MORNING BRIEFING
March 16, 2021

Inflation: Asking for Trouble?

Check out the accompanying chart collection.

(1) In 2016, Yellen wondered what determines inflation. (2) Now Yellen says any inflation pickup will be fleeting. (3) The Phillips curve: Fuhgettaboutit! (4) The 1970s were so yesterday. (5) Lots of job openings. (6) Skills mismatch or generous unemployment benefits, or both? (7) Small business owners need help but can't find workers. (8) Mixed readings on wage inflation. (9) Commodity and PPI costs soaring. (10) The base effect. (11) A sign of trouble for consumer price inflation. (12) SEC issues warnings about SPACs.

YRI Podcast. In our latest video podcast, Dr. Ed discusses the main points of today's *Morning Briefing.*

Inflation I: Do They Know What They Are Doing? In my 2020 book *Fed Watching for Fun and Profit*, I reviewed the October 14, 2016 speech by then-Fed Chair Janet Yellen at a conference sponsored by the Boston Fed and attended by Fed and academic economists. The topic of discussion: "The Elusive 'Great' Recovery: Causes and Implications for Future Business Cycle Dynamics." Her talk was titled "Macroeconomic Research After the Crisis." It was a remarkable speech that should have been titled "Macroeconomic Research in Crisis."

She talked about "hysteresis," the idea that persistent shortfalls in aggregate demand could adversely affect the supply side of the economy. Then she rhetorically asked: "If we assume that hysteresis is in fact present to some degree after deep recessions, the natural next question is to ask whether it might be possible to reverse these adverse supply-side effects by temporarily running a 'high-pressure economy,' with robust aggregate demand and a tight labor market." At the time, my commentary on her speech was titled "Some Like It Hot." I concluded that Yellen was in no hurry to rush the pace of rate hikes.

What I found unusual about her speech was that she admitted that there might be "limits in economists' understanding of the economy." Then she proceeded to list several questions that she hoped "the profession will try to answer." She got into some real meaning-of-life questions for macroeconomists. For example: “How does the financial sector interact with the broader economy?” Now get this one: “What determines inflation?”

Yellen is back as Secretary of the Treasury. Once again, she wants to run the economy hot so that the labor market will get back to full employment by next year. She endorsed Biden’s $1.9 trillion American Rescue Plan and promised that it will get us there. Now she undoubtedly will lobby for Biden’s Build Back Better plan to add even more heat to the economy.

This past Sunday on ABC’s “This Week,” Yellen acknowledged that inflation is likely to move higher in coming weeks. Apparently, she now knows what determines inflation. So she confidently claimed that it will be “temporary.” She added, “To get a sustained high inflation like we had in the 1970s, I absolutely don’t expect that. We’ve had a very well anchored inflation expectations, and a Federal Reserve that’s learned about how to manage inflation. So I don’t think it’s a significant risk, and if it materializes, we’ll certainly monitor for it, but we have tools to address it,” she stated. Inflation? There’s an app for that!

Fed Chair Jerome Powell seems to be fully on board. Both Yellen and Powell believe that the inflationary consequences of all the fiscal and monetary gasoline they are pouring onto the already hot economy will be “transient.” Besides, both would like to see higher inflation for a while.

What about the Phillips curve that posits an inverse relationship between unemployment and inflation? “Fuhgettaboutit” seems to be their implicit answer to a question that macroeconomists are no longer asking. Both Yellen and Powell worried about it in the past, and so did most macroeconomists. Now . . . not so much. That’s because price inflation remained remarkably subdued before the pandemic during 2019 when the labor market obviously achieved full employment.

Debbie and I find ourselves agreeing with Yellen and Powell that the inflationary consequences of their policies should be transient. That’s because we believe that productivity growth was rebounding before the pandemic and was accelerated by it. We see lots of technological innovations that could heat up productivity growth, which is the best way to cool off inflationary cost pressures, which are currently clearly mounting.

Nevertheless, we aren’t as certain as Yellen and Powell seem to be that the unprecedented stimulus provided by T-Fed won’t cause a more troubling burst of inflation, even if it is transient. We doubt that it would lead to a secular inflation problem simply because we can't see the Bond Vigilantes allowing that happen.

Before we examine the latest developments on the inflation front, let's go back to the 1970s experience.

