
# The Clash: Will Inflation Stay or Will it Go?

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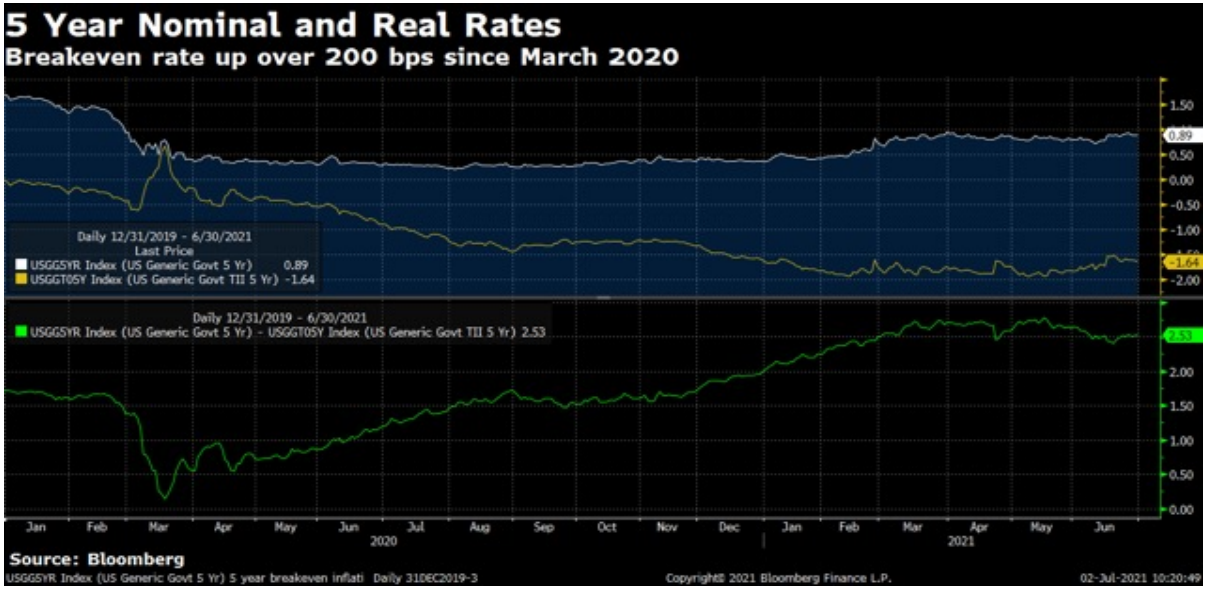
In recent months, the frequency and volume of talk about higher inflation has increased as standard inflation measures have risen to levels not seen in years. A portion of this increase is due to the extraordinary demand and supply shocks that rippled through the economy as a result of the spread of Covid-19. Last year, huge swaths of the economy were shut down, and in response both Congress and the Federal Reserve took unprecedented action to counteract the economic damage. As communities have reopened, higher prices have accompanied strong growth, and many market participants have begun to wonder if these higher inflation statistics are part of a secular move towards persistent higher prices. Over the course of the next few pages, we will frame the situation in a historical context, describe some of the apparent causes including the effect of monetary and fiscal policy, review the risks and policy implications, and describe our process for monitoring and adapting to the situation as it develops.

# Low Inflation Regime is Challenged by the Reopening

Broad measures of inflation have been persistently low for decades. In the U.S., inflation has averaged slightly above 2% over the past 30 years. Globalization and technological advancement are frequently cited as secular economic developments that have contained inflation over time. Achievements in these two areas have occurred at a breakneck speed over the past few decades. In a world where computational horsepower is constantly expanding, productivity can expand, placing downward pressure on costs. Labor costs and wages have also increased at an anemic pace, despite signs of tightness in the labor market and very low unemployment prior to the pandemic. In the arena of manufacturing, supply chains are much more nimble and can be adjusted in real time to control costs and avoid costly supply/demand imbalances that often resulted in shortages that raised prices for consumers. Having existed in this environment for such a long time, it's unsurprising that many investors (and policy makers too) have become somewhat complacent about the dangers of inflation.

