The Jump In US Inflation Is Transitory And Consistent With Our Recovery Story

May 14, 2021

Watching the jump in April consumer prices at first blush was unnerving. Headline CPI topped 4.2% year-over-year (a 13-year high) and core CPI reached 3.0% year-over-year (a twenty-five-year high).

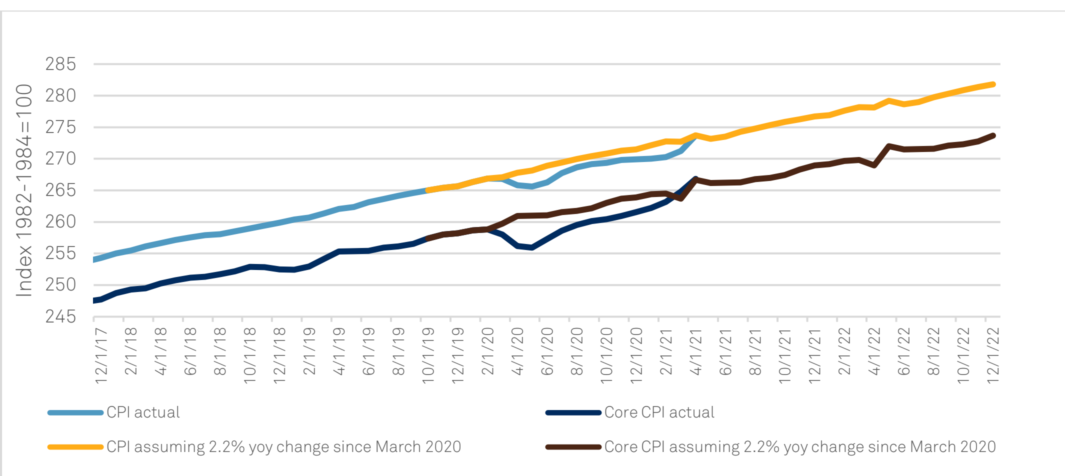
In contrast to much of the market commentary, we were not surprised. Indeed, we expected to see a spike in inflation as the U.S. economy climbs the acceleration ramp onto the superhighway, as GDP jumped 6.4% in the first quarter and we expect a surge of 11.3% in the second quarter fueled by a, faster vaccination rollout and reopening schedule on top of sizable savings and pent-up demand . As we have noted previously, an orderly, growth driven relation story is positive for both macro and credit.

We also believe the jump in inflation will be transitory. Why? We see it tied to the "base effect" from pandemic-depressed prices last year and near-term boost in prices from supply and labor bottlenecks as business activity catches up to the demand surge stemming from reopening. Even beyond the inflation spike in April and May driven by base effects, we think higher levels of stimulus-encouraged household savings will increase demand for goods and especially services, spurring inflation above 2% over the span of this year--but hardly to "runaway" levels.

How will things play out? We expect these near-term inflation swings to filter out of the economy over the year. Headline CPI to slow to 2.1% by 2022 after reaching 2.7% in 2021. After a second quarter boost, core CPI will likely come in around 2.1% for 2021 and drift higher, to 2.2% for 2022. Given a near-term rate of 2.2% CPI inflation would be consistent with the policy-setting Federal Open Market Committee's (FOMC) personal consumption expenditures (PCE) inflation target, that would place both headline CPI and Core CPI below the Fed's new average PCE inflation target of 2.0%.

Chart 1

Consumer Prices: Actual Relative to Trend



Source: BLS, S&P Global Economics calculations.

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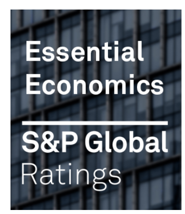

These trends can be visualized in the chart. Here we plot actual and projected inflation – overall and core - relative to a 2.2% year-over-year path from March 2020 through December 2022 (where prices were trending in late 2019). Using these metrics puts the April price jump into perspective. The rise in inflation was necessary in order to offset the underperformance of inflation during this time last year and return to the desired path., Going forward, we don't expect the Fed to raise rates until sometime in 2023 including because the new monetary policy framework allows for a temporary inflation overshoot.

For more on this, please see "Economic Research: U.S. Markets See Inflationary Ghosts; Macroeconomic Signs Disagree."

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