Inflation II: 1970s Wage-Price Spiral Again? In the US, the worst inflationary experience following World War II occurred during the 1970s. Almost everything that could go wrong on the inflation front did so back then. I reviewed what happened in my 2020 book *Fed Watching for Fun and Profit*. (See the excerpt.)

For starters, on August 15, 1971, President Richard Nixon suspended the convertibility of the dollar into gold. The value of the dollar in foreign exchange markets suddenly plummeted. That caused spikes in import prices as well as the prices of most commodities priced in dollars. During 1972 and 1973, for the first time since the Korean War, farm and food prices began to contribute substantially to inflationary pressures in the economy. Also, there was a major oil price shock during 1973 and again in 1979.

As a result, the Consumer Price Index (CPI) inflation rate soared from 2.7% during June 1972 to a record high of 14.8% during March 1980 (*Fig. 1*). Even the core inflation rate (i.e., the rate excluding food and energy) jumped from 3.0% to 13.0% over this period as higher energy costs led to faster wage gains, which were passed through into prices economywide. During the 1970s, strong labor unions in the private sector succeeded in quickly boosting wages through cost-of-living clauses in their contracts. The result was an inflationary wage-price spiral (*Fig. 2*).

Then-Fed Chair Paul Volcker stopped the inflationary wage-price spiral by tightening monetary policy significantly during the late 1970s and early 1980s, causing a severe recession. Inflation has continued to trend lower since then through today, mostly because of the four deflationary forces (i.e., the "4Ds"), which we have discussed many times along the way. (For a summary, see the excerpt titled "Four Deflationary Forces Keeping a Lid on Inflation" from my 2020 book.)

Inflation III: The Year of Living Dangerously. It's our view that the 1970s were uniquely inflation prone. A 1970s-style wage-price spiral now is unlikely, in our opinion, notwithstanding the fiscal and monetary excesses of our government. Numerous commodity price shocks since then haven't done much to boost inflation. Wage inflation has remained subdued ever since Volcker stopped the wage-price spiral.

Nevertheless, we want to be alert to the inflationary potential of the recent surge in commodity prices and other nonlabor costs. The same goes for labor market developments that might put upward pressure on wages. Let's review the latest relevant data:

(1) *Job openings.* It's hard to worry about a wage-price spiral when during February 10.0 million people were still unemployed and the labor force was down 4.2 million y/y. Also during the February 20 week, 20.1 million people received unemployment benefits. Then again, there are mounting signs that the labor market is tight. That could be because of a mismatch between jobs and skills. It could also be caused by very generous unemployment benefits providing a disincentive for people to return to work before those benefits run out, and the Biden plan just extended them through September!

January's JOLTS (Job Openings and Labor Turnover Survey) report showed that there were 6.9 million job openings during January, down only 0.2 million from a year ago just before the pandemic (*Fig. 3*). The ratio of unemployed workers to job openings fell to 1.46 during January, the lowest since last March (*Fig. 4*). The number of quits has soared from a low of 2.1 million during last April to 3.3 million during January, not much below pre-pandemic readings (*Fig. 5*). Perhaps some workers quit to stay home with their kids until childcare facilities and schools fully reopen. Others might have quit while collecting unemployment benefits.

Now get this: The survey of small business owners conducted by the National Federation of Small Business (NFIB) during February found that a record 40.0% had job openings and that 51.0% of those could find few or no qualified applicants for the open positions (*Fig. 6*).

(2) *Wages.* February's NFIB survey found that 19.0% of small business owners plan to raise worker compensation in the next three months (*Fig. 7*). That's actually a relatively high reading for this series, which has a good record as a leading indicator for wage inflation, measured as the y/y percent change in the average hourly earnings of production and nonsupervisory workers. The problem with this wage inflation series is that it has been biased upward since the start of the pandemic, as most of the job losses occurred among low-wage workers.

During January of last year, wage inflation was 3.3% y/y. It jumped to 7.8% during April. It was back down to 5.1% during February. The Atlanta Fed's wage growth tracker doesn't seem to have the same problem and has been hovering around 3.5% for the past year (*Fig. 8*).

(3) *Commodity prices.* Both the Goldman Sachs Commodity Index and the CRB all commodities spot price index have been soaring over the past 52 weeks (*Fig. 9*). The former is up 65.0% y/y, while the latter is up 28.5% y/y.

