Balance Sheet Insights
PIPER SANDLER FINANCIAL STRATEGIES
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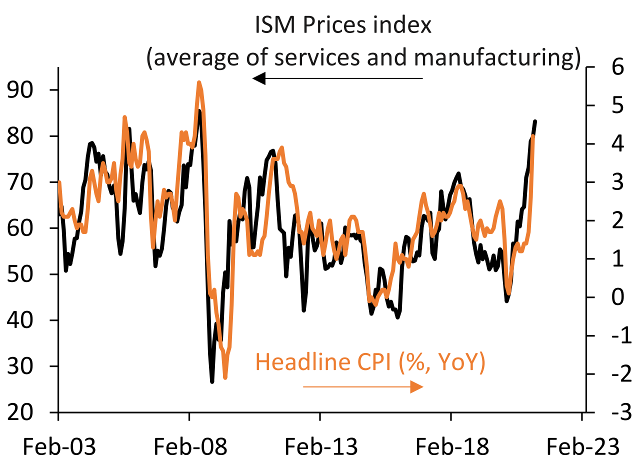
Don’t Buy the Inflation Hype

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

Unprecedented fiscal stimulus, base effects and supply chain disruptions will boost inflation. However, these factors should have a transitory impact on prices. Inflation expectations remain well anchored, with 30-year breakevens rising barely above 2.45% despite massive fiscal and monetary policy. The record drop in money velocity lends support to the view that the credit process is impaired and surging M2 money supply will have a limited impact on long lasting inflation. Tighter US labor markets will not lead to higher inflation as globalization has weakened the relation between wage growth and inflation. Furthermore “measured” inflation should remain subdued as the price metrics used by the BLS are designed/biased to keep inflation measurements lower.

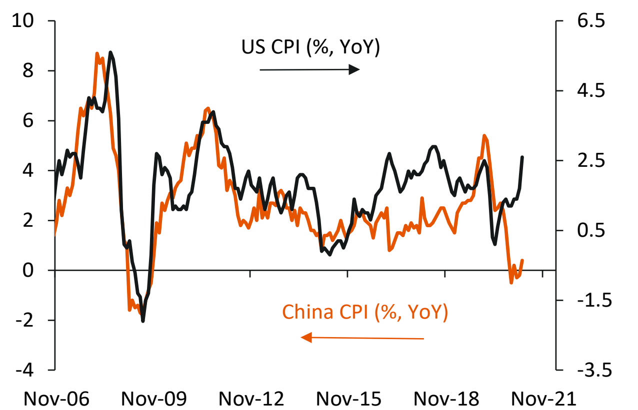
In April, headline CPI increased by 4.2% YoY hitting its highest level since September 2008. The surge in CPI coincided with the recent jump in other inflation indicators, such as the ISM manufacturing and non-manufacturing price indices (Figure 1). While the unprecedented fiscal stimulus is giving a boost to annualized consumer prices, base effects and supply chain disruptions are also leading to higher inflation prints. However, all these factors should have a transitory impact on longer term inflation.

Figure 1: Headline inflation surged above 4% YoY



Source: BLS, ISM, Piper Sandler

Figure 2: China’s core inflation is notably below that in the US



Source: BLS, Bloomberg, Piper Sandler

Base Effects and Supply Chain Disruptions

Last year as the economy shutdown due to COVID, prices dropped in March, April and May (with crude oil prices closing at a negative - $37.63 per barrel on 4/20/2020) before starting to rise again in June. Due to the sharp decline in prices last year, we expect year-over-year inflation growth rates to be temporarily distorted by these sorts of base effects. But price increases should moderate as the worst months drop out of the calculations.

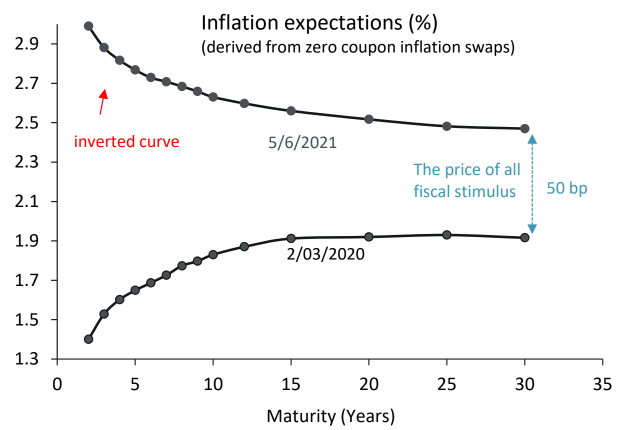
Furthermore, the disruption of domestic and international supply chains due to the pandemic, is increasing the cost of goods. For example, transportation costs increased as cargo logistics became more challenging and as a result businesses passed on the added costs from these disruptions into higher consumer prices. But again we expect these to be temporary increases, as the domestic and global supply chains gradually unclog and the economy recovers throughout 2021 and beyond.

