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Special Commentary — July 28, 2021

The Chains That Bind: No Relief for Inflation Until Supply Constraints Ease

Summary

Supply chain problems are more severe and taking longer to work out than initially anticipated, causing the "transitory" factors that are bidding up inflation to last longer. This second installment in our *The Chains That Bind* series discusses how persistent supply pressures not only will keep inflation higher for longer but also have the potential to stoke inflation that is not so transitory.

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***The Chains That Bind* Series**

Introducing the Pressure Gauge
(07/27/2021)

No Relief for Inflation Until Supply Constraints Ease

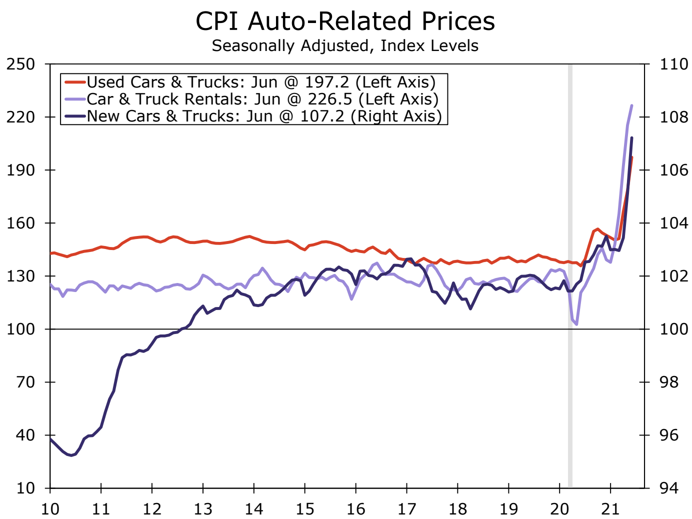
The Delta variant is on the rise, and we are not turning a blind eye to rising COVID case counts or of the belief that the pandemic is over. That said, inflation has edged out COVID as the predominant concern among financial markets, businesses and households for the better part of this year. At this particular moment when the global economy is coming back online, you cannot discuss inflation without understanding how supply chain problems have precipitated or at least exacerbated these inflation dynamics.

In January when we discussed supply-side risks to inflation, we noted that bottlenecks and shortages would generate higher cost pressures temporarily, but upward pressure should subside as businesses continue to adjust to the environment, demand growth cools and staffing challenges ease. We stand by this line of thinking six months later and note this is essentially what the Fed has in mind when it characterizes current inflation as "transitory." The rub, however, is that supply constraints have proved more severe and are taking longer to work out than initially anticipated. Price pressures across the economy continue to mount as a result.

Supply constraints continue to play a leading role in catching forecasters and policymakers off guard when it comes to recent inflation developments.The June FOMC meeting minutes revealed "more widespread supply constraints in product and labor markets" as a key contributor behind the upside surprise in inflation, which led officials to significantly mark up their year-end forecasts. Forecasts for 2022 and 2023 were barely changed, however, consistent with officials still largely viewing current inflation as temporary.

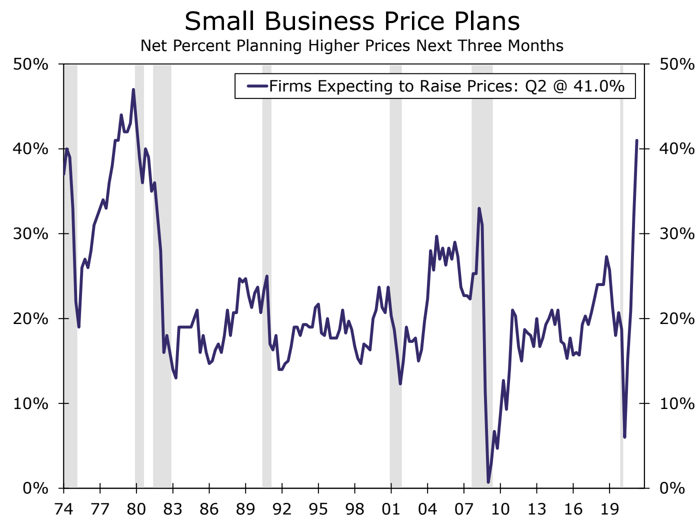
Sure, the rate of recent price gains due to supply issues in some sectors is unlikely to be sustained. Autos offer the most pertinent example. U.S. auto production has declined by 14% since February 2020 amid semiconductor shortages, putting prices well ahead of their pre-COVID price trend (Figure 1)[1]. At least a partial return toward Earth seems inevitable. Even if prices stayed at current *levels*, the *rate of change* would slow to zero. On this basis, the Fed is at least partly right when it says that the current degree of inflation is only temporary.

