MORNING BRIEFING
May 17, 2021

Inflationary Boom or What Else?

Check out the accompanying chart collection.

(1) Reagan & Volcker versus Biden & Powell. (2) Different spins on the inflationary boom from pessimists and optimists. (3) Tech-led productivity is the only way out of this mess. (4) Too many college graduates. (5) The meaning of post-pandemic life. (6) Fear of shortages versus fear of inflation. (7) Business cycle on fast track. (8) Base-effect inflation should diminish in coming months, but rent inflation could rebound. (9) Two conflicting measures of medical care services inflation. (10) Inflation remains subdued according to Cleveland Fed's median CPI. (11) Movie review: "The Woman in the Window" (+).

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

US Economy I: Regime Change & Alternative Scenarios. There certainly are lots of moving parts to consider when forecasting the outlook for the US economy. But maybe, if we keep it simple, the path ahead will be clearer.

In the early 1980s, President Ronald Reagan and Fed Chair Paul Volcker broke the back of inflation, setting the stage for the disinflationary economic boom of the 1980s-2010s. Now at the start of the 2020s, President Joe Biden and Fed Chair Jerome Powell are setting the stage for an inflationary boom.

Of course, that's an over-simplification but offers a useful perspective as we consider the following possible outlooks, with our subjective probabilities of each in parentheses:

(1) *Classic boom/bust cycle (15%).* Pessimists can predict that the boom won't last very long because it will be too inflationary, causing bond yields to soar and the Fed to tighten monetary policy sooner rather than later. In the past, rising interest rates would eventually trigger a financial crisis that turned into a widespread credit crunch and a recession (*Fig. 1*). Booms, especially inflationary ones with lots of speculative excesses, tended to lead to busts and bear markets in stocks. That scenario raises the interesting question of how we will get out of the next mess. That's

a subject for another day, hopefully not too soon.

(2) *Prolonged inflationary boom (10%).* Optimists can counter that an inflationary boom with rising interest rates doesn't have to lead to a recession, at least not for a while. If it doesn't, that scenario would certainly boost earnings much more than widely expected for the next couple of years and offset any decline in valuation multiples. The direction of the stock market would be sideways in this scenario, with plenty of opportunities for stock pickers to outperform.

(3) *Productivity-led boom (60%).* A more optimistic and bullish outlook hinges on productivity leading the boom, which may be happening already (*Fig. 2*). Productivity offers the only way to overcome the increasingly troublesome structural shortage of workers, especially skilled ones. There are certainly too many people with college degrees and not enough people with skills of the various trades (*Fig. 3*).

(4) *Stagflation (15%).* Alternatively, without a tech-led productivity boom, the result could be a return to the stagflation of the 1970s with rising costs getting pushed into prices, resulting in an inflationary spiral, making the pessimists right. Keep in mind, though, that productivity growth collapsed during the 1970s, while it's been heading higher since late 2015 (*Fig. 4*).

(5) *Bottom line.* The subjective probabilities we assigned to these four scenarios imply a 60% probability that the rebound in inflation will be transitory and a 40% probability that it will be more lasting. What about deflation? That's a possible eventual scenario but only after the boom turns into a bust.

US Economy II: Consumers Will Decide. The outlook will also depend largely on how consumer behavior might have been affected by the pandemic. Consumers' responses to the recent jump in inflation will be especially important. Consider the following:

(1) *Will they buy in advance of price increases?* The Internet has allowed consumers to become extremely price conscious, easily finding what they want at the lowest price offered and even shipped to their doors at no charge. They haven't felt compelled to buy in advance of price increases ever since the Great Inflation of the 1970s. In recent years, bursts of demand more often have been caused by big discounts offered during Black Fridays and Prime Days.

(2) *Will they buy in advance of shortages?* Perhaps now in the post-pandemic era, frequent and widespread shortages will convince consumers to buy what they need before the goods and services have sold out, even if they have to pay more than the list price and certainly without getting any discount. Fear of shortages of goods and fully booked services may be the new

normal. The price is no longer an issue; it's getting the rolls of toilet paper, used cars, and hotel rooms we need and want before they have run out.

