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In the Markets Now

Checking in on inflation

We believe in the old saying: a picture is worth a thousand words. Here, we aim to recap recent market action and provide some perspective to investors.

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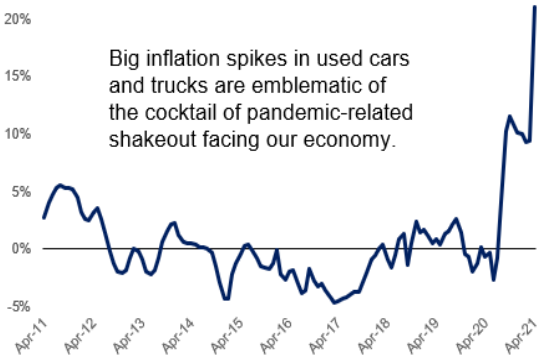
A HOT CPI REPORT SPOOKED INVESTORS, BUT WHAT'S THE REAL STORY?

After taking a few weeks off, what else can we do but return to the topic on everyone's mind: inflation. With a smoking CPI report now a few weeks behind us (featuring the highest jump in core inflation since 1981), let's talk through some of the dynamics at play. The April report both beat expectations and was incredibly interesting, but was also *maaaybe* not that prescriptive due to some of the unique forces at play (mostly Covid-related). To dig into it, let's use one of the main examples of price insanity—used auto prices—which were up 21% year over year and had an outsized effect on the headline number:

- **Base effects.** When looking at year-over-year data, *don't forget about the denominator*. In this case, the denominator—last year's used car prices—cratered as consumers tightened the belt (anticipating a recession) and big firms liquidated rental fleets (also anticipating recession). In hindsight, the big drop in used car prices was a one-off effect of the temporary pandemic/lockdown (same as the one-off spike in, say, hand sanitizer prices).
- **Reopening demand.** Bolstered by a healthy, stimulus-juiced consumer and better-than-feared results from car rental services, demand for used autos is returning at a breakneck pace. Rental car companies are desperately rebuilding their fleets as travel demand temporarily surges, creating short-term spikes in prices.
- **Supply constraints.** Nothing embodies the pandemic-related supply-chain issues like semiconductors, and nowhere has their shortage been more noted than in auto manufacturing. With demand surging, supply remains constrained by shuttered production (Covid + worker shortage) and a lack of needed parts.



And this combination of issues is playing out all across the economy. Reopening-linked items (e.g. airfare, hotels) are seeing massive demand, and many goods (e.g. microprocessors, lumber) are dealing with supply issues. Still, these are mainly Covid-related issues; there is little to suggest that these types of pressures will be permanent and result in the type of year-over-year-over-year inflation that is genuine cause for concern.

In fact, supply for many goods (cars, iPhones) are being beefed up as we speak. Some improvements will take longer than others (it takes longer to build a new copper mine than a microprocessor), but producers are ramping up to meet demand and technological improvements across industry will help with speed. As Goldman Sachs notes, the most prominent example of the current supply chain disruption—the shortage of microchips for autos—is set to fade later in Q2. Past that, consumers are also increasingly likely to start shifting dollars to services over goods—travel, NBA games, Marvel movies.

But Covid weirdness aside, there are also reasons to think inflation could be a little more persistent this time. There's a lot of money in the economy, and the Fed has a challenging dismount ahead after years of easy policy. Further, signs of real and persistent wage growth (esp. in lower income segments) paired with skyrocketing home prices both could easily juice the inflation data. And unfortunately, neither of these issues are as easily solvable as "turn the factory back on."

Still, I ultimately land on the conclusion that while inflation may run hotter than we got used to in the 2010s (and maybe for longer than some are comfortable with), it won't veer into problematic territory (much less hyper-inflation). This was a unique crisis, with a unique recovery, spurred by historic policymaking. **But as we return to normalcy, the inflation data should begin to, as well.** Reach out to your Baird Advisor with any questions or for further commentary on inflation.

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