The Wolf of Main Street

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Welcome to this *Economic Perspectives* webinar, entitled "**The Wolf of Main Street: an inflationary surprise awaits**".

[I plan to speak for about 20 minutes after which the call will open for questions. This call will not be recorded, but a recording of my remarks and the accompanying slidepack will be available afterwards.]

Thank you for sparing your time and attention today as we consider the evolution of the inflationary narrative in the wake of some wildly different national policy templates, developed in the context of the severe virus-induced disruption to economic activity. In terms of fiscal supports, US, Japan and Germany have acted vigorously, while China and India have offered the least. In terms of loan guarantees and promises, Italy, Germany, France and UK have pushed out the boat, while China, Indonesia and Russia have held the line. There is no standard response to the economic challenges posed by Covid-19, raising the prospect of significant national variations in economic performance – and inflationary experience – over the next 18 months and a recurrence of financial market volatility.

Way back in 2009, we hit upon a slogan, that: "the only credible resolution of the global credit crisis is a resurgence of global inflation". This was not intended as a forecast of imminent inflation – although 2010-11 was more inflationary than many had expected – but rather of a coming inflationary showdown, along the lines of *Gunfight at the OK Corral. (Fittingly, the famous gunfight at Tombstone, Arizona was also at 3pm!).* What we had in mind was a moment when historical debts – and claims - would be devalued. In simple terms, student loans and baby-boomer pension entitlements would be written down with the same pen. The accommodation of the spending priorities of a new generation would usher in a new monetary settlement that would necessitate the scaling down of inherited obligations. That moment looked quite close at hand last June, when we held the "Blowing up the box!" breakfast seminar at Innholders Hall. Courtesy of a global pandemic, the moment appears to be upon us.

Over the ensuing decade, we have debated the "inflation vs deflation" question on innumerable occasions in open forum, at conferences, seminars, investment meetings, classroom situations and in the bar. These, mostly good-humoured, debates have generally created more heat than light. Undeniable disinflationary, sometimes even deflationary, pressures have asserted themselves powerfully from time to time, while central banks have refused to tighten credit conditions even when the opportunity presented. This is despite ever lower starting points for interest rates and ever-looser covenants for loans. What was popularly described as a New Normal now feels like an Old Stalemate. That stalemate has been broken, decisively, by Covid-19. The inflation-deflation debate has taken a dramatic twist as we are confronted with an even wider dispersion of opinions regarding the global inflationary outlook, ranging from deflationary depression to rapid inflation.

Why are views of the inflationary outlook so diverse?

Disagreements about the inflation outlook have **three overlapping dimensions: inherent biases or priors; preferred theoretical structures or models and the relevant information set.** Economists over 40 years of age, and especially over 60 years of age, typically have formed very strong views about how the world works. Their economic worldview carries various items of baggage, which are known as priors: these predispose the holder to draw certain conclusions or make certain forecasts regardless of changing circumstances. In some cases, this worldview is articulated in an analytical model, in this case, a model of the inflationary process. For the individual concerned, if inflation isn't happening in their model, it isn't happening. Metaphorically, outside, it can be pouring with rain, but in the model the earth is bone dry. Thirdly, there is the evidence to be considered. Which items of data, numerical or otherwise, are considered relevant to the formation of the inflation outlook. Does the fiscal outlook matter? Does the growth of the money stock matter? Does the behaviour of the oil price matter?

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

The compilation of inflation views above, courtesy of my colleague Yvan Berthoux, summarises some very disparate outlooks – some inclined towards deflation and some towards much higher inflation – **based on differing priors, models, and differently-weighted information sets**. **These views are held strongly, sometimes passionately.** Some views are unidirectional, and some are multi-phasic: deflation now and inflation later, for example.

Predominantly, the Keynesians have adopted a deflationary outlook, based on the assertion of capacity under-utilisation in an output gap framework. However, had it been in use, the output gap framework would have failed miserably in its predictions of inflation in the 1930s and the 1970s. Nicholas Crafts and Peter Fearon estimate that there was still a US output gap of 25 per cent in 1933, assuming trend growth at the pre-1929 rate. Yet US CPI inflation rebounded to 5 per cent in 1934.

The notion of an output gap is a helpful heuristic device in a teaching context. However, its usefulness as a real-time forecasting tool was demolished more than 20 years ago by Athanasios Orphanides and Simon van Norden. They demonstrated that “subsequent revisions of the output gap are of the same order of magnitude as the output gap itself, that ex-post revisions are highly

persistent and that real-time estimates tend to be severely biased around business cycle turning points, when the cost of policy-induced errors due to incorrect measurement is at its greatest." The output gap rests on monumental assumptions and is subject to serious measurement problems.

