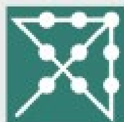
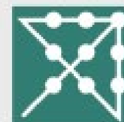
 Yardeni Research 

MORNING BRIEFING
February 16, 2022

Will Inflation Persist Along With Labor Shortages?

Executive Summary: Putin must be day-trading oil futures. … Why the inflation story is one of countervailing forces: Consumers' inflation expectations have been edging down even as price pressures continue to ramp up. Supply-chain disruptions should continue to ease as the pandemic abates, but labor shortages will persist for the foreseeable future. Wages and prices have been spiraling upward together recently, and productivity growth can't improve fast enough to slow the wage-price spiral for now. … Also: As the world braces for a wave of monetary tightening after years of ease in the extreme, we examine which of the major central banks likely will make their moves when, and why.

Geopolitics: Is Putin Day-Trading Oil Futures? The Kremlin on Saturday denounced US "peak hysteria" surrounding the Ukraine conflict but said Russian President Vladimir Putin and US leader Joe Biden had agreed to continue talking.

Ukrainian President Volodymyr Zelensky on Monday declared that Wednesday (today) will be a day of unity, as he addressed reports that a Russian invasion of his country could begin today. He posted his statement on Facebook. "We are told that February 16 will be the day of the attack," he said, according to a Facebook translation. Ukrainian officials claimed that Zelensky was just being sarcastic since he disputes US intelligence reports of an imminent Russian invasion. (Before he was president, Zelensky was a professional comedian. Seriously.)

Russia's defense ministry said on Tuesday that it is pulling back some troops from the border with Ukraine, according to multiple reports. The reports indicated that the Russian troops were returning to their bases after completing exercises near Ukraine.

Is Putin channeling his inner Orson Welles to do a remake of the actor's infamous 1938 *War of the Worlds* radio broadcast, which convinced millions of panicked Americans that alien invaders had landed in New Jersey? Or is Putin channeling his inner Ivan Boesky to day-trade Brent crude oil futures with his insider information?

Russia is naturally long oil since it produces over 10 million barrels per day, about the same as Saudi Arabia (*Fig. 1*). Multiplying that output by $1.00 and 365 days shows that every dollar increase in the per-barrel oil price equates to annual Russian oil revenues of $3.65

billion. At an oil price of $90 a barrel, Russia's oil revenues are around $328 billion at an annual rate currently (*Fig. 2*).

Putin must have been short Brent oil futures yesterday. The nearby price fell $3.11 a barrel to $93.02 on news that some Russia soldiers were withdrawn from the border with Ukraine.

US Inflation I: Have Expectations Peaked? The FRB-New York survey of consumers' inflation expectations over the next 12 months edged down to 5.8% during January from 6.0% during the last two months of 2021 (*Fig. 3*). Even more encouraging is to see that consumers' three-year-ahead inflation expectations fell to 3.5% last month, down from over 4.0% late last year.

The bad news is that inflation pressures are still building: Russia's military buildup on Ukraine's border has boosted oil prices. Droughts in the Midwest are pushing up feed and cattle prices. Droughts in South America are driving soybean prices higher. Another jump in energy and food prices could heat up consumers' inflationary expectations.

US Inflation II: Shortage of Goods vs Shortage of Labor. The CPI inflation rate soared from 1.4% y/y during January 2021 to 7.5% during January 2022. At first, Debbie and I agreed with the Fed's party line that the surge was mostly related to the pandemic's base effect, which was likely to be transitory. In our April 26 *Morning Briefing*, we reviewed the latest developments on the inflation front and concluded: "All of the above increases the risk that inflation soon will be higher and more persistent than widely expected, even by us." Since then, we've seen more evidence of inflation's persistence.

On Tuesday, November 30, Fed Chair Jerome Powell told a congressional committee that it's "probably a good time to retire that word ['transitory']." In his December 15, 2021 *press conference*, Powell stated: "Then in September, I'd say after Labor Day, [the supply-side issue was] both larger in its effect on inflation and more persistent." He also mentioned that just before the November 2-3 meeting of the FOMC, the committee was especially shocked by the 5.7% (saar) jump in the Employment Cost Index during Q3.

It is widely expected that supply-chain disruptions will ease as the pandemic abates. That makes sense to us. The pandemic is certainly showing signs of coming to an end (*Fig. 4*). In the US, new positive test results have plunged 81% from the record peak on January 14. January's regional and M-PMI business surveys showed significant declines in order backlogs and delivery times since mid-2021 (*Fig. 5* and *Fig. 6*).

