



Economic Perspectives

The Wolf of Main Street: an inflationary surprise awaits



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With the invaluable assistance of Tom Trill and Yvan Berthoux

Inflation: the untethered wolf

- Blowing up the box!
- A 40-year monetary regime is crumbling
- Fiscal prudence is abandoned
- Invoice, rent and tax payment terms relaxed
- Governments providing loan guarantees
- Debt delinquency redefined
- Defaults suppressed
- Central bank independence is suspended
- Inflation targets are obsolete
- The inflationary wolf is free to roam

Predicting inflation amidst monetary regime change

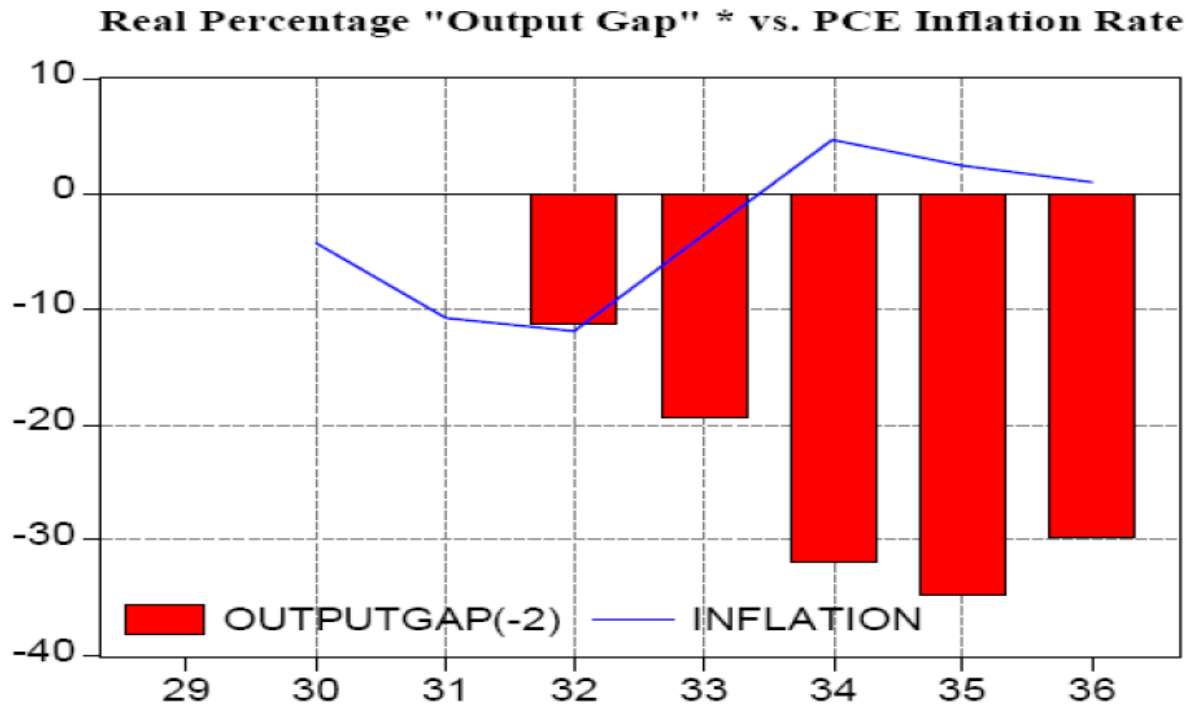
- Inflation is a complex, multi-faceted phenomenon
- Encompassing geopolitics, political economy, inter-generational dynamics, sociology and macro-financial economics
- During periods of institutional and political stability, inflation models work quite well
- During periods of regime change, models fail
- This is such a time – *Blowing up the box!*
- No substitute for detailed analysis of all the forces at work to gain insight into likely inflation dynamics

Recap of the Four Inflations

- Not mutually exclusive but distinctive
- Keynesian overheating in goods, services and labour markets caused by excess demand pressure or the constriction of supply capability or both
- Excessive money supply growth (arising from over-lending to the private sector)
- Supply chain inflation, running from emerging to developed market economies
- Fiscal indiscipline (undermining monetary policy, inflation expectations and attractiveness of domestic financial assets)

Why the Keynesian output gap is a bad predictor

- OG would have failed miserably in 1930s & 1970s

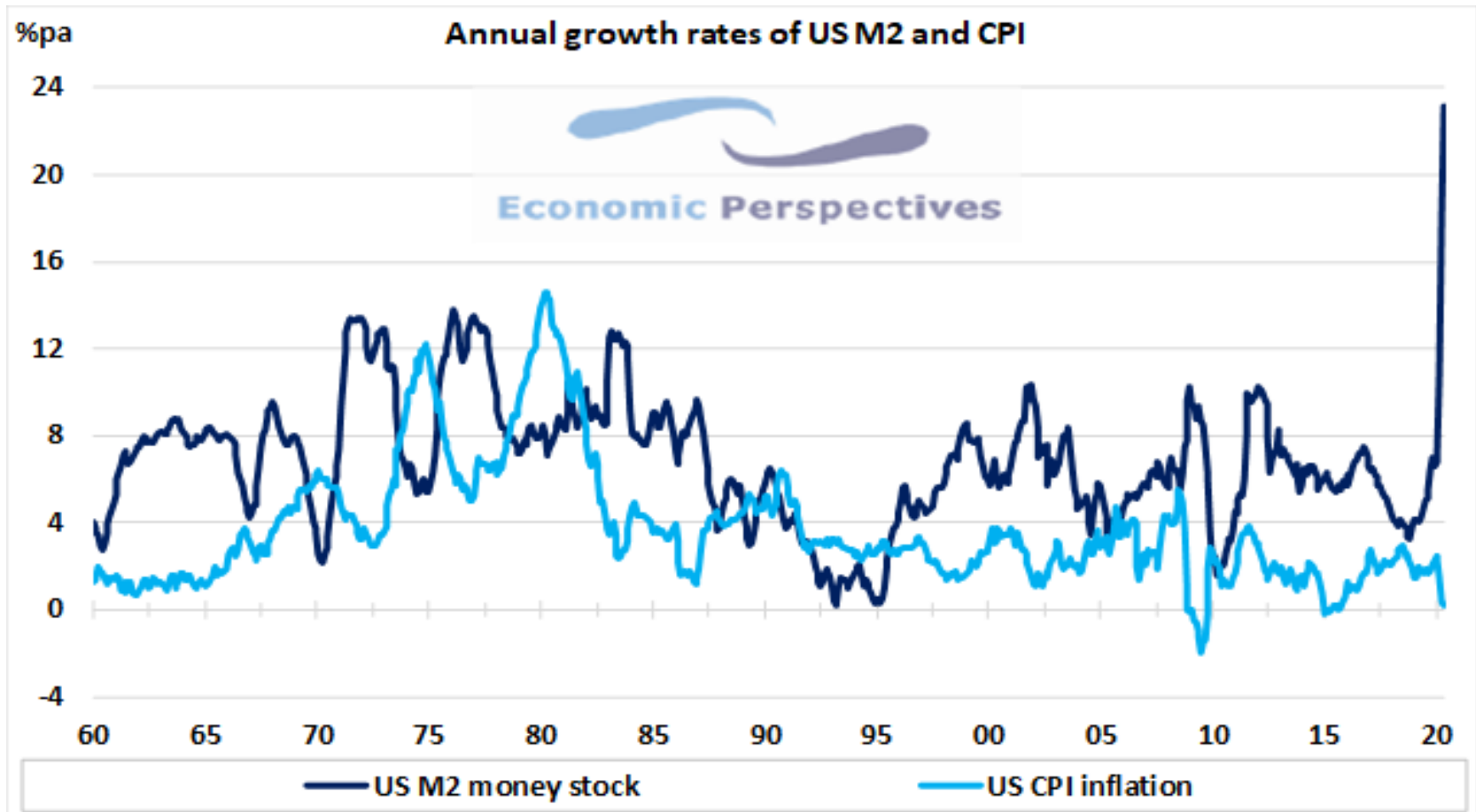


* Real percentage output gap was estimated by projecting 1929 real GDP level by 3% per annum. The output gap is advanced by 2 years.

Source: *The Econtrarian*, 1 June 2009

Why money supply growth is a bad predictor

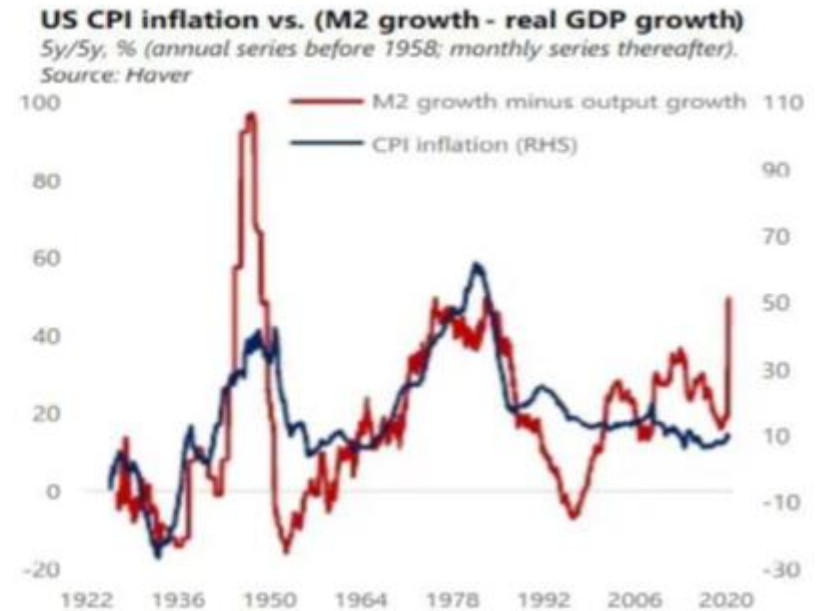
- US firehose *need* not be inflationary but likely will



Data source: Eikon Reuters

Monetarists emerging from the shadows ...