The disruption of global supply chains has allowed US producers to gain market share as well as increase their pricing power. However, with the global economy coming back online and supply chains recovering, US producers will try to maintain their market share by lowering prices. Market forces should pressure US prices lower given that China's core inflation rate is substantially below that in the US, and China's economy plays a dominant role in the world's supply chains (Figure 2).

Fiscal and Monetary Risks

It is likely that pent-up demand fueled by savings accumulated during the pandemic, as well as relief payments from several rounds of fiscal stimulus may cause a surge in prices. However, long term inflation expectations remain well anchored as most of the COVID relief outlays are a onetime payment aid and not a perpetual increase in spending. Indeed, 30yr inflation expectations averaged 1.96% prior to the pandemic outbreak and over the past 12 months have risen by only 50bp to 2.46% (Figure 3), despite more than $5 trillion in fiscal spending since last year. Also, the inflation expectations curve is inverted, suggesting that the market anticipates a near term surge in inflation, that will decline in the future.

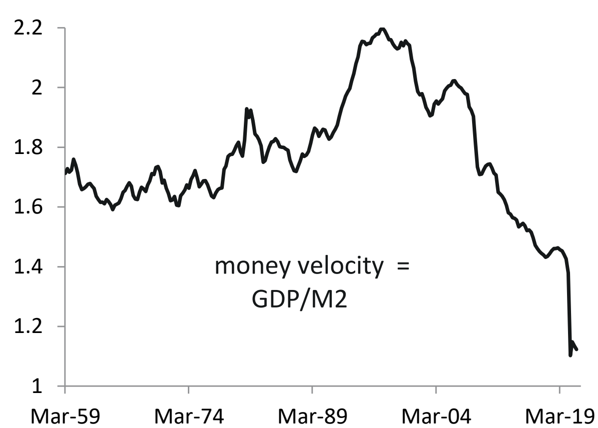
Figure 3: Long term inflation expectations remain well anchored



Source: Bloomberg, Piper Sandler

The greatest upside risk to inflation stems from the vast monetary policy that has been rolled out. But while the sharp rise in money supply has driven up bank reserves, it has not made a meaningful impact on the real economy. High inflation will materialize only if the money supply creates a sustained acceleration in economic activity that leads to rapid credit growth. The credit creation process seems impaired as the pace of US bank lending has declined and remains in negative territory. The record drop in money velocity lends support to the view that surging M2 money supply will have a limited impact on long lasting inflation (Figure 4).

Figure 4: Money velocity has dropped near record low levels



Source: Federal Reserve, Piper Sandler

False fears of wage-led inflation

Inflation could become a problem through a persistent and permanent increase in wages. However, the spike in average wage growth that the US labor market experienced last year, was a distortionary effect of the pandemic as more lower-income workers lost their jobs relative to high-income earners. With the economy opening more broadly and more lower-income jobs added to the labor market, the average wage growth has declined notably and should remain low.

More importantly, the common view that tighter labor markets lead to higher wages which in turn lead to higher inflation, held true prior to the early 1990s, but not anymore. Between 1974 and 1994 the correlation between wage growth and inflation was an astounding 92%, but since then it has dropped to 8% (Figure 5). Over the past 20 year, globalization has allowed US corporations to source cheap labor from around the world, thus restraining wage growth. More importantly, US business pricing power has weakened as global free trade has allowed foreign companies with lower costs to compete for US customers.

