What's up with inflation this year?

Chief economist's comment

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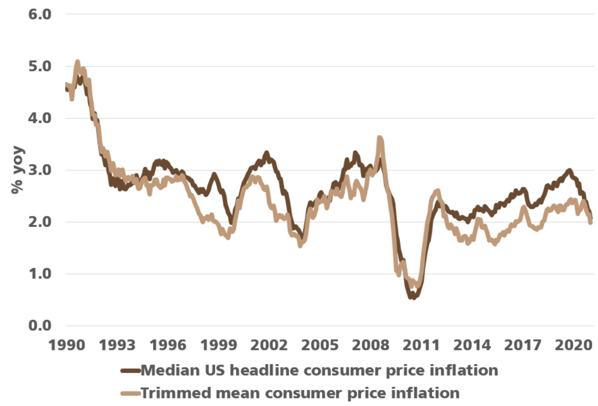
- In 2021, headline consumer price inflation is likely to be higher, but not high in the world's developed economies.
- Oil prices will create an inflation spike in the second quarter, but neither consumers nor central banks will care.
- When consumption patterns change, there may be some pressure on service sector prices in the second half of the year.
- Calculation problems mean that Eurozone consumer price data will likely modestly underreport the inflation reality later this year.

Most US prices are rising a normal amount

US trimmed mean, and median consumer price inflation



Source: Haver. The trimmed mean removes extreme price moves to focus on the change of most prices in the US economy

Inflation is a general change in prices, caused by economic imbalances. It is not a change in a few prices caused by supply chain difficulties for specific products. The world economy still has excess capacity which should keep inflation modest this year. Unusual spikes in demand for specific products, coupled with supply chain problems, have raised some product prices. However, as the US data demonstrates, most prices are behaving perfectly normally to date.

Headline consumer price inflation numbers will move higher in developed economies this year. They are unlikely to be high. Importantly, consumers will not necessarily notice several of the inflation increases, and these changes are unlikely to alter consumers' view of their real disposable income.

There are three probable drivers of developed economy consumer prices in 2021: reweighting, commodity prices, and demand shifts. It is only the demand story that should really worry investors, as it is this that might impact real income.

Reweighting

Consumer price inflation measures are based on a basket of goods. The assumption is that people don’t change their spending patterns very much—if 10% of your spending goes on food one month, 10% will go on food the following month. In normal circumstances, this is a perfectly reasonable assumption. In a pandemic, this does not work.

In the Eurozone and the United States (though not the United Kingdom), official CPI data underreported inflation reality in 2020. For example, during lockdown consumers spent far less than normal on restaurant meals, but far more than normal on food at home. Restaurant meals did not rise in price very much. Food at home rose in price a lot. But the consumer price weighting system was stuck in the past and did not keep up with the very big changes in what people were spending money on. This meant that in 2020 official CPI had too much emphasis on things that were falling in price and too little emphasis on things that were rising in price.

In the US, there are no changes to weightings this year (the index changes every two years). The Eurozone's weightings changed for the January CPI, and over the next few months this re-weighting will tend to increase reported inflation a little. Eurozone consumer prices will now give things like food consumed at home something closer to their real importance in the inflation calculation.

Will consumers care about this? They will not. Consumers have been living the reality of a higher inflation number for the past three quarters. The fact that the reported number is catching up with that reality is unlikely to change consumer behavior. Similarly, central bankers are unlikely to change their approach, as they should have understood that inflation was artificially low in 2020.

Commodity prices

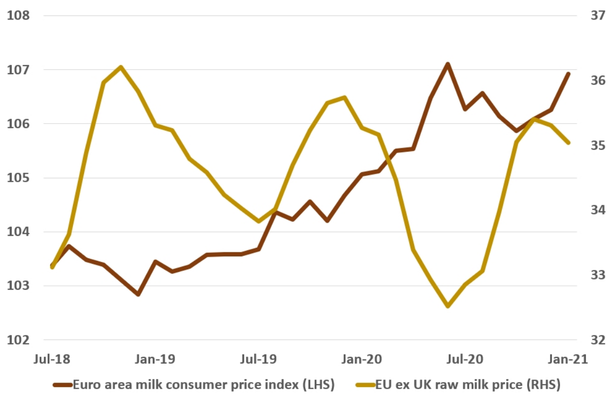
The year-on-year rate of consumer price inflation will be driven higher by the oil price. In April 2020, the oil price collapsed, and this was passed on to consumers in April and May. The yearly change in inflation rate in April and May 2020 will therefore be comparing to an abnormally low oil price. This affects both the headline and core oil price, because of course energy costs are embedded in other prices. The price of goods ordered online will reflect the oil price in the delivery costs.

Will consumers care about the oil price base effect? Probably not. Not that many people experienced the low oil prices last year—oil prices were low because no one was driving during lockdowns, so the low prices passed consumers by. In any case, normal people do not remember what price they paid for petrol a year ago. People will notice if the oil price is high in absolute terms or if it has changed recently, not the change relative to some far distant point in the past. If the movements of the oil price impacted consumers at all, it would have been around July when oil returned to a more normal level. If oil prices were to rise at a retail level again, then consumers would be more sensitive to the price changes. Central banks are also likely to ignore the price increase, as it will not last. By the second half of the year the base effect will have ended.

There are also some concerns about rising food commodity prices, and their impact on inflation. This is a concern for emerging markets, but in developed economies this is less relevant. Food in a developed economy has relatively little to do with food. We buy highly processed food, which is distributed and marketed in a relatively complicated way. This means that the biggest part of food prices is actually local labor costs. The 2020 food price increases had little to do with what was happening on farms, and a lot to do with the fact that supply chains used to supplying restaurants could not switch to supplying supermarkets. Even the price of something as basic as milk is not closely linked to the commodity price.

