

WHY INFLATION MAY STILL PERSIST

Several contributing factors to inflation may not be addressed by simply raising rates.

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Key Takeaways

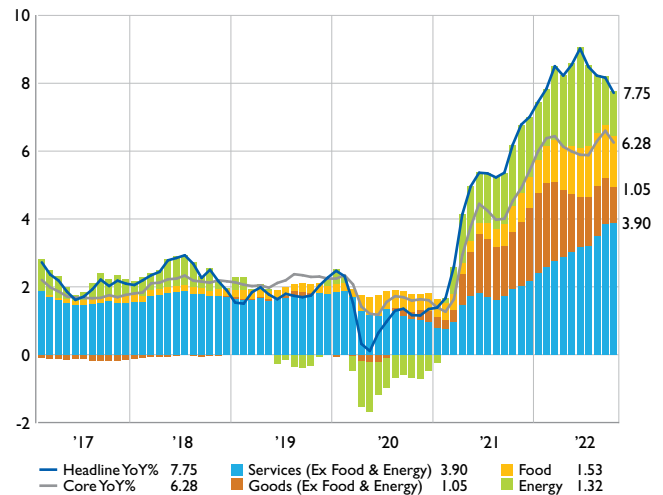
- Inflation may have peaked, but high prices for services continue.
- Several factors may be contributing to the “sticky” inflation, including a strong labor market, deglobalization, excess savings, and immigration barriers.
- These forces may keep inflation running relatively hot for the time being, since interest-rate hikes may not have much impact on them.

Inflation (particularly for goods) may have finally peaked during the summer as supply chains have opened further. However, we have reason to believe inflation may not fall as quickly as the Federal Reserve (Fed) would like, as various factors continue to contribute to the rise in prices.

Persistent inflation has been a major theme of 2022, forcing the Fed to take aggressive measures to counter the problem. As the following chart illustrates, pressure from goods and broken supply chains has been diminishing, but inflationary pressure from services has persisted.

The Price for Services Has Continued to Rise

One contributing factor to the rise in inflation in the U.S. stems from the historic amount of government stimulus handed out during the pandemic. According to the Fed, U.S. households accumulated \$2.3 trillion in savings between 2020 and 2021. These excess savings led to high levels of spending, which likely contributed to the persistent price increases amid constrained supply.



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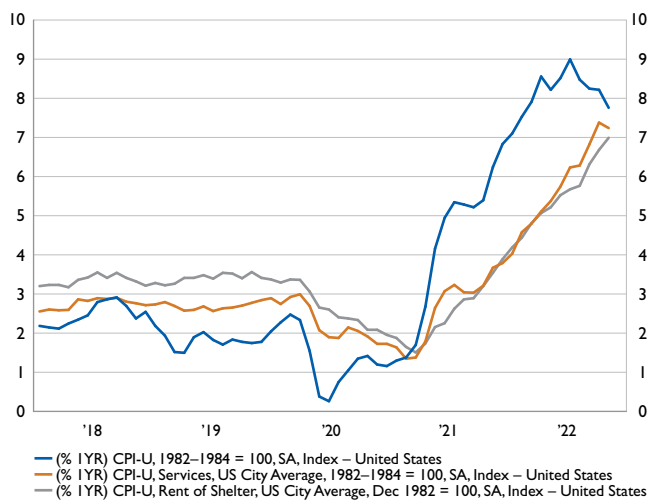
Although the level of excess savings has started to dwindle as spending has picked up and fiscal support diminished, the stock of excess savings remained at about \$1.7 trillion by mid-2022. This buffer has continued to provide some balance-sheet support that will likely keep inflation elevated for some time.

This, along with the extraordinary strength of the labor force, has added to the resiliency of the U.S. consumer and contributed to the recent inflationary environment. Other macro factors such as immigration barriers and deglobalization also have contributed to the persistency of inflation.

Flexible vs. Sticky Inflation

Prices in the U.S. have remained elevated. At its recent peak, headline Consumer Price Index (CPI) ran at a 9.0% pace in June. Since then, the rate decelerated down to 7.7% as of October. Falling gasoline prices contributed to the decline, but other expenses such as rent and services have continued to accelerate.

The Cost of Rent and Services Continue to Increase



While items such as energy and food can fluctuate wildly, others tend to change slowly because of the low frequency of their price adjustments. According to the Federal Reserve Bank of Atlanta, CPI can be divided into two broad sets of inflation: flexible and sticky.