(3) *Is the meaning of life still shopping?* The pandemic may have made consumers realize that life is short. They have had some time to reflect on the meaning of life. Many might have concluded that it is all about shopping, dining out, good seats in the stadium, and more sightseeing vacations. Their attitudes toward working for a living might also have changed, with more expecting to work from home or come and go as they please as long as they get the job done. Some might have decided that living on government benefits beats working for a living.

In addition to dealing with the recent jump in prices, consumers have other challenges up ahead. A significant slowdown in consumer spending and the economy is possible later this year when unemployment benefits run out and moratoriums on rents, mortgages, and student loans come to an end. Then again, the 12 months through March saw $4 trillion more in M2-type liquid assets than a year ago, and consumer revolving credit is down $97 billion over the 12 months through March. And of course, there is a record number of job openings for those who would like to go back to work.

(4) *What will businesses do about rising labor costs?* The outlook will also depend on how businesses respond to the shortage of labor. If they scramble to increase wages without increasing productivity, they will have no choice but to raise prices, resulting in a wage-price spiral. They might still find there simply aren't workers to fill their open positions even at higher pay, forcing them to reduce their output, resulting in shortages and upward pressure on prices.

(5) *So where do we stand?* Recognizing that there are important differences between the 1920s and the 2020s, we think the similarities will prevail. Consumers certainly seem to be in a Roaring 2020s mood. They've accumulated lots of savings that could keep the economic boom going for a while. Nevertheless, we expect that their pent-up demand during the pandemic will diminish over the rest of this year and that producers will restock their inventories, alleviating shortages. The Roaring 1920s was a period of great technological innovations that boosted productivity and standards of living. The same is likely to happen during the 2020s. Stay tuned.

US Economy III: The Inflation Question, Again. The US economy has experienced a V-shaped recovery, with real GDP surpassing its previous Q4-2019 peak during the current quarter (*Fig. 5*). As of May 14, the Atlanta Fed's *GDPNow* model showed real GDP for Q2 tracking at a remarkable 10.5% annual rate. So Q2 marks the end of the full recovery in real GDP and the beginning of the expansion phase of the economy. Booms usually occur at the tail end of expansions. This time, a combination of insanely stimulative fiscal and monetary policies has resulted in an unprecedented boom at the start of the current expansion.

But is it an inflationary boom? There's no question that inflation is back. But is it transitory, as Fed officials believe, or here to stay for a while? Debbie and I are in the transitory camp, for now. Neither the higher-than-expected jumps in April's CPI (up 4.2% y/y) nor those in the PPI (up 6.2% y/y) resolved the debate (*Fig. 6*). Consider the following:

(1) *CPI upside outliers.* Some CPI categories were driven higher by the "base effect." These prices were depressed by the year-ago lockdown: car & truck rental (up 82.2%!), gasoline (49.6), lodging (7.3), and airfares (9.6) (*Fig. 7*). These prices were boosted by the boom in housing demand: appliances (12.3) and furniture (7.8) (*Fig. 8*).

Used car prices jumped 21% (*Fig. 9*). The pandemic increased the demand for cars as people decided driving by themselves would be a safer means of transportation than taking mass transit. The Manheim Index for used car prices suggests another big jump in the CPI measure of this price during May.

The base effect should diminish over the next few months, providing a better handle on the underlying trend in consumer price inflation. We reckon that the headline CPI inflation rate will range between 3%-4% through the summer and then settle down to 2.0%-2.5% later this year.

(2) *CPI moderates.* Meanwhile, several of the more heavily weighted components of the CPI continue to moderate. Rent of primary residence was down to 1.8% y/y during April from 3.5% a year ago (*Fig. 10*). Owners' equivalent rent was down to 2.0% from 3.1% a year ago. These two components could turn from headwinds to tailwinds for inflation if more renters decide to stay put than to buy houses, which have seen their prices soar as a result of strong pandemic-related demand and a shortage of supply.

