PIMCO

The Great U.S. Inflation Head Fake

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In this Q&A, we assess investors' inflation concerns and outline reasons that near-term price adjustments are unlikely to lead to longer-term inflation.

SUMMARY

- Despite inflation concerns and the potential for multi-month price level adjustments, we believe year-over-year inflation will be contained in the second half of 2021.
- The markets appear to be pricing in a chance that the Fed will be more aggressive with interest rates than it is currently telegraphing.
- We expect price pressures to normalize later in 2021 as vaccination rates increase, shipping and supply bottlenecks clear, and durable goods purchases ease.

PIMCO's most recent *Cyclical Outlook*, "Dealing With an Inflation Head Fake," concludes that investors should be prepared for an inflation "head fake" in what is likely to be a volatile near-term investment environment. This head fake is likely to be most pronounced in the U.S., where higher commodities prices, trade bottlenecks, and projections for the fastest rate of growth in 40 years have contributed to fears of overheating. These fears are only likely to become more acute over the next several months as economic activity picks up alongside a better public health outlook, bringing with it a normalization in prices. Headline inflation is likely to accelerate up to 3.5% on a year-over-year (y/y) basis by May – the fastest pace in 10 years.

Over the next several months, we expect to witness a multi-month price level adjustment, which will feel a lot like a shift higher in *inflation*. However, over the second half of 2021 as the U.S. economy continues to normalize, we believe sequential (quarter-over-quarter) growth in real economic activity and prices will slow, bringing down the y/y rate of inflation. We expect core Consumer Price Index (CPI) inflation will end the year running modestly below 2%, and although core CPI is expected to accelerate to 2.2% in 2022, differences in index construction mean that the Fed's preferred core personal consumption expenditures (PCE) price measure will lag. This disappointment might be all the markets need to moderate expectations for tighter Fed policy.

In what follows, we provide answers to the most common questions we get on the U.S. inflation outlook, as investors prepare for what we anticipate will be an inflation head fake.

Q: WHY ARE YOUR INFLATION FORECASTS LOWER THAN THE FED'S?

A: The Federal Open Market Committee (FOMC) – the Fed's policymaking arm – is projecting core PCE inflation of 2.2% at the end of this year, which is 0.5 percentage points above our forecast and 0.3 percentage points above Bloomberg consensus. FOMC members don't release the details of their forecasts, but based on their comments, it appears that the Fed is expecting a somewhat larger lag between the time that supply comes back online after pandemic-related disruptions, and when demand accelerates. While we agree that a perfect storm of pandemic-related factors contributed to global factory and shipping bottlenecks, we think the brunt of the price increases from these issues have already happened, and we're skeptical that the situation will worsen enough to drive core inflation 0.5 percentage points higher than we currently expect over the coming months.

Q: HOW ARE SUPPLY CHAIN DISRUPTIONS AFFECTING U.S. INFLATION?

A: The current bottlenecks in global shipping started late last year after retailers cut orders in early 2020 expecting a slump in sales, only to be surprised by rapid recovery in consumer demand, as consumers invested in durable goods that were direct substitutes for the services affected by the pandemic. This demand, in turn, caught the shipping industry off guard and contributed to container shortages, higher freight rates, and slower lead times. The situation was particularly acute for the shipping routes from China to the west coast of the U.S.

However, with container ship freight rates already at multi-year highs and retailers passing on additional costs to consumers, we wonder just how much more inflation we should expect. Indeed, retail-goods inflation has already accelerated back to flat after declining 1.5% y/y in May of last year. Our forecasts expect that pace will climb to 2% y/y over the next several months – the fastest rate in over 10 years. However, we don't expect persistent *inflation*. Indeed, just as consumers substituted various services for durable goods in 2020, we suspect that demand for durable goods will cool somewhat in 2021 as a higher portion of the population is vaccinated and begins to once again consume services. This cooling demand could mitigate retailers' ability to pass on the higher costs, offsetting inflationary pressures in other service categories, such as airfare and lodging.

Q: WHAT ABOUT THE SEMICONDUCTOR SHORTAGE?

A: Similar to the problems plaguing the retail goods supply chain, the global semiconductor shortage (see our recent blog post, "Global Chip Shortage: The Winners and Losers") is disrupting U.S. auto production at a time when auto inventories were already low. Semiconductors only account for an estimated 3% of the total cost of building a car. However, production disruptions are contributing to vehicle supply shortages, which are, in turn, raising prices.

In 2020, car sales surged in the wake of the pandemic, thanks to demand for alternatives to public transportation, low rates, and government stimulus. At the same time, COVID-19 outbreaks shuttered vehicle assembly plants. As a result, the inventory-to-sales ratios for auto retailers fell to a 20-year low. New and used vehicles account for about 6.7% of the CPI basket, so this dynamic has had an impact on overall prices. Similar to our expectations for retail goods inflation, the inflationary effects of these supply frictions should be temporary. However, over the next few months, we expect low inventories to raise prices further, and the auto production disruption did cause us to nudge our inflation forecast for this year modestly higher. In the second half of this year, as bottlenecks clear and consumers moderate some of their durable goods purchases, auto inflation should also eventually normalize.

