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ECONOMIC REPORT

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THE 2ND QUARTER'S SPIKE IN INFLATION WAS FROM A TEMPORARY SURGE IN DEMAND, SUPPLY BOTTLENECKS

SUMMARY

- CPI inflation was 0.9% in June, a fourth consecutive month of inflation above 0.5%. Core CPI excluding food and energy also rose 0.9% in June. In quarterly terms, the second quarter's CPI inflation was the highest since 2005; its core CPI inflation was the highest since 1981.
- A few categories of goods and services are temporarily experiencing strong demand and limited supplies coming out of the pandemic, boosting inflation in recent months.
- Inflation will slow later in 2021 as supply starts to catch up with demand.
- The main concern is that consumers and businesses could start to expect inflation to persist at current levels, leading to a self-fulfilling cycle of prolonged high inflation, as happened in the 1970s. However, the temporary nature of current inflation pressures, and Fed watchfulness, should prevent this from happening.

The consumer price index for urban consumers (CPI) rose 0.9% in June, after increases of 0.6% in May and 0.8% in April. The CPI rose 2.3% in the second quarter of 2021 (not annualized), the highest quarterly inflation since 2005, when Hurricane Katrina made energy prices surge (see Chart 1). Energy prices rose 1.5% in June with gasoline prices up 2.5%. Food prices rose 0.8% over the month. Core CPI excluding food and energy also rose 0.9% in June, after rising 0.7% in May and 0.9% in April; the second quarter's 2.6% increase in core CPI (not annualized) was the highest since 1981, when an overheated economy forced the Federal Reserve to hike short-term interest rates above 20%. As in April and May, June saw prices rise quickly for goods and services that are experiencing strong demand as well as supply disruptions coming out of the pandemic. Used car and truck prices jumped 10.5% over the month, the biggest one-month gain ever (data go back to 1953), after increases of 10.0% in April and 7.3% in May. The increase in used car prices alone accounted for more than one-third of overall CPI inflation in June. New car prices were up 2.0% in June after increases of 1.6% in May and 0.5% in April. Car and truck rental prices rose 5.2% in June, 12.1% in May, and 16.2% in April. The story is similar for lodging away from home costs, up 7.0% in June; and airfares, up 2.7% in June after a 7.0% increase in May.

Other price indices also surged in the first half of 2021. The producer price index for final demand rose 1.0% in June after increases of 0.8% in May and 0.6% in April. The index had record-high quarterly increases in the first and second quarters of 2020 in data going back to 2010. The producer price index for all commodities (an older way of aggregating producer prices) rose 14.0% in the first half of 2021 (not annualized), the largest semiannual increase since 1946. The price index for personal consumption expenditures, the Fed's preferred measure of inflation ("the PCE deflator"), rose 0.5% in June, 1.6% in the second quarter of 2021, and 2.8% in the first half of the year, the highest semiannual increase since 1981. On a year-ago basis, CPI inflation was 5.4% in June. Core CPI inflation at 4.5% was the fastest since oil prices surged during the 1991 Gulf War. PPI final demand rose 7.1% in the same terms in June, and PPI all commodities rose 19.5%, the fastest since 1974. The PCE deflator rose 4.0% in those terms in May and June, the highest since 2008. June's year-ago comparisons overstate inflation since prices declined outright in March and April of 2020. But monthly, quarterly, and semiannual measures of inflation which are not affected by base comparison issues are also at multi-decade highs.

A temporary surge in demand collided with temporary supply bottlenecks in the first half of 2021, propelling prices higher. Consumers are flush with cash after a year of forced savings, stimulus payments, enhanced unemployment, record stock prices, and rock-bottom interest rates—and with the pandemic receding, they are ready to spend! By contrast, businesses cut costs and capacity in 2020 in case the recovery underwhelmed, and are struggling to ramp back up in the face of

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supply bottlenecks, hiring difficulties, and dizzying shifts in consumer preferences. The auto industry provides a clear example. A global semiconductor shortage has idled some automakers, causing a drop in vehicle production despite very strong demand for new vehicles. With supply down and demand up, prices of new, used, and rental vehicles have jumped (rental agencies reduced fleets in 2020 and are struggling to scale back up). Similar bottlenecks made lumber prices surge in late 2020 and early 2021. Housing demand soared as Americans spent more time at home and sought more living space, and lumber mills could not keep up, sending prices much higher.

