An Inflation Check-Up: Assessing the Drivers of U.S. Inflation

James Orlando, CFA, Senior Economist | 416-413-3180
Derek Burleton, VP & Deputy Chief Economist | 416-982-2514

July 20, 2021

Highlights

- Inflation in the U.S. is running at the highest level in a generation. Though we can point to the uniqueness of the pandemic as a major cause, the outlook for future inflation remains uncertain.
- We look to a series of current and forward-looking indicators to help assess the future path of inflation.
- Inflation expectations of consumers, businesses, and financial markets will be key. All of these indicators are pointing to somewhat elevated over the next few years.
- The other major influence will be from the labor market, which is just beginning to heat up. Wage growth expectations are validating the higher inflation outlook.

Temperatures are rising across the U.S., but inflation is even hotter. With pent-up pandemic spending pushing on constrained supply chains, inflation is reaching levels not seen for decades. With the inflation outlook so uncertain, many of our clients are asking, "Where will inflation be in 6 months, a year, or even 5 years?" To help shed some light on this question, we have assembled a broad collection of indicators that capture the present state of inflation and consensus views on where inflation is headed (Table 1).

Taking Stock of Current Inflation

Over the past decade, the Federal Reserve has struggled with disinflationary pressures. While inflation consistently came in below the 2% target, the Fed kept reinforcing that higher inflation was just around the corner. Well it has now got what it wished for. The Fed now finds itself in an unexpected position, witnessing a strong spurt in prices since the spring and having to talk down the risk that inflation is running too high. And it isn't just headline inflation, which includes volatile food and energy prices. Core CPI is up 4.5% year-over-year as of June, and the Fed's preferred core PCE metric reached a still-lofty 3.4% as of May.

The Fed's reaction to this move in prices has been to largely shrug it off, classifying it as 'transitory'. It has highlighted that current inflation is being distorted by pandemic factors and that other inflation metrics, like the volatility adjusted inflation rate from the Dallas Fed and the median inflation rate from the Cleveland Fed, are running closer to 2%. This implies that underlying inflation isn't taking off as much as the typical inflation gauges reveal. And there is credence to this view. The pandemic has created a unique dislocation in prices which is skewing the results. No wonder the Fed is holding firm, stating that as the economy normalizes and the gap in economy-wide supply and demand growth narrow, inflation pressures should ease.

Though this is all well and good in theory, normalization might not go so smoothly. The Fed has even admitted that the supply/demand imbalance in the goods markets may last longer than expected. Additionally, pent-up demand for in-person

Table 1: Key Inflation Metrics (%)*		
Indicators	Last Data Point	End 2019
Current Inflation Measures		
Headline CPI	5.39	2.29
Core CPI	4.47	2.26
Headline PCE	3.91	1.64
Core PCE	3.39	1.62
Core PCE (Using Only Market Prices)	2.84	1.48
Cleveland Fed Median PCE	2.02	2.45
Dallas Fed PCE Trimmed Mean (12 Months)	1.85	1.96
Economist Surveys		
Federal Reserve Long-Run Inflation Forecast (Median)	2.00	2.00
Blue Chip PCE Forecast End 2021 (Q/Q)	3.20	-
Blue Chip PCE Forecast End 2022 (Q/Q)	2.50	-
Survey of Professional Forecasters PCE Index (in 10 Years)	2.05	1.95
Business Surveys		
Atlanta Fed Business Unit Cost Expect. (Next Year)	2.80	1.80
CFO Survey Price Growth (Next Year)**	3.00	1.50
CFO Survey Wage Growth (Next Year)**	4.00	3.00
Consumer Surveys		
NY Fed Consumer Inflation Exp. Survey (in 1 Year)	4.00	2.53
NY Fed Consumer Earnings Exp. Survey (in 1 Year)	2.54	2.19
NY Fed Consumer Inflation Uncertainty (in 3 Years)	3.59	2.17
U. Michigan Inflation Exp. (in 1 Year)	4.20	2.30
U. Michigan Inflation Exp. (in 5 Years)	2.80	2.20
Market-Based Measures		
TIPS Comphensation (in 5 Years)	2.52	1.62
TIPS Comphensation (in 10 Years)	2.33	1.72
Labor Costs		
Atlanta Fed Wage Growth Tracker (Current, Non-Smoothed)	3.60	3.60
Unit Labor Costs	4.15	1.50
Employment Cost Index (Wages/Salaries)	2.73	2.91
Employment Cost Index (Total Comphensation)	2.64	2.74
Average Hourly Earnings	3.58	2.94

**All data points are year-on-year unless specified. **Feb 2020.*
Source: BLS, BEA, FRB, FRBCLE, FRBDAL, FRBNY, FRBATL, UMICH, DUKE, TD Economics.

events and travel are starting to lift prices for services. The point here is that even though we can be confident that part of the current inflation flare-up is transitory, whether inflation settles at 4%, 3%, or 2% over the next 6-18 months is still a difficult question to answer. Our TD Economics call is for inflation to average 3% through 2022, and settle just above 2% in 2023.