The problem is that while supply-chain disruptions are likely to be transitory (though less so than widely expected last year), labor shortages will persist for the foreseeable future. They will continue to put upward pressure on wages unless productivity growth improves significantly. We expect that will happen, but maybe not fast enough to slow the current wage-price spiral. Consider the following:

(1) *The 1940s analogy.* In the January 19 *Morning Briefing*, Debbie and I concluded that the current inflation episode is likely to be more like the post-WWII experience during the second half of the 1940s than the Great Inflation of the 1970s. Consumer durable goods inflation is leading the current surge in prices, similar to what happened when the soldiers came back home after WWII. We wrote:

"WWII ended on V-J (Victory over Japan) Day, August 15, 1945. The CPI inflation rate on a y/y basis jumped from 1.7% during February 1946 to peak at 19.7% during March 1947 (*Fig. 7*). It then plunged to zero in early 1949 and ended the decade in negative territory. Industrial production plummeted during 1945 and early 1946 as manufacturers scrambled to retool to produce consumer goods rather than armaments (*Fig. 8*). Then production rebounded dramatically in late 1946 and 1947, helping to bring down inflation by boosting supplies of consumer goods."

We continue to predict that consumer durable goods inflation will moderate over the rest of this year as demand declines while supplies expand.

(2) *The 1970s analogy.* For now, wages are rising at a faster pace, but not faster than prices, suggesting that a wage-price spiral similar to the 1970s experience is happening. We have been discussing this scenario frequently, and most recently in Monday's *Morning Briefing*.

(3) *The unique 2020s.* The biggest difference between now and the past two episodes of inflation is that now there is a severe and chronic labor shortage, as we have often discussed. After WWII, soldiers returned home and boosted employment (*Fig. 9*). During the 1970s, the Baby Boomers poured into the labor markets. This time, we believe that employers will respond to labor shortages by spending more on capital equipment and technology to boost productivity.

That's the happy "Roaring 2020s" scenario, of course. The unhappy one, for the here and now, is that productivity doesn't rise fast enough to squelch a wage-price spiral caused by labor shortages.

US Inflation III: Are Wages and Prices Spiraling? The latest data for wages and prices confirm that they are spiraling together. Here are some of our key takeaways:

(1) *Wages.* The Atlanta Fed's median wage growth tracker rose to 4.1% during January, the highest reading since summer 2008 (*Fig. 10*). It is highly correlated with the y/y growth rate in the wages and salaries component of the Employment Cost Index. Leading the way higher is younger workers. Here is the performance derby by age groups: 16-24 (10.6%), 25-54 (4.2), and 55 & over (2.5).

(2) *Prices.* January's PPI for final demand was up 9.7% y/y, down from its record high of 9.8% during the final two months of 2021 (*Fig. 11*). The PPI for personal consumption also might have peaked at 9.1% y/y during December, falling to 8.6% in January (*Fig. 12*). The bad news is that it might also augur for still higher inflation rates for the CPI (at 7.5% during January) and the PCED (at 5.8% during December).

Central Banks: Bumping Up Against Inflation & Each Other. Central bankers' flood-like monetary stimulus during the pandemic sent their balance sheets to dizzying heights and their interest rates close to zero (*Fig. 13*). As inflation has surged since early last year, it is time for the major central bankers to reverse course and start tightening. The Bond Vigilantes are jumping ahead of tightening maneuvers, pushing yields up around the globe.

Divergent normalization timelines among the major central banks are bound to create volatility in global asset prices. With the US economy facing the greatest inflation risk, the Fed will likely move to tighten next. (The Bank of England already has done so.) US CPI inflation reached 7.5% y/y in January, the highest in 40 years (*Fig. 14*). Annual inflation in the Eurozone came in at 5.1% for January, according to the flash estimate, the highest on record and well above the ECB's 2.0% target. But giving the ECB pause are the crisis in Ukraine and weak labor market.

Japan's inflation remains low, though higher interest rates in the US and Europe are pushing up Japanese borrowing costs. The PBOC is keeping the easy money flowing, as its economy remains weak—bridled by strict Covid containment measures—and its monetary policies are just beginning to jumpstart lending.