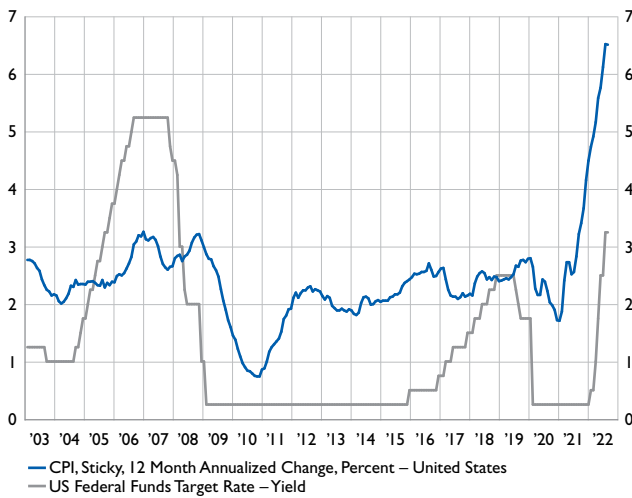
Flexible prices, which include gasoline and fresh produce, are affected by factors such as cost, availability of raw materials, or weather and can change quickly. On the other hand, sticky prices tend to be more stable and include many service-based categories such as shelter, insurance, and other common household expenses. These prices may be established annually, and changing these prices can incur considerable direct and indirect costs, which may deter firms from frequently changing prices.

Because sticky prices change slowly, they tend to incorporate expectations about future inflation. In other words, when consumers and businesses start to anticipate price increases, they can create self-perpetuating inflation environments.

According to the Atlanta Fed's study, "[I]nflation is a function of two forces: the inflation expectations of the public and the amount of slack in the economy." Inflation expectations are key in determining things such as wages and price decisions, whereas slack impacts the pricing power of firms and workers.

Since sticky inflation can be affected by inflation expectations, it may be useful when determining the direction of inflation. Accelerating sticky inflation can be problematic for a Fed trying to get price increases under control. This may indicate that inflation has spread to the broader economy, making it an even bigger problem rather than being transitory. The recent pickup in sticky inflation has forced the Fed to act aggressively with its interest-rate hikes.

“Sticky” Inflation and Fed Funds Target Rate



Given the current stickiness of inflation, the Fed may feel its job is far from complete. This can create the perfect storm for the Fed to overshoot.

Excess Savings

As mentioned, trillions of dollars in stimulus money were created during the pandemic to keep the U.S. economy afloat. Initially, high-income households saved this money by not traveling, eating at restaurants, and spending normally due to pandemic restrictions. Low- and middle-income families benefited from abundant government support, as this cash pile provided a buffer to counter higher prices, higher borrowing costs, and the threat of an imminent recession. This has allowed many businesses to report strong consumer demand, even as they have been raising prices to pass along rising costs.

This excess savings has kept the U.S. economy relatively resilient, but it also has allowed inflation to remain sticky. Households in the top half of the income distribution have continued to hold most of their excess savings. As this group is now able to travel and spend again, their excess savings are likely contributing to higher spending because of pent-up demand.

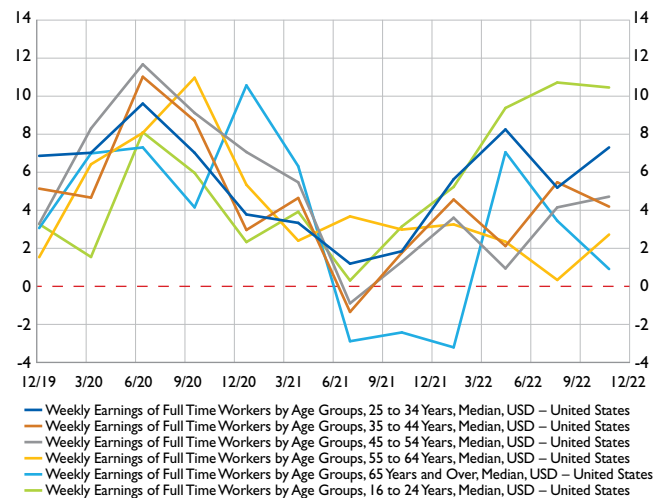
If the excess savings stood at around \$1.7 trillion in June, a burn rate of \$100 billion per month would mean consumers’ bank balances could normalize in 17 months. The \$100-billion burn rate was extrapolated by assuming that \$600 billion of the savings was used up over the first half of 2022. The actual monthly burn rate could vary from this estimate, and it should be taken with a grain of salt. Although this is a very rough estimate, it suggests inflation could remain sticky for several more months.

