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MACROCOSM

Is Inflation Still "Transitory"?

Wednesday, October 13, 2021

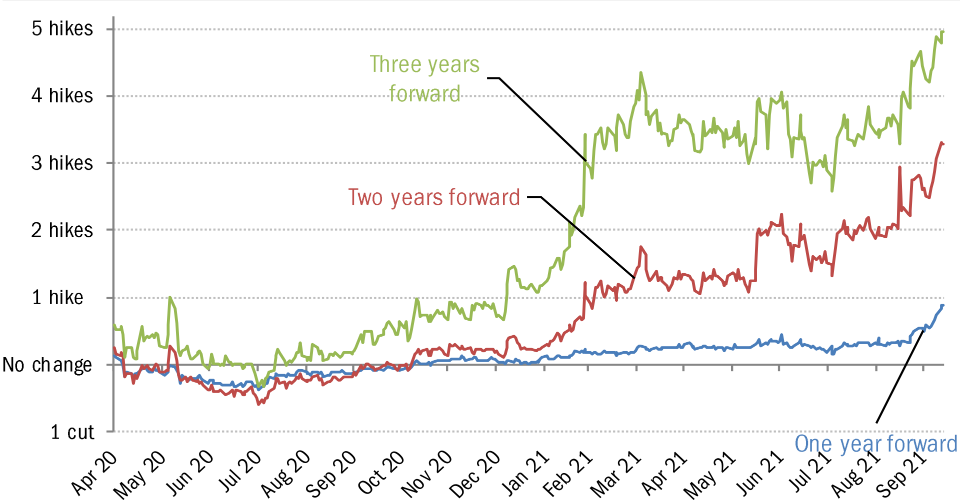
Donald Luskin

Yes. It's non-monetary, narrowly based, and not supported by expectations.

This morning's Consumer Price Index report – with year-on-year headline inflation up 5.39%, compared to 5.25% last month – reinforces chatter that unusually high inflation will turn out to be something more than "transitory." We've said it would be transitory since the beginning, even before Fed chair Jerome Powell started offering endless assurances that it would be. Now he's walked that back just a bit, calling supply chain constraints "frustrating," and "continuing into next year probably, and holding up inflation longer than we had thought." Atlanta Fed president Raphael Bostic says it's a "dirty word," and goes around with a jar into which he deposits a dollar whenever he slips and says "transitory" (if it's not transitory, will he have to deposit $1.05 next year?).

- The recent inflation chatter has coincided with a shift in market expectations for the timing of the Fed's lift-off from the current near-zero policy rate. Funds rate futures now discount lift-off as a certainty at the December 2022 FOMC meeting. The OIS forward curve now expects five rate hikes in three years (please see the chart below).
- We have long argued that the inflation we're seeing is not a monetary phenomenon, but rather a mismatch of supply and

OIS forward curve



Source: Bloomberg, TrendMacro calculations

Update to strategic view

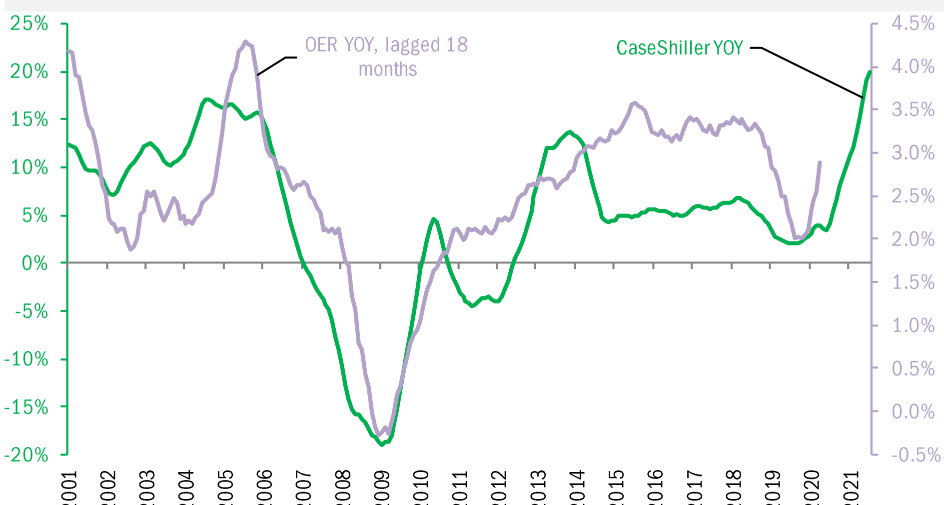
US MACRO, FEDERAL RESERVE: September CPI inflation grew 5.39% year-over-year, an uptick from the prior month. Fed officials are somewhat walking back their claims it is "transitory," so market-based expectations for rate hikes have now moved lift-off forward to December 2022. We don't believe the inflation is monetary in origin, so it would be an error to tighten policy to address it. If it were monetary, it would be more broad-based. It is, instead, explainable by outsize price gains in just two categories. It is unlikely that ongoing shortages could cause a repeat of last year's highly unusual price gains; indeed, shortages reduce the number of units consumers can buy. We are not worried about owners' equivalent rent sustaining inflation when high home prices translate into rental contracts. Even if OER returns to its peak levels of the housing bubble era, it would contribute only modestly more to CPI than it is now. Market and survey-based inflation expectations remain contained.