Also moderate has been the CPI inflation rate of medical care commodities (-1.7%) and medical care services (2.2) (*Fig. 11* and *Fig. 12*). However, we are concerned to see that the PCED for medical care services has been trending higher, rising to 3.5% during March, matching February's rate, which was the highest since December 2007. This measure has tended almost always to be lower than its CPI counterpart. Now it is rising above it. This effect may be pandemic related, as the CPI includes out-of-pocket costs to consumers of medical care services, while the PCED version of this measure includes government payments for medical care services. The government is clearly spending a great deal on Covid-related medicines, vaccinations, and hospital stays.

(3) *CPI alternative measures.* The Cleveland Fed *calculates* a whacky "median CPI," which

"excludes all price changes except for the one in the center of the distribution of price changes, where the price changes are ranked from lowest to highest (or most negative to most positive)" (*Fig. 13*). According to the research, "the median CPI provides a better signal of the underlying inflation trend than either the all-items CPI or the CPI excluding food and energy." Okay, what did it show for April? The median CPI was up only 2.1% y/y. It is down from a recent peak of 3.0% during October 2019.

The Cleveland Fed also has a "trimmed mean CPI," which is a weighted average of one-month inflation rates of components whose expenditure weights fall below the 92nd percentile and above the 8th percentile of price changes. It was up only 2.4% y/y during April.

The Cleveland Fed's website claims: "By omitting outliers (small and large price changes) and focusing on the interior of the distribution of price changes [the two alternative measures] … can provide a better signal of the underlying inflation trend than either the all-items CPI or the CPI excluding food and energy (also known as core CPI)."

(4) *PPI.* The final demand PPI rose 6.2% y/y during April (*Fig. 14*). Some of that increase was attributable to the base effect given that the annualized two-year percent change was 2.3%. The final demand for goods PPI soared 10.7% y/y, led by a 67.0% y/y jump in the index for steel mill products.

The PPI release includes items for personal consumption prices. The overall index jumped 5.7% y/y during April (*Fig. 15*). It is highly correlated with the CPI, which was up 4.2% over the same period. The core PPI for personal consumption was up 3.6% during April, while the core CPI was up 3.0% (*Fig. 16*).

Movie. "The Woman in the Window" (+) (*link*) is a dark crime thriller on Netflix starring Amy Adams. It is literally so dark that brightening the TV screen didn't make any difference since it takes place in the dimly lit home of a psychologist who lives alone and rarely goes out, suffering from agoraphobia. She does have a white cat who is easy to spot. She begins spying on her new neighbors and witnesses a violent crime, which she might have imagined since she pops pills and drinks wine all day. The thriller is a bit too slow paced to be very thrilling. However, Amy Adams is a really fine actress and shines in the darkness of the film, which was originally set for release in October 2019, but was sent back for re-writes and a re-edit following audience reaction at test screenings.

Calendars

US: Mon: Empire State Manufacturing Index 22.6, NAHB Housing Market Index 84. **Tues:** Housing Starts & Building Permits, API Crude Oil Inventories. (DailyFX estimates)