Inflation is set to slow in the second half of 2021 as supply bottlenecks improve and the wildest demand-supply dislocations of the last few months calm down. Commodity prices have already begun to fall: Through the end of July, lumber prices were down nearly 60% from their peak, soybean prices almost 15%, and copper prices 7% (see Chart 2). Futures prices for many commodities imply traders expect further pullbacks. Prices paid by dealers at used car auctions fell 3.0% from May to July. Even so, inflation will be historically high in 2021—so 2022's cost of living adjustment to Social Security benefits will be over 5%, the largest in a quarter century.

The Fed continues to see 2021's spike in inflation as "transitory." By this, they mean that one-off supply chain disruptions and the temporary effect of one-off stimulus programs have pushed inflation up, but these will fade over time. The obvious supply bottlenecks constricting the supply of goods with the worst inflation supports their view.

Inflation could be more persistent if 2021's shocks raise expectations of inflation over longer time horizons. Expectations play a strong role in how inflation happens as consumers, workers, and businesses incorporate them into plans and contracts. And consumer and business surveys do show an increase in inflation expectations in the first half of 2021. But expectations for inflation over multi-year time horizons have changed much less than near-term expectations, supporting the "transitory" view. Similarly, the inflation expectations implied by yields on inflation-protected bonds show investors are prepared for rapid price increases over the next twelve months, then substantially slower ones in the following years.

The spike in inflation in the first half of 2021 does not change PNC's baseline (most likely) forecast for monetary policy but does change the balance of risks around the baseline. At the conclusion of the most recent Federal Open Market Committee (FOMC) meeting on July 28, the

