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*ON OUR MINDS*

# Inflation: Menace or Mirage?

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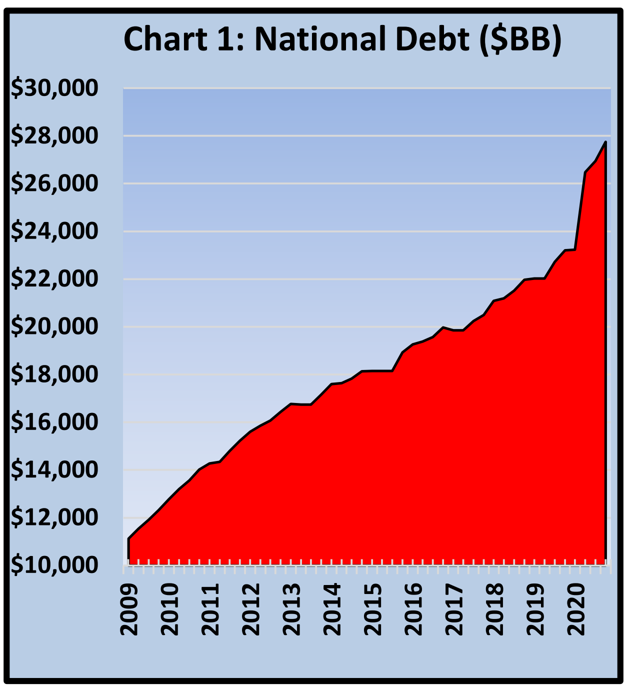
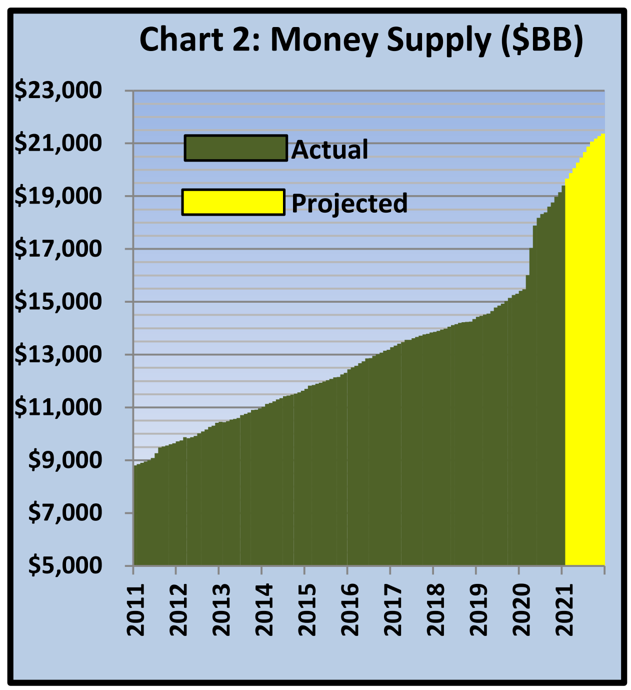
***April 1, 2021***

The prospect of high inflation terrifies investors. Spiraling prices can erode the purchasing power of today's paycheck and tomorrow's nest egg. But is inflation around the corner or still off in the distant future? This question has been at the top of Wall Street's worry list consistently since last spring when the Federal Reserve and Congress implemented a host of measures designed to protect the American economy from the ravages of Covid-19 shutdowns. The measures largely worked: Markets and the banking system continued to function normally throughout the pandemic, GDP rebounded sharply last summer, and jobs eventually began to return.

But last year's CARES Act, the Fed's alphabet soup of new lending facilities, and other government support have come at a cost. In part, the cost is measured as the huge increase in the federal debt, as shown in Chart 1. But it's also measured in the vast increase in the money supply, which after decades of 2% annual growth suddenly spurted 25% in 2020 (Chart 2).



