ECONOMIC OUTLOOK

REGIONS

December 2020

Inflation: Down, But Not Out?

Earlier this year, the FOMC announced a shift in their approach to targeting inflation, adopting a policy of average inflation targeting. Under this approach, the FOMC will seek an average rate of inflation of 2.0 percent over time, as opposed to shooting for a stable 2.0 percent rate of inflation. With inflation having for years run below the FOMC's 2.0 percent target, this change effectively means there will come a time when the FOMC tolerates inflation running above their target. Or, as the FOMC put it, "following periods when inflation has been running persistently below 2.0 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2.0 percent for some time." Of course, neither "moderately above" nor "some time" were defined, so it remains to be seen what this new approach will actually look like.

We discussed our thoughts on this change in some detail in the September 2020 edition of our *Outlook*. In short, our issue isn't so much how the FOMC approaches their inflation target, but instead is whether 2.0 percent is the appropriate target to be aiming at. We think it a reasonable question to ask given that, save for a brief spell in 2018, core PCE inflation has been easily below the FOMC's 2.0 percent target since the target was formally adopted in 2012. This is not, or at least should not be, surprising, as over the past two-plus decades the main drivers of inflation have been: 1) technology; 2) demographics; and 3) globalization. On their own, each of these factors would work to hold down inflation, but when combined they have been a powerful counter to any inflation pressures that may have otherwise gathered.

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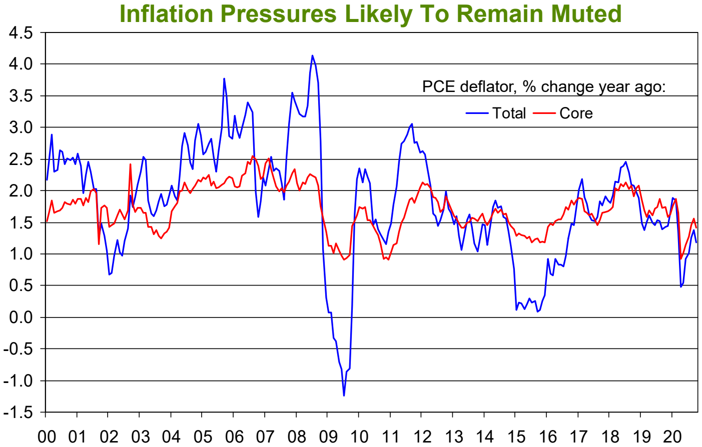
Inflation Pressures Likely To Remain Muted



Source: Bureau of Economic Analysis; Regions Economics Division

In our view, nothing that has happened over the course of the past several months diminishes the collective force of these factors as a check against sustained inflationary pressures. What we have seen over the past several months, however, is a sharp and sudden increase in the degree of economic slack, domestic and global, triggered by the pandemic and the efforts to stem its spread. This has led to further easing of inflation pressures, as seen in the preceding chart. As of October, headline inflation as measured by the PCE Deflator, the FOMC's preferred gauge, was 1.2 percent, with core inflation running at 1.4 percent.

While the discussion in our September *Outlook* focused on longer-term inflation trends, the question at present is how inflation will respond as the economy continues to recover. Indeed, this is one of the most common questions we've gotten from clients over the past several weeks, with many curious as to how the FOMC might respond to higher inflation. But, given the FOMC's recent shift in their approach to inflation targeting, whether, when, and to what extent there is a sustained acceleration in inflation and whether, when, and to what extent the FOMC would respond to a sustained acceleration in inflation are different sets of questions. Our focus here is on the former, and in what follows we'll point to some key determinants of the path of inflation in the months ahead.

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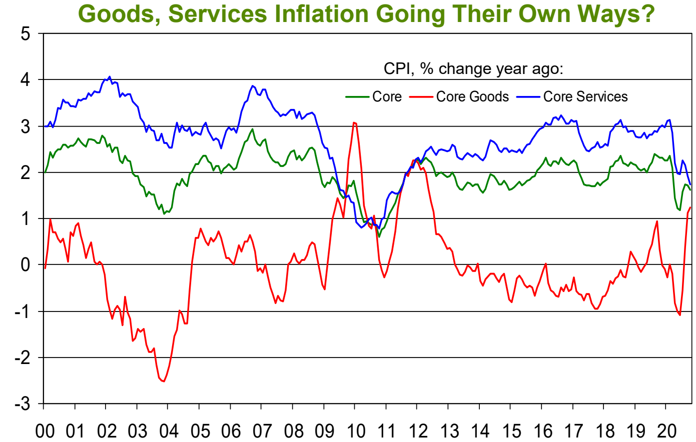
Goods, Services Inflation Going Their Own Ways?