The CRB raw industrials spot price index (up 28.5% y/y) is highly correlated with both the core crude materials Producer Price Index (PPI) (up 24.9%) and the core intermediate goods PPI (up 5.7%) (*Fig. 10* and *Fig. 11*).

(4) *PPI.* Both Yellen and Powell have said that inflation measures based on y/y comparisons are bound to rise temporarily, mostly because prices were depressed by the lockdowns a year ago. That "base effect" is already showing up in the inflation rate of the PPI for final demand, which bottomed last year at -1.5% during April (*Fig. 12*). It jumped to 2.8% during February and is bound to move higher still in March and April.

(5) *Consumer prices.* The PPI dataset includes a series for personal consumption (*Fig. 13*). As one would expect, its inflation rate is highly correlated with the inflation rate for the CPI and PCED (personal consumption expenditures deflator). The PPI's personal consumption component was up 2.5% during February, while the CPI was 1.7% during the month and the PCED was 1.5% during January.

By the way, February's NFIB survey found that 34.0% of small business owners are planning on raising their average selling prices, while 25.0% are doing so (*Fig. 14*). Both are the highest readings since 2008.

Strategy: SEC Attacks SPACs. Last week on March 10, the Securities and Exchange Commission (SEC) issued an alert titled "Celebrity Involvement with SPACs–Investor Alert." It follows up on a December 10, 2020 SEC bulletin titled "SPACS—What You Need to Know."

The December bulletin warns about some inherent conflicts of interests among sponsors of SPACs (special purpose acquisition companies). For starters, "investors should be aware that although most of the SPAC's capital has been provided by IPO investors, the sponsors and potentially other initial investors will benefit more than investors from the SPAC's completion of an initial business combination and may have an incentive to complete a transaction on terms that may be less favorable to you."

Furthermore, "additional funding from the sponsors may dilute your interest in the combined company or may be provided in the form of a loan or security that has different rights from your investments."

The recent alert warns that "celebrity involvement in a SPAC does not mean that the investment in a particular SPAC or SPACs generally is appropriate for all investors. Celebrities, like anyone else, can be lured into participating in a risky investment or may be better able to sustain the risk of loss. ***It is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment."*** The SEC put that last sentence in bold and italics for emphasis.

Now that you have been warned, let us know if you have a SPAC that might be interested in acquiring an economic and investment research firm. This does not constitute an offer to sell, a solicitation of an offer to buy, or a recommendation of any security or any other product or service. Just curious.

The bottom line is that a few of the speculative excesses in the market are under scrutiny by the regulators. The SEC is warning about SPACs with conflicts of interest, and the major central banks are warning about cryptocurrencies being used for illegal activities.

CALENDARS

US: Tues: Retail Sales Total & Control Group -0.6%/-1.1%, Headline & Manufacturing Industrial Production 0.4%/0.2%, Capacity Utilization Rate 75.6%, Business Inventories 0.3%, NAHB Housing Market Index 83.0, Export & Import Prices 1.2%/1.0%. **Wed:** Housing Starts & Building Permits 1.56mu/1.75mu, MBA Mortgage Applications, EIA Crude Oil Inventories, Fed Interest Rate Decision 0.25%, FOMC Economic Projections. (DailyFX estimates)

Global: Tues: Eurozone ZEW Economic Sentiment, Germany ZEW Economic Sentiment 74.0, France CPI -0.1%m/m/0.4%y/y, Italy CPI 0.1%m/m/0.6%y/y, Japan Industrial Production. **Wed:** Eurozone Headline & Core CPI 0.9%/1.1% y/y, Canada CPI 0.7%m/m/1.3%y/y, Australia Employment Change & Unemployment Rate 30k/6.3%, Mauderer, Elderson. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes last week and were at record highs simultaneously for the first time since October 2018. LargeCap's was at a record high for a second straight week; MidCap's for a fifth week; and SmallCap's for the fifth time in six weeks. In what has shaped up to be a typical V-shaped recovery, LargeCap's forward earnings has risen during 42 of the past 43 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 39 of the past 41 weeks, and SmallCap's posted 39 gains in the past 42 weeks. LargeCap's forward earnings is now up 27.8% from its lowest level since August 2017; MidCap's has risen 55.6% from its lowest level since May 2015; and SmallCap's is up 92.0% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings improved to a 12-month high of 1.6% y/y from 0.4%. That's up from mid-May's -19.3%, which was the lowest since October 2009, and down from 23.2% in September 2018, which was the highest since January 2011. The yearly rate of change in MidCap's forward earnings rose w/w to a 25-month high of 7.5% y/y from 6.6% y/y and is up from a record low of -32.7% at the end of May; that compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's rate turned higher too, rising to a 25-month high of 13.4% y/y from 11.0% y/y; it is up from a record low of -41.5% in early June. SmallCap's prior record low in its y/y percent change occurred during July 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October 2018. Analysts' y/y earnings growth forecasts for 2020 are still down substantially since early March but have been improving since July as companies easily beat low-balled consensus estimates for Q2 and Q3. Here are the latest consensus earnings growth rates for 2020, 2021, and 2022: LargeCap (-13.5%, 24.2%, 15.2%), MidCap (-22.8, 49.4, 16.3), and SmallCap (-27.9, 66.8, 19.9).

