MORNING BRIEFING
July 14, 2021

Inflationary Boom Continues

Check out the accompanying chart collection.

(1) Fed's wish to overshoot inflation target has come true. (2) The temporary base-effect-and-bottleneck theory of inflation (BEABTI) is getting harder to believe. (3) CPI got hotter in June. (4) Base and baseless effects. (5) Are inflationary expectations well anchored? (6) More small businesses passing higher costs to higher selling prices. (7) ECB adopts FAITH. (8) Tapering will follow substantial progress. (9) Handicapping odds of Biden's tax plans.

Fed I: Beware of What You Wish For. Last year during August, Fed officials announced that they were aiming to overshoot their 2.0% inflation target for the PCED because they had undershot it for so long. Their wish has come true in recent months. The headline and core PCED inflation rates, on a y/y basis, rose to 2.4% and 2.0% during March and continued to move higher, to 3.9% and 3.4%, during May (*Fig. 1*). They likely moved even higher in June. Yesterday, we learned that the headline and core CPI inflation rates rose to 5.4% and 4.5% last month (*Fig. 2*).

It's getting harder to believe that all this inflation is just a transitory base effect phenomenon. That's been Fed Chair Jerome Powell's interpretation of recent inflationary pressures. In his opinion, they mostly reflect rebounds in prices that were depressed a year ago by the lockdowns and temporary supply bottlenecks resulting from a surge in demand as the economy has reopened. Consider the following:

(1) *Three-month inflation rate.* Over the past three months through June, the headline and core CPI annualized inflation rates are 9.3% and 10.2% (*Fig. 3*). Those are startling increases considering that the cost of medical care services fell at an annual rate of 0.7% over the past three months. That was more than offset by the rebounds in rent of primary residence and owners' equivalent rent to 2.7% and 3.4% (*Fig. 4*).

(2) *Base effect.* Arguably, some CPI components are up sharply as a result of the base effect, even using the latest three-month numbers (annualized): lodging away from home (62.4), airfares (84.3), and car & truck rental (148.0). However, the price of gasoline, which peaked at 98.8% during the three months through March, was up only 1.6% through June (*Fig. 5*).

(3) *Off base.* On the other hand, the following annualized price increases over the last three months seem to be more pernicious: new vehicles (16.5%), used car & trucks (121.8), motor vehicle parts & equipment (10.0), household furniture & bedding (19.2), food (6.4), apparel (9.0), tobacco (3.6), tuition & childcare (3.0), and energy services (9.2).

(4) *Expectations.* By the way, on Monday, the Federal Reserve Bank of New York (FRB-NY) released its June survey of consumers' inflationary expectations. The one-year-ahead median jumped from 4.0% during May to 4.8% last month, while the three-years-ahead median edged down to 3.6% (*Fig. 6*). June's Conference Board survey found that 12-months-ahead inflation expectations rose to 6.7% (*Fig. 7*).

In recent remarks, Powell has claimed that inflationary expectations remain "well anchored." In the July 7 *Morning Briefing*, in a story titled "Anchor Aweigh?," Melissa and I asked, "At what point do rising short-term inflationary expectations become a long-term concern?"

(5) *Small business survey.* Yesterday, we learned that June's survey of small business owners, conducted by the National Federation of Independent Business (NFIB), found that 47% of business owners are raising their average selling prices, the highest reading since January 1981, which was the tail end of the Great Inflation of the 1970s (*Fig. 8*).

Price hikes were most frequent in wholesale (82% higher, 4% lower), retail (63% higher, 1% lower), and manufacturing (62% higher, 5% lower). Seasonally adjusted, a net 44% of respondents plans to hike prices (up 1 point). The NFIB concludes, "The incidence of price hikes on Main Street is clearly on the rise as owners pass on rising labor and operating costs to their customers."

(6) *ECB.* On July 8, the ECB *announced* that it would target 2% inflation in the medium term rather than "below but close to 2%." In other words, like the Fed, the ECB will tolerate short-term overshoots to its inflation goal. The strategy change came as the ECB completed its first policy review since 2003, which began during January 2020. The ECB is joining the Fed's faith in FAITH, i.e., flexible average inflation targeting hope.

Fed II: Wait Another Minutes. The economy is growing rapidly, inflation is higher than expected, and home prices are soaring. Those were the main observations of the participants at the June 15-16 meeting of the Federal Open Market Committee (FOMC), according to the *Minutes*.

