BEFORE THE BELL

Investors and the Fed aren't freaking out about inflation. Should they?

By Paul R. La Monica, CNN Business
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New York (CNN Business) — There is a gigantic disconnect between Main Street and Wall Street when it comes to inflation. Something's got to give.

The US government reported last week that consumer prices, excluding food and energy, rose at their fastest clip since 1992 in May. Sherwin-Williams (SHW) is lifting the price of paint, one of many companies that's responding to higher commodities costs.

Food prices are also surging. Chipotle (CMG) just raised prices. So did Campbell Soup (CPB).

And the chief financial officer of restaurant and arcade chain Dave & Buster's (PLAY) said during a recent earnings call with analysts that he expects a 6% to 8% increase in food costs for 2021 due to higher chicken, beef and dairy prices.

Wages are rising too, especially for workers in the retail, leisure and hospitality sectors that are returning to jobs as the economy reopens. That adds to inflationary pressures, because some companies will choose to hike prices in order to maintain profits.

Labor shortages aren't helping.

The CEO of online pet retailer Chewy (CHWY) wrote in a letter to shareholders after its latest earnings report that it "faced labor shortages in our fulfillment centers similar to those being faced by many companies nationwide." As a result, Chewy continues "to invest in higher wages and benefits" in order to fill job vacancies.

Yet investors — and the Federal Reserve — are shrugging off rising inflation as "transitory." Long-term bond yields are falling, which isn't what normally happens when inflation runs hot. If bond investors believed that price hikes are here to stay, they'd be demanding higher yields.

And the market is pricing in just a 3% chance of a rate hike from the Fed by the end of the year. That's down from a 10% likelihood of higher rates just a month ago. Investors know a rate hike is the central bank's best tool to fight rising inflation, and they'll want to hear more on the subject when Fed chair Jerome Powell speaks at a press conference on Wednesday.

"The bond market is still not concerned about inflation. It's buying what the Fed is selling," said Randy Warren, CEO of Warren Financial.

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The problem is that there is a chance the Fed could wait too long to react to inflation.

"Is inflation transitory or something more structural?" asked Steven Oh, global head of credit and fixed income with PineBridge Investments. "Will the Fed lose control of it down the road and make a policy error and not have the ability to rein it in?"

If the Fed and bond market are wrong about inflation, the central bank may have to wind down its pandemic stimulus much more quickly than it — and investors — would like. That would mean unwinding its big asset purchases and raising rates sooner rather than later.

Oh doesn't think that will be the case. And many others agree. They argue that investors must keep in mind how rapidly the economy has roared back.

For that reason, it should not be that big of a surprise that there are dislocations in the job market and supply chain. It will take time for conditions to revert to what they were like in late 2019 and early 2020 before Covid-19.

"There are a lot of questions about inflation because you see it in everyday life," said Bryan Koslow, principal of Clarus Group, a wealth management firm. "But we may have seen the peak, especially in terms of wage growth."

Even if that does turn out to be true, the mere fact that investors and consumers are so focused on prices is noteworthy. Inflation has essentially been a non-issue for more than a decade.

"The Fed has to take the inflation concerns seriously," said Troy Gayeski, co-chief investment officer and senior portfolio manager at SkyBridge Capital. He added that he thinks there is a 20% chance that inflation pressures turn out to be more persistent as opposed to transitory.

"The risk of meaningful inflation has been non-existent since 2008. Until now," Gayeski said.

What's getting more expensive

Food and paint aren't the only things getting more expensive. As CNN Business' Moira Ritter points out, the prices of just about everything have gone up lately.

Lumber prices have soared. And the housing market continues to boom. That's led to a big spike in the prices of couches and other household furnishings.

Used cars are a lot more expensive too. Chalk that up to people returning to work and a dearth of new cars on dealership lots due to the chip supply shortage that has hurt production of new vehicles.

Thursday: US jobless claims, Earnings from Kroger (KR) and Adobe (ADBE)