Inflation – friend, foe or figment of the market's imagination?


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Inflation is the new fear. We assess the reality of this based on evidence in the system. We then identify what inflation markers to look out for in the months and years ahead.

Mr. Market has morphed into an overnight inflation zealot evidenced by rising commodity prices, spiking bond yields, a rotation out of growth companies to 'value stocks' and belligerency towards central bankers trying to anchor inflation expectations.

But inflation evangelism must be contextualised against deflation fears a mere 11 months earlier. This extract from a leading global investment bank in their April 2020 client letter reveals how notoriously fickle market consensus is.

"core inflation (excluding food and energy) has recorded consecutive month-on-month declines for only the second time in the series' 63-year history – the last time was 1982. This reinforces our view that the scale of demand destruction in the economy means inflation is not going to be an issue for a long-time".

Why is inflation important?

Since the 2008 Global Financial Crisis (GFC) most economies faced growth headwinds and governments responded by underwriting growth with debt. Low levels of inflation allowed for rock bottom interest rates, ensuring manageable debt servicing. Any adjustment to higher levels of inflation would lead to a concomitant increase in global interest rates, thus raising the risk of debt defaults for some nations and recessions for most.

The path of global inflation since 2010

Global core inflation since 2009 has moved in a relatively consistent band between 2% and 3%.

For a brief moment in 2011/2012, it popped above 3% and during the pandemic in 2020, dropped below 2%. Developed market core inflation averaged about 1.5% over this time but periodically, prices would decline year-over-year leading to central bankers mustering all their might to avert persistent deflation (falling prices). In the developing world, core inflation declined from above 4% at the start of the decade to 2% in 2020.

Chart 1: Latest reported CPI Y-o-Y% versus history

Source: S&P Capital IQ, Northstar (March 2021)

Why did we experience two decades of disinflation?

Jongrim Ha, M. Ayhan Kose and Franziska Ohnsorge in their book: Inflation in Emerging and Developing Economies ascribe secular falling inflation to rising productivity linked to advances in information technology as well as trade liberalisation programs in emerging and developing economies. In addition, demographics (predominantly lower birth rates), heightened business competition, structural changes in the economy with less reliance on oil, better central bank management and anchored inflation expectations are all reasons cited for contained prices. There is no evidence that these longer-term trends will brake, in fact COVID-19 might well have further entrenched them.

The factors that do and don't cause inflation

Since the lows of the pandemic, inflation has been rising and in order to gauge the potential impact on the global economy and of course markets, we need to understand what factors are driving higher prices and whether these are transitory or permanent in nature. We also address an inflation risk that to-date has proven unfounded.

Oil and food shocks

Unsurprisingly, a definitive relationship exists between oil price volatility and inflation. According to Jongrim, Kose and Ohnsorge about 40% of the variation in global headline inflation since 1970 is ascribable to oil price changes. Since then, there have been 6 oil price plunges (defined as a drop of more than 30% over 7 months) and 14 oil prices spikes (defined as a rise of more than 30% over 7 months). Of the 14 oil price spikes, 9 of these reversed within 6 months.

Significant oil price moves caused inflation to, on average, increase by 2.4% within a year. But the oil effect moderated in later decades (1990's and 2000's) to just a 1% increase in inflation. Oil has the greatest effect on inflation in the developed world, whereas food prices have the largest impact on inflation in the developing world. Considering food and oil prices are 20% above pre-pandemic levels and metal prices 30% higher than in early 2020, a pick-up in inflation off the low levels of 2020 is inevitable and that is already visible in the glide path of inflation.

Demand shocks

According to Jongrim and Co's research, demand shocks are a determinable inflation influencer. A demand shock is a temporary increase or decrease in demand for goods and services. COVID-19 caused a boom in consumption of goods (positive demand shock) but a collapse in services (a negative demand shock). Over the last 20 years, the globe has predominantly experienced negative demand shocks with recessions in 1982, 1991 and 2009, in addition to economic slowdowns in 1998 and 2001. These all had a deflationary impact.

In response to COVID-19, governments are fiscally intervening to drive demand – for example, the US has just passed a US$1.9 trillion stimulus package – 27% of its GDP. Some economists view this as catalysing excess demand (a positive demand shock) and creating inflation. A counter argument is that households have demonstrated a propensity to save rather than spend (US households have saved over US$3 trillion since the start of the pandemic, more than all the combined US stimulus so far).

Chart 2: United States - personal savings as % of disposable personal income (quarterly)

Source: S&P Capital IQ, Northstar (March 2021)

To conclude our discussion on demand shock inflation, we mentioned above that COVID-19 created two parallel but opposite inflation effects in the global economy. As consumers found themselves home-bound, they redirected their expenditure to the consumption of goods and away from services that became inaccessible. This inflated the prices of consumer goods and deflated the prices of services. A commonly held view is that inflation will spike as services bounce back accompanied by higher service pricing from ultra-depressed levels, but this argument fails to acknowledge that expenditure will shift away from goods whose prices are COVID-19 inflated. A netting off price effect is a more realistic outcome.

