



MORNING BRIEFING

July 7, 2021

Inflationary Expectations

Check out the accompanying [chart collection](#).

(1) Powell says inflationary expectations still well anchored. (2) Powell is relieved that Fed doesn't have the same problem with sliding inflation as ECB and BOJ do. (3) Powell should set up dashboard for key inflation indicators. (4) One-year and three-year inflationary expectations currently at 4.0% and 3.6% according to FRBNY survey. (5) Americans most hurt by inflation see more of it than others do. Are they more alert to it? (6) Other surveys also show elevated short-term inflationary expectations. (7) Wage pressures rose during Q2. (8) Earned Income Proxy at record high.

Inflation I: Anchor Aweigh? Pay no attention to what you pay for goods and services over the next 12 months. That was one of the main messages in Fed Chair Jerome Powell's June 16 [press conference](#). During the Q&A, he was asked whether he believes that inflationary expectations remain anchored around 2%. Powell responded in the affirmative: "So the answer is yes, I think they are anchored and they're at a good place right now."

In his presser, Powell made a distinction between short-term and long-term inflationary expectations: "So we do tend to look at the longer-term inflation expectations, because that's really, we think, what matters for inflation. And you know, the shorter-term ones do tend to move around based on, for example, gasoline prices. So ... if gasoline prices were to spike, you'd see the shorter-term inflation expectation measures, particularly the surveys, move up. And that's maybe not a good signal for future inflation if gas happens to spike and then go back down again."

He said that he was gratified to see that long-term inflationary expectations had "moved up off the pandemic low." He hopes that the Fed can avoid the problem faced by both the ECB and BOJ "where you have expectations and inflation itself sliding down, and you have a really hard time stopping that process once it begins. ... So it's good actually to see longer-term inflation expectations move back up to a range—it's a range that's consistent with what our objectives are."

Melissa and I challenge the Fed chair to provide us all with a dashboard of the actual and expected inflation series that he and his colleagues are monitoring. We have a good idea of which ones should be on that dashboard, but it would be helpful to have him be as specific

about it as his predecessor, Janet Yellen, was about her employment dashboard.

In his prepared remarks, Powell said, “Our new framework for monetary policy emphasizes the importance of having well-anchored inflation expectations, both to foster price stability and to enhance our ability to promote our broad-based and inclusive maximum employment goal.” Are those expectations really as “well anchored” currently as Powell seems to believe?

At what point do rising short-term inflationary expectations become a long-term concern? Powell didn’t address that question since currently he’s simply gratified to see expectations rebounding from last year’s lows. His colleagues at the Federal Reserve Bank of New York (FRBNY) are tracking inflationary expectations closely in their [Survey of Consumer Expectations](#). The data start in June 2013 and are available through May of this year. Here are the latest relevant highlights:

(1) *Median one-year and three-year expectations.* In May, the median one-year and three-year expected inflation rates were 4.0% and 3.6% ([Fig. 1](#)). Both were the highest since the start of the data. The low for the one-year series was 2.3% during October 2019. The low for the three-year series was 2.4% during September of that same year. In other words, both have exceeded the Fed’s 2.0% inflation target since the start of the FRBNY survey and now well exceed it.

But are consumers’ inflationary expectations well anchored? The FRBNY survey data show that they are all over the map based on various demographic groups. However, there is a pattern. Older, less educated, lower-income Americans tend to anticipate higher inflation ahead. Of course, they are the most likely to be harmed by higher inflation and therefore perhaps see it more clearly than others.

(2) *Expectations by age.* Here are the latest one-year and three-year inflationary expectations by age demographics, according to the May FRBNY survey: under 40 years (3.2%, 2.9%), 40-60 years (4.0, 3.5), and over 60 years (4.8, 4.6) ([Fig. 2](#) and [Fig. 3](#)).

Our takeaway: Older people expect higher rates of inflation than younger people under both time horizons, perhaps because older people have more to lose with more of them on fixed incomes?

(3) *Expectations by education.* Here are the latest one-year and three-year inflationary expectations by education demographics: high school (5.6%, 4.5%), some college (4.1,

3.8), and bachelor's degree or higher (3.4, 3.2) ([Fig. 4](#) and [Fig. 5](#)).

Our takeaway: The lower the educational level, the higher the rates of inflation expected.

(4) *Expectations by income.* Here are the latest one-year and three-year inflationary expectations by annual income demographics: under 50k (4.0%, 3.8%), 50k-100k (4.5, 3.6), and over 100k (3.8, 3.5) ([Fig. 6](#) and [Fig. 7](#)).

