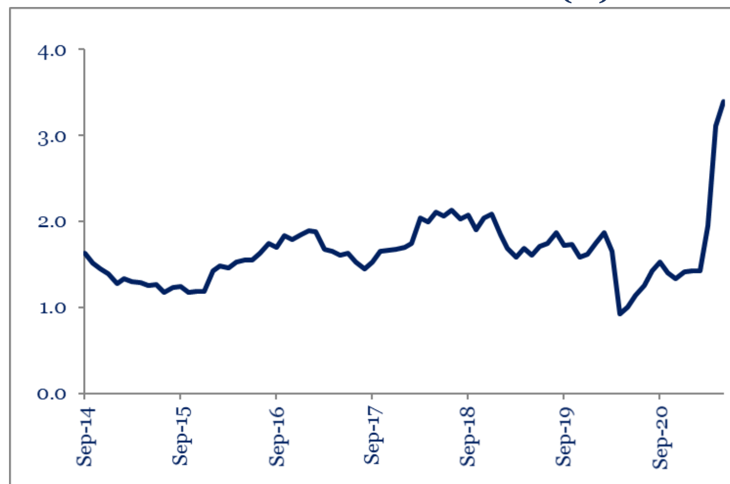
Is Inflation Transitory or Permanent?

There is a big debate going on amongst analysts and investors as to whether the recent pickup in inflation is transitory or permanent. The Federal Reserve, after having seen inflation rise above 2% in recent months, attributes this to a low base effect and supply chain disruptions. However, as economies reopen and supply bottlenecks normalize, the rate of inflation is expected to fall back to an average of around 2%, a level that is within the Fed's tolerance threshold. While a strong case can be made for inflation remaining persistent, we tend to subscribe to the Fed Chairman's belief that the recent rise in the inflation rate is transitory based on signals from the bond and labor markets.

In Exhibit 1. we present the Personal Consumption Expenditure Price Index, a gauge used by the Federal Open Market Committee to measure inflation. The index measures what consumers pay for goods and services including clothes, groceries, restaurant meals, recreational activities, and vehicles. As presented in this chart, US inflation rose 3.4% in June, which was the fastest pace in 13 years. Prices for used cars and trucks increased 10.5% from the previous month caused by a supply shortage, driving one-third of the rise in the overall index. In addition, service industries that were hit hard by the pandemic, such as air travel, rental cars, entertainment, and recreation – saw demand normalization causing prices to rise.

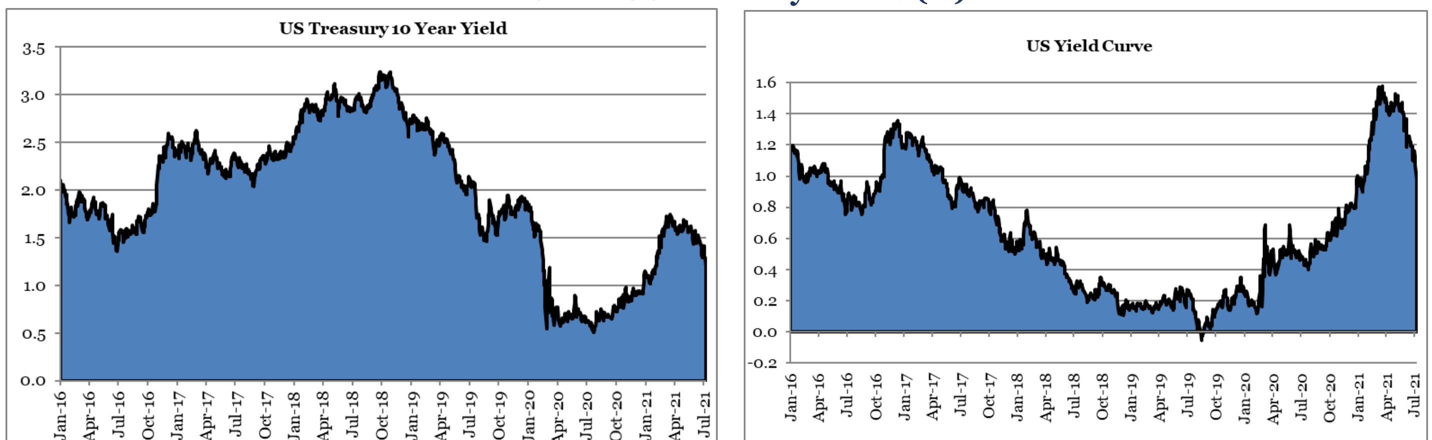
Exhibit 1. US Inflation Rate (%)



Source: Bloomberg, Bureau of Economic Analysis

Despite the recent rise in inflation, the bond market, however, appears to be sanguine about inflation fears.

