A DEEP DIVE INTO THE OUTLOOK FOR INFLATION

by **Robert F. DeLucia, CFA**
Consulting Economist

Summary and Major Conclusions:

I believe that investors must extend their time horizons beyond the inflationary trends of the next six months, which I think are transitory. There are strong reasons to assume that the next several months are unlikely to be the end of the current inflation cycle, which could persist for three years or more. I believe that there exist underlying fundamental inflationary pressures that will continue to build beneath the surface, even as headline government data depict a scenario of gradually weakening inflation beginning later this year.

- Data on inflation have escalated in recent months. The Consumer Price Index (CPI) increased in June at an annual rate of 5.4%, up from only 1.8% as recently as February. The core CPI — all items excluding food and energy — has risen by 4.5%, well above the 1.3% annual rate in February.
- Both the Federal Reserve and financial markets believe that the current spike in consumer inflation is transitory, a consequence of temporary bottlenecks and severe supply-chain distortions stemming from the frenetic and uneven reopening of the economy.
- Underlying demand is surging as massive pent-up demand from a previously locked-down economy is unleashed, but the factors of production — labor, materials, and capital — cannot be mobilized at a comparable pace.
- I have a fundamentally different view than that of the consensus. While I agree that the current spike in inflation is temporary, I expect a new more dangerous phase of inflation to begin later next year, a result of extreme fiscal and monetary stimulus.
- My belief is that there exist underlying inflationary pressures that will continue to build beneath the surface, even as headline government data depict a trend of gradually weakening inflationary pressures during the first half of next year.
- My inflation forecast is based upon history, which shows that government policy initiatives are the primary determinants of sustained long-term inflation trends. Unprecedented fiscal and monetary policies are contributing to an economic boom that in the past has resulted in a durable inflation cycle.
- Sustained GDP growth at an above-trend pace should result in a fully employed economy and a high level of capacity utilization within the next 18 months. Rapid growth in private credit demand by households and businesses will reinforce the extremely rapid growth in the money supply in 2020.
- Financial markets are extremely short-sighted, in my judgement, in focusing on current transitory supply-side forces and overlooking the powerful influence that extreme government policies can have on long-range inflation.
- Investors should look beyond monthly government data, which are coincident rather than leading indicators of inflation. An analysis of trends in service inflation, wages, inflation-indexed bonds, and company surveys can be more helpful in anticipating the future trend in inflation.

- The timing and speed of a shift from monetary accommodation to monetary restraint is the most important independent variable in the outlook. A deliberately slow pace of tightening by the Fed almost guarantees a sustained resurgence in inflation, which could begin later next year.

- Financial markets are likely to be in a consolidation phase during the next three months, with the equity market fluctuating within a trading range of plus or minus 10%.

- Rising inflation, elevated valuations, and investor concerns over the highly infectious Delta variant could limit the upside in equity prices; exceptionally strong growth in earnings along with highly accommodative financial conditions and deeply depressed bond yields could limit the downside.

- Risk assets could rally beginning later this year and during the first half of 2022, as inflationary pressures subside, and as the probability of a premature Fed rate-tightening cycle diminishes. The equity market could generate mildly positive returns through mid-2022.

- Under these assumptions, the equity market could stage a sustained rally over a six-to-nine-month time horizon, although the magnitude of returns would be limited by currently rich valuations. Bonds should register negative returns during this period, as long-term interest rates drift higher.

- Financial markets could become challenged during the second half of next year and in 2023 as the economy approaches full employment and underlying inflationary pressures become more visible at that time.

Inflation remains the critical variable in the outlook for the economy and financial markets. The spike in inflation data in recent months has been attributed to a confluence of temporary factors associated with the rapid reopening of the economy. At the same time, there are convincing arguments that a new inflation cycle is underway that could persist for several years, with significant ramifications for financial markets. This week's *Economic Perspective* provides answers to questions pertaining to current inflation trends and the outlook for inflation through 2024.

COULD YOU BEGIN WITH A REVIEW OF CURRENT INFLATION DATA?

Official government data on inflation have escalated in recent months. On a year-over-year basis, the Consumer Price Index (CPI) increased by 5.4% in June, up from only 1.8% as recently as February. The core CPI — all items excluding food and energy — has risen by 4.5%, up from only 1.3% in February. The Producer Price Index (PPI) has risen by nearly 10% over the past year, driven by increases in energy, industrial metals, and electronic components. Increases in wage inflation have been somewhat more moderate, with annual growth of 3.6%, up from 2% in May.