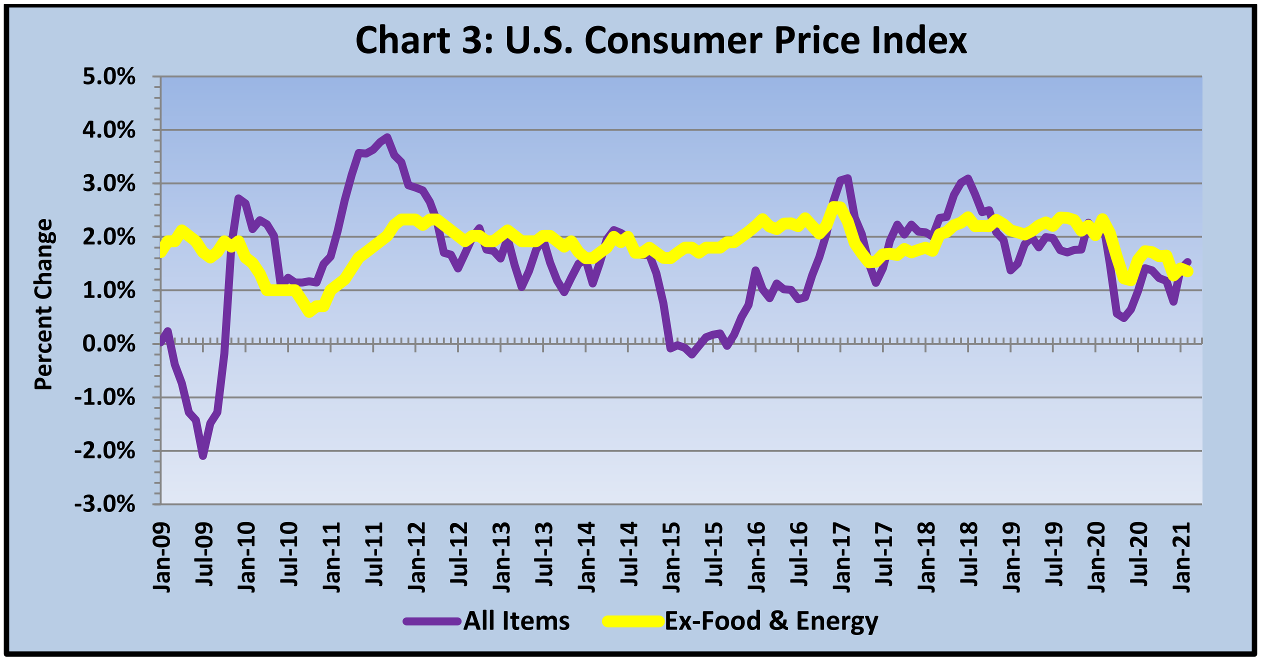

Source: Treasury Department




Source: Federal Reserve

The recent enactment of the $1.9 trillion American Rescue Plan will expand the deficit much further; it may also over-caffeinate consumer demand, perhaps leading to shortages. If the Biden administration and Congress also enact an even larger infrastructure bill, the economy may suddenly leap into hyperdrive for a while.

All of this suggests that inflation may finally be emerging after many years of dormancy,[1] but the data still show otherwise. Chart 3 shows the Consumer Price Index since 2009; both the "headline" all-inclusive and the less volatile "core" (excluding volatile items like food and energy) indices remain well below the Fed's long-term 2% target. Other indices mostly show a similar absence of any inflationary heat; the exception is producer prices of raw materials, where supply chain disruptions have caused price hikes in lumber, some industrial metals, and even oil.




Source: Bureau of Labor Statistics

The divergence between Wall Street's worries and the current reality is not new. As far back as 1944, Louis Jordan and the Timpany Five wondered,

*Is you is, or is you ain't inflation?*
*The way you're acting lately makes me frown*
*You'se is still my worry baby,*
*Seems the flame in your heart's done gone out*
*Inflation is a creature that has always been strange*
*Just when you're sure of it*
*You'll find it's gone.*[2]

[1] If the metaphor of inflation as a lurking menace seems familiar, perhaps that's because I addressed this topic using the same theme in "Grendel in Hiding", an *On Our Minds* commentary published May 19, 2020 in which I argued that higher inflation was the least of the economy's concerns at the time – and, in retrospect, so it was.

