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Broadening US price pressures builds case for swifter Fed action

The annual rate of inflation has seemingly peaked, but the details show a broadening out of price pressures. This indicates inflation is likely to be more persistent and pervasive than predicted by the Federal Reserve. With consumer inflation expectations also on the rise the case for earlier policy stimulus withdrawal is building

People reacting to higher prices

5.4% Annual rate of US inflation

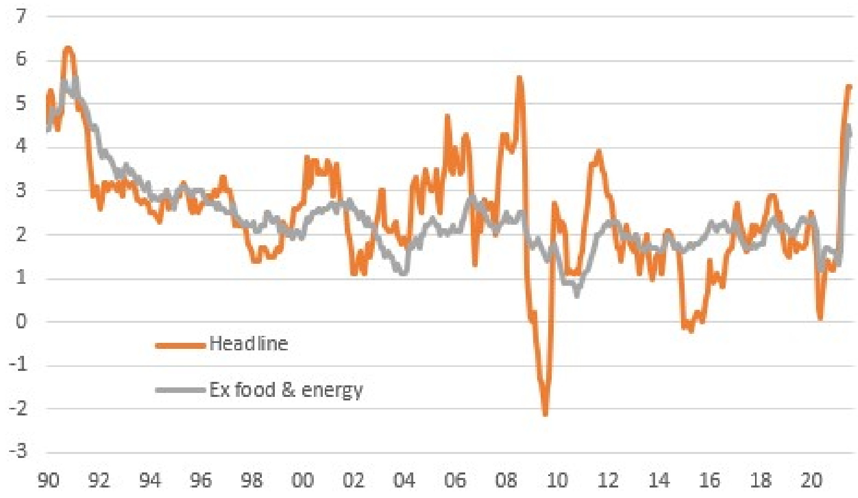
Inflation flattening, but spreading

The US consumer price index posted a 0.5% month-on-month increase in July, which was in line with expectations while the core (ex food and energy) index rose a more modest 0.3% MoM versus the 0.4% consensus. This leaves the annual rate of headline inflation at 5.4% and core at 4.3% versus 5.4% and 4.5% respectively last month.

The details show stability in used car prices (0.2% MoM) after their recent surge while apparel prices were unchanged on the month and airline fares fell 0.1% after having risen sharply in recent months. These three relatively soft figures are the main reason for the downside surprise on the core inflation figure.

However, there is a sense of a broadening out of price pressures with most other components either reporting the same MoM increase as last month or higher. For example, recreation showed a big acceleration (0.6% MoM), medical care posted its fastest increase since February (0.3%) and housing costs posted another 0.4% MoM increase.

US annual inflation rates (%)



Source: Macrobond, ING

Past the peak, but disinflation will be slow

We suspect that we have passed the peak for the annual rate of inflation given the stretched YoY price comparisons between a pandemic hit economy in 1H20 and a vibrant re-opened economy seen in 1H21 will fade through 3Q21. Nonetheless, we are not as optimistic as the Federal Reserve in thinking that we will quickly get back down to the 2% target area.

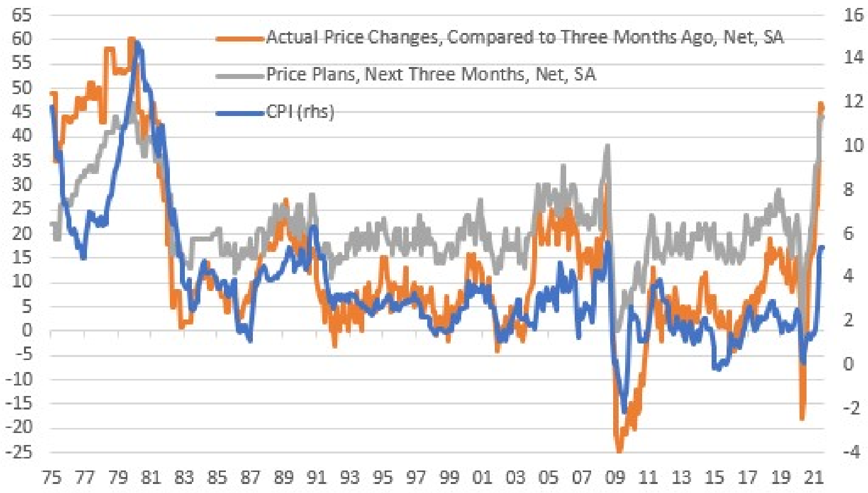
The key reason is that the stimulus fuelled economy is booming. Demand is outpacing the supply capacity of the economy given the scarring that the pandemic has caused as evidenced in production bottlenecks and labour shortages.

There are stress points throughout the economy with the National Federation of Independent Businesses (NFIB) reporting a new record high for the proportion of small businesses that have vacancies they can't fill while the Job Opening and Labour Turnover statistics showed job openings exceeded hiring by 3.4mn people in June. On the production side, the ISM continues to report customer inventory levels at record low levels while order backlogs are near record highs and supplier delivery times remain extreme.

