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With no signs of easing, supply bottleneck pushes inflation toward overheating

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Theme **Healthcare & Pharmaceuticals, Real Estate, Banking, Fintech, Insurance**

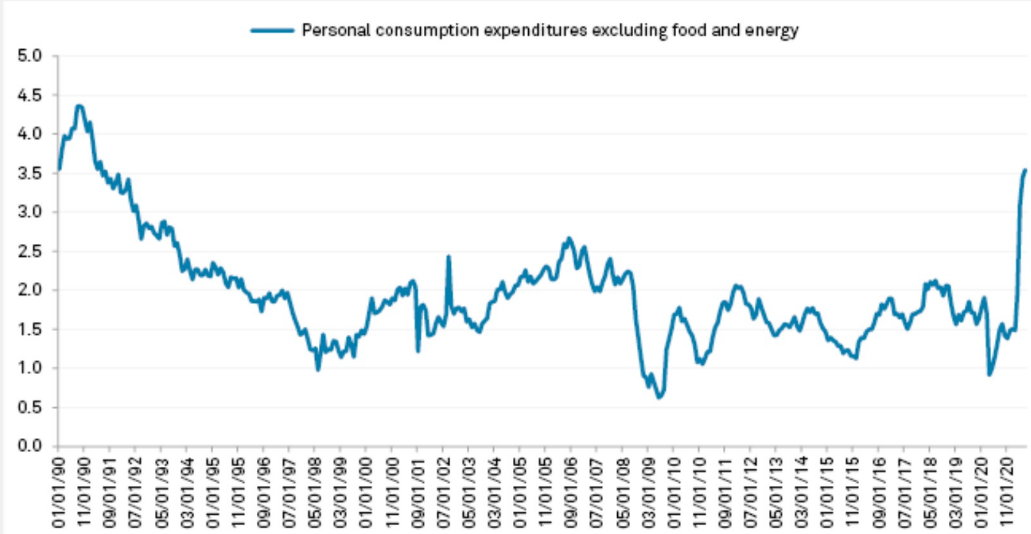
A global supply chain bottleneck that has caused significant increases in the price of used cars, washing machines and many other consumer goods looks set to continue, signaling that red-hot inflation is far from cooling off.

Shipping rates continue to accelerate, delivery delays are running at rates well above where they were early this year, and inventories continue to fall. The jam in the global supply chain, which was expected to lessen through the summer, may not be cleared until well into 2022, pushing up inflation data, weighing on bond markets and, potentially, forcing an abrupt shift in the Federal Reserve's accommodative monetary policy.

"Thus far, the inability for the supply side of the economy to meet demand

and the upward pressure on prices that imbalance causes, has been under-appreciated by forecasters and the Fed alike," said Sarah House, a senior economist with Wells Fargo Securities, in an interview.

Fed's preferred inflation measure surges to highest level in 30 years (%)



Data compiled July 30, 2021.
Source: Federal Reserve Bank of St. Louis

As the bottleneck has continued, the personal consumption expenditures price index jumped 3.54% from June 2020 to June 2021, the largest year-over-year increase since May 1991, according to government data released July 30. The index excludes food and energy prices and is the preferred measure of inflation for the Fed, which wants inflation to run above 2% for some time as one of several indicators that the economy has recovered from the pandemic.

