May 17, 2021

ECONOMIC REPORT

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **William Adams** Senior Economist | **Kurt Rankin** Economist | **Abbey Omodunbi** Senior Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

INFLATION SPIKED IN APRIL AS DEMAND RECOVERED MORE QUICKLY THAN SUPPLY, BUT IT WILL SETTLE DOWN

SUMMARY

- CPI inflation was 0.8% in April, sharply overshooting the 0.2% consensus. Price gains in a few specific categories accounted for much of the increase.
- PPI inflation was 0.6% in April.
- Consumer spending is recovering more quickly than the economy's productive capacity in some sectors; this is a temporary problem, but is pushing inflation higher for now. Sudden shifts in consumer preferences, supply chain disruptions, and labor shortages are contributing to this spike in inflation.
- Total inflation will slow in the second half of 2021 as supply catches up with demand, but core inflation will rise somewhat in 2022 and 2023 as the recovery strengthens.
- The Fed sees higher inflation as "transitory" and will not change policy in response to short-run data.

Inflation sharply overshot expectations in April. The consumer price index for urban consumers rose 0.8% from March, much higher than the consensus forecast of 0.2%. The CPI increased 0.6% in March. The upside surprise in April was in core CPI (excluding food and energy); it rose 0.9% on the month versus an expected 0.3%. Food prices rose 0.4% in April, while energy prices fell 0.1% after surging 12.8% from December to March.

The CPI in April was up 4.2% from one year earlier, but this is partly because prices outright declined in the spring of 2021 as the pandemic took hold. The CPI was up a smaller 3.1% in April from February 2020, before the pandemic. Similarly, core CPI was up 3.0% in April year-over-year, but only 2.6% from February 2020.

The largest monthly price increases in the CPI basket in April were for used cars and trucks and airlines fares, both up a whopping 10% over the month, and car and truck rental rates, which surged 16% (see Chart 1). Those three categories were responsible for nearly one-half of April's net increase in the CPI. Consumer demand has recovered rapidly from the 2020 downturn. Stimulus checks have funded down payments for many used car and truck shoppers, and the Fed has kept interest rates extremely low, making car loans cheap; this pushed up used vehicle prices in April. Newly vaccinated Americans are planning deferred vacations and business trips as restrictions on activity are lifted, allowing airlines and car rental agencies to raise prices. Stronger travel demand also supported the big increase in energy prices between December and March. Gasoline prices will spike again in the May CPI report due to the Colonial Pipeline shutdown.

Bottlenecks on the supply side of the economy are further exacerbating price increases. Supplier delivery delays have been a problem since the pandemic started, and severe shortages of some products are having ripple effects on the broader economy. A semiconductor shortage has idled auto plants, shrinking inventories on new car dealer lots to the lowest levels since the data series started in the early 1990s. Short supplies of new autos have pushed buyers into the used car market, pushing up prices there. The automakers have also restricted sales to rental fleets, making it difficult for them to replenish their supplies after they sold cars in 2020 to raise cash.

Producer prices rose sharply in April as well. The producer price index for final demand rose 0.6%, overshooting the 0.3% consensus forecast; this followed a 1.0% increase in March. Producer prices rose 6.2% in April on a year-over-year basis, up from 4.2% in March and the fastest pace since the final demand series began in 2010; the PPI for finished goods, which has a longer history, rose 9.5% from a year earlier in April, the strongest growth since the oil price spike of 2008.

INFLATION SPIKED IN APRIL AS DEMAND RECOVERED MORE QUICKLY THAN SUPPLY, BUT IT WILL SETTLE DOWN

But as with consumer prices, these PPIs were up less in April 2021 from February 2020 than from April 2020.

Producer price inflation was especially high for products that saw demand spike in the stay-at-home economy (see Chart 2). Wholesale mobile home prices in April jumped 6% on the month and 21% on the year, as social distancing and stimulus payments have driven a boom in RV and camper sales. Lumber prices surged 6% on the month and 90% on the year; starts and permits for new home construction have risen in recent months to their highest levels since the mid-2000s. And prices of metals and metal products jumped 5% in April from March and were up 27% over the year.

Lumber, like cars and trucks, is another product where supply chain bottlenecks are adding to inflation pressures from demand. While lumber prices are at record highs, prices for trees are actually depressed. Lumber mills are the bottleneck causing a disconnect between the cost of inputs (trees), intermediate products (lumber), and the finished product (housing).

April's surprisingly high inflation has definitely gotten the Federal Reserve's attention. But inflation trends before the pandemic are heavily influencing how the Fed reads the current data. In the decade of the 2010s inflation averaged slightly below the Fed's 2.0% target even as the unemployment rate fell to 3.5% in early 2020, the lowest rate in a half century. The Fed's primary inflation measure is the personal consumption expenditures (PCE) price index, which tends to run a bit below the CPI. Back in the mid-2010s Fed policymakers thought a multi-decade low in the unemployment rate would make inflation accelerate; they were surprised when inflation didn't budge in 2019 and 2020. The Fed started to worry that inflation could get stuck below their target, as has happened in Japan and the Eurozone in recent decades. In response, the Fed changed its monetary policy strategy in 2019: after periods when inflation averages below target, like 2010 to 2020, the Fed will aim for inflation "modestly above 2%" so that inflation averages 2% over a multi-year time horizon. The Fed was focused on the risk of too-low inflation throughout 2020 as consumer prices outright declined in the spring and the economy struggled through the pandemic.

