WELLS FARGO

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Oh, the Places You'll Go: Inflation Edition

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Summary

- For more than a year now, inflation has been the foremost—and at times seemingly only—driver of U.S. monetary policy. While stress in the banking system has vied for pole position in recent months, the way forward for the FOMC continues to predominantly depend on inflation's path ahead, in our view.
- Over the past year, the inflation picture has in some ways improved. Inflation has eased over a variety of measures and over a variety of durations. After reaching 9.1% last June, headline CPI is back under 5% year-over-year, and unlike the environment a year ago, pipeline price pressures are clearly weakening.
- But in other ways the picture has grown more concerning. The magnitude of the core inflation slowdown has been paltry in comparison to the problem, and leaves inflation still way too high for the Federal Reserve. The traditional core measures of CPI and PCE inflation remain much closer to their cycle highs than to the Fed's 2% target. What's more, the lack of material improvement comes despite another year to adjust to the COVID-induced shock and the Fed's aggressive monetary policy tightening.
- It is clear the rapidly rising price environment is not "transitory" as the Fed thought in 2021, but just how sticky might inflation prove to be? To help navigate the uncertain road ahead, we lay out three scenarios for inflation over the next 12 months.
    - **Baseline:** A demand-sapping recession and gradual unwinding of pandemic-era supply issues help put inflation firmly on a downward path, but are not enough to get core inflation back to the Fed's target on a sustained basis by Q2 of next year.
    - **Upside:** A recession is avoided or at least significantly delayed thanks to more resilient spending and hiring, generating both the ability and need for businesses to continue to raise prices at a strong rate. The Fed is slow to recognize policy is not yet sufficiently restrictive, keeping core PCE inflation at or above 3%.
    - **Downside:** Market share concerns resurface and businesses begin to battle more on price. Supply constraints prove to have been more influential in inflation's rise, and in turn, their unwinding leads to a sharper reduction in inflation. Core PCE rounds to 2% by this time next year.
- As implied by the name, we see our baseline scenario, in which core inflation slows materially but remains closer to 3% than 2% in a year's time, as the most likely outcome for inflation ahead. However, we'd weight the balance of risks as skewed to the upside as inflation carries momentum and economic activity has continued to hang in surprisingly well.

Inflation One Year Ahead
Year-over-Year Projections for Q2 2024

	Probability	CPI	Core CPI	PCE	Core PCE
Baseline	55%	2.1% - 2.6%	3.0% - 3.4%	1.8% - 2.1%	2.4% - 2.9%
Upside	30%	≥ 2.7%	≥ 3.5%	≥ 2.2%	≥ 3.0%
Downside	15%	≤ 2.0%	≤ 2.9%	≤ 1.7%	≤ 2.3%

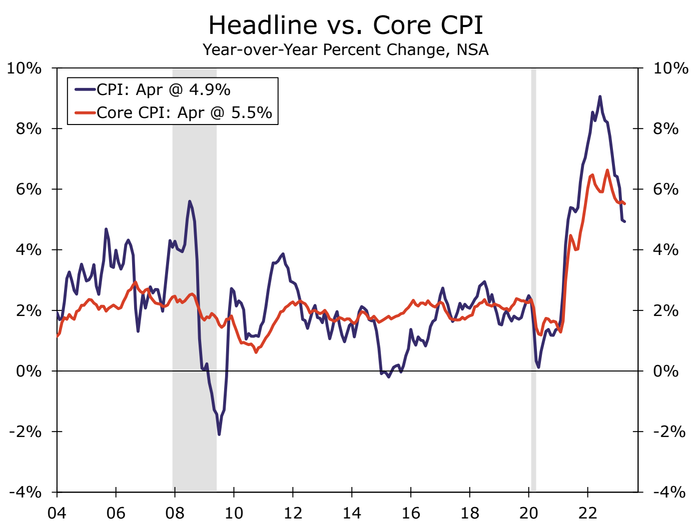
Source: Wells Fargo Economics

Another Year of Above-Target Inflation in the Books

For more than a year now, inflation has been the foremost—and at times seemingly only—driver of U.S. monetary policy. The fastest and most persistent inflation in over 40 years has led, not coincidentally, to the most aggressive monetary policy hiking cycle in as many years. Whether the FOMC's tightening efforts have come to an end, and which direction future adjustments may eventually take, continues to predominantly depend on inflation's path ahead, in our view.