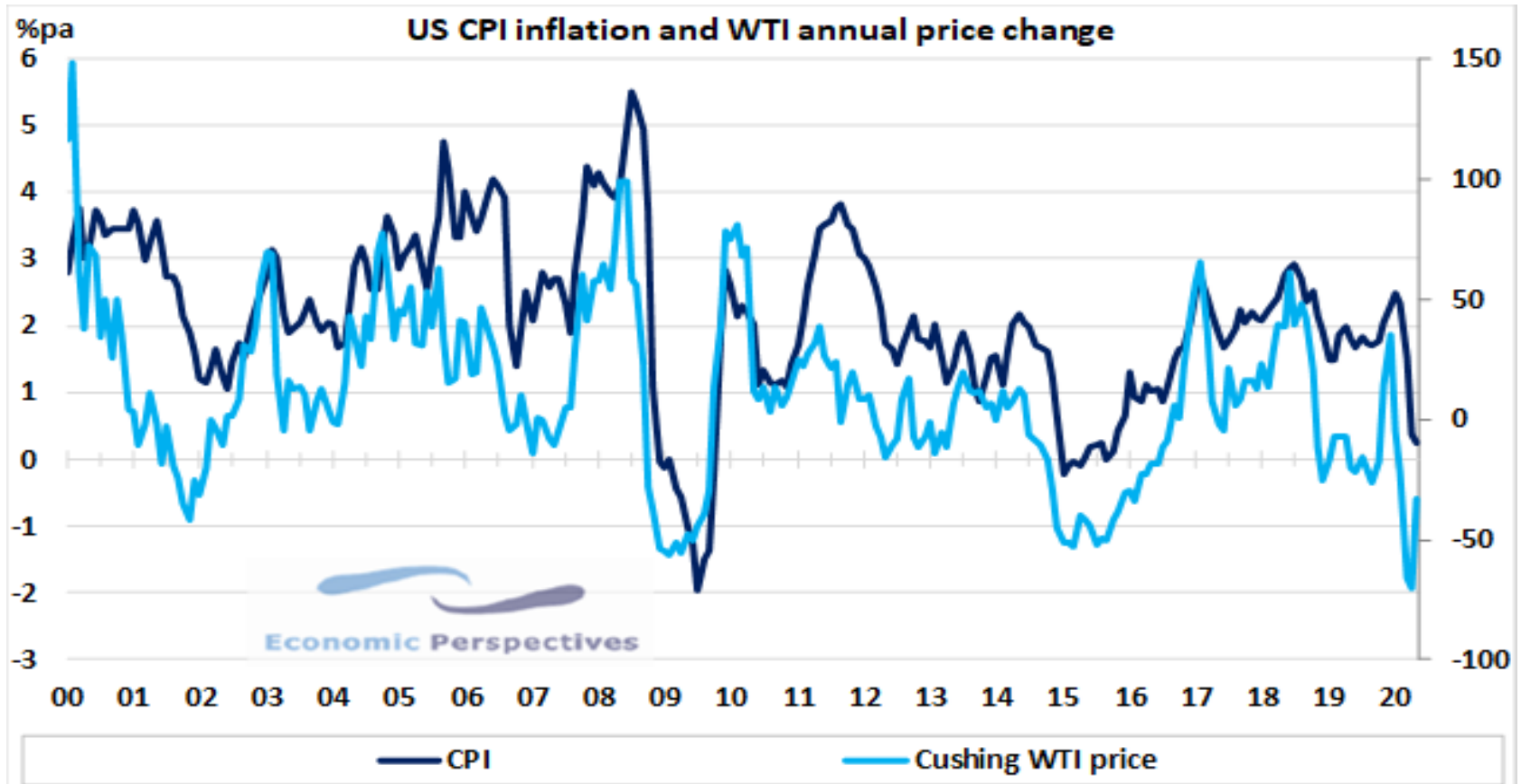
- ... but the multiplier is still unstable



Source: Tudor Investment Corporation

Geopolitics, oil prices and supply chain inflation

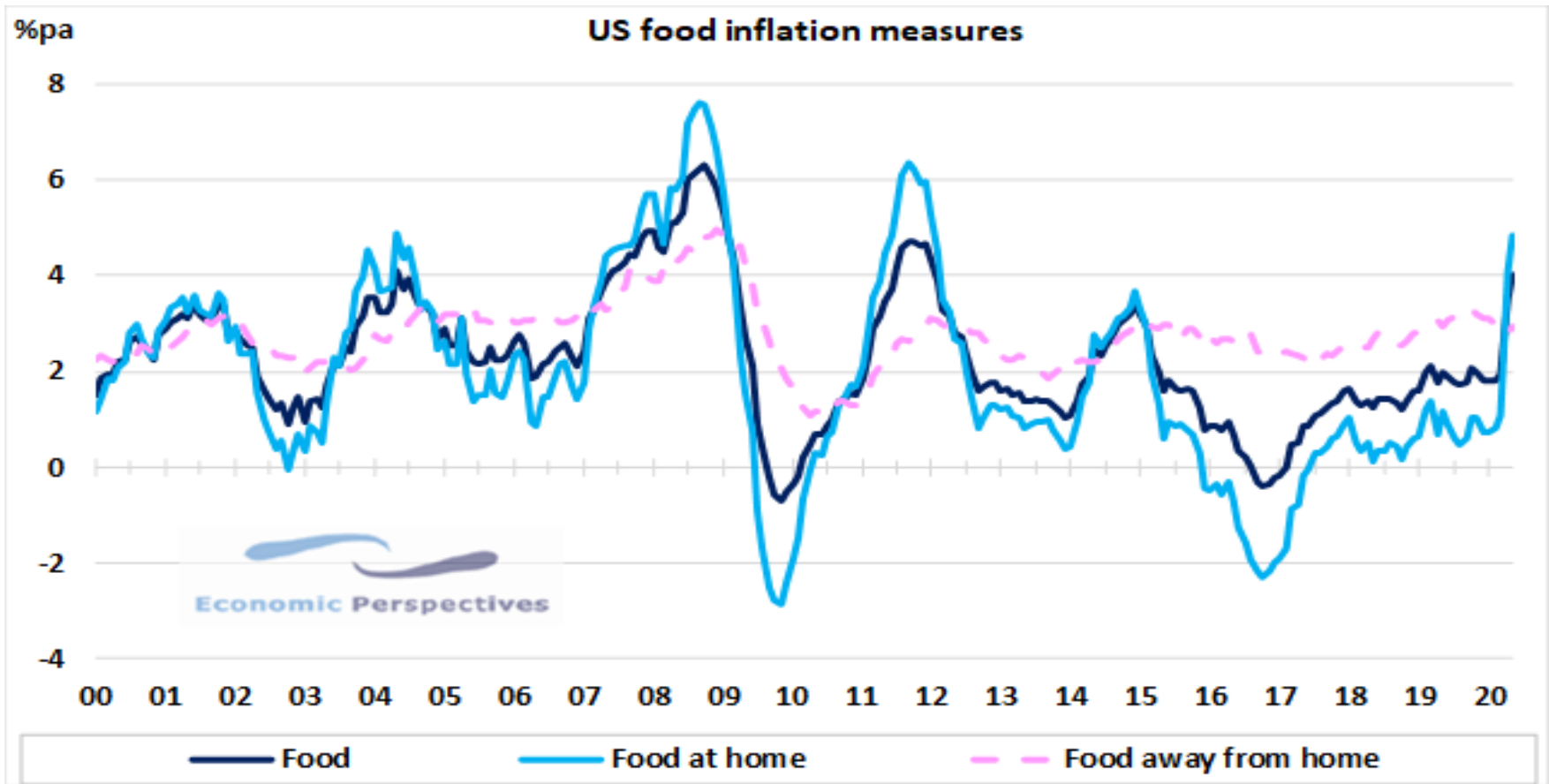
- Oil prices are key aspect of EM >> DM transmission



Data source: Eikon Reuters

Why is US food inflation soaring?

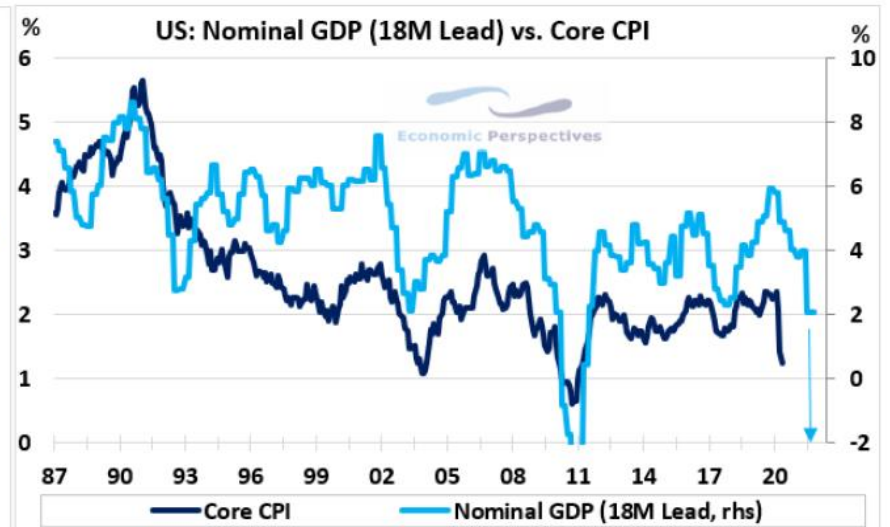
- Perils of a bifurcated food supply chain



Data source: Thomson Reuters Datastream

Forecasting looks easy ... but is littered with bear traps

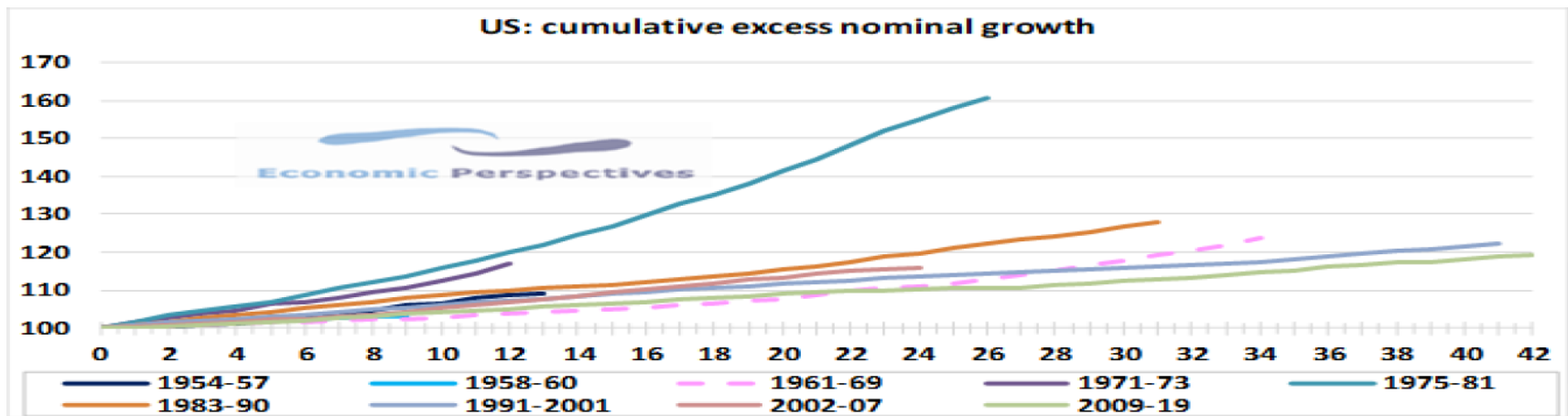
- Beware a rapid nominal recovery that turns the deflation forecast on its head



