INFOCUS

MACRO COMMENT

MAY 2022

US inflation: Past the peak, but then what?

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US inflation appears finally to have peaked, but how quickly will it decline in coming months? Commodity prices remain high and global supply chain bottlenecks are still evident. In this edition of *Infocus*, GianLuigi Mandruzzato looks at the factors that will influence US inflation in the near term.

In April, US inflation, as measured by the consumer price index (CPI), eased to 8.3% year-on-year (yoy) from 8.5% in March. Also core inflation, which excludes energy and food, fell to 6.2%. Nonetheless, inflation remains well above the Federal Reserve's 2% objective.

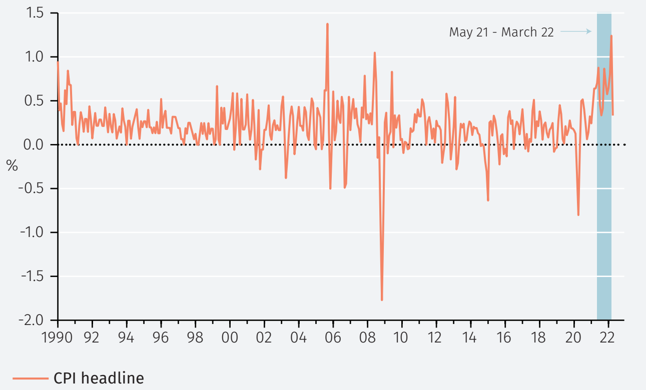
Many commentators note the risk that policymakers have lost control of inflation. They believe that high commodity prices and persistent bottlenecks in global supply chains will keep inflation high for a long time, forcing the Fed to raise interest rates aggressively.

In this edition of *Infocus* we analyse the impact of four factors on the inflation outlook in coming months:

1. the base effect;
2. the prices of food and energy raw materials;
3. supply chain bottlenecks;
4. the real estate market.

The base effect is expected to lower inflation, measured as the change in prices over twelve months, over the next few months. The change in annual inflation from month to month is approximately equal to the difference between the new monthly price change and that recorded in the same period twelve months earlier. The stronger the monthly rates of inflation over the past twelve months, the more likely it is that annual inflation will decline when they drop out of the calculation. This is the current case: the average monthly increase in the CPI in the period May 2021-March 2022 was 0.7%, much higher than the 0.2% recorded since 1990 (see Figure 1). This strong base effect points to lower inflation in the coming months.

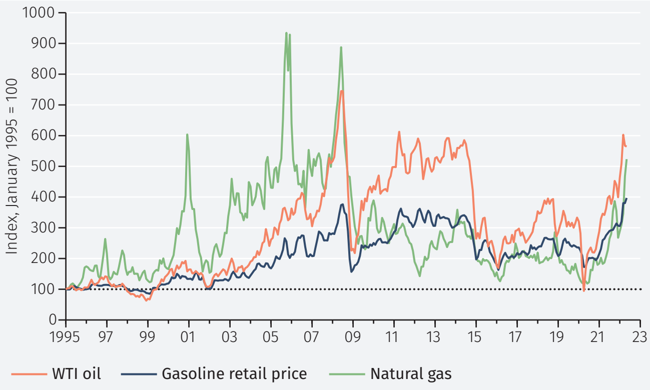
1. CPI all items, monthly changes



Sources: Refinitiv and EFGAM calculations. Data as at 11 May 2022.

However, the favourable base effect is no guarantee that inflation will fall quickly. Consider the recent increases in energy and food prices: these explain a large part of the rise in inflation and their contribution is expected to moderate in the future. Yet despite this benign medium-term outlook, the war in Ukraine has resulted in commodity prices remaining higher for longer. The WTI oil price remains above USD 100 per barrel, the gasoline price set a new all-time high of USD4.33 per gallon and the price of US natural gas has tripled since the beginning of 2021 (see Figure 2). In addition, the Bloomberg index of agricultural commodity prices has increased by 25% since the beginning of the year and remains at its highest level since 2014. There is clearly a risk that energy and food prices will remain at high levels in the coming months, limiting the decline in inflation during the rest of the year.

2. US energy prices



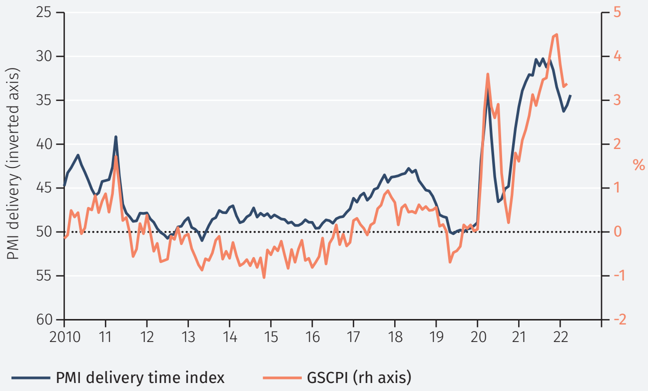
Sources: Refinitiv and EFGAM calculations. Data as at 11 May 2022.

