



## MORNING BRIEFING

August 18, 2021

### Searching for Peak Inflation

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

(1) Any pent-up demand left? (2) Business sales soared to new record high during June. (3) Restocking of depleted inventories should boost economic growth. (4) Factories are humming. (5) PCED inflation currently around 3.0%-4.0% should settle back down to 2.0%-2.5% later this year. (6) Should the Fed's inflation target be raised from 2.0% to 3.0%? (7) Base effect having less effect on boosting inflation now. (8) Demand shock and supply shortages still boosting some prices. (9) Lots of inflationary pressures still in PPI, commodity prices, and prices-received indexes.

**US Economy: Consumers Taking a Break?** Retail sales peaked at a record high of \$7.5 trillion during April and have dropped 1.8% since then through July ([Fig. 1](#)). In yesterday's [Morning Briefing](#), Debbie and I discussed the possibility that consumers have satisfied most of their pent-up demand for goods that built up during last year's lockdowns. That seems likely given the recent weakness in retail sales.

However, some of that weakness reflects a 10.4% drop over the past three months in the sales of motor vehicles and parts dealers, which need to rebuild their depleted inventories once the automakers get the parts they require to produce more cars. On the other hand, the recent weakness in housing activity resulting from soaring home prices can explain the weakness in housing-related retail sales in recent months ([Fig. 2](#)). That's certainly one area of retail sales where lots of pent-up demand has been met for a while.

We are counting on consumer spending on services to pick up some of the slack in consumers' spending on goods. The Delta variant could dampen the rebound in the former, while the latter could also be offset by vigorous inventory restocking. During June, business sales jumped 1.4% m/m to a new record high ([Fig. 3](#)). That increase was led by a 2.0% jump in the sales of wholesalers and a 1.6% increase in manufacturing shipments ([Fig. 4](#)). Their recent strength has more than offset the weakness in retail sales in recent months.

Inventory-to-sales ratios, adjusted for inflation, soared during last year's lockdowns and plummeted thereafter as demand for goods shot up once lockdowns were lifted ([Fig. 5](#) and [Fig. 6](#)). These ratios might have bottomed in May. There's plenty of space on shelves to rebuild inventories.

Factories continued to hum in July: Manufacturing output was up 1.3% m/m and 7.3% y/y to the highest reading since August 2019. Even the auto industry was able to increase assemblies slightly, by 870,000 units to 9.7 million units (saar), during July ([Fig. 7](#)). The categories leading the way to higher output were high-tech equipment (up 12.1% y/y), which includes communications equipment (14.3); computer & peripheral equipment (14.3); and semiconductors & other electronics (10.6) ([Fig. 8](#)).

**Inflation I: Moving the Goalpost.** 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. Well, all it took was a pandemic, and they finally did that by flooding the economy with an unprecedented amount of liquidity.

According to an August 16 Reuters [article](#), a study by two former senior staffers at the Fed recently made a case to raise the inflation goalpost from 2.0% to 3.0%. They argued that doing so would allow more marginalized groups to reenter the workforce, reducing economic inequities. Doing so could certainly push inflation higher for longer. Since Fed officials have embraced flexible average inflation targeting, accepting the idea of overshooting inflation for a while to make up for undershooting it for so long, they've basically moved the goalpost already.

**Inflation II: Some Good News.** Previously, Debbie and I predicted that the headline PCED inflation rate would range between 3.0%-4.0% through the summer and then settle down to 2.0%-2.5% later this year. We are still in that "transitory" camp.

The headline and core PCED inflation rates rose on a y/y basis to 2.4% and 2.0% during March; they continued to move higher during May, to 3.9% and 3.4%, and even higher during June, to 4.0% and 3.5%. We are still awaiting July's PCED rates but learned last week that the headline and core CPI inflation rates rose 5.4% and 4.3% y/y during July, with the former holding at June's rate and the latter down from 4.5%.

As Fed Chair Jerome Powell has often noted in recent months, the problem with annual rates of inflation now is that they are being boosted by the "base effect." That is, recent price rises may partly reflect the process of recovering from lockdown-depressed price levels a year ago. That's why we prefer evaluating inflation rates on a three-month annualized basis for now.

