

Economic Indicator — May 12, 2021

No One Said Reopening Would Be Cheap

Summary

The 0.8% surge in consumer prices in April, the largest monthly increase since 2009, was the latest sign of supply not being able to meet the onslaught of demand as the economy reopens. Goods and services prices both charged higher, leading the CPI to increase 4.2% over the past year. Today's report sets up some tough base comparisons for this time next year. We suspect that even as inflation has transpired earlier and to a greater degree than expected, the FOMC will still want to see how the dust settles before reacting to inflation given the unique confluence of events and current state of the labor market.

Economist(s)

Sarah House

Senior Economist | Wells Fargo Securities, LLC
sarah.house@wellsfargo.com | 704-410-3282

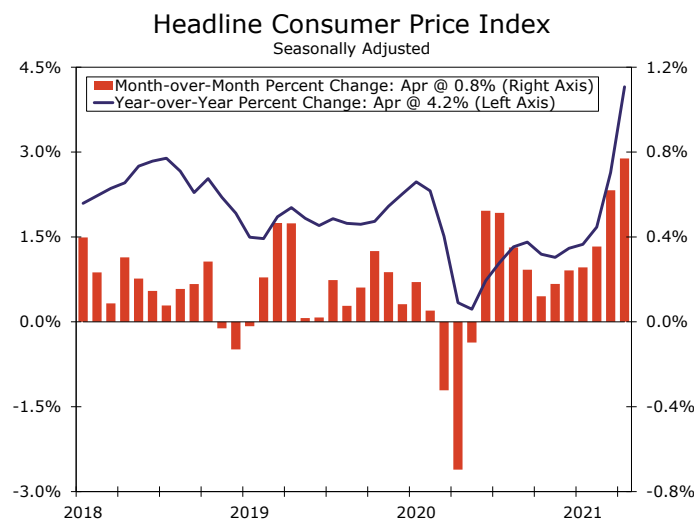
Shannon Seery

Economist | Wells Fargo Securities, LLC
shannon.seery@wellsfargo.com | 704-410-1681

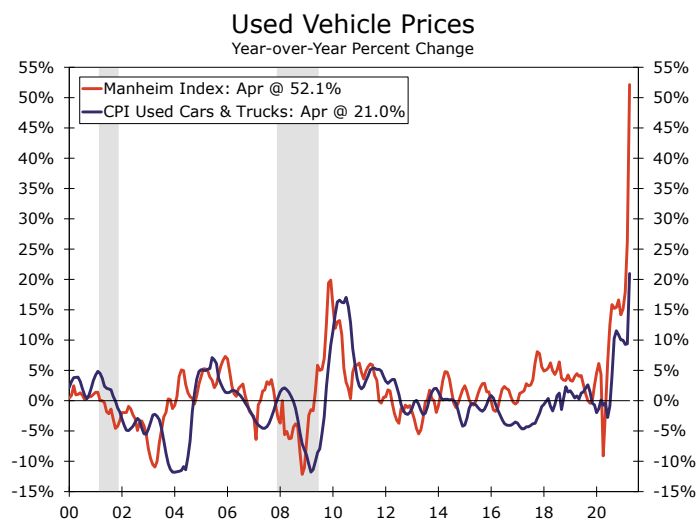
Prices Surge in April

Of all the shortages being discussed right now, signs of inflationary pressures are not one of them. Commodity prices have continued to tear higher and more manufacturers *and services* firms report input costs rising than at any time since at least 2008. Businesses are increasingly passing those costs on, as indicated by April NFIB's survey showing the largest share of firms raising prices since 1981. Today's CPI report showed prices rising 4.2% over the past year, the largest increase since 2008. That can only partly be traced to low base comparisons after lockdowns sent prices tumbling last April by the most in a single month since the throes of the financial crisis in 2008. *Base effects do not explain all the strength—inflation is rising now.*

Consumer prices leapt 0.8% in April, the largest monthly gain since 2009. Yet unlike prior months when prices soared to such a degree, the rise cannot be chalked up to energy, or even food. Core inflation skyrocketed 0.9% in April, the most since 1981. Over the past three months, core inflation is up at a 5.6% annualized pace.



Source: U.S. Department of Labor and Wells Fargo Securities



Source: Manheim, U.S. Department of Labor and Wells Fargo Securities

Prices Boiling

The recent strength in inflation comes down to two main causes: supply constraints and the reopening of the services economy. Price pressure is therefore bubbling for both goods and services, in contrast to most of the past 15 years when it was one or the other.

A range of shortages of key inputs are constraining production, which is limiting supply and giving way to higher goods prices. This is particularly evident in the prices of autos. Used autos surged 10% in April, as strapped supply has driven up wholesale prices. That was the largest monthly increase in the series' nearly 70-year history, and accounted more than one-third of the headline's gain. New auto prices also posted a solid 0.5% monthly gain. Auto production has largely been disrupted in recent months by semiconductor shortages, which don't appear to be abating anytime soon. Given the recent surge in sales and decline in retail inventory, we expect to see less dealer discounting on autos and consumers paying closer to sticker prices. Autos are therefore set to exert upward pressure on core goods prices for some time.

