

## What's Driving Soaring US Inflation?

- US CPI inflation smashed expectations for a 4th straight month
- Some factors may be transitory for uncertain periods...
- ...but don't ignore the ones that either may not be transitory...
- ...or that haven't even begun to exert upward pressure
- US front-end yields rise on brought-forward Fed hikes...
- ...while longer term yields fall partly on classic exit flatteners...
- ...but are too distorted by scarcity and liquidity issues into the debt ceiling crunch to be taken at face value
- Defining 'transitory' and cycle views

### US CPI, m/m % // y/y %, June:

Actual: 0.9 / 5.4

Scotia: 0.5 / 4.9

Consensus: 0.5 / 4.9

Prior: 0.6 / 5.0

### US core CPI, m/m % // y/y %, June:

Actual: 0.9 / 4.5

Scotia: 0.4 / 4.0

Consensus: 0.4 / 4.0

Prior: 0.7 / 3.8

US core inflation sharply exceeded consensus expectations for the fourth month in a row. The US Treasury yield curve steepened at first with 10s selling off by about 4bps before a second flattening trade swooped in to make the curve flat on the day while the dollar has sustainably appreciated.

## TREASURY CURVE FLATTENS

It's not fully clear to me whether that second trade was motivated by buyers who think the upside surprise was transitory (again....) or whether it was motivated by buyers who think the upside surprise brings forward Fed rate-hike expectations. The cheapening in US 2s would lend support to the latter interpretation but my view remains that the longer-end is too distorted by excess liquidity and expected scarcity into debt ceiling issues to be able to take a classic view of the curve. For that, we might have to wait until later in the summer if and when the debt ceiling issue is addressed and how. That uncertainty should temper bond market viewpoints.

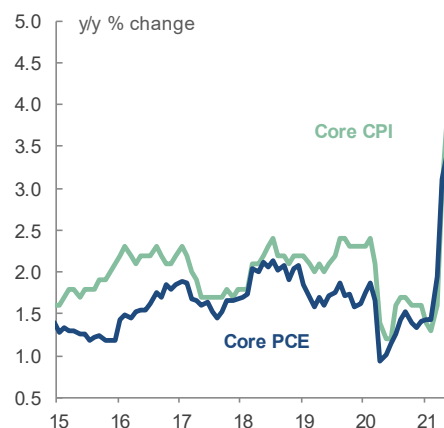
## WHAT DROVE IT?

Regardless, this is another report that humbles a model-based approach to forecasting inflation in a reopening economy with historic amounts of monetary and fiscal stimulus being applied to damaged supply chains. The Phillips curve is

## CONTACTS

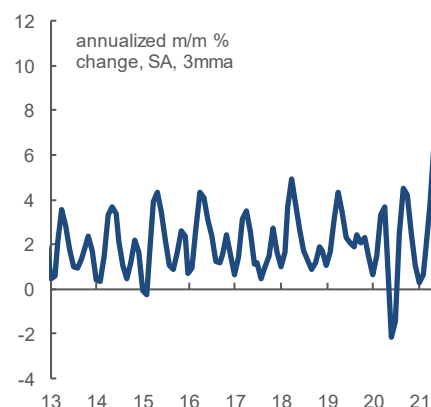
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### Chart 1 US Core PCE & CPI



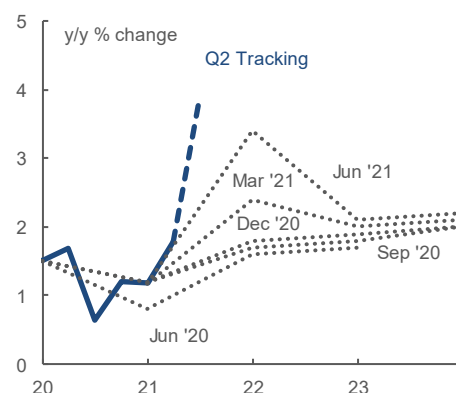
Sources: Scotiabank Economics, BLS, BEA.

### Chart 2 US Core CPI



Sources: Scotiabank Economics, BLS.

### Chart 3 Fed PCE Forecast



Sources: Scotiabank Economics, BEA, Federal Reserve.

parked on the shelf during this period. It's exceedingly difficult to estimate such price pressures in a massive out-of-sample experiment, but at a minimum we can provide honest assessments of the underlying drivers and opinions on where to from here.

