Inflation, The FED & Tie Demand

By Petr Ledvina

What is causing recent inflation? Most pundits blame rising inflation on supply chain issues and the FED. But supply chain issues did not cause the current inflationary rise in prices.

Instead, both the current and former administrations gave consumers substantial amounts of money in response to the pandemic.

This shifted aggregate demand into territory where the supply is relatively inelastic. That is, there is not much spare production capacity to produce more, so prices have been rising. Increased demand, in conjunction with COVID-related labor shortages, created some of the supply-demand imbalance, and manufacturing and transportation sectors were not able to handle such a dramatic rise in demand. One example of this has been the delays in U.S. ports.

If government had not provided such generous support, there would not have been a dramatic rise in demand, and the economy would instead have followed a normal recessionary path. We can compare consumer spending during the financial crisis of 2009 with recovery from the COVID recession (Figure 1). Consumers can't be happy with current inflation, yet the stimulus money received was welcomed and needed.

Why not blame the FED? When recessions hit in the past, the FED lowered interest rates in order to stimulate aggregate demand in the economy. Lower rates would entice new borrowing and spending by consumers and businesses alike. This spending would increase the demand for goods and services, thus enabling producers to hire more people to meet the demand.

However, this seems to have ended in the recovery from the financial crisis of 2009, when the FED increased its balance sheet from \$0.9T to \$4.5T over the course of six years.

Despite this effort by the FED, unemployment remained high for a long time, inflation remained below the FED's target of 2 percent until February 2020, and real wages did not grow until 2017.

This suggests that the FED's monetary policy entered a "liquidity trap." In other words, no matter how much money they printed, it did not stimulate aggregate demand significantly, if at all. Consumers did not borrow much because of high levels of debt (underwater mortgages for example). Also, banks tightened lending standards, and would not allow the Fed's "printed" money to enter the economy.

In addition, the fiscal response by the Bush and Obama administrations was in total about \$1T, of which \$380B was in direct support of the consumer in the form of tax cuts/rebates, tax credits and unemployment benefits over three years. At that time, economists argued for a much greater spending bill. But, due to political gridlock in Congress, nothing else was done.

Contrast this with the response to the COVID crisis. On the monetary side, the FED decreased interest rates across the maturity spectrum and its balance sheet increased from \$4.2T to \$8.9T. This response is somewhat similar to the 2009 recession. However, on the fiscal side, the Trump and Biden administrations' response was about \$1.6T just in direct assistance or in income support of consumers over 10 months. And this time it worked.

Unemployment declined relatively quickly, and while prices and inflation have been on the rise, workers' compensation also improved. Unfortunately, labor supply did not keep up with demand (more on this in a future article).

In November, the CPI index grew by 7.1 percent from a year ago, during which the most substantial increases were in shelter, energy and food. Food, representing 14 percent of the index, was up by 6.1 percent. Energy, representing 7.5 percent of the index, was up by 33.5 percent; and shelter, representing 32.5 percent of the index, was up by 3.9 percent. As expected, due to car chip shortages, vehicle costs contributed substantially by increasing 11.1 percent

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(seasonally adjusted percent change, BEA). In response, the FED is expected to raise short-term rates two or three times this year.

Is the inflation going to last? Some data from the last few months suggest that, with the exception of housing, consumer demand is slowing down.

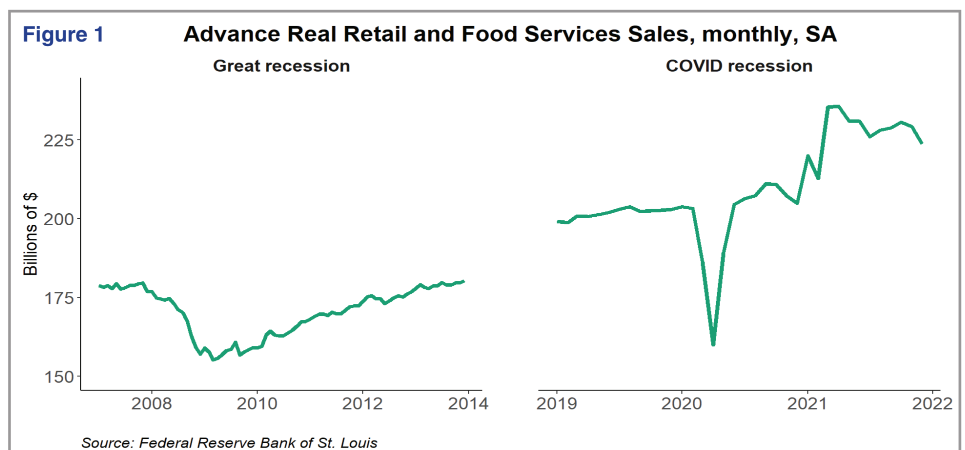
While nominal wages are rising, real wages have started to decline and the consumer savings rate as well. Starting in August, real disposable income declined in all four months by 0.1 percent, 1.6 percent, 0.3 percent and 0.2 percent, respectively (BEA). In addition, retail sales grew only modestly in November by 0.1 percent, and declined in December by 2.1 percent. Some attribute this to "scared customers" buying holiday gifts well before Christmas as the news of the log jam in U.S. ports spread around.

