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Fed Still Unimpressed with the Rise in Inflation

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Inflation is making a comeback. The Consumer Price Index rose 4.2% in April 2021 versus April of last year, the highest level since 2008, giving the stock market an excuse to pause its 12% rally thus far this year (S&P 500).

Increased economic activity, combined with supply chain issues, has been exaggerated by year-over-year comparisons to the lockdown lows of April 2020. Much of this should have been widely expected, but it seemed to surprise the markets, as equities were volatile on the day of the CPI announcement. For most of the year, the bond market has been pricing in higher inflation, as the 10-year Treasury yield (red line in Chart 1) has risen from 0.91% to 1.65%, but is still well below the 10-year Breakeven Inflation Rate – what the market is expecting for average inflation over the next ten years (blue line Chart 1) – suggesting higher rates to come. Bonds, in general, are having a tough time, as the Bloomberg Barclays Aggregate Bond index is down 2.7% year-to-date, since historically low yields cannot cover the price changes from rising rates.



Chart 1: 10-Year Breakeven Inflation Rate vs. 10-Year Treasury Constant Maturity Rate

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Source: FRED, Federal Reserve Board of Governors, US

For its part, the Fed is still unimpressed and insists that it is not time to even consider discussing tighter monetary policy. Chair Powell and most Governors on the speaking circuit maintain that the current rise in inflation pressure is "transitory", a word you will hear plenty of in the financial media, meaning that these higher prices are due to temporary phenomena and not indicative of meaningful inflation. There could be plenty of truth to that. Floods and brutal weather in Texas greatly impacted multiple industries, such as upholstery for furniture (foam is a petroleum product), as parts of the energy and chemical supply chain were temporarily shut down. COVID-19 related disruptions on production and global shipping are wreaking havoc on supply chains, and nearly every industry is impacted in some way.

For example, when is the last time you looked at a car dealership lot and it seemed empty? There is a dearth of new cars because of the semiconductor shortage (there are a lot of computer chips in cars, and chips are in short supply due to demand for PCs/laptops spiking in 2020, followed by droughts in Taiwan), which is causing rental car prices to soar and leaving used car prices up 15% as a result. Combine this with a 9% surge in airfare prices as travel spending spikes before airlines can react, and you have a serious impact on the inflation number from the transportation sector. FHN Financial estimates that if transportation had risen the same 0.7% that it did in March, rather than the actual increase of 3.97%, then the core CPI increase would have been 0.30% and not 0.92%. The inflation number is certainly concerning, but it is reasonable to see how some of the supply issues leading to higher prices are potentially temporary. However, many of these disruptions will dissipate as economies around the globe open up, post vaccine. In fact, rising prices are one of the most effective ways markets can correct supply and demand imbalances.

Yet, while many of the supply issues may indeed be transitory, the demand side of the equation is just getting started. For example, the housing market is red hot with demand surging from stimulus and low mortgage rates. Even a casual observer can see how distorted prices are right now, with construction costs absolutely through the roof. Lumber is up nearly 300% year-to-date and at multiples of what were normal ranges (see Chart 2 courtesy of NASDAQ). Copper prices are among economists' favorite indicators of building costs since it is used widely in construction, and it has nearly doubled pre-COVID levels and is going parabolically higher (Chart 3).



Chart 2: Price of Lumber (USD/1,000 board feet)
Source: NASDAQ



Chart 3: Price of Copper (USD per ton)

Source: Bloomberg

So, while the Fed is right about the temporary nature of some supply issues, the demand side of the equation should see a strong tailwind thanks to the combination of fiscal stimulus and a surge in post vaccine spending, especially now that the CDC has removed mask restrictions for vaccinated citizens. The economy could post 8% growth this year with all the stimulus. Nobody believes the Fed's reiteration that it will be years before rates have to move higher and borrowing costs can rise.

One important difference between bouts of inflation throughout history compared to now is that the Fed believes that they can control inflation if forced to, because they were successful in doing so during the early 1980's under Chairman Volker's leadership. The Fed feels that they do not need to start moving preemptively to take the economy down from a boil. We, too, believe that the Fed has the power to control inflation, and therefore we are not expecting a replay of the 1970's era inflation and borrowing costs in the double digits. We agree that while the Fed can manage the situation, it will be an uncomfortable process for the financial markets, and that is what we are focused on. While the Fed will not take any chances with this recovery, they could be forced to move sooner, faster, and to a larger extent in reducing accommodation, and this is where the risk to the markets lies.

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