Economics

IN FOCUS

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Vanquishing US inflation: 10 reasons to be hopeful

by **Avery Shenfeld** avery.shenfeld@cibc.com and **Karyne Charbonneau** karyne.charbonneau@cibc.com

When the economic history of 2022 is written, will the word "transitory" go down as its most inappropriate adjective? Hopes that inflation would prove to be a short-lived worry were repeatedly dashed, and in both the US and Canada, we'll close the books on the year without certainty that it will be vanquished in 2023. But in the rich landscape of US data we find ourselves looking at ten reasons why that's likely to be the case.

Reason 1: Money makes the world go round

Milton Friedman famously said that inflation is always and everywhere a monetary phenomenon. Money supply growth rates have fallen out of favour as inflation indicators, but perhaps there's something to be said for those old school economists who flagged the surge in the "M"s in 2020/21 as a harbinger of inflation ahead.

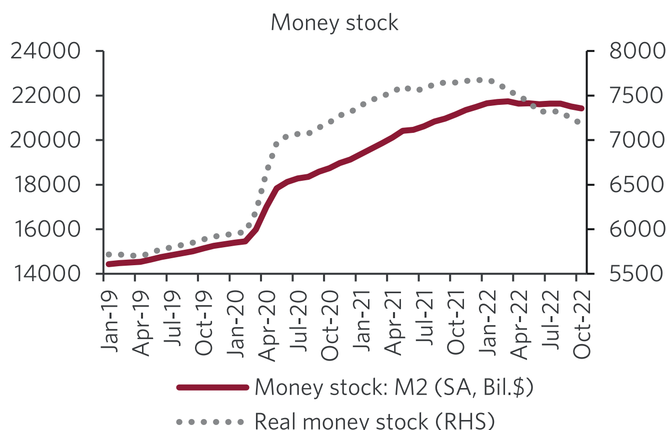
If so, then we might take some solace in what's been happening of late. The broad M2 money supply, either in nominal terms or deflated by the CPI, is now mired in a flat or even downward trend (Chart 1). It might, of course, still be elevated on a two year growth rate, but the lack of money growth should warm the cockles of a monetarist's heart.

Reason 2: The bond barons are believers

If there is wisdom in crowds, then the latest signals from the bond market are also encouraging. Where inflation-linked Treasury bonds (TIPS) trade relative to plain-vanilla Treasuries is an imperfect but still useful directional benchmark for where investors see inflation headed.

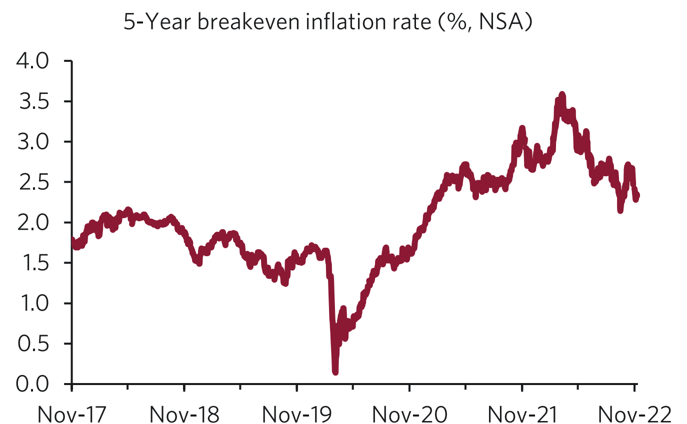
The so-called "breakeven rate", the pace for CPI that would equalize the return to maturity between these instruments, isn't a pure inflation expectations measure, because there are liquidity and other factors at play. But of late, the five-year breakeven rate seems to be moving comfortably back towards a view that the Fed will hit 2% target before long (Chart 2), particularly since the actual Fed target is based on the PCE price index, which tends to run a bit cooler than CPI.

