THE INFLATION PUZZLE

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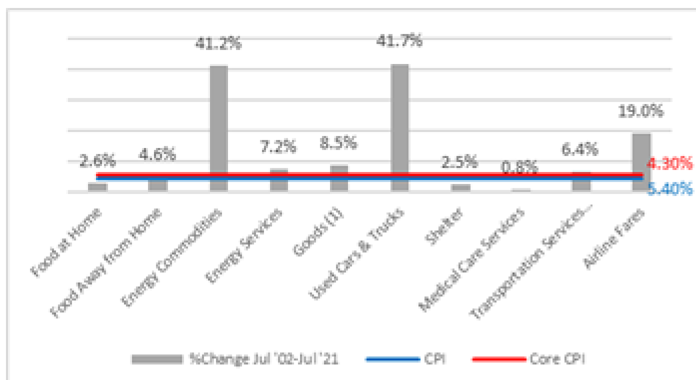
Inflation is an important driver of returns and market leadership, and currently one of the biggest debates in the market. Much of the focus on recent inflation data has been on the spikes and dramatic rebounds in categories like gasoline, airline tickets, or used cars. While their weight in the CPI basket is not that big (Exhibit 1), they are prone to significant volatility. The debate whether inflation will be transitory or more structural in nature centers around the dynamics in three main categories: Goods (and Commodities), Wages, and Housing (Shelter or Rents).

EXHIBIT 1: COMPOSITION OF CPI BASKET (JUNE 2021)

Food and Energy			21.0%	
	Large Subcategories	Groceries		7.6%
		Restaurants		6.2%
		Gasoline		4.0%
		Utilities		3.2%
Goods less Food and Energy			21.0%	
	Large Subcategories	New Vehicles		3.7%
		Used Vehicles		3.5%
		Apparel		2.7%
		Medical Care Commodities		1.5%
Services less Energy			58.0%	
	Large Subcategories	Shelter		32.6%
		Health Care Services		7.1%
		Transportation Services		5.3%

Source: Cornerstone Macro

EXHIBIT 2: CPI AND COMPONENT PRICE CHANGES JULY '20 TO JULY '21



(1) Goods inflation includes used cars and trucks
(2) Transportation Services includes airline tickets
Source: US Bureau of Labor Statistics

GOODS AND COMMODITIES: BACK TO NORMAL = DEFLATION

The jump in CPI witnessed in June and July was driven by fuel, used cars and trucks, and airline tickets. We expect goods pricing will eventually deflate for a couple of reasons. First, as bottlenecks in supply chains resolve themselves (from components to transportation), supply constraints will gradually lift. At the same time, we are seeing a shift in spending from goods to services as consumers regain confidence in and access to services like travel and leisure. Commodity oriented categories like fuel are increasingly bumping into elevated base effects. While we have seen price spikes in certain goods categories, we should not forget that the "normal situation" (i.e. the average of the last 20+ years) for categories like toys, furniture, tools, cars, apparel, etc … is more deflationary than inflationary.

WAGES: WAITING OR HOPING (?) FOR A LOT OF PEOPLE TO COME BACK TO THE LABOR MARKET

While wage growth is not a direct component of the CPI basket, it is seen as an important indirect component and a lead indicator of inflation. The labor market is clearly tight with more than one job opening for each unemployed person, but it is still unclear how the end of the supplemental unemployment insurance will change that dynamic (i.e. people coming back to the labor force).

One counter argument to the expected increase in labor force participation is the accelerated retirement of Baby Boomers during the Pandemic. On the other hand, the corporate sector used the pandemic to put in place major productivity enhancing investments. Also, the share of wages in the economy's total income has continued to trend down, limiting its impact on the overall economy.

While we have seen some pick up in wage growth, it has been mostly concentrated in the low skilled and lowest paying occupations. We agree that it is highly unlikely that any wage gains will be reversed, as wage growth is glacial in character and auto-correlated. But there is also an argument to be made that current wage pressures have a one-time component to them, linked to the re-opening of certain service sectors like hotels and restaurants. While Exhibit 3 shows a clear pick up in wage growth for low skilled labor, it looks more like reversion to the mean pre-Pandemic. Up to now at least, the weight of these wage increases have not had a serious impact on total wages as median wages for high skilled labor are trending flat to slightly down. One of the key issues plaguing the labor market is (and remains) the availability of qualified labor, a situation that was already in place pre-Pandemic. To have sustained impact on inflation, wage growth would have to accelerate further (and beyond productivity growth).