As economies began to reopen as a result of widespread Covid-19 vaccinations, lifting of mask mandates and occupancy restrictions, and reduced infection rates, economic activity increased dramatically. Beginning in April of 2021 this increased activity was accompanied by significantly higher inflation readings across a variety of data series. The headline U.S. Consumer Price Index (CPI) year-over-year was 4.2% in April and 5.0% in May. CPI is a standard inflation measure that compares the price of a constant weighted basket of goods and services with itself over time. Core CPI, which removes the volatile food and energy categories from the equation, was 3.0% in April and 3.8% in May, the highest levels recorded in well over a decade, but more subdued than the headline index. Today's 4.5% 12 month increase for June Core CPI was above consensus. The headline CPI which includes the more volatile food and energy categories was up 5.4%, the largest increase since August 2008. The June month over month rise of 0.9% indicates that inflationary pressures are still accelerating. The core personal consumption expenditures (PCE) index, an inflation measure preferred by the Fed, came in at 1.9% in March, 3.1% in April, and 3.9% in May. Alternatively, market measures of inflation that are derived from the prices of traded financial instruments can provide important information and are considered higher frequency and more "real-time" than the monthly data series. One example, illustrated below, is the 5-year breakeven inflation rate (the difference between the yield of the standard 5-year Treasury note and the 5-year inflation-protected Treasury security) which, having dropped to near zero in March 2020 reached 2.74% in mid-May. The equivalent 10-year measure is currently at 2.24%, having topped out near 2.60% during that same time period.

Finally, there are survey measures which capture inflation expectations (from consumers or businesses that respond to a survey) over different time horizons. The University of Michigan's monthly Consumer Sentiment Index contains indicators for 1-year and 5-year inflation expectations. While both of these measures moved up in 2021, the June report showed both indicators falling to 4.0% and 2.8%, respectively-still very hot readings. It's noteworthy that these two inflation indicators declined modestly in a month where the overall sentiment index rose by 3.5 points, perhaps indicating confidence amongst consumers that inflation will prove temporary, even as the economy continues to recover.



# Digging Deeper Into the Details

Within most of these measures there are compositional elements that can explain some of the rise. For instance within the CPI, the Food & Shelter categories, which collectively make up close to 50% of the headline calculation, saw 0.3% and 0.4% month-over-month increases in May, respectively. In the May CPI report, the sharp rise in used cars prices accounted for one-third of the increase in Core CPI. The increase in used car prices, lumber, microchips, and oil/gas have all received plenty of media attention, as they may reflect pockets of inflation that relate more to the reopening of the economy than to broad based and sustainable price increases. Data series such as the Trimmed Mean CPI and Median CPI, seek to isolate the average (unweighted) level of inflation across multiple categories or to exclude the sectors that are showing the highest and lowest readings to get a more mid-level reading. These series show elevated inflation within the economy, but at a less worrisome level than the more conventional CPI Index.