Global: Mon: Italy CPI 0.4%m/m/1.1%y/y, Japan GDP -4.6% (annualized), Japan Machine Tool Orders, RBA Meeting Minutes. **Tues:** Eurozone GDP -0.6%q/q/-1.8%y/y, Eurozone Balance of Trade, UK Employment, Westpac Consumer Confidence. (DailyFX estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): Last week saw the US MSCI index fall 1.4% for its third decline in four weeks and its biggest drop in 11 weeks. The US ranked 30th of the 49 global stock markets that we follow in a week when 11 of the 49 countries rose in US dollar terms and the AC World ex-US index dropped 1.8% for its biggest decline in 11 weeks as all regions fell. EMEA was the best-performing region last week, albeit with a decline of 6.0%, ahead of EMU (-0.5%), EM Latin America (-0.7), EM Eastern Europe (-0.9), and EAFE (-1.4). EM Asia was the biggest underperformer with a decline of 3.6%, followed by BRIC (-2.4). Peru was the best-performing country last week, with an 11.3% gain, followed by Austria (4.2), Hungary (4.2), and Greece (4.1). Taiwan was the worst performer with a decline of 8.4%, followed by Singapore (5.2), New Zealand (-4.3), and Israel (-4.1). EMEA is now the top-performing region so far in 2021 with a gain of 11.0%, ahead of EMU (10.9), the US (10.0), EM Eastern Europe (9.0), EAFE (6.7), and the AC-World ex-US (5.7). The following regions are lagging: BRIC (-1.7), EM Asia (-0.3), and EM Latin America (2.0). The top-performing countries ytd: Austria (24.9), Sweden (17.5), Canada (17.4), the Czech Republic (16.1), and Norway (15.6). The biggest laggards of 2021 so far: Turkey (-20.3), Colombia (-18.6), the Philippines (-12.2), New Zealand (-11.9), and Sri Lanka (-11.4).

S&P 1500/500/400/600 Performance (*link*): All three of these indexes fell last week in their first simultaneous decline since mid-March. LargeCap dropped 1.4% for the week, a tad less then the declines for SmallCap (-1.4%) and MidCap (-1.7). LargeCap and MidCap ended the week 1.4% and 1.7% below their respective record highs on May 7, while SmallCap was 3.1% below its March 122 record on March 12. Eight of the 33 sectors were higher for the week, the lowest count since mid-March and down from 23 rising a week earlier. MidCap Energy rose 2.1% in the best performance for the week, followed by SmallCap Communication Services (1.7), SmallCap Consumer Staples (1.6), and LargeCap Consumer Staples (0.4). LargeCap Consumer Discretionary (-3.7) was the worst performer, followed by MidCap Consumer Discretionary (-3.4), SmallCap Tech (-2.8), and MidCap Tech (-2.6). SmallCap continues to lead so far in 2021 with a gain of 21.1%, ahead of both MidCap (18.0) and LargeCap (11.1). All 33 sectors are higher ytd, paced by these best sector performers: SmallCap Energy (58.1), MidCap Energy (48.6), SmallCap Consumer Discretionary (43.0), LargeCap Energy (40.2), and MidCap Materials (32.0). The biggest laggards so far in 2021, albeit with gains: MidCap Communication Services (0.9), MidCap Tech (1.8), LargeCap Tech (4.1), LargeCap Consumer Staples (4.5), and LargeCap Utilities (4.6).

S&P 500 Sectors and Industries Performance (*link*): Just three of the 11 S&P 500 sectors rose last week, but eight outperformed the composite index's 1.4% decline. That compares to a 1.2% gain for the S&P 500 a week earlier when seven sectors rose and six outperformed the index. Consumer Staples rose 0.4% for the biggest gain of the week, ahead of Financials (0.3%), Materials (0.1), Utilities (-0.4), Health Care (-0.6), Industrials (-0.6), Energy (-0.8), and Real Estate (-1.0). The worst performers this week: Consumer Discretionary (-3.7), Tech (-2.2), and Communication Services (-2.0). With respect to 2021's performance, the S&P 500 has risen 11.1% so far, with all 11 sectors higher ytd and six beating the broader index. The leading sectors so far in 2021: Energy (40.2), Financials (28.3), Materials (21.1), Industrials (18.0), Real Estate (15.0), and Communication Services (13.9). This year's laggards to date, albeit with gains: Tech (4.1), Consumer Staples (4.5), Utilities (4.6), Consumer Discretionary (4.9), and Health Care (8.5).

