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Research Briefing | US

It ain't stagflation, but it sure is "M.E.S.S.I."

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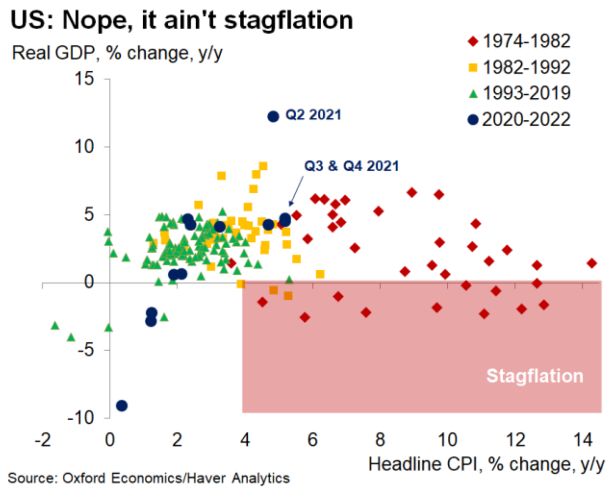
- **It's not runaway inflation, and it's certainly not stagflation. In fact, the US economy is going through a bout of "M.E.S.S.I." inflation dynamics – *Moderating Expansion with Sticky Supply-driven Inflation* – a rare phenomenon where strong, but cooling demand is met by constrained, but accelerating supply, leading to transitory, yet sticky inflation.**
- **Our latest assessment points to still-healthy inflation dynamics where inflation and demand are negatively correlated, and wage growth reflects a re-leveling of low wages rather than the onset of a spiraling price-wage inflation loop.**
- **We estimate the risk of a structural shift from the current low inflation regime to a high inflation regime (i.e., persistently above 5%) is currently around 20%. But in our view the factors that led to previous regime shifts are not present now.**
- **While it's naïve to think the Fed can unclog ports, boost semiconductor output, or free labor supply, more hawkish monetary policy guidance will lead to tighter financial conditions, constraining demand growth as the fiscal impulse diminishes and supply growth accelerates. This should ensure inflation cools.**

In the debate between transitory and runaway inflation, we have repeatedly said that the truth lies somewhere in the middle, with inflation likely to be "sticky but not oppressive". Still, with successive shocks affecting global supply chains and labor supply remaining constrained, many have been worrying about stagflation, fearing that we're headed into an economy where inflation is rampant and the economy feeble.

There's no doubt that inflation is currently running much hotter than in the decade pre-Covid. But what's missing in the discussion on stagflation is the "stag" part – stagnation. In the last episode of stagflation from late 1973 through 1975, headline CPI inflation averaged 11% but real GDP *contracted* 3.1%. Today, headline CPI inflation is running at 5.4%, but real GDP is *expanding* at a strong 4% clip (**Figure 1**).

Figure 1: We're far from stagflation



While the mid-1970s featured a prolonged period of stagflation, we've had only a couple of close encounters with this phenomenon since the 1990s. Today's environment is clearly not stagflationary.

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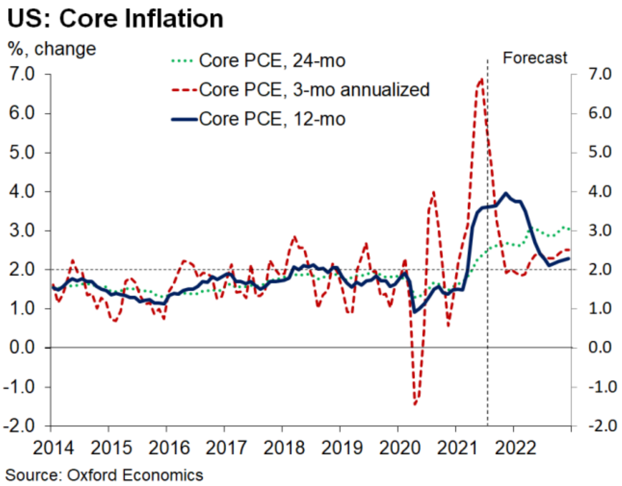
M.E.S.S.I. inflation dynamics

In our view, today's inflation dynamics are best described as MESSI – *Moderating Expansion with Sticky Supply-driven Inflation*. These dynamics aren't only a reflection of supply constraints; nor are they only an indication of strong demand. Rather, they're a combination of these two forces creating a messy inflation environment.

Initially, extreme health conditions, severe social distancing measures, and unprecedented fiscal transfers to households supported a surge in spending on goods. With domestic and international supply struggling to rebound quickly and inventories being run down, prices for goods surged. Later, as the health situation improved, the re-opening of the economy led to greater demand for services which also ran into the tight supply conditions, leading to higher service sector inflation (**Figure 2**).