Another factor that could slow the decline in inflation is the persistence of global supply chain bottlenecks. The new anti-Covid lockdowns in China since last March have again lengthened the delivery times of manufactured goods, as reflected in the lower PMI sub-index (see Figure 3).[1] Falling PMI delivery times correspond with increases in the Global Supply Chain Pressure Index (GSCPI) developed by the Federal Reserve

[1] Following the analysis of the Federal Reserve Bank of New York, the average of the PMI delivery times index for China, eurozone, Japan, South Korea, Taiwan, UK and US is used.

Bank of New York, which is positively correlated with the US inflation rate.[2]

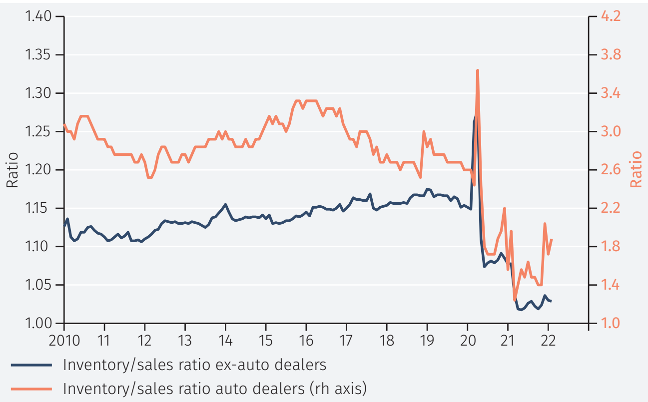
3. PMI delivery times and New York Fed GSCPI



Sources: Refinitiv and EFGAM calculations. Data as at 11 May 2022.

The difficulties in supplying retailers with goods are also apparent from the low inventory-to-sales ratio (see Figure 4). The low level of inventories risks further fuelling the demand for manufactured goods, potentially stressing global supply chains and pushing the prices of goods higher. This is particularly evident in the automotive sector and suggests that tensions in used car prices may return despite recent declines.

4. Retailers' inventories remain low



Sources: Refinitiv and EFGAM calculations. Data as at 11 May 2022.

Turning to our fourth factor, rising house prices in the US are symptomatic of the effects of supply shortages. The combination of anti-covid measures and delays in the delivery of building materials alongside the increase in demand resulting from low interest rates and high savings has reduced the stock of houses available on the market. As a ratio to monthly sales, the stock of houses for sale covers less than three months, a level not seen even at the dawn of the housing bubble in 2005. Unsurprisingly, house prices have risen: the annual growth of the Office of Federal Housing Enterprise Oversight house price index, which was only 6% yoy at the beginning of 2020, has been above 18% yoy since May 2021.

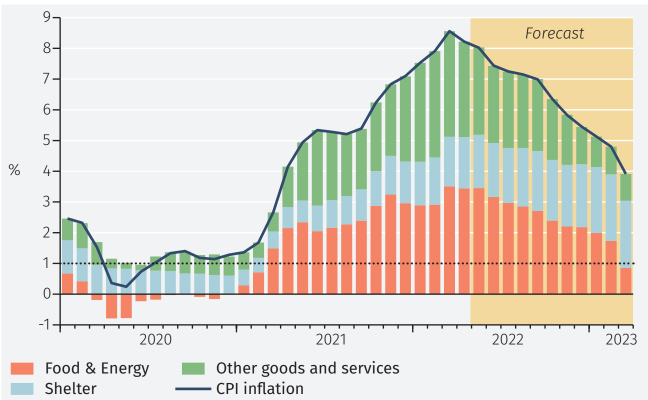
5. House prices and CPI shelter

Sources: Refinitiv and EFGAM calculations. Data as at 11 May 2022.

House prices lead by about 12 months the shelter component of the CPI, which constitutes about a third of the US CPI basket (see Figure 5). The historical relationship suggests that the increase in the price of shelter will approach 7% yoy at the beginning of 2023 and that its contribution to overall inflation will rise by more than half a percentage point to about 2.2%.

In conclusion, the April decline in US inflation suggests that the peak is finally behind us. However, the short-term scenario for prices remains uncertain and several factors suggest that inflation, while moderating, will stay high for the remainder of 2022 and in early 2023 (see Figure 6). There is a risk that the Federal Reserve's March projections are overly optimistic regarding the anticipated decline in the inflation rate by the end of 2022.

6. Main contributions to US CPI inflation (year-on-year)



Sources: Refinitiv and EFGAM calculations. Data as at 11 May 2022.

[2] See Stefan Gerlach 'Supply chains and US inflation', EFG *Infocus* 14 February 2022..

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