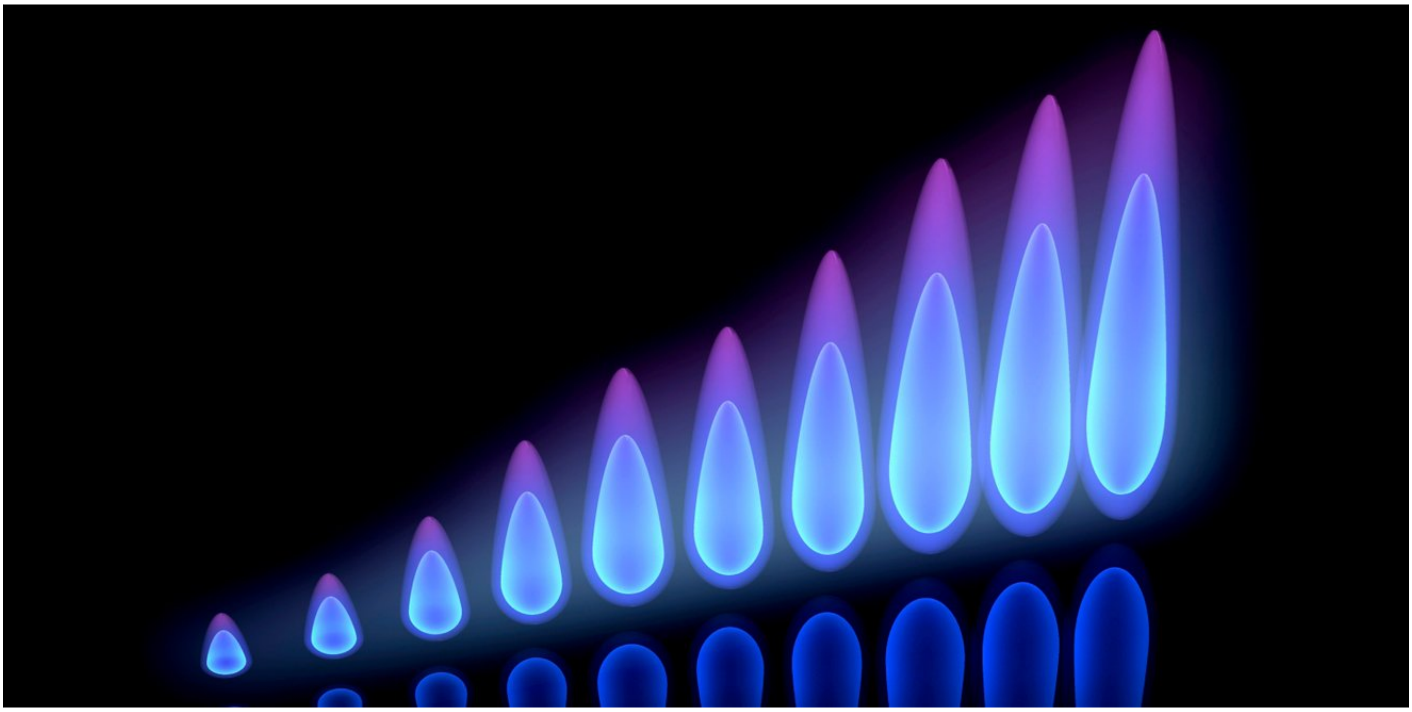

The Case for Transitory Inflation Stands—For Now

November 30, 2021

The October reading of the Consumer Price Index—the most widely used gauge of inflationary pressure in an economy—registered the biggest monthly increase in over 13 years. With year-over-year inflation in the United States topping 5% each month since June, calls questioning the transitory nature of recent price increases are getting louder. We remain in the transitory camp, as we believe nearly all current drivers of pricing pressure will likely subside over the next year.

Inflation Discussion in Context

The pandemic disrupted a decade-long trend of services inflation averaging more than 2% a year, while goods prices registered muted gains, if any. As pandemic-induced lockdowns kept most consumers unable to spend on services that have historically driven headline inflation, spending turned to goods.