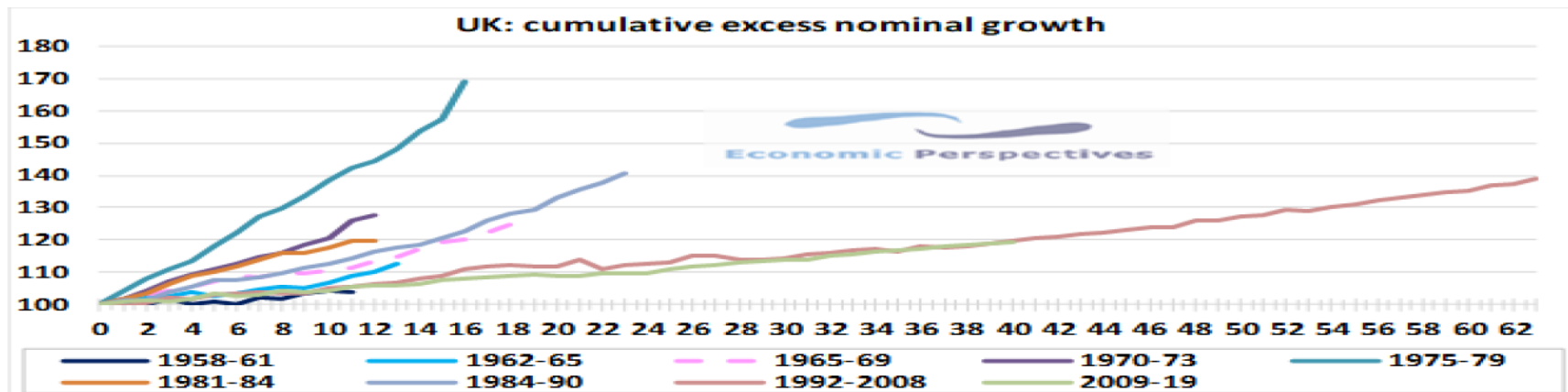
Data source: CPB Netherlands, FRED

Nominal recovery will outstrip real recovery

- More desperate the fix, faster the inflation



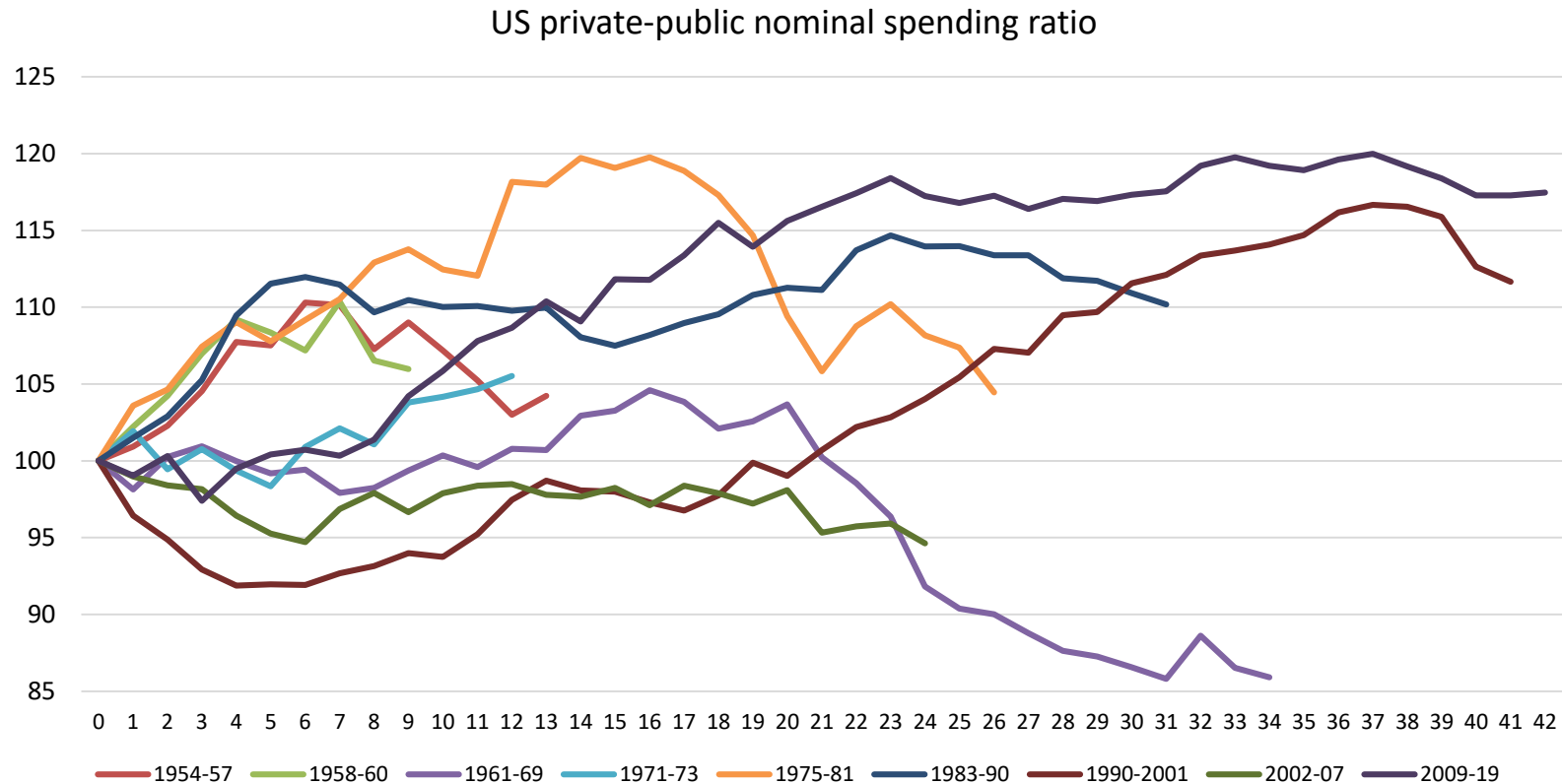
Data source: Thomson Reuters Datastream



Data source: Thomson Reuters Datastream

Government as an instigator/facilitator of inflation

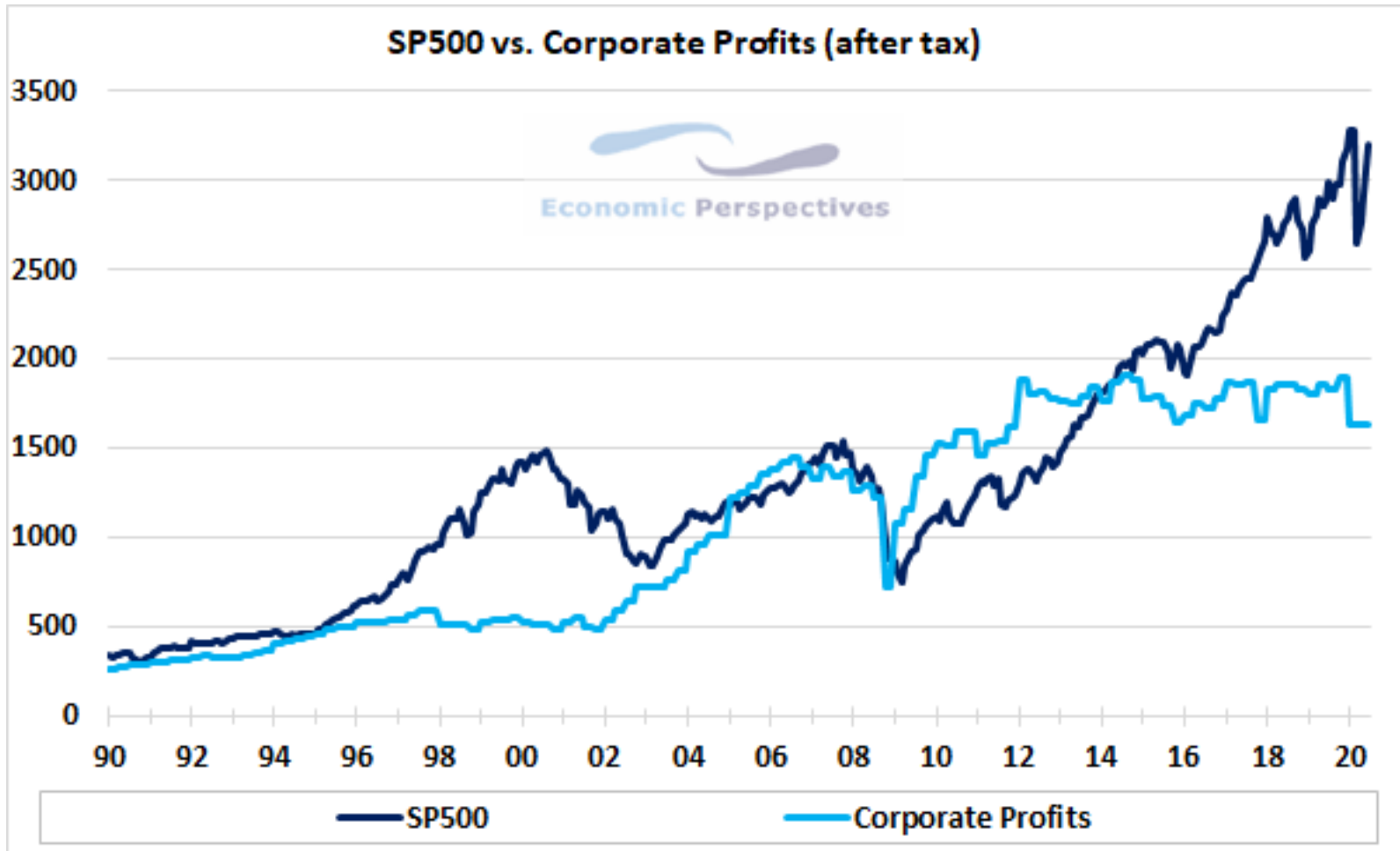
- Recoveries have become tilted to public spending



Data source: US Bureau of Economic Analysis

Real recovery: why profitability matters

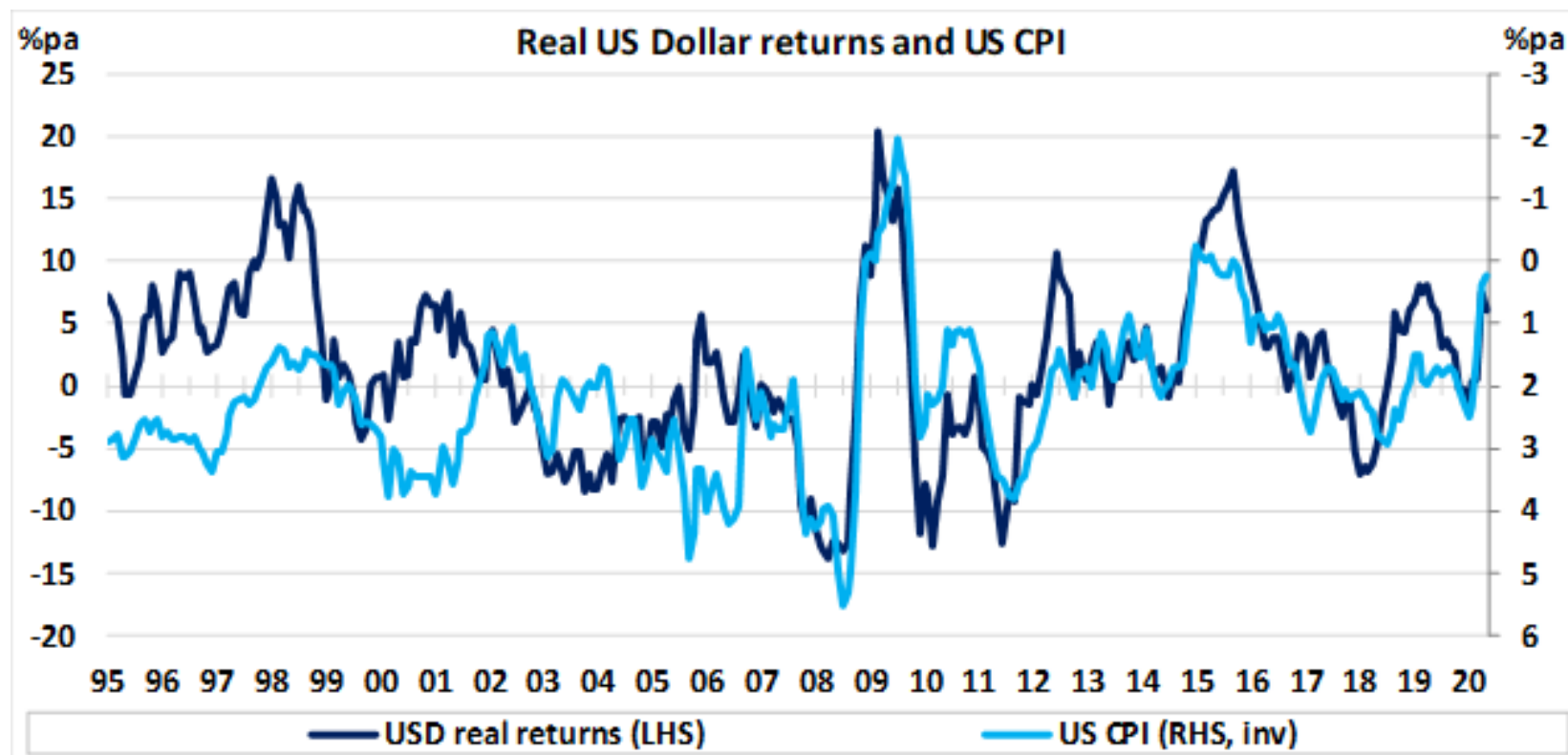
- “Profits are an opinion; cash is a fact” (Rappaport)