Nevertheless, the voting members of the FOMC decided to leave monetary policy as is, citing insufficient progress so far toward the Fed's "maximum employment" goal. The decision was consistent with the Fed's new emphasis on employment over inflation, which first became evident when it embraced average inflation targeting in an August 2020 *statement* reviewing the Fed's long-term goals and monetary policy strategy.

Registering his support of the decision in advance, the second-in-command FOMC official—FRB-NY President John C. Williams—gave a July 12 *speech* supporting average inflation targeting and advocating for waiting to raise interest rates for longer than usual following negative shocks to the economy such as the pandemic.

But how long is longer than usual? Only a couple of months, if Melissa and I are correct: We continue to think the Fed may start tapering its bond purchases at the end of September. After all, more FOMC officials already have raised their expectations for starting to lift the federal funds rate in 2022 rather than 2023, as their June 16 *economic projections* attest. As we discussed in our June 28 *Morning Briefing*, we expect further guidance on tapering bond purchases as soon as the July 27-28 meeting, and Fed officials have said that tapering will precede raising interest rates. So Melissa and I continue to eye the September 21-22 FOMC meeting as the one that marks the Fed's change in policy path.

By then, the pandemic federal unemployment insurance benefits will have been reduced dramatically, and schools nationwide will be back in session, as we discussed in our May 11 *Morning Briefing* titled "The Opera Ain't Over Until Papi Sings." Both conditions should drive more of the long-term unemployed and temporary stay-at-home parents back into the labor force. Powell mentioned both of these drivers in his June 16 *press conference* and in the latest Minutes.

Here is more about what the Minutes specifically said:

(1) *Growth.* "[E]conomic activity was expanding at a historically rapid pace, led by robust gains in consumer spending. A vast majority of participants revised up their projections for real GDP growth this year compared with the projections they had submitted in March."

(2) *Inflation.* "[P]articipants remarked that the actual rise in inflation was larger than anticipated, with the 12-month change in the PCE price index reaching 3.6 percent in April. Participants attributed the upside surprise to more widespread supply constraints in product and labor markets than they had anticipated and to a larger-than-expected surge in consumer demand as the economy reopened." Nevertheless, this was widely viewed as

“transitory.”

However, a “substantial majority of participants judged that the risks to their inflation projections were tilted to the upside because of concerns that supply disruptions and labor shortages might linger for longer and might have larger or more persistent effects on prices and wages than they currently assumed. Several participants expressed concern that longer-term inflation expectations might rise to inappropriate levels if elevated inflation readings persisted.”

(3) *Housing.* “A majority of participants observed that housing market activity remained strong.” The Minutes added that “…several participants highlighted, however, that low interest rates were contributing to elevated house prices and that valuation pressures in housing markets might pose financial stability risks.”

(4) *Employment.* “Many participants remarked, however, that the economy was still far from achieving the Committee's broad-based and inclusive maximum-employment goal, and some participants indicated that recent job gains, while strong, were weaker than they had expected. A number of participants noted that the labor market recovery continued to be uneven across demographic and income groups and across sectors.”

The Minutes noted that District contacts observed “trouble hiring workers to meet demand, likely reflecting factors such as early retirements, concerns about the virus, childcare responsibilities, and expanded unemployment insurance benefits. Some participants remarked that these factors were making people either less able or less inclined to work in the current environment.”

(5) *Tapering.* “The Committee's standard of ‘substantial further progress’ was generally seen as not having yet been met, though participants expected progress to continue. Various participants mentioned that they expected the conditions for beginning to reduce the pace of asset purchases to be met somewhat earlier than they had anticipated at previous meetings in light of incoming data.”

Fed III: Checking Powell’s Dashboard. If we were still in the era of standard inflation targeting—i.e., the era before August 2020—no doubt the Fed would have begun tightening policy already in response to the recent rise in inflation. But now that we are in the era of average inflation targeting, the goalposts have changed.

In our July 7 *Morning Briefing*, Melissa and I quipped that Powell should provide a public inflation dashboard so we can all see the data he is reacting to. In all seriousness, we would welcome that. But for now, Powell is clearly more concerned about employment than inflation.

Now, not only is the FOMC open to overshooting its 2.0% inflation target to make up for past inflation undershoots, unheard of before August 2020, but it also seems to be prioritizing the goal of full employment above its long-standing top goal of price stability. That commitment was reiterated by Powell during his April 28 *press conference* when he outlined various metrics that he is watching as a signal that "substantial further progress" has been achieved toward the Fed's employment goal. Powell outlined the same metrics again in the opening statement of his June 16 *press conference* following the FOMC meeting.