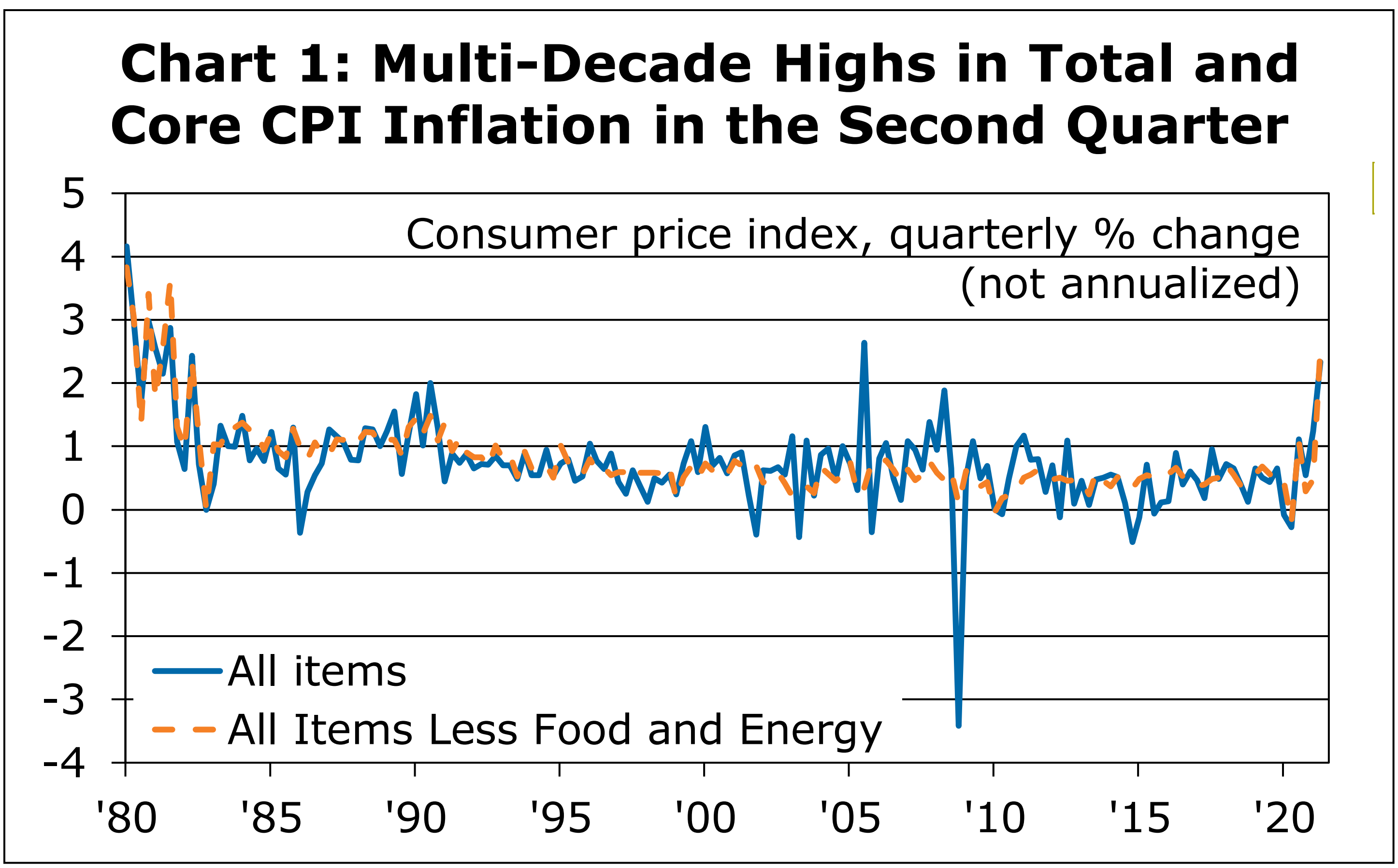

Chart source: Bureau of Labor Statistics

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FOMC reaffirmed the conditions for the economy to meet before they rein in monetary stimulus, conditions they first announced in December 2020. Before they start slowing their purchases of Treasurys and agency debt (a.k.a. taper quantitative easing "QE"), the recovery must make "substantial further progress" toward the Fed's goals of maximum employment and price stability (back in December, inflation was well below their 2% target).

The FOMC expects to wait until three conditions are met before raising the Federal Funds rate. First, the labor market should recover to conditions "consistent with the Committee's assessments of maximum employment." Second, inflation should rise to 2%. Third, inflation should be "on track to moderately exceed 2% for some time." Realized and expected inflation are up from late 2020, so the Fed is much less worried about inflation undershooting their target. And if job growth stays as robust as expected, in a few months the Fed will likely declare "substantial further progress" has been achieved and begin tapering QE programs. "Maximum employment" is quite a bit further off. Payroll employment in June was 6.8 million below the pre-crisis level, and the unemployment rate was 2.4 percentage points above early 2020's 3.5% level. The FOMC also wants to see broader-based inflation across goods and services to be convinced that inflation is "on track to moderately exceed 2%." PNC forecasts for the Fed to begin tapering its asset purchases in early 2022 and make an initial increase in the fed Funds rate in mid-2023.

The minutes of the Fed's June decision state that most FOMC members see risks to the inflation outlook to the upside since "transitory" inflation might fade slower than they expect; Chair Powell reiterated this view at the press conference following the Fed's July 28 decision. The risk that "transitory" inflation lasts longer than expected, or that it triggers a self-fulfilling increase in inflation expectations, means that the Fed is more likely to tighten earlier than in the baseline forecast than to tighten later.

