A Note On Current US Inflation: Transitory Or Sticky – That Is The Question

Lighthouse Canton's View

Following the jump in both the Headline and Core figures in June, there has been much debate around the nature of US inflation. Our view is that inflation is here to stay and will be sticky in nature. While the Consumer Price Index or CPI will most likely dip from the present red hot levels, it would most likely persist above the Fed's target of 2% for a longer period of time. Therefore we find it only apt that in this month's memo that we examine and discuss a few key data sets in order to corroborate our view.

As the title of this month's memo suggests, this piece will examine the state of current inflation. Therefore instead of a longer historical time period, we will focus on the last 6 months of data. It would be an unfair comparision to look at any data before the last 6 months, given that seldom in the past have we seen a combination of loose monetary policy along with unemployment dole outs and fiscal stimulus to prop up the economy as we have observed today.

In June 2021, the US printed a Headline CPI of 0.90% month-on-month ("MoM") seasonally adjusted ("SA") with Transportation, Apparels and Housing including Energy contributing the most. Core CPI printed 0.88 MoM% SA. Headline CPI printed 5.3% year-on-year ("YoY") annualized.

Table 1: CPI Constituents Trends for period January 2021 to June 2021

Expenditure category	Weights (%)	Jun-21	May-21	Apr-21	Mar-21	Feb-21	Jan-21
Headline CPI		**0.90**	**0.60**	**0.80**	**0.60**	**0.40**	**0.30**
Food and beverages	**15.16**						
food		0.80	0.40	0.40	0.10	0.20	0.10
beverages(non-alcoholic)		0.90	(0.50)	0.30	(0.20)	(0.10)	0.10
beverages (alcoholic)		0.50	0.40	0.20	0.30	(0.10)	(0.10)
other foods		0.20	(0.20)	0.00	0.00	0.10	(0.60)
Housing	**42.39**	0.50	0.30	0.40	0.30	0.20	0.10
Fuels and utilities		1.50	0.00	(0.10)	5.00	3.90	3.50
Household furnishings and operations		0.10	0.90	0.90	0.40	(0.10)	(0.50)
Apparel	2.66	0.70	1.20	0.30	(0.30)	(0.70)	2.20
Transportation	**15.16**	5.60	4.00	4.30	0.20	(0.40)	(0.60)
Medical care	8.87	0.00	(0.10)	0.00	0.10	0.50	0.50
Recreation	5.80	(0.30)	0.40	1.20	(0.20)	0.50	0.10
Education and communication	6.81	(0.20)	0.40	3.10	(1.80)	(0.20)	(0.60)
Other goods and services	3.16	1.60	0.00	0.20	(0.30)	0.10	0.20
Core CPI (*All Items Less Food and Energy*)		**0.88**	**0.74**	**0.92**	**0.34**	**0.10**	**0.03**

Source: BLS, Bloomberg and Lighthouse Canton

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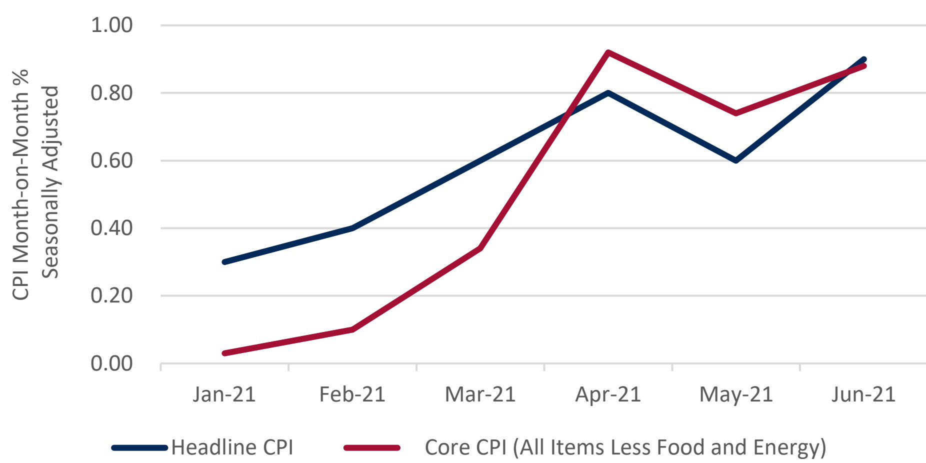
Charting the Headline and Core CPI figures since beginning of this year, seems to be showing an upward trend as shown by the chart below.