Output gaps

An obvious consequence of COVID-19 is that it caused economies to operate well below their true economic potential resulting in slack or 'output gaps'. Output gaps meaningfully influence inflation. An economy operating below potential, where latent excess capacity (such as labour) exists, subdues prices as against one operating above its normal long-term economic steady-state, this causes inflation. A concern for many market participants is that the stimulus and other measures being injected into the global system will cause overheating, especially as supply constraints are a short-term issue. This risk could be over-played, whilst the US will have its output gap close within a year, most other economies have such slack from COVID-19 damage that output gaps will take years to close.

Excess money supply

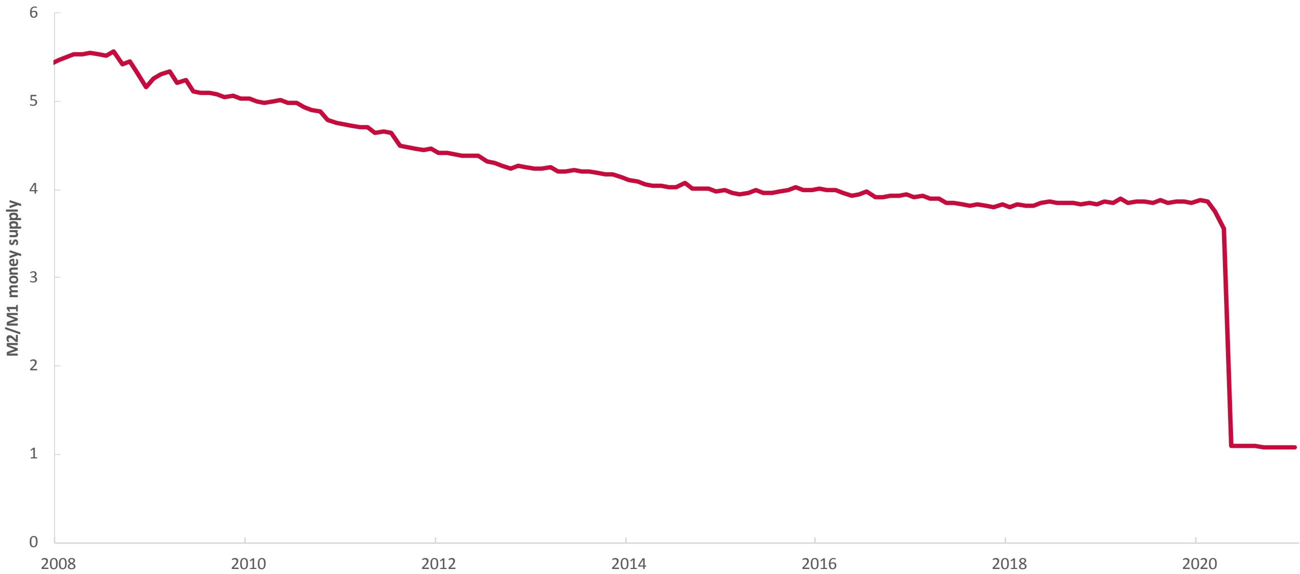
Probably the most touted reason given for future inflation is that central banks have printed excessive quantities of money and the theory goes that 'too much money chasing too few goods' garners higher prices.

It is true that central banks have created money, almost US$10 trillion of it over the pandemic, which is equivalent to 20% of the combined GDP of developed economies. Approximately 20% of the total supply of US dollars was created this past year.

But inflation is not an instant pudding with one ingredient, being new money creation, it requires other critical inputs. These being that banks extend this new money as loans to borrowers, that they spend it, that this causes demand to rise and at a rate that cannot be satisfied by existing supply.

To-date banks have been too cautious to extend loans, believing that in a pandemic, debtors might be incapable of repaying these loans. This has meant that the excess supply of new money has not found its way into the economy to stoke inflation. This process of money washing through the system is known as the money multiplier – higher money multipliers imply that new money creation is being put to work, chart 3 shows that similar to the GFC, the multiplier has been falling.

Chart 3: US money multiplier



Source: iNet, Northstar (March 2021)

Psychology - inflation expectations

In his address just this past week, Federal Chair Jerome Powell reiterated his committee's objective of 'having long-term inflation expectations well anchored at 2%' whilst acknowledging that inflation would rise to 2.4% this year before settling back to 2% in 2022 and heading higher in 2023. Prospective inflation is deeply linked to historical inflation levels because inflation is behaviourally affected. Consumers postpone or advance purchase decisions based on their future view of prices, which in turn causes deflation or inflation. Although the other risks raised above tend to be transitory and relatively manageable, one of the gravest threats causing inflation to adjust sustainably higher or deflation being entrenched is the expectation of future inflation. Most current surveys reveal that inflation expectations globally are rising, but only modestly so.

Conclusion

We titled this article, **'Inflation - friend, foe or figment of the market's imagination'**. Our concluding comments are firstly, that inflation is necessary, it is a natural by-product of a healthy growing economy. Secondly, that an indebted world cannot tolerate accelerating prices that force interest rates higher, making debt servicing unmanageable. Thirdly, that inflation is rising off very depressed pandemic levels and that the market is rational in acknowledging this. Our back of the matchbox calculation is that the Fed's predictions on prices seem reasonable. Lastly, that all the inflation factors presently in the system are transitory in nature and only when or if this changes, do we believe that it is credible to forecast a more sustained higher secular trend in prices.

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