Data source: Eikon Reuters, FRED

The pivotal role of the US Dollar

- Erosion of 'safe asset' status



Data source: Eikon Reuters

Why are inflation forecasts so disperse?

- No common understanding of the inflation process
- No agreement on which data items are important
- Three dimensions of disagreement:
 - Priors or biases
 - Analytical models or theoretical structures, reflecting schools of economic thought
 - Weight to be attached to various data items
- Forecast dispersion reflects the striking disparity between inferences drawn from the output gap and money supply growth

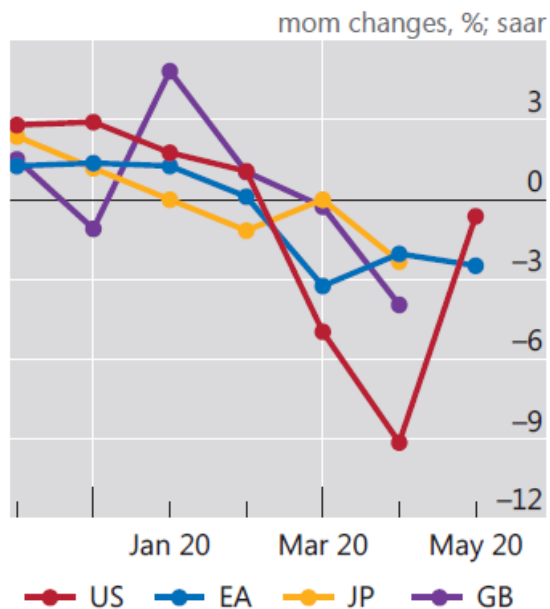
Beware strongly-held views of the inflation outlook

Name	Profession	Inflation / Deflation	Favoured assets
Charles Goodhart and Manoj Pradhan	Academic/Economist	Inflation	
Olivier Blanchard	Academic/Economist	Deflation	
David Miles and Andrew Scott	Academic/Economist	Deflation more likely	
Jeffrey Gundlach	Investment Manager	Inflation	Bearish on US Dollar and Stocks Bullish on Gold non-US equities
Howard Marks	Investment Manager		Defensive allocation: high-quality companies rather senior in the capital structure
Paul Tudor Jones	Investment Manager	Inflation	Mega bull on Bitcoin
Paul Singer	Investment Manager	Inflation	Gold
David Einhorn	Investment Manager	Inflation	Gold
Crispin Odey	Investment Manager		Gold
Stanley Druckenmiller	Investment Manager		Defensive allocation: extremely poor risk reward on equities
Diego Parrilla	Investment Manager	Stagflation	Gold
Danielle Lacalle	Independent Economist	Stagflation	Gold
Jesse Felder	Independent Economist	Inflation	Bearish on US Dollar and stocks Bullish on Gold
David Rosenberg	Independent Economist	Deflation first (for up to 3 years) Then inflation	Bullish on inflation hedges: TIPS, Gold, commodities, precious metals, Real Estate and farm lands
Ben Hunt	Independent Economist	Concerned on Inflation	Investors need to hedge against inflation uncertainty
Lakshman Achuthan	Independent Economist	Deflation first, then inflation	
Russell Napier	Independent Economist	Inflation, Financial Repression	Bearish on bonds and EM markets with too much foreign currency debt Bullish on USD, Gold, Switzerland, Singapore
Lacy Hunt	Independent Economist	Deflation	
Albert Edwards	Economist / Bank	Deflation	
Kolanovic / JP Morgan	Economist / Bank	Inflation	Bearish on USD Bullish on Gold
Jefferies	Economist / Bank	Inflation	Commodities Basket

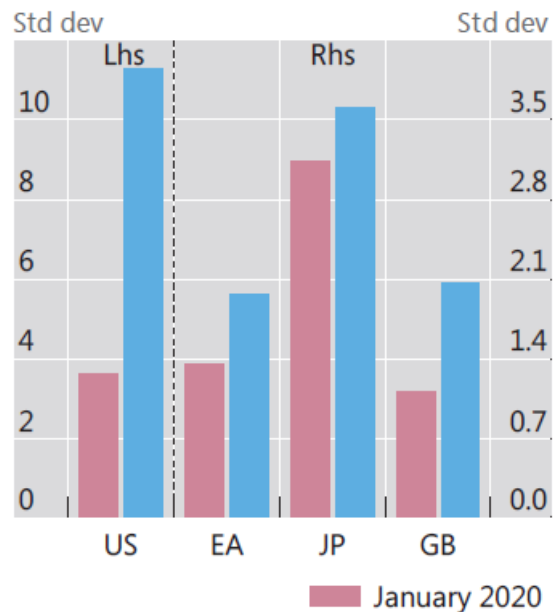
Beware, inflation uncertainty is rising

- Powerful, conflicting forces are at work

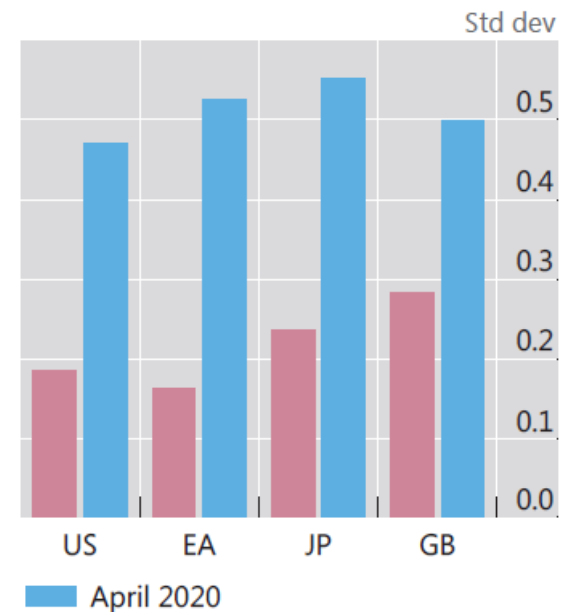
Headline inflation



Dispersion of inflation across sectors¹



Dispersion of 2021 headline inflation forecasts²



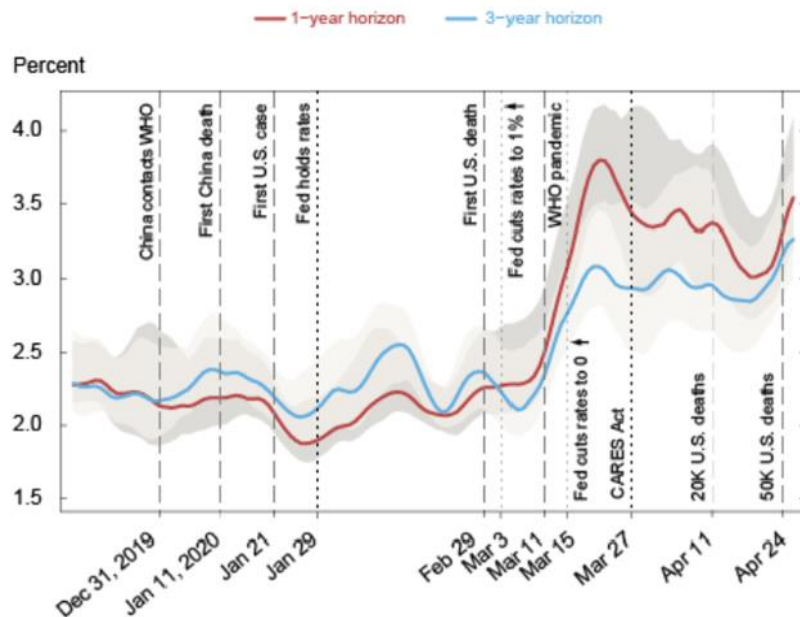
¹ Standard deviation of year-on-year inflation across 19 (US), 12 (EA and GB) and 10 (JP) sectors. ² Standard deviation of 2021 consumer price inflation forecasts based on monthly surveys across professional forecasters.

Sources: Consensus Economics; Datastream; Eurostat; national data; BIS calculations.