Chart 1: Consumer Price Index Trend YTD



Source: Bloomberg and Lighthouse Canton

So, is CPI Transitory or Sticky?

Before we attempt to answer the question, it is important to understand the relevance thereof.

When inflation is viewed as transitory, the Fed will keep the rates low and continue its bond buying program to support the market, thereby keeping the borrowing costs down. A status quo will maintain both equity and bond valuations at current levels.

On the contrary, inflation viewed as sticky would leave the Fed with little choice but to start tapering its bond buying program as a prelude to raising interest rates to prevent overheating of the economy.

Either way, both actions are likely to negatively impact the equity and debt markets. An increase in interest rates will increase the cost of capital for companies, thereby negatively impacting their equity valuations in addition to bringing the bond prices down as yields shoot up. To add, both the bond and equity markets are devoid of any cushion owing to their ripe valuations and hence the fall could be sharp.

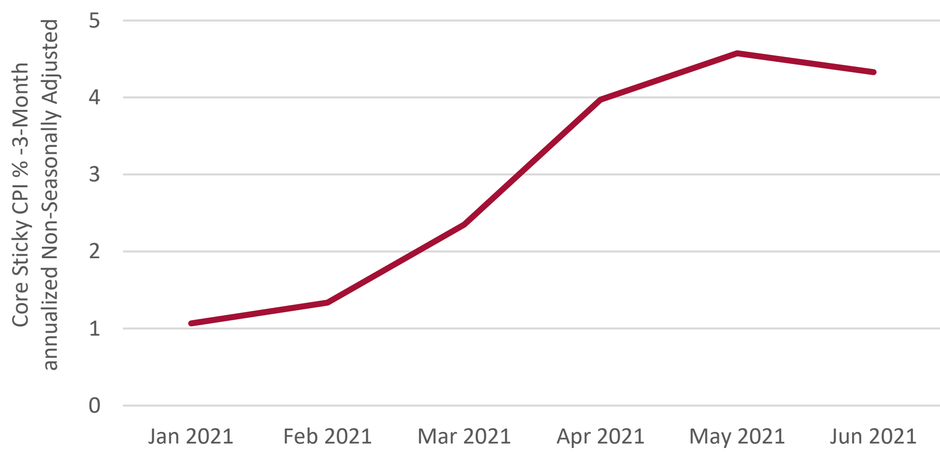
So, let us look at certain data points to get a better understanding of the situation.

Let us first examine two benchmarks – Core CPI and Core Sticky CPI.

As evidenced on Chart 1, **Core CPI** has been trending upwards. To determine Core CPI, Food and Energy which experiences the highest volatility in prices, is excluded. Yet despite such an exclusion, the trend has been upwards.

Another measurement of stickiness is the **Core Sticky CPI**. A benchmark released by the Atlanta Fed which tracks the stable constituents of CPI, it points to elevated levels of CPI in the prices of constituents that are stable in nature such as Shelter or Medical Care, and a similar upwards trend is evidenced in Chart 2 below.

Chart 2: Core Sticky CPI

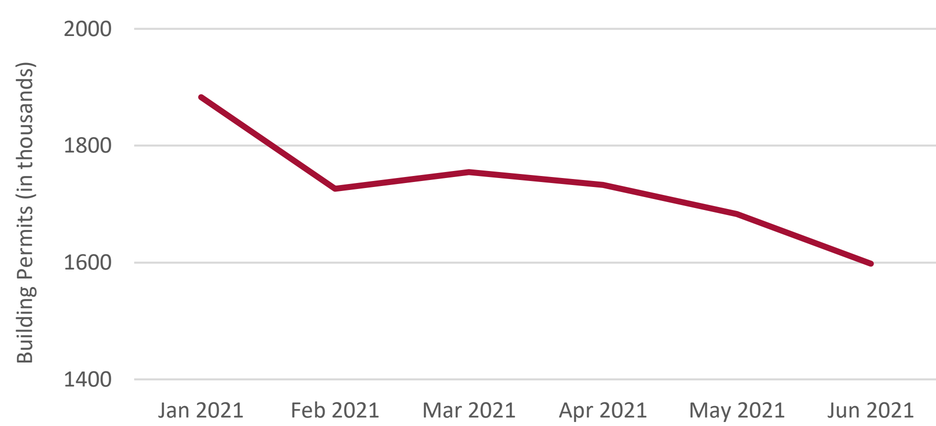


Source: Federal Reserve Bank of Atlanta, Bloomberg and Lighthouse Canton

We now turn our attention to **Housing**, the largest constituent of the Consumer Price Index, at approximately 42%.