Chart 1: Money supply flat, or down in real terms



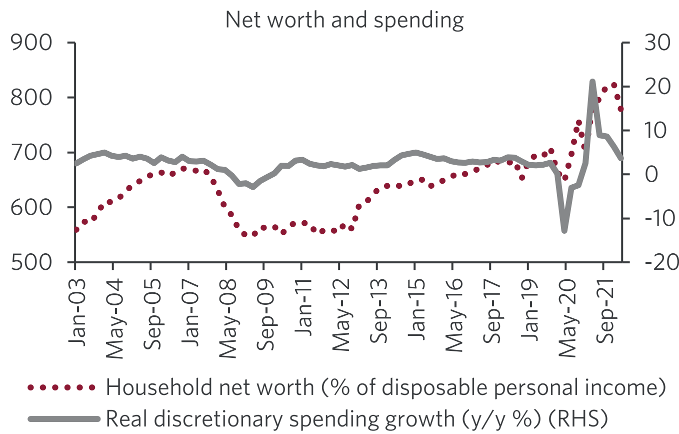
Source: Federal Reserve Board, BLS, CIBC

Chart 2: Easing five year TIPS breakeven inflation rate



Source: Federal Reserve Bank of St. Louis

Chart 3: Households give up some net worth gains



Source: Federal Reserve Board, BEA, CIBC

Reason 3: For richer or poorer

Consumer spending power is ultimately needed to support rising prices, and that doesn't always have to come out of current income. Wealth gains that make fresh savings seem less urgent can also lean Americans to spend more of their paycheques, particularly on discretionary items. Of late, an increase in debt levels, and falling equity valuations, have put a bit of a squeeze on that source of spending power (Chart 3).

Reason 4: Slipping shipping costs

Soaring shipping costs were one of many factors behind this cycle's inflation surge. The spike in demand for goods while service consumption was held back, higher fuel costs, snarled ports due to COVID disruptions and trucker shortages made moving goods a costly exercise. But we've hit a dry spell for the Baltic Dry index, a benchmark for the cost of seaborne transport for bulk goods, which has nosedived from earlier heights (Chart 4, left). Similarly, the producer price index for trucking peaked at 26% year-on-year in March, but price declines since May had chopped that 12-month pace in half by October (Chart 4, right).

Reason 5: You are what you eat

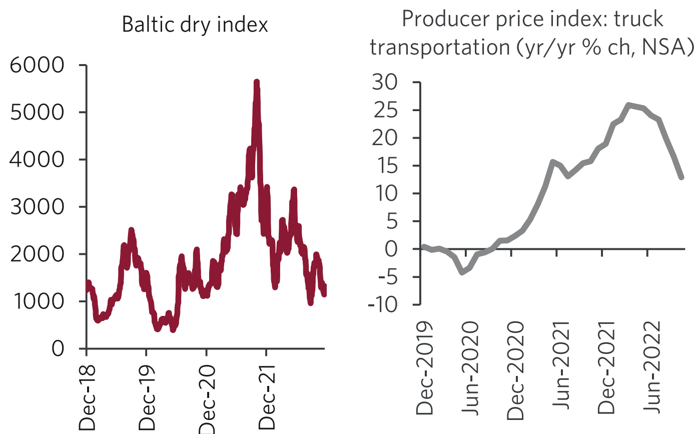
Food has been a big part of the inflation story, in part because it carries a significant weight in the goods basket. There hasn't been much relief yet in the supermarket aisle or in US producer prices for fully processed foods, but further upstream, there are some signs that the worst may have passed. Easing freight rates, a deal to allow Ukrainian grains safe passage from ports, and a bountiful harvest in North America's grain belt were among the factors that have some key food commodities moderating or at least levelling off (Chart 5).

With the additional help of a strong US dollar, year-on-year inflation in food import prices has plunged from a peak near 16% earlier this year to only 2.2% in October. Closer to home, US prices for intermediate food producers have seen seasonally adjusted price declines in the three months to October. With a lag, the calmer waters upstream should flow into a calmer pace for retail foods.

