

Powell's High Wire Act (Tyler's Version)

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Author's note: A couple of weeks ago, the pop music star Taylor Swift released a re-recorded version of her hit album Red, amid a legal fight with the original album's label. The new release, now called Red (Taylor's Version), includes an expanded version of the hit anthem "All Too Well" that adds important perspective and detail to the original.

Following Ms. Swift's estimable example, I offer here an updated version of the On Our Minds commentary I originally published last week.¹ Several readers had noted that the original article seemed inconclusive – which, to be honest, was an accurate depiction of my state of mind regarding inflation at the time of publication. In the days since, my outlook has shifted; hence I am republishing this article with additional material and a new conclusion. In deference to Ms. Swift, I've highlighted the new sections in red boxes, beginning on page 4.

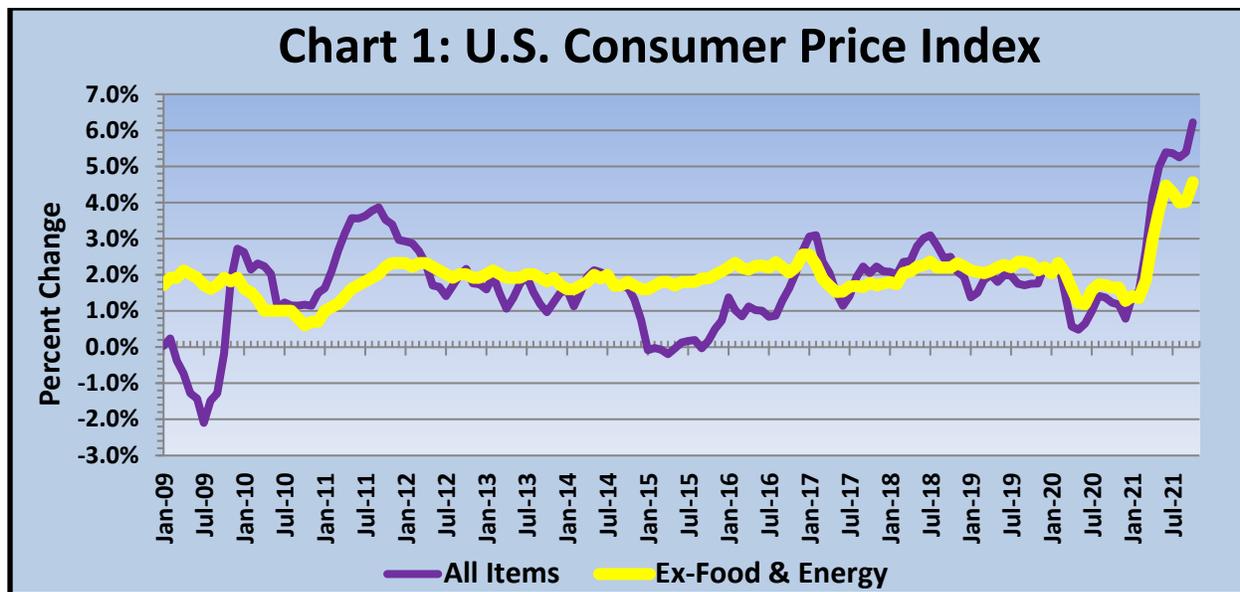
In April of this year, I published an *On Our Minds* commentary² suggesting that inflation was not an imminent threat – and indeed, the Consumer Price Index remained relatively muted through the summer and early fall. Although the “headline” numbers ticked up a bit, they were easily explained by the economy’s rebound from depressed prices related to the year-earlier pandemic shutdown – a phenomenon most notable in energy prices.

Today, however, the data show a suddenly very different story. Chart 1 (next page) shows the recent spike in consumer prices, both with and without the more volatile food and energy components of the index. After decades of stability – dating back to the early 1990s, far off the left edge of the chart – inflation has jumped sharply higher, with the “all items” headline index now topping 6%.

In that April commentary, I compared inflation to a fire, in that both require three elements: fuel, oxygen, and spark. At the time, it was evident that the U.S. economy had plenty of fuel to burn, in the form of a money supply that had jumped more than 25% since the pandemic had begun a year earlier. We were beginning to see evidence of oxygen – that is, consumer demand – as the unemployment rate fell and people began to resume their pre-pandemic lifestyles. But the spark – inability of supply to meet demand – wasn't yet evident.