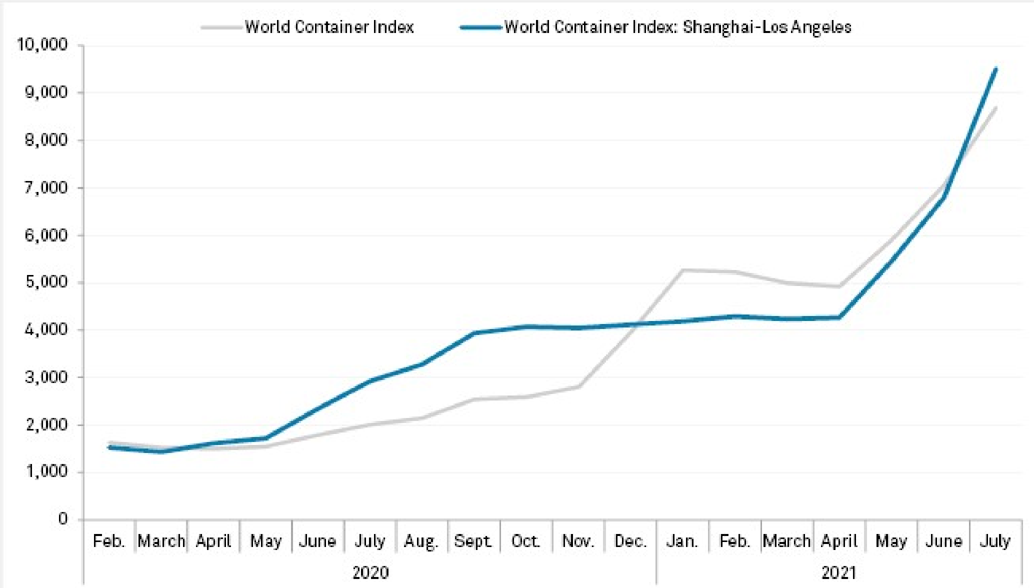
The persistent supply bottleneck may not negate the Fed's argument that inflation is largely "transitory," caused by a temporary trade hurdle and the sharp rise from 2020 demand for goods, which bottomed out during the most destructive portions of the pandemic.

"The rub, however, is that supply constraints have proved more severe and are taking longer to work out than initially anticipated," House wrote in a July 28 report co-authored by Wells Fargo economists Tim Quinlan and Shannon Seery. "Price pressures across the economy continue to mount as a result."

Prices are unlikely to return to pre-pandemic levels, the economists wrote, but they also have shown little sign of moderating or normalizing, a clear indication that inflation may be nearing risk of overheating.

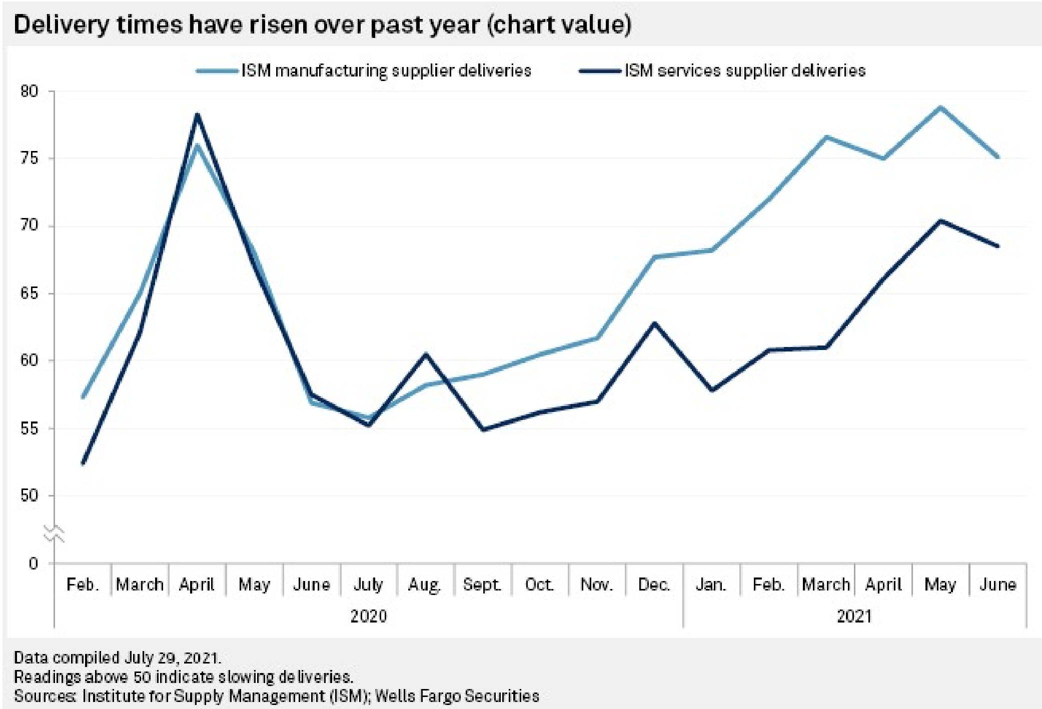
Container freight rates, for example, have increased more than four-fold from pre-pandemic levels.