Figure 1



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

Figure 2

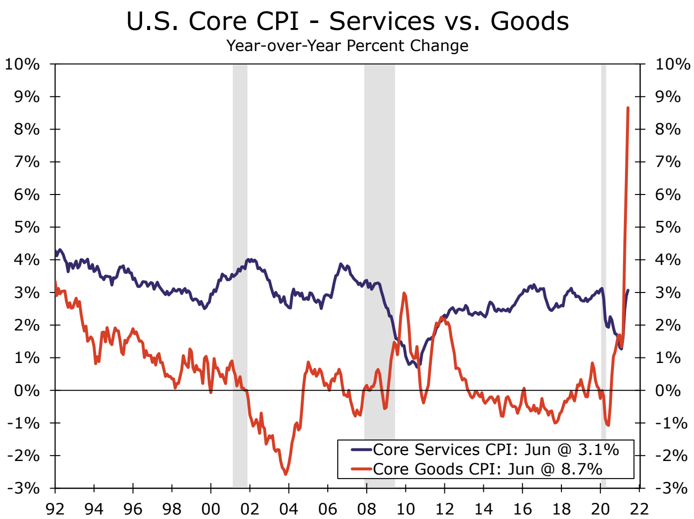


Source: NFIB and Wells Fargo Securities

At issue, though, is that the eventual normalization in inflation is increasingly getting delayed. Our Pressure Gauge illustrates that broad-based price pressures associated with snarled supply chains have yet to abate in any meaningful way. In some cases, such as inventories and shipping costs, they continue to worsen. While car prices are likely to give back some ground soon (auction prices for used vehicles slipped in June and July), a marked and widespread slowing in goods inflation is not yet upon us. Shipping costs are increasing at a double-digit pace, wait times for products remain unusually long even as throughput at ports has improved, inventories are still inadequate and labor is hard to find. Not only are these problems symptomatic of ongoing supply chain constraints, they are a source of price pressure that continues to filter through the economy and stoke inflation. More small businesses report planning to raise prices than at anytime since 1980 (Figure 2).

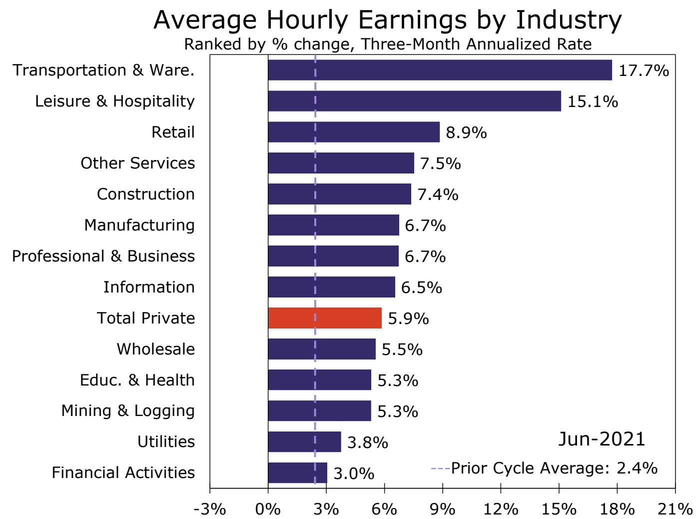
The ongoing upward pressure on goods prices comes as services prices are no longer providing an offset (Figure 3). Experience spending has rebounded, pulling prices higher with it, and the surge in home prices over the past year is finally filtering into measured inflation. Any giveback in goods prices or easing in services inflation looks increasingly delayed by the rapid rise in labor costs over the past few months, the most notable of which has been transportation and warehousing wages (Figure 4). The case for businesses to absorb higher costs is not very compelling when demand is solid and they cannot keep product in stock.

Figure 3



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

Figure 4



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

The upshot is that inflation is going to remain elevated as long as supply lines are jammed and inventories are depleted. Like us, Fed officials are unclear on the timing of when supply constraints will eventually ease, but they are clear that it will matter for the near-term inflation outlook. The duration and degree of supply-related inflation pressure also matter for the medium-term outlook, however. With each passing month supply lines struggle, the ensuing inflationary pressures have the potential to become entrenched in expectations of future inflation. While we do not expect inflation to be running at its current rate—nearly 10% annualized the past three months—a year from now, a protracted period in which supply struggles to catch up with demand will keep the heat turned up on actual inflation and inflation expectations. Fed officials, including Chair Powell, have pointed to "well-anchored" inflation expectations as a reason to not become overly worried about recent inflation prints. However, supply issues today could stoke inflation that is not so transitory.

Endnotes

[1] See "What's Trending?" (02/18/2021) for more detail. (Return to Section)

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