The Great Inflation Debate

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Watch any of the financial news channels over the course of a day, and it is likely you will see multiple references and much debate regarding inflation. The debate centers around whether we are at the start of a lasting rise in inflation from economies reopening with all the monetary and fiscal stimulus still in place. There are compelling arguments on both sides of the equation with seemingly the only consensus being there will be at least a short-term pickup in inflation.

Near-term inflation?

Multiple rounds of stimulus checks and headline inflation figures are real, but how long will it last? The simplest explanation for an inflationary jump over the next couple of months is that this current inflation will be measured against the Consumer Price Index, (CPI) from last spring.

However, it is not the only reason. Covid-19 wreaked major havoc on supply chains worldwide as country lockdowns stopped the flow of materials and goods forcing companies to draw down inventories. Now with demand picking up, issues with getting semiconductors, lumber, plastics, etc. are creating delays and problems restocking inventories. Not to mention the difficulties some businesses are having finding workers. According to the National Federation of Independent Business (NFIB), a record high seasonally adjusted 44% of small business could not fill job openings last month.

New employees and replenished inventories are going to be needed as we may have the perfect storm for a massive pickup in spending. The passage of the American Rescue Plan Act which included $1,400 stimulus checks for many Americans and the historically accommodative Federal Reserve have created an environment flush with liquidity just as more states are looking to get closer to being fully reopened. As the March retail sales increase of 9.8% might indicate, people are looking to get out and spend.

What happens when supply issues meet rising demand?

A great example of what happens when supply issues meet rising demand is the rental car industry. Last spring with economies closed, many rental car companies were forced to sell a portion of their car inventories to raise cash. Today, as travel demand heats up, that lack of inventory is presenting a widespread problem. Due in part to the semiconductor shortage delaying car production, rental car companies are having difficulties replacing their fleets leading to numerous stories of people either not being able to find car rentals or having to pay exorbitant rental rates. One story says people travelling to Hawaii have resorted to renting U-Hauls.

What is the case for sustained inflation?

Even before Covid-19, there was a push to reverse decades of globalization and move supply chains back home. That push has only intensified with the current supply chain disruptions. This deglobalization is potentially inflationary as one of the benefits of globalization has been lower prices for consumer goods.

Then there is the case for rising wages as companies struggling to fill jobs are having to pay more to acquire their services. Also, potentially adding to rising wage pressure is the push to raise the minimum wage with Chipotle becoming the latest company to lift hourly wages to $15. Sustained wage increases could make inflation more permanent.

Perhaps the best argument for inflation is central banks are willing to let inflation run hot. The risks are that they underestimate inflationary pressure and lose control of it, or the market begins to believe they have lost control of it and inflation becomes a self-fulfilling prophecy.

Why could inflation be transitory?

The Federal Reserve is in the camp that believes inflation will be transitory. One of the biggest reasons cited is the amount of labor slack. As of this writing, there are still over 8 million fewer people on payrolls than just prior to the pandemic, and many believe it is difficult to have lasting wage inflation with such significant labor slack. As vaccination rates increase and the extended federal unemployment ends, people will reenter the labor market thus dampening wage growth.

The issues causing the current rise in inflation, the expected surge in spending and supply chain issues should eventually work themselves through. The surge in spending should be temporary as the stimulus checks make their way into the economy and additional unemployment benefits end. This should help alleviate some of the supply constraints.

The continued major advances in technology should help constrain inflation as it allows companies to be more efficient needing fewer employees and less equipment.
Finally, where the base effect or the comparison to last year works to outsize inflation figures in 2021, that should reverse next year when 2022 inflation data is compared to the likely higher 2021 inflation data.

Whether inflation turns out to be transitory or not will have an impact on the economy, the markets, and the Federal Reserve's decision to begin normalizing monetary policy. Regardless of who ultimately proves to be correct, in the near-term, we should prepare to pay a little bit more for our goods and services.

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