Figure 2: Core inflation dynamics



While the US economy is past the peak inflationary impulse, we expect the rotation in consumer spending will lead to a sticky, yet transitory bout of inflation

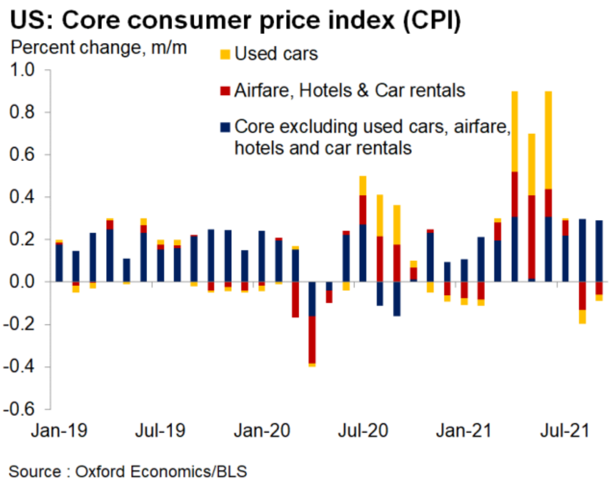
Inflation remains pro-cyclical: no inflationary psychology

Healthy inflation dynamics

Importantly, we doubt that we've not entered an "inflationary psychology" realm, in which elevated inflation leads households to pull their purchases forward, thereby feeding the demand-supply imbalance and spurring higher inflation. In fact, a recent Morning Consult survey shows that more than half of US consumers decided *against* purchasing an item in September because it was more expensive than expected.

Recent inflation data confirms these healthy dynamics, with significant price fallbacks in goods and services categories that were shunned by consumers in August and September. With spending on used vehicles falling, and demand for travel and leisure restrained by the surge in Delta variant infections, prices for vehicles, rental cars, hotels, and airfare all fell sharply (**Figure 3**).

Figure 3: Core inflation reflects the consumer spending rotation



The latest inflation data points to pro-cyclical dynamics. Following a summer surge, monthly core CPI gains have cooled as Covid-sensitive sectors have been restrained.

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Few signs of a wage-inflation feedback loop

Healthy wage dynamics and stronger productivity growth

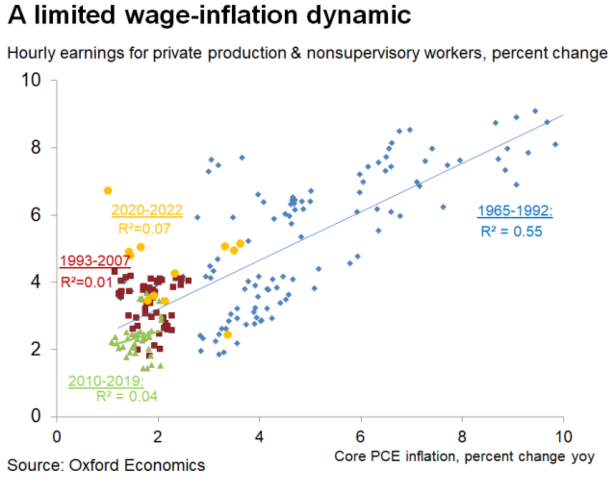
A key risk for the inflation outlook stems from the possibility of a self-reinforcing dynamic between wage growth and consumer price inflation. During previous high inflation regimes this feedback loop tended to be strong, but after the economy entered a low-inflation regime in the 1990s the dynamic has dissipated (**Figure 4**).

Sure, there's abundant evidence of strong wage increases at the lower end of the income spectrum, and small businesses are reporting record levels of wage increases as well as record-high wage expectations. But we doubt that workers have permanently gained more bargaining power. Instead, we believe the current wage dynamics reflect a one-time re-leveling of low wages amid lingering labor supply constraints. Wage measures adjusted for compositional shifts in the labor force – like the Atlanta Fed wage growth tracker, or the Employment Cost Index – don't point to spiraling wage inflation. And, if anything, consumer confidence readings have shown a deterioration in inflation-adjusted income expectations, with only 30% of households expecting to be better off financially in a year. This is the lowest level since August 2016.

What's more, it appears unlikely that companies will factor higher 2021 inflation into their wage-setting behavior for 2022 – unless higher profits and stronger productivity allow them. Indeed, a recent Fed paper by Jeremy Rudd poured cold water on the idea that inflation expectations are central in determining actual inflation outcomes. Rudd convincingly argues that there's little evidence to show that consumers or businesses act in anticipation of higher inflation, especially in a low inflation regime – when inflation is not on people's radars.