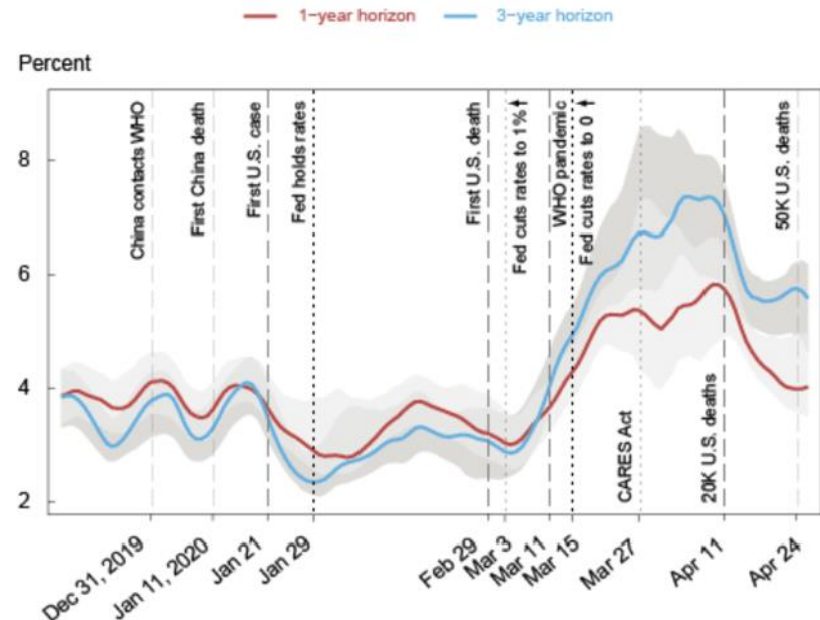
US inflation uncertainty is rising

- “Whatever it takes” = No matter the cost

Inflation Uncertainty Has Increased Sharply With the Onset of COVID-19



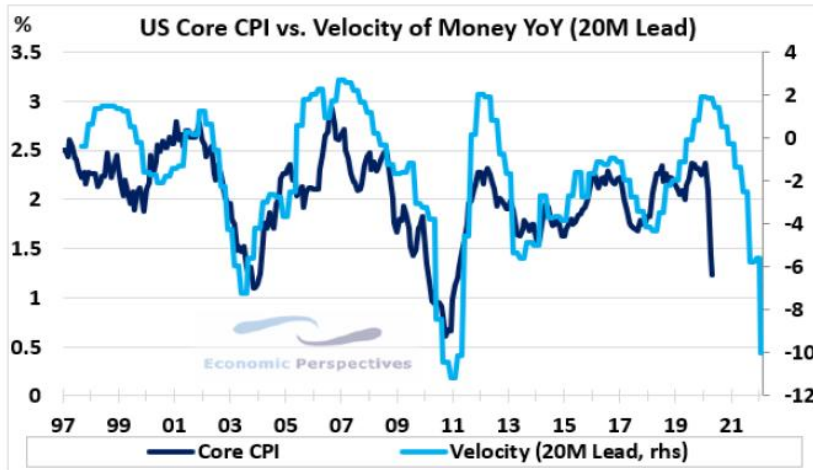
Disagreement in Inflation Expectations across Respondents Has Risen since the Emergence of the COVID-19 Pandemic



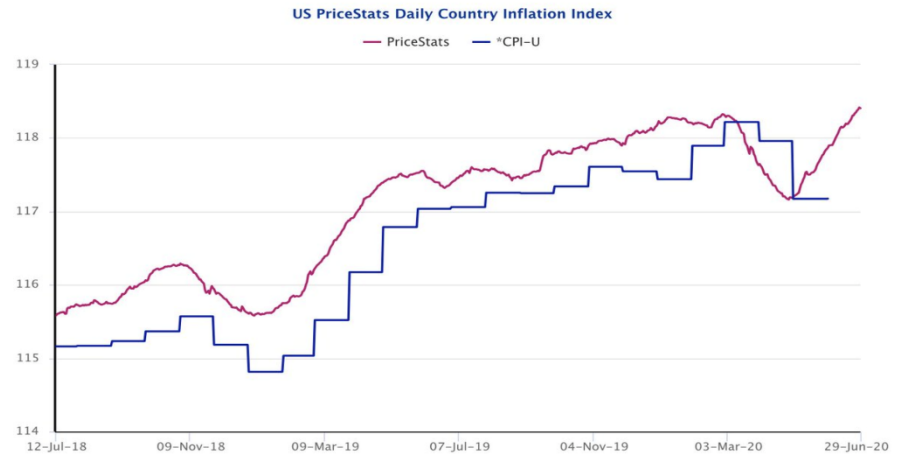
Source: NY Fed

Where is US inflation heading in the near term?

- Models say down; evidence says up!



Data source: FRED



Source: State Street Global Markets Research

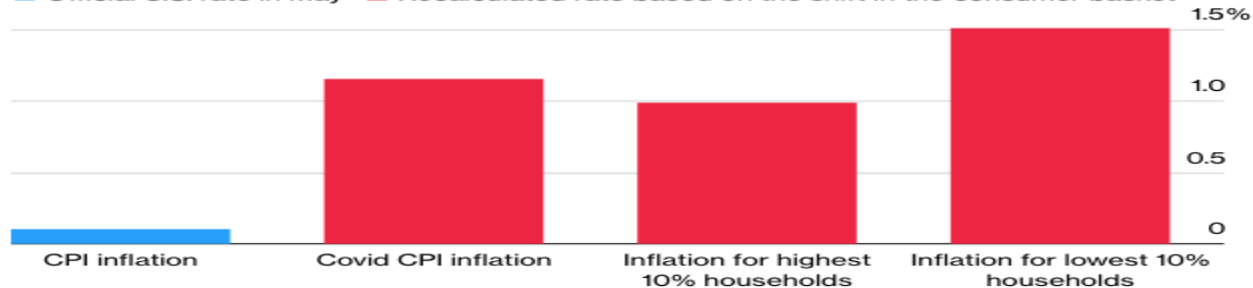
Date: 07/11/2018-06/29/2020

Source: State Street

Recalculating Inflation

'Have nots' suffered disproportionately as virus changed buying patterns

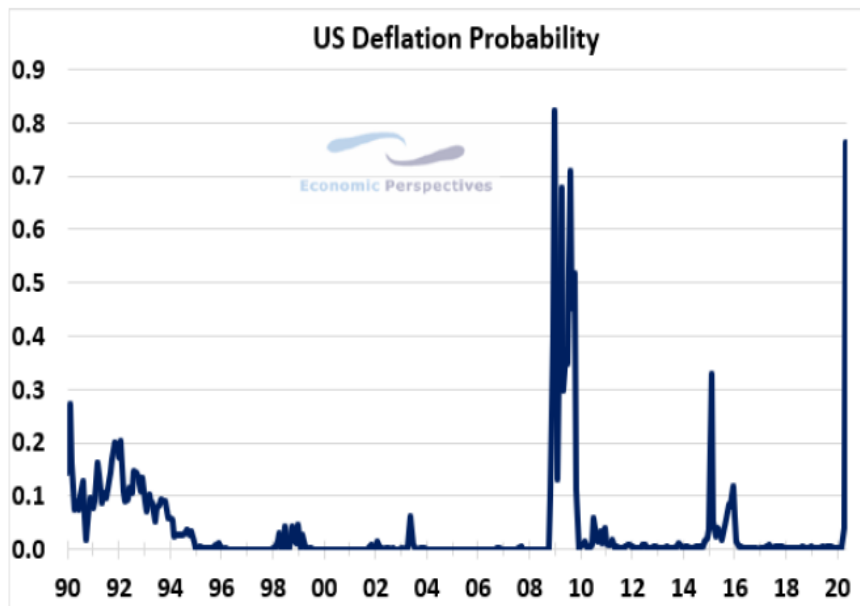
Official U.S. rate in May (blue bar), Recalculated rate based on the shift in the consumer basket (red bar)



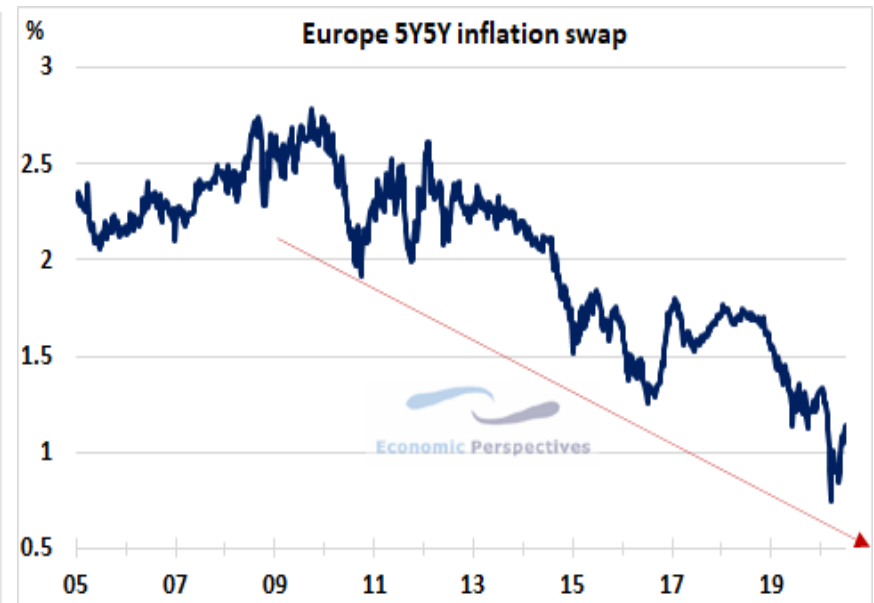
Sources: Bloomberg Economics, BLS, <https://opportunityinsights.org>
 Note: Inflation for the lowest (highest) 10% takes the alternative CPI basket for the lowest (highest) decile of household income before taxes from the 2018 Consumer Expenditure Survey

Tails of the unexpected!