S&P 500 Technical Indicators (*link*): The S&P 500 fell 1.4% last week and weakened relative to its 50-day (50-dma) and 200-day moving averages (200-dma). It was above its 50-dma for an 11th week after dropping below for a week at the end of February for only the second time since early November. It was above its 200-dma for a 46th straight week last week after being below for 13 weeks through late May. The S&P 500's 50-dma rose last week for a 28th week after falling for a week at the end of October for the first time in six months. The price index dropped to 2.6% above its rising 50-dma from 4.8% a week earlier and below its 19-week high of 5.8% during mid-April. That compares to 0.1% below its rising 50-dma the week at the end of February and is down from a 13-week high of 6.0% above its rising 50-dma in mid-November. The index mostly has been trading above its 50-dma since late April 2020; it in June 2020 at 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index was above its 200-dma for a 46th week, but dropped to 12.3% above its rising 200-dma from 14.5% a week earlier. That compares to a 14-week high of 15.4% in mid-April and a 17-week low of 9.7% above at the end of February. It's down from 17.0% above in early December, which was the highest since November 2009 and up from the 26.6% below registered on March 23—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008.

S&P 500 Sectors Technical Indicators (*link*): Nine S&P 500 sectors traded above their 50-dmas last week, down from all 11 sectors above in the prior week; that compares to four above at the end of January. Consumer Discretionary and Tech moved below their 50-dmas in the latest week for the first time in seven weeks. Looking at the longer-term 200-dmas, all 11 sectors traded above them for an 11th week. During April 2020, just one sector (Health Care) was above its 200-dma. The 50-dma has been rising for all 11 sectors for six weeks. That compares to just six sectors with a rising 50-dma in mid-March, which had been the lowest count since early November. All 11 sectors have had rising 200-dmas for the past 10 weeks. Energy's 200-dma finally turned higher in mid-December after mostly falling since October 2018.

US Economic Indicators

Retail Sales (*link*): April sales were a surprise on the downside—missing consensus expectations by a large margin, though the $3.6 trillion rebound in personal saving in March—to a near record-high $6.0 trillion—suggest retail sales likely climbed to new highs at the start of Q2, as April sales could be stronger than first reported. Retail sales in April was stalled at March's record high, while the gain in March retail sales was revised upward to 10.7% (from 9.8%)—the second-largest increase on record. Meanwhile, core retail sales—which excludes autos, gasoline, building materials, and food—contracted 1.5% following March's rebound of 7.6%, which was stronger than the 6.9% preliminary estimate. Of the 13 retail sales categories, five increased while eight contracted, with motor vehicle and health & personal care retailers posting new record highs last month. Here's a snapshot of the sales performances of the 13 categories during April and versus last April's bottom: food services & drinking places (3.0% m/m & 116.8% y/y), motor vehicles (2.9 & 104.5), electronics & appliance stores (1.2 & 139.0), health & personal care (1.0 & 24.7), food & beverage stores (0.4 & 1.5), building materials & garden equipment (-0.4 & 33.8), nonstore retailers (-0.6 & 14.5), furniture & home furnishings (-0.7 & 196.4), gasoline (-1.1 & 76.1), miscellaneous store retailers (-1.1 & 83.6), sporting goods & hobby stores (-3.6 & 115.0), general merchandise (-4.9 & 15.1), and clothing & accessories (-5.1 & 726.8).

Consumer Sentiment Index (*link*): Inflation fears sent the Consumer Sentiment Index (CSI) south in early May, with the both the one-year expected inflation and long-term rates shooting up to decade highs of 4.6% and 3.1%, respectively. The rates were at 3.2% and 2.7% a year ago. The Consumer Sentiment Index (CSI) unexpectedly slumped to 82.8 in mid-May after rebounding from 76.8 in February to 88.3 in April, with both the present situation (to 90.8 from 97.2) and expectations (77.6 from 82.7) components falling, following gains of 11.0 points and 12.0 points, respectively, during the two months through April. According to Richard Curtin, director of the survey, shoppers referred to higher prices for homes, cars, and other goods on average more "than any time since the last inflationary era in 1980."

