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The Inflation Rate Is Sizzling, And The U.S. Economy And Stock Market Will Pay The Price

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Inflationary pressures, already at a 30-year peak for the U.S. economy, are building to a crescendo. Amid supply-chain backups, high energy prices, surging rents and labor force shortages that are forcing big wage hikes even at huge employers like **Amazon.com** (**AMZN**) and **Walmart** (**WMT**), the inflation rate could hit levels last seen in 1982.

The Federal Reserve could beat a faster retreat from its extraordinarily easy monetary policy, bowing to the inflation-stoked political backlash. That could happen as soon as its Dec. 14-15 meeting, some economists predict. **A faster Fed taper** would open the door to earlier rate hikes.

But even if price pressures start to come off a boil in the first half of 2022, the inflation rate may not fall enough to avoid shaking the financial markets and economy. If inflation continues to run above the Fed's comfort zone close to 2% through next year, that could signal a policy error. It also could mean a fundamental break from the long disinflationary era that brought **ultra-low interest rates** and high valuations for the stock market, and especially tech stocks.

As long as workers hold the upper hand in wage negotiations, the inflation rate is likely to keep running hot.

The outlook hinges on whether the millions of workers who opted out of the job market during the pandemic will opt back in. Much of Wall Street expects that to happen. But Jefferies chief financial economist Aneta Markowska, in her 2022 outlook, "A War for Labor," makes a case that wage pressures will "remain intense."

"We see a structural decline in labor supply, coupled with unprecedented labor demand," Markowska wrote. She expects those forces to produce "the tightest labor market conditions since the 1950s."

Shrinking Labor Force

One key insight from Markowska: The working-age population (16 and up) has grown by 2.4 million since the start of the pandemic. But all of the population growth and then some — 2.7 million — has come among those age 65 and up. Labor force participation generally tumbles to just 20% for this age group, she notes.

Kansas City Fed researchers found that retirees ballooned by 3.5 million from the onset of the pandemic to June 2021. That's about 2.1 million more than prior trends would have predicted. The group includes 700,000 people under age 60 and another half-million from age 60 to 67.

The researchers found that the excess growth in the retired population had less to do with new retirements than with Covid keeping younger retirees from returning to work, as many tend to do.

Early retirees may still flow back into the labor force as vaccine and booster uptake minimizes Covid flare-ups. Higher pay could help push retired workers off the fence and persuade current workers to delay **retirement**. Yet the wealth effect of high stock prices and home values may have the opposite effect. Social Security's coming 5.9% cost-of-living adjustment in January also could take some sting out of inflation.

A relative dearth of immigration visas during the pandemic has exacerbated the demographic impact on the labor force. The libertarian Cato Institute estimates that visas to adult immigrants, refugees and temporary foreign workers from March 2020 through July 2021 fell by 1.2 million, or 55%.

Bottom line: Potential labor supply has stagnated, at best, but likely has declined.

Supply Chains Are A Mess; Here Are The Big Winners

Is There Labor Slack?

Economists from both Jefferies and UBS predict that the U.S. will create 5 million jobs through the end of 2022. That matches the rise in the number of working-age adults who have opted out of the labor market since February 2020.

If labor force participation surges by 4 million through the end of 2022, as UBS envisions, the ranks of the unemployed would only fall by 1 million. That would hold the jobless rate's slide to 3.8%, above the 3.5% pre-Covid level. But if only half of those 5 million potential workers come off the sidelines, as Markowska's scenario implies, the jobless rate would crash to 3%. That would easily be the lowest level since 1953, when the Korean War had depleted the ranks of potential workers.

"Our base-case assumption is that wage growth remains in the 4.5%-5% range over the next year, but risks to that view are clearly skewed to the upside," she wrote.

Workers In Driver's Seat, Give Inflation A Ride

To get some idea what such a tight labor market would mean, just look at what's going on now. American workers are in the driver's seat in a way they haven't been in decades.