WHAT IS THE CONSENSUS VIEW REGARDING THE OUTLOOK FOR INFLATION?

Both the Federal Reserve and financial markets believe that the current spike in consumer inflation is transitory, a consequence of temporary bottlenecks and severe supply-chain distortions stemming from the frenetic and uneven reopening of the economy. The essence of this view is that there currently exists a ***temporary imbalance*** between aggregate supply and demand in the global economy, causing prices to increase.

The divergence between supply and demand is evident in many markets. Underlying demand is surging as massive pent-up demand from a partially locked-down economy is unleashed, whereas the factors of production — labor, materials, and capital — cannot be mobilized at a comparable pace. The bottom line according to this popular view is that core consumer inflation will peak before yearend and gradually decline toward the Federal Reserve's long-term inflation target, stabilizing around 2%.

DO YOU AGREE WITH THIS CONSENSUS VIEW?

No, my view is that this scenario is misguided. I believe that investors must extend their time horizons beyond the inflationary trends of the next six months, which I agree are transitory. *But there are strong reasons to assume that the next several months are unlikely to be the end of the current inflation cycle, which could persist for three years or more*. In other words, current reopening pressures on costs and selling prices are real but not sustainable and will eventually run their course; however, another phase of the inflation cycle could begin later next year and persist into 2024 and beyond.

I believe that there exist underlying fundamental inflationary pressures that will continue to build beneath the surface, even as headline government data depict a scenario of gradually weakening inflation beginning later this year. These underlying forces will be supported by rapid growth in spending and the approach of full employment. The bottom line is that supply imbalances will eventually recede, resulting in a steady deceleration in measured inflation, and for a brief period temporarily concealing powerful underlying inflationary momentum resulting from unprecedented government policies.

ARE THERE PROPRIETARY GAUGES THAT COULD PROVIDE A WARNING OF A RESURGENCE IN INFLATION?

There are several important statistical measures of future inflation that tend to lead the official monthly government data:

- **Service Inflation:** The CPI consists of both goods and services, the latter comprising 75% of the total index. *The current surge in inflation is driven primarily by goods, but the long-term direction of inflation will be driven by services*. Compared with a 6.5% annual inflation rate for core goods, service inflation is currently 3.1%. There is a strong correlation between service sector inflation and wage inflation. Investors should focus on the service component as a leading indicator of overall consumer inflation.

- **Customized Inflation Metrics:** One deficiency of the CPI is that it can be heavily influenced by a small group of items. The Federal Reserve Bank of Cleveland has created a ***Trimmed-Mean CPI***, which attempts to measure underlying inflation trends by removing the most volatile items. This measure is currently at 3%, up from 2% in January, but lower than headline inflation. I expect this metric to begin to signal higher underlying inflation as the next year unfolds.

- **Inflation-Indexed Bonds:** History has shown that changes in inflationary expectations are a reliable indicator of future changes in actual inflation. As measured by the market for Treasury Inflation-Protected Securities (TIPS), the implied outlook for inflation is currently 2.35%, down from a recent peak of 2.6%. The average of the three years ending in 2019 (pre-pandemic) was 2%.

- **Wages and Salaries:** Although wage rates are typically a confirming, rather than leading, indicator of inflation, trends in worker compensation can provide insights regarding supply and demand within the real economy. Average hourly earnings are currently in an accelerating trend, rising from 2% in May to a current pace of 3.5%, and further increases lie ahead.

- **Business Surveys of Pricing Plans:** Surveys of the small business sector show that 44% of companies plan to raise selling prices during the next three months, the highest percentage since 1980. The same surveys show that business costs are rising at the fastest rate since the early 1980s.

WHAT ARE THE KEY ECONOMIC AND POLICY TRENDS FOR INVESTORS TO MONITOR?

While investors should continue to monitor the monthly inflation reports from the government, these are coincident indicators; investors must closely track leading indicators of inflation, which are more anticipatory. In this regard, I will be closely monitoring the following trends:

- **Federal Reserve:** The timing and magnitude of a shift from monetary accommodation to monetary restraint is the most important independent variable in the outlook. *A deliberately slow pace of tightening by the Fed almost guarantees a sustained resurgence in inflation, which could begin later next year*.

