MORNING BRIEFING
May 10, 2023

Inflation During & After The Pandemic

Check out the accompanying chart collection.

Executive Summary: The inflation problem of recent years has proven to be transitory for consumer goods but persistent for consumer services. Even so, overall inflation has been moderating this year. In our soft-landing economic scenario (60% odds), we see the PCED rate falling into the 3.0%-4.0% range over the remainder of 2023 and below 3.0% in 2024 and 2025. Consumers' inflation expectations aren't so sanguine. In advance of this week's inflation reports, we review recent developments on the inflation front. … Also: Wage inflation has been moderating too, but it's still higher than Fed Chair Powell would like to see.

US Inflation I: Here Is What Has Happened So Far. This is a big week for April's inflation news. On Monday, the Federal Reserve Bank of New York released its survey of consumers' inflationary expectations. On Wednesday, we will get the CPI, followed by the PPI on Thursday.

The bad news is that consumers are expecting inflation of 4.5% over the next 12 months (*Fig. 1*). However, that's down from a peak of 6.8% during June 2022. More encouraging is that consumers expect that the annual inflation rate over the next three years will average 2.9%, down from a peak of 4.2% during 2021.

The latest reading for the three-years ahead series is in line with pre-pandemic readings. Prior to the pandemic, the one-year ahead and three-years ahead expectations tended to track each other closely. Fed officials should be pleased with the three-years expectations but undoubtedly would like to see the one-year expectation also around 2.5%-3.0%, which was the pre-pandemic range for both series.

Inflation has turned out to be both transitory for consumer goods and persistent for consumer services. About a year ago, in the April 19 *Morning Briefing*, Debbie and I wrote:

"History shows that the inflation genie is hard to stuff back in the bottle without a recession first slimming the scoundrel down. Fed officials hope to achieve a Goldilocks soft landing by raising interest rates to cool off the demand side of the economy just enough so that the supply side of the economy isn't forced to cut back production and employment. They must

also be counting on some improvements in the supply-chain problem.

"We think they might succeed. In our scenario, the PCED headline inflation rate peaks during H1-2022 between 6.0%-7.0%. Led by consumer durable goods prices, it moderates to 4.0%-5.0% during H2-2022. Next year, it falls to 3.0%-4.0% as persistently rising rent inflation offsets moderation in other consumer prices."

It took a bit longer than we expected, but the PCED headline inflation rate fell into the 4.0%-5.0% range during the first three months of this year and is still on track to fall to the 3.0%-4.0% range over the remainder of this year (*Fig. 2*). We think that this inflation rate could fall below 3.0% in 2024 and 2025. And this should all happen with the economy executing a soft landing, which is our 60% probability scenario, rather than a hard one. In our 40% probability hard-landing scenario, inflation remains persistent, forcing the Fed to raise interest rates until they cause a credit crunch and a recession.

Let's review some of the recent developments on the inflation front:

(1) *Durable goods inflation.* The jump in the inflation rates for durable goods on both a CPI and a PCED basis has turned out to be relatively transitory after all (*Fig. 3*). The CPI durable goods inflation rate jumped from -0.6% y/y during March 2020, the first month of the two-months-long lockdown, to peak at 18.7% during February 2022. In March of this year, it was back down to -1.0%.

During the lockdowns, we all suffered from cabin fever. As the lockdowns were lifted, Americans found that shopping for housing-related goods was one way to cure the fever. Since we were spending more time at home, we wanted to spend more on renovations, furniture, appliances, and decorations. The CPI prices of furniture and bedding soared 19.8% from March 2020 through March 2022. Over that same period, the CPI prices of major appliances jumped 28.7% (*Fig. 4*).

The pandemic disrupted global supply chains. The Federal Reserve Bank of New York compiles a monthly Global Supply Chain Pressure Index (*Fig. 5*). It rose rapidly from 0.10 standard deviations from average value during October 2020 to peak at 4.32 during December 2021. It fell just below zero during February of this year and was down to -1.32 during April.