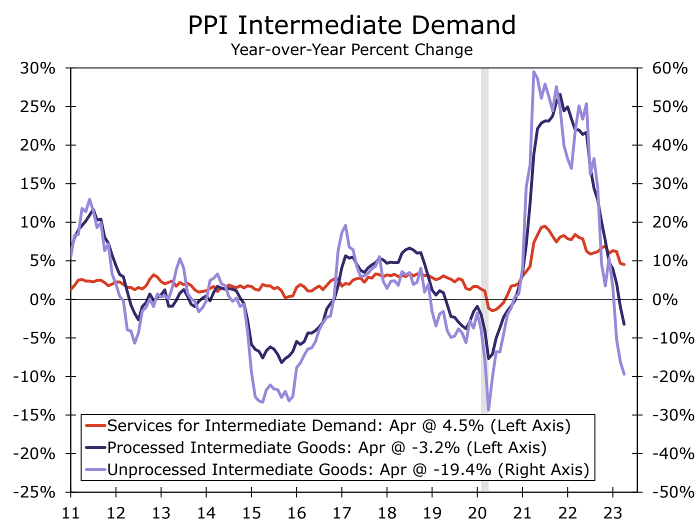
Since the Fed embarked on its tightening campaign a little over a year ago, the inflation picture has in some ways improved and in others ways grown more concerning. On the positive side, inflation has eased over a variety of indicators (CPI, PCE and PPI) and over various durations (3-month, 6-month or 12-month bases). Headline CPI, at 4.9% year-over-year in April, has fallen by nearly half since peaking at 9.1% in June 2022 (Figure 1). Excluding food and energy, consumer price growth has also come off its highs, albeit not as much as the headline index. Price pressures further back in the pipeline are weakening, unlike the environment of a year ago. Input prices for goods have fallen outright over the past year, while input costs of services are rising more slowly (Figure 2).

Figure 1



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

Figure 2



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

On the negative side, realized progress on inflation has thus far been narrowly driven. For example, the 3.3-point drop in headline CPI inflation over the past year has been more than accounted for by deflation for energy and vehicles, of which contributions to the year-over-year rate have fallen by a combined 3.8 points (2.5 and 1.3 points, respectively; Figure 3). More than half of published categories are still up at least 5% on a year-ago basis, and the *median* rate of CPI ran at a 5.9% annualized clip the past three months.

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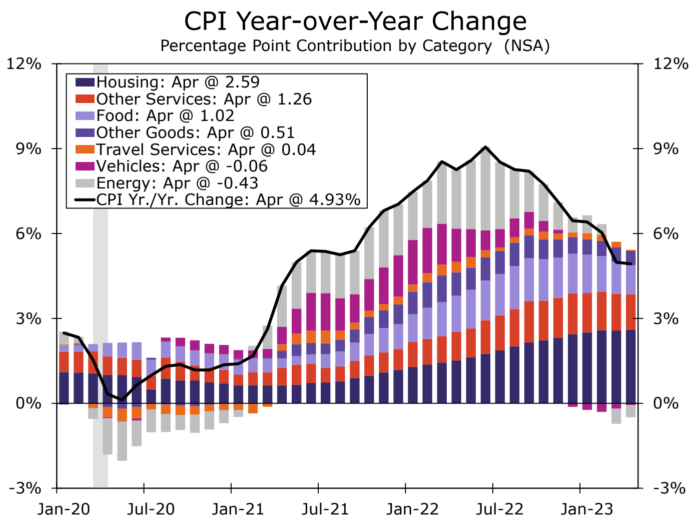
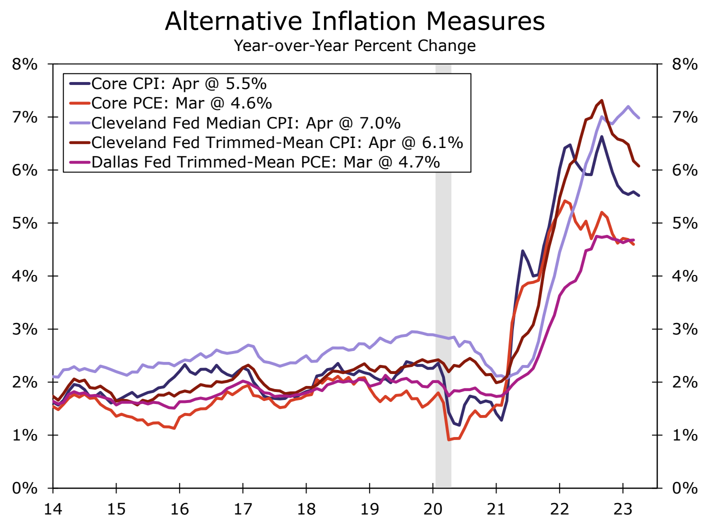
What's more, the magnitude of the slowdown has been paltry in comparison to the problem, and that leaves inflation still much too high for the Federal Reserve. The traditional core measures of CPI and PCE inflation, as well as the median and trimmed mean alternatives, remain much closer to their cycle highs than to the Fed's 2% target (Figure 4).