Other categories of goods also moved higher like household furnishings (+0.9%), recreational goods (+1.2%) and apparel (+0.3%), signaling a pick up in demand and perhaps companies increased ability to pass on higher costs. As supply struggles to keep pace with demand, we expect good prices to firm further this year.

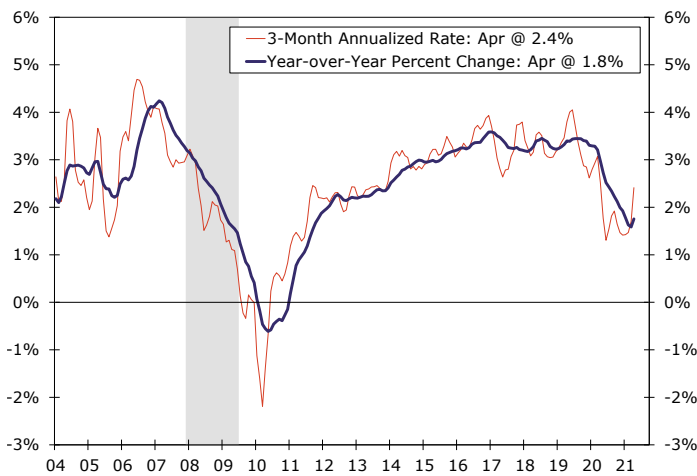
At the same time, the reopening of the services sector is giving way to a surge in demand. Services costs are rising as a result. The pick-up in travel and hospitality-related activities specifically is boosting prices. Car and truck rentals surged 16.2% in April, which marks the second-consecutive month of double-digit gains. Similarly, airfare prices jumped 10.2% while hotel prices rose 7.6%. Admissions to sporting events was another category to see particularly strong price gains, up 10.1% in April.

Consumer demand is set to surge in the second and third quarters amid an improving public health backdrop and warmer weather. The pick up in activity will likely boost prices of many in-person services as industries face higher input costs for physical inputs and labor.

Shelter prices also posted a solid increase, advancing by the most since the start of the pandemic, up 0.4%. Although rental prices are firming, shelter prices look to have been driven higher by the aforementioned surge in hotel prices. Owners' equivalent rent of residences rose a trend like 0.2%. Shelter prices are moving higher, with the three-month annualized rate rising to 3.5%, or the highest since mid-2019, in April. But we still expect the solid price gains in the purchase market over the past year to begin to more meaningfully filter through into the CPI in the second half of the year, which will provide an additional lift to core services prices.

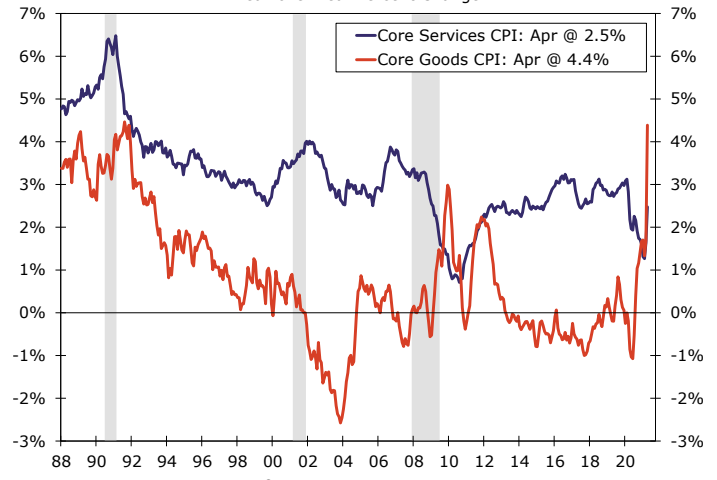
Goods and services inflation are once again moving in the same direction. This suggests base-effects aside, we are likely to see firmer consumer prices over the course of the year.

U.S. CPI - Shelter Costs
Both Series are 3-Month Moving Averages



Source: U.S. Department of Labor and Wells Fargo Securities

Core Goods vs. Core Services CPI
Year-over-Year Percent Change



Source: U.S. Department of Labor and Wells Fargo Securities

Fed Will Remain Stoic in Face of Inflation Onslaught

As sharp as April's increase in consumer prices were, we do not think this will push the Fed off its current easy policy path. First, FOMC members have been adamant that the degree of price increases this year is likely to be "transitory." Yes, prices are surging now as the economy more fully reopens, consumers have money to spend, and the supply side of the economy is having trouble keeping up. But inflation is a process, and current gains would need to be matched and exceeded for inflation to take off further from here. For all the talk of low base comparisons lifting the year-ago rate of inflation this month ahead of today's report, it is important to remember how difficult base comparisons will be this time next year. The Fed will wish to see how the dust settles on inflation and inflation expectations before reacting to this unique confluence of events. Second, the Fed's most immediate concern remains the labor market and limiting scarring. As Friday's jobs report showed, that is still likely to take some time. We expect the Fed to remain patient in adjusting policy as a result.

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	International Economist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	International Economist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economist	(704) 410-1681	shannon.seery@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Nicole Cervi	Economic Analyst	(704) 410-3059	nicole.cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	(704) 410-1437	sara.cotsakis@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

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