As shown in Chart 3, building permits across single unit or multifamily housing have been declining steadily. A declining trend would typically lead to declining inventories within the housing market in the future, thereby supporting housing prices as supply will remain tight.

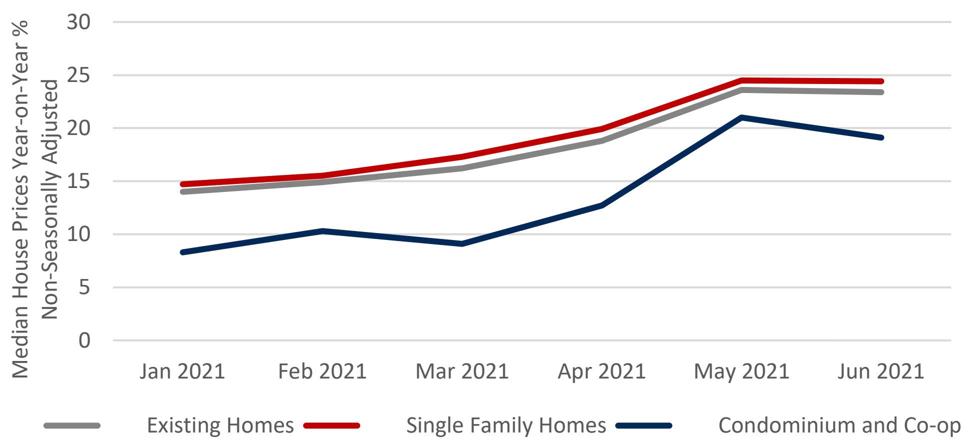
Chart 3: Building Permits



Source: U.S. Census Bureau, Bloomberg, and Lighthouse Canton

Median housing prices, a measure of the current levels of housing prices, have also been on the rise with the trend looking to stabilize near these elevated levels, thereby enhancing the stickiness (as per Chart 4). Higher home prices will most likely dissuade prospective buyers from purchasing properties, thereby cooling the demand while the falling number of building permits will contain the supply as well.

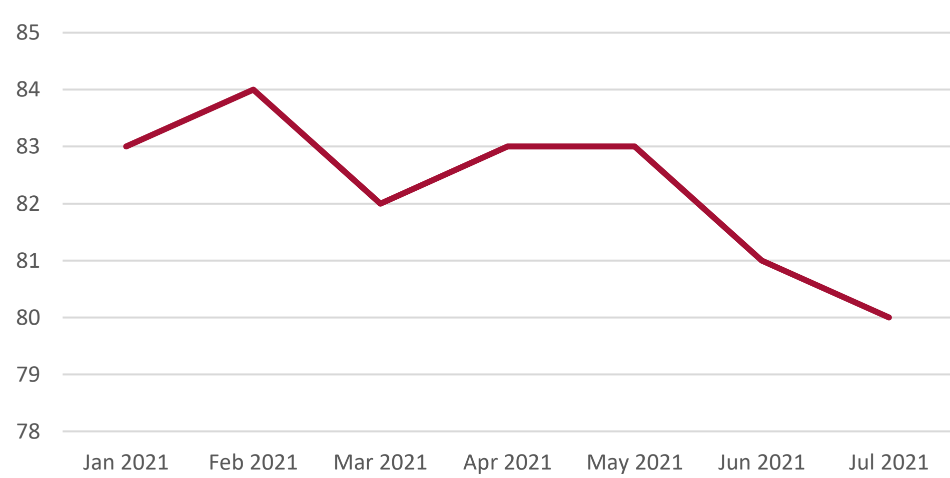
Chart 4: Median House Prices



Source: National Association of Realtors, Bloomberg, and Lighthouse Canton

This rise in housing prices and its effect on property purchases is evident in the trend we are seeing in the housing market survey where a reading above 50 indicates that the builders view the conditions as favorable. It has been showing a declining trend over this year (Chart 5). This survey considers current levels of Single-family sales, single family sales for the next 6 months while also considering the traffic of prospective buyers.