Demand for goods in 2020-2021 accelerated strongly, while supply remains hampered by sudden, rolling port closures in China, a country that maintains near-zero tolerance of new COVID cases. However, as vaccination rates increase worldwide, COVID-related disruptions are likely to fade into history, and logistics should once again run more smoothly.

Rapidly rising prices of used cars and gasoline more recently explain close to 50% of consumer price increases since the start of the second quarter of 2021. During the depths of the lockdowns, carmakers grossly underestimated the pent-up demand for new cars and canceled orders for semiconductors. Semiconductor supply is normalizing, but the process feels painfully slow for now.

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So far, pricing pressures are confined to a handful of items. Moreover, consumers do not expect pricing pressures and scarcity to persist: there are no signs of hoarding. In fact, the supply-demand adjustment is occurring as expected: consumers are postponing purchases in response to higher prices. Overall demand is down more than 10% since the re-opening peak, with much of the deceleration concentrated in motor vehicles.

Beyond car prices, commentators point to two sources of higher inflation moving into 2022: labor and energy shortages. Let’s look at each in turn.

Where Are All the Workers?

On pre-COVID trends, the U.S. economy would have 126 million employed in the fall of 2021. While employment has recovered from the depths of April 2020, we are still 7.6 million workers short of the pre-pandemic trend.

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COVID-related lockdowns disrupted traditional employment in unique ways. About a million opted for early retirement, and others struck out on their own. In 2021, people are starting their own businesses at a rate some 30% higher than the pre-pandemic trend. So far, many more have eschewed returning to the labor force because of lingering COVID-19 concerns and associated child-care needs.

Surveys indicate that 10 million people currently not in the labor force intend to search for work in the next year. While many are unlikely to return to their pre-pandemic jobs, data suggest that current U.S. labor shortages will normalize over the course of 2022.

Energy: A Winter of Discontent?

Rapidly rising gas prices are contributing meaningfully to the overall inflation felt by consumers. Natural gas prices across Europe are up nearly sixfold from last winter. Natural gas is now trading at a rough equivalent of $200 a barrel of oil.

Inventories in the Euro area are in line with long-term averages. Inventories last year were artificially high as the pandemic lockdowns reduced demand for natural gas. Italy and Germany currently have four to six months of natural gas supply, so the likelihood of shortages is negligible.

The narrative of spiking natural gas prices has been centered on a lack of investment in fossil fuels as capital markets and policymakers have turned their focus to green energy. Substitution from fossil fuels to green energy is likely to last decades rather than a few years: did we manage to underinvest by so much so soon.

Instead, it seems the politics around the development of the Nord Stream 2 Pipeline (NS2) are the main culprit behind the 2021 energy price spike. NS2 is an $11 billion, 765-mile pipeline project started in 2011 to double the natural-gas carrying capacity from Russia to Germany. NS2 is financed by a consortium of companies from several European member states, including Russia, Germany, Austria, France, and the Netherlands.

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Outside of the original Nord Stream 1, which also runs through the Baltic Sea, legacy pipelines transport gas to Europe through Belarus, Poland, and the Ukraine. Ukraine alone receives $2 billion a year in transit fees for current pipelines, which are ultimately paid for by European consumers and businesses and lead to structurally higher natural gas prices in Europe than other regions globally.

At the end of August, German courts ruled that the Swiss-based NS2 will not be exempt from European Union competition rules, meaning that the consortium of companies involved must guarantee that Gazprom cannot have monopoly rights over the pipeline. In November, the German regulator temporarily suspended the pipeline’s approval until all relevant assets are transferred to separate entities for producing, transporting, and distributing gas.

The German regulator has until the beginning of January to approve before turning it over to the European Commission for final review by March. NS2 is expected to be fully operational by the second half of 2022, with spot prices likely trending down long before that.

Our Base Case: Transitory

The COVID-19 pandemic has wreaked havoc with the global economy. However, as effective vaccines become widely available beyond Europe and North America, pandemic-induced disruptions in supply chains and labor markets are likely to subside. In other words, consumer price inflation is likely to prove transitory, although the transition will be measured not in weeks but in quarters.

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