Economics | June 6, 2022

Questions & answers. When will inflation peak?

Economic and financial market events

- **Volatility continues on global sharemarkets, the $64 question being: when will inflation peak? Investors are watchful with investor inflation expectations easing in recent weeks. The benchmark US S&P 500 index has lifted by 5.3 per cent after 'bottoming' at 3,900.8 points on May 19. And the US 10-year Treasury yield has fallen by 27 basis points to 2.93 per cent after hitting 3.20 per cent on May 9.**

How important is inflation?

- Well, tongue in cheek, we would say that there are three issues on the minds of global investors at present: inflation, inflation and inflation. And while that may sound a bit flippant, there is no questioning the importance of inflation at present. Rising costs – prices as well as wages – are weighing on business profitability. Longer-term interest rates are rising in response to the longer-term inflationary risks. And central banks are responding to higher rates of inflation by lifting interest rates.
- All of these factors are on the minds of investors. One day, investors are optimistic that central banks are on top of the situation and will slow economies and deflate the inflation balloon without causing a recession. The next day, the nervousness returns.

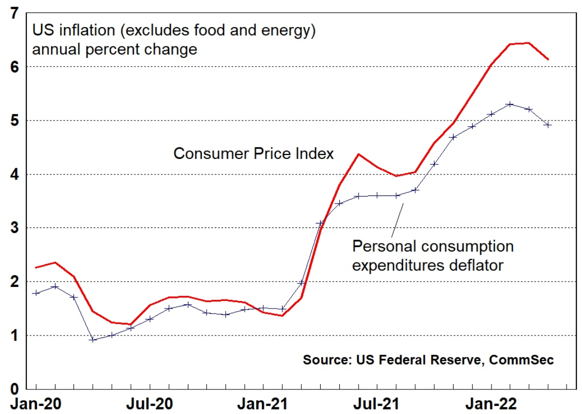
So what's the bottom line?

- In the US, key price and wage measures have eased in annual terms in the past month – admittedly from the fastest rates in the past 40 or 50 years. So there are grounds for encouragement. But before we get too carried away, a similar easing or flattening trend occurred around nine months ago.
- Still, investors will be watching inflation measures like a hawk. If the Federal Reserve believes progress is being made in controlling inflation then it will be less aggressive in lifting interest rates. And there is a big difference in controlling inflation and reducing inflation rates. Underlying annual inflation rates are around 5-6 per cent. The Federal Reserve won't be content with just stabilising these inflation rates, but rather would want to see progress on inflation rates falling to around 2 per cent.
- Certainly, central banks can only do so much. They can lift rates to slow the pace of the domestic economy but they can't fix the Covid-induced shortage of goods or cut oil prices.

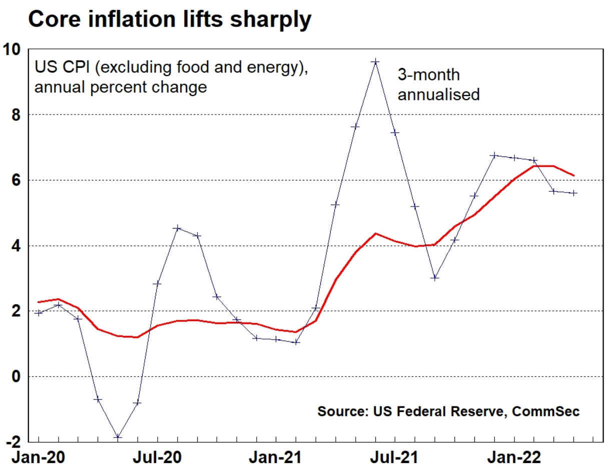
So this is a global problem?

- Yes. One point that deserves stressing is that the inflation problem is very much a global situation. Covid lockdowns caused economies to contract, but early and decisive actions by governments and central banks led to 'V-shaped' economic recoveries. The quick global response in finding vaccines for the Covid virus was also an unexpected surprise.

Inflation peaking?



- Deflationary threats quickly turned to inflation with spending (demand) responding more quickly than supply. More people got the virus, couldn't attend work and production (supply) suffered. And this supply-chain problem remains with us.
- Central banks thought inflation would be a 'transitory' situation. The perception that people would get Covid and then come back to work after seven days. Workforces would return to full strength.

