Economic Perspectives

Persistent inflation as a political compromise

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A couple of quotations

- "Changes in the general level of prices have always excited great interest. Obscure in origin, they exert a profound and far-reaching influence on the whole economic and social life of a country."

  Knut Wicksell, 1898
- "If price stability is squandered, financial stability is put at risk. If financial stability is lost, the economy is imperilled and the social contract is threatened."

  Kevin Warsh, WSJ, 12 December 2021

Persistent inflation as a political compromise

- From a US/Western European public policy perspective, inflation has become the cure, not the disease.
- In the context of the Covid policy response, the authorities engineered an ‘unanticipated’ inflation as the essential ‘second act’ of financial repression.
- While there were many who *did* anticipate the inflation, the professional consensus failed dismally to identify what was happening.
- The purpose of the inflation is to devalue claims on the public sector and pension promises in general.

Inflation as a stealth tax

- As Milton Friedman once said: "Inflation is the one form of taxation that can be imposed without legislation".
- The scale of the inter-generational income and wealth redistribution that is now required lies beyond the scope of tax and entitlement changes feasible for an elected government – Piketty's wealth taxes incompatible with political realism.
- Only a multi-year inflation can achieve the radical redistribution that will empower Millennials and Zoomers and disenfranchise the Boomers.

- It's not "The economy, stupid!" – it's the shifting geopolitical landscape and the polarisation of national politics. The government budget has become the primary tool for managing economic outcomes.
- Central banks are ciphers in the drama, sometimes appearing to act independently but politically constrained.
- Central bank balance sheets are at the disposal of the political process.

Three views of the US economic outlook

- **1 Fairytale ending**: inflation subsides and recession is averted; credit default cycle is mild; budget deficit is tamed by growth and fiscal adjustments; central bank independence is restored.
- **2 Thunder and lightning**: shocking collapse of consumer and business demand brings a short, sharp recession, but destroys pricing power. Unemployment rises, threat of a serious credit default cycle, budget deficit climbs and monetary policy eases again.

Three views of the US economic outlook

- 3 **Persistent inflation** : political realities dictate that the Fed must abort its monetary tightening and the state must prevent an abrupt destruction of consumer demand. Income subsidies and supports are reintroduced to stabilise the consumer economy, budget deficit expands, monetary growth rebounds. Inflation falls back in 2023, only to take off again. Inflation stays volatile in a higher range, economy struggles to grow. Unemployment rises to 5-6 per cent.

Fairytale forecasts – Real GDP growth

- Drawn from the June *Consensus Forecasts*

	2021	2022F	2023F
World	5.9	2.9	2.8
North America	5.6	2.7	1.8
Asia Pacific	6.1	4.0	4.3
Western Europe	5.6	2.8	1.8
Eastern Europe	6.1	-2.6	2.1
LatAm ex-Venezuela	6.9	2.1	2.0
Other countries	4.4	5.1	3.3
US	5.7	2.6	1.8
Japan	1.7	1.7	1.9
EU	5.3	2.7	2.1
Germany	2.9	1.8	2.1
France	6.8	2.5	1.6
UK	7.4	3.5	0.8
Italy	6.6	2.6	1.7
Canada	4.5	3.7	2.3