Our takeaway: Generally, the lower the income, the greater the rates of inflation expected (with one exception in that data: the higher one-year inflation rate expected by the middle-income group than the lower-income one). Lower-income workers may be more exposed to inflation than higher-income workers.

(5) *One-year commodity inflationary expectations.* Last but certainly not least are the one-year expected inflation rates for gasoline (9.8%), rent (9.7), medical care (9.4), food (8.0), and college education (6.1). Those would be significant price increases, if they occur, in some of the most important items that people consume.

(6) *Other surveys.* The Conference Board's survey of inflationary expectations over the next 12 months jumped to 6.7% during June—the highest since March 2011. It was as low as 4.4% at the start of last year ([Fig. 8](#)).

According to the University of Michigan Surveys of Consumers, during June, references to high prices for homes, vehicles, and household durables rose to their highest levels since the all-time peak was set in November 1974 in the midst of a recession. These unfavorable perceptions of market prices reduced overall buying attitudes for vehicles and homes to their lowest point since 1982. The declines were especially sharp among households with incomes in the top third, who account for more than half of the dollar volume of retail sales.

Powell undoubtedly follows this survey closely and probably was gratified to see the inflation rates Americans expect ease somewhat in June. For the next year, consumers expect prices to increase 4.2% compared with a 4.6% increase in May. For the next five years, inflation is expected to rise by 2.8%, down from 3.0% the prior month.

Inflation II: Here and Now. For the here and now, Powell is right about the price of gasoline. It is rising and undoubtedly influencing short-term inflationary expectations. On Monday, the price of oil jumped to its highest level in six years after talks between OPEC and its oil-producing allies were postponed indefinitely, with the group failing to reach an

agreement on production policy for August and beyond.

The nearby futures price of a gallon of gasoline has rebounded dramatically from last year's low of \$0.41 on March 23 to \$2.30 on July 2 ([Fig. 9](#)). And that was before OPEC+ failed to agree on production over the past weekend. Gasoline usage has rebounded dramatically since last year's lockdown recession ([Fig. 10](#)). Here are a few more recent "here and now" inflationary indicators:

(1) *Commodity prices*. Notwithstanding the recent weakness in lumber, copper, and grain prices, both the CRB all commodities spot price index and the CRB raw industrials spot price indexes remained on very steep uptrends through July 2 ([Fig. 11](#)).

(2) *Prices-paid*. During June, the prices-paid indexes in the M-PMI survey rose to 92.1, the highest since July 1979 ([Fig. 12](#)). The comparable index in the NM-PMI survey edged down to 79.5 during June from 80.6 during May, which was the highest reading since September 2005.

US Labor Market I: Wages on the Rise. Rising inflationary expectations and rapidly increasing costs of input materials are important drivers of inflation. However, the most important driver is unit labor costs (ULC). ULC is the ratio of hourly compensation (HC) to productivity. The 20-quarter annualized inflation rate in nonfarm business ULC is highly correlated with the comparable inflation rate in the core PCE deflator ([Fig. 13](#)). The former has been trending higher since it bottomed most recently during Q4-2013 at -0.2%. It rose to 2.8% during Q1-2021.

We continue to closely monitor the monthly average hourly earnings (AHE) data. AHE focuses on wages, while HC is a broader measure that includes wages, salaries, and benefits. Let's have a look at the latest data to see which way wage inflation is going:

(1) *Composition distortion*. The headlines are full of stories about labor shortages and rising wages. The yearly percent changes in the monthly data on AHE are hard to read because they are very sensitive to the composition effect. Early last year during the lockdowns, lots of lower-wage workers lost their jobs, which perversely boosted AHE ([Fig. 14](#)). When many of them started coming back to work last spring, AHE fell.

(2) *Lower and higher wages*. In the past, Debbie and I usually have focused on the yearly percent change in AHE for all workers. Now we are focusing more on the three-month percent change in AHE (saar) of lower-wage and higher-wage workers. The former includes

production and nonsupervisory workers, who account for about 80% of payroll employment.

June's data show higher AHE gains for lower-wage workers than higher-wage workers: all workers (5.7%), lower-wage workers (6.5), and higher-wage workers (2.8) ([Fig. 15](#) and [Fig. 16](#)).

(3) *Widespread wage pressures*. Here is the performance derby of AHE over the past three months for various industries at annual rates: total (5.7%), goods-producing (6.7), service-producing (5.5), construction (7.2), natural resources (5.2), manufacturing (6.6), durable goods manufacturing (6.4), nondurable goods manufacturing (7.4), retail trade (8.6), wholesale trade (5.4), transportation & warehousing (16.7), utilities (3.7), information services (6.4), financial activities (3.0), professional & business services (6.6), education & health services (14.3), and other services (7.3).