Exhibit 2. US Treasury Yields (%)

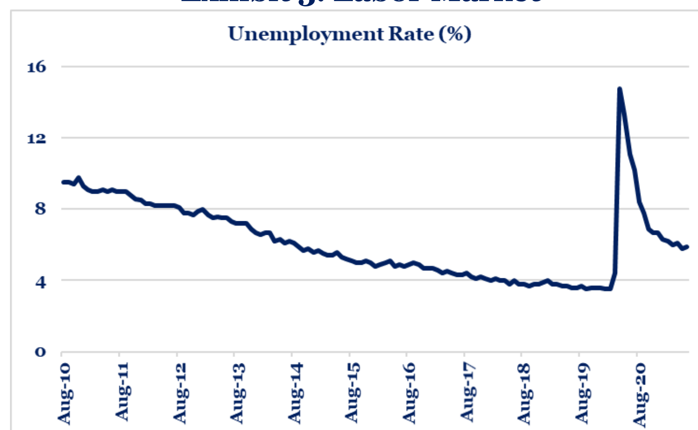


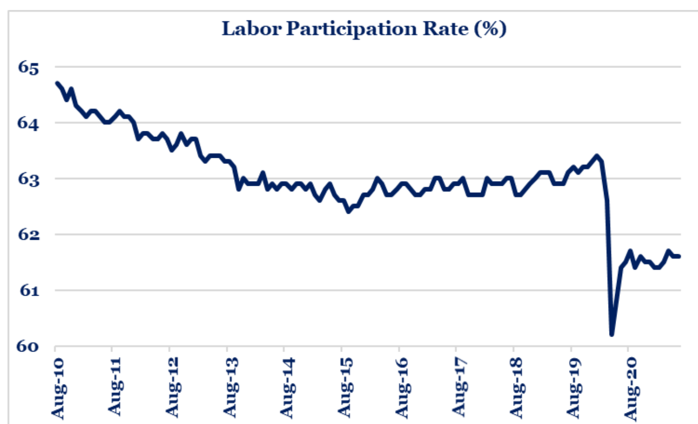
Source: Bloomberg

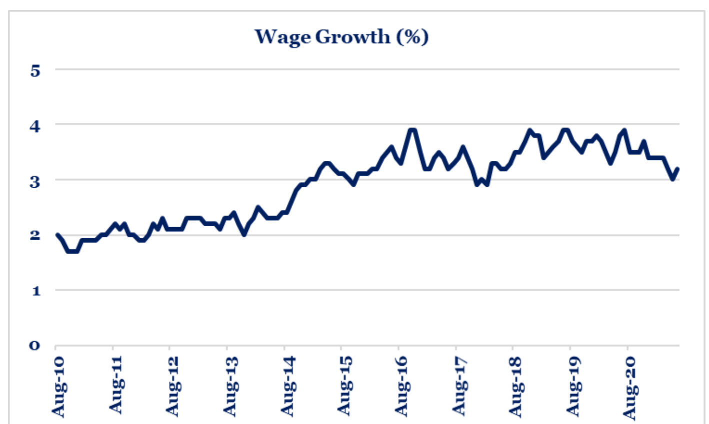
As presented in Exhibit 2, the 10-year Treasury yield has declined from 1.74% at the end of March to below 1.2% recently. One might expect that higher current rate of inflation and higher expected future rates of inflation, would result in higher yields across the yield curve, as investors would be expected to demand higher yields to compensate them for taking on the inflation risk. However, as shown in Exhibit 2, the 10-year Treasury yield has declined and the yield curve has flattened over the last few months with the spread between two- and 10- year yields hovering around 100bps, down from a recent high of 160bps in March. This implies that the bond market is not anticipating a persistent pick-up in inflation, or an increase in inflation is not priced into the bond market.

Next, we turn to cues from the labor market. The basic tenet of the Philips Curve states that there is an inverse relationship between unemployment and any corresponding change in wages. As wages increase, companies are forced to increase prices to cover higher costs thus leading to inflation. According to the employment data from the Bureau of Labor Statistics, the current unemployment rate of 5.9% is still above the pre-pandemic levels (Exhibit 2) and US payrolls are still 6.76 million below the pre-pandemic level.

Exhibit 3. Labor Market







Furthermore, while the labor participation rate has improved from March 2020, it is well below the level it had reached before the pandemic started. According to the Atlanta Fed's Wage Growth Tracker, individual nominal wage growth was 3.2%in June, which is below the recent peak and appears to be in a downward trend for now, despite the volatility in the underlying hourly wage growth data published by the Bureau of Labor Statistics. Hence, we have yet to observe persistent upward pressure on wages (Exhibit 3).

Hence, taking our cues from the bond and labor markets as well as observing the base effect of lower inflation in 2020, we believe that the rate of inflation should start to taper in the fourth quarter.