We currently have no idea what is the sustainable trend rate of US GDP growth nor the steady-state rate of US unemployment. What we do know is that extraordinary measures have been taken to shore up nominal demand, that central banks have committed to absorb vast quantities of government debt, and that further efforts are being made to forestall bankruptcies and defaults. The big unknown is the damage to the capability of private sector businesses to produce and distribute goods and services, conditional on an adequate rate of profitability. **Supply-side dynamics will play a key role in the evolution of inflation.**

If the Keynesians are resolute in their deflationary analysis, the dwindling band of monetarists has re-emerged from the shadows to warn of a steep increase in inflation based on the recent extraordinary behaviour of various measures of the money supply. According to Shadowstats, the M3 measure of the US money supply grew by more than 25 per cent in the year to May. Since those heady days in the 1970s, when money-price causation appeared to have clear empirical validation, the picture has clouded to the point of obscurity. These days, monetarists prefer to use 5-year moving averages, glossing over the embarrassing tendency of inflation to precede money supply growth.

There is nothing new under the sun! In 1844, John Stuart Mill wrote:

"The notion that every increase in the amount of the circulating medium must raise prices, proceeds, as it seems to us, upon the erroneous supposition, that an increase of money must be an increase of purchasing power.

The purchasing power of an individual at any moment is not measured by the money actually in his pocket, whether we mean by money the metals, or include bank notes. It consists, first, of the money in his possession; secondly, of the money at his banker's, and all other money due to him and payable on demand; thirdly, of whatever credit he happens to possess. To the full measure of this three-fold amount he has the power of purchase. How much

he will employ of this power, depends upon his necessities, or, in the present case, upon his expectations of profit. Whatever portion of it he does employ, constitutes his demand for commodities, and determines the extent to which he will act upon price."

John Stuart Mill, *The Currency Question*, Westminster Papers, 1844

This timeless definition should guide our thinking in 2020 also. When credit spreads began to blow out in mid-March, the US central bank acted swiftly to counteract the development by introducing a brand new mechanism for intervening in corporate credit markets and securing the fiscal backing to do so. By this means, credit markets remained open and the pace of bond issuance has been brisk. Other governments provided loan guarantees so that commercial banks could lend freely to protect their customers from cash-flow crisis and potential insolvency. Private sector balance sheets have swelled in 2020, whereas they imploded in 2008. Global purchasing power has been enhanced over the past 4 months, not depleted. This quickening of the pace of credit growth infers a faster pace of nominal spending lies ahead.

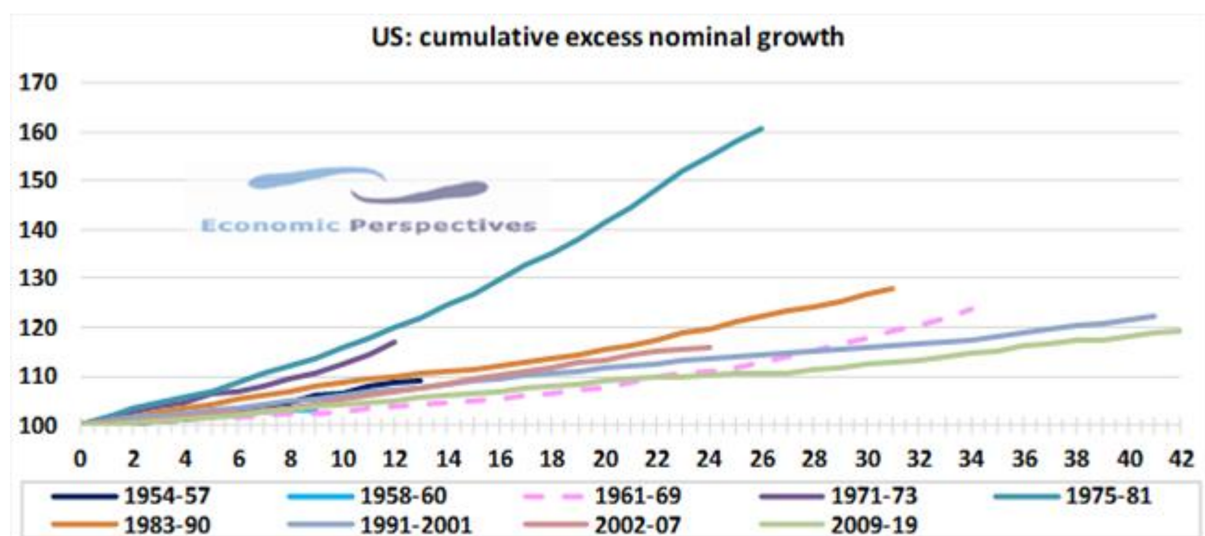
Even if this spending power is not released immediately, because of uncertainty, it remains a potent and latent force in the recovery. Both governments and businesses have already raised the finance; when they have the contingency (government) or the confidence (households and businesses), they will spend and nominal spending growth will increase. **Where the contingency and the confidence coalesce, inflationary pressures will assert prominently.**

