The Three Prongs of Inflation

Supply-chain bottlenecks and disruptions are holding up inflation longer than expected; here's what investors need to know.

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The US Federal Reserve (Fed)'s message on inflation has changed. Fed Chairman Jerome Powell recently characterized supply-chain bottlenecks and disruptions as "frustrating" and as "holding up inflation longer than we had thought." The Fed's mea culpa is small consolation for investors whose portfolios haven't been positioned optimally for a longer-than-expected period of higher inflation.

I previously said inflation would likely be stickier than the market or the Fed anticipated. The question now is: Has inflation already peaked? In my opinion, the short answer is no.

The Systemic Nature of Supply Shocks

Inflation is being pushed higher by three catalysts—labor, raw materials, and transportation—that are interrelated in ways that create longer-lasting systemic risks for the economy. I use the term systemic because of the parallel to systemic financial risks, in which stress in one area of the market spills over into other parts of the financial system, amplifying the initial problem.

For example, the CEO of a computer hardware company recently told our analysts that it wasn't just semiconductors that were in short supply, but also plastic, resin, copper, and steel. Then once the hardware is built, it's transported on container ships that are backed up at US ports. Finally, a scarcity of truck drivers and port workers means that getting the finished products to stores is delayed.

Thus, while some supply-chain strains may ease relatively soon, the ongoing bottlenecks could take at least another year to resolve.

Why Supply-Chain Issues (and Inflation) Could Persist

- **Labor:** US wages are up 4.6% over the past year (as of September 2021) amid a tight labor market. Indeed, **FIGURE 1** shows the highest job quits rate in 20 years, suggesting workers are confident in their ability to find other employment. This is a good predictor of potentially even higher wages going forward. Meanwhile, some 5 million people have left the labor force during COVID-19, half of whom are 65 and older. Lower immigration rates and lingering health concerns have also shrunk the labor pool. Finally, strikes at large corporations across industries reflect a shift in power from management to labor, which could put more upward pressure on wages. Elsewhere, COVID-19 resurgences in Asia shut down factories and ports, exacerbating supply challenges.

Key Points

- The Fed has changed its messaging on inflation, which is sticking around longer than anticipated.
- Inflation is being pushed higher by three interrelated catalysts that are creating longer-lasting systemic risks for the economy.
- Labor, raw materials, transportation, and housing are contributing to current supply-chain issues and could be partly to blame for continued inflation.

FIGURE 1
High Quits Rate Pushing Wages Higher
US Employment Cost Index (ECI) and US Quits Rate