This money will eventually run out, but in the meantime, Americans have continued to spend. Recently, consumption patterns have shifted from goods to services such as airlines and hotels, which have been reporting strong bookings. This shift also benefited low-wage workers as those in industries such as hospitality, retail, and healthcare have seen their wages rise faster than inflation.

Labor Shortage Continues

There have been various forces at play in pushing up hourly rates for some positions that traditionally paid minimum wage. In fact, wage growth for the youngest group (ages 16 - 24) has accelerated much faster than those of other age groups.

Wages Have Risen Faster for the Economy’s Youngest Workers



The relationship between minimum wage and inflation has been widely debated and remains complex. However, there is reason to believe that forces that have lifted lower wages recently may have been impacting prices for consumers.

Labor shortage and the “Great Resignation” have been new realities that have affected the labor market.

According to a Pew Research Center survey, people have left jobs last year mainly due to low wages.

Evidence suggests that wage growth has recently been the strongest for low-wage workers.

According to the Economic Policy Institute, more than 25 U.S. states will raise their minimum wages next year. The benefits of raising the minimum wage have been debated for the past decade. Minimum wages may boost low-wage hourly earnings, but it also burdens businesses with additional financial strain. Despite the absence of federal action, many states and cities have been raising their own minimum wages.

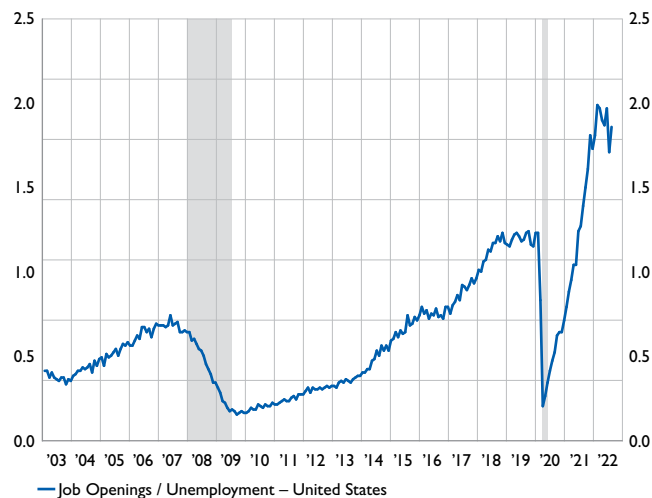
In fact, businesses have been so desperate for workers that many have been already paying low-wage staff above the federal minimum wage. In recent years, employers have had to compete to attract staff, which has been particularly true in industries such as leisure and hospitality.

Wage increases have a circular effect. As higher cost of goods and services eventually cause market prices to increase, higher wages will be necessary to compensate the increased prices on consumer goods. Rising minimum wages will at some point likely lead to layoffs as labor costs rise, but no one is certain when or to what degree that will happen. In the meantime, many employers have been covering the cost of higher wages by raising prices for consumers.

Employment and Productivity

Another reason to believe wage inflation may remain sticky is the excess demand for labor relative to the number of unemployed people. Currently, there are nearly two job openings per one unemployed person.