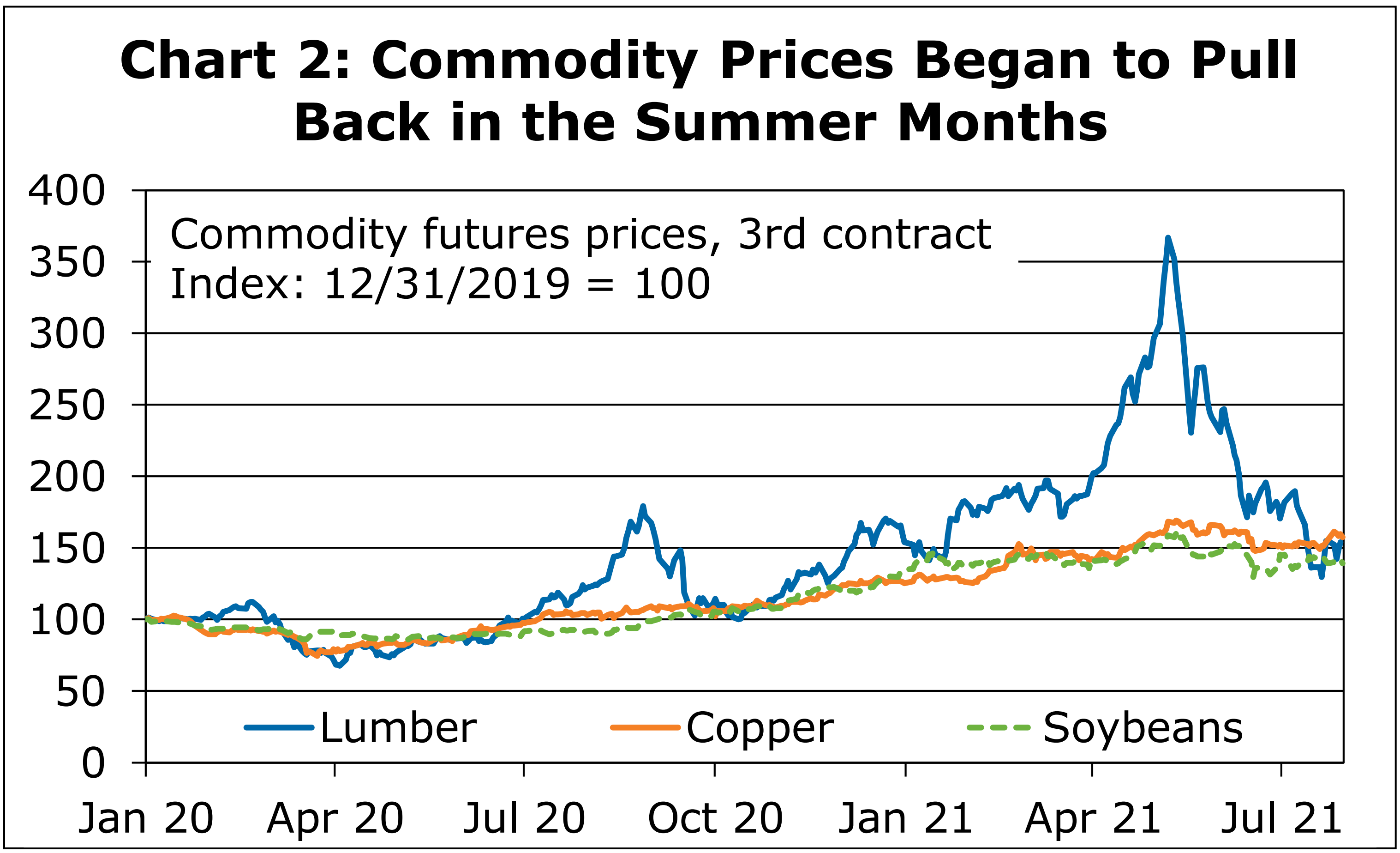

Chart sources: CME, COMEX, CBOT, Bloomberg

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