- Inflation risk is unpriced – in US and Europe

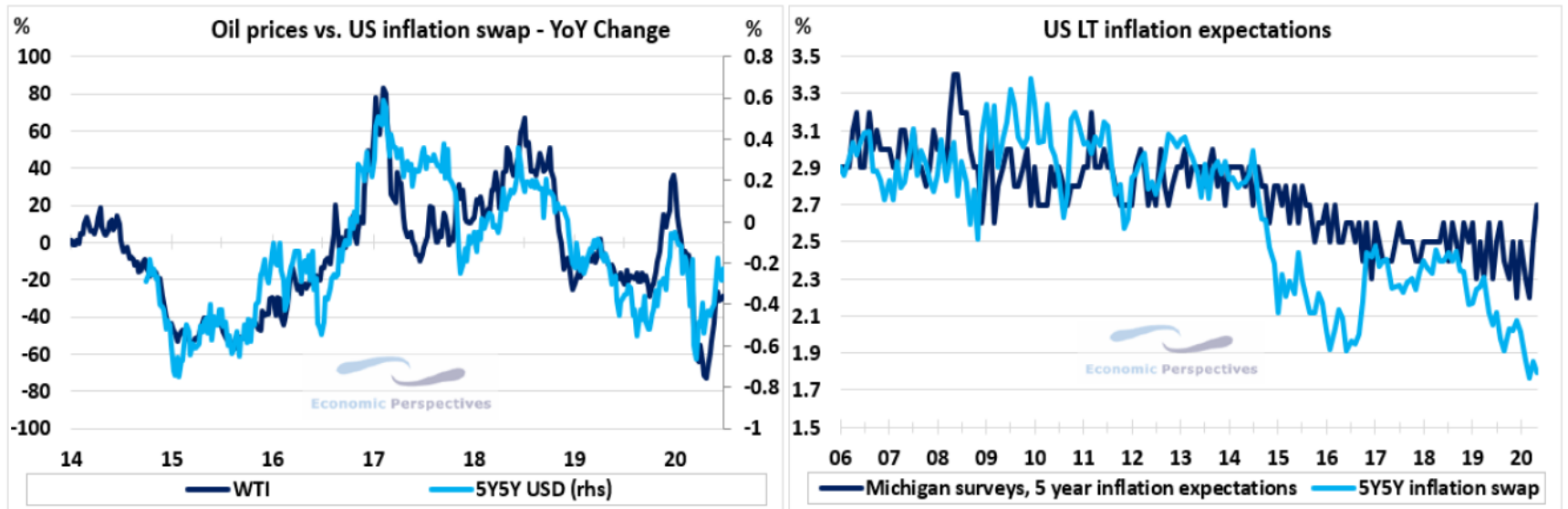


Data source: Eikon Reuters, FRED



Inflation pricing vs inflation expectations

- People have expectations; markets have prices



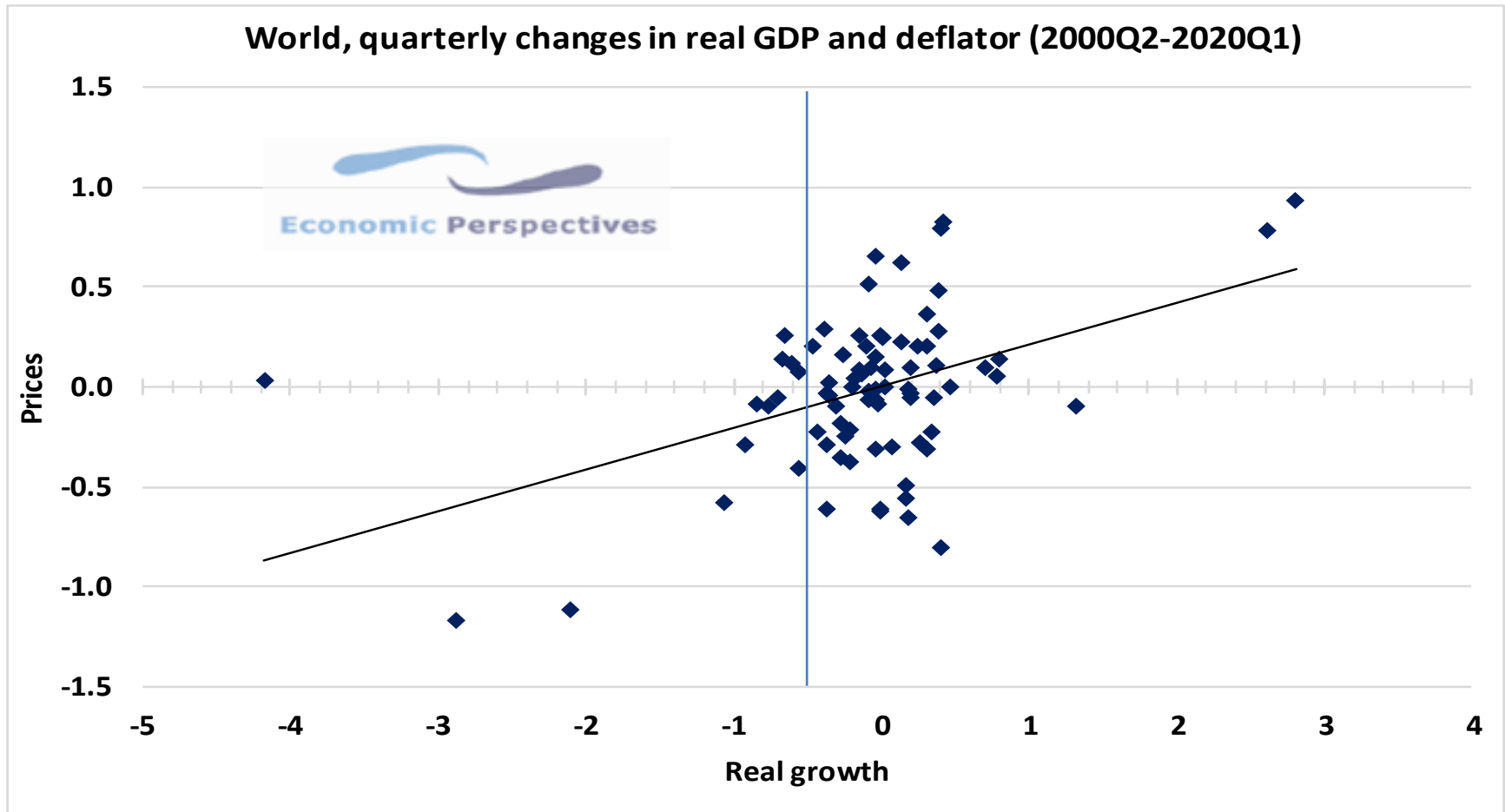
Data source: Eikon Reuters

Ending up in stagflation?

- Depressive forces are for real
- Governments cannot sustain income replacement transfers, subsidies & loan guarantees indefinitely
- Distinct risk that private sector recovery will peter out by next Spring and the stalled debt delinquency and default cycle will resume
- Governments will increasingly monetise their budget deficits – and existing debts
- Opening the way for the conjunction of faster inflation and stagnant output in 2021-22

Global output and inflation appear positively correlated ...

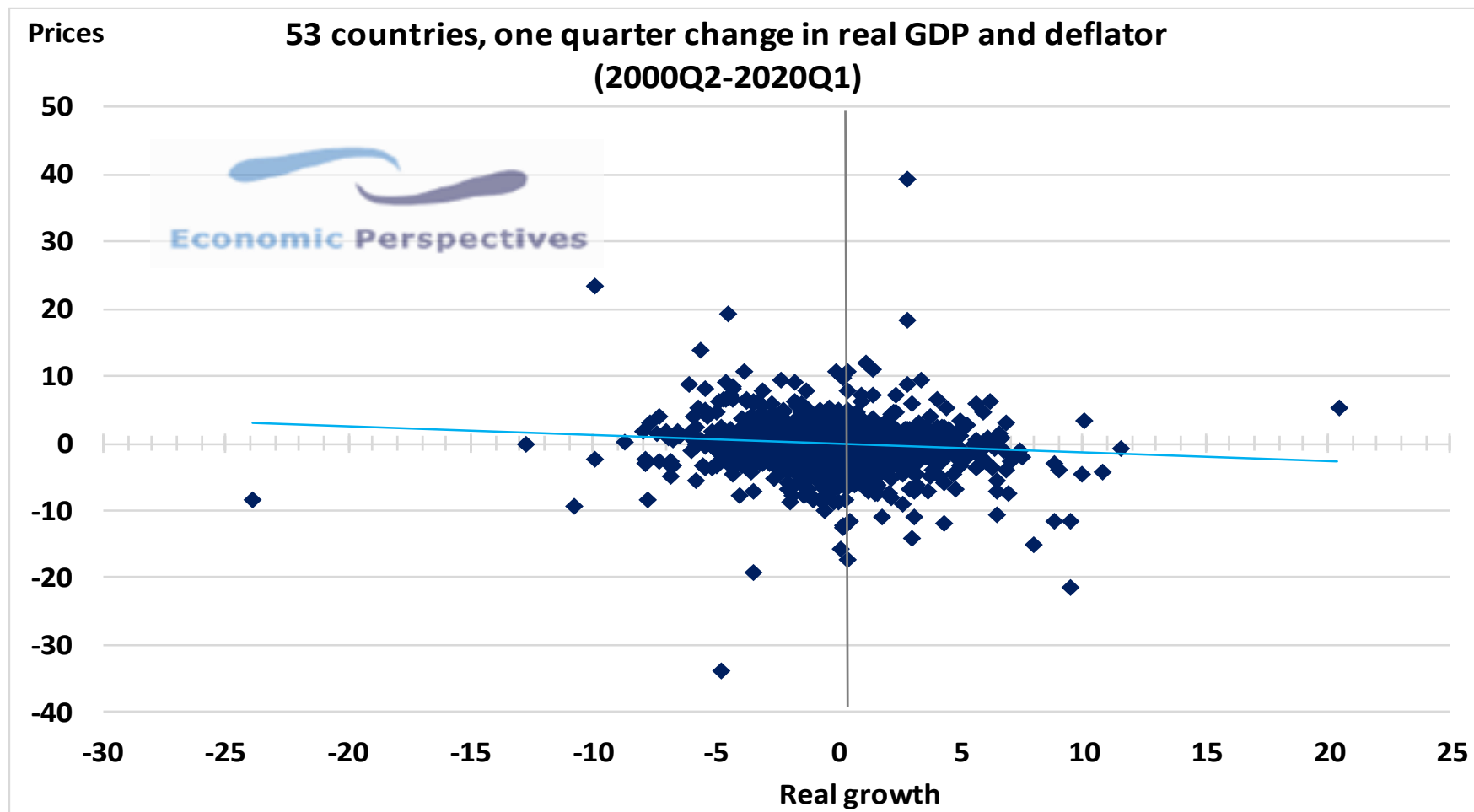
- .. But the association rests on very few data points



Data source: Thomson Reuters Datastream

At the national level, the correlation evaporates

- Disinflationary growth and stagflation occur often



Data source: Thomson Reuters Datastream

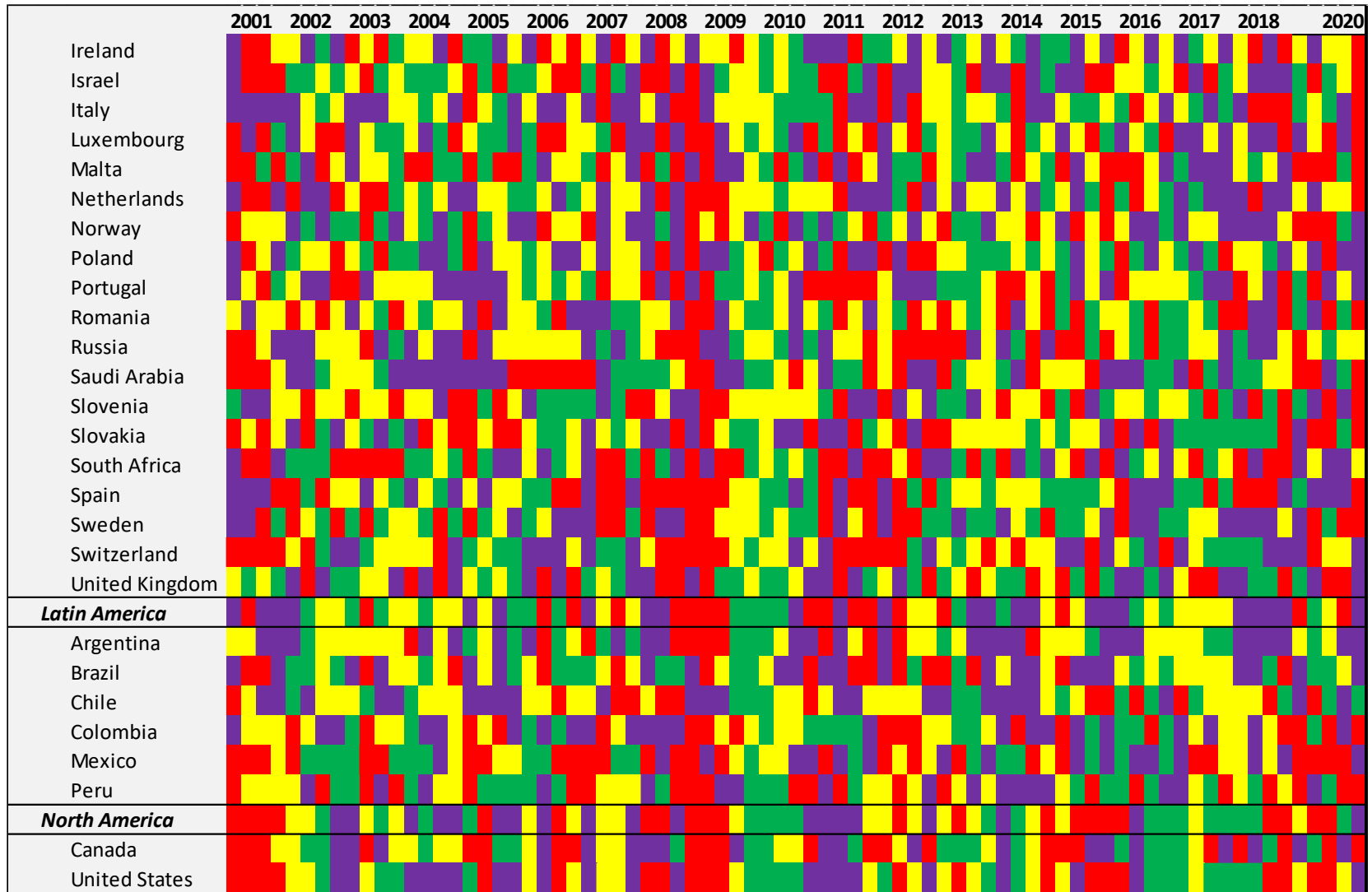
Cells have almost equal proportions of all states