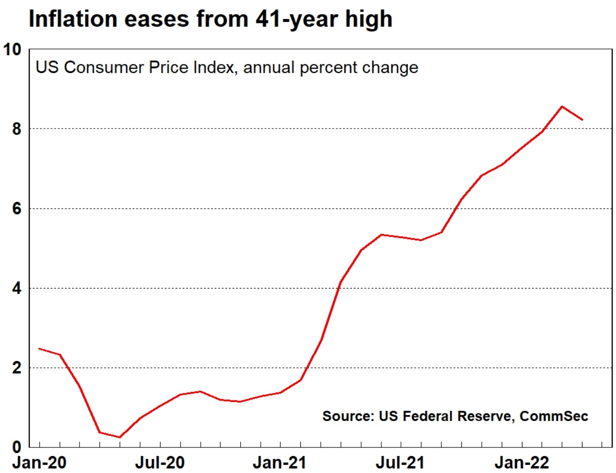


But there were complications?

- The Omicron variant of the virus is highly contagious. Despite social distancing and lockdowns, more people succumbed to the virus – and sometimes more than once. And if people didn't get Covid, they may have got influenza.
- The war in the Ukraine from February 24 has also put upward pressure on a raft of commodities such as oil, natural gas, wheat and cooking oils.
- And China persisted with a 'zero Covid' policy, causing the economy to slow and further delaying the global supply response. On Wednesday, June 1, Shanghai ended a two-month lockdown.

Central banks have responded

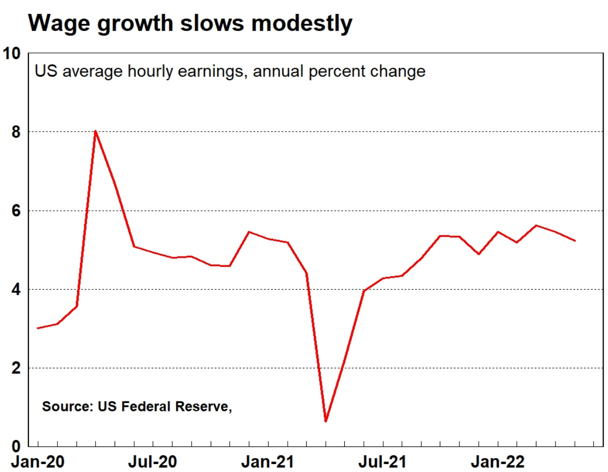
- With the benefit of hindsight, central banks probably wish they had started the removal of monetary stimulus – that is, lifted interest rates – a little earlier. But who could have predicted all the events that have transpired.
- Now the concern is whether central banks have become too aggressive in lifting rates. The 25 basis point (quarter of a per cent) rate hikes that were common initially have now become 50bp moves. If lockdowns in China are phased out and Chinese authorities are successful in applying stimulus, the supply response may be quicker and stronger than currently expected.
- And then there is the war in Ukraine. If the war was to end in the next few weeks or months then some of the cost pressures will ease. Having said that there are no imminent signs of an end to the war – ceasefire negotiations have stalled.



- The US Federal Reserve lifted rates by 25bp on March 16, 2022 and followed that up with a 50bp move on May 4. The Fed is widely expected to raise the federal funds rate by 50bp in June and July. A raft of central banks started lifting rates much earlier. Hungary, Brazil and Iceland were amongst the central banks lifting interest rates in April-June 2021. The first rate hike in Australia was on May 3, 2022.

What is the risk of a policy mistake?

- Given that central banks are responding to a unique set of circumstances, there is a high risk of policy mistakes. One of the difficulties is tracking the supply-chain issues. Purchasing manager surveys and indicators of shipping rates, transport cost surveys and measures of computer chip availability are all helpful but not perfect. Most analysts will keep the focus on producer and consumer prices.



As always, presumably all eyes are on what happens in the US?

- The US economy is still the biggest in the world and economic trends there have a big impact on global financial markets.

But each country has to face its own set of circumstances. Some countries cut interest rates decisively in the Covid emergency and have more work to do to bring policy rates back to 'normality'.