S&P 500/400/600 Valuation (*link*): Valuations surged higher for all three of these indexes last week. LargeCap was the smallest gainer; its forward P/E rose 0.4pt to 21.9. That's down from a 19-year high of 22.7 in early January and up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's jumped 0.9pt to a seven-month high of 20.5. Its current level is 2.4pts below its record high of 22.9 in early June. SmallCap's soared 1.2pts w/w to 21.6. It's now down 5.1pts from its record high of 26.7 in early June. That compares to MidCap's 10.7 and SmallCap's 11.1 in March 2020, which were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 30th week, but by only 0.3pt. That's the longest stretch at a discount since May and during 2002-03. SmallCap's P/E had been mostly below from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a premium to MidCap's for a ninth week after 11 weeks at a discount. At the beginning of the year, it had been at the steepest discount to that index since January 2006.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. In the latest week, the S&P 500's Q1-2021 estimate rose 1 cent to $39.62, instead of declining as typically seen in the three weeks before the quarter's end. That $39.62 estimate for Q1-2021 represents a gain of 19.6% y/y on a frozen actual basis and a 22.3% y/y gain on a pro forma basis. That would be the first quarter of double-digit percentage growth since Q4-2018 and compares to a pro forma 4.1% gain in Q4-2020. Seven sectors are currently expected to post positive y/y earnings growth in Q1-2021, but the final results are likely to be higher. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2021 versus their final Q4-2020 growth rates: Consumer Discretionary (71.2% in Q1-2021 versus -2.6% in Q4-2020), Financials (65.0, 24.0), Materials (42.8, 22.7), Information Technology (23.4, 20.0), S&P 500 (22.3, 4.1), Health Care (17.6, 10.6), Communication Services (13.5, 10.2), Utilities (2.0, -2.7), Consumer Staples (-0.2, 5.4), Real Estate (-0.3, -10.7), Industrials (-12.4, -36.6), and Energy (-14.1. -105.2).

US ECONOMIC INDICATORS

Regional M-PMI (*link*): The New York Fed gives the first glimpse of manufacturing activity in March and shows growth in the region expanded at its fastest pace since last summer, while price inflation accelerated at the fastest clip in a decade for both input and output prices. March's composite index climbed for the second month to 17.4 after falling steadily from 17.0

last September to 3.5 by this January. The new orders (to 9.1 from 10.8) measure showed billings expanding at a pace similar to February's rate, while the shipments (21.1 from 4.0) gauge was up notably—to its highest reading since November 2018. Meanwhile, both employment (to 9.4 from 12.1) and the average workweek (10.9 from 9.0) continued to increase modestly this month. In the meantime, delivery times (to 11.4 from 9.1) continued to lengthen, and inventories (8.1 from 6.5) were somewhat higher. The prices paid (to 64.4 from 57.8) index shows inflationary prices are skyrocketing; the measure bottomed at 4.1 last May. Meanwhile, the prices- received (24.2 from 23.4) index held around February's pace, but has accelerated sharply from last April's low of -8.4. Looking ahead, the survey showed firms remained optimistic, with the index for future business conditions (to 36.4 from 34.9) moving higher as the shipments (46.5 from 35.1) measure bounced up and employment (31.4 from 16.6) expectations climbed to their highest level in over 10 years. Meanwhile, the prices-paid (to 64.4 from 55.8) and prices-received (38.3 from 32.5) indexes continued to march upward; they bottomed at 14.9 and 0.6, respectively, last April.

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