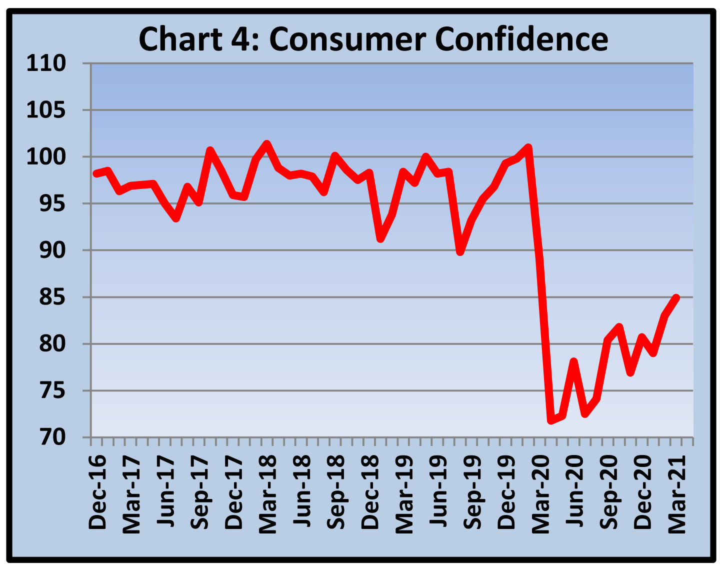
[2] This song has been recorded by hundreds of artists over the years, attesting to the eternal relevance of inflation to American investors and music fans alike. Perhaps you prefer the well-known covers by Bing Crosby, Joe Jackson, B.B. King, Michael Feinstein, Ann Rabson, or Catherine Russell. (It's possible I may have misheard a couple of words in the song, of course.)

The songwriter's use of "flame" is an especially apt word choice. As I mentioned in a February commentary,[3] inflation is very much like fire in that it needs three things: fuel (money supply), oxygen (consumer demand), and spark (scarcity). In this sense, the inflation hawks do have legitimate concerns. The fuel has been present for months already, and it continues to grow as depicted in Chart 2.

Consumer demand is also beginning to emerge – helped, no doubt, by stimulus checks sent out in December and again early this year. Jobs gains are also helping to fuel demand: Last week saw the fewest layoffs in any week since the pandemic began, and the March non-farm payrolls and unemployment reports tomorrow are expected to show renewed gains as more firms bring back their workers.

Demand – *spending* – won't return robustly until consumers feel confident that their jobs are secure and their personal balance sheets are in order. Chart 4 shows the University of Michigan consumer sentiment index, which has finally begun to recover after months of pandemic-induced weakness; it appears that the animal spirits are returning.

There is still the question of scarcity. Inflation hawks have latched onto recent reports of semiconductor chip shortages, of delays caused by the *Ever Given* grounding in the Suez Canal, and of difficulties sourcing lumber and other building supplies. While these issues are real, they are not indicative of a sustained bout of widespread inflation. Instead, they are reflective of supply chain disruptions caused by an uneven Covid-19 response. As companies resolve these logistical problems, inventories can be rebuilt; there isn't any fundamental reason for shortages to persist.