Milk is not milk

Raw milk commodity price index and whole milk consumer price index for the Eurozone



Source: Eurostat, Haver, UBS

Commodity food price inflation is therefore likely to be only a very small component of developed economy food consumer prices. Will consumers care about this? It is unlikely that they will notice—partly because little if any of the price change will be passed along to consumer prices, and partly because food consumption patterns are likely to change again.

Pent-up demand

In 2020, people had little choice but to save money. Lockdowns and restrictions stopped people spending. While it was possible to adapt and keep shopping for goods online, swathes of service sector spending became impossible.

The first wave of easing restrictions has led to a surge in demand for goods, particularly for things like furniture and electronics. After so long at home, with little to do but watch home makeover programs on television, people seem to have been keen to refurnish. Long and complicated global supply chains have struggled to supply this increase in demand. This has led to some goods prices rising. US durable goods price inflation (things like furniture and appliances) was negative during lockdown, but quickly rose to nearly 4% when lockdown eased. Eurozone furniture prices have gone from near zero to 1.2% (for the Euro zone that is a big move).

As restrictions ease and fear lessens, we think that there will be a shift in spending to services. People will want to have fun, and that means entertainment and hospitality, rather than durable goods. It is an unusual person who posts pictures of a new washing machine on an Instagram feed. Service sector prices are more important to the economy than goods prices. If service sector demand overwhelms supply, there might be higher service sector prices with a bigger impact on headline inflation.

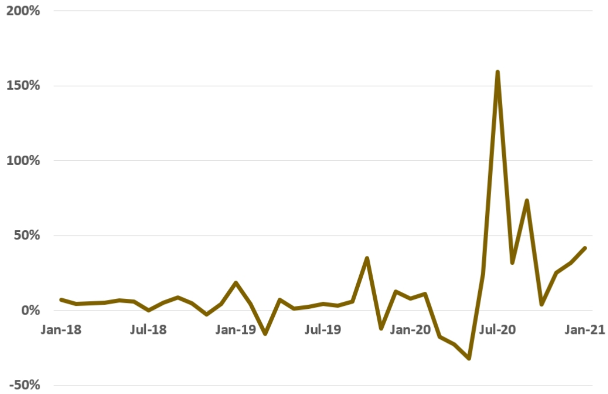
It is unlikely that all areas of the service sector will open at the same time. Restrictions are likely to be lifted in a staggered fashion. Travel and tourism is likely to be one of the last sectors of the economy to have restrictions eased. This means that tourism exporters (countries that lots of people visit) risk having excess service sector capacity as their hotel and leisure industry has more supply than the domestic population can demand, subduing prices. That will limit price changes.

The speed with which supply can change in the personal services sector is generally faster than is the case in the manufacturing sector. Personal services are more labor intensive and less capital intensive than the manufacturing sector (and tend to have shorter and less complicated supply chains). Quite a few jobs are low skilled. This allows for faster changes in supply. Analysis by Yelp suggests that US restaurant openings collapsed during lockdown (hardly surprising), but were back at normal levels by August 2020. A rapid supply response will limit price increases.

There has also been a significant jump in new businesses in the service sector. In many advanced economies around the world, there has been a surge of new businesses being set up as soon as restrictions started to lift. The big driver of this in the US was retail businesses. That may seem odd at a time when shopping malls face a bleak future, but it probably represents people setting up internet-based retail businesses (TikTok content creators selling merchandise, and so on). However, the accommodation and entertainment sector has also had a very strong growth in new businesses, averaging 52% year-on-year growth since July 2020 and making it one of the stronger sectors for business creation.

US service sector supply surges back

Growth in new business applications, accommodation and food services, % yoy



Source: US St Louis Federal Reserve FRED database, UBS

This is not to suggest that there will be no service sector price increases. If there are labor shortages, prices are likely to rise. But a shift to spending on services is likely to be met with a faster supply response than has been the case in the manufacturing sector.

The Eurozone has one additional consideration with service sector prices—the return of the weighting issue. Eurozone consumer prices assumed 2020 spending patterns had not changed from 2019. In 2021, consumer price inflation is assuming that spending patterns will be as they were during the pandemic. If your foreign holiday does cost more in 2021, it will not have a huge impact in Eurozone consumer prices, because euro consumer prices are essentially pretending you are not going on holiday this year. If you throw yourself into a roaring twenties lifestyle, and pay for the fun, euro consumer prices assume you are partying like it is 2020.

As mentioned, this is a euro-specific issue, and will not affect the US. While Eurozone consumers focus their spending on manufactured products, headline consumer prices will not be too far from reality, but the moment spending shifts back to services, 2021 euro consumer price inflation will likely underreport what is really happening.

Conclusions

The rise in inflation rates at the start of this year is partly data catching up with reality, and partly an oil price effect that neither consumers nor central banks will care too much about. This is a temporary inflation spike which investors should ignore.

In the second half of this year the spike in spending on manufactured goods is likely to be replaced by a spike in spending on services, especially personal services. The spike in demand for goods met with a sluggish supply response —the complexity of modern supply chains and the nature of manufacturing production did not help. The spike in demand for services is likely to be met with a faster supply response, and while some prices may rise the service sector price increase is likely to be less dramatic. The reported numbers from Europe (which markets will focus on) are likely to understate what is actually happening in the economy, at least to some extent, when spending shifts to services.

Appendix

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