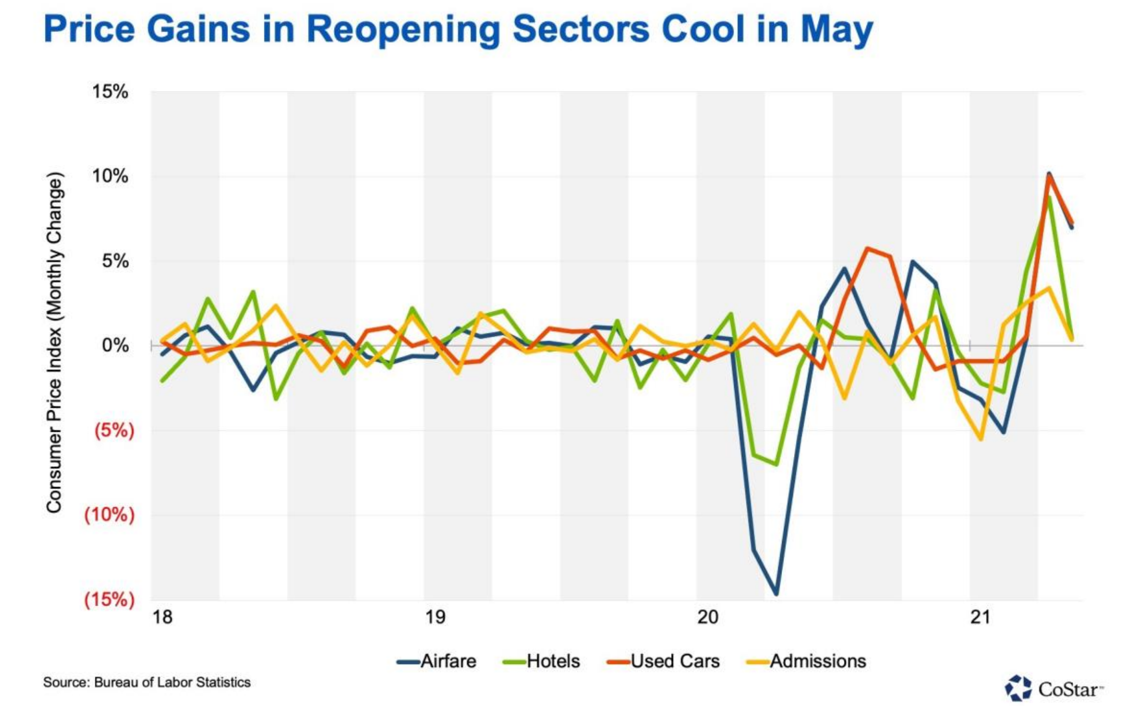
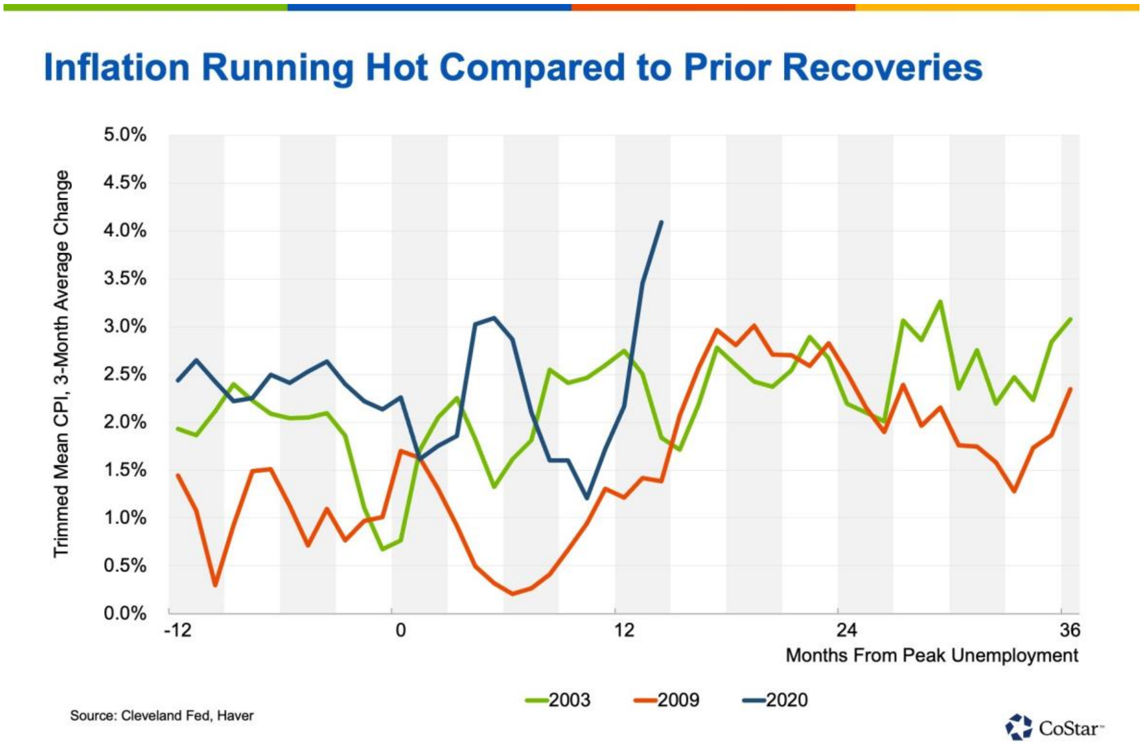
The Fed Predicted Rising Prices. It's Getting Them.