Source: Bureau of Labor Statistics; Regions Economics Division

In thinking about the path of inflation in the months ahead, it helps to distinguish between goods prices and services prices. Just as patterns in consumer spending have shifted over the past several months, so too have patterns in goods prices and services prices, as seen in the above chart. Recall that the restrictions imposed in the early phases of the pandemic had a greater impact on the broad services sector, as activities such as travel, tourism, recreation, dining out, and sporting events, amongst others, came to an abrupt halt while most non-hospital medical services were put on hold. This led to widespread declines in services prices in March, April, and May, resulting in significantly slower core (i.e., non-energy) services inflation. Prices for core (i.e., excluding food

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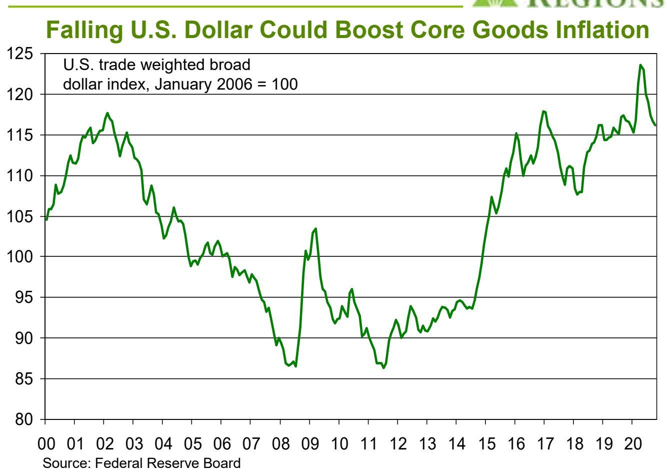
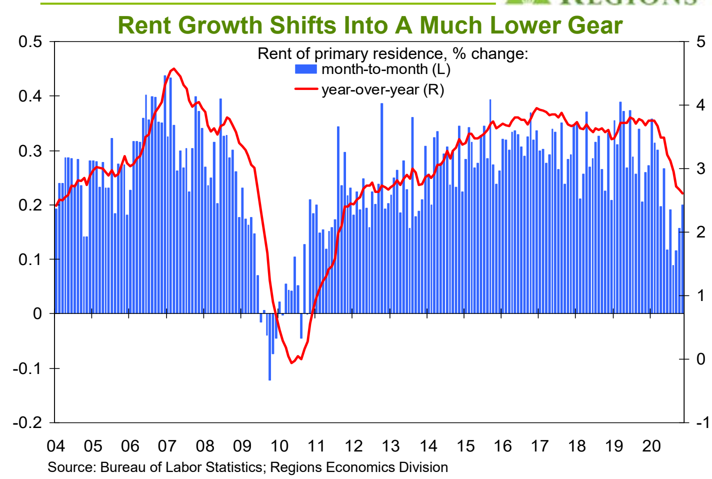
and energy) goods fell in the early months of the pandemic, reflecting the sharp pullback in overall spending. Early on, about the only places to find inflation were grocery/general merchandise stores, as consumers rushed to stock up on food and, let's say, other essentials ahead of an indefinite period of being largely confined to home. For instance, prices for food consumed at home jumped by 2.6 percent in March, the largest monthly increase since February 1974, while prices for household paper products and cleaning products also spiked.

Since those early days, however, a robust rebound in spending on goods coupled with generally lean inventories has sparked a reversal of what had been several years of persistent goods price deflation. For instance, in October, core goods prices were up 1.2 percent year-on-year, the largest such increase since June 2012. But, even as the economy opened back up over the past several months, a considerable segment of the broad services sector continues to operate at limited capacity, if at all. As such, services prices remain listless, and core services inflation has fallen below the 2.0 percent mark for the first time since 2011. In terms of overall core inflation, with a much higher weight attached to services prices than to goods prices (reflecting relative shares of total consumer spending), services prices have dominated and will continue to do so. As such, overall core inflation is likely to remain somewhat muted for some time to come even if core goods prices continue to firm, as we expect will be the case.



