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ECONOMIC TALKING POINTS

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The Three Rules Of Inflation

When it comes to US inflation three rules apply:

Rule number 1. Inflation cannot thrive in the absence of escalating wages. Inscribe that in stone. If you look at the latest data, it shows pay growth has been stabilizing, if not actually decelerating. These trends show up whether you look at average hourly earnings or the broader employment cost index.

Rule number 2. There are occasions when aggregate demand for goods and services *briefly* exceeds the capacity of the economy to fulfill it. That can lead to a run up in prices. But it reflects a temporary imbalance, one that will soon return to equilibrium as the US and international economy emerges from the pandemic tunnel.

Rule number 3. Annual inflation rates can suddenly surge if the base year was abnormally low. That's precisely what we are going to experience the next several months. In such instances, year-over-year changes tell us nothing where inflation is headed. Frankly, we suggest you ignore such year-ago comparisons for now.

So where does inflation and the economy stand?

The bottom two rules may trouble traders in the financial markets, but their concerns are unlikely to last. Just the first rule bears close monitoring. The threat of rampant inflation only exists if wages persistently accelerates faster than productivity— and there is no evidence of that underway.

As for business activity in general, clearly a new economic cycle has begun. OK, let's employ the more popular phrase: a new economic cycle is *blasting off*.

Look, we can all cheer this recovery. What is problematic, however, is that this is occurring at a time when global supply chains have been severely disrupted by a once-in-a century global shock, the pandemic. For much of last year, factories shut production. Stores were forced to close and Americans were nestled at home. The result: manufacturers, wholesalers and retailers saw their inventories gradually diminish, and in some cases they were totally depleted.

Now let's spin this forward. The economy is now in full revival mode. Given the current hot demand for all kinds of commodities, those suppliers who still possessed increasingly scarce products enjoyed greater pricing power —*at the moment*. This explains the sharp increase in March's producer prices --- and why some firms were forced to pass those costs on to consumers last month.

March's 0.6% increase in CPI was the largest monthly rise in nearly 9 years. But it was almost all the result of higher fuel prices and, to a less extent, that of new cars and shelter (both owner's equivalent rent and rent itself). The cost of food and used cars actually eased.

Over the past 12 months, headline consumer prices increased 2.6%, the fastest since August 2018. But it's a statistic figure with little significance.

If you take out the volatile elements of food and energy —which provide a more accurate picture of the underlying forces driving inflation — then core CPI rose 0.3%. Hardly a shocker since it climbed faster last summer. Over the year, it increased a modest 1.6%.

Chart 1. One-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted, Mar. 2020 - Mar. 2021

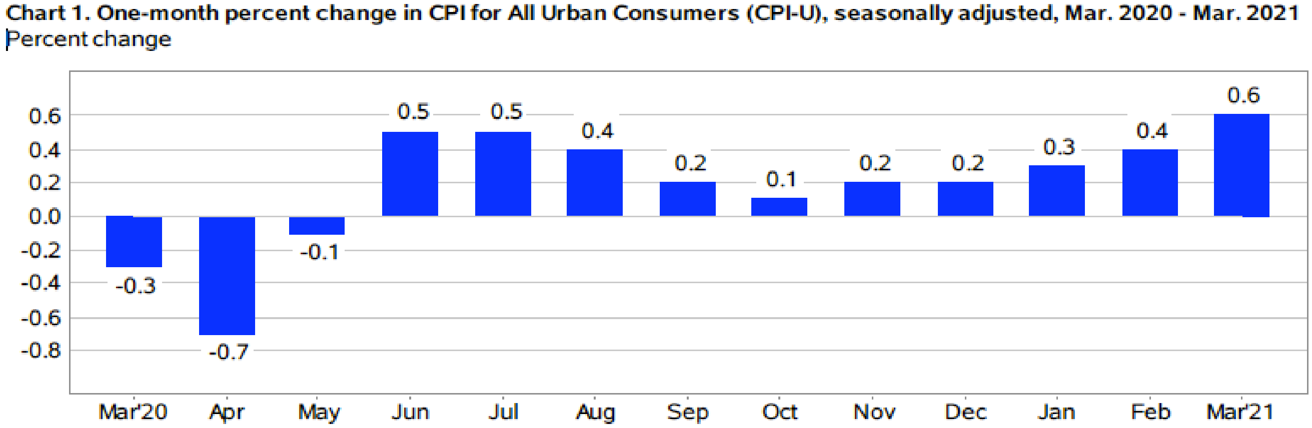
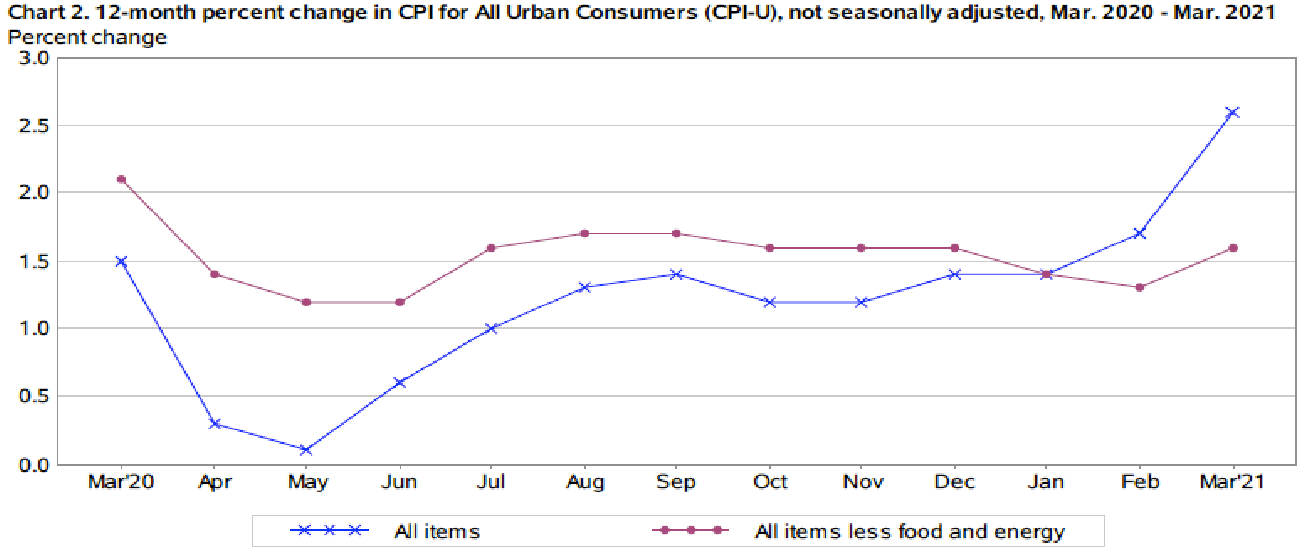