Amid global supply bottleneck shipping costs skyrocket ($ per 40 foot box)



Data compiled July 29, 2021.
The World Container Index is an assessment of container freight rates sourced from international market participants.
Sources: Wells Fargo Securities; Drewry

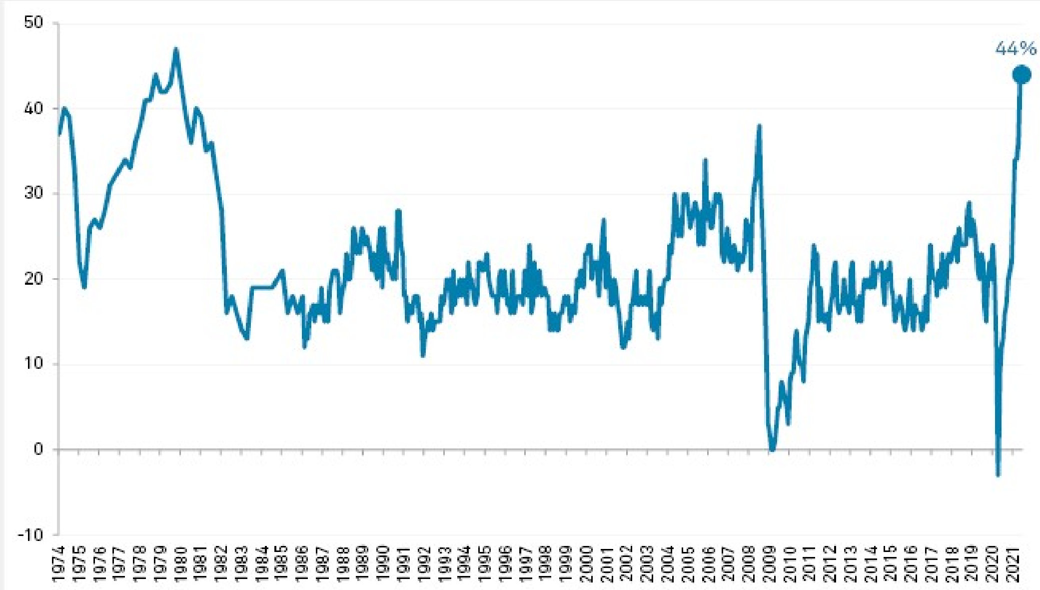
The cost of a 40-foot container has, on average, jumped from $1,633 in February 2020 to $8,692 in July 2021, according to Drewry, a maritime research consultancy. Over that same period, the cost of a 40-foot container on the Shanghai to Los Angeles shipping route has climbed from $1,525 to $9,510, a more than five-fold increase.



Delivery times have also slowed, with manufacturing supplier delivery times roughly 30% slower than they were a year ago, according to the Institute for Supply Management's latest data.

"Shipping costs are increasing at a double-digit pace, wait times for products remain unusually long even as throughput at ports has improved, inventories are still inadequate and labor is hard to find," the Wells Fargo economists wrote. "Not only are these problems symptomatic of ongoing supply chain constraints, they are a source of price pressure that continues to filter through the economy and stoke inflation."

Number of US small businesses expecting to raise prices hit highest level since 1980 (%)



Data compiled on July 29, 2021.
Source: National Federation of Independent Business (NFIB)

A new normal

A June survey from the National Federation of Independent Business, or NFIB, found that 44% of businesses expect to raise their prices, due to the combination of supply chain disruptions and a need to raise wages in order to fill open positions.