In addition to steady demand and what in many cases remain spotty inventories, core goods prices could get support from further declines in the exchange value of the U.S. dollar. To the extent that consumer spending on goods falls on imported goods, a stronger U.S. dollar puts downward pressure on prices of imported goods, and the dollar's strong run over the prior several years was a prime contributor to the persistent core goods deflation referenced above. In contrast, a weaker U.S. dollar puts upward pressure on prices of imported goods; should the dollar continue to weaken in the months ahead, as we and many others, albeit to varying degrees, expect will be the case, that would help sustain the recent firming in core goods inflation.

At the same time, core services prices are unlikely to gain sustained traction unless and until economic activity comes much closer to normal than it now is. For instance, lodging costs continue to post double-digit year-on-year declines, reflecting the dramatic reduction in travel, while public transportation costs are on their own streak of double-digit declines on an over-the-year basis, reflecting the extent to which commuting patterns have changed over the course of the pandemic. This includes the large numbers of people who formerly relied on public transportation but who have instead opted for private transportation for their commuting needs (which helps to explain the furious pace at which used motor vehicle prices rose earlier this year).



One of the main drags on core services inflation over coming months could be the sharp deceleration in rent growth, which we expect to persist for some time. The relative weighting of rents means the effect will be much more pronounced in the CPI data, but there will still be an impact on the PCE Deflator, such that no matter which measure of core services inflation you prefer, slower rent growth will be a drag. Rent growth has slowed sharply over the past several months, as illustrated in the above chart, as the weakness in labor market conditions has curbed demand for rental apartments. Keep in mind that the effects of the pandemic on the labor market have been felt much more acutely by those in lower-skill, lower-earnings industry groups, who are much more likely to be renters rather than owners.

Moreover, with moratoriums on evictions expiring on December 31 and millions of renters behind on their rent payments, there could be a sudden increase in the number of units on the rental market in early-2021, which would further weigh on rent growth. And, speaking of additional supply, we have often discussed the substantial backlog of multi-family housing units under construction, which for the past two years has been larger than at any time since the early-1970s. Though this is a longer-term issue, it is reasonable to think that, as more of these units are completed and brought on to the market, market rents will come under greater pressure, particularly without a fully healed labor market.

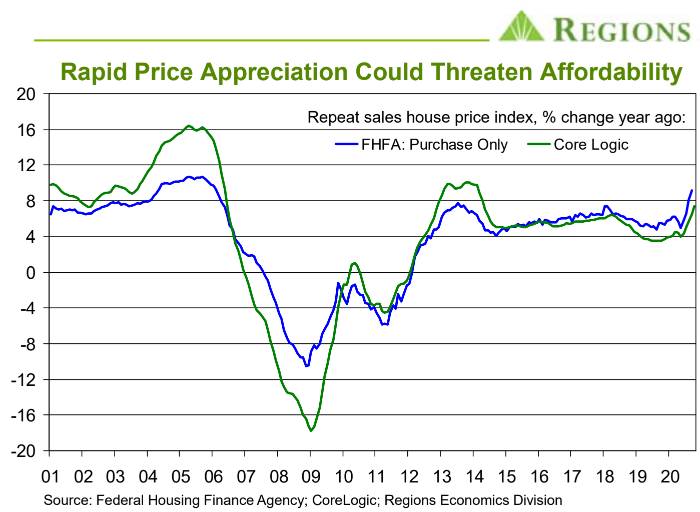
Clearly, there are large segments of the services sector in which demand will remain impaired until there is an effective vaccine against the COVID-19 virus. For as long as spending in these areas remains suppressed, prices will likely remain lower than would otherwise be the case. Moreover, even when there is an effective vaccine readily available for widespread distribution, it remains to be seen when policy makers will be confident enough to rescind any remaining restrictions on economic and social activity. It also remains to be seen whether, or to what extent, consumer attitudes will have changed due to the experience of the pandemic, which in turn will impact consumer spending patterns. At some point it is reasonable to expect a spike in consumer spending on services, which in turn would provide a lift to services prices. The timing, and magnitude, of any such spike, however, remains unclear. It is also worth noting that, to the extent the recovery in the labor market lags the recovery in the broader economy, a common trait in the past few cycles, that could push a recovery in the rental housing market that much further back, meaning that rent growth could be a more persistent drag on core services inflation.

There is, unfortunately, another variable that must be accounted for in any discussion of the near-term path of inflation. The ongoing spike in COVID-19 cases, which many fear will accelerate through the holiday season, is clearly impacting the economy, and many state and local governments have begun to once again impose restrictions on economic and social activity. As such, core services prices could come under renewed downward pressure. As far as goods prices, should consumers again rush to grocery/general merchandise stores to stock up on food and, let's say, other essentials, this would push prices higher. But, it remains to be seen how broad based any upward pressure on core goods prices would be. After all, much of the spending done since the onset of the pandemic has been on big-ticket items such as home furnishings, electronics, and home exercise equipment, purchases not likely to be repeated any time soon. The point is that there may not be as pronounced of a spike in demand for consumer goods, particularly if the promise of a vaccine acts as a light at the end of the tunnel for consumers largely confined to home.