Even that way, there's no question that the Fed is surpassing its inflation goal. But will the

overshoot be sustained or transitory? Powell has acknowledged that in addition to the base effect, inflationary pressures reflect current supply bottlenecks resulting from a surge in demand as the economy has reopened. He believes that both effects are inherently transitory.

Interestingly, three-month annualized CPI inflation data for July are looking slightly less menacing than they did for June. But that could be not only because the initial post-lockdown pent-up demand surge in some categories of inflation is beginning to wane but also because concerns about Covid variant Delta have depressed demand some. If so, then inflation could pick up again, especially if Delta's spread scares more people into getting vaccinated, allowing them to go out into the world more comfortably and to spend more freely. If the latest inflation rates instead mostly reflect a weakening of pent-up demand, then we may have hit the peak in post-pandemic inflation.

For now, here's what the three-month annualized CPI data are showing:

(1) *Three-month inflation rate.* Over the past three months through July, the headline and core CPI annualized inflation rates are 8.1% and 7.8% ([Fig. 9](#)). Those increases were less startling than June's comparable increases of 9.3% and 10.2%. However, the increases continued to be concerning considering that the cost of medical care services rose only 0.6% over the past three months. That was more than offset by the rebounds in rent of primary residence and owners' equivalent rent to 2.5% and 3.7% ([Fig. 10](#)). The latter category remained on an upward climb, while the former eased a bit from June's three-month figure.

(2) *Base effect.* Arguably, some CPI components are up sharply because of the base effect, but some of the base effect began to abate during July using the latest three-month numbers (annualized) versus June's comps: lodging away from home (55.3%, 62.4%), airfares (39.0, 84.3), and car & truck rental (49.8, 148.0). In addition, the price of gasoline, which peaked at a 98.8% rate of rise during the three months through March, was up 17.0% through July ([Fig. 11](#)).

(3) *Off base.* On the other hand, the following annualized price increases over the last three months seem to reflect more of the demand shock and supply shortages than the base effect: new vehicles (21.6%), motor vehicle parts & equipment (10.7), food (7.8), tobacco (4.8), and tuition & childcare (3.1). Each of these CPI categories saw continued increases in their three-month (annualized) inflation rates during July compared to June. Meanwhile, the following consumer categories experienced historically high rates, but decreased a bit from

June's comparable three-month gauges: used car & trucks (75.2), household furniture & bedding (8.1), apparel (7.9), and energy services (6.5).

**Inflation III: Some Bad News.** Now for the bad news: Here are some of the latest readings of alternative measures of inflation, which—unlike the CPI on a three-month basis—show no signs of cooling off:

(1) *PPI*. The final demand PPI rose to 7.8% y/y during July ([Fig. 12](#)). The final demand for goods PPI soared 11.9% y/y, while services rose 5.8 y/y. Some portion of those increases was due to the base effect, but not the increases in their entirety.

The PPI release includes items for personal consumption prices. The overall index jumped 6.8% y/y during July. It is highly correlated with the CPI, which was up 5.4% over the same period. The core PPI for personal consumption was up 5.2% during July, while the core CPI was up 4.3% ([Fig. 13](#) and [Fig. 14](#)).

(2) *Commodity and input prices*. Both the CRB all commodities spot price index and the CRB raw industrials spot price indexes remained on very steep uptrends through mid-August ([Fig. 15](#)).

During July, the average of prices-paid indexes in the M-PMI and NM-PMI surveys was 84.0, down only slightly from June's record high of 85.8 ([Fig. 16](#)).

(3) *Small business survey*. July's survey of small business owners, conducted by the National Federation of Independent Business, found that 46% of business owners have been raising their average selling prices. The reading was just a hair below last month's 47%, the highest reading since January 1981. Seasonally adjusted, a net 44% of respondents plan to hike prices, unchanged from last month ([Fig. 17](#)).

