

The Little Inflation with the Big Bite

Welcome to this Economic Perspectives breakfast seminar – the fourth one we have held here, in the splendid surroundings of the Innholders Hall. In previous seminars, we have addressed the unresolved macroeconomic issues arising from the over-use or mis-use of leverage (Debt and Delusion: lessons unlearned); the importance of considering the inflation narrative as distinct from the activity, or growth, narrative (Year of the Stag); and understanding very low real interest rates as a by-product of irresponsible policymaking rather than as a New Normal (The Real Reason Real rates are so low). The format remains the same. My presentation will last about 20 minutes, allowing plenty of time for questions.

Today, I intend to tackle the **global inflationary outlook head-on**. After almost 20 years since Debt and Delusion, friends have long given up asking if I plan to write another book. However, if I were ever to indulge in that masochistic endeavour again, then inflation would be the most likely topic. **Inflation sits at the heart of every significant economic debate and every important investment decision**. Yet the determination of inflation cannot be encapsulated in an economic model, because **at its root it describes an enduring human power struggle over real resources**. That power struggle has an economic dimension, in relation to the contributions of, and rewards to, labour and capital, but **it has also an international dimension, an inter-generational dimension and a socio-political dimension**.

When I started my career at the London Business School in 1975, global inflation – then running at 12 per cent a year – was public enemy number one. The battle to bring inflation under control was fought on four fronts: **the return to responsibility in government budgets, the restoration of a satisfactory return to capital** (which entailed many costly confrontations with labour unions and other vested interests), **the removal of tariff and non-tariff barriers to world trade** and the **reformulation of domestic monetary policy**. It required concerted action on all four fronts to deliver the low inflation environment we have enjoyed, in advanced economies, since the early 1990s and, about a decade later in emerging economies.

Conversely, it would require substantial upheavals for global inflation to return to double-digits – the **Large Inflation**. In some measure, it would require fiscal irresponsibility, the restoration of a satisfactory return to employed labour (which may entail many costly confrontations with private monopolies and uncompetitive practices), the re-imposition of barriers to international trade and the return of monetary policies that are dominated by the need to finance large budget deficits. While we have ample indications that the world is travelling in this direction – and, arguably, **four protagonists in Donald Trump, President Xi, Shinzo Abe and Narendra Modi** – the Large Inflation is neither a certain nor an imminent outcome. Observe nonetheless that trade tensions display the international dimension, fiscal tensions betray the inter-generational dimension and labour market tensions portray the socio-political dimension. While, for now, the Large Inflation is a prospect, not a reality, **the key point is that it is a more credible prospect than it was 5 years ago or even 2 years ago. The pricing of distant inflation risk should already reflect this, much more than it does**.

Turning the spotlight on the Little Inflation, our contention is that **global inflation will continue its upward trajectory for at least one more year**. After 5 years of disinflation, the tide turned for advanced economies in late-2015. In emerging economies, the turn is much more recent. The last inflationary flurry was in 2010-11 in the context of dramatic increases in energy and commodity prices. It failed to gain much traction then due to the significant under-utilisation of real resources in the wake of the GFC. **Today, the outlook for global inflation is shaped by the interaction of the reckless extension of easy credit policies with supply bottlenecks. The result is a multifaceted inflationary process that combines several distinct transmission mechanisms**.

Before describing these in more detail, it may be helpful to discuss the **nominal framework which provides the overarching context for global inflation**. On page 5 of the slide pack is shown the straightforward narrative of currency-neutral, global nominal GDP growth. It traces the journey from a 6 per cent world in 2003 to an overstretched 10 per cent world in 2007, via zero growth in 2009 and a rebound to almost 9 per cent in 2010, to a worrisome nominal deceleration that reached 4 per cent in 2015. **Just as the debt deflationists were declaring victory and impending doom, a funny thing happened.**

The simultaneous – but hardly co-ordinated – policy relaxations in Europe, Japan and China kickstarted global nominal GDP growth, **lifting us from a 4 per cent world to a 6 per cent world in 2 years**. Quite understandably, **the strongest nominal accelerations have been in Europe and Asia, with North America as a laggard in the global procession**. However, the US has picked up the running in the past 6 months and is **on course to deliver bumper nominal growth this year**. Private sector debt gathered momentum last year, as capital market issuance revived and EM bank lending growth also recovered, and is tracking at around 5 per cent annual growth: **unspectacular, but in conjunction with very tight credit spreads (page 14), sufficient to sustain the nominal GDP environment.**