Chart 1 shows soaring core inflation in year-ago terms and how the correlations will see core CPI translate into a hotter core PCE reading on July 30<sup>th</sup> (probably over 4% y/y). A lot of central banks in the world would have already tightened on that but I find the Fed is all-in on a binary bet.

Chart 2 shows the annualized month-ago changes in core inflation. This chart vividly demonstrates that the initial tendency for Fed Chair Powell to dismiss all inflation as base effect driven has been demonstrated to be complete and utter nonsense. I've long emphasized the importance of looking to this measure instead of the year-over-year rate when evaluating incremental price pressures.

Chart 3 shows the extent to which the FOMC's inflation forecasts have been so far off from reality. Everyone knew the base effects as we were forecasting inflation for this year over the past year, so clearly the massive upside beats represent lowballed assessments of incremental price pressures. San Fran President Daly—a dove with a strong labour market background—commented after the release that the Fed expected higher inflation. Uh, righto.... That is a serious misrepresentation of FOMC forecasts.

Daly also commented that these forces are temporary, but this is a significant area of uncertainty across the broader FOMC. For instance, Richmond Fed President Barkin noted after CPI that higher wages of lower-income workers due to "stubbornly low" workforce participation are helping to drive inflation and that it will take until around late summer in order to more carefully evaluate the risks to inflation. In my view, the overall FOMC has been spending too much time talking up estimates of labour slack and talking down inflation and inflation risk to date, though less so more recently. It should be transitioning toward less bond buying now or very shortly as per the views of others like Kaplan and Bullard. Onto Powell tomorrow.

Charts 4 and 5 show that most of the inflation continues to be derived from the goods side of the economy and do so in both year-over-year and month-ago terms. 65% of total consumption is made up of services and remains underweighted due to the pandemic. As the services economy reopens, we may well see a) this weight rise, and b) services inflation accelerate which means that unless you've got a large book of bonds to foist onto the unsuspecting then one should remain very guarded toward the transitory argument.

Where did inflation come from this latest month? Charts 6 and 7 (next page) help to answer that question by showing the weighted and unweighted contributions to month-over-month seasonally adjusted prices. The hottest weighted pressures last month came from vehicles (used and new) and gasoline plus housing through owners' equivalent rent and lodging away from now.

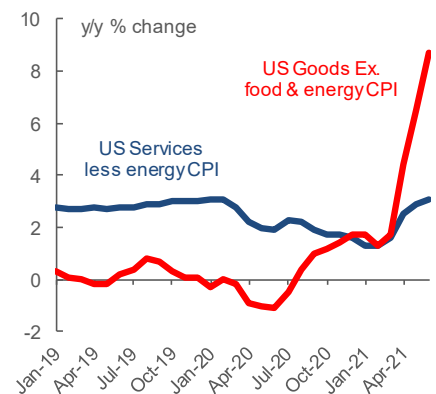
Charts 8 and 9 (page 4) do the same thing for the year-over-year changes in prices and yield some similarities and differences.

The remaining charts on the last page seek to illustrate drivers that are a mixture of possibly transitory upsides and transitory downsides with comments throughout.

While vehicle prices were the hottest contributor (chart 10), don't overstate their role. In weighted terms, used vehicle prices added 0.3% m/m to headline CPI, leaving the other six-tenths or about two-thirds of the spike in prices to be explained by other factors. New vehicle prices added 0.07% to m/m CPI for a minor additional role. Further, how transitory vehicle price inflation may be is highly uncertain given the scale and scope of damage to vehicle supply chains including but not limited to chip shortages.

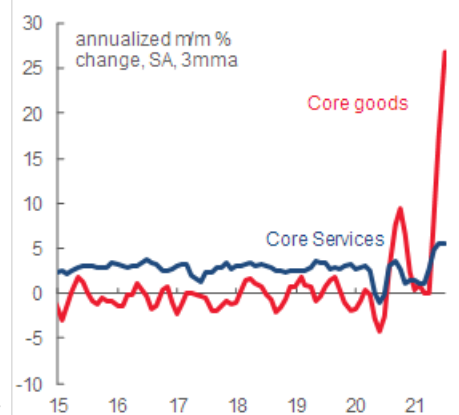
Food-at-home prices are correcting off the year-ago surge (chart 11). This illustrates that we've already seen some of the transitory upward influences having been eliminated. The year-ago stockpiling effect is causing base effects that are driving this category lower now in year-over-year terms.