(4) *Bottom line*. Wages have been rising at a faster pace over the past three months through June. Prior to the pandemic, wage inflation was moving higher. AHE rose 3.0% y/y through January of last year, when the unemployment rate was down to 3.5%. Most of the industries listed above have been showing annualized wage increases well above that pace over the past three months.

We still expect that productivity will offset much of the increase in hourly compensation in coming years. We are less confident about that happening over the next few quarters.

US Labor Market II: Income Hits Another Record High. Although payroll employment in June was still 6.8 million below its pre-pandemic record high during February 2020, our Earned Income Proxy (EIP) for private wages and salaries in personal income rose 0.5% m/m and 10.5% y/y during the month to yet another record high of \$6.8 trillion (saar) ([Fig. 17](#)).

We can also construct EIPs for lower-wage and higher-wage workers ([Fig. 18](#)). Both were also at record highs during June. The lower-wage EIP rose 0.3% m/m and 11.3% y/y to \$4.6 trillion (saar), while the higher-wage EIP rose 1.2% m/m and 8.8% y/y to \$2.2 trillion.

Calendars

US: Wed: Job Openings 8.3 million, MBA Mortgage Applications, API Crude Oil Inventories,

FOMC Meeting Minutes. **Thurs:** Initial & Continuous Jobless Claims 350k/3.34m, Consumer Credit \$18.4b, Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Germany Industrial Production 0.5%, Japan Leading & Coincident Indicators, Lowe. **Thurs:** Germany Trade Balance €15.4b, China CPI & PPI 1.3%/8.8% y/y, ECB Monetary Policy Statement. (Bloomberg 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 a 17th week and the first time since October 2018. LargeCap's was at a record high for an 18th straight week; MidCap's was at a record for a 21st week; and SmallCap's posted its 21st gain in 23 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 58 of the past 59 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 55 of the past 57 weeks, and SmallCap's posted 55 gains in the past 58 weeks. LargeCap's forward earnings is now up 43.7% from its lowest level since August 2017; MidCap's has risen 83.2% from its lowest level since May 2015; and SmallCap's is up 129.2% 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 edged up 0.1ppt to 39.9% y/y but is down from a record high of 40.4% at the end of May. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings rose w/w to 72.5% y/y from 71.0%. That's down from a record high of 78.8% at the end of May and up from record low of -32.7% in May 2020. SmallCap's rate dropped to 119.4% y/y from a record high of 124.2%; it is up from a record low of -41.5% in June 2020. Companies have been easily beating consensus estimates since the Q2-2020 earnings season, causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (37.1%, 11.7%), MidCap (60.9, 9.6), and SmallCap (92.5, 16.5).

S&P 500/400/600 Valuation ([link](#)): Valuations were mixed last week for these three

indexes, but they remain above their multi-month lows from mid-June. LargeCap's forward P/E rose to 21.5 from 21.2 a week earlier and is up from an eight-month low of 20.7 the week before that. That compares to a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's dropped 0.2pt w/w to 17.9 but remains 0.6pt above its 14-month low of 17.3 three weeks ago. Still, that's down from a seven-month high of 20.5 in early March. Its current level is 5.0pts below its record high of 22.9 in June 2020. SmallCap's dropped 0.3pt w/w to 17.8 but remains above its 14-month low of 17.4 in mid-June. It's now down 8.9pts from its record high of 26.7 in early June 2020. 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 41st week. That's the longest stretch at a discount since last May and during 2002-03. SmallCap's P/E had been mostly below LargeCap's from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a slim discount to MidCap's for a second straight week. It had been at an atypical discount to MidCap around the start of the year for 10 straight weeks.

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. Those gains have endured even through the current earnings warnings season, when forecasts typically decline. In the latest week, the S&P 500's Q2-2021 estimate jumped 16 cents to \$45.07. That \$45.07 estimate for Q2-2021 represents a gain of 61.1% y/y on a frozen actual basis and a 65.4% y/y gain on a pro forma basis. That would mark the second straight quarter of double-digit percentage growth and compares to a pro forma 52.8% gain in Q1-2021. Ten of the 11 sectors are expected to post positive y/y earnings growth during Q2-2021, the same as during Q1-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q2-2021 versus their final Q1-2021 growth rates: Industrials (568.5% in Q2-2021 versus 3.0% in Q1-2021), Consumer Discretionary (270.9, 226.1), Energy (225.5, 28.0), Materials (115.2, 62.4), Financials (100.3, 138.0), S&P 500 (65.4, 52.8), Communication Services (39.8, 53.1), Information Technology (31.6, 44.9), Real Estate (24.7, 5.8), Health Care (10.8, 26.7), Consumer Staples (10.1, 11.1), and Utilities (-0.9, -0.9).

