE.

It would appear the bond market is agreeing with the Fed, and that this spike in inflation is temporary and transitory – a reflection of the very low base numbers from last year, as well as a short-term supply-chain disruption. Both appear to be taking a view that this will not feed into wage inflation, nor will it change the psychology of inflation expectations – that it won't develop into a "wagey-pricey" loop. In fact, the Fed seems to have gone further, implying that they will ride through this period – until full employment has been reached – before they expect to amend policy. Meanwhile this 'transitory' Core CPI is well ahead of their 2% target. Unfortunately, by the time they find out whether they are correct, it may be too late.

Rather than taking the punchbowl away once the party gets going, they run the risk of waiting until the party is getting out of control and all the uninvited guests have turned up.

Even though the wage data is still very murky, a very tight US labour market faces the prospect that wages must rise by 5% just to keep up with headline inflation. Clear data on wages is still months away, but sometimes anecdotal evidence can paint a clear picture. Sarah Baxter's article in the Sunday Times (6/6/21) helps to highlight the unintended consequences of Joe Biden's largesse.

The Markets appear to be prepared to live with 3% US core inflation, and it seems, initially anyway, core inflation of 4% - with market participants accepting of the view that this move up in inflation is temporary and will not develop into something more permanent.

This relaxed view from the market and the Fed provides downside risk for bonds. If these month-on-month (which are more illustrative than the annualised version) prices rises continue, and wage data starts to follow suit, bond markets may then not be so forgiving. We have constructed the Core element of the models to be conscious of the need to be well placed to cope if, and when, bond markets start to react to rising concerns over inflation.

Even with the inflation genie out of the bottle, equity markets should still be supported if we get rising Nominal GDP trends (more growth, more inflation), providing the latter doesn't get too elevated, and/or the authorities take too long to recognize inflationary forces are not as transitory as they had previously assumed.