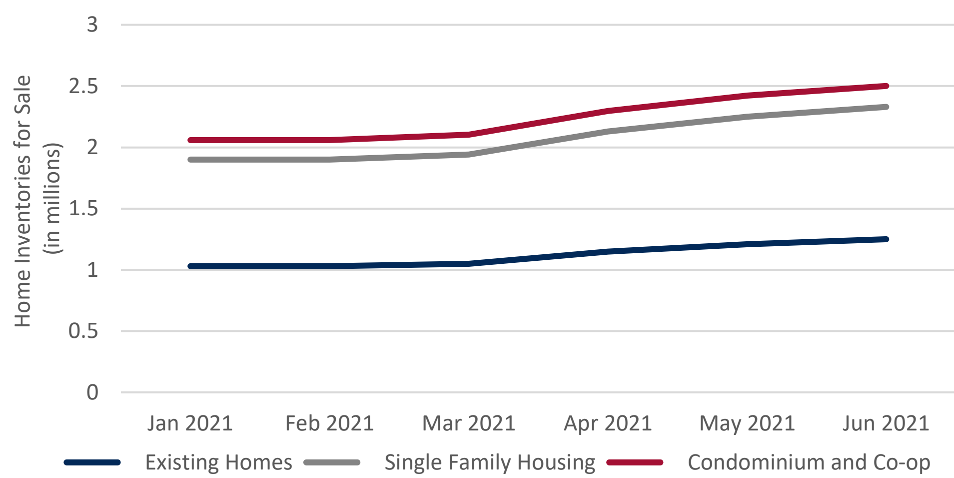
Chart 5: Housing Market Survey



Source: National Association of Home Builders, Bloomberg, and Lighthouse Canton

Finally, a look into the current home inventories point towards a slight increase (Chart 6). An increase in inventories now is likely to point to a decline in housing prices later, as supply increases in the housing market.

Chart 6: Home Inventories for Sale



Source: National Association of Realtors, Bloomberg, and Lighthouse Canton.

Based on the datapoints presented above, the housing market survey seems to point towards a decline in CPI print. However rapidly declining building permits and a near flat home inventories will most likely prevent a sharp decline and help stabilize the prices at near current levels.

Moving on to **Transportation**, which represents approximately 15% of the CPI. As shown in the table below, Used Cars and Trucks have been the biggest contributor in this segment since March 2021.

Table 2: Transportation and its Constituents

	Jun 2021	May 2021	Apr 2021	Mar 2021	Feb 2021	Jan 2021
Transportation Commodities Less Motor Fuel	**5.60**	**4.00**	**4.30**	**0.20**	**(0.40)**	**(0.60)**
New Vehicles	2.00	1.60	0.50	0.00	0.00	(0.50)
New Cars and Trucks	2.00	1.60	0.50	0.00	0.00	(0.50)
New Cars	1.90	1.60	0.30	(0.30)	0.00	(0.50)
New Trucks	2.00	1.60	0.60	0.00	0.00	(0.50)
Used Cars and Trucks	**10.50**	7.30	10.00	**0.50**	(0.90)	(0.90)
Motor Vehicle Parts and Equipment	0.70	0.90	0.90	(0.10)	0.10	0.60
Tires	0.90	1.10	1.50	(1.00)	0.20	1.00

Source: BLS, Bloomberg and Lighthouse Canton

The rationale behind Used Cars & Trucks printing red hot numbers is due to the shortages in semiconductor chips manufactured. The shortages are largely due to increased demand for chips (across other industries including Data Centers and Internet of Things (IOT)) coupled with supply bottlenecks. While supply bottlenecks are likely to ease soon, what is likely to continue would be the supply unable to keep pace with the increase in demand in near term.

