
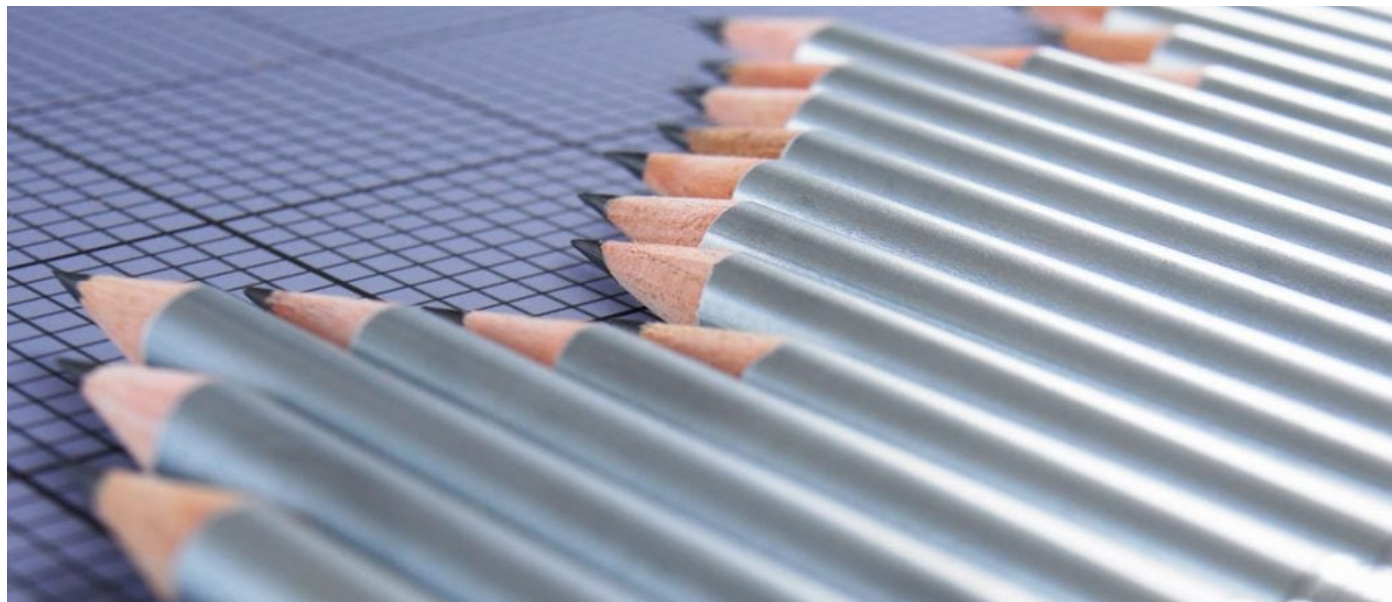


Inflation: Is It Transitory or Permanent? Consumers Will Decide

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The key debate: Inflation

Questions to consider:

- Is it transitory?
- Is it demand driven, and is that demand going to subside?
- Is it supply driven, and is that supply constraint going away, and when?
- Is it wage driven?

Recent economic data indicates that both the Federal Reserve (Fed) and the markets are pricing in transitory inflation, but at the end of the day, it is the consumer who will decide whether this inflation is transitory — demand- or wage-driven inflation — and whether producers are able to make their supply-driven price increases stick. To the extent that wages and input costs are going up, margins in the market would go down, and we likely would see multiples contract.

What are potential impacts?



Goods sector

Consumer demand for goods remains exceptionally high, a cause for demand-driven inflation.

- Some companies report feeling quite bullish about mid- and long-term consumer demand trends in North America.
- The consumer is in better shape financially than they've ever been, given stimulus-driven replacement and lower debt servicing costs.



Housing sector

Demand remains extremely strong, driving materials cost increases and reinforcing demand-driven inflation.

- Steel joist and steel deck prices are at all-time record highs, and demand is extraordinary.
- Some home builders have had to limit sales due to overwhelmingly strong demand.



Industrial sector

Supply-driven inflation is creating supply chain disruption, driving up input costs and transportation costs.

- The Philadelphia Fed's *Manufacturing Survey* saw "more widespread" price increases for inputs though the prices received index dropped. Additionally, firms raised their outlook on the prices they would receive in the coming year, their expectations for consumer inflation and their long-run inflation forecasts.

- The Empire Fed *Manufacturing Survey* saw similar dynamics, with its prices paid index rising to “a level last reached in 2011, pointing to sharp input price increases.”
- While the strong freight market dynamics are primarily driven by the consumer sector, the industrial side of the U.S. economy continues to be challenged by supply chain shortages, mainly related to semi-conductors. The White House met with industry leaders on this topic and indicated short- and long-term solutions were discussed, including adding domestic capacity. Typical lead time on building new semiconductor capacity is about 18 to 24 months, so freight equipment capacity could be constrained longer than a few more months. While it is likely the industry will find solutions sooner, this situation could add even more upward pressure on freight rates.

Services-driven inflation is now showing up in hiring concerns, just as post-pandemic reopening is ramping up.

Numerous anecdotes highlight companies (most notably restaurants) having to offer higher wages to attract workers. The March NFIB *Small Business Survey* corroborated these wage pressure worries. The most common explanations for the difficulty in filling jobs are:

- COVID-19-related concerns about in-person work
- Supplemental benefits pushing total unemployment above full “replacement” levels for many workers

Summary

Consumers are anticipating inflation to move higher, and with wage growth dynamics in their favor, will likely push up the Employment Cost Index (ECI) to cover their expected inflation. Consumers appear to expect things to become particularly painful over the next year in the non-discretionary sectors. At the same time, some companies are drawing a “line in the sand” suggesting that above 3% to 4% for food price inflation is where demand destruction could begin. Financial markets appear to be preparing for near-term increases followed by a retreat, falling in line with the Fed. Markets appear to be making moves that indicate inflation is already priced in.

Contact a Westwood Wealth Advisor if you have any questions.

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