Figure 3



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

Figure 4



Source: Federal Reserve System, U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Economics

The lack of material improvement after another year to adjust to the COVID-induced shock and the Fed's aggressive monetary policy tightening makes the task of returning inflation back near its 2% goal appear even more daunting. Core inflation has been running above the FOMC's target for two years now. The longer elevated inflation lasts, the greater the risk of entrenchment.

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It is clear the rapidly rising price environment is not "transitory" as the Fed thought in 2021, but just how sticky might inflation prove to be? Forecasting is an inherently uncertain business, but the outlook for inflation is unusually hazy at present amid the unique events of the past few years. To help navigate the uncertain road ahead, we lay out three scenarios for how inflation may unfold.

Baseline Scenario: Clearly Climbing Down, but Destination Out of Reach

In our base case scenario, we expect inflation to improve meaningfully over the next year, but the slowdown will be bumpy and fall short of pushing core inflation all the way back to 2%. A key element to our outlook for disinflation is a demand-sapping U.S. recession. We have laid out what this recession looks like in other reports, and we will not dwell on the details here. In our view, it will take more than normalized supply chains and a rebound in labor supply to drive inflation back to 2% or even 2.5% on a *sustained* basis. Consumers' impressive financial position coming out of lockdowns, insatiable appetite for goods, pent-up demand for services and a plethora of job opportunities lent itself to little pushback against higher prices the past few years. But as household finances deteriorate, job prospects dim and unemployment heads higher, consumers' capacity and willingness to spend will be more limited.