The nominal recovery will outstrip the real

The single most important lesson that central banks took away from the Great Financial Crisis (GFC) was to keep (private sector) credit flowing at all costs. The failure of Lehman Brothers in September 2008 triggered a cascade of default through the global credit system, amplified by the complex web of derivative transactions. With good reason, this episode was known colloquially as a "credit crunch". Goods destined for the bustling shopping seasons around end-year festivals, had already been despatched from Asia when the Lehman bombshell fell. Many of these goods, now seaborne, were no longer wanted as orders were cancelled in anticipation of very tough trading conditions.

When credit fractures in highly financialised developed market economies, purchasing power is immediately withdrawn from the global economy and prices will fall in consequence. Those without savings and dependent on the availability of credit, lose the capacity to finance some of their intended purchases and those with savings typically save proportionately more out of current income. The result is that nominal spending is sharply constricted: US nominal GDP was scarcely higher in 2009 Q3 than 2007 Q2.

However, from the ground zero of the final negative quarter, nominal GDP typically outstrips real GDP. In the June *Global Inflation Perspective*, we examined the trajectories of excess nominal spending over real activity for US, UK and Japan over the past 60 years. Some trajectories are shallow, corresponding to a mild inflationary experience, but others (e.g. 1975-81 and 1971-73 for the US and numerous episodes for the UK) are steep. Japan has had some recovery phases that were deflationary (real profile above nominal), but neither US nor UK has had any in the past 60 years.



Data source: Thomson Reuters Datastream

It would be a mistake to think of inflation as emanating only from the private sector, from the markets for goods and services. Government actors have frequently had prominent roles, influencing market prices through the variation of taxes and subsidies, through the pricing of publicly-provided goods and services, and through various types of financial market interventions.

In a US context, we observe that in the early stages of recovery, the public sector has played a more significant role over the past 30 years. One hypothesis is that, as private sector indebtedness has increased, the harder it has become to stimulate a private sector spending recovery using low interest rates.

In 2020, the public policy response has been more extravagant than ever before, **propelling a nominal recovery that we should expect to surpass that of output by a clear margin.**

Over the past decade, *Economic Perspectives* has published more than 30 full length *Global Inflation Perspectives* and countless slide presentations. My colleague, Tom Traill, compiles our *Global Inflation Heat Maps* every month and *Global GDP Heat Maps* every quarter, containing inflation measured by the GDP deflator. Our thesis is that inflation is a complex, multi-faceted phenomenon, that encompasses (among other things) geopolitics, political economy, inter-generational dynamics, sociology, and macro-financial economics. **During periods of institutional and political stability, it is possible to model the inflationary process with reasonable accuracy. However, these intervals of stability are punctuated by radical upheaval, making inflation forecasting especially difficult. This is such a time.** Neither money supply growth (however defined) nor the Keynesian output gap is a reliable guide to the inflationary outlook amidst monetary regime change.

The purpose of surveying so many disparate views of the inflationary outlook – and their investment implications – is not to pour scorn on any or all of them. Rather, to explain that inflation is an emergent phenomenon, like the eruption of a volcano. There may be genuine grounds of disagreement in respect of the threat and imminence of eruption but there is much less excuse for failing to notice the strength of the forces that are building below the surface. Quite how, when and where volcanoes erupt retains an element of mystery.

Similarly, we judge this inflationary moment to have plenty of mystery attached. **Powerful forces are at work – in the production and distribution of physical goods, in patterns of consumer behaviour, in the movement of people, in the supply of credit, in the willingness of governments to intervene, in the lack of international co-ordination and not least, the**

evolution of the coronavirus – that make many diverse inflation scenarios credible. We didn't choose this elevated level of inflation uncertainty; it chose to invade our world at this critical moment and we have to deal with it.

Near-term inflation outlook

The inflationary outlook is blurred by many powerful forces acting and interacting simultaneously. The global economy has suffered a heart attack and is, thankfully, making a spirited recovery. Yet, the progress of the patient, and the strength of medication that will be required, are unknown. This is no ordinary economic recovery and its inflationary dynamics will be distinctive, not least because of the gargantuan efforts of the authorities to prevent an economic catastrophe. **Economic models and historical precedents are likely to be of limited help: this episode is one of a kind. Rather than reaching for 'off the peg' prognoses, this episode demands a bespoke analysis.**

The credible, and undeniably deflationary, scenario of bankruptcy and default in 2020 has been stopped in its tracks. At the very least, it has been deferred for 6-12 months, but depending on the inflationary dynamics that unfold in this interval, it is conceivable that the default cycle has been transformed from a jarring spectacle to a corrosive malaise.