Source: University of Michigan

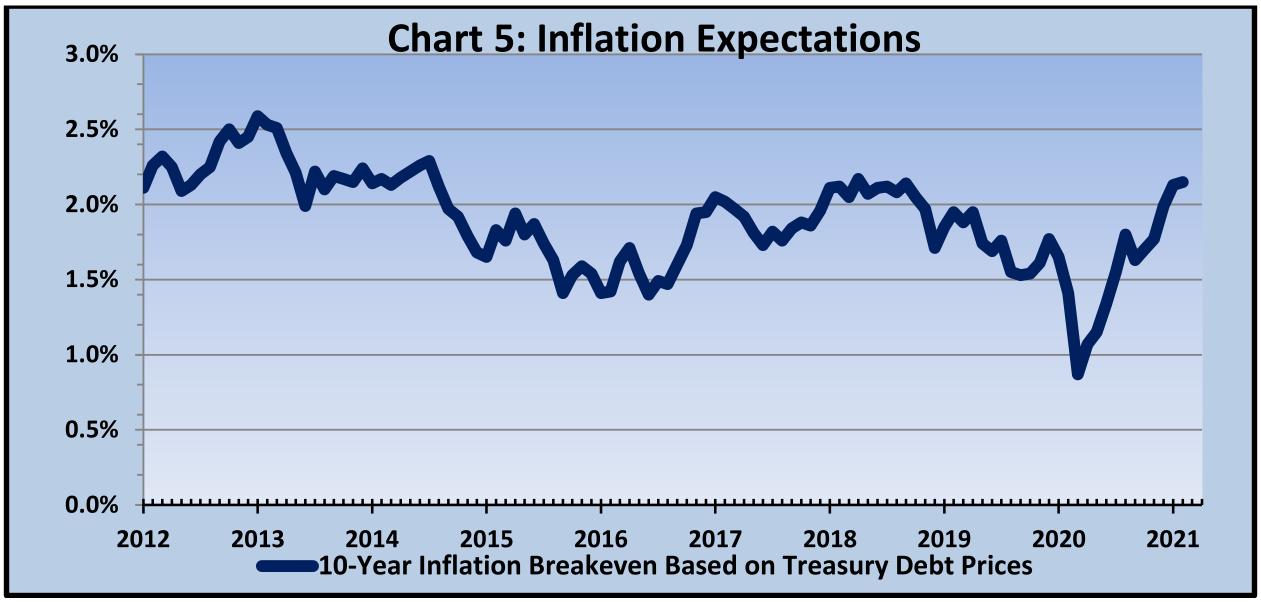
Further, when consumer demand comes back, it will first return in precisely those areas where there is currently abundant excess capacity: the high-touch services like travel and hospitality where millions of furloughed workers can come back to their jobs, and where existing facilities can reopen quickly. Disneyland reopened last month, for example, without any reports of problems rehiring employees or restocking souvenir stands. The same will be true for Major League Baseball as its season opens today, and for movie theaters and airlines as consumers return to those activities as well. Even when oxygen (consumer demand) returns to the economy, in other words, spark (scarcity) will still be missing – at least for now.

[3] "What's a Trillion Dollars Among Friends," *On Our Minds,* published February 17, 2021.

To be fair, it's possible that the ARP and infrastructure bills may together overstimulate the economy, while expanding the annual federal deficit and the cumulative national debt even further. This could lead to two problems: First, excessive stimulus can lead to an overly tight jobs market and frenzied consumer demand; second, in a fractured political environment, Congress may be unable to agree on how to pay for the trillions of dollars it will spend. Both problems can be solved by allowing inflation to rise, but at the cost of higher interest rates and the drag of higher taxes.

The result conceivably could be stagflation. Over the longer term, this risk should not be ignored. Still, Fed Chair Jerome Powell is probably right in discounting its relevance in the immediate period. Investors tend to agree, as long-term inflation expectations remain muted despite having picked up from their pandemic lows (Chart 5).

