DUCENTA SQUARED
ASSET MANAGEMENT

Monthly Fixed Income Insight

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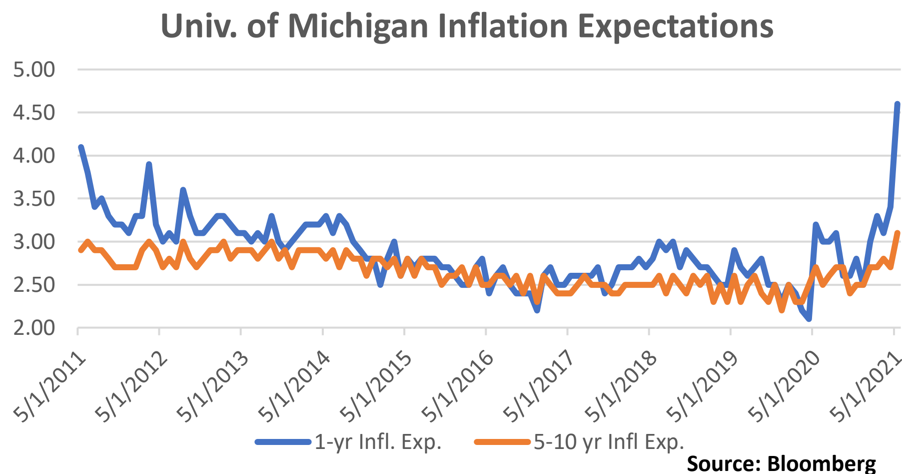
Inflation - Transitory or Permanent?

The April CPI report surprised the market with a much stronger than expected surge in inflation. The Core CPI, which excludes energy and food, increased by 0.9%, the largest monthly increase since 1981. On an annual basis, headline CPI increased to 4.2% and the Core CPI rose to 3.0%. With the economy reopening and strong household balance sheets, demand is soaring, but supply is constrained by a variety of shortages including labor, raw materials, and shipping containers. With the inflation alarm bells ringing, the Federal Reserve remains confident that the rise in prices will be transitory. In this month's Fixed Income Insight, we wanted to the discuss three reasons Fed officials believe that inflation pressures will prove transitory.

Inflation Expectations

The Federal Reserve believes inflation expectations are well anchored and short-term price increases will have only a temporary impact on long-term inflation. Inflation expectations are simply the rate at which consumers, businesses, or investors expect prices to rise in the future. They matter because inflation expectations can become self-fulfilling prophecies and lead to actual inflation as businesses raise prices and labor demands higher wages in anticipation of future increases. Two measures of inflation expectations are the University of Michigan Consumer Sentiment Survey and the breakeven inflation rate derived from the Treasury Inflation Protected Securities (TIPS) market. As seen below, the University of Michigan Survey shows inflation expectations are well anchored in the sense that short-term inflation pressures give way to lower longer-term expectations. More troubling to the Fed, however, is the rise to the highest levels in over a decade for both short- and long-term inflation expectations. Similarly, the TIPS market is also flashing warning signs with 10-year breakeven inflation rates rising from a pandemic low of 0.55% to over 2.50% today.



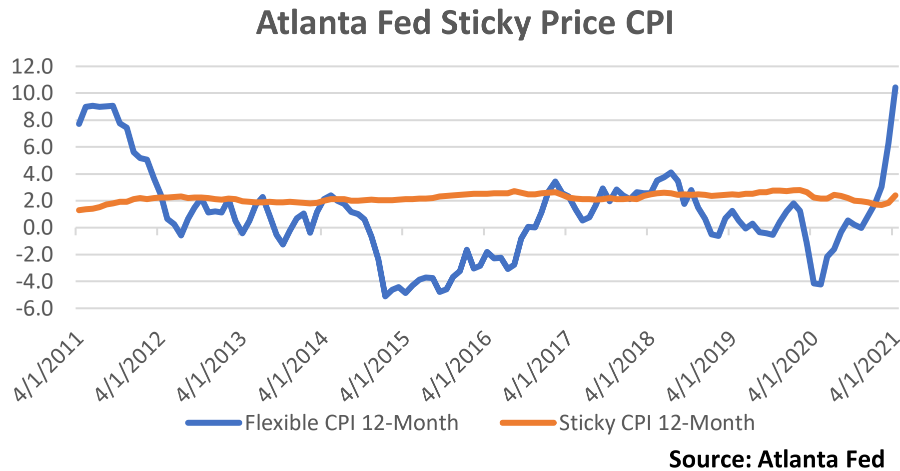
Source: Bloomberg

Sticky Prices

To the Federal Reserve, not all price increases are created equal. Some prices in the CPI move frequently and others are slow to change. The Atlanta Fed categorizes these into "sticky" and "flexible" prices and believes the "sticky" component is a better guide to where inflation is heading. The large jump in April's

CPI was mostly from the "flexible" or volatile categories like used car prices, airfares, lodging, and food away from home. In fact, these four categories alone accounted for 60% of the rise in the April CPI.

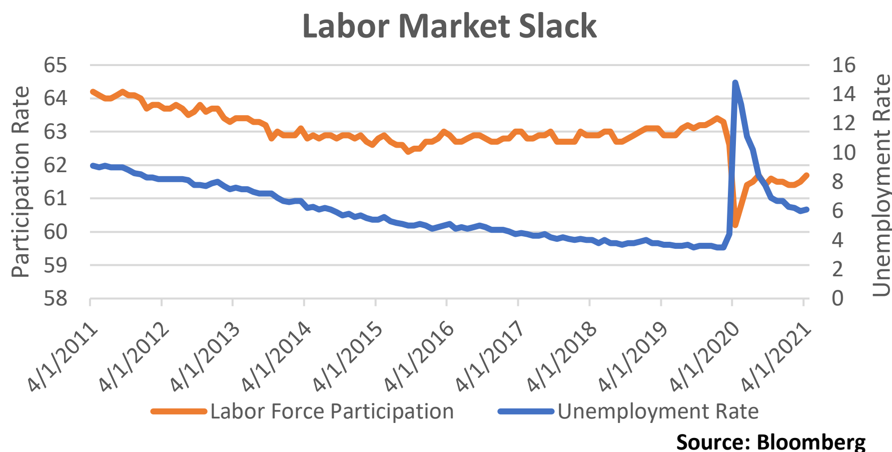
These price increases are viewed as transitory resulting from the supply and demand imbalances created by the pandemic.



Source: Atlanta Fed

Labor Market Slack

The pandemic created unprecedented labor market slack with approximately 21 million jobs lost, and the unemployment rate climbing to 14.8%. Significant progress has been made and the outlook is positive given the economic reopening and rapid vaccine roll-out, but employment is still 7 million jobs below pre-COVID levels. In his April 28th press conference, Fed Chairman Powell stated, "it seems unlikely that we would see inflation moving up in a persistent way that would actually move inflation expectations up while there was still significant slack in the labor market." By his own admission, Chairman Powell, however, does concede that the relationship between the unemployment rate, wages, and inflation is not as strong as it was in the past.



Source: Bloomberg

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Conclusion

The outlook for inflation is very uncertain. The debate on transitory or permanent will not be resolved for at least three to six months. What is clear is that the summer will test the Federal Reserve's resolve on the transitory nature of inflation pressures. We believe current inflation fears are overdone and that the surge in prices is a result of strong reopening demand, supply shortages, and the base effects from negative inflation readings from the start of the pandemic. Ultimately these short-term imbalances will normalize, and we expect inflation measures to end the year slightly above the Fed's 2% target.

Past performance is no guarantee of future results.
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