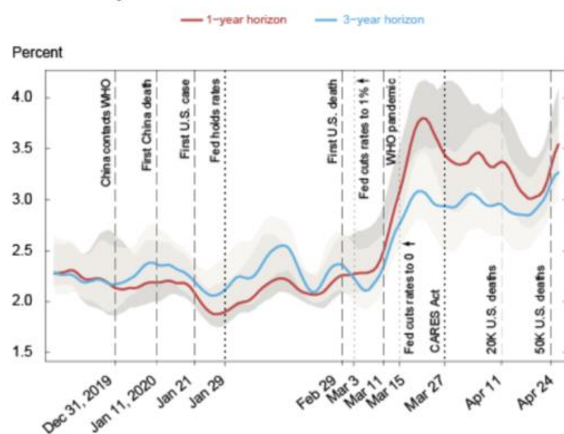
Rather than a sustained deflation or a destabilising lurch towards hyperinflation, a more credible resolution is stagflation, last endured in the 1970s as another shift in monetary regime was underway. The extraordinary, albeit brief, contraction of the global economy has imparted an initially deflationary adjustment, notably via energy prices. Once the oil markets have been forced into balance by the lack of oil storage, then the tables are likely to be turned: a revival of oil demand will confront a much more constrained supply environment. Commodity prices have already made a spirited recovery from their March lows.

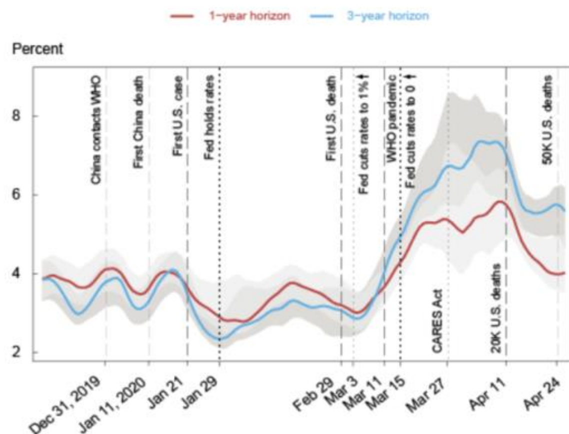
As the year wears on, the supply shocks and self-inflicted adjustments as companies and countries seek to reorganise supply chains, are likely to supplant demand effects in the determination of inflation trends. **The scale of government spending will aggravate the disparities between nominal impulses and the realities of restarting profitable productive activity.**

The near-term behaviour of US inflation is extremely important. If, as we suspect, and the real-time Price Stats index suggests, US inflation is already rebounding, then there is an implication for the US Dollar also. Since 2007, there has been an extraordinary inverse correlation between the real return of a US deposit to a foreigner and the annual rate of CPI inflation. If US inflation lurches higher, we anticipate that the US Dollar could weaken simultaneously, amplifying any increase in Dollar-priced commodities.

The abrupt nature of the imposition of economic lockdowns, as the seriousness of the Covid-19 threat became painfully real, meant that the consumer was unable to enjoy the full benefit of deeply discounted goods. While, for clothing and footwear, excess inventory moved online, there was no repeat of the deep discounting of food items in 2008-09. Perishable items perished. (In the UK, it was reported that 40m litres of beer were poured down the drain! Shame!) The price discovery process was interrupted when lockdowns occurred and prices could not fall as far as they otherwise might.

We are extremely concerned that the market is currently underestimating the probability of a sudden rise in inflation over the next 12 to 24 months (government bonds are pricing virtually no inflation risk in the medium term). The New York Fed recently showed that even though median inflation expectations do not show a discernible trend in response to the Covid-19 crisis, the uncertainty and disagreement over inflation expectations across respondents has increased significantly in recent weeks. This finding is echoed by the BIS in its latest annual report.





To summarise, the global economy has been threatened by a **hard deflationary** reset but policy responses are designed to transform this into a **soft inflationary** reset – involving the devaluation of old promises, the erosion of nominal debts, (student) debt forgiveness and the socialisation of private debt. The institutional structure that has held inflation in check for the best part of 40 years is crumbling. Inflation expectations are becoming unanchored and inflation uncertainty is rising. The wolf has been untethered and an inflationary surprise lies in store.