Housing, Shelter , and Rents: moving back to the city?

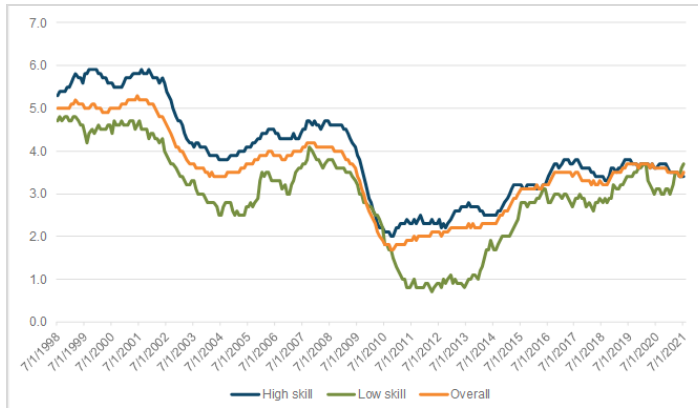
Rents, which are used as a proxy for the cost of home ownership, comprise more than 30% of the overall CPI basket and over 40% of the core CPI calculation. Rents fell during the Pandemic, but have quickly recovered. As the vacancy rate remains low, there is a possibility that this piece of the inflation puzzle is more structural in character.

While the shelter component has steadily moved higher over the last couple of months, it has historically not been a very volatile series. An interesting argument put forward by Citigroup economists is the potential impact that the "return to the major cities" can have on the shelter component of CPI. The Zillow Observed Rent Index, which is used by several economists as a lead indicator of the shelter CPI component, has moved higher over the last several months (Exhibit 4). Rents in the gateway cities of New York, Los Angeles, and San Francisco seem to be stabilizing after the "move to suburbia" depressed rents through the first half of 2021. Being able to "work from anywhere" has continued to support lower tax metropolitan areas like Atlanta, Dallas, and Miami. This trend has not (yet) been translated in the shelter component of the CPI, which came in below expectations in July (Exhibit 2).

Conclusion

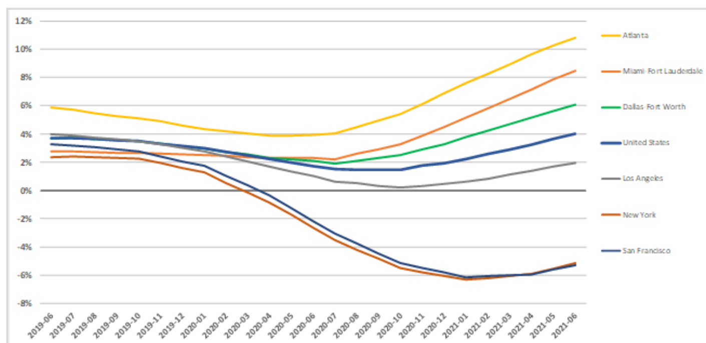
- The most recent CPI numbers have done little to resolve the persistent versus transitory inflation debate.
- There is a chance inflation does not fall back as quickly as the Fed hopes, with the most likely culprit rents.
- Both wages and rents are slow moving and low volatility components of inflation, but historically they have not been a source of sharp negative surprises.
- While it may take longer for inflation to fall back, it does not mean it will be structurally and significantly higher or that it will tailspin. This points to the importance of inflation expectations, which remain subdued.
- The direct impact of shelter and indirect impact of wages may be offset by deflation of goods in the CPI.
- As we move into 2022, CPI numbers will also start to bump into tougher comps and higher base effects. Because of volatile base effects, the true inflation picture may not be visible until 2023.

Exhibit 3: Median Wage Growth (12m Moving Average Since 1997)



Source: Federal Reserve Bank of Atlanta

Exhibit 4: Zillow Observed Rent Index Year-Over-Year Growth



Source: Zillow.com
Data range: 6/19/-6/21

Main Sources:

Cornerstone Macro Eco Outlook: "If you're going to worry about prices, think Disinflation/Deflation – Not Inflation", 07/22/2021

Empirical Research Portfolio Strategy: "Inflation: It's complicated and the Cost of Hedging is Low", 08/18/2021

Citi US Economics Weekly, 07/30/2021

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