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Asset Management

Observations on Post-COVID Inflation Data

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We've received two months of inflation data since the coronavirus shut down and they paint an interesting picture of the economy. The impact is broadly but not exclusively deflationary. It's these divergences that tell a story of a recession very different from those in recent history. Historically recessions have been broad based demand destructions but recent data reflect something more complex. While there is certainly dramatic demand destruction in certain areas there are also rapid shifts in demand, increasing demand in certain sectors, and supply shortages. Taken together, it means that the path of inflation going forward will likely be unlike anything in recent history.

Thus far, the most dramatic pricing change from the pandemic is oil. The drop in oil is having a significant impact across all inflation measures. Consumer, producer, import, and export prices were weak and the vast majority of that weakness can be traced back to oil prices, either directly or indirectly through sectors that use oil as inputs (airfares, chemicals, etc.). The latest PPI release was the worst since December 2008, but within the detail over half of the decline in final demand prices can be traced directly back to oil prices. Oil price drops are usually a good proxy for the general health of the economy but now it is likely overstating the drop in end demand because people are prohibited from travelling. Declines in oil also usually have a reflexive stimulative effect because it lowers prices for parts of the economy that remain strong, but because travel is limited that pass through of lower prices cannot be felt. Ultimately this means that oil prices can only rationalize through lower production which means a smaller oil industry and lower growth, but ultimately higher prices.

The shut downs in travel that have been driving oil prices lower were felt throughout the consumer price data. The recently released April Core CPI was the largest monthly decline in the history of the series. Segments related to travel like airline fares, rental car prices, and hotel fees were the lowest ever in March only to hit even lower lows in the April data. A quarter of the monthly drop in Core CPI in April could be traced back to airline fares alone, with over half of the decline coming from the broader transportation series. Car rental, bus fares, and parking fees all posted the worst month for pricing ever. Price declines weren't limited to transportation. Apparel prices are also declining rapidly, with some sub-segment prices also the worst.

But while some segments were posting their biggest declines ever, others were posting their biggest increases. Food prices increased in April at the fastest rate since 1974. Many food sub-segments like poultry, bread, or snacks posted their largest price increases ever. The large price gains weren't confined to food but were spread across a range of sectors reflecting shifts in demand. Other segments that had their largest price increases ever include household paper goods, dishes, musical instruments, and window coverings. This divergence paints a story not just of declining demand but of rapidly and dramatically shifting demand; of the need for contraction in some segments but also tight supply and the need for expansion in others.

The third interesting piece of the pricing data is the segments of the economy where demand is dropping rapidly but prices aren't declining. In the recent Q1 GDP data, some of the most dramatic declines were in the medical industry. However in the inflation data hospital pricing is increasing at rapid rates, with some of the largest increases ever occurring this year. This goes against the conventional wisdom that demand declines lead to price declines, and ultimately means that demand will not tell the full story. The ways in which supply is constrained either by regulation or to meet consumers' new ideas around safety or social distancing will be just as important.

Recent press releases from airline companies may offer some clues to the future. Air travel has declined dramatically as have prices, as discussed above. When envisioning air travel after lock downs, airlines are discussing not using middle seats, boarding planes in less efficient ways to minimize contact, and continuing to fly fewer routes. All this means both less demand, a smaller airline industry, and lower revenues but with higher prices. This defies conventional wisdom but that’s because this isn’t a recession in the traditional sense, it is a rapid shift in the productivity of the economy. These kinds of shifts to business models decreasing efficiency will likely be necessary throughout the economy -- the end of just in time inventory, the need for supply chain redundancies, reconfiguring stores and office spaces, expenses towards workplace safety, etc. Real GDP will likely be lower, but prices likely won’t be. And these are just bottom up observations from the limited growth and inflation data we’ve received about the impact of the shut downs. What has yet to hit the data is the $2T in fiscal stimulus and rapid expansion in monetary policy. If we’re already seeing mixed inflation data before the stimulus is really felt, it leaves open significant inflation risks over coming months. Between now and then there are still downside risks. It's estimated that around a third of Americans didn't pay their April 1st rent but the data we received for household rents, the biggest component of consumer inflation, were in line with historical averages. However, over the longer-term, as oil stabilizes and industries adjust to a new normal, the risks seem solidly towards higher inflation.

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