- **Measures of Capacity Utilization:** Currently at 75.5%, capacity utilization is depressed, signaling adequate supply across most industries. The pre-pandemic peak of 80% is unlikely to be reached until late 2022 or 2023, at which time the economy should be experiencing upward pressures on costs and selling prices.

- **Pricing Power:** Many companies are reporting that they have successfully offset rising input costs with higher selling prices. As a result, company profit margins are near all-time highs. I will be monitoring quarterly earnings reports to confirm the sustainability of company pricing power.

- **Labor Market Trends:** There remains considerable slack in the labor market, with nonfarm payrolls still nearly seven million below the pre-pandemic peak. At only 61.5%, the labor participation rate also remains well below its pre-pandemic level of 63.3%. I expect the economy to reach full employment in early 2023, at which time wage pressures could begin to build rapidly.

- **Household Spending:** Consumer prices ultimately respond to supply and demand, the most important component of demand being personal consumption. The longer the boom in consumer spending persists, the more likely that supply-side pressures and bottlenecks will emerge in the economy, pushing inflation higher. Capital formation is also dependent upon final demand; a capital investment boom would reinforce underlying inflationary pressures.

WHAT IS THE FOUNDATION FOR YOUR INFLATION OUTLOOK?

My inflation forecast is based upon the observation that underlying economic and policy factors — rather than temporary shocks — are the primary determinants of sustained long-term inflation trends. *Unprecedented fiscal and monetary policies are contributing to an economic boom that should begin to generate inflationary pressures, in two respects*:

1. Sustained GDP growth at an above-trend pace will quickly bring about full employment, tight capacity utilization, and permanent bottlenecks.

2. Rapid growth in private credit demand by households and businesses will reinforce the extremely rapid growth in the money supply over the past 18 months.

WHAT IS YOUR INFLATION FORECAST FOR THE NEXT SEVERAL YEARS?

My forecast for inflation can be summarized using the following timeline: (1) The current period of ***cost-push inflation*** that should unwind by yearend; (2) A period of decelerating inflation data during the first six to nine months of 2022; and (3) A protracted period of ***demand-pull inflation*** beginning later next year and persisting well into 2024. This three-stage inflation timeline was discussed more fully in a recent report (see *Economic Perspective* dated May 31, 2021):

- In the short term, ongoing supply-side disruptions should continue to exert upward pressure on measured inflation. Currently at **4.5%**, core consumer inflation could rise to a peak of **5%** or more before yearend.

- Beyond yearend, the measured rate of inflation should decline during the next six to nine months, as supply chains are restored to normal and bottlenecks resolved. Core consumer inflation could decline to **2.5%** by the middle of next year.

- Long-term inflationary pressures should become apparent later next year, consistent with an economy nearing full employment, accompanied by an acceleration in credit growth. Inflation could rise to **5%** during 2023 and 2024. The rate of inflation over the five-year period ending in 2025 could average **3.5%**.

WHAT ARE THE PRIMARY INVESTMENT IMPLICATIONS?

Financial markets are extremely short-sighted, in my judgement, in focusing on transitory supply-side forces and overlooking the enduring influence that extreme government policies can have on long-range inflation. My assumptions for financial markets can be summarized as follows, using my previously discussed three-stage timeline for inflation:

1. Financial markets are likely to be in a consolidation phase during the next three months, with the equity market fluctuating within a trading range of plus or minus 10%. Rising inflation, elevated valuations, and investor concerns over the highly infectious Delta variant could limit the upside; exceptionally strong growth in company earnings along with highly accommodative financial conditions and deeply depressed bond yields could limit the downside.

2. Risk assets could rally beginning later this year and during the first half of 2022, as inflationary pressures subside, and as the probability of a premature Fed rate-tightening cycle diminishes. Some medical experts expect the current fourth wave of the coronavirus pandemic to peak in the autumn months and begin to stabilize through yearend, although the Delta variant remains the primary wild card in the outlook.

3. Under these assumptions, the equity market could stage a sustained rally over a six-to-nine-month time horizon, although the magnitude of returns would be limited by currently rich valuations. Bonds should register negative returns during this period, as long-term interest rates drift higher.

4. Financial markets could become challenged during the second half of next year and in 2023 as the economy approaches full employment and underlying inflationary pressures become more visible. At that point, financial markets could begin to discount a more aggressive tightening of monetary policy in 2023 and 2024 along with slower economic and profit growth.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

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S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

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