Global Economic Indicators

Global Composite PMIs ([link](#)): Strong global demand continued as Q2 drew to a close, with June's C-PMI (to 56.6 from 58.5) expanding at a rate close to May's 15-year high. The report noted that the US and Europe remained the bright spots, while the Asian economies continued to struggle. The service (to 57.5 from 59.6) sector continued to outperform the manufacturing (55.5 from 56.0) sector for the third successive month—with the former the second strongest since mid-2007. The US C-PMI (63.7) was the top-ranked nation in terms of all-industry output growth in June, followed closely by Ireland (63.4), Spain (62.4), and the UK (62.2). The Eurozone's (59.5) rate of expansion accelerated at its fastest pace since mid-2006. Meanwhile, the larger economies in Asia paled in comparison. Growth in China (50.6) posted its weakest growth rate during the current 14-month sequence of expansion, while economic activity contracted in both Japan (48.9) and India (43.1). In the meantime, Australia (56.7), Russia (55.0), and Brazil (54.6) continued to expand.

US Non-Manufacturing PMIs ([link](#)): The US service sector continued to expand at a robust pace in June, though both the ISM and IHS Markit surveys showed a downtick in their measures. ISM's NM-PMI slipped to 60.1 in June after jumping from a recent low of 55.3 in February to a record-high 64.0 in May. Both the production (to 60.4 from 66.2) and new orders (62.1 from 63.9) measures took a step back in June, though remained in the neighborhood of their March record highs of 69.4 and 67.2, respectively. Meanwhile, the employment (to 49.3 from 55.3) gauge fell into contractionary territory for the first time this year; it peaked at 58.8 in May. The supplier deliveries (to 68.5 from 70.4) measure held around recent highs, reflecting the difficulties suppliers continue to experience due to the Covid-19 impact. In the meantime, price pressures remained intense, with the price index (to 79.5 from 80.6), not far from its all-time high of 83.5 September 2005. Switching to the IHS Markit NM-PMI measure, it slipped from 70.4 in May to 64.6 in June—rounding out the best quarter in PMI survey history—as June's NM-PMI was the third best on record behind May and April. Activity was robust across the service sector, showing a marked increase in new business at the end of Q2, with the upturn in new sales attributed to the acquisition of new clients. Meanwhile, input prices increased at the second-fastest rate on record as supplier price hikes and greater wage bills pushed up cost burdens.

Eurozone Retail Sales ([link](#)): Eurozone retail sales advanced in May for the third time in four months in May, up 4.6% m/m and 9.1% over the period to a new record high—3.4% above its pre-pandemic level. Two of the three major components posted significant

increases during both May and the four months through May: non-food products excluding auto fuel (8.8% m/m and 17.8% for the four months) and auto fuel (8.1 and 10.2), with the former jumping to a new record high. Meanwhile, spending on food, drinks & tobacco contracted for the third time in four months, by 0.2% m/m and 0.5% over the period. May data are available for three of the top four Eurozone economies and show sales in Germany increased for the third time in four months, by 4.2% in May and 9.9% over the period, while sales in France were up 9.9% and 5.3% over the comparable periods. Retail sales in Spain were flat in May after a 0.9% decline in April; sales were up 3.2% during the two months through March.

Germany Manufacturing Orders ([link](#)): German factory orders contracted 3.7% in May, though April's 0.2% loss was revised to a 1.2% gain, putting billings for that month within 0.4% of December 2017's record high. May's decline was driven by a 6.7% drop in foreign demand, led by a 9.3% plunge in billings from outside the Eurozone; orders from inside the Eurozone slid 2.3%. The sharp decline in orders from outside the Eurozone was fairly widespread, with capital (-10.5%), intermediate (-9.9), and consumer durable goods (-5.0) billings all posting sizeable declines during the month; consumer nondurable goods orders rebounded 12.5%, following April's 23.6% plunge. Meanwhile, domestic orders rose for the third time in four months, by 0.9% in May and 6.9% over the period. Here's a look at the performance by market group for total orders, foreign orders from inside & outside the Eurozone, and domestic orders, respectively, since bottoming last April: capital goods (106.4%, 150.2%, 100.9%, 93.6%), intermediate goods (50.0, 58.2, 46.2, 48.5), consumer durable goods (85.9, 124.2, 43.5, 94.1), and consumer nondurable goods (6.1, 4.2, 9.0, 4.7).

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