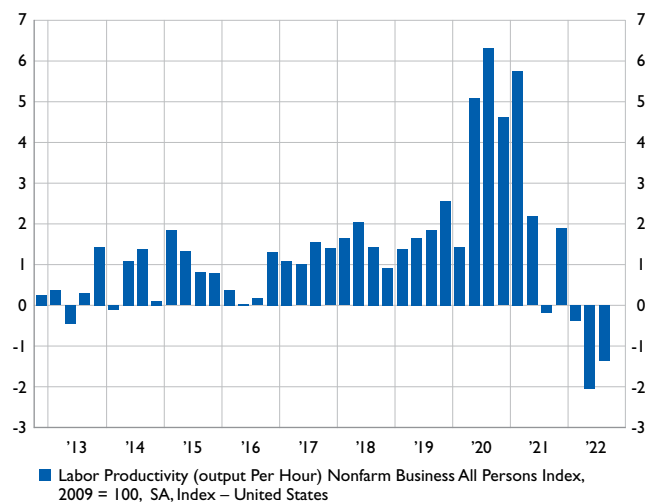
Job Openings Have Soared Since 2020



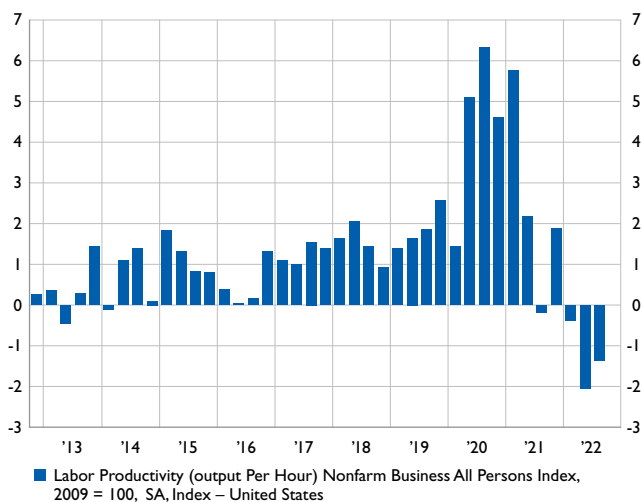
Even as pandemic protocols were lifted, many businesses haven’t been able to operate at pre-pandemic capacity. Restaurant service has remained an issue, and employers have struggled with productivity as they train new workers. Studies have shown that lower productivity leads to higher inflation.

Worker Productivity Has Continued to Be an Issue

When a workforce is less productive, it produces less goods and services, which means higher cost per unit.



Immigration Barriers



Since 2020, employers have been short workers, which partly stems from lower immigration and excess retirements. In short, we have too few workers, which has led employers to raise wages. While opening barriers to immigration may be an answer to surging inflation, it hasn't been a politically palatable option for many years.

Worker shortages have particularly affected industries such as transportation and warehousing as well as accommodation and food services. For instance, a severe shortage of workers in transportation and warehousing have directly impacted supply chains, which in turn has contributed to inflation.

In recent years, the U.S. government has issued fewer visas to adult immigrants than in prior years. This has burdened businesses that are now struggling to fill vacant jobs. Allowing immigrants to fill some of the vacant jobs would help ease labor shortages and slow down inflation, especially given that the inflation rate is currently being most affected by the service sector. That said, the immigration situation is unlikely to get resolved anytime soon.

Deglobalization

Friend-shoring (or the transferring of supply chains to ally countries) is another trend that may push prices higher. Whereas globalization reduced production and labor costs, the recent trend toward deglobalization has been burdened by high tariffs and geopolitical tensions. The

supply-chain congestion during the pandemic has forced companies and national leaders to reconsider a global supply chain that is dependent on fewer nations to produce manufactured goods.

China's zero-COVID policy and geopolitical tensions, such as those caused by Russia's invasion of Ukraine, have led businesses to scramble to find alternative sources to fill supply gaps. Tensions between the U.S. and China further exacerbate the supply-chain issue, as deglobalization will undo the cost savings that benefited consumers around the globe. This deglobalization trend will put upward pressure on prices even as supply shortages are addressed.

Conclusion

Unlike the Fed's initial thinking, the recent run-up in inflation has not been transitory. Instead, inflation turned out to be much stickier than central bankers had anticipated.

Whereas the traditional measure of headline CPI has started to decelerate, sticky CPI has continued to accelerate. As the high month-over-month numbers start to roll off, year-over-year numbers may come down, particularly next year. However, we are still a long way from a 3% (much less a 2%) inflation level. Certain factors such as excess savings, a tight labor force, immigration barriers, and deglobalization represent relatively new forces that may be keeping inflation running hot for the time being. The Fed has clearly articulated its intentions of taming inflation.

According to the International Monetary Fund, central banks must keep raising interest rates aggressively to prevent prices and wages from spiraling out of control. This has been the Fed's playbook, but it also slows business expansion. Many of these contributors to the recent inflation problem are unlikely to get fully addressed by interest-rate hikes, but raising interest rates continues to be the primary strategy. While the Fed may be able to influence demand to control costs, there is little the central bank can do to address some of the other forces keeping inflation sticky. Perhaps the Fed simply needs time and help from Congress and the administration in the form of improved trade relations and relaxed immigration barriers to allow inflation to decrease naturally again.

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