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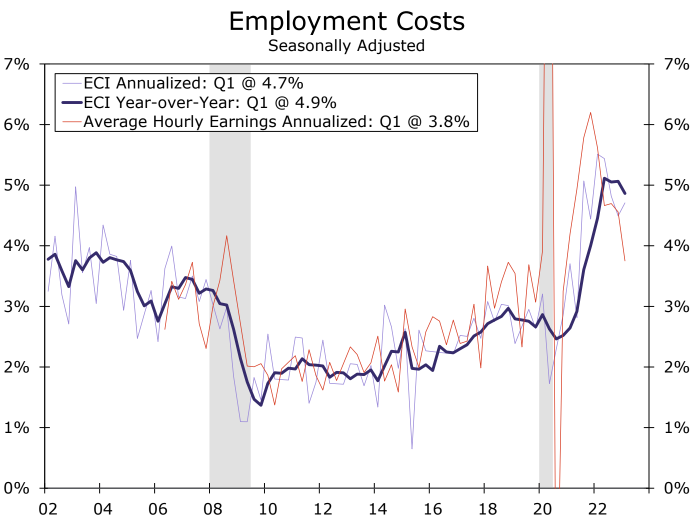
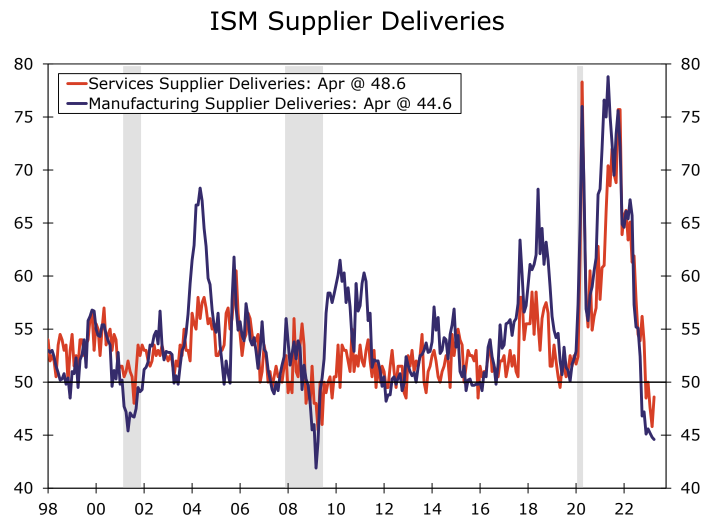
That is not to say supply-side factors will not play a role in reducing inflation. As health concerns have faded and "excess" savings have dwindled, a growing share of workers have made their way back to the labor force. Labor cost growth has cooled a bit with workers somewhat easier to come by (Figure 5). Supply chain strains that reached a fever pitch around the start of 2022 have also largely subsided, with the ISM manufacturing and services supplier deliveries components in contraction territory (Figure 6).

Figure 5



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

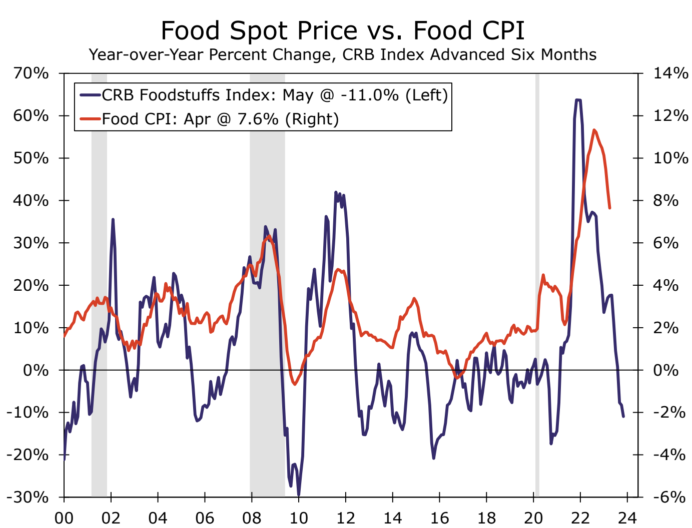
Figure 6



Source: Institute for Supply Management and Wells Fargo Economics

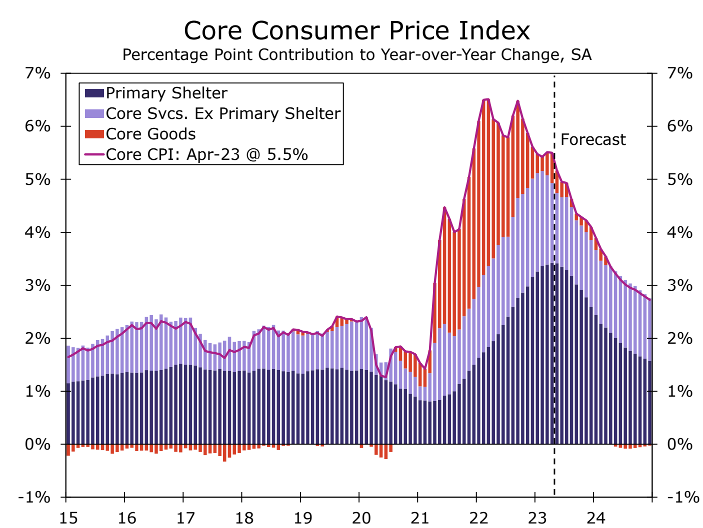
We estimate the more balanced picture between demand and supply will drive the year-year-year rate of CPI down from 4.9% at present to a quite palatable 2.3% by the second quarter of next year. Tamer commodity prices are an important part of the equation. We look for prices for energy services to decline over the near term to follow the pullback in natural gas prices, while oil and gasoline prices would likely move somewhat lower in a recessionary environment. Food inflation also looks poised to slow further, following a decline in related commodity prices (Figure 7).