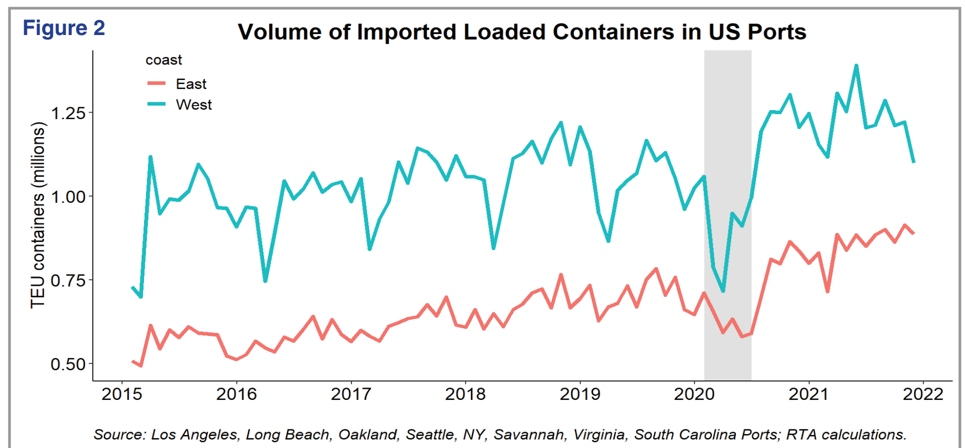
If that is the case, and consumer spending is not as robust as in the last 18 months, we should see some moderation in container traffic. The throughput of West Coast ports started to decline in May 2021, while on the East Coast the flow of containers is still elevated from pre-pandemic levels (Figure 2).

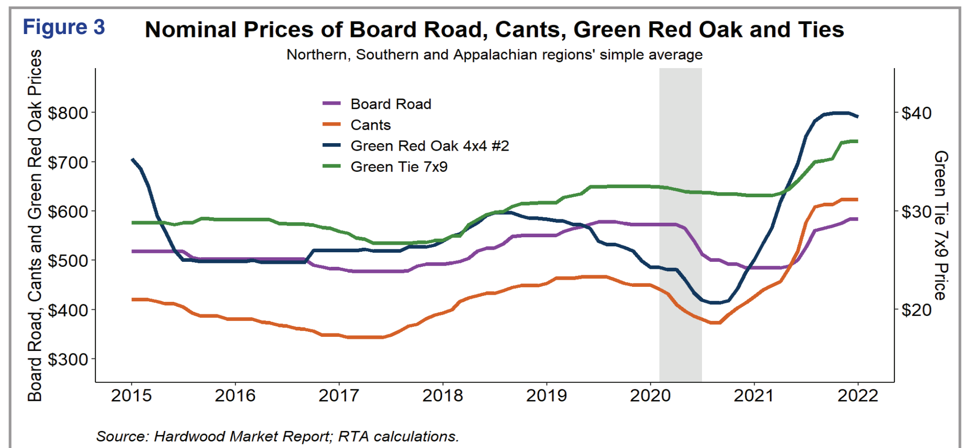
Also, railroad intermodal traffic slowed considerably from its peak in April 2021 (see Business Trends). In addition, the Freightos Baltic Daily Index tracking container shipping cost declined from its peak of $11,109 in September 2021 to $9,680 on Jan. 21, 2022. It remains a possibility that the flow of containers and goods was disrupted by port closures and power outages in China. At the same time, however, pallet lumber demand and prices seemed to stabilize (Figure 3).