[Strategy dashboard]

demand. Demand is both pent-up from the pandemic lockdowns, and enhanced by stimulus payments; supply, as Powell points out, is constrained by low inventories. _The idea of tightening policy to fix a non-monetary inflation is absurd and dangerous on the face of it – a hawkish turn in the still-fragile post-pandemic economy would crash both demand and supply, so how would that help inflation?_

- Happily, based on the minutes of the September FOMC released just as we are going to press, the Fed sees lift-off much further in the future than the markets seem to (see "Data Insights: FOMC Minutes" October 13, 2021),
- _If inflation were the result of too-loose monetary policy, it would be broad-based. Yet we continue to be struck by how few_ items in the CPI basket _explain outsized numbers like this morning's_.
- _Price gains in just two categories – gasoline and motor vehicles, both of which have been afflicted by supply constraints that have nothing to do with monetary policy – explain all but 11 bp of the gap between this September's 5.39% YOY CPI and the Fed's 2.5% target_ (the Fed's 2% target is based on PCE inflation, which historically runs 0.5% below CPI).
- _In other words, if just those two items were removed, CPI inflation would be right at target._
- That implies something about persistence, too. Over the last 12 months, the price of gasoline is up 43.3%; new cars and trucks up 8.8%; and used cars and trucks up 24.4%. _For them to make the same outsized contribution to overall CPI again a year from now, they'd have to repeat those outsized price gains._
- If scarcity – no, it would have to be deepening scarcity – were to continue to drive such gains, then by necessity consumers would have to buy fewer units. So even then, their contribution to inflation would be less than it has been (the Fed's preferred PCE measure correctly accounts for this; CPI does not).
- To be sure, other items in the consumption basket could hypothetically take their place to sustain high rates of inflation. The one most often mentioned in client conversations is owners'

Owners' equivalent rent versus home prices



Source: Bloomberg, TrendMacro calculations

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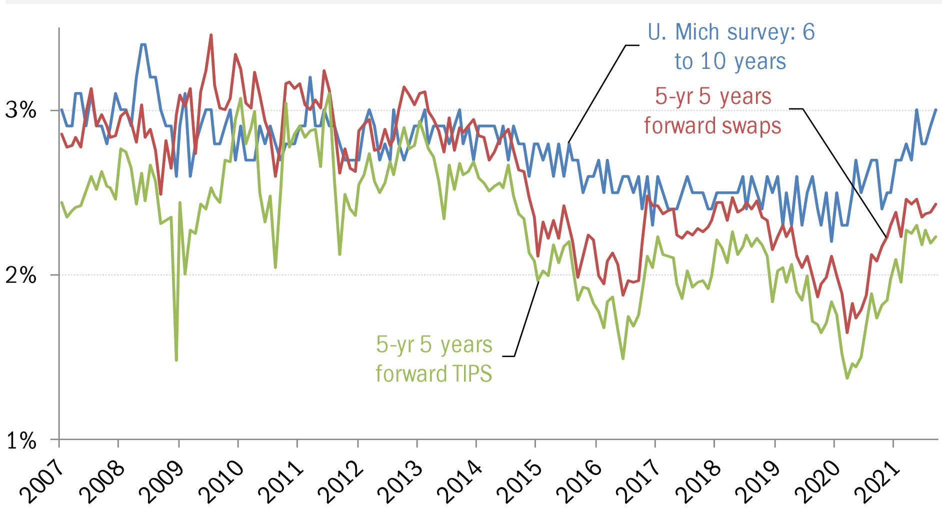
equivalent rent (OER) – the category that embodies home price inflation, at 23.56% the highest-weighted item in the basket.

- This is a concern because home prices have risen the last year at the steepest rate in the history of the data (please see the chart on the previous page), even steeper than at the peak of the housing bubble of the mid-2000's. However, US price indices do not observe home prices directly. Rather, their economic value is imputed from home rental prices. Rental rates are adjusted when contracts expire, so the OER component of CPI lags changes in home prices by about 18 months (again, please see the chart on the previous page).
- *It's worth wondering what will happen next year when this year's outsized home price increases get reflected in rental contracts.*
- Directionally, increases in OER will definitely show up as higher-than-otherwise CPI. But the magnitudes are less than you might guess.
- First, it's not like OER isn't contributing to CPI inflation already. In fact, it was the single largest contributor in this morning's September report, explaining 0.09% of the 0.4% month-over-month gain in overall prices. YOY, OER has increased 2.9%, contributing 0.68% to the 5.39% overall CPI inflation rate.
- *A year from now, say, if OER's rate of change were to match the worst in the history of the data, from the housing bubble era, that would be 4.3% YOY. That would contribute 1.01% to CPI inflation – that is to say, only 33 bp more that it is contributing now.*
- Finally, good evidence that today's high inflation rates are transitory comes from data on expectations. Market-implied 5-year inflation 5 years forward is no higher than it was in the two years before the pandemic, and considerably lower than it was during and after the Great Recession. Consumer surveys of long-term expectations are the highest in five years, but at levels consistent with the low inflation during and after the Great Recession (please see the chart below).

Inflation Expectations



Source: Bloomberg, TrendMacro calculations

- *We don't see how inflation can be anything but transitory if it's not embedded in market or consumer expectations. This isn't the Spanish Inquisition. If you don't expect it, it won't happen – because it's expectations that make it happen.*
- *We're sticking with our "transitory" call. We just hope the Fed does too. We're betting it will.*

Bottom line

September CPI inflation grew 5.39% year-over-year, an uptick from the prior month. Fed officials are somewhat walking back their claims it is "transitory," so market-based expectations for rate hikes have now moved lift-off forward to December 2022. We don't believe the inflation is monetary in origin, so it would be an error to tighten policy to address it. If it were monetary, it would be more broad-based. It is, instead, explainable by outsize price gains in just two categories. It is unlikely that ongoing shortages could cause a repeat of last year's highly unusual price gains; indeed, shortages reduce the number of units consumers can buy. We are not worried about owners' equivalent rent sustaining inflation when high home prices translate into rental contracts. Even if OER returns to its peak levels of the housing bubble era, it would contribute only modestly more to CPI than it is now. Market and survey-based inflation expectations remain contained.