As a result, costs are increasing throughout the economy and the strength of demand means that companies have a sense of more pricing power then they have experienced in years. As the chart of NFIB data below shows we are at 40-year highs in terms of the proportion of companies raising prices and for the proportion expecting to raise them further in coming months.

As such, imminent major declines in inflation look unlikely.

NFIB survey points to ongoing price pressures

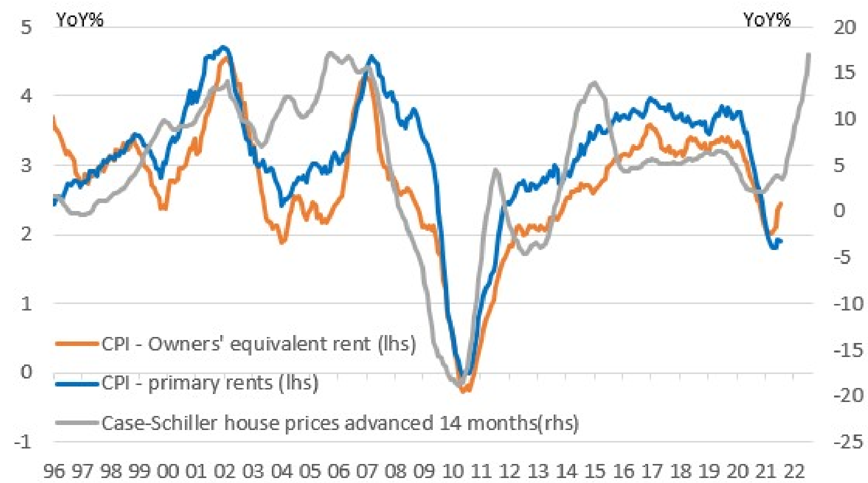


Source: Macrobond, ING

Housing costs the big upside threat

Another key reason why we think inflation will stay higher for longer is housing costs. Primary rents and owners' equivalent rent account for a third of the CPI basket with movements in these components tending to lag 12-18 months below house price changes. The chart below suggests that housing components of inflation will be the story to watch through the second half of this year and could add nearly a full percentage point to annual inflation on their own.

US house prices and the relationship with housing related CPI



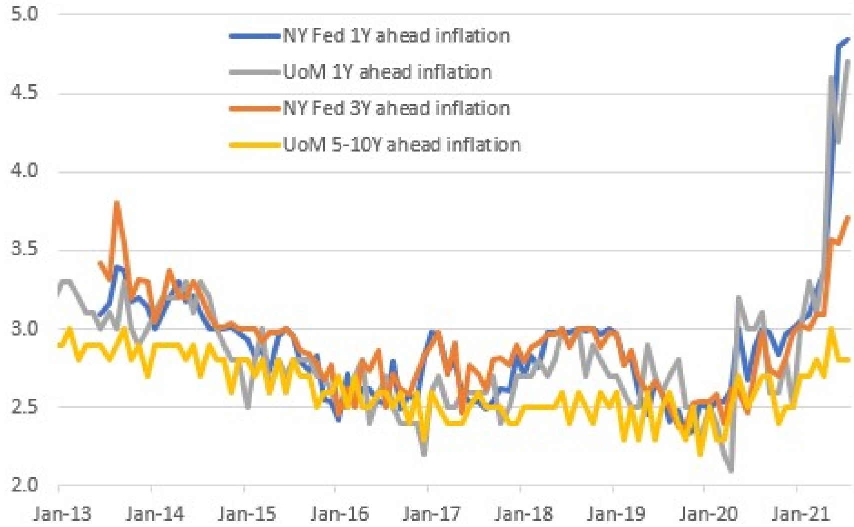
Source: Macrobond, ING

2022 Fed rate rises looking more likely

Given this backdrop we expect US headline inflation to stay above 4% through 1Q22 with core inflation unlikely to get below 3% until the summer of next year. We also expect the strong growth to story continue and with workers remaining in short supply, we see further wage pressure.

Inflation expectations have also moved higher, with the 3Y viewpoint within the NY Fed's own survey casting serious doubt on the FOMC statement's assertion that "longer-term inflation expectations remain well anchored at 2 percent".

US consumer inflation expectations series (annual % change)



Source: Macrobond, ING

With the economy having regained all the pandemic related lost output and the jobs recovery starting to get traction, there appears to be less and less reason to continue with Federal Reserve QE asset purchases of $120bn per month. More Fed officials are making the case for an early and swift taper (see recent comments from James Bullard and Raphael Bostic) and we expect more clarity on this issue from the Fed's Jackson Hole conference later this month.

We expect to see the taper start in 4Q and conclude by late 1Q22/early 2Q22, which would help to pave the way for the first interest rate increases in late 2022.

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