The increase is the largest since 1980 and only likely to worsen. A large percentage of small business owners survey expect the bottleneck to last six months or more, said Holly Wade, executive director of NFIB's research center.

"It is a significant challenge," Wade said in an interview. "We're starting from a new normal."

The longer that challenge lasts, the higher the risk that the post-pandemic recovery may be derailed, said Oren Klachkin, lead economist with Oxford Economics.

"With the crisis far from over and supply chains interlinked across borders, turning the economy back on won't be as simple as turning it off," Klachkin said. "If supply chain and labor market constraints don't ease, then the economy won't be able to make a full recovery."

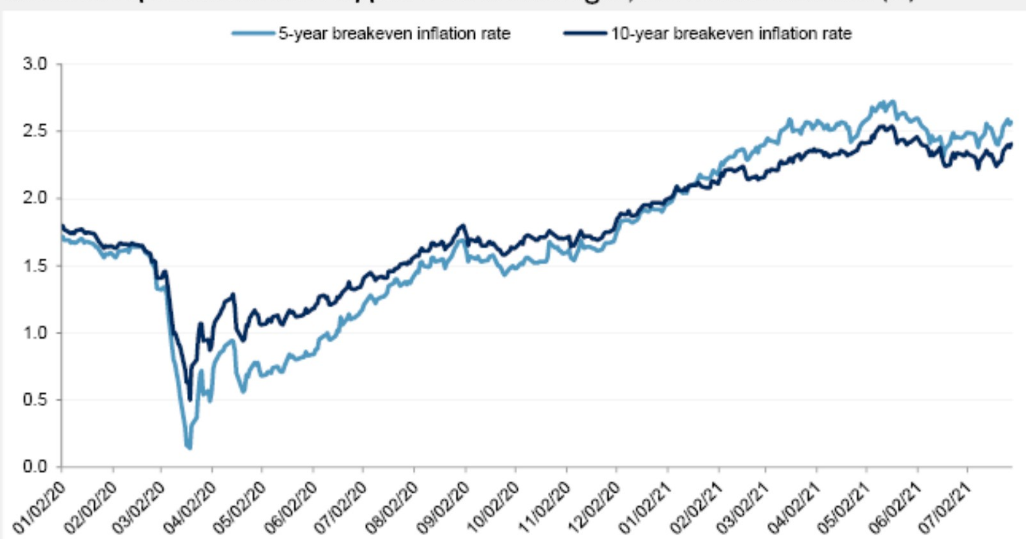
During a July 28 press conference, Federal Reserve Chairman Jerome Powell downplayed the recent runup in inflation, claiming that while it has surpassed expectations, the rise was largely due to the impact the semiconductor shortage has had on car prices and hotels and airlines recovering from 2020 lows.

"And those frankly don't carry significant implications in the long run for inflation or for the American economy," Powell said.

Still, if the bottleneck sticks and inflation data continues to rise, the Fed may need to tighten policy earlier than Powell and other officials want, experts said.

"But a lot depends on why inflation is stronger and how long those factors might endure," Klachkin said.

Inflation expectations have dipped from recent highs, but remain elevated (%)



Data compiled on July 29, 2021.
Source: Federal Reserve Bank of St. Louis

Even as the bottleneck remains, there are some signs that inflation may be cooling somewhat, said Mike Larson, a senior analyst at Weiss Ratings.

The 5- and 10-year breakeven rates, measures of the government bond market's inflation expectations, settled at 2.57% and 2.41%, respectively, on July 28, down from their most recent highs in May.

In addition, while inflation has been stoked by "enormous amounts" of fiscal and monetary stimulus, many new spending proposals from the Biden administration, including the recent infrastructure package, have been for amounts well below initial expectations, Larson said.

"Certainly, the near-term news continues to be challenging," Larson said.