¹ The parallel with Ms. Swift is admittedly only superficial. For one thing, I have no dispute with Eastern Bank about the ownership of these *On Our Minds* commentaries. Nor is my subject matter thematically linked in any way to Ms. Swift's, as I can't find any common ground between romantic breakups and inflation beyond the emotional pain they both inflict.

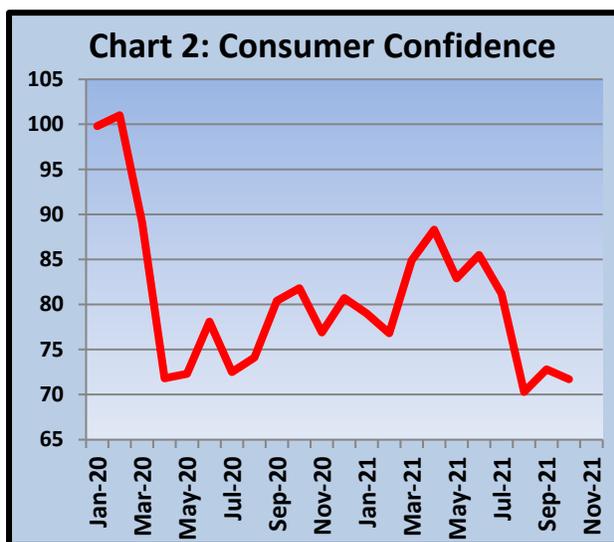
² “Inflation: Menace or Mirage?” April 1, 2021.



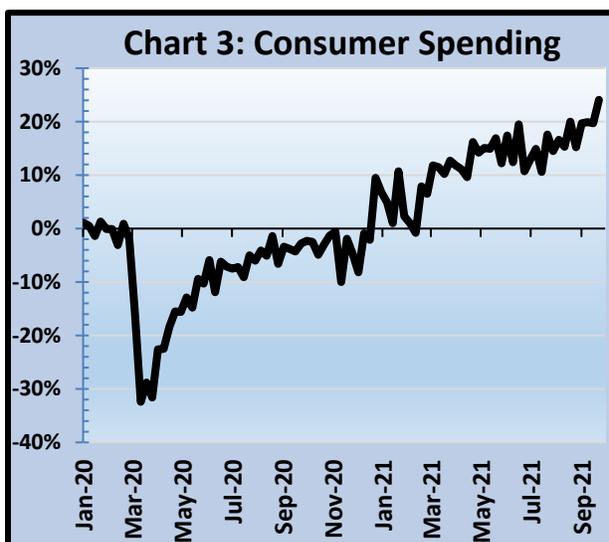
Source: FactSet

Today, we have all three elements solidly in place. The money supply continues to grow rapidly as the Federal Reserve ensures ample liquidity and continues to buy government debt; it’s now about 35% above its February 2020 level. That’s quite a lot of dried-out dead leaves on the forest floor, just waiting for a careless camper to drop a match.

The demand side – the oxygen – has likewise expanded rapidly, spurred by the hot winds of rapid changes in the labor market. The economy has added nearly six million new jobs this year, and the pace has accelerated since the Delta variant began to ebb in late summer. Consumers still report that they are worried (Chart 2), but their behavior has told a different story as actual spending has risen sharply in recent months (Chart 3, which compares spending to the January 2020 level). There’s plenty of oxygen demand to go with the fuel of elevated money supply.



Source: University of Michigan



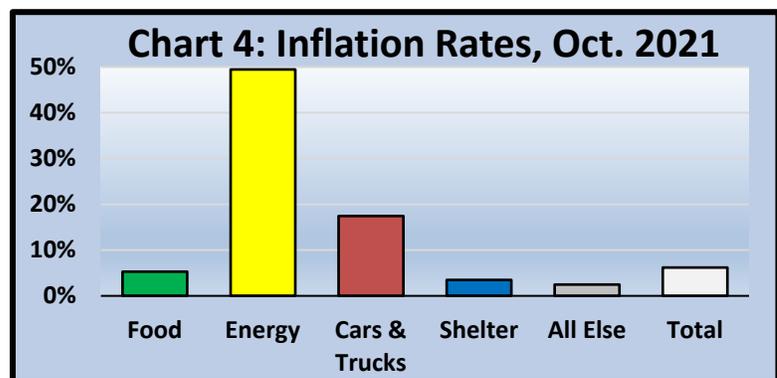
Source: www.tracktherecovery.org

But what's really ignited inflation recently is the spark – the shortages of key products at all levels of the supply chain. Those shortages were initially in raw materials (e.g., lumber, rare earth metals) and they gradually filtered through to intermediate goods. Short supplies of semiconductor chips have choked off production of automobiles, home appliances, and a wide array of other consumer items.

