February 2, 2021

MACRO STRATEGY

How to Stop Worrying and Learn to Love Inflation

Key Takeaways

- There is a lot of discussion and worry about inflation in 2021. Most of the anxiety appears to conflate transient inflation, which we anticipate in 2021, with true economic overheating, which we do not.
- More importantly, the Fed is unlikely to conflate the two, and should be believed when it says it will allow average inflation to finally reach 2 percent. There is a long way until we get to their 2 percent average inflation target.
- Even in view of inflation spikes that could exceed 2.5 percent this year, we feel underlying economic conditions are far from overheated.

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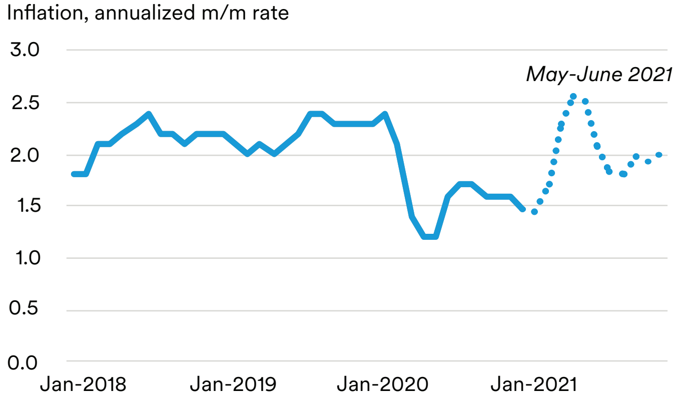
Base effects on inflation will be big. But the Fed will look through them.

Last year was a very strange year and affected just about everything, including inflation. Weak inflation in May and June 2020 means we can expect inflation spikes due to base effects.

If the month on month growth of inflation reaches 2 percent on an annualized (a 0.165 percent month on month growth rate), inflation can hit 2.6 percent year on year in May and June due to base effects.

We focus this year on month-over-month growth rates, and their annual equivalents rather than year on year growth.

Figure 1 | Base effects on core CPI with illustrative 2 percent annual growth rate.



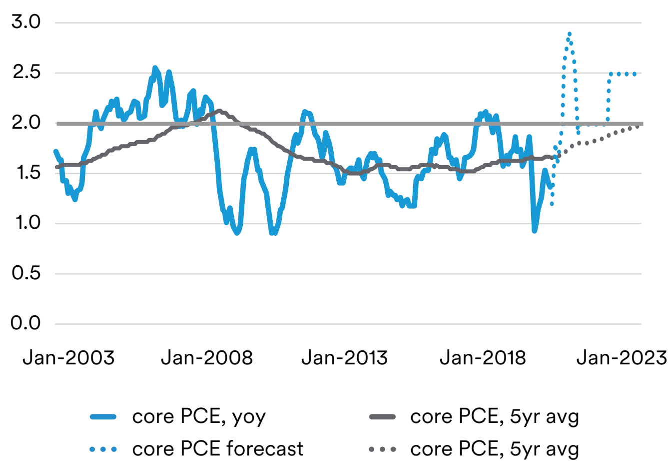
Source: BLS/Haver, Metlife Investment Management

Instead, this is what the Fed is keeping an eye on.

It appears that Fed officials are looking for something approaching a business cycle average inflation rate of roughly 2 percent. Using the length of a business cycle is not explicitly stated, but there have been some hints.[1]

Most business cycles are closer to 5 years long, the most recent expansion notwithstanding. The 5-year average core PCE has been chronically below 2 percent (see figure 2).

Figure 2 | Targeting 2 percent average inflation



Source: BLS/Haver, Metlife Investment

So far in this business cycle, starting at the onset of the COVID-induced recession in March 2020, the 5-year moving average core PCE is at 1.1 percent. In figure 2, we chart our forecast, which is for 2.0 percent inflation for both 2021 and 2022. We then assume it rises to 2.5 percent in January 2023 and stays there until average inflation hits its 2 percent target in February 2024. All told, the Fed would need to wait a little more than 3 years from now to raise rates.[2]

We believe labor market weakness means almost no risk of true overheating.

How can you get overheating with a terrible labor market? In short, it seems very unlikely.

The official U.S. unemployment rate is elevated, at 6.7 percent.[3] However, this does not begin to fully reflect true labor market conditions. The labor market participation rate is at its lowest since 1976 (when female participation was still on a secular increase). In addition to the number of officially unemployed, there are many additional millions of workers that want a job but have not officially registered. U-6, the broadest measure of underemployment, reports an underemployment rate of 11.7 percent.[4]