Figure 7



Source: U.S. Department of Labor, Commodity Research Bureau and Wells Fargo Economics

Figure 8



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

Progress on core inflation is likely to prove slower-going than on the headline index.

We expect disinflation to extend to the core index, although progress is likely to prove slower-going than on the headline index. We look for core CPI inflation to slow from 5.5% year-over-year at present to 3.2% in Q2-2024. A moderation in shelter inflation is likely to be the most visible driver of lower core inflation (Figure 8). Official measures of shelter cost growth tend to lag private sector measures of rent and various home price indices by roughly three and five quarters for primary rent and owners' equivalent rent, respectively, due to housing units being sampled only twice per year and contracts typically resetting even less frequently. We look for the year-over-year rate of primary shelter (owners' equivalent rent and rent of primary residence) to slow from 8.3% at present to a little below 5% a year from now, accounting for roughly 60% of the core's decline over the next 12 months.

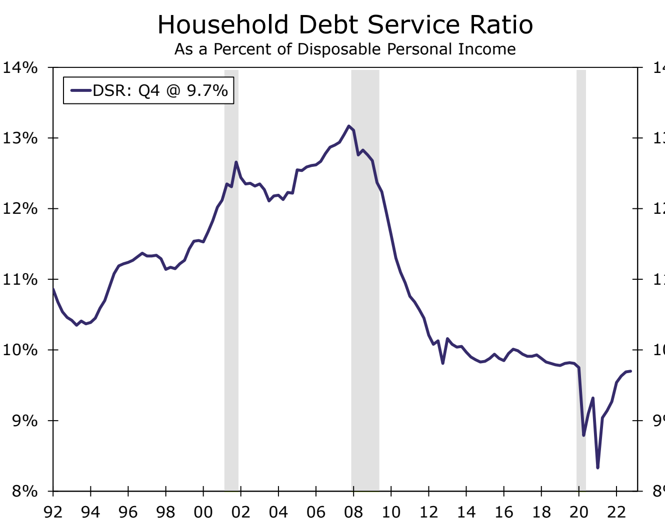
At the same time, goods should become more neutral for price growth as consumer spending shifts back toward services and supply chain pressure eases. We expect a bit more deflation in vehicles over the next year, while inflation among other core goods continues to gradually ease. More restrained activity and a somewhat looser labor market should also help inflation for non-housing services to slow even as medical care inflation likely remains firm.

Upside: Economy Keeps Flying and Fed Keeps Waiting for Lags to Hit

Over the next 12 months, a less marked improvement in inflation relative to our baseline—or the more nightmarish scenario of effectively no improvement—would likely occur as the result of a more resilient demand environment in which a recession is avoided or at least significantly delayed. Although consumer finances are deteriorating directionally, they remain strong in an absolute sense. Households in aggregate are still sitting on over $700B in excess savings, and monthly debt service payments remain lower than at any point prior to 2020 (Figure 9).