- Green: inflationary growth; Purple: stagflation; Red: deflation; Yellow: disinflationary growth



Data source: Thomson Reuters Datastream

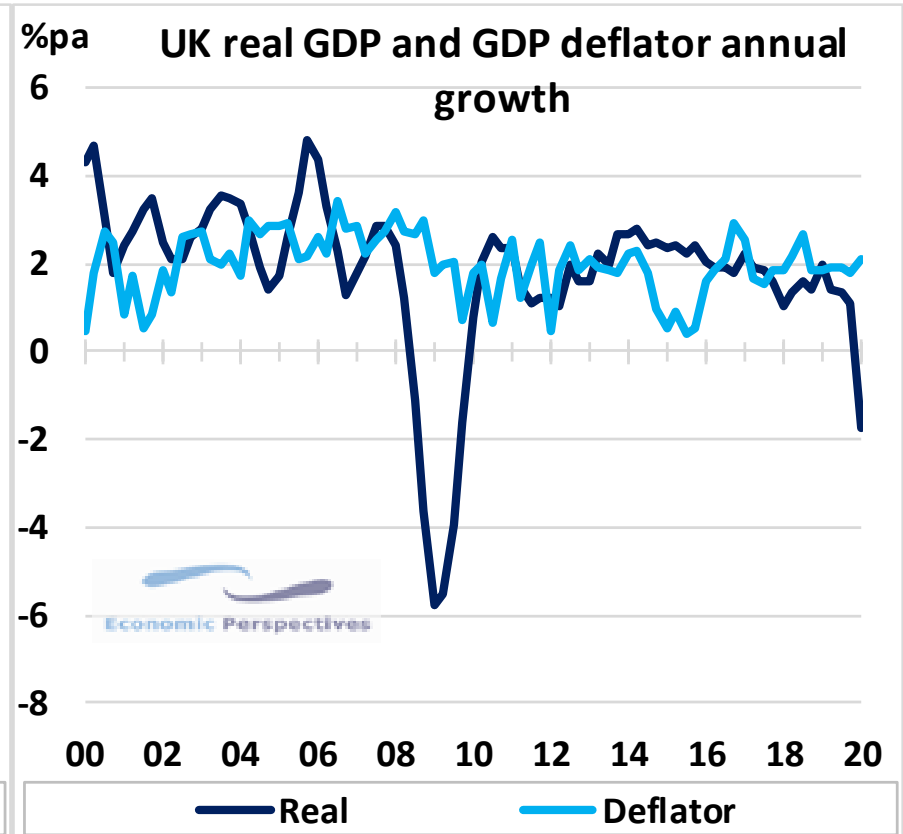
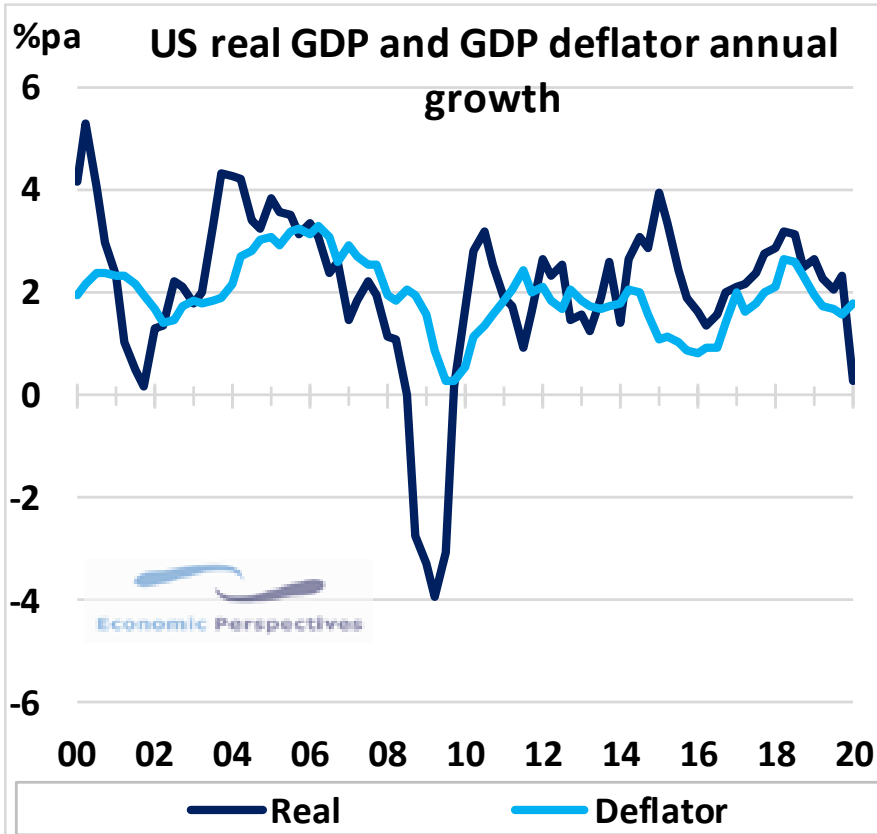
Expect a splurge of red to give way to green and purple



Data source: Thomson Reuters Datastream

National growth-inflation narratives are distinctive

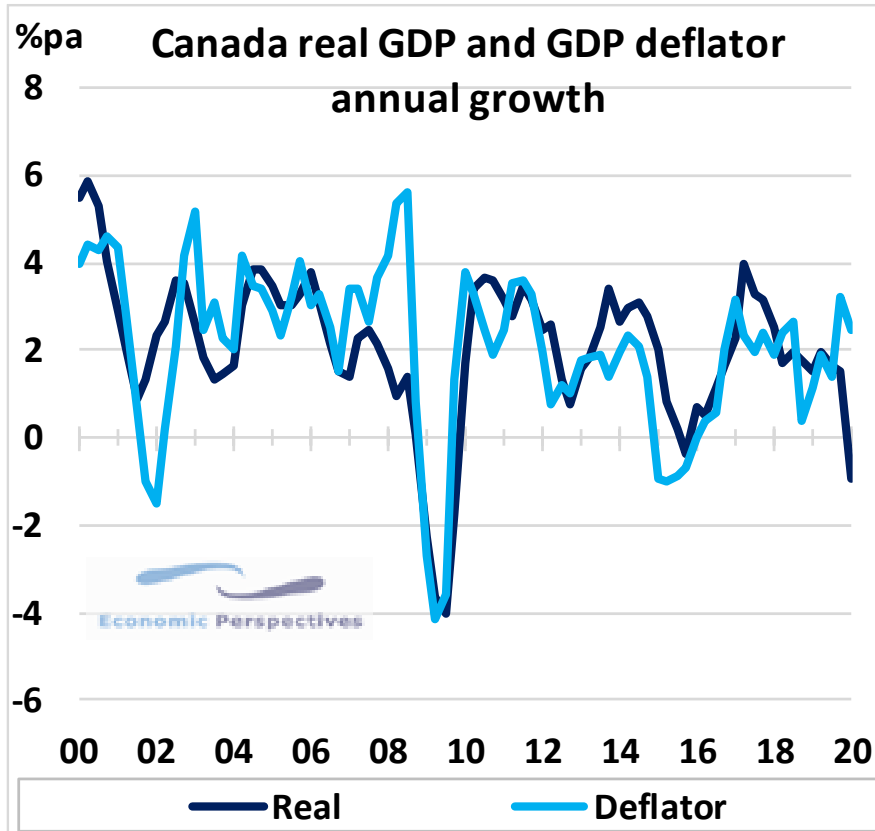
- Importance of supply-side dynamics



Data source: Thomson Reuters Datastream and EP calculations

Canada's growth-inflation correlation is high

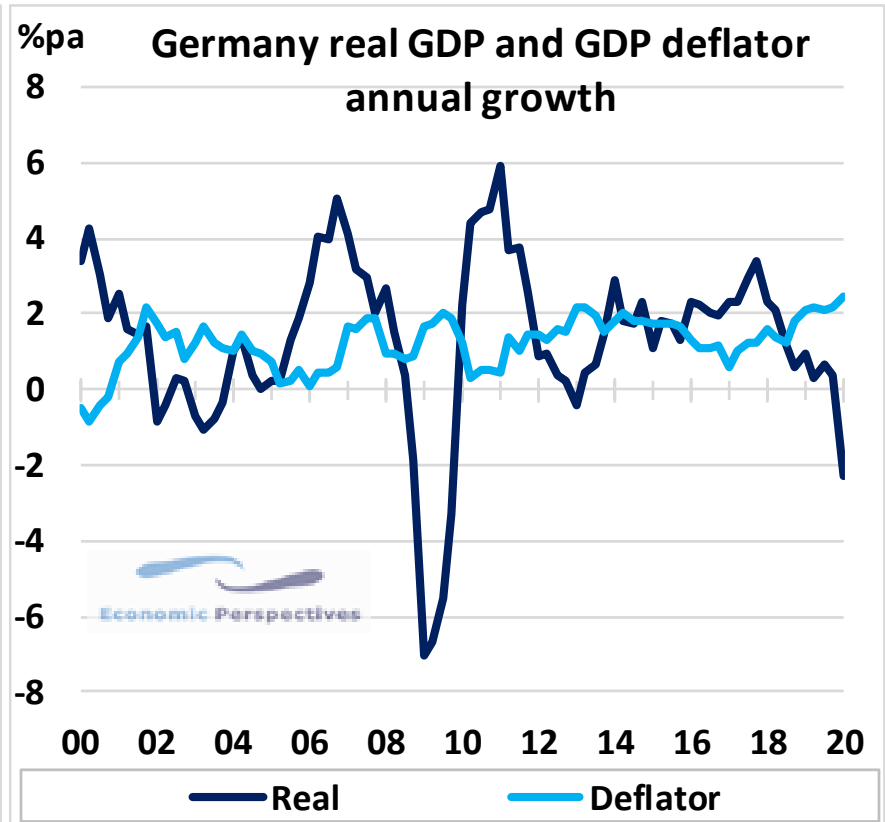
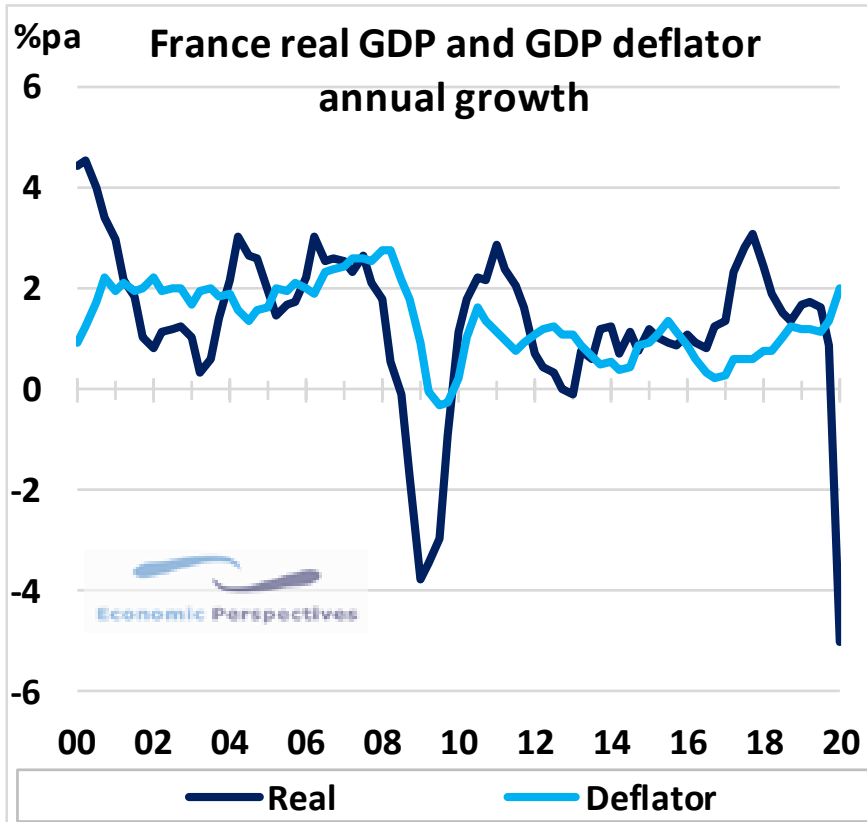
- China's is not!