Reason 6: Yes, we have that in stock

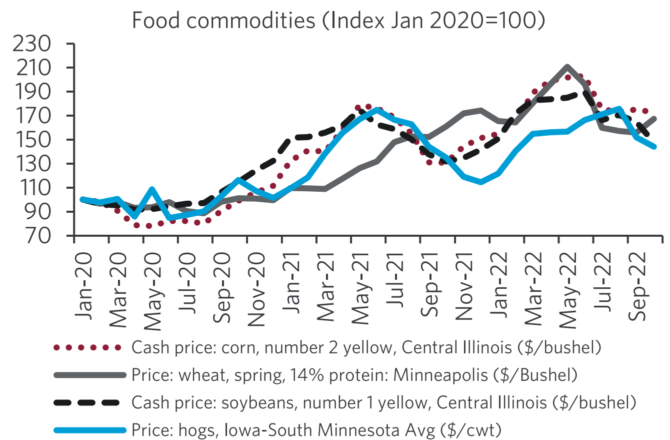
Nothing goes on sale when the shelves are stripped bare. New car dealers are still struggling with relatively bare lots, leaving vehicle shoppers in no position to bargain for discounts from sticker prices. But there has been some improvement in used car and truck availability, and a melting in inflation in such vehicles. More broadly, non-auto retail inventory-to-sales ratios have nearly recovered to pre-pandemic norms, suggesting that we'll start to see more discounts on such goods in the months ahead (Chart 6).

