First Trust Portfolios Canada
Monday Morning OUTLOOK

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Inflation Returns

Inflation is back and worse than it's been in decades. Consumer prices rose 0.9% in October and are up 6.2% in the last twelve months. Two more months of moderate increases, and the CPI will be 6.5% in 2021, the highest inflation since 1982.

As a result, after surging in the earliest stages of the pandemic, "real" (inflation-adjusted) average hourly wages have been trending downward since peaking in April 2020 and are down 1.2% in the past year. In fact, real average hourly wages are up only 1.5% since February 2020 (pre-COVID) versus a gain of 2.3% in the twenty months before COVID arrived.

One of the Keynesian justifications for applying a very loose monetary policy was to run the economy "hot," in order to offset damage from COVID itself and pandemic lockdowns. But this has apparently backfired as inflation accelerated rapidly. It looks like workers are the ones getting burned.

The Federal Reserve, however, says inflation is going to drop next year. And we think the Fed is probably right about the direction of inflation; prices should go up next year, but not as fast as this year.

Why? Think of oil, for example, which ended last year at $48 per barrel (for West Texas Intermediate) and closed on Friday at $81. Could oil prices move up again in 2022? Sure. Will they go up almost 70% like they have so far this year? Probably not. Then there are the massive supply-chain issues, particularly with computer chips, that have disrupted the automobile market. Prices for new cars and trucks are up 9.8% from a year ago; prices for used cars and trucks are up 26.4%. Higher semiconductor production should curb price increases next year and prices might even fall modestly in this sector.

The problem is that the most recent forecast from the Federal Reserve (released September 22) suggests its favorite inflation measure will only be 2.2% next year, which translates into an increase of about 2.5% for the Consumer Price Index (CPI). Sorry…put us down supporting the "Over."

We think the Fed is making the same mistake it made last year. At the end of last year, the Fed projected that its favorite measure of prices would be up 1.8% in 2021, which translates into roughly a 2.0% increase in the Consumer Price Index (CPI). Oops! Not even close.

The M2 measure of the money supply is up almost 40% from where it was in February 2020, substantially faster than the pre-COVID trend. Ultimately, this is the root cause of the inflation we're seeing. Yes, the extra government spending matters, too. But it matters because the Fed is monetizing the extra debt related to that spending; otherwise, it'd just be transferring demand from one group to another.

We think CPI inflation will run around 4.0% next year and might continue to do so for multiple years until either the extra M2 growth passes through the economy or the Fed somehow drains some of the extra M2 from the monetary system.

The same thing happened in the 1970s, when the Fed believed that rising inflation was transitory, and therefore did not slow growth in the money supply. As long as the Fed thinks inflation is transitory, it will not drain money from the system. Although the Fed is "tapering," that just means the expansion of its balance sheet will proceed at a slower pace, not that the balance sheet will actually shrink.

Look for housing rents to be a key source of inflation in the years ahead. Housing rents – both for actual tenants as well as the imputed rent of homeowners – were both artificially low last year due to limits on evictions. Now that the limits on evictions are over, the rental value of real estate will rise more quickly, and rents make up more than 30% of the CPI.

The Fed has let inflation take root in the US economy. We don't expect to be back at the Fed's 2.0% target anytime soon.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-15 / 7:30 am	Empire State Mfg Survey – Nov	22.0	**26.0**	30.9	19.8
11-16 / 7:30 am	Retail Sales – Oct	+1.4%	**+1.5%**		+0.7%
7:30 am	Retail Sales Ex-Auto - Oct	+1.0%	**+0.3%**		+0.8%
7:30 am	Import Prices – Oct	+1.0%	**+0.9%**		+0.4%
7:30 am	Export Prices - Oct	+1.0%	**+0.9%**		+0.1%
8:15 am	Industrial Production – Oct	+0.8%	**+1.2%**		-1.3%
8:15 am	Capacity Utilization – Oct	75.9%	**76.0%**		75.2%
9:00 am	Business Inventories - Sep	+0.6%	**+0.7%**		+0.6%
11-17 / 7:30 am	Housing Starts – Oct	1.580 Mil	**1.579 Mil**		1.555 Mil
11-18 / 7:30 am	Initial Claims – Nov 14	260K	**264K**		267K
7:30 am	Philly Fed Survey – Nov	23.9	**26.5**		23.8