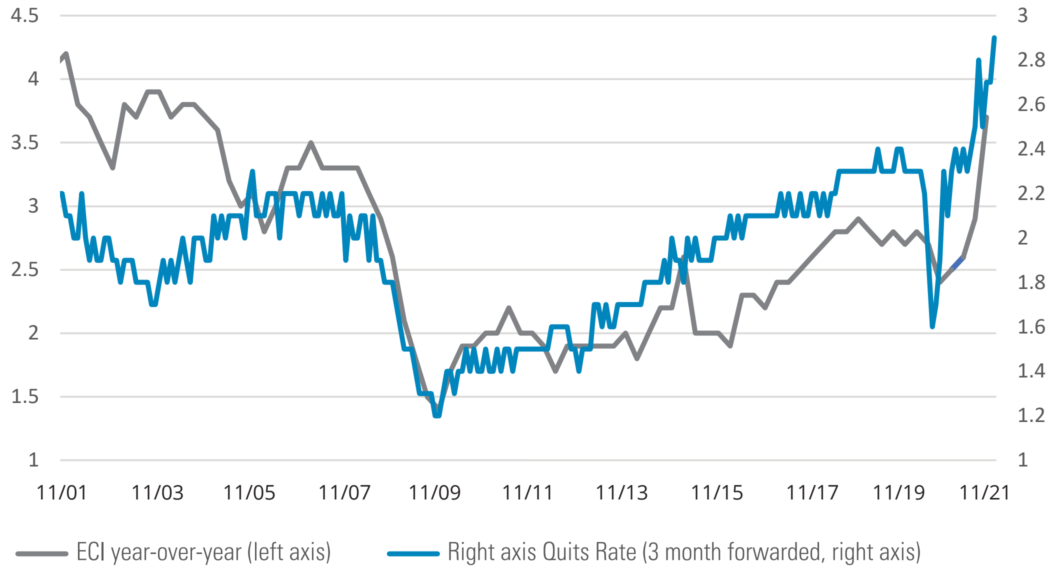

Chart data: ECI: quarterly data June 2001–September 2021; Quits Rate: March 2001–August 2021 (x-axis date range is through November 2021 due to Quits Rate being forwarded 3 months). The Employment Cost Index essentially measures the change in total employee compensation each quarter. It is based on a survey of employer payrolls conducted by the Bureau of Labor Statistics in the final month of each quarter. Source: Bloomberg.

- **Raw materials:** The price of oil is up a stunning 80% year-to-date. Other commodity prices, such as metals, are up around 30%. Part of the story here is demand-driven as the global economy reopens, but there are two other contributing factors that may be longer-lasting. First, commodity supplies are constrained due to much lower capital expenditures and greater capital discipline after a period of overinvestment and underdelivering to shareholders. Second, decarbonization is raising the breakeven price at which companies can increase production economically. The result: shortages of everything from computers to cars, canned goods, and clothing.
- **Transportation:** The average price to ship a 40-foot container has quadrupled over the past year.[1] Bottlenecks at temporarily shut-down seaports and a flurry of congestion at rail terminals, warehouses, and distribution networks are extending the time it takes to move goods from China and other Asian ports to the US. It's also been taking a long time just to get empty containers to where they are needed. Shortfalls may be peaking though, as some labor conditions ease and more transportation assets come online.
- **Housing:** Could housing become the fourth prong of higher inflation? US home prices are up around 20% over the past year, while rents are up around 10% nationally. Owner's equivalent rent (OER),[2] the Consumer Price Index (CPI)[3] code for "shelter costs," is driven by the rental market and represents 30% of core CPI. I wouldn't be surprised to see OER rise 4%-6% by the end of 2022, which could tack 1.2-2.0 percentage points onto inflation over the next 12 months.

[1] Source: Drewry Shipping Consultants
[2] Owners' equivalent rent (OER) is the amount of rent that would have to be paid in order to substitute a currently owned house as a rental property.
[3] The Consumer Price Index (CPI) is a measure of change in consumer prices as determined by the US Bureau of Labor Statistics.

Investment Implications

- **Consider seeking potential inflation protection for your portfolio.** Potential inflation hedges may include **commodities, certain equities, and real assets:**
  - Commodities exposures in natural resources, agriculture, and industrial metals tend to be the most inflation-sensitive assets. Gold may also help, but its potential benefits are more dependent on lower real (inflation-adjusted) yields.
  - Consider more value-oriented, cyclical equity sectors, such as energy, financials, materials, and some industrials. A key attribute to look for in any company in this environment, regardless of sector, is its pricing power.
  - Real assets and some equity real estate investment trusts could provide yet another means of defending against inflation risk.
- **In fixed income, keep it short.** While I still expect high-quality bonds to confer diversification benefits in the event of an equity sell-off, shortening fixed-income duration[4] and adding shorter-duration Treasury inflation-protected securities exposure to help guard against an inflation-induced spike in interest rates might make sense.
- **Central banks' reaction function may be changing.** I continue to expect a reflationary environment, a likely positive for risk assets.[5] However, I am closely watching how central banks respond to higher inflation. A swifter, more aggressive policy-tightening stance could spell trouble for the cycle and for risk assets generally.

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Talk to your financial professional about strategies to help hedge your portfolio against inflation.

[4] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movements.

[5] Risk assets refer to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

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