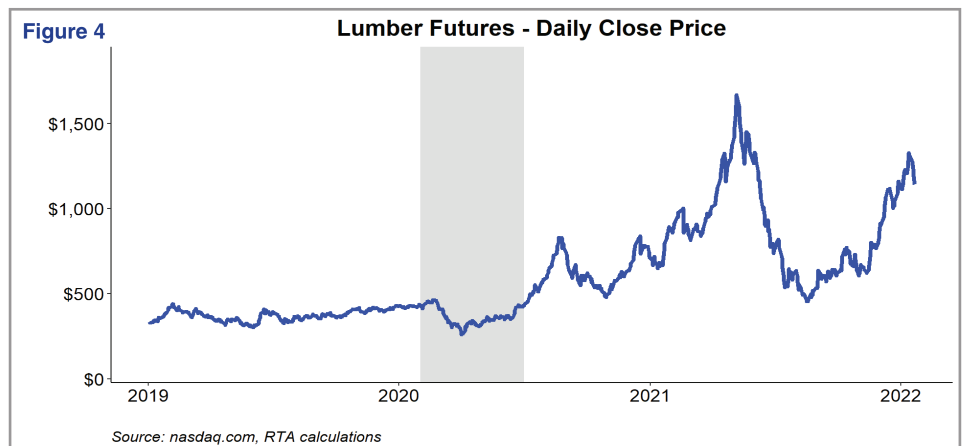
The opposite seems to be happening in the housing market, which still looks strong, with new permits and housing starts for December 2021 showing significant increases despite seasonal patterns (see Business Trends). Perhaps the increase is caused by buyers wanting to purchase before the FED raises interest rates, even with home prices rising by 19.1 percent from October 2020 to October 2021 and by 29.1 percent from two years ago.

This poses questions of who is buying and how they can afford it. According to the New York FED, in the past 18 months, most new mortgages were taken out by people with above-average credit scores.









In Q3 2021, 69 percent of new mortgages were issued to borrowers with credit scores above 760. Experian, a credit rating agency, estimates that on average this high score is associated with borrowers aged 50 and older. So, this is not the Millennial generation. Also, these older people usually tend to own a house already. According to some estimates, about 77 percent of people aged 50+ owned their homes prior to 2020 (U.S. Census Bureau). While some analysts point to people wanting bigger houses because of COVID, it seems that a substantial part of the demand comes from people buying second homes, or homes for rental income or investment. In addition, professional investors and corporations bought about 18 percent of the houses in Q3 2021. For comparison, in Q3 2009, it was 8 percent (bloomberg.com).

This continuous housing demand puts pressure on softwood lumber, with prices getting close to their peak in May 2021 (Figure 4). But there are other reasons for this price increase. First, in early November, nature played its part again in the form of torrential rains in British Columbia, an area that was struck by wildfires just a few months previously. This disrupted logging and transportation as railroads had to deal with mud slides and tracks washed away (vancoversun.com, CN and CP websites). There were absolutely no trains passing through the main corridor between Vancouver and Kamloops for eight days in November 2021. This caused a disruption in the supply of construction lumber. Second, the U.S. government doubled the tariffs on Canadian softwood lumber on Nov. 24 from an average of 8.9 percent to 17.9 percent.

What Does This Mean For Crossties?

The housing boom should continue in the near future, but softwood lumber prices should moderate as the effects of adverse weather in British Columbia are resolved, thus lowering the incentive for hardwood sawmills to cut construction lumber.

Meanwhile, consumer demand is slowing down and with it the demand for pallet lumber, although there should still be elevated container traffic and pallet demand until inventories in the U.S. economy are replenished (see Business Trends).

As a result, tie production may remain relatively low for some time. At the same time, demand for ties should increase from last-year levels by 1.9 percent in 2022 and 2.0 percent in 2023 (RTA forecast, Table 1).

Table 1

New Wood Crossties (in thousands)

Year	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	Pct
2019	2.3%	14,471	4,105	18,575	-13.0%
2020	-3.4%	15,309	3,175	18,483	-0.5%
2021	5.5%	14,230	4,096	18,326	-0.9%
2022	3.9%	14,230	4,439	18,669	1.9%
2023	2.7%	14,603	4,444	19,046	2.0%

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