Here is an update on those metrics:

(1) *Employment*. Powell has been watching the headline unemployment rate but has said that it understates the shortfall in employment (*Fig. 9*). Instead, he seems to prefer the Bureau of Labor Statistics' employment measure including private and government nonfarm payrolls. It remains 6.8 million below its pre-pandemic level (*Fig. 10*).

(2) *Sector employment.* Powell also has been watching employment in specific sectors where unevenness has occurred, for example, in the leisure and hospitality sector, which remains more than 2.0 million below its pre-pandemic level (*Fig. 11*). The latest Minutes also mentioned the unevenness in sectors.

(3) *Racial employment.* Powell is paying attention not just to unevenness in sectors but also in race. Employment levels for African American and Hispanic workers have yet to recover (*Fig. 12*). The latest Minutes also mentioned the unevenness in racial employment.

(4) *Participation rate.* One of Powell's main concerns also is the labor force participation rate (*Fig. 13*). Powell has said that it has been weak due not only to skills mismatches, geographical differences, virus fears, and stagnant wages, but also because of the childcare issues created by school closures and the incentive not to work presented by supplementary federal unemployment assistance, as we discussed above. The latest Minutes also mentioned the unevenness in labor force participation.

(5) *Vaccinations.* The percentage of the population 16 years and older that is fully vaccinated against Covid-19 is also on the radar of Powell and his colleagues. The Minutes

indicated that progress on vaccines has been positive and is key to the economic recovery.

Fiscal Policy: Taxing Odds. Will there be a corporate tax increase? Possibly not, said our friend Jim Lucier at *Capital Alpha Partners* last week. Bad news for markets, however, is that the odds of a corporate tax are probably still better than even, he adds. The good news is that the odds of a corporate tax increase alone are better than the odds of a corporate tax increase and an individual tax increase combined.

These conclusions are based on a line-by-line study that Jim's team conducted of the Treasury department's fiscal 2022 "*Green Book*," released at the end of May. It provides details on the administration's tax plan. Most of the proposals are not new news, but which will stick remains up in the air. The Green Book is not proposed legislation. As such, each of its proposals will have to be introduced and passed by Congress.

Here's more of Jim's thinking on the matter:

(1) *Slow fold.* Jim's team doubts that Biden's tax proposals will happen given their exceedingly slow progress through Congress. The policy development phase of the legislative year is more than half over. July is the month that Congress begins to execute on the ideas that it developed earlier in the year.

The urgency that existed back in March, when the House and Senate moved at lighting speed to approve and implement Covid-19 aid, has vanished. More importantly, the major bills that typically move through Congress annually have not moved. The debt ceiling, which was suspended until July 31, has yet to be addressed.

The necessary first step toward passing tax increases later on a party-line vote would be a budget resolution. House Speaker Nancy Pelosi (D-CA) and Senate Majority Leader Charles Schumer (D-NY) will likely aim to "bypass their own budget committees to negotiate a budget resolution on the leadership level that they force on the House and Senate from the top-down." It is a risky strategy, but the only one that is available this late in the year, Jim reckons.

(2) *Lowering the ante.* The President proposes raising $3.7 trillion in new revenue. However, Jim's team wagers that the Green Book contains less than $1 trillion in tax proposals that Congress might be likelier than not to pass. Most of the Treasury proposals "are aggressive, technical, difficult to explain, and unlike tax proposals that Congress has considered before."

The problem for the administration is that the full-blown American Jobs Plan and American Families Plan would be incredibly expensive to pay for. Jim notes that the "easy" tax increases would not raise nearly enough money. For example, increasing the top income-tax rate back to 39.6% for taxpayers earning over $400,000 per year only raises $132 billion, according to the Treasury's own estimate. Raising the corporate tax rate to 25% only raises $490 billion, Jim observes.

(For an overview of the proposals in the Treasury's Green Book, see the Proskauer tax blog's *post* "Treasury's Green Book Provides Details on the Biden Administration's Tax Plan.")