Perversely, the more robust the global economic performance – thinking now in terms of reported real GDP growth – the greater the support for the further expansion of the credit aggregates. **Default risk is missing, presumed dead**. Corporate earnings growth has been invigorated by the uplift in global nominal incomes and expenditures, causing investors to worry *less* about corporate bond risks than before. Moreover, we have entered a market phase in which it is more likely that **credit underwriting standards will fall, rather than rise**. While we are undoubtedly stoking up debt-related perils for the future, **the reality is that the capital markets are ‘open all hours’**. The climate is reminiscent of 2003, after Greenspan and Bernanke had given their respective reassurances that the Fed had an antidote to deflation in their medicine chest.

A quick word on global broad money growth, which has slipped from almost 8 per cent a year in 2015 to about 5.5 per cent most recently. We think that this reflects banks’ loss of global market share in the credit markets and the falling real rate of return on bank deposits. The money-ness of non-bank credit is currently very high and the incentive to hold excess balances in the banking system is correspondingly low. There is also evidence that listed companies have been over-distributing their earnings, consistent with a deceleration of wholesale money balances. **In short, we regard broad money deceleration as having no obvious relevance to the outlook for global nominal GDP or global equity market valuation.**

Another key element of the inflation outlook is the increasing influence of capacity constraints and bottlenecks. The global population of working age is growing at only 1 per cent a year, and only 0.7 per cent a year outside of sub-Saharan Africa. **The robots are coming, but not quickly enough to prevent severe widespread labour shortages**. There has been an unprecedented lengthening of the average asset lives of privately-owned physical capital in advanced economies in the wake of the GFC. Global energy capex, in nominal terms, dropped by over 60 per cent between 2014 and 2016 and is expected to remain 20 per cent lower than the 2014 peak even in 2021. Meanwhile, our physical infrastructure is falling to bits: McKinsey (page 18) reckons that **“the world needs to invest US\$3.3trn annually through 2030 to repair and renew the economic infrastructure.”**

Much is made of the scope for technological innovation to reduce costs and disrupt existing business models. However, the construction of robust, compliance-friendly global supply chains is an application of technology that appears to be working in the opposite direction: acting as a rising barrier to entry and a catalyst for growing industrial concentration (page 20). **We contend that the margin**

expansion associated with the unchecked advance of oligopoly and monopoly power is a much more potent inflationary force than the disinflationary impact of so-called Amazon-isation.

The **Little Inflation** that took hold in late 2015, after the oil and commodity price collapse was exhausted, is slowly gathering strength. **It is a global inflationary process that has 5 strands.** First, the transmission of inflationary pressure along global supply chains from EM producers to DM consumers. There are clear indications that export price inflation is rising in EM countries and import price inflation is increasing in DM countries. **In the Euro area, these pressures will be dampened, but in the US Dollar area they will be amplified.**

Secondly, despite some significant and ongoing headwinds, clear signs of wage acceleration are visible in US, Japan and UK. As we discuss in our latest *Global Inflation Perspective*, unit labour cost inflation has risen at roughly half the pace of general inflation over the past 2 years, but the prospect is for wage growth to catch up some of this lost ground in 2018-19. **The manner and speed of income rotation from entrepreneurial incomes to employee incomes is as much a socio-political matter as it is a macro-economic outcome of labour market tightness.**

Thirdly, there is an unmistakable drift towards **deliberate fiscal relaxation**, led by US, Canada and Germany in the advanced economies, in China, and in numerous emerging countries. While fiscal attitudes in the member states of the Euro area remain quite conservative, the pressures at the core of the EU point to an urgent relaxation. Plans to redirect resources from central European states to southern European states will not wash. **After a decade of fiscal moderation and penny-pinching, the political pressures for fiscal relaxation are intensifying.**

Fourthly, the prices of industrial commodities, particularly metals, have responded quite predictably to **a positive phase of the global goods inventory and trade cycles.** Industrial production growth, at 4 per cent annually, is the strongest reading since 2011, and the tight inventory position has restored producer purchasing power, evidenced by producer price inflation. The imposition of US tariffs on steel and aluminium is expected to have a further constricting effect on supply, not only for these metals, but also for copper, nickel and tin.