In short, there is likely to be greater support for core goods prices than for core services prices through 1H 2021. And, given the relative weights in the composition of indexes of consumer prices, this suggests overall consumer-level inflation will remain fairly muted until at least the back half of 2021. That said, don't be surprised if inflation appears to be picking up much more aggressively over the first half of 2021 than this discussion may imply. Over-the-year comparisons will be made much easier by prices having been flat-to-lower from February through May in 2020, and these base effects would exaggerate measured inflation while shedding no light on underlying inflation pressures. The FOMC will look straight through any such base effects, as will we.

If You Really, Really Want To See Rapidly Rising Prices . . .

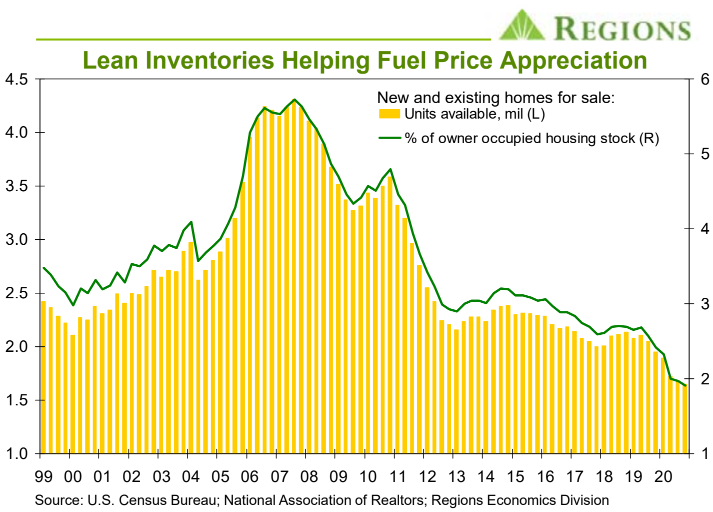
While it may be hard to find much inflation in, you know, the actual inflation data, there is one place you don't have to look very hard to see rapidly rising prices. That place is the for-sale segment of the housing market. Home sales were no different than any other type of economic activity in the early phases of the pandemic, with sales of both new and existing homes falling sharply. Since then, however, the for-sale segment of the housing market has been on a tear, with monthly sales rates rising to heights last seen in 2005-06 and rates of house price appreciation ramping up to multi-year highs. As of September (the last available observation), the FHFA House Price Index (HPI) was up 9.2 percent year-on-year, the largest such increase since February 2006. As of October, the CoreLogic HPI, an alternative (and our preferred) measure of house prices, was up 7.3 percent year-on-year, the largest such increase since April 2014. While each is a repeat sales house price index, the FHFA and CoreLogic indexes differ in that the FHFA index only captures sales of homes on which the originating balance on the mortgage loan is under the conforming loan limit, which in 2020 is $510,400 and will rise to $548,250, whereas the CoreLogic index includes higher-priced sales. Still, the two indexes are telling the same story, which is that the pace of house price appreciation has accelerated sharply over recent months.



Aside from the rate at which house prices are rising, the breadth of house price appreciation is also striking. In other words, the faster rate of price appreciation shown in the chart above is not simply being driven by a relatively small number of large metro areas but instead reflects faster price appreciation across metro areas of all sizes across a wide swath of the U.S. This includes many metro areas in which middling demographic trends have tended to be a drag on housing market activity and in which house price appreciation is typically somewhat muted. As such, over recent months we have seen faster house price appreciation across a wide range of markets and across all price buckets. And, though there is no gauge of new home prices comparable to the repeat sales HPIs, new home prices are also rising at a faster rate.

It's somewhat understandable if hearing current rates of home sales and price appreciation being compared to those seen during the prior cycle make you nervous about the state of the housing market. After all, we all remember how that all worked out last time around. That said, it is important to realize that now is not then. While it is true that extraordinarily low mortgage interest rates are fueling demand for home purchases, one key difference between now and the prior cycle is how much more stringent mortgage lending standards have been over the past several years. For instance, on a dollar volume basis, 24 percent of mortgage loans originated in Q2 2005 went to borrowers with credit scores below 660, the same share that went to borrowers with credit scores of 760 or more, according to data from Equifax and the Federal Reserve Bank of New York. Since that point, these shares have gone in different directions. Borrowers with credit scores below 660 accounted for just 4 percent of mortgage loans originated in Q3 2020 (again, on a dollar volume basis), compared to the 72 percent of mortgage loan originations accounted for by borrowers with credit scores of 760 or more.