**Chart 4**  
**US Goods vs. Services Inflation**



Sources: Scotiabank Economics, BLS.

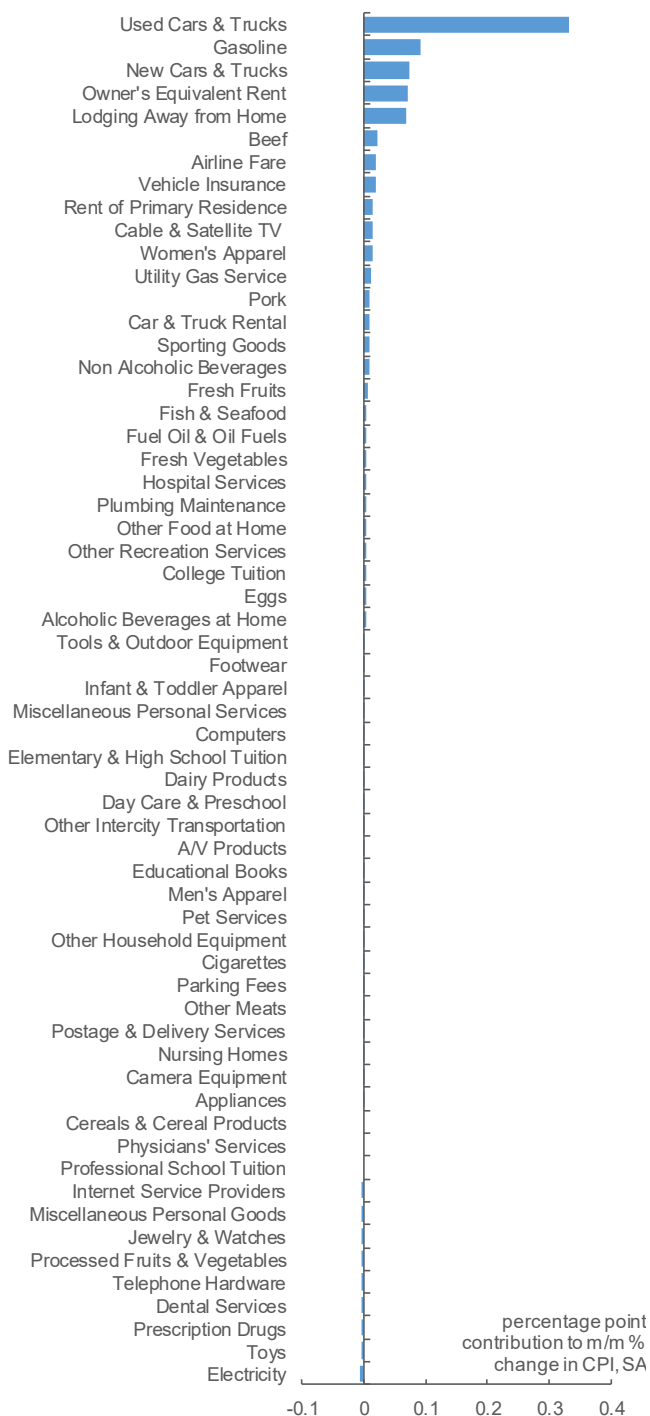
**Chart 5**  
**US Core Goods & Services Inflation**



Sources: Scotiabank Economics, BLS.