(4) *Expectations*. Looking ahead, the Federal Reserve Bank of New York's July 2021 [Survey of Consumer Expectations](#) shows that median one-year-ahead inflation expectations were unchanged from last month at 4.8%, while the three-years-ahead median inflation expectations increased slightly to 3.7% ([Fig. 18](#)). The Conference Board survey found that 12-months-ahead inflation expectations fell slightly during July to 6.6%, after rising to 6.7% last month ([Fig. 19](#)).

## Calendars

**US: Wed:** Housing Starts & Building Permits 1.602mu/1.610mu, MBA Mortgage Applications, Crude Oil Inventories, FOMC Minutes. **Thurs:** Leading Indicators 0.8%, Initial & Continuous Jobless Claims 365k/2.80m, Philadelphia Fed Manufacturing Index 23.0, Natural Gas Storage. (Bloomberg estimates)

**Global: Wed:** Eurozone Headline & Core CPI 2.2%/0.7% y/y, UK Headline & Core CPI 2.3%/2.2% y/y, Canada CPI 0.3%/m/m/3.4%/y/y, Australia Employment Change -45k, Australia Unemployment Rate & Participation Rate 5.0%/66.0%. **Thurs:** Japan Core CPI -0.4% y/y, Kent. (Bloomberg estimates)

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## Strategy Indicators

**S&P 500 Q2 Earnings Season Monitor ([link](#)):** With 92% of the S&P 500 companies finished reporting revenues and earnings for Q2-2021, revenues have blown by the consensus forecast by a record-high 5.2%. Earnings have exceeded estimates by 16.9%, but that beat is the lowest of the Covid-19 recovery thus far. At the same point during the Q1 season, revenues were 3.8% above forecast and earnings beat by 23.4% in large part due to banks' reversals of loan loss reserves. The S&P 500's earnings surprise also appears to have weakened substantially q/q excluding the Financials. The S&P 500's Q2 earnings surprise excluding Financials is 15.0% compared to 20.3% during Q1. For the 458 companies that have reported Q2 earnings through mid-day Tuesday, 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 current sample of Q2 reporters so far has a record-high y/y revenue gain of 24.4% and an earnings gain of 115.2%, surpassed only by Q4-2010's 211.1% rise. A record-high 88% of the Q2 reporters so far has reported a positive earnings surprise, with a record-high 87% also beating revenues forecasts. Slightly fewer companies have reported positive y/y earnings growth in Q2 (88%) than positive y/y revenue growth (90). With the retailers among the few companies left to report Q2-2021 results, these figures will change less markedly in the coming weeks. Q2's final y/y growth rates will more than likely mark the peak of the recovery from the Covid-19 shutdown.

## US Economic Indicators

**Retail Sales** ([link](#)): Retail sales fell more than expected in July as supply shortages sent motor vehicle sales south for the third successive month and online sales dropped sharply, depressed by Amazon's changing its Prime Day from July to June. Headline retail sales sank 1.1% after a revised 0.7% (from 0.6%) gain in June and a 1.4% drop in May. Core retail sales—which excludes autos, gasoline, building materials, and food—contracted 1.0% in July following a 1.4% gain and a 1.1% loss the previous two months. Despite the recent declines, headline and core retail sales remain in record territory, within 1.8% and 1.2% of their record highs posted in April and March, respectively. Of the 13 retail sales categories, five increased in June, while eight declined—with health & personal care retailers, gasoline stations, miscellaneous store retailers, and food services & drinking places posting record sales last month. Here's a snapshot of the sales performances of the 13 categories during July, versus last April's bottom, and relative to their pre-Covid levels: miscellaneous store retailers (3.5%, 92.5%, 21.1%), gasoline stations (2.4, 89.4, 18.9), food services & drinking places (1.7, 141.3, 9.1), electronics & appliance stores (0.3, 144.6, 16.9), health & personal care (0.1, 25.5, 12.1), general merchandise (-0.1, 19.9, 12.8), furniture & home furnishings (-0.6, 187.2, 14.3), food & beverage stores (-0.7, 3.3, 13.9), building materials & garden equipment (-1.2, 20.0, 17.4), sporting goods & hobby stores (-1.9, 144.7, 36.3), clothing & accessories (-2.6, 811.1, 14.5), nonstore retailers (-3.1, 11.4, 30.2), and motor vehicles (-3.9, 85.8, 20.1).