Consumer price inflation has been in the news recently, and for good reason. Headline inflation in May was up 0.6% over April, higher than expectations and boosting the year-over-year rate to 5%, the fastest rate since 2008. About half of that increase was due to the comparison to last May when prices were broadly falling as the coronavirus begin to spread in the U.S.

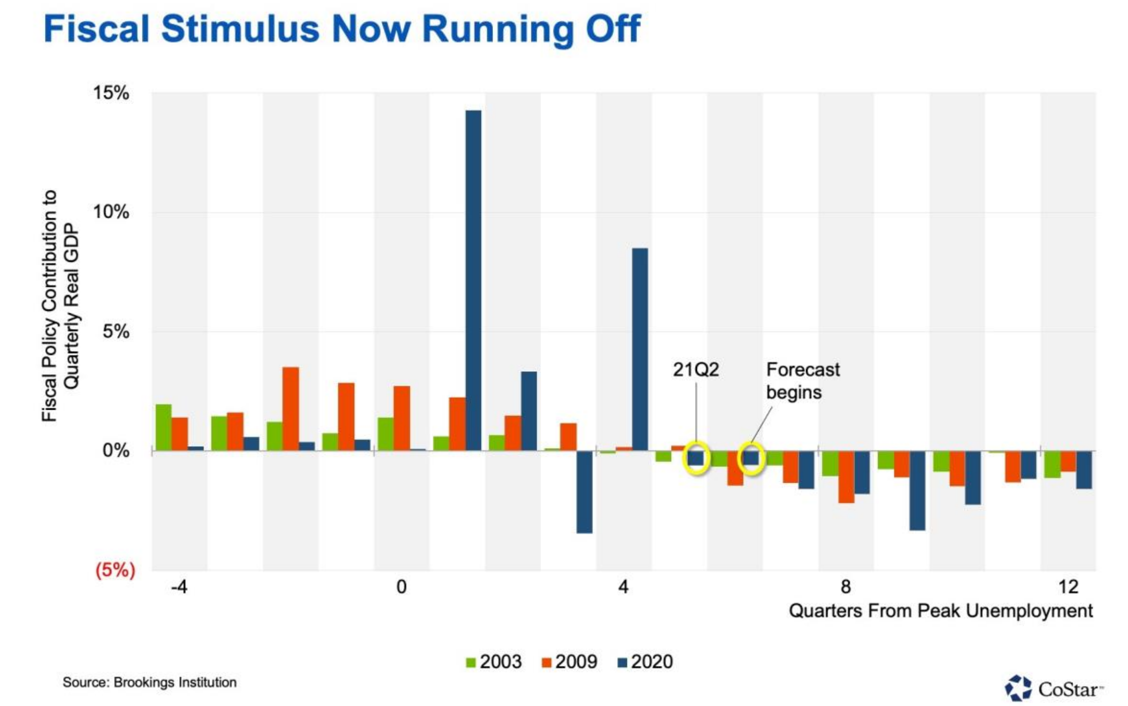
April's strong increase included unprecedented gains in prices among reopening-related sectors, many of which began to cool in May. While prices of used cars and airfares are still rising disproportionately to the overall index, they account for a very small share of the basket of goods included in consumer price inflation.