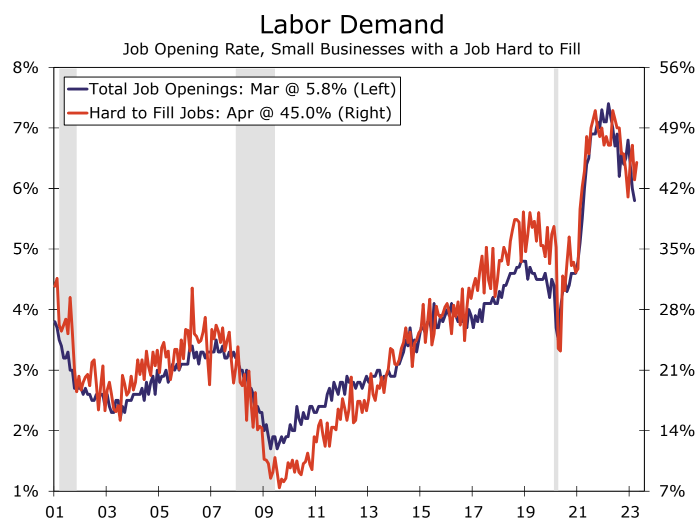
Consumers' capacity to continue spending—and thus businesses to continue raising prices at historically fast rates—could be further supported by the labor market better-weathering the Fed's efforts to dampen demand. Businesses continue to report a historically high need for workers (Figure 10). Hiring has also remained robust is supporting nominal income. Labor supply growth has been hampered on a cyclical basis by older workers' slow return to the workforce, but also on a structural basis, given the longer-term slowdown in working-age population growth. A stubbornly tight labor market could ensue and keep labor costs running north of 4%.

Figure 9



Source: Federal Reserve Board and Wells Fargo Economics

Figure 10



Source: U.S. Department of Labor, NFIB and Wells Fargo Economics

As of now, it also appears many FOMC participants believe monetary policy is very close to being, if not already, sufficiently restrictive to curtail inflation. However, the patient stance could prove premature, particularly if broader financial conditions fail to tighten as much as the FOMC expects. The inertia of policy—whereby a Fed in motion tends to stay in motion, and a Fed at rest tends to stay at rest—may make the Committee slow to restart tightening should a more restrictive stance prove warranted in the months ahead. Inflation could fester further in the coming year as a result. In addition to being merely slow to restart tightening if needed, an additional upside risk to price growth would be if the FOMC simply becomes tolerant of ~3% inflation when faced with the uncomfortable trade off of higher unemployment.

Under a backdrop of more persistent spending growth and labor market strength, we would expect to see firmer energy prices and more durable inflation in discretionary categories in the year ahead, including travel, recreation and food away from home. The retreat in globalization could also lend more near-term support to goods prices than we have accounted for in our baseline. And while the die is largely cast for housing inflation over the next year or so, more resilient demand for home-buying at prevailing mortgage rates and a better-than-expected jobs market would support rent and home prices, and keep shelter inflation from returning to more historic norms later in 2024.

Downside: Market Share Battles Return, Unwinding of Supply Constraints Proves More Potent

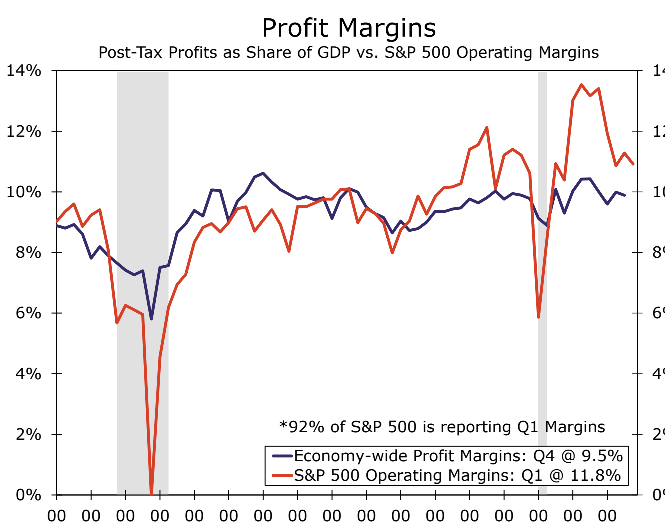
Our current outlook is for a relatively mild decline in GDP (-1.0% peak-to-trough vs. an average of -2.7% in the 12 post-WWII recessions) and restrained rise in the unemployment rate (+1.2% vs. an average of +3.6%). Therefore, a steeper and/or earlier downturn than envisioned, perhaps fueled by more acute stress in the banking system, would take more wind out of inflation's sails over the next 12 months.