Below, we examine each situation in more detail:

(1) *Fed thinking about just doing it.* The latest projections at the Fed indicated three rate rises this year, but traders already are pricing in more than that. We don't expect the Fed to

do an emergency rate increase before its March meeting as some have speculated, as that would suggest to markets that the Fed is panicked. However, two Fed officials recently suggested frontloading monetary tightening to stave off inflation's rise: FRB-St. Louis Fed President James *Bullard* and FRB-Kansas City President Esther *George*. Meanwhile, the doves, such as FRB-San Francisco President Mary Daly, haven't yet flown the coup; she has *argued* for a measured path to avoid market disorder.

(2) *ECB hikes on the table.* At the conclusion of its last meeting on February 3, the ECB held rates steady. It was at that point that ECB President Christine Lagarde acknowledged that "the situation has indeed changed" and a rate increase couldn't be ruled out this year. Some still expect the ECB to move away from a negative deposit rate at the end of this year after first ending its asset purchase program.

The bank may need to move even while an inflationary fiscal stimulus program, namely the Next Generation EU "green" fund, is going on. Beyond fiscal stimulus, the looming crisis in the Ukraine is likely to continue pushing prices higher over the short term. "Oil, gas and electricity have become more expensive. And as we import a lot of energy, these prices are, to some extent, beyond the sphere of influence of our economy," Lagarde *said* during a February 11 interview. Gasoline prices in Germany have reached a record of 1.71 euros per liter, or the equivalent of $7.31 per gallon.

Lagarde's latest comments came on the heels of the Bank of England's first back-to-back rate increase since 2004, raising short-term borrowing costs to 0.5% on Thursday after an initial rate hike in December.

(3) *Holding the line at the BOJ.* Japan is not immune to inflationary pressures but has been less affected by them than other major economies. Yield Curve Control, the BOJ's policy to control long-term interest rates, has been in force since 2016, and the BOJ is sticking to its near 0% target for the 10-year Japanese government bond yield (JGB). On Monday, the BOJ promised to hold the line for the JGB at 0.25% to prevent rising global yields from pushing up domestic borrowing costs too much.

The benchmark 10-year JGB had hit a six-year high this month, and the day of the BOJ's announcement saw yields drop to as low as 0.20%. For now, the BOJ may have won the battle against the global Bond Vigilantes, but the war may not be over, as global rates continue to rise.

(4) *PBOC: No longer 'setting its own agenda'?* Chinese monetary policy stands in

counterpoint to the tightening cycle beginning in the rest of the world. Last Wednesday, a BOJ policymaker said that China's "zero-Covid" restrictions could weigh on global growth by prolonging supply chain disruptions, *reported* CNBC. Last month, International Monetary Fund head Kristalina Georgieva remarked that China should reassess its zero-Covid approach.

In January, the PBOC unexpectedly cut the rate on one-year medium-term lending facility loans to some financial institutions to 2.85% from 2.95%, accompanying a 10 basis-point cut in the seven-day reverse repurchase agreement rate, *reported* Reuters. China's benchmark sovereign yields fell to the lowest since 2018 on the news.

The central bank has said that it would make monetary policy action "ample, targeted and front-loaded." Another cut doesn't look imminent because the stimulus finally seemed to be showing up in stronger-than-expected lending data, for January. But don't expect the PBOC to reverse course and tighten anytime soon. In its quarterly report on Friday, the PBOC reassured markets that it would keep liquidity reasonably ample and increase financing support for key sectors and weak links of the economy but not resort to "flood-like" stimulus.

However, the PBOC also alluded to watching the outlook for monetary policy in the rest of the world as rate rises elsewhere fuel emerging market capital outflows, Bloomberg *observed*. "Set our own agenda"—a phrase the PBOC uses to emphasize its monetary policy autonomy—was cited only one time in Friday's report, down from four times in the previous quarterly report, signaling that the PBOC is paying more attention to external bank policies, suggested Bloomberg. April seems the most likely timeframe for another policy rate cut, the article opined, following the release of Q1 economic data.

Calendars

US: Wed: Retail Sales Total, Core, and Control Group 2.0%/0.8%/1.0%; Headline & Manufacturing Industrial Production 0.4%/0.3%; Capacity Utilization 76.8%; Business Inventories 2.1%; Import & Export Prices 1.3%/1.3%; NAHB Housing Market Index 83; MBA Mortgage Applications; Crude Oil & Gasoline Inventories; FOMC Minutes. **Thurs:** Initial & Continuous Jobless Claims 219k/1.605m; Housing Starts & Building Permits 1.700mu/1.760mu; Philadelphia Fed Manufacturing Index 20.0; Natural Gas Storage; Bullard; Mester. (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production 0.5%m/m/-0.5%y/y; UK Headline & Core CPI -0.2%m/m/5.4%y/y & -0.4%m/m/4.3%y/y; UK PPI 0.9%m/m/13.1%y/y; Japan Core Machinery Orders -1.8%m/m/0.6%y/y; Australia Employment Change -15k; Australia Unemployment & Participation Rates 4.2%/66.0%; Wuermeling; Debelle. **Thurs:** Japan Core CPI 0.3%y/y; ECB Economic Bulletin; Lane; Schnabel. (Bloomberg estimates)