**Business Sales & Inventories** ([link](#)): Nominal business sales in June climbed to yet another record high, while May real business sales (reported with a lag) continued to hold around March's record high. Nominal business sales rebounded 1.4% in June, following May's 0.2% downtick, climbing every month but two since bottoming last April—soaring 41.7% over the period. Real business sales has followed an up-and-down pattern so far this year, falling 2.2% in May, though has still managed a 1.3% ytd gain. Real sales of both retailers and wholesalers remain in record territory, though below their record highs in March and April, respectively, while real manufacturing sales slumped 6.0% during the four months through June. The nominal inventories-to-sales ratio has fluctuated between 1.25 and 1.26 for the past four months, with June's at 1.25—just a tick above its record low of 1.24 posted in March 2011; it was at 1.73 last April. Meanwhile, the real inventories-to-sales ratio for May ticked up to 1.40 from 1.38 in both April and March, which was the lowest since spring 2013.

**Industrial Production** ([link](#)): Industrial production in July got a boost from automakers as they either shortened or cancelled their typical July factory shutdowns, the Fed reported, as

they continued to struggle with the global semiconductor shortage. Headline industrial production expanded a larger-than-expected 0.9% last month, with manufacturing output jumping 1.4%, as production of motor vehicles & parts rebounded 11.2% following June's 5.9% shortfall. Even with July's jump, motor vehicle production is down 3.0% ytd, though headline and manufacturing production are both up 2.8% over the period—with the former within 0.2% of its pre-Covid level and manufacturing output 0.8% above its reading. Here's a snapshot of July production by market group (and their components) since last April and where they stand relative to their pre-Covid levels: business equipment (46.7% & +2.1%), led by transit equipment (275.4 & +1.7), followed by industrial equipment (28.4 & +0.2), and information processing equipment (13.0 & +6.7). The gain in consumer goods (20.1 & +0.9) production was led by a surge in consumer durable goods (92.3 & +1.5), while nondurable goods (7.9 & +0.7) output was more subdued.

**Capacity Utilization** ([link](#)): The headline capacity utilization rate rose for the third consecutive month, from 74.7% in April to 76.1% in July—the highest since March 2020. The rate is up 12.7ppts from last April's low and is currently 3.5ppts below its long-run average. Meanwhile, manufacturing's capacity utilization rate is up 3.8ppts since its recent low of 72.8% this February to 76.6% in July—putting it 1.1ppt above its pre-pandemic percentage. The capacity utilization rate for mining jumped to a 16-month high of 76.9% in July from its recent bottom of 66.4% five months ago. The operating rate for utilities is bouncing around recent lows, falling from 74.3% in June to 72.6% in July. The rates for all three of these sectors remained below their long-run averages.

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## Global Economic Indicators

**Eurozone GDP** ([link](#)): The Eurozone during Q2 emerged from its Covid-led recession, with an easing of pandemic-related restrictions. Economic activity in the Eurozone expanded 2.0% last quarter, matching its flash estimate, after a double-dip recession during Q4-2020 (-0.6%) and Q1-2021 (-0.3). Activity last quarter was 13.6% above a year ago, but remains some 3.0% below pre-Covid levels. Portugal (+4.9%) posted the biggest quarterly increase, followed by Austria (+4.3) and Latvia (+3.7). Looking at the largest Eurozone economies, Spain (2.8) and Italy (2.7) expanded at faster paces than Germany and France, which rose 1.5% and 0.9%, respectively. Compared to a year ago, real GDP in Spain (19.8% y/y), France (18.7), and Italy (17.3) all posted double-digit gains. Germany's (9.2) growth was in the high single digits, likely curbed by supply-chain problems given Germany's large auto industry. Looking ahead, most forecasts are showing continued growth in the Eurozone

during Q3 despite the Delta variant and continued supply-chain issues.

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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

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