Chart 2. 12-month percent change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted, Mar. 2020 - Mar. 2021



So for a brief time, headline inflation will run hotter. There's nothing shocking or worrisome about it. We simply have an economy that is adjusting to two major events: (1) bottlenecks in the world supply chain that have slowed the delivery of goods to producers and retailers in the US; and (2) a surge in demand from consumers and businesses due to the trillions of dollars in fiscal stimulus that was designed to revive economic activity.

As I said a moment ago, the resulting price pressures will subside later this year. The disruption in supply chains is expected to ease and the fiscal stimulus will be followed by fiscal restraint (read taxes!).

Above all, it is important to remember that the main determinant of runaway inflation is still absent. Labor markets are not tight. And while it is true that employers are expressing some difficulties finding suitable workers, those firms have shown so sign of aggressively bidding up wages. That's the pin still firmly resting in the inflation grenade.

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United States

	I 2020	II 2020	III 2020	IV 2020	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023
Real Gross Domestic Product (GDP):																
%	-5.0	--31.4	33.4	4.3	5.2	5.8	5.3	6.7	3.8	4.9	5.5	4.2	2.8	3.5	3.1	2.9
Personal Consumption Expenditures:																
PCE %	-6.9	-33.2	41.0	2.3	5.5	6.6	5.1	6.0	2.4	5.2	4.2	3.6	3.1	4.1	2.8	3.5
Inflation, end of period, year-over-year:																
CPI %	1.5	0.6	1.4	1.4	2.6	2.7	2.5	2.5	2.4	2.4	2.3	2.2	2.5	2.6	2.6	2.7
Unemployment Rate (end of period):																
%	4.4	11.1	7.8	6.7	6.0	5.8	5.7	5.6	5.4	5.5	5.6	5.4	5.4	4.9	4.4	4.1
Non-farm Payrolls, monthly avg. thousand:																
	-303	-4,427	1,322	213	539	455	510	620	424	325	265	240	185	225	235	250
Treasury 10-yr Note Yield % (end of period):																
	0.63	0.65	0.68	0.91	1.75	1.71	1.65	1.79	1.77	2.05	2.00	1.94	1.90	2.05	2.00	2.10
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.88	1.13

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
US	2.6	1.6	2.2	1.8	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	5.8	4.6	3.1
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.8	3.3	2.5	2.0
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.9	4.4	4.6	3.1
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	2.2	0.3	0.7	-4.8	2.4	2.8	2.2
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.0	1.6	-5.1	5.4	3.4	2.9
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-8.2	9.1	6.4	5.7
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.1	2.3	6.9	5.7	5.6
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-4.1	2.9	2.7	2.4
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	-8.3	3.3	2.8	2.7
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	2.5	3.0	2.7
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	-3.1	2.4	3.3	2.0
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.9	-4.2	4.4	4.2	3.9