It should be noted that while the gap between these shares had been steadily increasing since the 2007-09 recession, the degree to which it widened over the past two quarters is notable. To some extent, this reflects the uneven manner in which the pandemic and the efforts to stem its spread have impacted the economy. As noted in the prior section, the effects of the pandemic on the labor market have been felt much more acutely by those in lower-skill, lower-earnings industry groups, who are much more likely to be renters rather than owners. Those who have kept their job and remain confident about their job and income prospects have aggressively taken advantage of low mortgage interest rates to either refinance existing mortgages or purchase a home.



A meaningfully stronger credit profile of mortgage borrowers is a key difference on the demand side of the market between the current and prior cycles. A much more pronounced, and perhaps much more important, difference can be found on the supply side of the for-sale segment of the housing market. As shown in the above chart, inventories of homes for sale – new and existing – had been notably low over the past few years but have fallen even lower over the course of the pandemic. The combination of strong growth in demand and increasingly lean inventories has fueled the acceleration in the rate of house price appreciation seen over the past several months. As there is no quick fix for the lack of adequate inventory, the extent to which house price appreciation holds up over coming quarters will largely be determined by the demand side of the market.

We think it worth repeating a point we've often made in our regular coverage of the monthly data on residential construction and sales. While low mortgage rates are acting as an effective buffer, helping preserve affordability in the face of robust house price appreciation, the higher house prices rise, the thinner that buffer becomes. While there are those who think the only thing that can put a meaningful dent in affordability is a pronounced increase in mortgage interest rates, should price appreciation continue to run at the rates seen over the past several months, affordability will come under increasing pressure even if mortgage interest rates do not budge. That would in turn lead to weakening demand for home purchases.

To be clear, we do not believe the market is at that point yet, nor are there any signs of being at that point in the weekly data on applications for purchase mortgage loans or in the monthly data on new single family construction. Moreover, builder commentary suggests there has been no let-up in demand for new single family homes. That we're not there yet, however, does not mean we won't ever be there, a point that never seems to sink in on those either unable or unwilling to do anything beyond extrapolating today's data points or today's market conditions out to forever. As such, we will continue to carefully monitor the weekly data (not seasonally adjusted) on applications for purchase mortgage loans, which act as an early indicator of any shift in demand.

To the extent that perceptions (or fears) of what a turn in the housing market cycle may look like are shaped by the experience of the prior cycle, it's helpful to think about how that might look this time around. Given what has been a prolonged period of chronic undersupply, an extended period of more stringent lending standards, and an aggregate equity position stronger than at any time since Q3 1990 (based on data from the Federal Reserve's "Flow of Funds" reports), the starting point of a turn in the housing market cycle, whenever it comes, would be vastly different than was the case in the prior cycle. So, rather than an outright collapse in demand and severe declines in house prices, what seems more likely is an orderly pullback in demand coupled with pronounced deceleration in the pace of price appreciation. To be sure, after the last time around, it would be unwise to rule out the possibility that house prices could decline. At the same time, however, market conditions suggest any declines in house prices in this cycle would be shallow and short-lived.

Some point to pending expirations of foreclosure moratoriums and the coming end to mortgage forbearance periods as a looming threat to the housing market. Black Knight, a leading provider of mortgage loan data and analytics, estimates that as of December 1, there were 2.76 million homeowners in active forbearance plans, down from almost 5 million back in May. It is, in light of the adverse effects on the labor market of the ongoing surge in COVID-19 cases, possible that the number of homeowners in forbearance will rise in the weeks ahead. But, it is reasonable to expect most loans now in forbearance will return to "current" status, as opposed to progressing to foreclosure. Still, even if every loan now in forbearance ultimately turned into a foreclosure, the number of foreclosures would not even begin to approach the number seen during the last cycle.

We continue to expect single family construction and sales to rise further in the months ahead, but at a more restrained pace than that seen over recent months. We've noted before that, barring an outright collapse in the broader economy, the main threat to the for-sale segment of the housing market remains affordability being eroded by continued robust house price appreciation. But, just as lean inventories are helping fuel this robust price appreciation, lean inventories, along with much-improved equity positions, would mitigate the extent of any damage done were the housing market cycle to turn. So, once again, now is not then.