With productivity growth accelerating since the onset of the pandemic, unit labor cost growth has fallen to a meager 0.2% y/y – compared with growth of 1.7% from 2015 to 2019. So businesses should be able to manage higher compensation costs without excessive pressure on their margins and thus the need to pass on higher costs will be low.

Figure 4: No wage-inflation spiral



Since the mid-1990s, there has been almost no correlation between wage growth and consumer price inflation

Sticky inflation into 2022 with moderate risks to the upside

We're in team "sticky, but transitory"

Our baseline view suggests persistently high inflation into the first half of 2022 with the recent rise in energy prices adding around 0.2ppts to headline inflation. We forecast personal consumption expenditure (PCE) inflation at 4.4% y/y in Q4 2021 and 2.1% in Q4 2022, and core PCE inflation at 3.8% in Q4 2021 and 2.3% y/y in Q4 2022.

Combined, elevated resource utilization, lingering supply constraints, and higher commodities prices are an upside risk to our inflation forecast. But, given the negative

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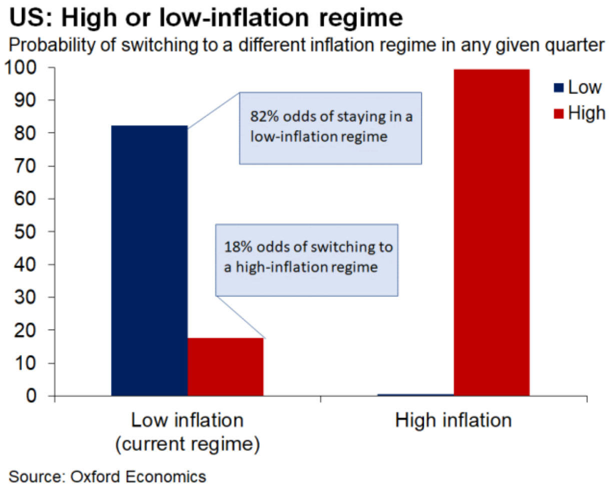
fiscal impulse in 2022, the gradual rebound in domestic and global production, and the expected gradual tightening of monetary policy, we think the risk is moderate. As of today, our Markov switching model shows an 18% chance of the US economy shifting into a high-inflation regime (persistently above 5%). While these odds are near their highest since the 1990s, our analysis indicates that such a regime shift generally requires a combination of factors that aren't present now (**Figure 5**).

In the 1940s, these factors included excessively loose monetary policy, the lingering effect of a 40%-dollar devaluation, expansionary fiscal policy, and the end of price controls after WWII. In the 1970s, they included the gradual politicization of the Fed, output gap mismeasurements, the end of the gold standard in 1971, and the oil price shocks.

Today, structural factors continue to point to low inflation. In particular, higher savings and lower spending as the US population ages, ongoing technological advances, solid productivity growth post-pandemic, and sustained (though slower) globalization should keep a structural lid on price pressures.

Figure 5: Still low odds of an inflation regime shift



The odds of a shift from the current low-inflation regime to a high-inflation regime have risen from 10%-15% before the summer to around 20% in Q3 2021. Still, the factors that led to prior regime shifts aren't present today.

Fed uncertainty in the face of sticky inflation is more hawkish

Sticky inflation is nudging the Fed hawkish

While the Fed's new policy framework is more tolerant of inflation to generate a broad labor market recovery, Fed Chair Powell, Vice Chair Clarida and various other FOMC members have repeatedly stressed that if measures of inflation expectations move up in a way that is inconsistent with the Fed's inflation mandate, they will tighten monetary policy.

With the Fed having to consistently revise its inflation forecast up, policymakers' language has gradually moved from describing inflation as purely "transitory" to discussing how factors leading to persistent inflation are expected to "lessen" and "abate" – a subtle but notable shift. The fact that Fed Chair Powell and the core of the FOMC are openly discussing the precise timing of QE asset purchase tapering (starting next month and running through mid-2022), and signaling that a December 2022 rate lift-off would be "entirely consistent with the new monetary policy framework" is key in that regard.

Yes, it's naïve to think that the Fed can unclog ports, boost semiconductors production, or free labor supply. But more hawkish monetary policy guidance will lead to a tightening of financial conditions via higher long-term rates, a stronger dollar and potentially lower stock prices. This should limit the pace of demand growth, and thereby constrain one of the prime inflation drivers as supply gradually ramps up.

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