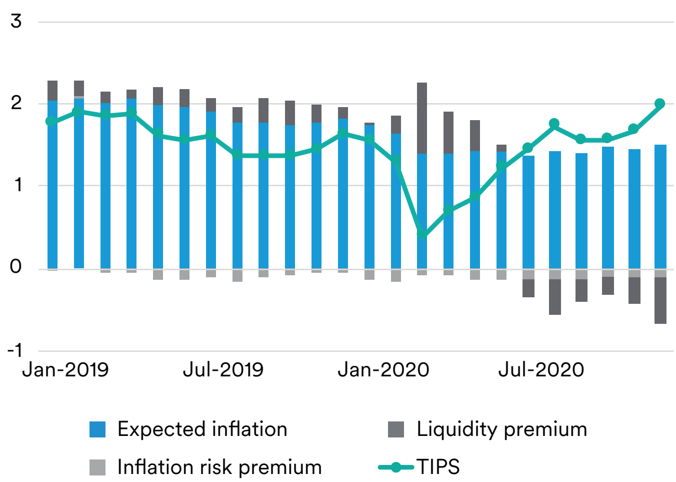
As a result, wages are expected to remain weak. Average wages actually rose during the worst of the pandemic, because the lowest wage workers were laid off. This time, it was driven by the fact that some low wage sectors—retail and restaurants—were those hardest hit by the pandemic. During the acceleration in demand over the summer, average wages dipped as firms rehired their lower-paid workers.

As services recover during 2021, we expect that pattern to be repeated. We feel average wages are likely to remain soft, or indeed fall, for much of the summer as the lower wage workers get reabsorbed into the economy.

But what about breakevens?

The breakeven inflation rates implied by TIPS pricing appears to show a sharply increasing inflation expectations beginning in November.[5]

Figure 3 | Breakeven inflation (5 year maturity)



Source: Federal Reserve Board DKW Model/Haver, Metlife Investment Management

However, a principal component analysis[6] of the breakeven shows that the true inflation expectations component may have declined at the onset of the pandemic in March 2020 and remained fairly stable thereafter. Looking at University of Michigan inflation expectations from the consumer sentiment report broadly confirms this, with inflation expectations tapering off over the second half of 2020 in both the 1 year and the 5 year inflation expectations indices.

The liquidity premium accounts for most of the change in the inflation breakeven. TIPS usually carry a liquidity premium, attributed to the nominal Treasury market being generally more liquid than the TIPS market. This liquidity premium spiked in spring 2020 during the early stages of the pandemic (the liquidity premium enters into the equation negatively, so this increase led to a drop in breakevens). But since April the TIPS liquidity premium declined, eventually going negative beginning in July.[7] During crises—both in the 2008 financial crisis and the current one—it appears that the substantial Fed asset purchase programs leads to a negative liquidity premium in TIPS markets. This, and not inflation expectations, appears to be the main driver of the months-long rise in the TIPS breakeven.

Transitory bumps aren't expected to derail the Fed.

Two other wild cards this year are stimulus and the expectations of a vaccine-led spending spree.

As we saw in 2020, stimulus spending tends to be mostly transient. The majority of the $900 billion fiscal package is expected to enter the economy within the year. Any further stimulus is also likely to be disbursed within the year.

Vaccinations and the expected fall-off in COVID cases, as well as the warmer months ahead, are expected to lead to a burst of economic activity. Producers will be in a very difficult position of trying to guess historically uncertain demand patterns well in advance. Vaccination distribution schedules, COVID mutations, any expected additional stimulus packages, as well as the formation of new habits, new technologies, and well as divining individuals' risk tolerance along the way to herd immunity. Supply, demand, and prices are all likely to be volatile across sectors. However, we feel demand-led price pressures are likely to be resolved over a relatively short period of time.

Fundamentally, however, we believe there is nothing in the macroeconomic environment that speaks to anything but a transient disruption in price levels. Instead we can best see potential price increases in 2021 as temporary shocks along the way to recovery.

A long way to go until we get to the Fed's 2 percent average inflation target.

We expect quite a lot of volatility in price levels this year. We could see certain metrics approach alarming levels, such as year-on year-headline inflation in the neighborhood of 3 percent in spring and summer. However, we do not see—nor anticipate seeing—evidence of true overheating, characterized by production above capacity and tight labor markets. We expect inflation to be well in hand by year end, likely around the 2 percent mark. We feel the Fed will also likely consider inflation levels to be well in hand, and we expect them to remain on hold through 2022.

Endnotes

[1] For example, Charles Evans' comments at the American Economic Association, or the FRBSF Economic Letter "Average-Inflation Targeting and the Effective Lower Bound," August 10, 2020.

[2] Note too that our forecast is above that of the Bloomberg consensus forecast, which would potentially take even longer to hit 2 percent average inflation. Following the Bloomberg forecast would mean 2 percent will take even longer to achieve.

[3] BLS.gov, December 2020 unemployment rate.

[4] 7.1 million out of the labor force but want a job, in addition to 10.7 million officially unemployed (December 2020 BLS employment report).

[5] I look at 5 year maturities. The analysis that follows broadly holds true for 10 year maturities as well.

[6] Using the method suggested in D'Amico, Kim, and Wei , "TIPS from TIPS: The Information Content of Treasury Inflation-Protection Security Prices," 2018, and Kim, Walsh, and Wei, "Tips from TIPS: Update and Discussions," 2019.

[7] Kim, Walsh and Wei, "Tips from TIPS: Update and Discussion," May 1, 2019, data updated 12/31/2020.

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[2] At estimated fair value. Includes MetLife general account and separate account assets and unaffiliated/third party assets.

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