The Forward-looking Indicators

In order to monitor risks around the persistence of inflation over the medium term, we would put particular weight on two types of indicators:

1. Inflation expectations (and whether they will become unanchored).
2. Trends in wage growth.

And given that there is no perfect barometer of either, we will be tracking a number of data points, several of which are included in Table 1.

What to Expect When you are Expecting

The first critical element in determining the future path of inflation is all about beliefs. If consumers and businesses think inflation will be higher in the future, it will become a self-fulfilling prophecy. After the high inflation of the 1970s and 1980s, central banks spent years building credibility that it could control inflation and anchor price growth around 2%.

The first set of expectations covers that of the economic forecast community. Clearly, economists within the Fed and the broader consensus still believe that price growth will cool down next year and will gravitate towards the 2% level over the long-run.

But what about business expectations? We can see from our inflation table that business surveys reveal that their assumptions around increases in wages, overall unit costs, and general prices have all ramped up by roughly a percentage point compared to those prior to the pandemic. This also signals that businesses are preparing to pass some of the recent higher costs on to consumers in the months ahead.

High inflation expectations from businesses (around 3%) appear to be on the high side, especially relative to that of economic forecasters (2.5% in 2022). The Fed in particular has played down the importance of short-term expectations since they tend to be heavily influenced by recency bias in the data. Unfortunately, business surveys covering a longer-term view are not readily available.

There is more wealth of data around consumer expectations. Based on a survey conducted by the NY Fed, consumers are now anticipating inflation at almost 4% over the next three years, nearly double the pre-crisis level. This expectation, too, can show some implicit volatility. For example, if gasoline and food prices pull back in the coming months, medium-term expectations would probably follow suit. To the extent that the 3- and 5-year measures hold up even as shorter-term expectations are ratcheted down, it could provide some useful information to policymakers around the risk of persistence.

We are also seeing financial market participants prepare for higher inflation. Bond market measures of inflation expectations, which are derived from the spread on Treasury Inflation Protection Securities (TIPS) and nominal U.S. Treasury yields, rose confidently over the last 11 months. Market participants were clearly positioning themselves for higher inflation, by favoring securities that protect against inflation. The pricing reached a high of 2.7% in May 2021, but has come down to about 2.5% in recent weeks. Even with the pull-back in market-based inflation expectations, our inflation table reveals that investors are still positioned for greater than 2% inflation.

Is Your Company Raising Your Wages?

The other key pre-requisite for sustained inflation is rising wages/unit labor costs. With the economy opening up so rapidly, competition for workers is intense. The demand for labor has resulted in record job postings, and we are even seeing firms offer sign-on bonus incentives for positions across the income spectrum. This demand for workers is only just starting to show up in wage data, which have recently accelerated into the 3-4% range. The best measure of total compensation is the quarterly Employment Cost Index (ECI), which is likely to better capture the impact of one-time payments. Data for the second quarter won't be available until July 30th.

The acceleration in wage growth underway may act to limit medium-term upside by drawing more people into the workforce and reducing labor shortages down the road. However, it could also work the other way, pushing up consumer spending and reinforcing the growth cycle narrative.

Wages are only inflationary to the extent that they grow faster than productivity. Unit labor costs (ULC), which transform wages into a per unit of output basis, had been kept at bay earlier in the pandemic through large gains in productivity. However, year-over-year gains in ULC have accelerated recently, moving above 4% year-over-year in the first quarter of 2021. If sustained, this would raise more red flags around the risk of sustained inflation.

In terms of current wage expectations, CFO surveys reveal that businesses are anticipating wage growth of around 4% next year, while the Atlanta Fed survey sees gains in unit labor costs of around 3%. This is consistent with our forecast for inflation to be closer to 3% than 4% in 2022.

Bottom Line

Current inflation is running at multi-decade highs. Though this is largely due to unique factors caused by the pandemic, an easing of inflation back down to more comfortable levels may not be so easy. For this reason, we are tracking a host of current and forward-looking inflation measures to help determine the outlook for prices.

The pace of the economic recovery will be a dominant factor going forward. With the economy running hot, many companies are struggling to find workers and are paying-up to fill staffing needs. Even when the transitory factors fall out of the inflation data, broad-based inflation could start to takeover. This argument is further supported by the fact that business, consumer, and financial market inflation expectations have been trending up along with measures of wage growth. If they continue to do so, this will anchor a higher trajectory for future prices. It is this risk that caused us to upgrade our 2022 and 2023 inflation outlook in our latest Quarterly Economic Forecast.

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