Business Sales & Inventories (*link*): Nominal business sales in March soared to a new record high, while real business sales (reported with a lag) fell in February after reaching a new record high in January. Nominal business sales rebounded 5.7% in March after falling 1.6% in February—which was the first decline in 10 months. Both sales of retailers and wholesalers reached new record highs in March, while manufacturers' was stalled in record-high territory. Real business sales dropped 3.2% in February after rebounding by the same amount in January to a new record high. Real sales of both retailers and wholesalers eased in February after jumping to new record highs in January, while real manufacturing sales slumped 3.7% in February after advancing eight of the prior nine months, by a total of 17.9%, which at the time had more than recovered its pandemic-related losses. March's nominal inventories-to-sales ratio sank to 1.26 (the lowest since April 2012) after climbing from 1.30 to 1.33 in February; it was at 1.72 last April. Meanwhile, the real inventories-to-sales ratio for February climbed to 1.37 after sinking to 1.32 in January, which was the lowest since February 2006; it had soared to a record high of 1.66 in April from 1.43 in February.

Industrial Production (*link*): Industrial production in April expanded for the 10th month since bottoming a year ago, climbing 0.7% m/m and 16.4% y/y, though is still 2.7% below its pre-pandemic level. Manufacturing output advanced 0.4% and 23.0% over the comparable periods and was 1.6% short of its pre-Covid reading. Here's a snapshot of April production by market group (and their components) since last April and where they stand relative to their pre-Covid levels: business equipment (40.4% & -0.7%), led by transit equipment (283.6 & -3.1), followed by industrial equipment (28.9 & -0.8), and information processing equipment (7.2 & +1.2). The gain in consumer goods (20.6% & 0.0%) production was led by a surge in consumer durable goods (94.8 & -4.1), while nondurable goods (8.8 & +1.3) output was more subdued.

Capacity Utilization (*link*): The headline capacity utilization rate continued to rebound from February's weather-related decline. The overall utilization rate climbed to 74.9% in April from 74.4% in March and 72.7% in February. The rate is up 10.7ppts from last April's low and is currently 4.7ppts below its long-run average. Manufacturing's capacity utilization rate advanced for the second month to 74.1% in April after tumbling from 74.6% to 71.6% in February, while the operating rate for mining increased 7.4ppts over the two-month period to 82.1%. The operating rate for utilities increased to 71.4% in April after sinking from 76.8% to 69.7% in March. The rates for all three of these sectors remained below their long-run averages.

Import Prices (*link*): Import prices have heated up the past five months, climbing 0.7% in April and

5.9% over the period, after being little changed the prior three months. Prices are up 10.6% since bottoming last April, the highest yearly rate since October 2011. Before turning positive this January (+1.0% y/y), yearly price gains had declined for 11 successive months. Petroleum prices were a big contributor to both the April and five-month gain in overall import prices—climbing 1.2% and 44.9% over the respective periods—with the yearly rate soaring 133.7%, the highest since March 2000! Meanwhile, nonpetroleum prices rose 0.7% last month and 3.4% during the five months through April, with the yearly rate accelerating 5.3%—the highest since September 2011. The yearly rate for industrial supplies & materials imports (50.7% y/y) accelerated to its highest reading since July 2008, after turning positive for the first time in a year in January, while the rate for capital goods (1.3) continued to hold around 1.0%, up from November 2019's bottom of -2.0%. The rate for consumer goods ex autos (0.8% y/y) moved further into positive territory, while the rate for autos (0.9) remained in a flat trend just above 1.0%. Food prices (7.5) have accelerated sharply recently, to the highest rate since November 2011, after bouncing around zero the past few years. Import prices are accelerating among our trading partners, with import prices for goods from the EU (5.6) increasing at the highest rate since the end of 2011, while China (2.1) posted its highest yearly gain since March 2012. The rate for the NICs (5.2) was the highest since May 2011, while the rate for Japan (1.7) recorded its highest rate since January 2012, after hovering around zero from early 2019 through the end of last year.

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