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Stonebridge Market Update: A Comment on Inflation

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Opening Remarks

Recently the media and market pundits have offered their concerns and perspective on "inflation." At Stonebridge we take economic scenarios seriously and inflation is no exception. We thought you would find Dr. Daniel Laufenberg's perspective on inflation of interest in part because he was on the economics research staff of the Board of Governors of the Federal Reserve System during the 1970's when consumer price inflation was spiralling upward, as well as during the early 1980's when the Fed successfully decelerated consumer price advances.

A Comment on Inflation

Inflation can be very confusing in large part because a higher price alone is not inflation unless the increase is sustained and the price advances are widespread. Recall that the textbook definition of inflation is sustained increases in the general price level, with the emphasis on sustained and general prices.

If the price of a good or service increases dramatically, it most likely is because demand is outpacing supply. The higher price reflects this imbalance. The question is just how long will this imbalance persist, which is another way of asking if the price increases can be sustained. If the imbalance is not corrected with a price increase, resulting in less demand or more supply, then an even higher price is a reasonable expectation. On the other hand, if strong demand or supply constraints are considered temporary (currently referred to as transitory) due to special circumstances like a pandemic, then it is less likely for suppliers to add capacity. The key here is sustainability. In other words, inflation is the process of prices moving higher, not high prices alone.

Of course, a dramatic increase in the price of a good or service does not automatically lead to a dramatic increase in the general price level. For example, in the first quarter of this year, the overall consumer price index (CPI) increased at a 3.7% annual rate, well above the Fed's target of 2%. However, if energy prices are excluded from the CPI, the index rose a scant 1.3% at an annual rate, which is below the Fed's target. The point is that it was energy prices, in particular gasoline prices, that drove the overall CPI higher last quarter. For now, this is a relative price change. If it persists and spills over into other prices in the form of delivery and transportation costs, then it could become inflationary.

That said, commodity prices have been climbing over the last year, raising a red flag on inflation for some. We have been through these episodes in the past and the outcome for inflation has been mixed. If commodity prices continue to climb and they cannot be offset by efficiencies elsewhere, then it could lead to higher prices. After all, it is not considered inflationary unless the higher costs are passed through to the prices paid by consumers.

Construction costs at the moment are a hot topic because material costs have skyrocketed. What is interesting here is that those costs do not show up in consumer prices until housing rents increase (shelter costs in the CPI and the PCE price index). In that regard, shelter, which represents 33% of the overall CPI and 42% of the core CPI, increased a mere 1.7% over the year ended in March, while the wholesale price of lumber climbed 65.3% over the same period. If lumber (building materials) prices continue to rise, they will eventually find their way into shelter costs in the form of higher rents, both primary rent and homeowners' equivalent rent. This is especially true with mortgage interest rates already at very low levels for an extended period, limiting the potential savings to homeowners from refinancing their mortgages.

Inflation expectations, which were mentioned earlier, play a major role in the outlook for interest rates. Clearly if investors expect inflation to be 3% over the next 10 years, bond yields would be far different than if the expectation was for inflation to average 1%. Also, if inflation is expected to remain high (prices broadly continue to increase at a rapid pace), then wage and salary increases may start to reflect this expectation, which in turn adds to operating costs and warrants further price increases in the absence of productivity gains (so-called cost push inflation). I suspect we are still a long way from cost-push.

At the recent Berkshire Hathaway shareholders' meeting, Warren Buffet noted that prices are going up, up, up. Most of the prices he referred to are commodity prices or input costs and not necessarily prices on finished products, such as consumer goods and services, at least not yet. I suspect that consumer price inflation will average something in the 2-2.5% range this year and next. Whether it will be enough to push the Fed to act will depend on whether inflation expectations start to edge higher. In its recent policy statements, the Federal Open Market Committee has noted that "longer term inflation expectations remain well anchored at 2 percent," suggesting that they are unconcerned about inflation derailing consumer spending and in turn the economic recovery anytime soon.

Nevertheless, with all the federal government stimulus payments so far this year, as well as plans for more debt financed spending ahead, and the Federal Reserve maintaining its extremely accommodative monetary policy, there is little doubt that the risk to the inflation outlook is skewed to the upside. At the moment, I am not yet ready to revise my inflation forecast higher owing to anticipated supply gains in response to higher prices, as well as some slowdown in demand growth.