INVESTMENT STRATEGY BRIEF

# CAMP **TRANSIT**ORY

## A LOOK AT THE IMPACT OF TRANSIT ON INFLATION

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Northern Trust
Global Asset Allocation

**Wouter Sturkenboom, CFA**
Chief Investment Strategist EMEA & APAC
ws65@ntrs.com

**Dan Phillips, CFA**
Director, Asset Allocation Strategy
dp61@ntrs.com

**James McDonald**
Chief Investment Strategist
jxm8@ntrs.com

**Colin Cheesman, CFA**
Investment Analyst
cc327@ntrs.com

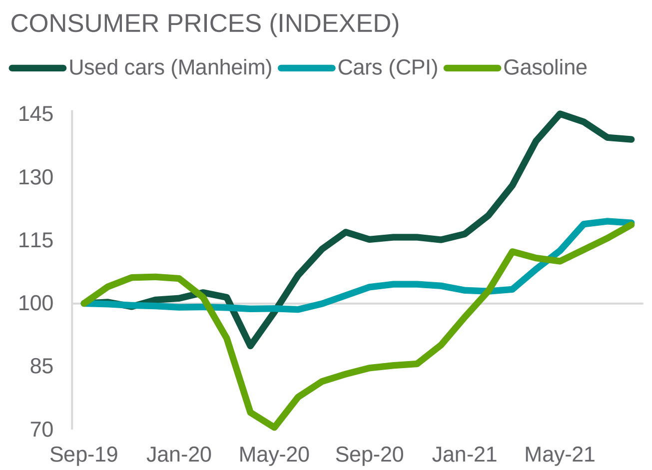

**The current inflation debate has two primary sides. Camp Transitory makes the case that recent inflation is due to a combination of temporary factors such as base-level effects, the pandemic recovery and supply chain disruptions. Camp Structural argues that recent inflation is the starting point of a self-sustaining spiral of rolling price increases that will end with inflation running materially higher than its pre-pandemic level. The cost of transportation is a big part of the debate. And, for us, we put the transit in transitory.**

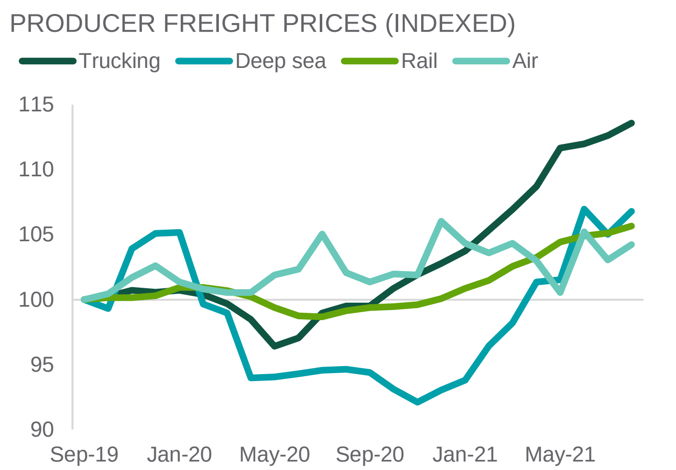
**The importance of transit.** Transportation comprises ~17% of the headline Consumer Price Index (CPI). It is the second largest component behind housing (~42%). Since consumer transportation prices have risen 17% this year, it is prudent to dive into it when evaluating the sustainability of recent higher inflation. Transit inflation consists of multiple components and needs to be analyzed looking at both consumer direct costs (e.g., cars and gasoline) and indirect costs (e.g., transit cost built into other end-good prices).

**Direct consumer cost pressures.** The biggest CPI transportation components include car prices (8.4% CPI weight) and gasoline (3.8%). Since the pandemic recovery began in earnest last April, these two components have combined for roughly half of the total rise in CPI. Even small transportation components like airfare (0.7%) and car rentals (0.2%) have had an outsized impact due to their big price swings. Outside of new and used cars, the year-over-year (y/y) price increases have been materially driven by base effects. As prices bottomed out last May, base effects should dissipate over the coming months.

**EXHIBIT 1: COST TO MOVE YOURSELF, COST TO MOVE YOUR GOODS**

Car prices have rolled over, while freight prices should come down as supply/demand imbalances find a new equilibrium.




Source: Northern Trust Asset Management, Bloomberg, Refinitiv. Left: Manheim used car values, CPI new and used cars, CPI gasoline. Right: PPI components. Values indexed to 100 on 9/30/2019 and through 8/31/2021.

**Indirect consumer cost pressures.** Indirect transit inflation largely consists of freight components such as trucking, air, sea and rail. All transit costs have risen this year, with trucking at the top of the list with a 13% rise y/y (Exhibit 1). Labor shortages, container shortages and port delays have all been factors behind the price increases, as has increased demand for transit from companies trying to fulfill surging consumer demand.

**How long, exactly, is transitory?** This recent inflation spike has lasted longer than many first expected. But we don't define transitory by length of time. Instead, transitory is defined by whether the underlying supply/demand conditions can be "fixed" on their own or will take outside forces (such as central banks raising rates to temper demand). By this definition we remain firmly in Camp Transitory. Prices of these transit-oriented goods have increased due to a combination of surging pandemic recovery demand and insufficient supply, which should dissipate as production resumes and ports clear. Semiconductor shortages have acutely plagued automobile production (as well as other goods). It will likely take well into 2022 before that problem is fully resolved, but many goods markets have already started to correct. Indeed, used car prices have come down a bit in the last few months (Exhibit 1). Meanwhile, higher demand elasticity (change in demand per change in price) allows consumers to delay purchases if prices are too high. Also, if price increases aren't repeatable, by definition inflation will be transitory (if gas prices stay at today's same "high" prices over the next year, gasoline inflation will be 0%). Because we believe these supply/demand mismatches can fix themselves, we remain in the transitory camp — even if transitory proves longer than preconceived time-based definitions.

**Market Implications: Inflation remains a risk case, but not a base case.** We don't believe transitory inflation is a problem for investors because it's not currently perceived as a problem by the Federal Reserve and other central banks. We believe central banks are right to take this view. We don't believe the transitory drivers pushing inflation higher — importantly transit costs — will be sustained; instead, we expect structural disinflationary forces —such as technological advancement and automation — will reassert their impact. To combat our risk case that we are wrong on inflation, we remain overweight Natural Resources, which historically benefits from inflationary periods while also exhibiting solid fundamentals — with improved capital discipline leading to elevated cash flow levels.