Chart 6

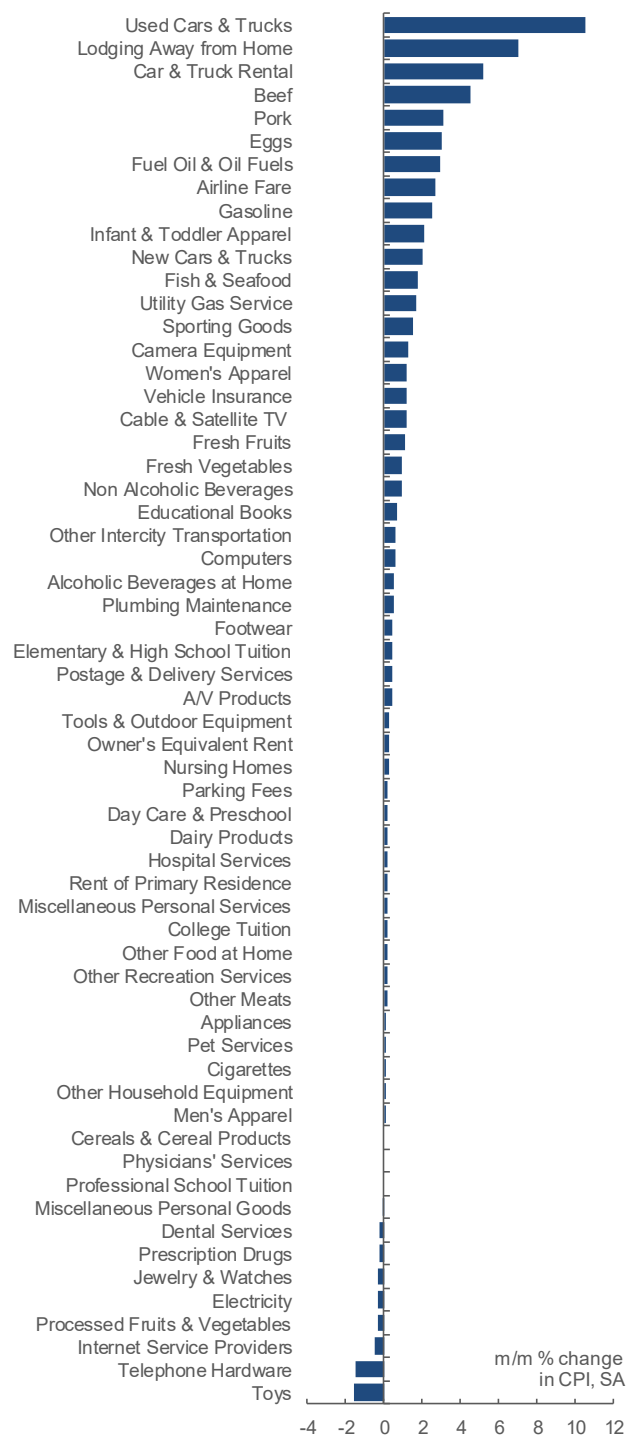
### June Weighted Contributions to Monthly Change in US Headline CPI



Sources: Scotiabank Economics, US BLS

Chart 7

### June Changes in US Headline CPI Categories



Sources: Scotiabank Economics, US BLS.

Chart 8

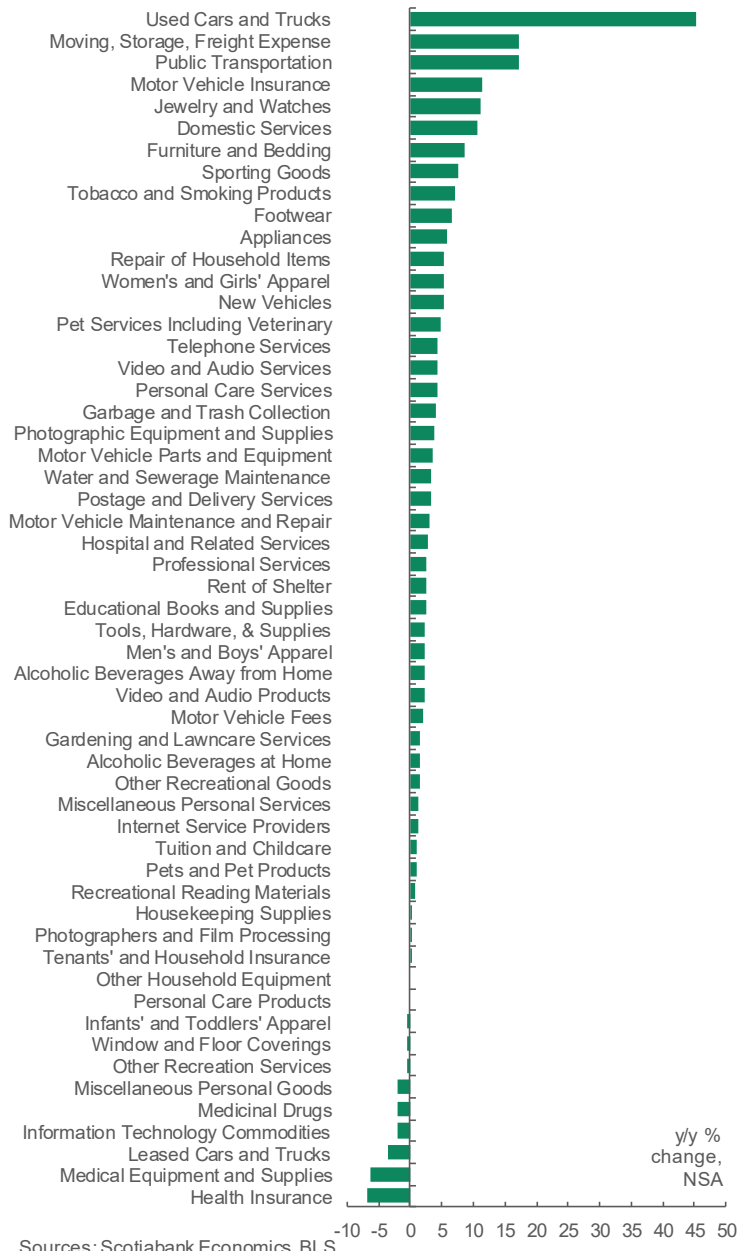
### June Weighted Contributions to the 12-Month Change in US Headline CPI



