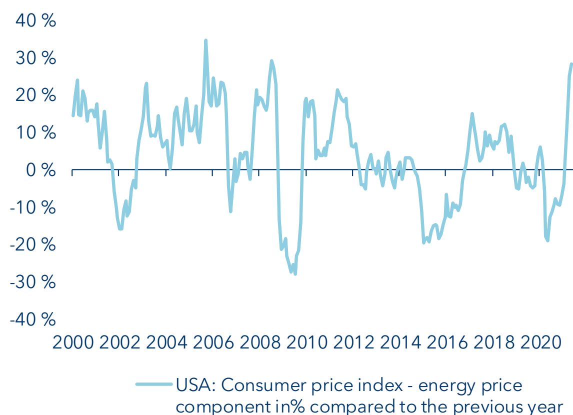
US inflation: No major threat – unless…

News from the financial markets

The annualised US inflation rate has spiked in recent months, with the May reading of 5% far exceeding economists' estimates. Many investors now fear that the pace of consumer price increases will remain at an elevated level – a concern that would only turn out to be justified if today's short supply of willing workers becomes a lasting factor in the labour market.

The current spike in inflation, as demonstrated most clearly in the USA right now, is essentially attributable to base effects (see "Is inflation on the verge of flaring up?", February 2021. The first wave of Covid-19 got rolling in March 2020 and, in response to the ensuing containment measures, many prices fell significantly as consumer spending shifted into reverse during the lockdown. More than anything else, the cost of oil has had and will continue to have a major influence on price developments. North Sea Brent crude, for example, plummeted more than 70% between January and April 2020, trading at times below USD 20 per barrel in some markets. Meanwhile, crude prices have rebounded dramatically to exceed even their pre-Covid level: currently, a barrel of Brent costs USD 73 and the flow-through effects are exerting a strong influence on the inflation rate. In the USA, for example, the energy price component of the consumer price index (CPI) rose by 29% in May compared to the previous year. This means that energy prices alone accounted for more than 40% of the year-on-year increase in inflation.

The predominant base effect: higher energy prices



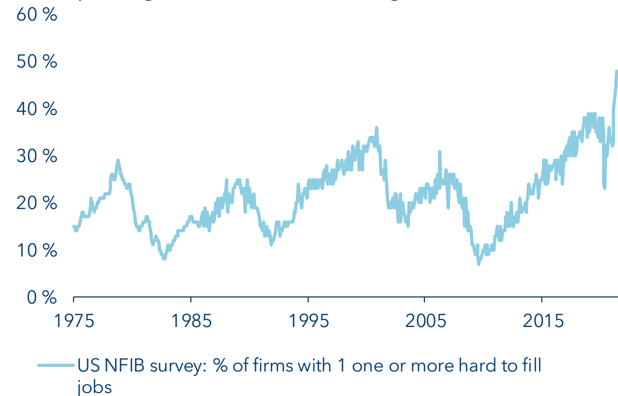
Sources: VP Bank, Refinitiv

Now that the US service sector is back to running normally in many segments, prices are also on the rebound. Air travel and hotel bookings are picking up and their costs are also comparatively higher than the rock-bottom levels seen last year in the wake of the containment measures. And all the while, a shortage of semiconductors is indirectly having an impact on consumer prices. The reason: If new cars are unavailable due to the dearth of semiconductors, people opt to buy second-hand cars. Prices for preowned vehicles have increased massively. Even if all these ostensibly inflationary factors persist for a while to come, they are merely special effects of the pandemic. It will take some time for this "price dust" to settle, but by the beginning of 2022 at the latest, these transitory effects will be a thing of the past. At which point, inflation rates will recede again – the key is in the comparables. And this is precisely why the financial markets are viewing the current inflation readings somewhat relaxed. Market-based inflation expectations have recently fallen noticeably, as also evidenced by the drop in 10-year Treasury yields. The latter stood a tad above 1.70% at the end of March; in the meantime, they have retreated to just below 1.50%.

Unusual phenomenon in the labour market

But the coronavirus pandemic is spawning many an unexpected phenomenon, one of which could influence the course of inflation; namely, the labour market. Oddly, Americans are not returning to their jobs at present, even though there is high demand for workers. Now that the economy is largely back to business as usual, workers are being desperately sought: almost half of the small businesses surveyed in May by the National Federation of Independent Business (NFIB) reported unfilled job openings – more than double the 48-year average.