After April's higher than expected CPI inflation, the Fed will revise up their inflation forecasts at the next release of their projections, in mid-June. In their March projections the median inflation forecast (measured by the PCE deflator) was 2.4% in the fourth quarter of 2021 from a year earlier.

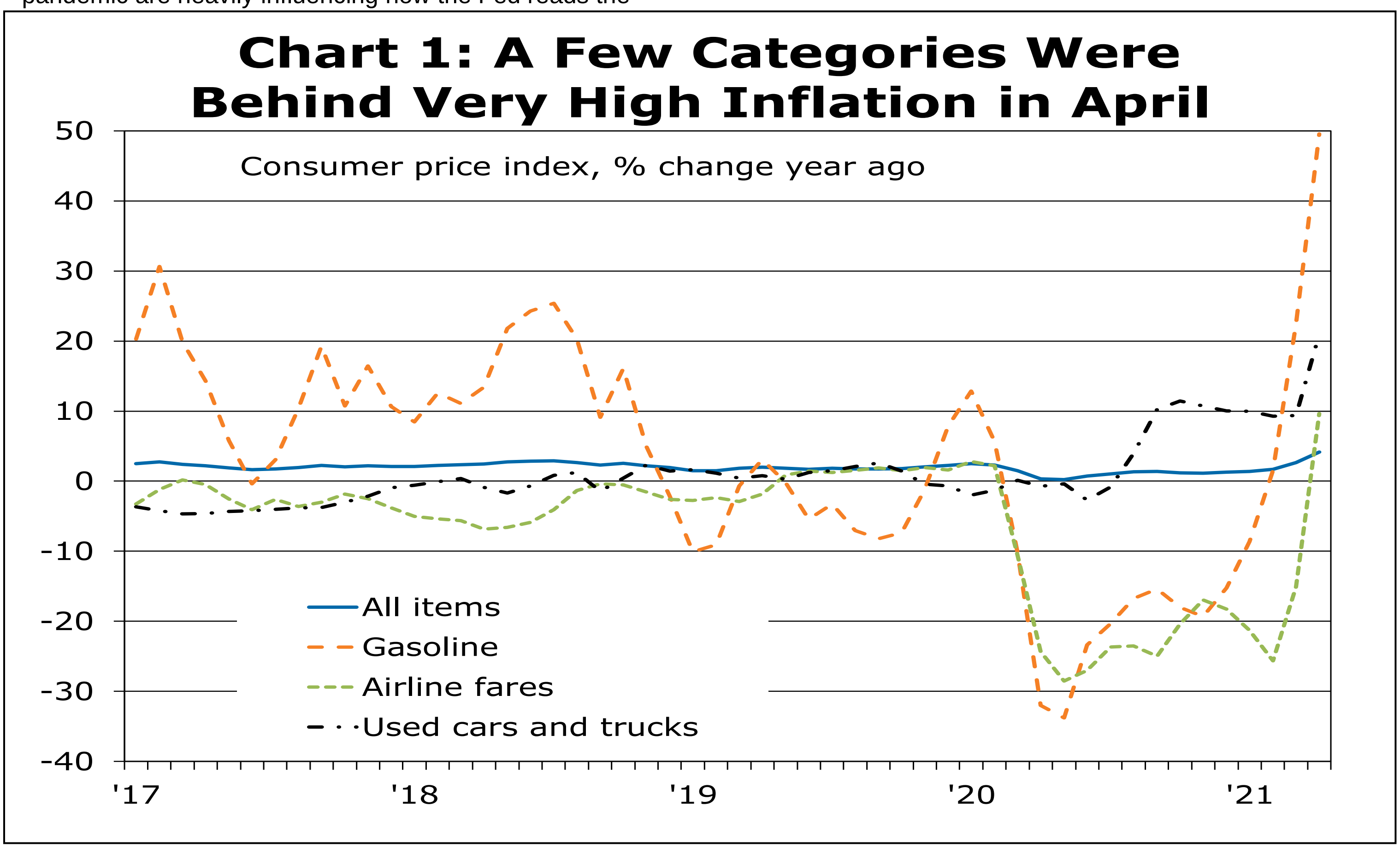

Chart source: Bureau of Labor Statistics

INFLATION SPIKED IN APRIL AS DEMAND RECOVERED MORE QUICKLY THAN SUPPLY, BUT IT WILL SETTLE DOWN

Fed policymakers have said that they view April's spike in inflation as "transitory" and not a justification for raising interest rates. Shortages of used cars and single-family homes will be less extreme in the second half of 2021 as Americans return to big cities they temporarily left during the pandemic and start using public transit again. Motor vehicle production will ramp back up as semiconductor shortages fade, reducing pressure on used-car prices. Nimble entrepreneurs and businesses will (re)open lumber mills and drill new shale oil wells later this year, easing shortages of lumber and gasoline. Core inflation will likely pick up somewhat in 2022 as the recovery broadens.