More than 10,000 **Deere & Co.** (**DE**) employees in Iowa, Illinois and Kansas went on strike Oct. 14, as 90% of them voted to reject a contract offering a 6% pay hike in the first year and a

$3,500 ratification bonus. Then, by a narrow majority, they spurned a 10% first-year hike, along with an $8,500 up-front bonus. Among other key concessions to the United Auto Workers by Deere: quarterly cost-of-living adjustments to help ensure that wage gains aren't eroded if the inflation rate continues to run hot. Even then, only after modest additional concessions by the farm machinery giant did workers vote to take the offer last week.

As vaccinations ramped up early this year, job openings piled up by the millions, shattering the pre-Covid peak. September's 10.4 million openings, though down from July's record, were nearly 40% above the 7.6 million prior high in November 2018.

With employers battling to attract workers, a record 4.4 million Americans — 3% of employer payrolls — quit their jobs in September.

Big Employers Hike Wages

In August, **CVS** (**CVS**) said it would hike its minimum wage from $11 an hour to $15 by next summer. In September, **Walmart** (**WMT**) lifted minimum pay in its stores from as low as $11 an hour to a range of $12-$17, based on location, while raising pay for 565,000 of its workers. Two weeks later, **Amazon.com** (**AMZN**) announced 125,000 job openings in fulfillment and transportation with an average starting wage of $18. In especially hot labor markets, the e-commerce leader will pay new logistics employees as much as $22.50, on top of a $3,000 signing bonus.

Despite wage hikes of more than 10% this year at franchised units and over 15% at company-operated sites, **McDonald's** (**MCD**) is "not being able to have the restaurants fully staffed," CEO Chris Kempczinski said on the Oct. 27 earnings call. That's led to "dialing back late night" hours and to slower drive-thru service.

Kellogg (**K**) CEO Steve Cahillane, in a Nov. 4 call, said an "acute" labor shortage "is resulting in absenteeism, high turnover, difficulty maintaining temporary labor and, for some of us, even labor strikes."

Covid Still Restricts Workforce

Unionized or not, workers all across the country are reaping the benefits of off-the-charts demand for labor even as the fallout from Covid's delta variant has thinned the applicant pool.

Over the past three months, employment grew by 1.4 million, while the labor force has edged up by just 100,000. That's driven the jobless rate down from 5.4% to 4.6%.

Is that so low? In 2016-17, the then-current level of unemployment yielded only about 2.7% average hourly wage gains. So why has **hourly pay shot up 4.9% over the past year?**

Much of the blame lies with the pandemic, whose effects have lingered longer than expected due to the delta variant.

"We thought that schools reopening and elapsing unemployment benefits would produce some sort of additional labor supply," Fed chair Jerome Powell said Nov. 3. "That doesn't seem to have been the case."

When Will Labor Force Return?

Generous pandemic unemployment benefits, including an extra $300 per week, enabled many modest-wage workers to stay on the sidelines and still get paid nearly as much as, if not more than, they did pre-Covid. Those benefits expired in about half the states on Labor Day weekend and in the rest of the states a month or two earlier.

Still, "difficulty finding child care" continues to be an issue for parents amid Covid flare-ups, said Jim O'Sullivan, chief macro strategist at TD Securities. The unemployed also may be feeling "less urgency to find a job," thanks partly to savings left over from three rounds of stimulus checks, he said. He expects labor force participation to pick up in coming months as people spend down that cash cushion.

Mark Zandi, chief economist at Moody's Analytics, estimates that low- to middle-income individuals may have built up a cumulative $500 billion in savings during the pandemic. That amounts to $10,000 apiece, yet they face close to $4,000 in monthly household expenses. "The financial pressure to return to work is thus quickly intensifying," Zandi wrote.