Q: HOUSING PRICES ARE RISING AT THE FASTEST RATE IN 15 YEARS. WHAT DOES THAT MEAN FOR RENTAL INFLATION?

A: U.S. home prices have increased 11% over the past year as demand for more space away from large city centers and increased housing affordability from low interest rates have bumped up against low supply. However, before translating this into an outlook for shelter inflation, it's important to keep in mind that home prices have not been included in U.S. inflation indexes since the 1980s. The U.S. statistical agencies consider buying a home an *investment* and, instead, use rental rates to measure changes in the cost of shelter – even for homes that are owner-occupied.

As a result, rent and owners' equivalent rent (OER) are more sensitive both to trends in labor markets and to how expensive owning a home is versus renting. The pandemic-period behavior of shelter inflation is consistent with this: Even though home price inflation is up sharply, rental inflation has actually fallen. In fact, rental inflation, as measured by the Bureau of Labor Statistics, is down from 3.3% y/y before the pandemic to 2.0% y/y as of March 2021. Looking ahead, although the lagged effects of a strong labor market recovery and rising rates should contribute to a bottoming in CPI-based rental inflation in the second quarter, the CPI should not be expected to mirror the strength in housing inflation.

Q: DOES PIMCO'S FORECAST INCORPORATE NORMALIZING AIRFARES AND LODGING PRICES AS A GREATER PORTION OF THE POPULATION STARTS TRAVELING?

A: Yes. Over the past year, prices for COVID-sensitive sectors have been quick to adjust to the overall level of activity. Just as we saw prices move sharply lower as travel ground to a halt last year, we are now expecting strong recovery as travel resumes. High-frequency data suggest that mobility and air traffic in the U.S. started to improve meaningfully in March, and for the price level for these sectors to fully recover to pre-COVID levels in late 2022.

However, while we do expect strong price recovery, these sectors make up a relatively limited part of the overall CPI basket. Hotels and airfare each account for less than 1% of CPI. As a result, a strong recovery for these sectors will support our near-term forecast for a head fake. That is to say, they will likely create some volatility in the monthly reports but are not a significant enough part of the basket to drive the overall trajectory for U.S. inflation.

Q: WON'T PENT-UP DEMAND AND EXCESS SAVINGS CONTRIBUTE TO HIGHER INFLATION?

A: Recovering demand should help prices normalize this year, but this should be thought of as a multi-month price level adjustment, and not a rise in inflation. While we do expect consumers to save less of their government stimulus checks in 2021, we don't expect them to spend a large part of the excess savings accumulated last year. In other words, the savings rate is likely to normalize but not drop too much below its pre-pandemic level. We are forecasting this for a few reasons: First, historically after recessions, the savings rate tends to remain somewhat elevated relative to its pre-recession level as consumers build back savings and ensure they can maintain consumption in the event of another downturn. Second, much of this excess saving is concentrated on the balance sheets of wealthy households, which are more likely to continue saving and investing the additional wealth. All of this suggests that while government stimulus measures will likely close the output gap this year, we don't expect a large and persistent overshoot of the output gap to contribute to runaway inflation. (See our recent blog post, "Focusing on Inflation May Miss the Bigger Risk.")

Q: WHAT ABOUT THE FED'S PREFERRED MEASURE, PCE INFLATION?

A: Over the next few months, we expect PCE inflation to accelerate faster than CPI. Indeed, we expect core CPI to reach 2.2%, while PCE is expected to peak at 2.3%. However, over the next year, PCE inflation is likely to drop back below CPI and only gradually accelerate toward the Fed's 2% target. Part of the reason for this is that the PCE-based consumer price basket is constructed using weights that evolve along with changing consumption patterns. So when last year's consumption patterns shifted toward durable goods, this boosted the weight of durable goods in the PCE, resulting in a larger contribution to overall inflation. However, as economic activity normalizes and the weights of the PCE basket revert, PCE inflation should lag the CPI somewhat. Furthermore, because shelter prices make up a smaller portion of the PCE price basket irrespective of changing trends in consumption, the PCE has been less affected by disinflationary trends in rental markets. This boosted PCE relative to CPI as rental inflation was falling, but should reverse later this year when rental inflation starts to recover.

THE BOTTOM LINE

Over the next several months, we expect to witness a multi-month *price level* adjustment in the U.S., which will feel a lot like a shift higher in *inflation*. The March CPI report released this week confirmed the first month of this multi-month price level adjustment, with core inflation up 0.3% m/m, and we could get similar readings in April and May. However, over the second half of 2021, as the economy further normalizes, we expect sequential growth in real economic activity and prices to slow, moderating the y/y pace of inflation.

U.S. Federal Reserve (Fed);

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CMR2021-0411-1599091