Chart 4: Declining shipping costs



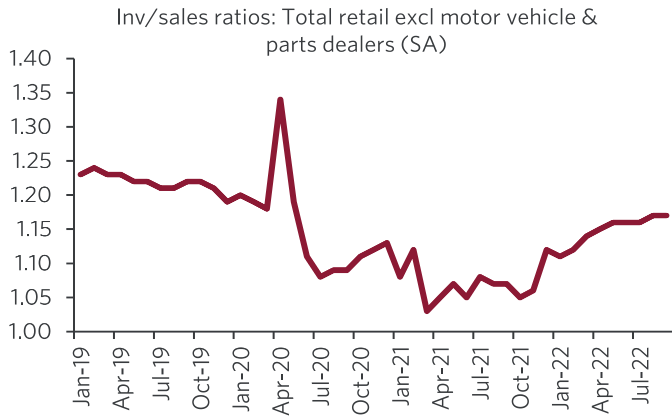
Source: Bloomberg, BLS, CIBC

Chart 5: Many food commodities easing or levelling off



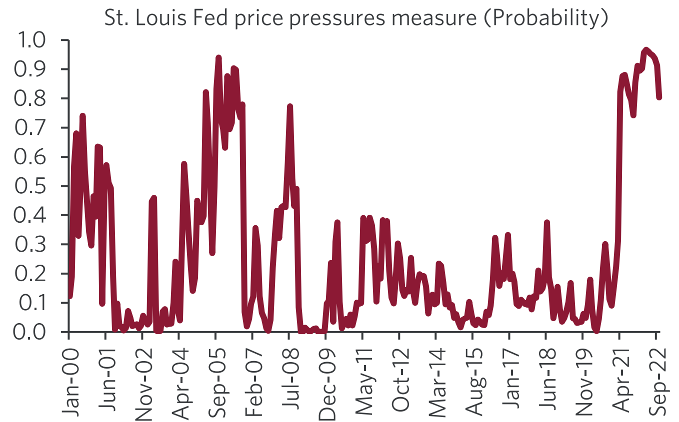
Source: WSJ via Haver Analytics, CIBC

Chart 6: Retail inventories have recovered



Source: Census Bureau, CIBC

Chart 8: Inflation indicator has turned



Source: Federal Reserve Bank of St. Louis

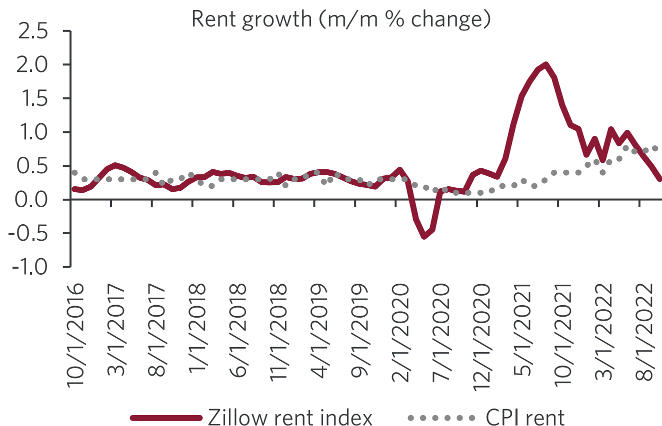
Snarled supply chains were a reason why some goods were in short supply through much of the pandemic, but we're seeing some relief on that front. The ISM index for supplier deliveries turned into "faster" territory in October for the first time since 2016, a clear sign that businesses should be able to better manage their inventory and keep shelves stocked in 2023.

Reason 7: Your home is your castle

Rent plays an outsized role in the US CPI, since it has a large weight in consumption for those who rent their homes or apartments, and the cost of renting a house is used as a proxy for inflation facing home owners. Soaring rents have been the bane of inflation watchers in 2022, but the news looks much better for the year ahead.

Recent rent increases in the CPI reflect what current renters are seeing as their leases come due, when their rents are reset to catch up to prevailing rents on new leases tracked by Zillow.

Chart 7: Leading rent indicator has decelerated



Source: Bloomberg, BLS, CIBC

But the latter have now decelerated sharply (Chart 7), suggesting that leases coming due further into 2023 won't have nearly as much catching up to do.

Reason 8: Meet me in Saint Louis

Why stop at the 10 factors outlined in this paper when you can look at 104 data series all at once? The Price Pressures Measure from the St. Louis Federal Reserve Bank does that, making use of that rich data set to develop an estimate for the probability that PCE index inflation will top 2.5% over the next 12 months. Unfortunately, the number crunchers in St. Louis are still pretty sure that will be the case, but at least the probability is starting to turn lower, and from where we are 2½% is a tough benchmark to achieve (Chart 8).

Reason 9: Quitters are for Twitter

A certain tech firm has been hit with a lot of quitting — and layoffs — of late, for reasons that have been in the headlines. But elsewhere, the percentage of Americans who are voluntarily leaving one job to hunt for another has started to decline. That's typically good news as an indicator for a dampening in wage pressures on inflation, as quits tend to escalate when workers are most desperate to chase higher earnings, and most confident that there are jobs out there that pay more than the one they already have.

Reason 10: Don't fight the Fed

We've saved the big Kahuna for last: don't fight the Fed. The central bank doesn't always have the room to cut rates enough to prevent a recession, but it has plenty of firepower in both hikes to the funds rate and quantitative tightening to dampen economic growth and thereby supress demand. We haven't yet seen the fruits of their efforts to dampen demand, as the economy and the labour market don't yet have the slack needed to quell inflation. But it's coming.

Rate hikes work their way into the economy with a considerable lag, initially hitting a relatively narrow group of interest sensitive sectors, but spread as the slowdown in those industries impacts employment and investment decisions through the multiplier effect. The Fed's forecasting model suggests that as of Q4 2022, we've only felt the equivalent of the full impact of a 100 basis point hike in rates in the level of the output gap (the difference between the level of real GDP and its non-inflationary potential).

Most of the impact of the hikes to date, and what we expect will be a move to a 5% upper ceiling on the funds rate in early 2023, still lies ahead, even if its not coming faster than you can count to ten.

Contacts:

Avery Shenfeld
416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
416 956-3219
andrew.grantham@cibc.com

Karyne Charbonneau
613 552-1341
karyne.charbonneau@cibc.com

Katherine Judge
416 956-6527
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com

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