Source: Scotiabank Economics, BLS.

Chart 9

### June 12-Month Changes in US Headline CPI Categories



Sources: Scotiabank Economics, BLS.

Chart 12 shows that supply chain issues are reaching beyond vehicles as washing machine prices continue to rise sharply. There is a tiny weight on this category, but it could be treated as symptomatic of supply chain issues that go well beyond vehicles. My household has been waiting over 2 months for delivery of a new stove.

Chart 13 shows that after years of soaring prices, prescription drugs are falling in year-over-year terms. I'm not sure that will continue but would note its potential to be an upside driver over the cycle.

Chart 14 shows rising cell phone service prices that may be due to the pandemic and may be transitory. If demand picks up with a job recovery then that could mitigate some of this transitory argument.

Chart 15 shows the extent to which medical care inflation—with a CPI weight of just under 9%—has swung toward sharply disinflationary forces. Given the multi-decade tendency for medical care prices to rise I wouldn't count on this drag effect being persistent especially with an aging population and cost pressures from new technologies and treatments.

Chart 16 shows rising apparel prices. We would expect to see further upward pressure along with return to office effects and greater mobility and so it's highly premature to view this driver as transitory.

Chart 17 shows that airfare prices are on an upswing. It's unclear how transitory this may prove to be as business and consumer travel returns along with vaccines.

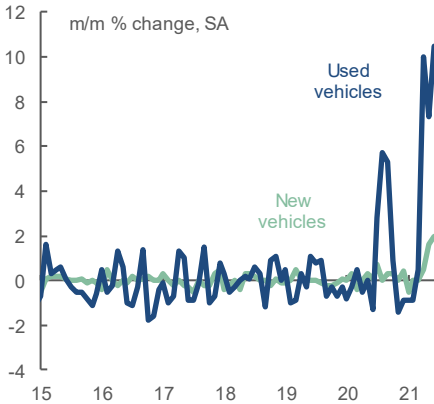
## DEFINING TRANSITORY AND CYCLE VIEWS

Throughout one's assessment of these and other drivers of US inflation, a parting point involves emphasizing how to view and define transitory. I don't define it as something to be settled within, say, six months versus a full-cycle perspective. It doesn't matter to me if inflation may pull off such heights within that time frame since monetary policy is supposed to look at the fuller cycle. Second, it's not transitory to me even if inflation falls back to half this rate over the cycle on average since that would still make it exceptionally challenging to support present levels of stimulus if inflation ebbs but averages out around the target.

As for longer run drivers, my view remains that tendency to look back in time to forces that kept inflation low may not hold in future. Demographics is probably shifting toward being inflationary as higher older age dependency ratios drive price inflation. Trade policy has not been focused upon liberalizing trade since China's ascension to the WTO and if anything is turning more protectionist. Technological change may also be facing fundamentally different forces through the rise of digital companies and hence the public policy focus in N.A., Europe and even China upon curbing powers. Add in damaged supply chains that will likely be damaged for the cycle by the pandemic and prior trade wars, plus historic stimulus and it seems to me the inflation risk remains tilted to the upside over the cycle.