Calendars

US: Wed: Headline & Core PPI 6.8%/5.1% y/y, MBA Mortgage Applications, EIA Crude Oil Inventories, Beige Book. **Thurs:** Headline & Manufacturing Industrial Production 0.6%/0.2%, Capacity Utilization 75.6%, Initial & Continuous Jobless Claims 360k/3.31m, Empire State Manufacturing Index 18.0, Philadelphia Fed Manufacturing Index 28.0, Import & Export Prices 1.2%/1.2%, Natural Gas Storage, OPEC Monthly Report, Powell, Evans. (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production -0.2%m/m/22.2%y/y, Spain CPI 0.4%m/m/2.6%y/y, UK Headline & Core CPI 2.2%/2.0% y/y, Japan Industrial Production & Capacity Utilization, China GDP 1.2%q/q/8.1%y/y, China Retail Sales 11.0% y/y, China Industrial Production 7.8% y/y, China Unemployment Rate 5.2%, Australia Employment Change & Unemployment Rate 30k/5.0%, BOC Interest Rate Decision 0.25%. **Thurs:** Italy CPI 0.1%m/m/1.3%y/y, UK Employment Change & Unemployment Rate 90k3m/3m/4.7%, BOE Credit Conditions Survey, BOJ Monetary Policy Statement. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q2 Earnings Season Monitor (*link*): With 4% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, revenues are beating the consensus forecast by a well-above-trend 4.3%, and earnings have exceeded estimates by 15.3%. At the same point during the Q1 season, revenues were 3.2% above forecast and earnings beat by 30.3% in large part due to loan loss reversals at the banks. The S&P 500's earnings surprise then during Q1 was just 10.0% excluding Financials. For the 18 companies that have reported Q2 earnings through Monday's close, the aggregate y/y revenue and earnings growth rates and the percentage of companies reporting a positive revenue and earnings surprise have improved significantly from their Q1 measures due to the low base a year earlier when the US economy was shut down due to Covid-19. The small sample of Q2 reporters so far collectively has a y/y revenue gain of 20.6% and an earnings gain of 153.5%. A whopping 89% of the Q2 reporters so far has reported a positive earnings surprise, and 94% has beaten revenues forecasts. More companies have reported positive y/y earnings growth in Q2 (89%) than positive y/y revenue growth (83). These figures will change markedly as more Q2-2021 results are reported in the coming weeks. The y/y growth rates will more than likely mark the peak of the recovery from the Covid-19 shutdown.

US Economic Indicators

CPI (*link*): June's core CPI advanced 0.9% following gains of 0.7% and 0.9% the prior two months, with the three-month percent change accelerating 10.2% (saar)—the sharpest rise since October 1981! That pushed the yearly rate up to 4.5%, the highest since 1991. Commodities less food & energy commodities accelerated 24.4% (saar) during the three months through June, compared to -2.7% during the same span a year ago. Here are the 3-month annualized inflation rates for the main core goods components during the three months through June and their comparable 2020 rates, from highest to lowest: used cars & trucks (121.8% & -7.1%, saar), household furniture & bedding (19.2 & -0.2), new vehicles (16.5 & 1.6), apparel (9.0 & -19.5) alcoholic beverages (4.0 & 4.2), tobacco (3.6 & 1.1), and prescription drugs (0.0 & 0.8), Services less energy services advanced 5.4% (saar) during the three months through June, compared with 0.1% over the comparable 2020 period. Here's the same exercise for services components from highest to lowest: Car & truck rental (148.0 & -16.8), airfares (84.3 & -69.8), lodging away from home (62.4% & -23.5), motor vehicle insurance (18.0 & -33.8), owners' equivalent rent (3.4 & 2.1), rent of primary residence (2.7 & 2.4), hospital services (2.3 & 4.0), and physicians' services (-0.2 & 4.3).

NFIB Small Business Optimism Index (*link*): "Small businesses' optimism is rising as the economy opens up, yet a record number of employers continue to report that there are few or no qualified applicants for open positions," NFIB Chief Economist Bill Dunkelberg said in a statement. “Owners are also having a hard time keeping their inventory stocks up with strong sales and supply chain problems.” Meanwhile, the net percent of owners raising their average selling prices jumped 7ppts to 47%—the highest reading since January 1981! The NFIB Small Business Optimism Index (SBOI) improved to 102.5 in June—the first time the Index exceeded 100 since November 2020; it dipped from 99.8 to 99.6 in May. Seven of the 10 Index components improved in June, while three declined—capital spending plans (to 25% from 27%), current job openings (46 from 48), and expected credit conditions (-4 from -3). Owners expecting better business conditions (to -12 from -26) posted the biggest improvement last month—though remained in negative territory—followed by earnings trends (-5 from -11), sales expectations (7 from 3), plans to increase inventories (11 from 6), current inventory (11 from 8), and now is a good time to expand (15 from 13). For the owners surveyed, quality of labor (26%) remained the top business problem, followed by taxes (18), inflation (13), government requirements (11), and cost of labor (8). Notably, inflation concerns have climbed rapidly, from a recent low of 1% to the highest percentage since September 2008.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102