**Consumer Price Index Heat Map (MoM% Change)**

| | Weight | Jun '20 | Jul '20 | Aug '20 | Sep '20 | Oct '20 | Nov '20 | Dec '20 | Jan '21 | Feb '21 | Mar '21 | Apr '21 | May '21 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Headline CPI | 100% | 0.5% | 0.5% | 0.4% | 0.2% | 0.1% | 0.2% | 0.2% | 0.3% | 0.4% | 0.6% | 0.8% | 0.6% |
| Shelter | 34% | 0.1% | 0.2% | 0.1% | 0.1% | 0.1% | 0.1% | 0.1% | 0.1% | 0.2% | 0.3% | 0.4% | 0.3% |
| Food | 14% | 0.5% | -0.3% | 0.1% | 0.1% | 0.2% | 0.0% | 0.3% | 0.1% | 0.2% | 0.1% | 0.4% | 0.4% |
| Medical Services | 7% | 0.5% | 0.5% | 0.1% | 0.0% | -0.3% | -0.1% | -0.1% | 0.5% | 0.5% | 0.1% | 0.0% | -0.1% |
| Vehicles & Parts | 7% | -0.5% | 1.4% | 2.2% | 2.2% | 0.5% | -0.6% | -0.1% | -0.6% | -0.4% | 0.2% | 4.3% | 4.0% |
| Educ./Comm. Svcs | 6% | -0.1% | 1.2% | 0.1% | 0.0% | 0.2% | 0.0% | 0.1% | 0.0% | 0.1% | 0.0% | 0.1% | 0.2% |
| Energy | 6% | 4.4% | 2.1% | 0.9% | 1.4% | 0.6% | 0.7% | 2.6% | 3.5% | 3.9% | 5.0% | -0.1% | 0.0% |
| Transportation Services | 5% | 2.4% | 2.8% | -0.7% | -0.3% | 0.2% | 1.3% | -0.6% | -0.3% | -0.1% | 1.8% | 2.9% | 1.5% |
| Recreation Services | 4% | -0.8% | -1.2% | 0.5% | 0.4% | 0.5% | 0.5% | -0.5% | -1.0% | 0.6% | 0.8% | 0.8% | 0.2% |
| HH Furnishings/Supplies | 4% | 0.5% | 0.4% | 1.0% | -0.2% | -0.4% | 0.8% | 0.0% | -0.5% | -0.1% | 0.4% | 0.9% | 0.9% |
| Apparel | 3% | 1.4% | 0.7% | 0.4% | -0.4% | -0.9% | 0.7% | 0.9% | 2.2% | -0.7% | -0.3% | 0.3% | 1.2% |
| Recreation Goods | 2% | 0.0% | 0.6% | 0.8% | -0.4% | -0.1% | 0.3% | 0.2% | 0.1% | 0.5% | -0.2% | 1.2% | 0.4% |
| Medical Goods | 2% | 0.0% | 0.0% | 0.3% | -0.6% | -0.7% | -0.4% | -0.2% | -0.1% | -0.7% | 0.1% | 0.6% | 0.0% |
| | | | | | | | | | | | | | |
| Core (Ex Food & Energy) | 80% | 0.2% | 0.5% | 0.3% | 0.2% | 0.1% | 0.2% | 0.0% | 0.0% | 0.1% | 0.3% | 0.9% | 0.7% |
| Core Services | 60% | 0.3% | 0.5% | 0.1% | 0.1% | 0.1% | 0.2% | 0.0% | 0.0% | 0.2% | 0.4% | 0.5% | 0.4% |
| Core Goods | 20% | 0.1% | 0.7% | 1.0% | 0.5% | 0.0% | 0.0% | 0.1% | 0.1% | -0.2% | 0.1% | 2.0% | 1.8% |

Source: BLS, CreditSights. Note: Shows select MoM price change per CPI category, sorted by weight in the headline index. Category labels abbreviated from official titles. Seasonally Adjusted. Intra-category color scheme.

# Relief Spending Morphs into Permanent Deficit Spending?

Congressional action is likely responsible for some portion of this distortion in prices, as lawmakers voted to enact three massive spending bills since March 2020 to cushion Covid-19's blow. For individuals, each piece of legislation included direct payments and extended unemployment benefits. Small businesses were allocated forgivable loans intended to assist with payroll expenses. State and local governments received support to bridge budget shortfalls, and significant funds were also earmarked for schools and medical facilities. In total, Congress has allocated in excess of $5 trillion over the last 15 months, affecting almost every facet of the economy. Dropping hundreds of billions of dollars into the hands of individuals, businesses, state and local governments, hospitals and schools no doubt had a salutary effect on the price of goods and services. In addition, all of this government stimulus must be paid for with additional government borrowing – it's worth noting the U.S. was averaging an almost $900 billion fiscal deficit even before Covid-19 hit. The additional issuance of government debt could result in higher interest rates, which would potentially be inflationary if businesses raise prices to insulate profit margins from being hurt by higher borrowing costs.

