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It ain't stagflation, but it sure is "M.E.S.S.I."

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- **It's not runaway inflation, and it's certainly not stagflation. In fact, the US economy is going through a bout of "M.E.S.S.I." inflation dynamics – *Moderating Expansion with Sticky Supply-driven Inflation* – a rare phenomenon where strong, but cooling demand is met by constrained, but accelerating supply, leading to transitory, yet sticky inflation.**

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In the debate between transitory and runaway inflation, we have repeatedly said that the truth lies somewhere in the middle, with inflation likely to be "sticky but not oppressive". Still, with successive shocks affecting global supply chains and labor supply remaining constrained, many have been worrying about stagflation, fearing that we're headed into an economy where inflation is rampant and the economy feeble.

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Initially, extreme health conditions, severe social distancing measures, and unprecedented fiscal transfers to households supported a surge in spending on goods. With domestic and international supply struggling to rebound quickly and inventories being run down, prices for goods surged. Later, as the health situation improved, the re-opening of the economy led to greater demand for services which also ran into the tight supply conditions, leading to higher service sector inflation (**Figure 2**).

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Sticky inflation into 2022 with moderate risks to the upside

Our baseline view suggests persistently high inflation into the first half of 2022 with the recent rise in energy prices adding around 0.2ppts to headline inflation. We forecast personal consumption expenditure (PCE) inflation at 4.4% y/y in Q4 2021 and 2.1% in Q4 2022, and core PCE inflation at 3.8% in Q4 2021 and 2.3% y/y in Q4 2022.