Despite capacity increases in the automotive chip segments, leading chip manufacturers like Taiwan Semiconductors Manufacturing Company Limited (TSMC) and Intel Corporation (INTC) have announced supply shortages to continue well into 2022 and even early 2023 (by Intel CEO) in their Q2 2021 earnings call.

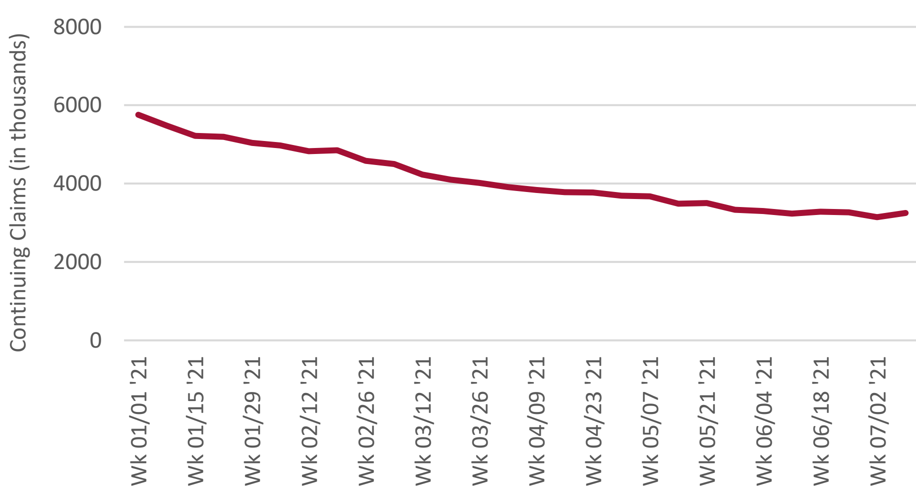
With such demand supply mismatch, specifically driven by supply shortfall, we feel that this would most likely keep upward pressure on the Transportation prints in coming months, hence contribute further to the stickiness of CPI.

Two other factors which we have also considered in our assessment of the nature of inflation are the **labor market** and **wage growth**.

The health of the **labor market** typically determines the inflation levels in the long run. While this might not turn the tables, it certainly goes a long way in sustaining the level of inflation by driving up consumption (also can be referred as Demand-Pull Inflation).

Continuing jobless claims, an indicator that reports on the number of jobless claims, has seen a steady decline since beginning of the year as shown in Chart 7 below.

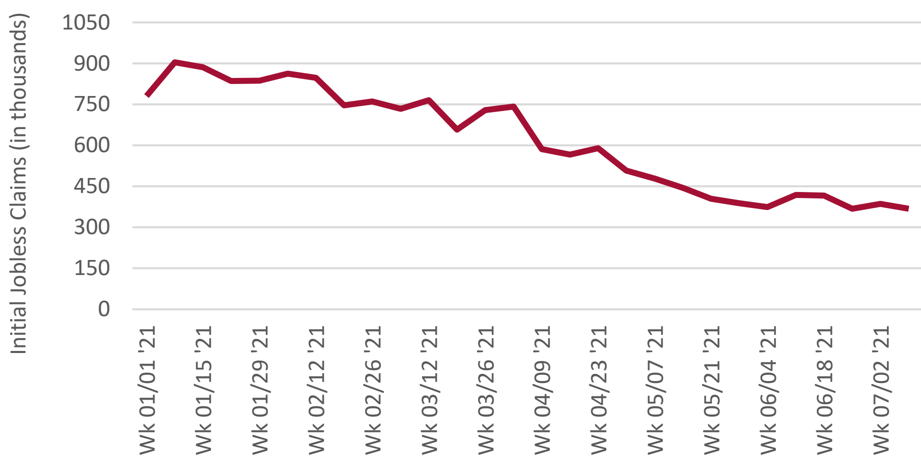
Chart 7: Continuing Jobless Claims



Source: Department. of Labor, Bloomberg, and Lighthouse Canton.

Poring further into the Initial Jobless Claims, which refers to claims for unemployment benefits filed by unemployed individuals with state unemployment agencies, we see a declining trend there as well (Chart 8), reflecting a gradual strengthening of the labor market.

Chart 8: Initial Jobless Claims



Source: Dept. of Labor, Bloomberg, and Lighthouse Canton.

