Inflation

ADVISORS CAPITAL MANAGEMENT

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Recently, there has been renewed concern regarding rising inflation, driven most significantly by increases in prices for various consumer goods. Consequently, U.S. inflation expectations have surged to their highest level since 2013. According to the Federal Reserve Bank of New York's September Survey of Consumer Expectations, the median one-year ahead expected inflation rate is currently 5.3% – a dramatic increase from expectations of only 3.4% recorded in April. Food prices, shipping costs, and energy prices are all going up. But we need to examine to what extent these rising prices are the result of transitory forces, and to what extent are they the result of larger looming issues in our economy. I would like to take this time to examine the sources of the inflationary pressures confronting the U.S. economy, and what they may portend for economic growth.

Fundamentally, prices are the result of market forces acting to balance demand and supply in the economy. Inflation, or an increase in prices, is merely the result of an imbalance on either the demand side or the supply side that is forcing price levels to find a new equilibrium. Inflationary pressures on the demand side, or "demand-pull" inflation, occurs when the level of aggregate demand has increased beyond the level of available goods and services in an economy. Simply put, it is "too many dollars chasing too few goods and services." Inflationary pressures on the supply side, or "cost-push" inflation, occurs when scarcity in one of the factors of production leads to an increase in the prices of those inputs. The increase in input prices leads to a decrease in the supply of output or to higher prices being passed down the supply chain, either of which result in the consumer paying more for those goods and services.

The U.S. has been at risk of sparking demand-side inflation for some time. As the economy recovers from the pandemic and demand for consumer goods and services has risen, so too have prices. The Consumer Price Index (CPI) rose 5.4% in September from a year earlier, the sharpest increase since August 2008. Most of this current price change is likely being driven by pandemic-related shifts that should subside over time. That being said, I do think there are other forces at play in our economy which may lead us into a more inflationary environment in the not-so-distant future.

For example, our burgeoning federal debt has been an issue of increasing concern for many years. Even prior to the pandemic, federal debt held by the public steadily outpaced growth in GDP, leading to a rising debt-to-GDP ratio. The U.S. response to the coronavirus pandemic has been the most expensive economic relief effort in modern history: $13.6 trillion have been allowed for coronavirus economic relief, and to date, $9.1 trillion have been disbursed or committed. This has had a net impact of increasing our federal budget deficit by over $5.3 trillion. Debt held by the public is projected to total 108% of GDP this year, exceeding the previous post-World War II record of 106% of GDP in 1946.

Despite these unprecedented amounts of government spending, yields on 10-year Treasury securities remain below pre-pandemic levels. It seems that, for now, the market remains confident that the Federal Reserve will be gentle in scaling back its purchases of government bonds in order to safeguard the economic recovery. However, monetizing the debt cannot be a long-term solution, and increases in the money supply relative to the real goods and services an economy produces will eventually lead to higher price levels. While there are signs that part of the recent rise in prices may be due to transitory effects, if, as I suspect may be the case, inflation is likely to be a threat on a more sustained basis, further fiscal stimulus may push monetary policymakers to be less accommodative if they want to avoid setting off demand-side inflation.

The more troubling development of late is that the U.S., and indeed the rest of the world, seems to now be embroiled in supply-side inflationary pressures as well. From energy, to transportation, to raw materials, accounts of supply shortages abound in a plethora of industries from countries the world over. The Wall Street Journal recently reported that producer prices in China, a major manufacturing hub for multinational corporations, increased by the most in year-ago terms since 1996 – when official data was first released. These goods then need to be shipped around the world to shipping ports that are so backed up tankers are now having to drop anchor and wait for space to open in order to offload their cargo. The costs continue to pile up even once the cargo reaches land as shortages of warehouse space, truck drivers, and rising fuel prices compound the inflationary pressures that began back at the factories. These additional costs in production and transportation will ultimately reach the end consumer in the form of scarce supply, higher prices, or both.

As we look to 2022, the supply side challenges that have taken hold around the world suggest there are underlying pressures that could cause inflation to be higher on a more sustained basis. Supply constraints and price pressure are a near-term threat to growth but if we do get through current energy price shock and covid drag, the tendency toward inflation remains, unfortunately, well above average of about 2% over the past 2 decades. There's also concern that if growth expectations continue to decline and price expectations continue to rise, we may be heading into a stagflationary environment as increased supply side costs erode consumer purchasing power and, ultimately, final demand. As recently noted in a report by the Brookings Institution, the spike in energy prices is emblematic of the problems created by supply disruptions that could eventually impede aggregate demand. This will be particularly challenging if central banks are forced to take more aggressive actions to contain inflation.

While the U.S. is not recovering as quickly as we anticipated maybe 3 or 6 months ago, our GDP is still growing above trend pace. We forecast GDP growth in the fourth quarter to be in the low 3% range. And while both demand- and supply-side inflationary pressures persist, I am hopeful that there is enough support from other forces in our economy, increased productivity in particular, where if we can get through this current drag, the economy will continue to grow and recover.

Alan Greenspan served five terms as chairman of the Board of Governors of the Federal Reserve System from August 11, 1987, when he was first appointed by President Ronald Reagan. His last term ended on January 31, 2006. He was appointed chairman by four different presidents.