US Economic Indicators

Producer Price Index (*link*): January saw the producer price index for final demand post its biggest monthly increase since spring 2021, accelerating from 0.4% in December to 1.0% in January, while core prices (0.8%) increased at double December's 0.4% gain. The yearly rate for the headline (9.7% y/y) measure barely budged from its record-high 9.8% posted during the final two months of 2021, with the core rate (9.4) back up at November's record high. During January, prices for final demand goods rebounded 1.0%—on widespread gains—after slowing the prior two months, from 1.3% in October to -0.1% in December, the first monthly decline since April 2020. The yearly rate eased for the second month to 13.1%, after accelerating steadily from -5.2% in April 2020 to a record high 14.9% by November 2021. The increase in final demand services prices held steady at 0.7% in January, with an increase in hospital outpatient care a big contributor to January's gain. The yearly rate eased to 7.7% after accelerating to a new record high of 8.1% at the end of 2021. Looking at pipeline prices, pressures remain very high, though have eased. The yearly rate for intermediate goods prices held at 24.2% y/y in January, down from November's 26.5% y/y—which was its highest rate since the mid-1970s. The rate for crude prices slowed steadily to 29.5% y/y in January from 55.3% in October; it was at 59.0% last April—which was within a tick of its 59.1% record high in April 1973.

Regional M-PMI (*link*): The New York Fed has provided the first glimpse of manufacturing activity in February and shows business activity in the region remained at a virtual standstill, though price pressures remained intense—with the prices-received measure reaching a new record high. February's composite index increased to 3.1 after falling from 31.9 in December to -0.7 in January, which was the first negative reading since mid-2020. The composite index averaged 29.7 during the final half of 2020. New orders (to 1.4 from -5.0) improved a bit this month after contracting slightly in January, while shipments (2.9 from 1.0) held steady this month; both finished 2021 with a robust reading of 27.1. Labor market indicators show employment (23.1 from 16.1) expanding at a solid pace this month, while the average workweek (10.9 from 10.3) continued to lengthen. Meanwhile, delivery times

(21.6) continued to lengthen at January's pace, and unfilled orders (14.4 from 12.1) moved higher at a slightly faster pace. The prices-paid measure eased slightly for the third month from 83.0 in November to 76.6 this month—just south of last May's record highs 83.5. The prices-received gauge, meanwhile, shot up to a new record high of 54.1 this month after slowing from 50.8 in November to 37.1 in January. Firms remained optimistic about the six-month outlook, but the intensity has faded in recent months, with the future business conditions index slowing steadily from 52.0 in October to 28.2 this month—the weakest since April 2020. The report notes that longer delivery times, higher prices, and employment gains are expected in the months ahead. Both the prices-paid (70.3 from 76.7) and prices-received (51.4 from 62.1) remained close to January's record highs.

Global Economic Indicators

Eurozone GDP (*link*): The Omicron wave of Covid-19 infections slowed Eurozone real GDP growth during Q4—with the service sector especially weak. Growth in the overall Eurozone matched its flash estimate, climbing 0.3% during Q4—a sharp slowdown from Q3's 2.3%—though the y/y growth rate was a respectable 4.6%. Spain posted the strongest growth among the member states last quarter, expanding 2.0%, not far from Q3's 2.6% and 5.2% above its Q4-2020 level. France (0.7%) and Italy (0.6) both outpaced the growth rate of the overall Eurozone, though their Q4 rates were considerably slower than their Q3 rates of 3.1% and 2.6%, respectively. Still, they were up a robust 5.4% and 6.4%, respectively, from their Q4-2020 levels. Meanwhile, Germany's GDP contracted 0.7% after expanding 1.7% and 2.2% the previous two quarters, as it was impacted by severe supply shortages as well as Omicron. However, it did finish the year in the plus column on a y/y basis, 1.4% above the rate in the final quarter of 2020 though a sharp slowing from Q2-2021's 10.4%.

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