Data source: Thomson Reuters Datastream and EP calculations

France and German correlations differ ...

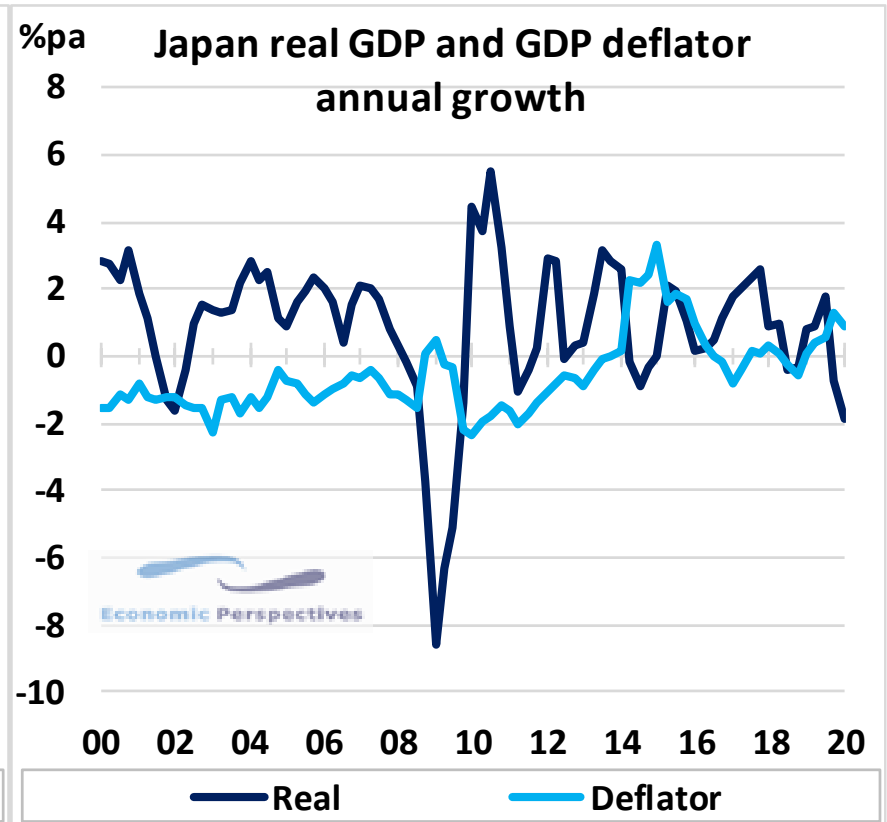
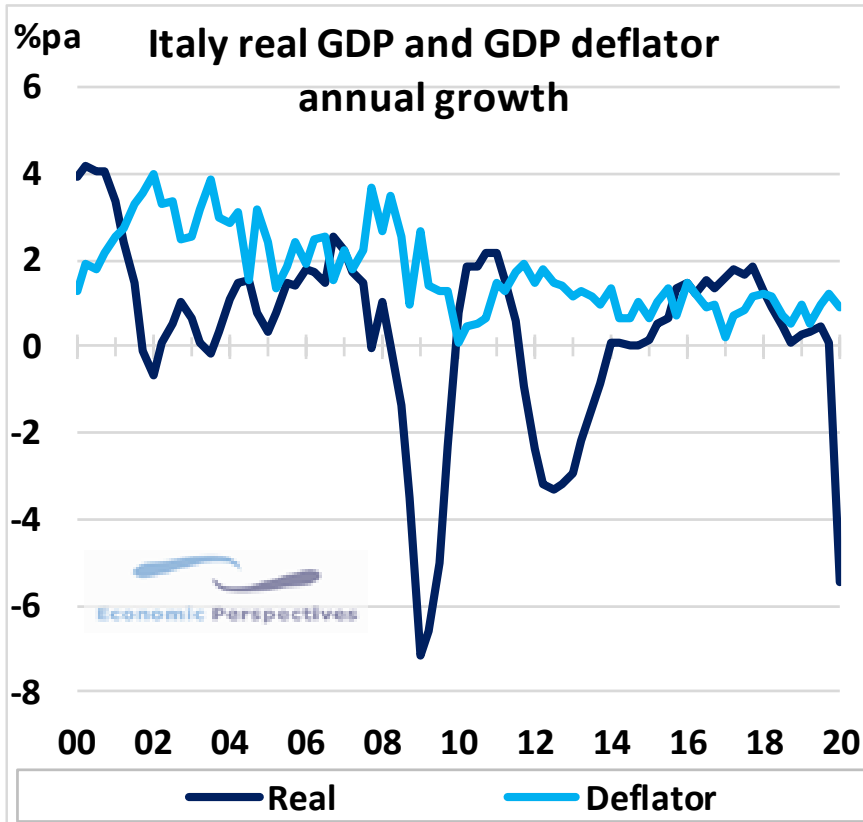
- ... despite sharing a currency



Data source: Thomson Reuters Datastream and EP calculations

Italy's stagnation has often been inflationary ...

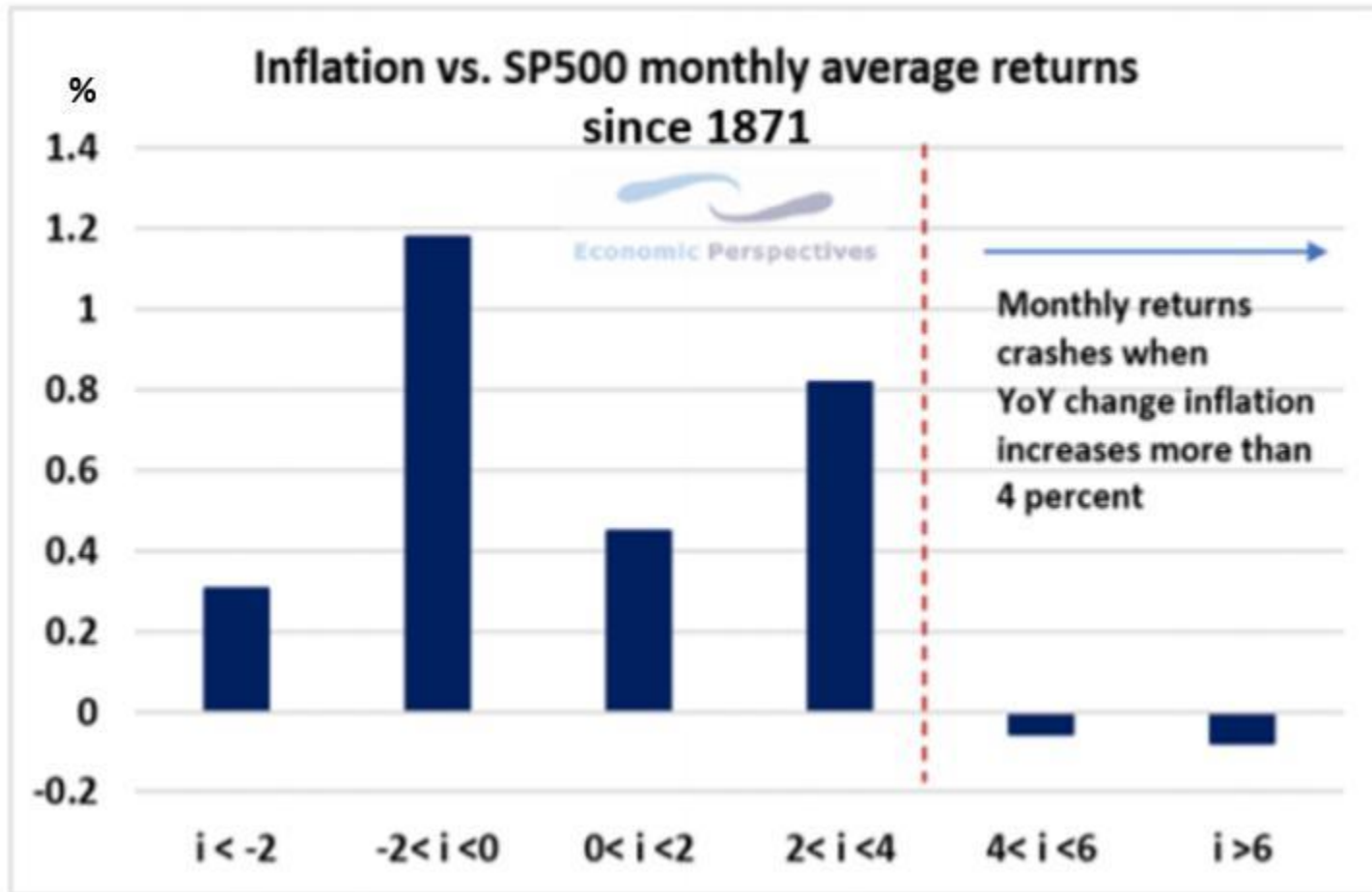
- .. while Japan has coupled deflation with growth



Data source: Thomson Reuters Datastream and EP calculations

High inflation is also negative for stocks

- What happens to the traditional 60/40 equity bond portfolios if inflation rises above 4 percent?



Data source: Eikon Reuter, FRED, EP calculations

Conclusions

- In advanced economies, governments have taken considerable risks, giving rise to elevated inflation uncertainty and unpriced upside risk
- Deflation risk could reappear in 2021 in a worst-case scenario
- Expect public works programmes on a grand scale
- Beyond short-term inflation dynamics, stagflation is our central scenario for 2021-23
- An inter-generational monetary reset is underway



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