Automakers faced shortages of parts because of the pandemic's impact on the auto industry's global supply chains. The shortage of inventories caused new car prices to

increase 14.2% from March 2020 through March 2022. Over this same period, used car prices soared 48.0%. To avoid public transportation, many Americans scrambled to buy cars. In addition, many households that moved from urban to suburban and rural areas required a car to get around.

(2) *Durable goods disinflation.* Consumers' post-lockdown buying binge was fueled by excess savings accumulated during the lockdowns and attributable to the helicopter money provided by the federal government through three rounds of pandemic relief checks. The binge was focused on purchasing goods since many services were still constrained by social distancing restrictions.

On an inflation-adjusted basis, real consumption of goods jumped 22.0% from March 2020 to peak at a record-high $5.8 trillion (saar) during March 2021 (*Fig. 6*). Over the same period, real consumption of services rose 6.1%. It didn't make a new record high until January 2023. But it has continued to rise in record-high territory as demand for goods stalled. The buying binge for goods was mostly attributable to durable goods while it lasted (*Fig. 7*).

The buying binge for goods depleted the inventories of goods producers, importers, and providers during H1-2020 as Americans scrambled to hoard household products (*Fig. 8*). During H2-2020, there was modest inventory rebuilding. But during the first three quarters of 2021, demand outpaced production and imports of goods, resulting in lots of inventory liquidation.

In response to the buying binge and the shortage of inventories, goods industries ramped up their new orders to restock. The result was a big backlog of orders that couldn't be filled fast enough or couldn't be delivered on time because of the shortage of trucking capacity and logjammed West Coast ports. So inflation continued to soar in response to the apparent shortages of goods.

But just as the supply-chain problems abated, consumers pivoted to buying services rather than goods. Inventories rose dramatically from Q4-2021 through Q4-2022. Increasingly, these represented unintended accumulations that forced the goods industries, especially the durable goods industries, to cut their prices and to reduce their orders for more goods. As a result, inventory investment showed a slight liquidation during Q1-2023.

This set of inventory circumstances differs considerably from that of the previous two recessions (*Fig. 9*). During those two periods, inventory liquidation occurred, and did so for

both manufacturers and distributors. This time, manufacturing inventories have declined since the lockdowns for the most part with the exception of a big jump at the end of last year. The big pile-up in inventories from late 2021 through 2022 occurred among wholesalers and retailers.

(3) *Nondurable goods inflation and disinflation.* The CPI nondurable goods inflation rate on a y/y basis peaked at 16.2% during June 2022 (*Fig. 10*). It fell to 2.8% during March. Leading the way up and down were food and energy prices, which were inflated during the first half of last year by Russia's invasion of Ukraine. Food inflation has been more persistent than energy inflation, but the former is moderating rapidly now, with the three-month annualized rate down to 3.6% through March.

Helping to moderate food inflation is disinflation in the PPI for truck transportation (*Fig. 11*). It peaked at a record-high 25.9% y/y last March. It was down to -5.1% during March of this year. As we reviewed yesterday, employment in the trucking industry rose to a record high during April.

(4) *Pesky and persistent services inflation.* As we anticipated last April, the CPI services inflation rate has been much more persistently high than the inflation rates for durable and nondurable goods. That's largely because of the way rent inflation is measured to reflect all currently outstanding rental rates. Rent inflation for new leases has been coming down quickly since early last year (*Fig. 12*). The Apartment List rent inflation rate on a y/y basis peaked at 18.1% during December 2021. It was down to 1.7% in April.

During the pandemic, many landlords faced state-mandated moratoriums on raising rents and even collecting them. As these restrictions were lifted, landlords increased rents dramatically in 2021. However, this shockwave from the pandemic has been dissipating.

The CPI rent inflation measures are starting to reflect the drop in new leases (*Fig. 13*). The three-month annualized CPI rent of primary residence fell to 8.0% during March, the lowest rate since June 2022.

Fed officials have acknowledged that the CPI rent inflation measure has some serious drawbacks. However, they've countered that inflation in core services excluding housing has also remained persistently high around 4.0%-5.0% for the past year based on the PCED measure of inflation (*Fig. 14*).

