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We are grateful to be emerging from the pandemic and relishing opportunities to reconnect for lunch, coffee, in-person meetings, or just to say "hi". In these early days of re-opening, traffic remains light and the pace of life still feels relaxed.

As we absorb life and economic conditions post-lockdown, an old foe has greeted us that we have not experienced for some time – inflation. Those navigating home remodels have reported incredible increases in costs due to higher prices for lumber, appliances, materials, and labor. Price increases for goods and services have been quite broad and the Consumer Price Index (CPI) has had the largest monthly increases since 1982, yet for it to become a more durable trend we would expect wages to also be driving higher. There are isolated examples of employees being hard to find and signing bonuses even being offered at McDonald's. However, we continue to have unemployment more than double the rate than when we entered the pandemic. It seems unlikely we will have significant wage inflation with unemployment at current levels.

In the absence of upward pressure on wages, will our current goods inflation evolve into a durable trend? Our friends at Rosenberg Research have done great work on this and despite the technical challenges of supplying goods as demand rapidly recovers, inflation is more likely to be transitory as opposed to permanent:

Delving into the details, there are areas of the CPI clearly being skewed by the re-opening trade and supply chain issues. Items like air fares, movies, sports events, theater, restaurants, autos, car rental, hotels and motels, housing-related materials and apparel. This is 20% of the CPI and it shot up 2.4% in May. In the past six months, this COVID-19-impacted share of the index has jumped at a 22% annual rate. I will take it as a solid assumption that this is not sustainable. And let's keep in mind that whether we are talking about accommodation, sports, clothing, or airlines, prices are still lower today than they were pre-pandemic. Is closing the 2020 deflation gap here really a long-lasting source of inflation?

At the same time, prices for used cars and trucks followed April's historic 10.0% jump with an additional 7.3% gain in May while the price for new vehicles rose 1.6%. Demand for used cars has gotten a boost amid the global chip shortage that has snagged production for new autos. But auto buying intentions have recently not just stalled out but have fallen to their lowest level in 39 years. Airline fares rose 7.0% on the month, following April's 10.2% rise, as vaccines enable an uplift in travel demand and the carriers are closing last year's deflation gap.

Meanwhile, car and truck rental prices rose 12.1%, and have boosted their prices by 55% so far this year, not because they've run out of workers, but because they liquidated their fleets when the pandemic got rolling and like most businesses, were completely unprepared for the early vaccinations, re-openings and snapback in demand. Those same companies are also desperately bidding on used vehicles at auctions, and it is this distortion that has played a critical role in this inflation run-up. But it is all temporary and why so many people think the Fed is out to lunch on this is the real mystery.

None of this is recurring, in part because any uptick in wage growth after the pandemic, if it happens at all, is going to coincide with a sharp tightening of fiscal policy that should limit the total increase in consumer spending power. There won't be another round of $2,000 checks going out again soon, and enhanced unemployment benefits are set to expire nationwide in a few months. Most pundits don't realize how these benefits were critical to holding the glue together for the economy —in March, the $8.2 trillion of federal government transfers to individuals (at an annual rate) was almost the same as the $8.5 trillion in private sector wages and salaries! Historically, wages and salaries in private industry in any given month are 2.4x the amount of government handouts —this past March, the two were almost identical.

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Meanwhile, the other 80% of the CPI pie, far less influenced by the noise and distortions caused by the pandemic, the prior lockdowns and current re-opening phase, rose only 0.15% in May and the six-month trend is stable at a mere +1.6% annual rate (emphasis added is ours)**.** That other 80% provides a clear picture of what prices really look like beyond the direct and indirect effects of the pandemic. Once the normal price-demand elasticities are restored in the "go and have fun" sectors and the supply chain issues are ironed out, which they always are, then the 20% will converge on the 80% at below 2% on inflation, and we will then be hearing about the Fed's frustration in actually not getting to its objective. (*Rosenberg Research – June 14, 2021)*

Our cautious nature and disciplined approach lead us to pause and consider the consensus narrative on inflation. We see the news headlines, and we pay careful attention to the details. With demand returning at a much faster rate than supply, our conclusion is that inflation will trend higher, but not durably so. And lumber prices? After a meteoric rise, they are now about 50% off their highs.

Thank you for the trust you place in us.