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Last week, investors shuddered as data showed a big rise in prices in the US and a greater-than-expected rise in prices in the eurozone. Stocks sold off, US Treasury yields climbed higher, and market pundits obsessed over inflation. I feel it's important at this juncture to remind investors of a few truths surrounding inflation and the Federal Reserve.

The Fed does not have a trigger finger

Just because the Fed reacts negatively or says it's surprised by one or more data points doesn't mean it's going to tighten monetary policy at its next meeting. Some investors were taken aback by Fed Vice Chair Richard Clarida's comments last week when he said he was surprised by some recent data points such as the Consumer Price Index, which was much higher than he expected. However, he was quick to reassure: "Honestly, we need to recognize that there's a fair amount of noise right now, and it will be prudent and appropriate to gather more evidence..."¹ Don't forget that the Fed's new catch phrase is "patiently accommodative." In other words, the Fed is going to err on the side of accommodation and is likely to deliberate extensively before tightening.

The Fed anticipates a spike in inflation as the economy re-opens

At a Wall Street Journal conference in early March, Fed Chair Jay Powell explained that, "We expect that as the economy reopens and hopefully picks up, we will see inflation move up through base effects. That could create some upward pressure on prices."² In fact, time and again, Powell and other Fed officials have telegraphed that a spike in inflation is likely as the US economy re-opens. The Fed is ready and accepting of that rise in inflation.

We won't know any time soon if the increase in inflation is temporary or persistent

A temporary rise in inflation is at least partially the result of base effects — in other words, the comparisons to a year ago look distorted given what poor shape the economy was in last spring as the pandemic took hold. In addition, there is currently a mismatch between supply and demand which can drive up prices — think of the supply chain issues that are being experienced right now in some industries and the pent-up demand that is now being exercised as economies re-open. However, these are likely to create only temporary inflation. After all, how many flights can you take and haircuts can you get once the economy re-opens? Clearly, the law of diminishing marginal utility suggests that at a certain point, satisfaction with each additional flight or haircut is reduced.

Now, there are forces that can lead to more persistent inflation. Typically wage increases lead to “stickier” inflation. We have not yet seen a significant rise in average hourly earnings in the United States, and it seems unlikely that will happen quickly given the very substantial amount of labor market slack.

Monetarists would argue that it all comes down to money supply; a significant increase in money supply can spur persistent inflation, and right now we have seen a very significant increase. However, one other key ingredient is usually present as well: an increase in the velocity of money, which we have not yet seen. The quantity theory of money posits that inflation is not just a function of money supply but also the velocity of money. As the St. Louis Fed explained in a brief research note, “If for some reason the money velocity declines rapidly during an expansionary monetary policy period, it can offset the increase in money supply and even lead to deflation instead of inflation.”³ But even if a money supply increase is enough to spur persistent inflation, this would not occur immediately — it usually occurs with an 18-24 month lag, suggesting we may not see it until late 2021 or early 2022.

The Fed’s inflation targeting policy represents a paradigm shift for the Fed

The Fed has gone through several paradigm shifts in the last several decades, and they’ve been transformational. I’m old enough to remember when the Fed didn’t believe in regular communication with the public, when the size of then-Fed Chair Alan Greenspan’s briefcase was the best indicator of what the Fed’s decision on rates would be at the next Federal Open Market Committee (FOMC) meeting. And now of course, the Fed is extremely transparent, working hard to telegraph its views and actions before taking them. Similarly, the Fed had a very different inflation targeting policy before last summer. Its current policy, called Average Inflation Targeting (AIT), means that the Fed’s objective is to push inflation enduringly above 2% and attain full employment before considering tightening. In other words, this new policy enables the Fed to be far more flexible and essentially tolerate economic overheating. This is NOT the Fed of yesteryear, which believed that its role was to take away the punch bowl just as the party was getting started. This Fed might leave out the punch bowl into the wee hours, even as partygoers get drunk.

What does this mean for investors?

This begs the question: what are investors afraid of? Are they afraid of inflation — or the Fed tightening in reaction to inflation? It seems to me that they are far more worried about the latter than the former. That would explain why last week’s negative reaction to signs of inflation was so very short-lived, as Fed officials provided reassurance. And so perhaps investors should be more concerned about the former, especially if the Fed remains “behind the curve” and is unable to easily tame inflation once it tries to. While I must stress that this is far from my base case scenario, it is a risk that needs

to be considered since inflation can have a negative impact on some asset classes. If persistently higher inflation were to occur, investors could benefit from exposure to commodities, cyclical stocks, inflation-protected securities, emerging market assets and even dividend-paying stocks as part of a diversified portfolio.

This week there is more potential for volatility, as investors wait with bated breath for the FOMC minutes, which could offer more insight into what the Fed is thinking with regard to inflation and tightening.

Source

¹Source: The Wall Street Journal, "Fed's Clarida 'Surprised' by Inflation Report, But Stresses Need to See More Data," May 12, 2021

²Source: CNBC, "Fed Chairman Powell says economic reopening could cause inflation to pick up temporarily," March 4, 2021

³Source: Federal Reserve Bank of St. Louis, "What Does Money Velocity Tell Us about Low Inflation in the U.S.?" Sept. 1, 2014

Important information

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

Diversification does not guarantee a profit or eliminate the risk of loss.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Common stocks do not assure dividend payments. Dividends are paid only when declared by an issuer's board of directors and the amount of any dividend may vary over time.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

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