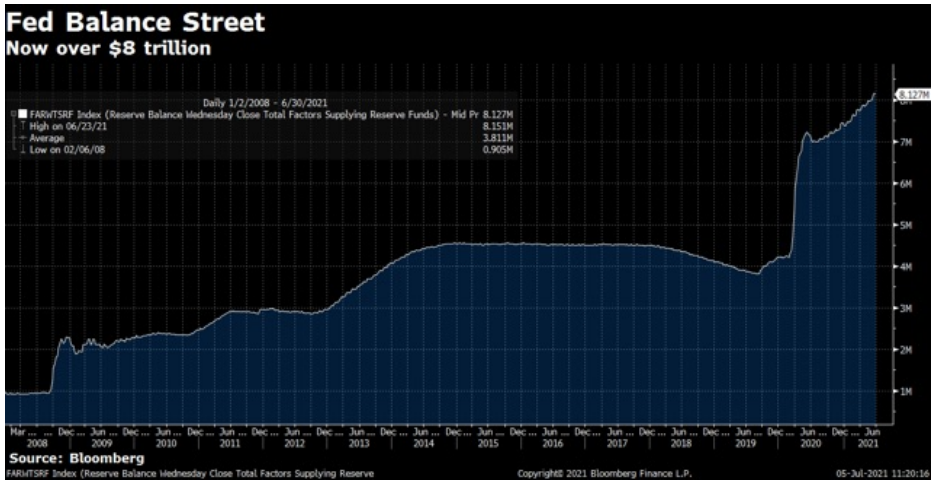
**Summary of Covid-Related Fiscal Stimulus**

| Date | Name | Size |
|---|---|---|
| March 2020 | **Coronavirus Aid, Relief and Economic Security Act** | $2.2 Trillion |
| | Aid to distressed corporations | $500B |
| | Payments to individuals | $300B |
| | Forgivable small business loans | $377B |
| | Extended unemployment benefits | $260B |
| December 2020 | **Consolidated Appropriations Act** | $900 Billion |
| | Forgivable small business loans | $284B |
| | Payments to individuals | $166B |
| | Extended unemployment benefits | $120B |
| | Schools and Universities | $82B |
| March 2021 | **American Rescue Plan Act** | $1.9 Trillion |
| | Payments to individuals | $400B |
| | State and local governments | $350B |
| | Extended unemployment benefits | $200B |
| | Schools and Universities | $130B |

Source: Bloomberg, Wall Street Journal

# Risks to Perpetually Accommodative Monetary Policy?

The Federal Reserve's extraordinary measures to combat the pandemic also has implications for price levels. Using a playbook developed after the Great Financial Crisis, in March 2020 the Fed dropped short term rates under their direct control to effectively zero. In addition, the Fed began buying certain fixed income securities in the open to market to increase the money supply to encourage lending and investment. The Fed's balance sheet, still bloated at almost $4 trillion from the aftermath of the great financial crisis, began to rise again. Over the last year the Fed has bought an additional of $3 trillion of securities, leaving the balance sheet at over $8 trillion. And while the stated objective of the Fed's measures is to stimulate the real economy, we believe there are undoubtedly effects on price levels across asset classes. Exceptional strength in housing prices, industrial commodities, financial assets (stocks, bonds) and even esoteric assets like cryptocurrencies and NFTs all suggest unintended consequences of the Fed's actions.



# Putting the Pieces Together– What do We See?

Viewed in this context, we believe the spring/summer inflation spike is likely to endure a few months longer, before beginning to decline as year-over-year base effects recede later this fall. While the current inflation scare is certainly alarming, we expect that there is more smoke than fire. Clearly there are risks to our outlook and plenty of competing viewpoints, so additional time will be needed to evaluate the sustainability of the recent spike in inflation measures. We will be monitoring the situation closely. In the meantime, Central Banks appear alert and are taking incremental steps to acknowledge the pickup in inflation and describe a timeline for policy action that is appropriate and sufficiently responsive, without committing too early. If delivered in a timely and well telegraphed manner, the Fed's policy reaction to clear signs that inflation is becoming more structural will likely be sufficient to bring inflation back toward the Fed's target range. Should they delay taking action, the market may be forced to preemptively push interest rates higher in expectation of the Fed needing to resort to more aggressive measures to rein in stubbornly high inflation. A more accelerated pace of policy normalization risks choking off power to the U.S. economy and raises the probability of a recession. Portfolios that are well diversified and include asset classes such as equities, commodities, and real assets are built to weather inflationary episodes. We are prepared to make strategic adjustments to portfolios to position appropriately for a more enduring inflationary environment.

If you would like for a Hancock Whitney financial advisor to review your asset allocation, please contact us by reaching out to any Hancock Whitney associate to set up an appointment.

# About Our Authors

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**Sources:** [1]Bloomberg, [2]U.S. Bureau of Labor Statistics, [3]U.S. Bureau of Economic Analysis, [4]Peter G. Peterson Foundation