Core Inflation Rate Stayed Tame in 2011 Commodity Spike

Besides the tight labor market, surging commodity prices also are fueling inflation. Yet in some respects, this commodity price boom looks like the one fueled by government stimulus, particularly in China, after the 2007-2009 financial crisis. After collapsing from record heights in late 2008, oil prices surged back above $120 a barrel — 50% higher than now — in 2011. Copper prices surged to a record $4.50 a pound, just above today's prices.

Still, core consumer prices, excluding volatile food and energy categories, showed no ill-effect, rising just 2.2% in 2011.

So what's changed this time, pushing the core inflation rate to 4.6% and overall inflation to 6.2%, both 30-year highs?

Pricing Power Boosts Profit Margins, Stock Market

A key difference is that businesses have been able to pass along their higher costs in the form of price increases. Take **Dollar Tree** (**DLTR**), whose stock just hit a record high as the **specialty discounter said it would roll out $1.25 pricing** across its stores vs. the old $1 model.

Despite climbing labor and commodity costs, S&P 500 companies have posted 12.9% average profit margins in the third quarter, FactSet data shows. That's a hair below Q2's record and comfortably above the pre-Covid trend of just over 11%.

Strong economic growth and rising profit margins have buoyed stock prices, despite surging inflation. So far this year as of Nov. 23, the Dow Jones has climbed 16.5%, the S&P 500 22.6% and the Nasdaq composite 22.4%

The combination of hefty wage gains, massive fiscal stimulus and asset appreciation seems to have inoculated the American consumer against this bout of inflation.

That was the message of October retail sales' stronger-than-expected 1.7% gain, which came despite lapsed pandemic jobless aid.

Consumers Have 'Tremendous Firepower'

Seasonally adjusted retail sales are now 23% above the February 2020 pre-pandemic peak. For perspective, it took just under 10 years to achieve the same growth from the 2007 peak ahead of the prior downturn.

Yet "households still have tremendous firepower," Markowska told IBD. Even as spending on services picks up, she no longer expects that goods consumption will suffer much payback.

BCA Research estimates that U.S. households have accumulated an extra $2.2 trillion in savings during the pandemic. Spending half of that, as BCA expects, would provide a lift equal to 5% of GDP.

Further, BCA sees an additional consumption boost of $600 billion to $900 billion, as households spend a tiny fraction of housing wealth (5%-8%) and stock market gains (2%-4%).

"We expect gale-force consumption tailwinds" over the next 12 months, wrote BCA chief U.S. investment strategist Doug Peta.

Impact Of Auto, Goods Prices On Inflation Rate

Yet investors should expect the data to throw some curveballs.

Prices for durable goods, such as autos, appliances and computers, have tended to fall 1%-2% a year over the past decade. But they vaulted 14.3% over the past year. That alone has added 1.7 percentage points to the CPI inflation rate.

As the chip shortage eases, which appears to be happening now, new and used vehicle prices should moderate after 10% and 26% annual gains, respectively.

Also, the end of the busy holiday hiring and buying season should provide some reprieve for overtaxed supply chains.

As the boost to demand from fiscal stimulus fades and supply-chain issues ease, "goods (inflation) will probably be negative in a year's time," O'Sullivan told IBD.

Meanwhile, TD Securities sees oil prices holding around the current level of $76 a barrel, though a cold winter presents upside inflation risk.

Inflation Rate Not Picking Up Rent Spike, Yet

There are other risks, as well. The national median apartment rent, based on current market pricing, has spiked 16.4% since January, five times the 3.2% trend in 2017-19, according to Apartment List. That's happened as the national vacancy rate has tumbled from 7% before the pandemic to just 4%.

Fewer people have been moving out, as single-family home prices surged beyond the reach of many, and more millennials want to have their own place.

Yet CPI data shows the rent of a primary residence has seen only 2.7% inflation over the past year. Owner's equivalent rent — what someone would be able to rent their home out for — is up 3.1%.