Perhaps the most consequential shortage has turned out to be labor: For the fourth straight month, the U.S. has had more than ten million job openings that companies have been unable to fill.³ This labor shortage is felt most acutely in transportation logistics: Cargo ships are unable to unload their wares because the ports have too few crane operators to offload containers; trucking companies can't move merchandise from dock to warehouse to retail store because they can't find drivers. Airlines can't schedule more flights because the aviators they laid off two years ago have either retired or taken better-paying jobs flying jets for Amazon.com and FedEx.

And so it has come to pass that consumer demand and supply have disconnected: Consumers are returning to their workplaces and going out to the mall again, but they aren't taking mass transit to get there; yet they can't find cars to purchase on dealer lots. Similarly, we may be ready to fly again, but the aircraft remain parked because the airlines can't schedule flights without pilots.

This dynamic is evident in a breakdown of the recent inflation statistics, released in early November. Chart 4 shows the annual change in prices of a few key items alongside the overall consumer price index. The combined effects of supply chain disruptions, labor shortages, and changing consumer behavior are evident in the 17.5% increase in the prices of passenger cars and light trucks from a year ago. Unwilling to ride the bus and unable to afford new cars, millions of consumers have flocked to the used car lots. While new vehicle prices have risen 9.8% over the past year, the average price of used cars has skyrocketed 26.4%.



Source: Bureau of Labor Statistics

The first three columns in Chart 4 all share one thing in common: They are functions of short-term fluctuations in supply and demand. Food prices are up 5.3% in part because of difficulties getting farm output to market; energy prices plunged last year when demand evaporated and then recovered sharply this year as producers held output steady;⁴ and vehicle prices leapt in response to a pandemic-induced change in consumer demand.

³ In the *On Our Minds* commentary “Too Many Jobs? Or Too Few?” (August 26, 2021), I examined some of the reasons behind this labor shortage. Among them are Boomer retirements, skills gaps, child care and elder care responsibilities, and government policy.

⁴ In fact, despite the 49% spike from a year ago shown in the chart, the current \$82 cost of a barrel of oil is still more than \$25 below its 2014 peak. A gallon of gasoline is likewise still no more expensive than it was seven years ago.

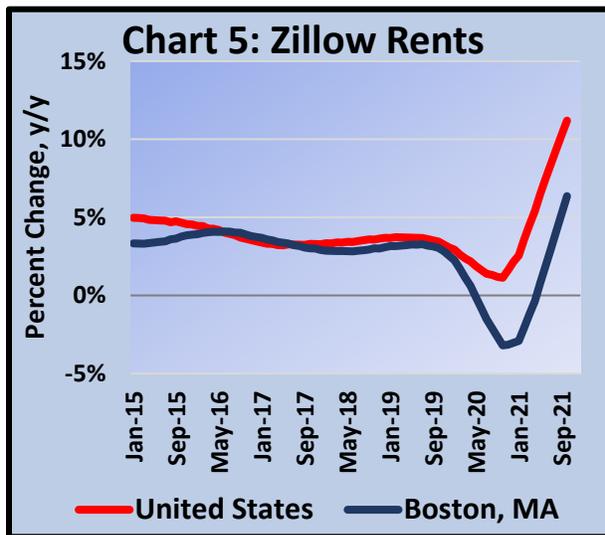
The column on the far right side of Chart 4 tells a different story, however. The “all else” category showed, in aggregate, only a 2.5% increase in consumer prices. The *median* inflation rate among all 337 distinct consumer goods and services categories tracked by the Bureau of Labor Statistics was only 4.1% in October – well below the 6.2% *mean* trumpeted in the press.

In short, the inflation we’re seeing is largely confined to a few highly visible – and short-term in nature – categories. To the degree that companies can unkink their supply lines and lure more workers back into the labor force, these product-specific inflationary spikes would likely abate. If that happens, then Fed Chair Jerome Powell will be proved correct in his assessment that this inflationary episode will have been transitory and not persistent.