Fifthly, food and energy price inflation is a wild card. We don't subscribe to the view that core CPI is all that matters. In poorer countries, primary product inflation carries a large weight in the index and is very influential in the formation of consumer inflation expectations. **Food and energy inflation can also be a leading indicator of generalised pricing pressures.** The firming of crude oil prices in 2018 may soon be capped by an output response, but the market is more finely balanced than a couple of years ago, when inventories were abundant. **Our inflationary thesis does not depend upon a chunky contribution from food and energy, but we may have one.**

To recap, the underpinnings of the Little Inflation are supply chain pressures, DM labour market overheating, fiscal relaxation, booming industrial metals prices and the wild card of food and energy inflation. To mis-quote Solomon, a cord of 5 strands is not easily broken!

Who cares about a **Little Inflation**, even one that looks to be growing a little larger? Every investor should care, because the prevailing attitude to the return of (any) inflation is a mixture of incredulity and complacency. By definition, even modestly rising inflation is unanticipated inflation. In response to the progress of benchmark US Treasury bond yields over the past year, and the significant contribution of inflation breakevens, we hear two arguments quite often. First, that **central banks won't allow the terminal interest rate to rise because it would be too painful for borrowers**, and second, that **if the terminal interest rate did rise then it would kill off the global economic expansion** almost immediately, triggering a sharp fall in interest rates. In other words, that the terminal interest

rate is self-limiting: a departure to the upside carries the seeds of its own reversal. **We are not persuaded by either of these arguments.**

The illusion of central bank control over the interest rate structure – long and short rates – has been cultivated by the central banks themselves. Central bankers have fostered false notions of precision in policy-making. They bemoan the difficulty of bringing inflation back up to target as if to infer that sustaining inflation above 2 per cent would be well-nigh impossible. They insist that inflation expectations are firmly anchored at their beloved 2 per cent, as if that meant something. In their models, there is a strong gravitational pull towards 2 per cent inflation, but models are inadequate representations of real life. **In life, as in golf, par is not the worst possible outcome.**

Whereas inflation is like Kryptonite to conventional fixed income investments – robbing them of strength and performance – **the effects of inflation on equity investments are insidious and furtive.** Inflation sets traps for equity investors. According to one well-regarded US study, the average, forward-looking, P/E ratio *rises* during the transition from sub-1 per cent core CPI to the 2-3 per cent range. The return of a Little Inflation (from its virtual absence) represents an improvement in corporate pricing power and a probable earnings boost. **However, the transition from 2-3 per cent core CPI to 3-4 per cent is associated with a 25 per cent de-rating.** Perhaps, we have become so conditioned by 1-3 per cent central bank target inflation ranges that interest rate consequences are only taken seriously once inflation breaches 3 per cent. There is every likelihood that this will happen, both for global inflation and for US inflation, within the next 12 months. **This is the Little Inflation with the Big Bite.**

I mentioned earlier that we have transitioned from a world of 4 per cent nominal GDP growth to a 6 per cent world in just 2 years. Benchmark bond yields that looked just a little on the low side 2 years ago would (and do) look ridiculous now. Over the past 50 years, bond yields have adapted to their nominal environment and there is every reason to suppose that they will do so again. Our judgement, published in our March *Global Credit Perspective*, is that a suitable benchmark bond yield for the US in late-2018 would be around 3.75 per cent.

It's time to reiterate the key points and close.

- 1 Currently, we observe no serious impediment to the continued expansion of global debt, especially corporate debt, which helps underpin a gently rising pace of global nominal GDP growth and modest appreciation of global equity markets.
- 2 While there are threats to the global credit cycle on the horizon, they do not yet seem imminent.
- 3 The mere continuation of nominal GDP at a 6 per cent annual pace will tend to drag the structure of interest rates higher this year. This will culminate, quite possibly, in a bond yield spike, that punctures the economic expansion.
- 4 Yet, even as the global activity cycle begins to wane, we would expect the Little Inflation to continue to build over the next 12 months. The inflation narrative should be kept apart from the growth narrative.
- 5 The Little Inflation poses a dual threat to capital preservation: in the incremental damage that it inflicts directly and as a potential trigger for the changes in the socio-political climate that could usher in a Large Inflation in due course.

The cost of term inflation protection is still quite low. Deep value stocks are still deeply out of favour. Safety may look very different in 12 months' time.

Thank you for your time and attention.

