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COLUMBIA THREADNEEDLE INVESTMENTS

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Don't get overheated about inflation just yet

Sustained inflation is unlikely, but there are structural and economic factors to monitor over the next 12 to 24 months.

As we emerge from COVID-19 lockdowns, the U.S. appears poised for a period of high growth. And along with rising GDP prospects, inflation hawks have begun sounding alarms, unsettling investors. While we agree that the potential for rising inflation is something to take seriously, the inflation story is not so simple — partly because the Federal Reserve has been clear that its reaction to inflationary pressures will be different this time. We think that there are three important phases to consider in the inflation story.

Phase 1: The impact of base effects

Currently, core PCE inflation (the preferred metric of the Federal Reserve) is about 1.5% year-over-year and is expected to rise this year. This increase is mostly due to the increased demand for services as the economy reopens and the expiration of certain pandemic-related medical reimbursement programs (health care spending is approximately 18% of PCE). Because of the sharp drop in inflation in March and April of 2020, any normalization this year will look and feel inflationary. This increase is not inflation per se, but rather a transient base effect: a phenomenon driven by the abnormally low levels we saw a year ago.

Phase 2: Capacity constraints, supply chain issues and increasing fiscal spending

As vaccinations increase and the economy fully reopens, we expect to see a return to the activities we've all missed while in quarantine like traveling and dining out. The resumption of these activities, likely in the summer/early fall (assuming there will be no adverse impact from COVID variants), will generate inflationary pressures. There could also be upward pressures on prices from supply constraints in revived sectors. We expect that this inflationary pressure will also be transitory in nature — since, at some point, demand for services will be normalized.

President Biden's latest $1.9 trillion stimulus supercharges the outlook for significant fiscal spending, and his proposed infrastructure bill, if passed, could mean another $2 trillion could start to flow into the economy in 2022 and beyond. There will certainly be inflationary pressures from these inputs, but we don't think it will be enough to push inflation above the Fed's comfort level on a sustained basis, and the Fed's new paradigm for responding to inflation is a critical piece of the puzzle.

Phase 3: Employment rebounds and inflation meets — or exceeds — the 2% target

Historically, the Fed’s inflation bogey has been core PCE above 2%, and the market has extrapolated that a level above that threshold would trigger the central bank to raise rates. But the Federal Reserve has evolved its thinking around inflation. In statements this year, Fed Chair Powell has stated that the central bank would not act to counter inflation by raising interest rates until labor market conditions have reached levels consistent with its assessments of maximum employment. There’s no numeric definition of maximum employment, and the Fed’s focus on this metric is both a significant departure from its established view and an experiment that could establish a broad-based labor force benefit in a stronger economy. As a result, investors are left to parse the Fed’s statements on the overall health of the labor market and evaluate data on wages, discouraged workers and labor market scarring. Our research shows that we’re at least several years away from maximum employment.

Getting to maximum employment is likely to entail generating PCE above 2%. And, in addition to the focus on maximum employment, the Fed is pursuing a new policy framework called flexible average inflation targeting (FAIT) to address its 2% target. In short, instead of trying to maintain an absolute 2% inflation ceiling, the Fed will allow for periods of higher inflation if the rate averages to 2% over time. This gives them the flexibility to run the economy “hot” for relatively short periods to spur growth while keeping a lid on longer term, potentially destructive, inflationary pressures. The combination of FAIT and maximum employment could mean that we’re unlikely to see the Fed raise rates until 2022. Of course, markets try to anticipate Fed moves, but positioning for sustained inflation at this point seems premature in our view.

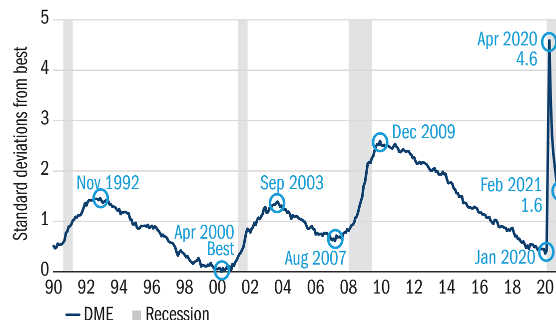
The bottom line: Keep calm and carry on (being vigilant)

Near term, inflation will be transient rather than persistent. But this doesn’t mean the pressures will be any less real for markets and investors as the economy recovers. Longer term, the Fed’s new mandate, which implies they will be more tolerant of inflation, could help smooth the economic ride and settle the market’s nerves. Only time — and the data — will tell if it does. Until then, keep an eye on inflation, but don’t let it dominate your view.

Our distance from maximum employment assessment estimates how far we are from the best level of maximum employment in the past 30 years. Currently, we’re 1.6 standard deviations from the best level, reached in 2000. Prepandemic, we were at 0.36. If this metric moves at its typical pace of 0.15 to 0.28 per annum, it may take several years before the Fed raises rates.

Distance from maximum employment

If historical trends hold, maximum employment rates are still several years away



Source: Columbia Threadneedle as of February 28, 2021. Many thanks to Roberto Perli, Cornerstone Macro, for his work on this subject.

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