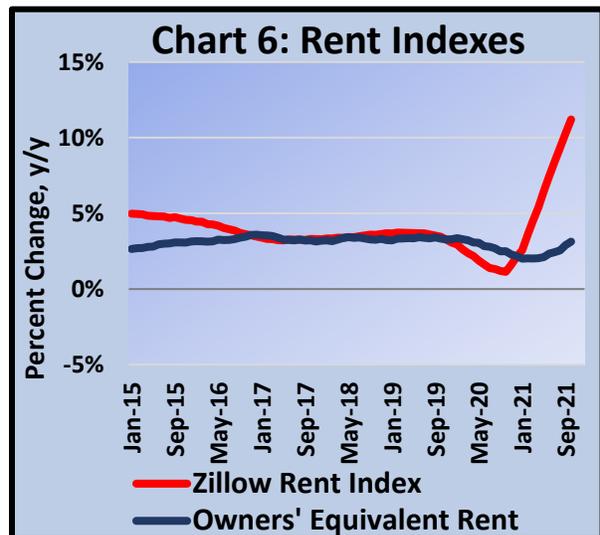
The biggest inflation wild card may turn out to be the housing market. In the center of Chart 4, prices for shelter appear to have remained relatively stable, up only 3.5% over the past year. That may seem hard to square with reports of double-digit gains in home prices, but I have suggested previously that the long moratorium on evictions, along with large-scale moves to the suburbs and exurbs from some major urban centers, served to hold rental prices down.

Maybe so, but I think there’s something else, too, and this worries me. In calculating consumer prices, the Bureau of Labor Statistics uses a proxy for housing costs known as “owners’ equivalent rents.” The intent is to separate out the costs of home ownership into two components, namely *rent* and *investment real estate*. The CPI then uses only the rent portion, along with actual rents, in calculating CPI.

Since most people retain their residences from one year to the next, average prices on the entire national housing stock change only very gradually. But for those people who are moving to a new residence, the numbers look very different. The real estate firm Zillow tracks changes in current listings closely, and then imputes an index meant to reflect the current market rates across the whole of the residential market. Chart 5 shows this index for the country and for Boston metropolitan area.



Source: Zillow

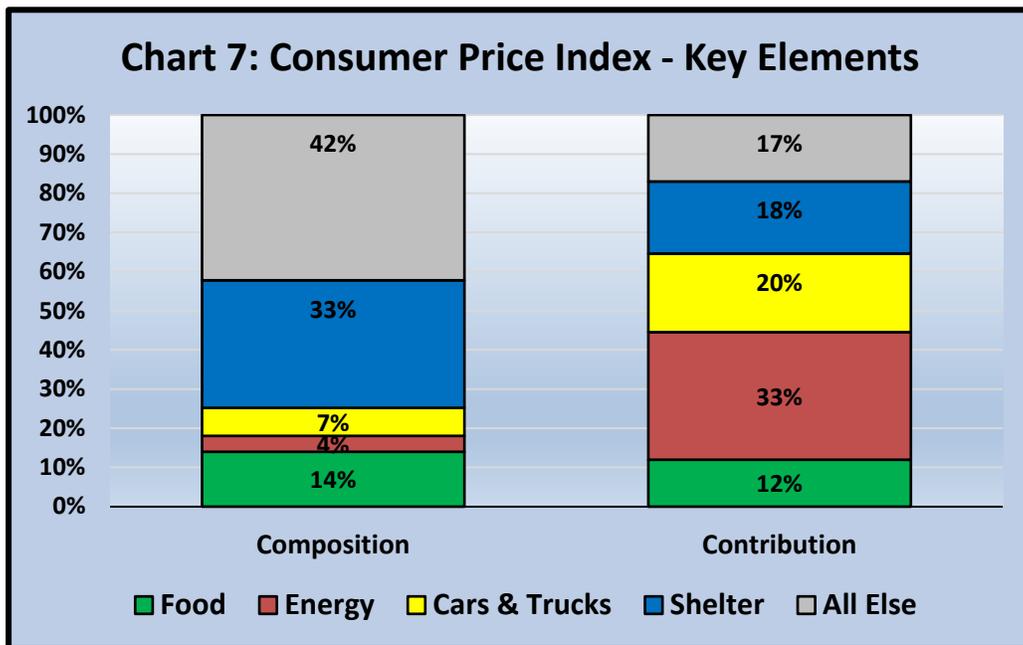


Sources: Zillow, Bureau of Labor Statistics

After several years of steady 4% increases, rents initially fell during the pandemic before suddenly surging upward. Today, this rent index is about 11% ahead of a year ago, and about 12% above pre-pandemic levels. The Zillow index may give a better indication of the housing market's direction than the CPI's shelter index does – and the trend is clearly increasingly upward.