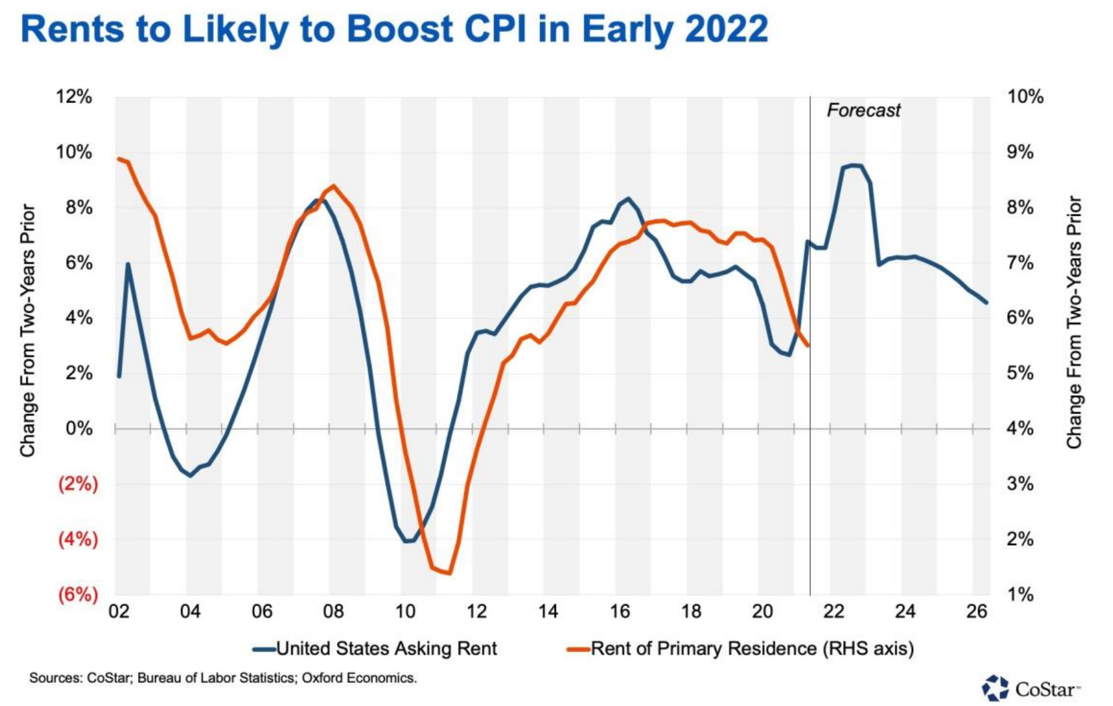
Nevertheless, a deeper look into the components of consumer price inflation beyond these few sectors reveals a move higher in general. The Cleveland Fed provides modified versions of core inflation, including a trimmed-mean consumer price inflation that excludes the most volatile components, including those mentioned above. This index shows core inflation in recent months outpacing the rate at the same point in the prior two recoveries, averaging an annualized 4% increase over the past three months compared to about half of that at the same point in 2004 and 2010.



It is helpful to remember, though, that the recovery this time around has been boosted by unprecedented fiscal stimulus. With more cash in hand, consumer spending during the downturn has outperformed the same point in prior recoveries by a significant margin. However, as we look forward, fiscal policy may already be transitioning from a tailwind into a headwind, especially as half of all states have opted to shut down extra unemployment benefits early. There remains some uncertainty over the trajectory of stimulus in coming years, as the Biden administration is in talks with Congress around an infrastructure package.



But inflation is likely to soon get a boost from its largest component. The Bureau of Labor Statistics’ rent series accounts for almost 40% of core inflation, and this has been on a downward trend since early 2020. However, CoStar’s rents series, which leads the bureau's series by about nine months, hints at a coming upturn in inflation, with rents rising through late 2022.



Note: This graph includes two-year percentage changes, rather than year-over-year change, to avoid base effect distortions from the pandemic.

Inflation above 2% appears likely to be the norm through 2022. Whether it will continue to rise depends on whether expectations for future inflation become unanchored from the Federal Reserve’s target or whether the Fed itself will consider that more restrictive monetary policy is needed.

On the inflation expectations front, several surveys provide some insight:

- May data from the University of Michigan showed that consumers expect the five-year inflation rate to be 3%, above the most recent 10-year average of 2.6%.
- May data from the Federal Reserve showed that the bond market expected the five-year inflation to be 1.77%, below the 10-year average of 1.86%.

- April data from the New York Fed showed that the median three-year-ahead inflation expectation sits at 3.1%, only slightly above the average since 2013 of 2.9%.

All three have risen by different degrees in 2021 but remain within post-2010 ranges, a time when inflation was shown to consistently miss the Fed's target.

The Fed has been quite clear that higher inflation is exactly what is expected. There is always a risk that as the recovery continues at a rapid rate, inflation becomes unmanageable. However, the pickup in inflation recently may simply be a sign of short-term imbalances in supply and demand as economic conditions return to full health.

The Week Ahead …

The coming week should provide more clarity around how members of the Federal Reserve think about the recent stronger-than-expected inflation, with the committee releasing its policy statement on Wednesday. The committee has maintained a firm "wait and see" approach regarding changes to policy in response to improved data. With considerable exigent labor slack, especially when taking into account broader measures of utilization, the committee is likely to remain patient with policy unchanged.

The highlight of the week from an economic data perspective should be retail sales for May released on Tuesday. Sales have swung wildly around stimulus payments, roughly unchanged in April after a staggering 11% gain in March. As vaccinations take hold, in-person retail is likely to benefit at the expense of online shopping.

Elsewhere this week, early measures of manufacturing for the month of June will be released by local Federal Reserve districts. The New York Fed plans to release its manufacturing index on Tuesday, while the Philadelphia Fed releases its similar index on Thursday. Of particular concern are the delivery time measures within the indexes, hopefully subsided as global supply chain disruptions ease.

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