The truth lies somewhere in the middle. The private-sector data only reflects the part of the rental market that is turning over, O'Sullivan says. CPI inflation data reflects the whole market. The Labor Department only updates one-sixth of the sample each month. So there may be zero rent increase for someone who signed a new lease, say, 9 months ago. That means these measures, which together account for 30% of the CPI's weight, should keep rising in coming months.

Not The 1970s Again

And sharp rent and housing-price increases, along with higher food and gas prices, may continue to shape consumer inflation expectations. That, in turn, will help drive wage negotiations. The New York Fed's latest consumer survey shows households expect rent to grow 10.1% over the next year, while overall prices rise 5.7%.

"If we get to the point where the labor market has tightened significantly further, you have a risk of a bit of a wage-price spiral," Peter Hooper, Deutsche Bank's global head of economic research, told IBD.

"We're not looking at a 1970s scenario," Hooper said. In the Great Inflation period from 1965-1982, easy fiscal and monetary policy combined with energy shortages to produce periods of double-digit inflation.

"But more persistent 2.5%-3% inflation," Hooper said, is "going to mean Fed policymakers have to be a little more aggressive."

Deutsche Bank's economics team expects two Fed rate hikes in 2022, but says optimal risk management might call for the first rate hike of the cycle before the end of 2021.

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The Fed's Big Policy Shift

In prior cycles, the Fed raised its key interest rate preemptively to head off potential economy overheating. It succeeded perhaps too well. The inflation rate undershot the Fed's 2% target for years. In 2019, the Fed basically admitted that it had been keeping policy too tight, leaning against economic growth. The new policy, formalized in 2020 as **average inflation targeting**, strived to push the inflation rate moderately above 2% for a time.

By mid-2022, Fed chief Powell has signaled that "for a time" will be done. If inflation remains more than modestly above target and the labor market appears tight, it may be time to act.

2022 Inflation Rate Outlook

The outlook is far from clear. O'Sullivan sees the core CPI, excluding food and energy, slipping to 2.3% by the end of next year. The Fed pays more heed to the personal consumption expenditures price index, which has a much smaller exposure to rent and typically runs slightly lower than the CPI.

UBS sees the core PCE inflation rate falling to 1.6% in 2022, below the Fed's target. However, Markowska sees core PCE inflation only falling to 2.8% next year, out of the Fed's comfort zone.

Markowska thinks the Fed will wait until next September for its first hike. Yet that would leave "a lot of catching up to do." So she's expecting a rate hike every quarter, until the Fed's benchmark interest rate reaches 2.5% in late 2024.

That's a lot more tightening than Wall Street is expecting. But investors should be open to the possibility that the era of rock-bottom rates and minimal inflation is over.

Powell, who just got **nominated for a second term as Federal Reserve chair**, doesn't pretend to have all the answers. "We hope to achieve significantly greater clarity about where this economy is going and what the characteristics of the post-pandemic economy are over the first half of next year."

Long-Term Inflation Rate Trends

At his Nov. 3 news conference, Powell explained that the Fed was surprised in the last cycle by the extent to which older workers delayed retirement, boosting labor force participation. He suggested that the recent rise in retirements might be a return to trend, rather than a temporary effect of Covid.

"Recent decades have tended to be structurally disinflationary, but that's shifting," Deutsche Bank's Hooper said. As the first baby boomers turn 75, labor force participation is trending lower. China is no longer the restraining force on prices that it once was. "Obviously, the whole globalization trend has taken a bit of a turn," with increasing efforts to bring production back onshore.

The last cycle's shale boom delivered reliably low gas prices, but scant profits or shareholder value for energy sector investors. Now, with oil companies — and OPEC — determined to capitalize on their winnowing period of opportunity, output is being restrained to maximize profits.

"Dealing with climate change does tend to raise costs, on balance," Hooper said.

Longer-term, the U.S. be headed toward a new era of supersized productivity and low inflation, as robotics advance and self-driving cars and trucks reach scale. But the road to get there may be bumpy.