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December 2020

Q2 '20 (a)	Q3 '20 (p)	Q4 '20 (f)	Q1 '21 (f)	Q2 '21 (f)	Q3 '21 (f)	Q4 '21 (f)	Q1 '22 (f)		2018 (a)	2019 (a)	2020 (f)	2021 (f)	2022 (f)
-31.4	33.1	3.4	0.5	1.6	5.0	5.3	3.9	Real GDP[1]	3.0	2.2	-3.6	3.2	3.7
-33.2	40.6	2.8	-0.6	3.6	6.8	6.8	4.0	Real Personal Consumption[1]	2.7	2.4	-3.9	4.0	4.4
-27.2	21.8	4.7	3.0	3.7	5.4	5.1	4.3	Real Business Fixed Investment[1]	6.9	2.9	-4.6	3.8	4.4
-35.9	66.6	7.7	1.1	1.0	4.0	3.8	2.6	Equipment[1]	8.0	2.1	-6.0	6.2	2.6
-11.4	6.0	2.0	5.1	5.8	6.3	7.4	6.8	Intellectual Property and Software[1]	7.8	6.4	0.9	3.9	6.2
-33.6	-15.8	-5.7	3.7	6.7	7.3	3.9	3.3	Structures[1]	3.7	-0.6	-10.8	-2.7	5.3
-35.6	62.3	22.6	5.8	-3.0	-4.4	-3.3	-0.1	Real Residential Fixed Investment[1]	-0.6	-1.7	5.2	7.3	-0.7
2.5	-4.9	-2.0	-1.4	-2.8	0.3	1.7	1.5	Real Government Expenditures[1]	1.8	2.3	1.0	-1.6	0.7
-775.1	-1,016.4	-1,051.1	-1,064.6	-1,072.4	-1,090.1	-1,086.0	-1,075.6	Real Net Exports[2]	-877.7	-917.6	-907.6	-1,078.3	-1,080.4
766	1,041	1,155	1,077	1,064	1,054	1,055	1,059	Single Family Housing Starts, ths. of units[3]	872	893	982	1,062	1,071
313	399	358	363	363	374	377	371	Multi-Family Housing Starts, ths. of units[3]	376	403	397	369	378
11.3	15.3	15.9	16.0	16.0	16.2	16.2	16.4	Vehicle Sales, millions of units[3]	17.2	17.0	14.4	16.1	16.5
13.0	8.8	6.8	6.6	6.4	6.1	5.8	5.4	Unemployment Rate, %[4]	3.9	3.7	8.1	6.2	5.1
-11.2	-6.9	-6.1	-5.7	7.8	3.1	2.6	2.8	Non-Farm Employment[5]	1.6	1.4	-5.8	1.7	2.7
48.5	-16.0	-9.8	2.8	-6.3	-2.7	-0.1	1.5	Real Disposable Personal Income[1]	3.6	2.2	6.0	-2.6	0.3
0.6	1.2	1.3	1.4	2.4	1.9	1.9	1.9	GDP Price Deflator[5]	2.4	1.8	1.2	1.9	1.8
0.6	1.2	1.3	1.5	2.3	1.9	2.1	2.1	PCE Deflator[5]	2.1	1.5	1.2	1.9	2.0
0.4	1.3	1.1	1.4	2.9	2.1	2.1	2.0	Consumer Price Index[5]	2.4	1.8	1.2	2.1	1.8
1.0	1.4	1.5	1.5	2.2	1.9	2.0	2.1	Core PCE Deflator[5]	2.0	1.7	1.4	1.9	2.1
1.3	1.7	1.6	1.6	2.6	2.0	2.2	2.3	Core Consumer Price Index[5]	2.1	2.2	1.7	2.1	2.3
0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	1.78	2.16	0.42	0.13	0.13
0.69	0.65	0.86	0.97	1.08	1.15	1.24	1.35	10-Year Treasury Note Yield, %[4]	2.91	2.14	0.89	1.11	1.45
3.24	2.95	2.78	2.81	2.92	3.04	3.12	3.24	30-Year Fixed Mortgage, %[4]	4.54	3.94	3.12	2.97	3.32
-3.5	-2.1	-2.3	-2.2	-2.4	-2.4	-2.5	-2.5	Current Account, % of GDP	-2.2	-2.2	-2.5	-2.4	-2.5

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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