Job openings are at an all-time high



Sources: VP Bank, Refinitiv, NFIB

The survey also revealed that more and more companies are willing to pay higher wages. So, if the associated costs were to be passed on to the finished goods, a wage-price spiral could ensue. This in turn would be the

seedbed for a sustained rise in inflation rates, as we discussed in "Is inflation on the verge of flaring up?". And it still represents a risk factor. Nonetheless, since the pandemic and today's developments in the labour market are without precedent, it is too early to draw any conclusions. Whatever the case may be, these developments need to be watched carefully in the months ahead.
But what are the actual reasons for the short supply of willing workers? We have identified four possibilities:

• State financial assistance

In March last year, the Trump-administration responded to the Corona-induced slump by signing the CARES Act. The US Social Security system has more holes in it than Swiss cheese, so the necessity arose to distribute direct government payments to the populace in order to avert widespread impoverishment. These included income-related stipends as well as an extension of unemployment benefits for the jobless. The latter received USD 600 per week through the end of July 2020 on top of their unemployment benefits. Then in August, the weekly additional payments were reduced to USD 300 and simultaneously the programme was extended until the beginning of September 2021. It can be presumed that these supplementary benefits are the reason why workers have less incentive to rejoin to labour force.

• Fear of becoming infected with Covid-19

According to Standard & Poor's, the fear of catching Covid on the job is perhaps still playing a role in the shortage of labour supply. In the USA, the number of people who refuse vaccination is relatively large: one in four Americans does not intend to get the jab. This segment of the population in particular are likely to prefer taking advantage of the enhanced unemployment benefits than getting a job and running the risk of infection.

• Intentional opt-out of the workforce

It is striking that the participation rate of workers 55 years and older has hardly budged now that things are getting back to near-normal. It is entirely possible that some people in this age group have opted to withdraw from the labour force. Here, the stock market's superior performance over the past year could be playing a role: it can be conjectured that the accumulated personal wealth provides a strong incentive for early retirement.

• Professional reorientation

Many workers used the lockdown periods to change careers. A March 2021 study entitled "Pulse of the American Worker" by Prudential Financial revealed that one in four workers is thinking about changing jobs once the pandemic has subsided. Now that much of the economy has returned to some degree of normalcy, this factor could come into play. At least a certain part of the current labour shortage could be attributable to the fact that the generous unemployment benefits (by American standards) have given people an opportunity to rethink their careers and investigate new ways of earning a living.

Inflation in the eurozone

The tendencies in the eurozone are quite similar to those in the States. Here, inflation rates are likely to remain at a relatively (i.e. comparatively) high level throughout the second half of 2021. Also in the second half, Germany's VAT reduction is making itself shown. From 1 July to 31 December 2020, a lower rate of 16% did apply. Since the normal VAT rate of 19% is back in force, this will have an effect. In other words, the coming months should see inflation rates of 4% or so; but in 2022, things will be back to the status quo ante. Due to structural growth drawbacks, the eurozone will likely be faced once again with inflation rates that are too low rather than too high in the long run.

Summary

Although inflation rates appear high right now, this is essentially due to base effects. Today's recalibrating price level is coming off the baseline set by the pandemic-ridden months of 2020. This special factor will expire at the latest by early next year. However, if it turns out that the labour supply shortage in the US lasts longer or even becomes a permanent problem, the inflation picture could look entirely different. Employers would have to pay higher wages in order to attract labour, a situation that could trigger a wage-price spiral with lasting consequences on the inflation rate. Granted, this is still just a notional risk. However, developments in the US labour market need to be watched with an Argus eye.

The US Federal Reserve also seems to be giving some thought to the possibility that high inflation rates will prove to be more stubborn. At any rate, the Fed struck a slightly different tone following its June meeting, thereby preparing the markets for an end of its ultra-expansionary monetary policy. We expect that the Fed will soon present a roadmap for reducing the securities purchases. But regardless of the eventual course of headline inflation, we consider today's expansionary monetary policy to be no longer appropriate in light of the high growth rates.

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Contact

VP Bank Ltd	Aeulestrasse 6 9490 Vaduz · Liechtenstein T +423 235 66 55 · F +423 235 65 00 · info@vpbank.com
VP Bank (Switzerland) Ltd	Talstrasse 59 8001 Zurich · Switzerland T +41 44 226 24 24 · F +41 44 226 25 24 · info.ch@vpbank.com
VP Bank (Luxembourg) SA	2, rue Edward Steichen · L-2540 Luxembourg T +352 404 770-1 · F +352 481 117 · info.lu@vpbank.com
VP Bank (BVI) Ltd	VP Bank House · 156 Main Street · PO Box 2341 Road Town · Tortola VG1110 · British Virgin Islands T +1 284 494 11 00 · F +1 284 494 11 44 · info.bvi@vpbank.com
VP Bank Ltd Singapore Branch	8 Marina View · #27-03 Asia Square Tower 1 Singapore 018960 · Singapore T +65 6305 0050 · F +65 6305 0051 · info.sg@vpbank.com

Content responsibility

Bernd Hartmann, Head CIO Office
Dr. Thomas Gitzel, Senior Economist

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