The Perceived Sources of Unexpected Inflation *

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August 2024

Abstract

We use high-frequency asset price changes around Consumer Price Index announcements in the US to learn about market perceptions regarding the economy. We write a New Keynesian Model with incomplete information and an inflation announcement to extract the demand and supply share of unexpected inflation through observable asset price changes around the announcement. Empirically, we find that the response of future annual dividends of S&P 500 companies to a positive surprise in inflation around US CPI announcements was positive before the covid period but turned negative post covid. We also find that future treasury nominal yields and forward breakeven inflation rates increase in response to a positive surprise in inflation throughout the period. Interpreting our empirical findings through the lens of the model, we find that the relative share of supply in unexpected inflation has increased by 20 percentage points post covid.

JEL Codes: E31, E40, E44, E50, D80, D84

Keywords: inflation, high-frequency, demand, supply, asset prices, expectations

*We thank Matthieu Gomez, Jennifer La'O, José Scheinkman, and Jesse Schreger for their invaluable guidance and support. We would also like to thank Hassan Afrouzi and Fernando Cirelli for their regular and excellent feedback. We have also benefited from discussions with Émilien Gouin-Bonenfant, Noémie Pinardon-Touati, Stephanie Schmitt-Grohe, Martin Uribe, Laura Veldkamp and Michael Woodford.

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