Wages growth, however, paints a different picture. Table 3 below depicts a decline in overall real earnings combined with a decline in earnings of blue-collar workers. This, coupled with the labor force participation rate still reporting below pre-pandemic levels, could be one of the reasons leading to the Fed's dovish stance.

Table 3: Wages and Labor Costs (Seasonally Adjusted)

Current and real (constant 1982-1984 dollars) Earnings for all employees on private nonfarm payrolls (in USD)	Ticker	Jan 2021	Feb 2021	Mar 2021
Real Average Hourly Earnings	REALAHRE	11.41	11.4	11.32
Real Average Weekly Earnings	REALAWKE	399.34	394.44	395.01
Average Hourly Earnings	AHE TOTL	29.92	30	29.97
Average Weekly Earnings	REALCWKE	1047.2	1038	1045.95

Current and real (constant 1982-1984 dollars) Earnings for production and nonsupervisory employees on private nonfarm payrolls (in USD)	Ticker	Jan 2021	Feb 2021	Mar 2021
Real Average Hourly Earnings	USHETOTC	9.82	9.81	9.76
Average Weekly Earnings	USWETOTA	864.82	857.14	869.29

Source: BLS, Bloomberg and Lighthouse Canton

Finally let us look at a table focusing on Special Aggregate Indexes (table below). These dissect the inflation print with more granularity by removing the constituents that have contributed the most to reflect the current readings. The last index depicts a peak in the month of April, followed by a gradual decline in subsequent months. Yet the absolute number is reasonably elevated for a monthly print. This points to enhanced stickiness, even if we were to assume that Used Cars and Trucks print has peaked.

Table 4: Consumer Prices, MoM% SA

Special Aggregate Indexes	Jun 2021	May 2021	Apr 2021	Mar 2021	Feb 2021	Jan 2021
All Items Less Food	0.90	0.70	0.80	0.70	0.40	0.30
All Items Less Shelter	1.10	0.80	1.00	0.80	0.40	0.30
All Items Less Food & Shelter	1.20	0.90	1.10	1.00	0.50	0.40
All Items Less Food, Shelter, & Energy	1.20	1.10	1.30	0.40	0.10	0.00
All Items Less Food Shelter Energy & Used Cars & Trucks	**0.50**	**0.60**	**0.70**	**0.40**	**0.10**	**0.10**

Source: BLS, Bloomberg and Lighthouse Canton

Given the analysis of the data above leads to our view of inflation remaining sticky, we would recommend investors to reduce the duration of their Fixed Income portfolio, preferably between 3 and 5 years. In our opinion,this would reduce the downside risk should there be a surprise in the tapering announcements.

So why is the Fed dovish?

The Federal Reserve, however, still maintains a dovish stance and that is largely owing to a weak wages market (as explained in Table 3) and lower labor force participation rate. The US Labor force Participation Rate (Seasonally Adjusted) stood at 61.60% in June 2021 as opposed to pre-pandemic levels of 63.40% *(Source: BLS, Bloomberg)*. This means that the labor force is short by 6.76 million workers compared to pre-pandemic levels. A higher labor force participation rate will bring the unemployment rate down in the long run thereby aiding in the economic recovery.

September 2021 will mark the end of unemployment handouts (US$ 1400) and we believe that better clarity could be achieved when it comes to the level of Labor force participation then. We anticipate that blue collar workers have not been looking for a job as the dole out is higher than the wages they would earn otherwise. Once the dole out stops in September, this is when we believe that the real picture of the labor market, and more specifically labor participation rate, will emerge.

Jay Powell is caught between a rock and a hard place and perhaps will be forced to remain accommodative until he is completely sure of a complete recovery in the above.

His plight is better explained by the quote *" Uneasy lies the head that wears the crown".*

What are the possible risks to our view of inflation being sticky?

The most obvious risk would be the resurgence of COVID cases, perhaps caused by a much aggressive variant which would leave the authorities with no option but to lockdown the economy again. Hence stalling economic activity.

Another possible risk is that the Fed changes its definition of “transitory” from 6 – 9 months to a longer period. The Fed’s belief is that inflation will taper down below its target level of 2% in 2022 (in 6 – 9 months) and that is where our view differs from Fed. However nothing stops the Fed from increasing the time frame.