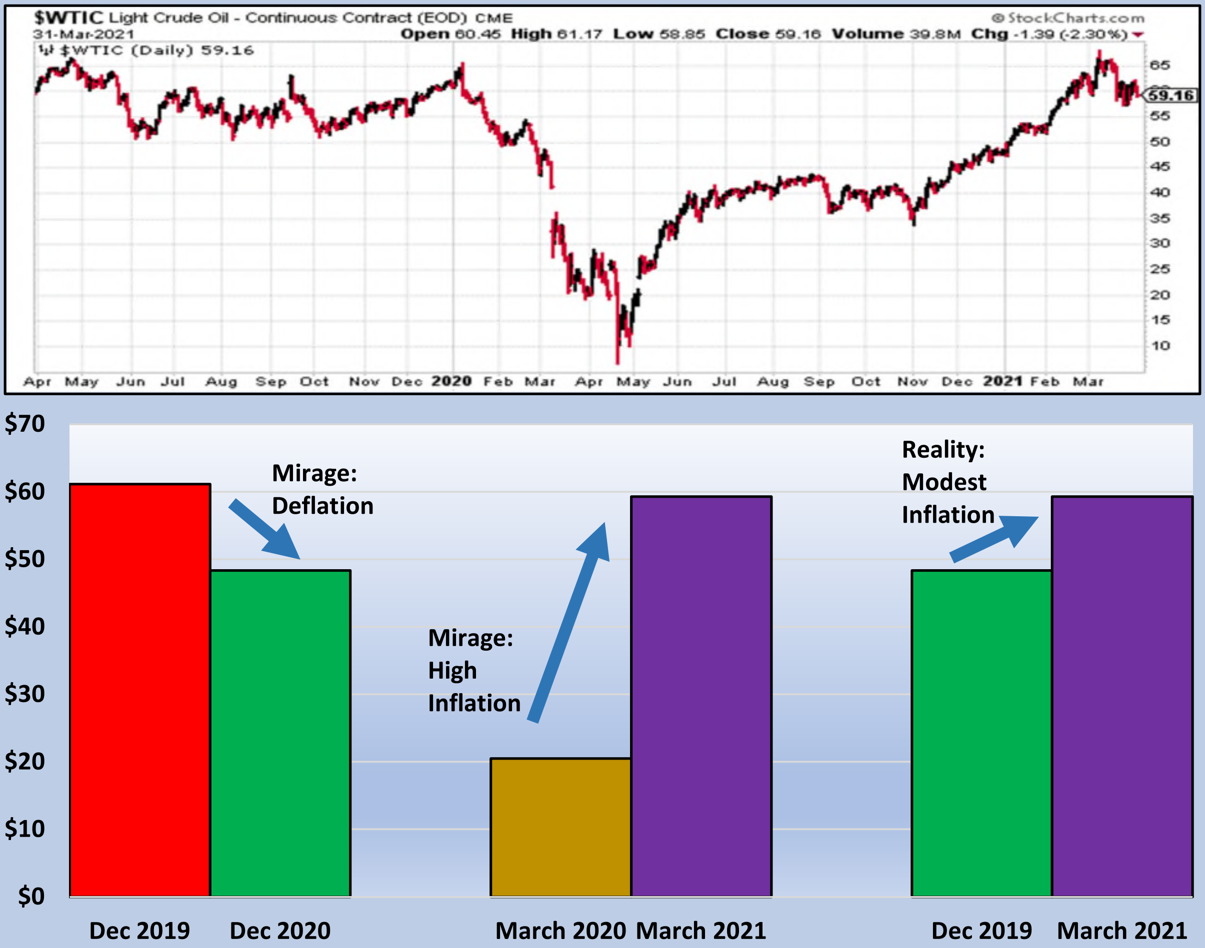



Source: Federal Reserve

In the next couple of months, however, we may see a sharp increase in reported inflation, but for reasons that are well understood and not fundamentally concerning. Prices plunged last March and April as the pandemic shut down many aspects of the U.S. economy, and those low prices are about to filter into the annual inflation rate calculations.

To take one example, Chart 6 (next page) shows both the overall trend in oil prices and three specific point-to-point comparisons. A barrel of oil cost about $60 in December 2019, before dropping to $20 by April 2020 and then gradually recovering. By year-end 2020, that same barrel of West Texas Intermediate had climbed to $50; thus, the December 2020 calculation showed oil price *deflation* from $60 to $50 (bottom left). But today, this comparison has flipped: WTI is currently about $60 again, compared with $20 a year ago – a tripling in price (bottom center). Yet the change from December 2020 to March 2021 is only about $10 per barrel (bottom right). In other words, the *appearance* of a rapid increase in inflation from January to April this year will be considerably worse than the *reality*, what economists call a "base effect." It will gradually diminish over the next several months, and investors shouldn't lose sleep over it.

**Chart 6: Oil Price Changes**




Sources: Stockcharts.com (top); U.S. Energy Administration (bottom)

So: *Is there is, or is there ain't inflation?* There is some, to be sure, but the occasional flare up due to base effects or supply chain disruptions shouldn't surprise investors and shouldn't be misinterpreted as a fundamental shift in the current economic climate. Inflation is indeed a creature that has always been strange, but it's not one to fear today.