At its April 28 meeting the Federal Open Market Committee agreed to wait until the economy makes "substantial further progress" before reducing their purchases of long-term assets (a.k.a. quantitative easing), and also set three criteria for the economy to meet before raising the fed funds rate: first, for the labor market to recover to conditions "consistent with the Committee's assessments of maximum employment"; second, for inflation to rise to 2%; and third, for inflation to be "on track to moderately exceed 2% for some time."

April's inflation report meets the Fed's second condition for a rate hike. But "maximum employment" is a long way off. Payroll employment in April was 8.2 million below where it was in February 2020, before the pandemic. And the FOMC views much of the recent acceleration in inflation as due to one-time factors, including base effects, very strong demand in a few areas, and temporary supply bottlenecks. The committee wants to see broader inflation, across most consumer goods and services, before it is ready to say that inflation is "on track to moderately exceed 2%." PNC's baseline forecast is for the Fed to begin tapering its asset purchases in early 2022, and then to start raising the fed Funds rate in late 2023.

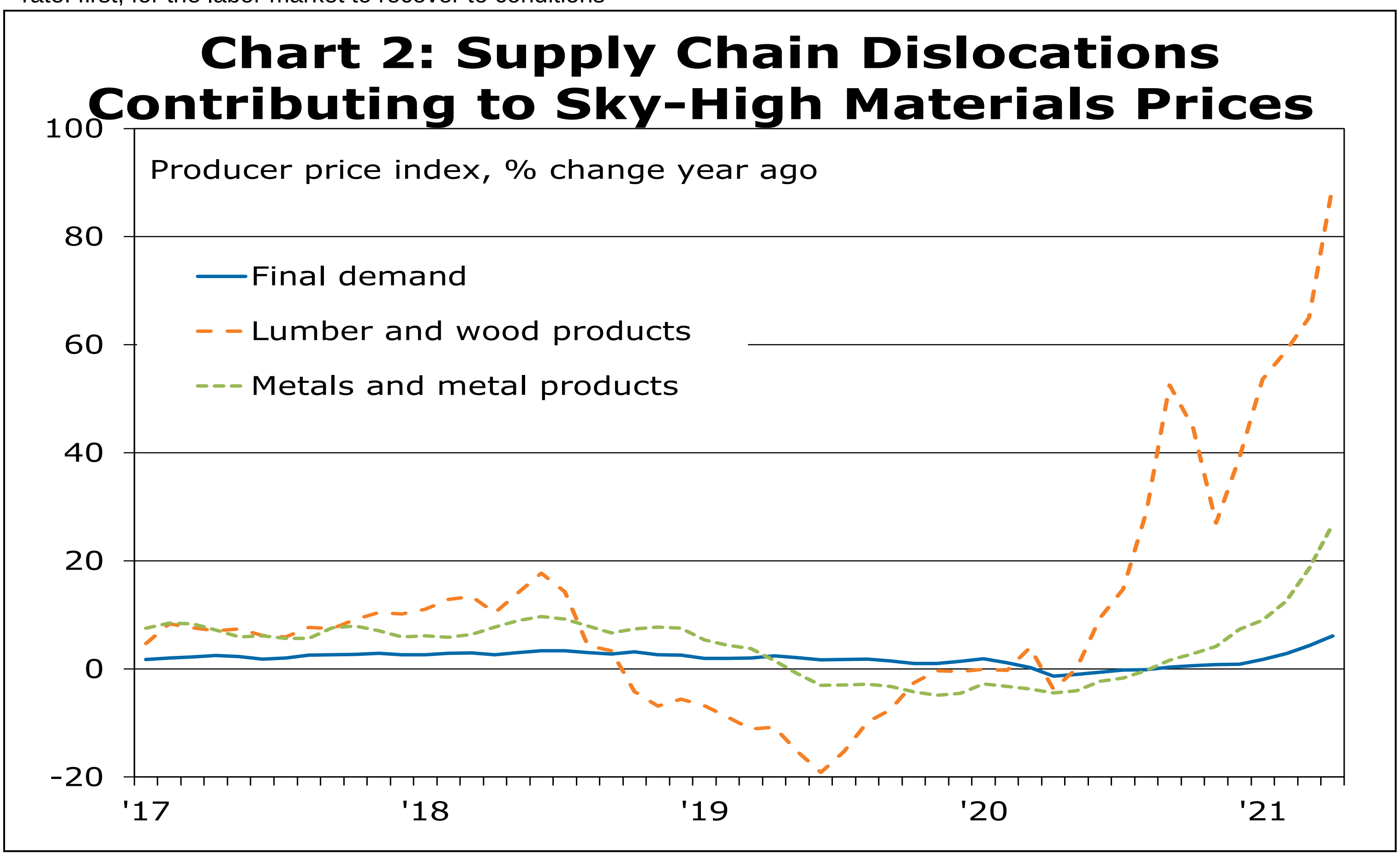

Chart source: Bureau of Labor Statistics

Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.