Fiercer battles for market share as demand dries up could also help drive down inflation somewhat faster than expected. Over the past two years, consumers' spending spree has left plenty of sales to go around. However, businesses may increasingly prioritize volume as conditions turn more tepid, with elevated profit margins offering some scope for selling prices to rise more slowly than input costs ahead (Figure 11).

Easing supply constraints could also prove to be a more potent source of inflation relief. Just as the impact of key parts shortages and transportation bottlenecks was underappreciated on inflation's way up, the impact of their unwinding could similarly be underappreciated on the way down. Supplier delivery times are now contracting at a pace previously reserved for recessions, while the New York Fed's Global Supply Chain Pressure Index is more than one standard deviation below its historical average and points to CPI core goods falling 1.0%-1.5% on a year-over-year basis versus our baseline expectation for a roughly flat reading a year from now (Figure 12).

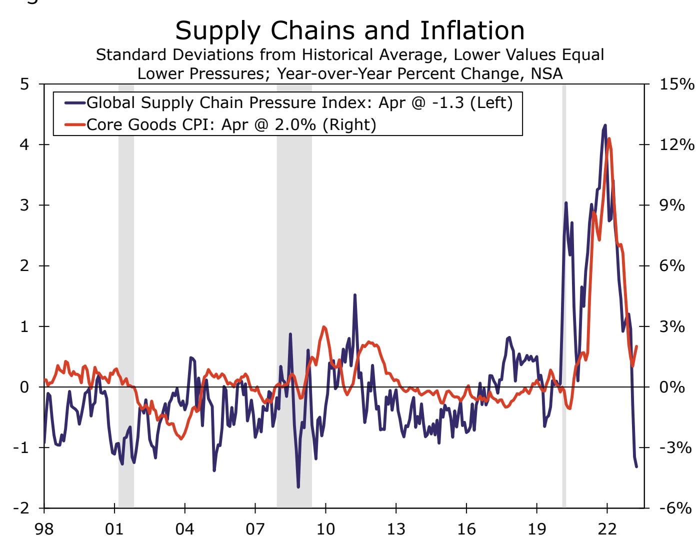
Just as the impact of shortages and bottlenecks was underappreciated on inflation's way up, the impact of their unwinding could similarly be underappreciated on the way down.

Figure 11



Source: U.S. Department of Commerce, S&P Global and Wells Fargo Economics

Figure 12



Source: Federal Reserve Bank of New York, U.S. Department of Labor and Wells Fargo Economics

Notably, parts shortages are fading in the hard-hit auto sector, with motor vehicle assemblies in April racing past their 2019 average. We have penciled in a 2.5%-3.0% drop in vehicle prices over the next year, but that would still leave prices for new and used vehicles significantly above their pre-COVID trends (16% and 34%, respectively). A more significant drop as inventories continue to recover and financing costs weigh on transaction prices for increasingly squeezed consumers would not surprise us. Neither would a more abrupt weakening in commodity prices.

Labor force growth has also kicked into a higher gear since the start of the year. And while the jobs market remains tight overall, a couple of dynamics could expedite a cooling in wage growth. First, the 2021-2022 job-switching frenzy that raised the cost of retaining existing and attracting new workers has come to an end. Second, employers' push to return to the office may leave remote-worker hold outs with more modest advances in pay.

Risks to Our Baseline Skew to the Upside

As implied by its name, we see the baseline scenario as the most likely outcome for inflation through the second quarter of next year. The effects of the substantial fiscal and monetary policy support offered in response to the pandemic as well as acute supply disruptions to goods and labor continue to linger, but are gradually fading. However, the risks to our inflation outlook are skewed more to the upside than downside, in our view. Core measures continue to suggest that inflation is still wielding considerable momentum. Consumer spending and hiring have cooled in recent months, but do not appear to be immediately petering out. Without end markets clearly reeling, businesses could continue to raise prices at a relatively strong rate, especially now that customers have re-learned that prices go up over time—a lesson largely lost over the past cycle. But a more rapid decline that brings inflation more or less on target in a year's time cannot be ruled out either if easing supply constraints prove underappreciated on inflation's way down as they did on inflation's way up.

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