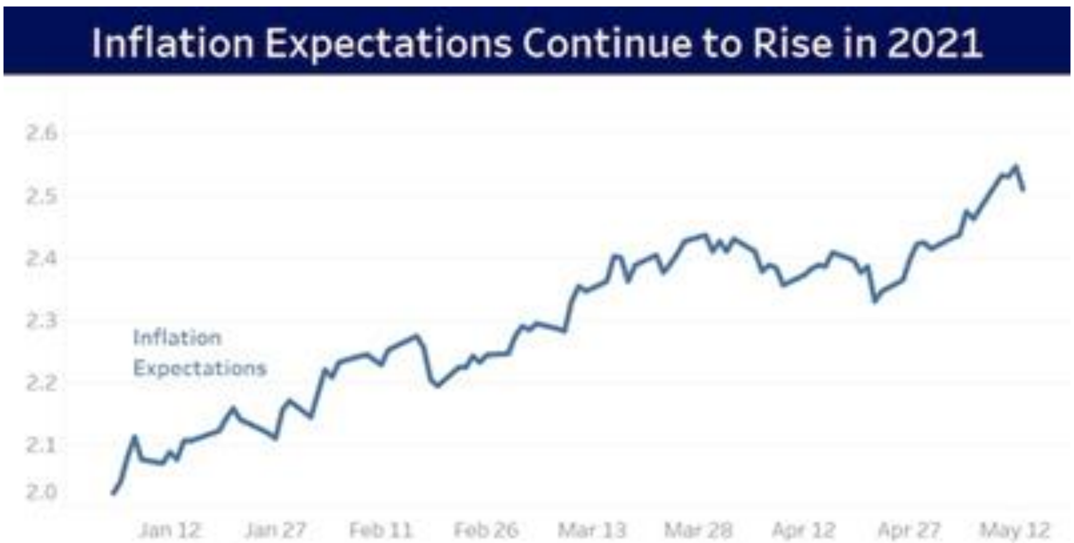
Inflation Expectations Show Up in Data

Worries about impending inflation have been growing in recent months. Even though evidence for general price increases across all products and services driven by increases in the money supply is still scant, expectations of future inflation are showing up clearly in the data. Those expectations can become self-fulfilling.

By the numbers: Since the beginning of 2021, market inflation expectations have risen more than 24%. Market inflation expectations are measured by the difference in nominal rates of Treasury bonds and the real rates as implied from inflation protected bonds. On January 4, the average difference on those measures across 5, 7, 10, and 30 year bonds was just over 2%, which is what the Fed has been targeting for years. The spread now stands over 2.5%. Clearly, the market sees inflation rising.



Consumers are picking up these signals. Last week, the University of Michigan released its [initial reading of Consumer Sentiment for May](). Sentiment fell in the beginning of May, which is surprising given receding virus numbers and more economic reopening. The leading reason, according to the release, is the "highest expected year-ahead inflation rate as well as the highest long term inflation rate in the past decade."

Consumers expecting inflation, and that it will negatively impact them is remarkable because there are at least a couple of generations now that have never lived through a period of damaging high inflation. The last such period ended in the early 1980s.

The problem with rising inflation expectations is they can become self-fulfilling. If consumers expect higher prices, they move purchases forward, increasing demand and raising prices. Similarly, they begin to demand higher wages at work. From the Michigan release, "[the] combination of persistent demand in the face of rising prices creates the potential for an inflationary psychology, fostering buy-in-advance rationales and cost-of-living increases in wages." This phenomenon is most potent when consumers have money to spend, as they do now.

Businesses see higher prices: Further increasing the tension on prices are the very real price increases businesses are experiencing in their supply chains. Those price increases are mostly because of supply and demand issues hitting multiple spots in the supply chain all at once. Businesses are starting to pass those prices along to final customers, which is reinforcing their notion that general price inflation is at hand.

Bottom line: Some of these factors, like with the supply chain, will work themselves out. However, the Fed will have to remain vigilant to see that inflation doesn't rise much more sharply than it anticipates.

—Curtis Dubay, Senior Economist, U.S. Chamber of Commerce