Chart 6 overlays the national Zillow and the CPI Owners' Equivalent Rent indices for comparison. What becomes clear in this view is that Zillow's estimates suggest that the government CPI data is undercounting the rising cost of housing in this country. Over time, as leases end and as families periodically change residences, the glacial pace of CPI's shelter component is likely to turn upward as well. As this happens, the implications for overall inflation are magnified.

Chart 7 explains why small changes in housing prices can lead to big changes in the Consumer Price Index, by comparing the *composition* of the CPI to the *contribution* of the same elements highlighted in Chart 4. The left-hand column shows the weighting of each element in the total index; think of this column as the wallet of a hypothetical household: Food represents 14% of this household's monthly budget, while energy (including gasoline, heating oil, electricity, and all other energy sources) represents only 4%, and so on.



Source: Bureau of Labor Statistics, Eastern Bank Wealth Management

The right-hand column shows each category's cumulative contribution to the total 6.2% inflation rate, calculated by multiplying each item's weighting in the basket by its own specific change in prices. In this chart, energy's 4% wallet share is multiplied by its 49% inflation rate, contributing 2.1 percentage points to the overall 6.2% inflation rate, i.e., about one-third of the total. Likewise, the 3.5% gain in housing prices, multiplied by shelter's 33% share of household spending, adds up to 1.15 percentage points, or 18% of the total CPI.

Why does this matter? Energy and cars represent only 11% of household spending but are responsible for more than half of the reported inflation rate. Shelter, on the other hand, is three times as important to the hypothetical household budget but today contributes only half as much to inflation. If the CPI shelter component starts to rise as quickly as the Zillow index has moved, overall CPI would rise higher even if energy and vehicle prices suddenly stabilize. Worse, housing price changes tend to be sticky, while energy and used car prices are more volatile. Thus, a sharp increase in housing cost inflation could transform the overall narrative from *transitory* to *persistent* inflation.

This leaves the Federal Reserve in a difficult position. Its two primary mandates are now in direct conflict with each other: To curb incipient inflation, the Fed would normally raise interest rates and hasten its exit from bond purchases. But to encourage maximum employment, the central bank must keep rates low enough to encourage businesses to expand their borrowing and hiring decisions. As Leon Russell noted during a previous inflationary era fifty years ago, *I'm up on the tight wire / One side's ice and one is fire*.

Fed Chair Jerome Powell has been walking that tightrope in his recent press conferences and testimony before Congress. He can do so safely only if he can persuasively argue that inflation is in fact transitory; that would give him latitude to keep interest rates low, focusing on jobs while letting inflation run hot for a while. But if the fire of inflation begins to look persistent, failure to raise rates now could allow prices to run amok as they did in the 1970s. Were Mr. Powell to raise rates sooner in a bid to head off higher inflation, he would risk thwarting jobs growth and possibly even throwing the U.S. into a recession. That's quite a tightrope indeed.

Earlier this week, President Biden renominated Mr. Powell to a second four-year term as Fed Chair. His job is now secure, but he is still under intense scrutiny to steer the economy away from persistently high inflation. In this respect, it is notable that Mr. Powell acknowledged for the first time in early November that the current inflationary episode may last well into next year. By then, he apparently hopes, easing pressures in volatile categories will cool off the overall CPI. Perhaps so, but it seems increasingly likely that rising housing costs may yet keep the CPI uncomfortably high for a considerably longer time.

Markets already seem to be assuming that inflation is here to stay. Current yields on Fed futures contracts suggest that the bond market anticipates two or three rate hikes next year, a more aggressive trajectory than the Fed's closely watched "dot plot" indicates. In other words, investors are currently giving the Fed latitude to raise rates earlier than the Fed has forecast. Mr. Powell would be wise to follow the markets' lead: Raising rates sooner but more gradually appears to be the Fed's best path toward keeping inflation in check without causing a recession.

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