Chart 10

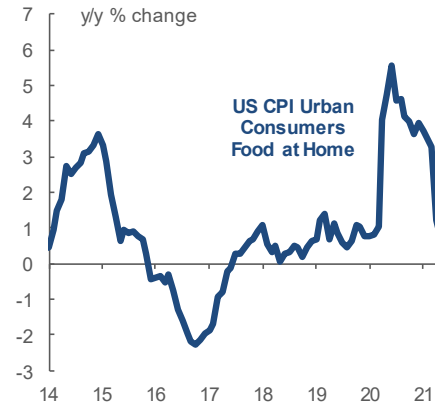
### New vs Used Vehicle Inflation



Sources: Scotiabank Economics, Bloomberg.

Chart 11

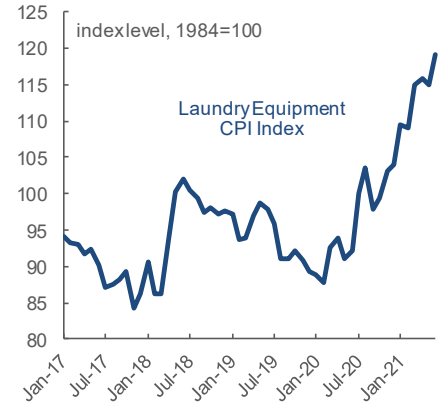
### Food Prices



Sources: Scotiabank Economics, Bureau of Labor Statistics, Statistics Canada.

Chart 12

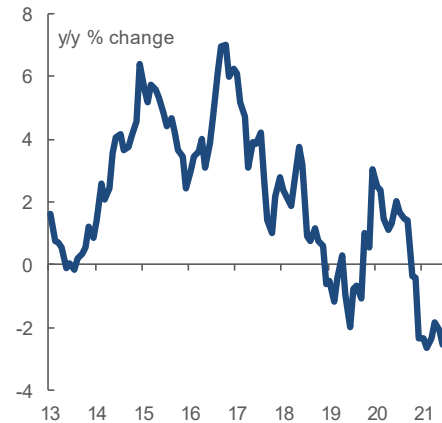
### Washing Machine Prices



Sources: Scotiabank Economics, BLS.

Chart 13

### Falling Prescription Drug Prices



Sources: Scotiabank Economics, BLS.

Chart 14

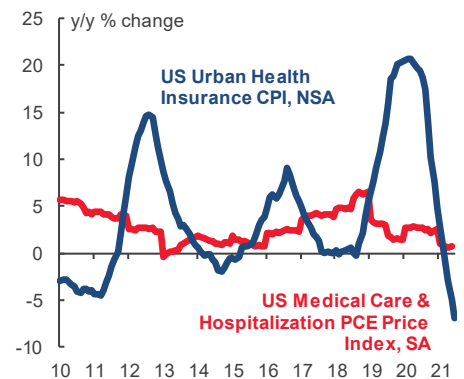
### US Cell Phone Service Inflation



Sources: Scotiabank Economics, BLS.

Chart 15

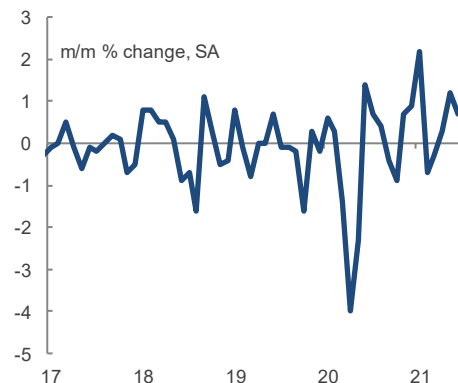
### US Medical Care Insurance Inflation



Sources: Scotiabank Economics, US BLS, US Bureau of Economic Analysis.

Chart 16

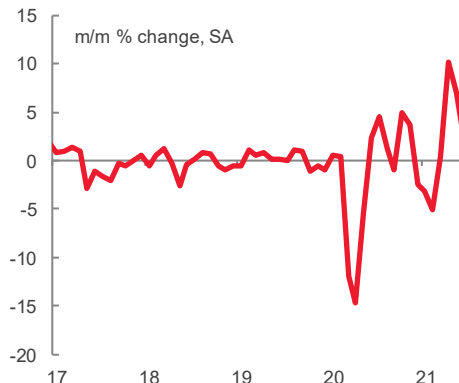
### US Apparel



Sources: Scotiabank Economics, BLS.

Chart 17

### US Airfare



Sources: Scotiabank Economics, BLS.

Chart 18

### US Financial Services



Sources: Scotiabank Economics, BLS.

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