US Inflation II: Wage Inflation Remains an Issue. Fed officials are monitoring not only

price inflation but also wage inflation. In his May 3 *presser*, Fed Chair Jerome Powell said, "Wage increases have been moving down, and that's a good sign, down to a more sustainable level." He opined that might continue while still "avoiding a recession." Alternatively, "It's possible that we will have what I hope would be a mild recession."

Powell's simple arithmetical model is that wage inflation should equal price inflation plus productivity growth. He explained that 3% wage increases would be consistent with 2% price inflation, assuming productivity is growing 1%. He said that wage inflation is currently around 5%, and he would like to see it come down to 3%, assuming as he does that the Fed will succeed in lowering price inflation to 2%.

Powell said that the Fed monitors several measures of wage inflation, particularly the Employment Cost Index (ECI), average hourly earnings, average hourly earnings (AHE), the Atlanta Fed's Wage Growth Tracker (WGT), and hourly compensation (HC) in the quarterly productivity report. Where are they now? Consider the following:

(1) During April, AHE was up 5.0% y/y, while the WGT rose 6.4% in March (*Fig. 15*).

(2) The wages and salaries component of the ECI was up 5.1% y/y through Q1. Over the same period, HC was up 4.8% (*Fig. 16*).

Calendars

US: Wed: Headline & Core CPI 0.4%m/m/5.0%y/y & 0.4%m/m/5.5%y/y; Federal Budget Balance -$302b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Headline & Core PPI 0.3%m/m/2.4%y/y & 0.2%m/m/3.3%y/y; Initial & Continuous Jobless Claims 245k/1.82m; Natural Gas Storage; OPEC Monthly Report; Waller. (Bloomberg estimates)

Global: Wed: Germany CPI 0.4%m/m/7.2%y/y; Italy Industrial Production 0.3%; UK RICS House Price Balance -40%; Japan Leading & Coincident Indicators; China CPI 1.0%y/y; China PPI -2.5%y/y; BOJ Summary of Opinions. **Thurs:** UK NIESR Monthly GDP Tracker 0.0%; BOE Interest Rate Decision 4.50%; Schnabel; DeGuindos; Bailey; Mauderer; Balz. (Bloomberg estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Optimism is not improving on Main Street as more owners struggle with finding qualified workers," said NFIB Chief Economist Bill Dunkelberg. "Inflation remains a top concern for small businesses but is showing signs of easing." April's *Small Business Optimism Index* (SBOI) sank to its lowest level since January 2013, down from a recent peak of 102.5 during June 2021 to 89.0 this April, remaining below the 49-year average of 98.0 for the 16th consecutive month. The last time the index was at or above the average was December 2021 (98.9). In April, four of the 10 components of the SBOI increased while six decreased. Contributing positively to the SBOI were the two employment components, plans to increase employment (+2ppts to 17%) and current job openings (+2 to 45), followed by now is a good time to expand (+1 to 3) and expected credit conditions (+1 to -8). Current inventory (-6 to -5), earnings trends (-5 to -23), and sales expectations (-4 to -19) were the biggest drags on the SBOI, followed by expect economy to improve (-2 to -49), capital outlay plans (-1 to 19), and plans to increase inventories (-1 to -5). *Quality of labor* (24%) replaced inflation (23) as the small business owners' single business problem in April, with the former down 14ppts from last July's peak of 37% (which was the highest since Q4-1979); taxes (14) and cost of labor (9) round out the top five biggest problems. The net percentage of owners *raising selling prices* continued to ease, sinking to a 25-month low of 33% in April from a near-record-high 66% last March, while the net percentage of owners *planning to increase selling prices* fell to 21%, which is the lowest since November 2020; it was at a record high of 54% during November 2021. A net 40% of owners reported *raising compensation* last month, down from 46% the first two months of this year and back to its recent low posted last November; it was at a record high 50% at the start of 2022. A net 21% of owners *plan to increase compensation* in the next three months—a two-year low and 11ppts below October 2022's 32%, which matched the record high posted the final two months of 2021.

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