- In Australia, the cash rate was 0.75 per cent before Covid hit, so another 25-50 basis points of rate hikes will get rates broadly back to where they started. Inflation and wage growth are well below levels recorded in other advanced nations. And Australians have taken on more debt at super-low interest rates. So a modest lift in interest rates could have a big impact in slowing the economy as we wait for supply of goods to pick up.

So what are some of the details of what is happening with US inflation?

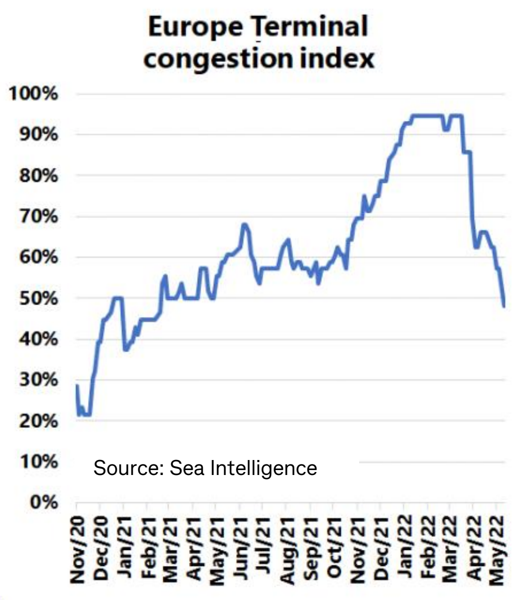
- Well if we look at the **'core' measure of consumer prices – excludes volatile food and energy prices** – the annual rate lifted quickly from 1.4 per cent in February 2021 to 4.5 per cent in June 2021 before tapering to 4 per cent over August and September. Then the annual rate lifted to 6.5 per cent in March before easing to 6.2 per cent in April.
- **The annualised 3-month average rate** has eased from 6.8 per cent in December 2021 to 5.6 per cent in April. So there are positive signs but there is a long way to get annual inflation back to levels near 2 per cent.
- To highlight the influence of food and energy prices, the **annual rate of the headline CPI** rose from 1.4 per cent in January 2021 to 8.5 per cent in March 2022. That is quite a phenomenal lift in a short space of time.
- The Federal Reserve preferred measure of inflation is the **"Core personal consumption expenditures deflator".** The annual rate peaked at 5.3 per cent in February and stood at 4.9 per cent in April.
- The measure of business inflation is the **producer price index.** The annual rate fell from 11.5 per cent in March to 11 per cent in April. The 'core' rate fell from 9.5 per cent to 8.8 per cent.
- A key measure of wages is **average hourly earnings.** In May, wage growth slowed from 5.5 per cent to 5.2 per cent after previously hitting 5.6 per cent in March.

What about US economic activity?

- It is early days, but the US economy remains in good shape. Unemployment stands at 3.6 per cent, 390,000 jobs were created in May and according to monthly gauges of purchasing managers, services and manufacturing sectors continue to expand.
- Consumers are still spending – growth was 0.9 per cent in April and 8.2 per cent over the year to April. But home sales have slowed for the past three months and construction spending in April recorded the slowest growth in nine months.

And what about supply chain indicators?

- A research group called Sea-Intelligence report that 10.5 per cent of the global shipping fleet is still unavailable due to supply-chain issues but that is an improvement compared with 13.8 per cent in January. Sea-Intelligence also compiles a terminal congestion index and while it remains high in the US, it has seen "substantial improvement" in Europe, although still at elevated levels.
- The US Department of Transportation compiles the *Transportation Supply Chain Indicators Tracker*. In mid May it reported that *"the total number of container ships waiting for berths at U.S. ports has dropped by 47 per cent since peaking in early February."* The Port Authority of New York and New Jersey imported the highest number of containers on record in March.
- The Federal Reserve Bank of New York compiles the *Global Supply Chain Pressure index* and in April it reported the first increase in supply chain pressures since December 2021. Longer delivery times in China and the Euro area and backlogs in the UK pushed the index higher.
- According to the Maritime Executive:" *"The Marine Exchange of Southern California is now reporting that the anchorage off the San Pedro ports complex is entirely empty and no containerships are waiting at sea near the ports."*



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