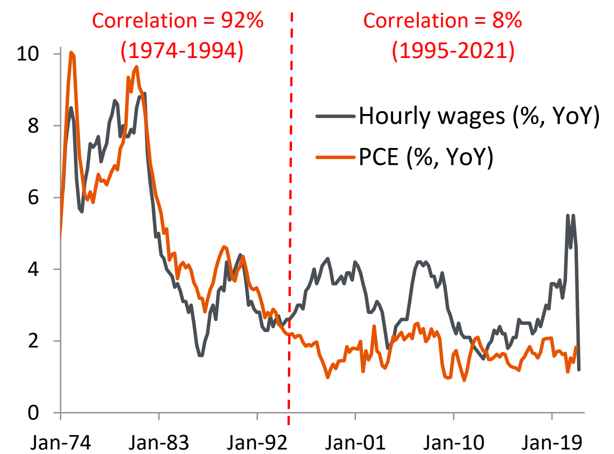
Measured inflation to stay low by design

Over the past 20 years, the Federal Reserve has generated plenty of inflation, but the benchmarks used do not adequately capture this price growth. For example, the surge in housing prices is not reflected in the CPI calculation although most Americans spending behavior is impacted by home prices. Indeed, when the value of a house increases homeowners increase their consumption because they feel wealthier. However, since the purchase of a home is not considered consumption but investment, home purchases are not a component of the index. Instead, the BLS uses owners' equivalent rent (OER) to measure housing inflation, which has not kept up with housing prices. While OER has increased by 29% since 2012, the Case Shiller Home price index has surged by nearly 80% during the same period (Figure 6).

Shelter has an enormous weight in inflation indices, with OER representing about 30% of core CPI. As a result CPI significantly underestimates the true level of inflation. By substituting OER with the Case Shiller index we find that core CPI inflation in March was 5.6%, not the 1.6% the BLS reports (Figure 7). If part of the fiscal and monetary stimulus is going into housing and other sectors of the economy that are not considered consumption, core CPI will remain relatively benign. Therefore, the price metrics designed and used by the BLS will display lower inflation prints.

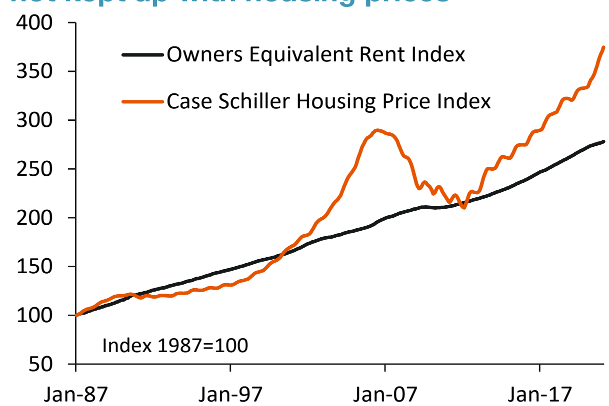
More importantly, CPI and other similar metrics (i.e. PCE) will be sending the wrong signal to the Fed, regarding when to tighten monetary policy. Indeed, in early 2003-04 the Fed

Figure 5: Over the last 25 years inflation and wage growth have decoupled



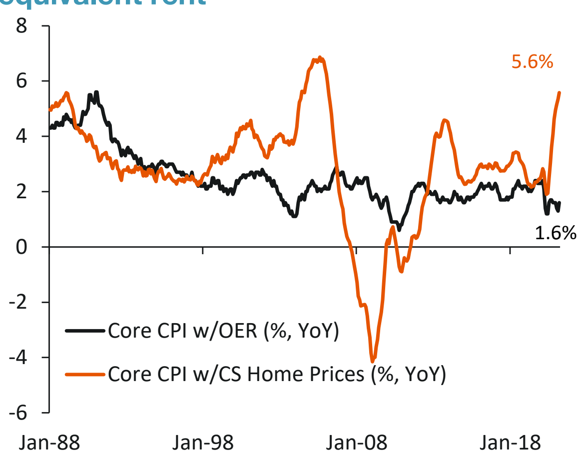
Source: BLS, Piper Sandler

Figure 6: Owners' equivalent rent (OER) has not kept up with housing prices



Source: BLS, Federal Reserve, Piper Sandler

Figure 7: Core inflation is significantly higher when using home prices instead of owners' equivalent rent



Source: BLS, Federal Reserve, Piper Sandler lowered Fed funds to 1% as core CPI based on OER was averaging 1.3%, while core CPI based on the Case Shiller index was rising above 4%.

If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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