Fairytale forecasts: CPI inflation

- Drawn from the June *Consensus Forecasts*

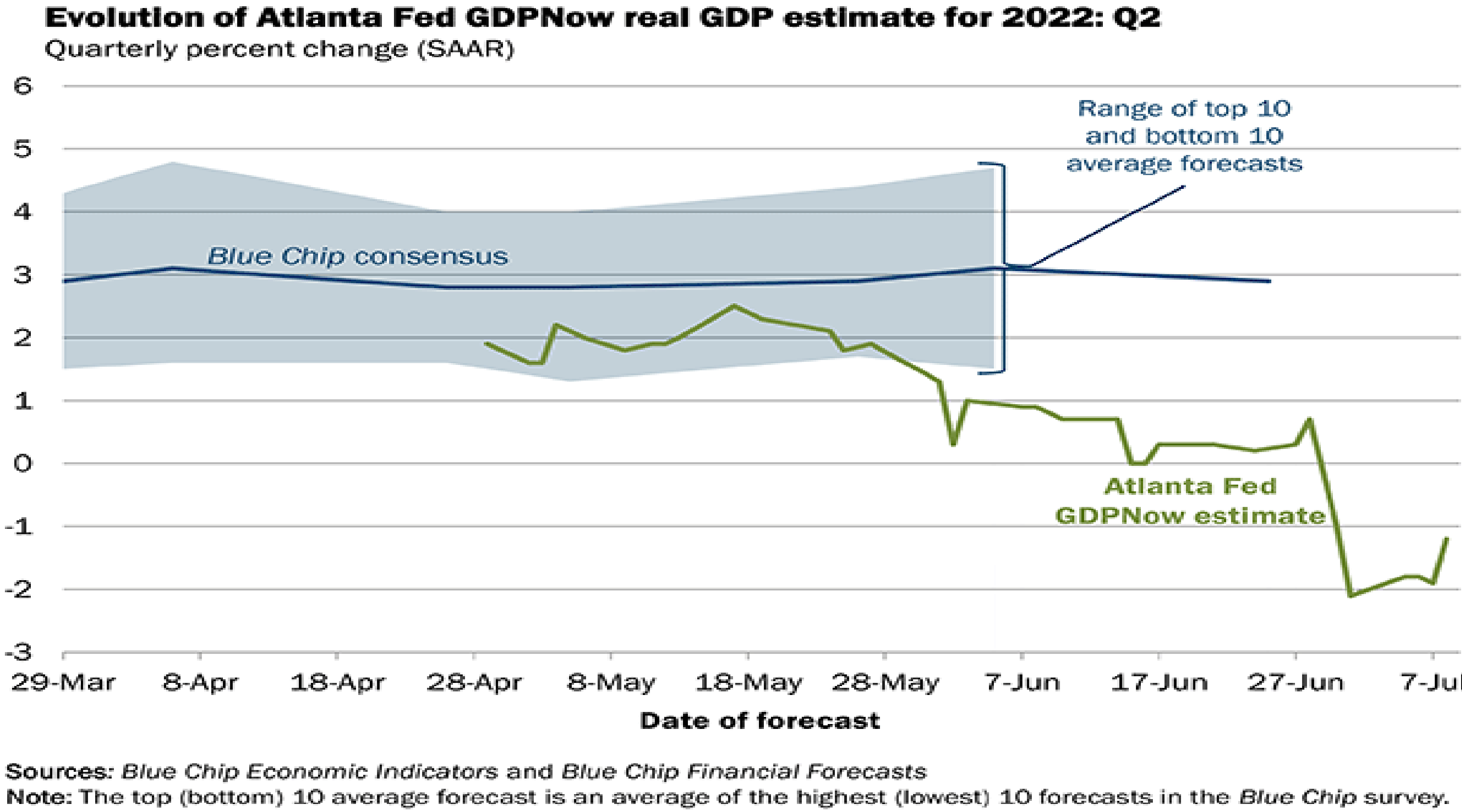
	2021	2022F	2023F
World	3.6	6.9	3.8
North America	4.6	7.6	3.6
Asia Pacific	1.5	3.1	2.5
Western Europe	2.4	6.6	3.1
Eastern Europe	8.7	23.1	10.5
LatAm ex-Venezuela	11.8	12.8	8.8
Other countries	5.8	7.5	5.9
US	4.7	7.7	3.6
Japan	-0.2	1.9	1.2
EU	2.6	7.0	3.2
Germany	3.1	6.9	3.4
France	1.7	5.0	2.6
UK	2.6	8.5	5.2
Italy	1.9	6.4	2.6
Canada	3.4	6.3	3.1

Fairytale forecasts: what lies beneath?

- A misunderstanding of the low unemployment rate, which reflects negative supply shocks that are structural, and positive demand shocks that are transitory and fading.
- A model-driven narrative of normalisation to the pre-Covid trajectory of US economy, and to the inflation objective of 2 per cent.
- Assumption of benign financial conditions – that credit is accessible, affordable and attractive.
- Expects budget deficit to contract sharply without stalling consumer recovery.

US forecasters in denial over faltering momentum

- Likely depletion of inventories in Q2



Consumer spending is still holding out …

Atlanta Fed GDPNow estimates for 2022: Q2, growth rates and changes

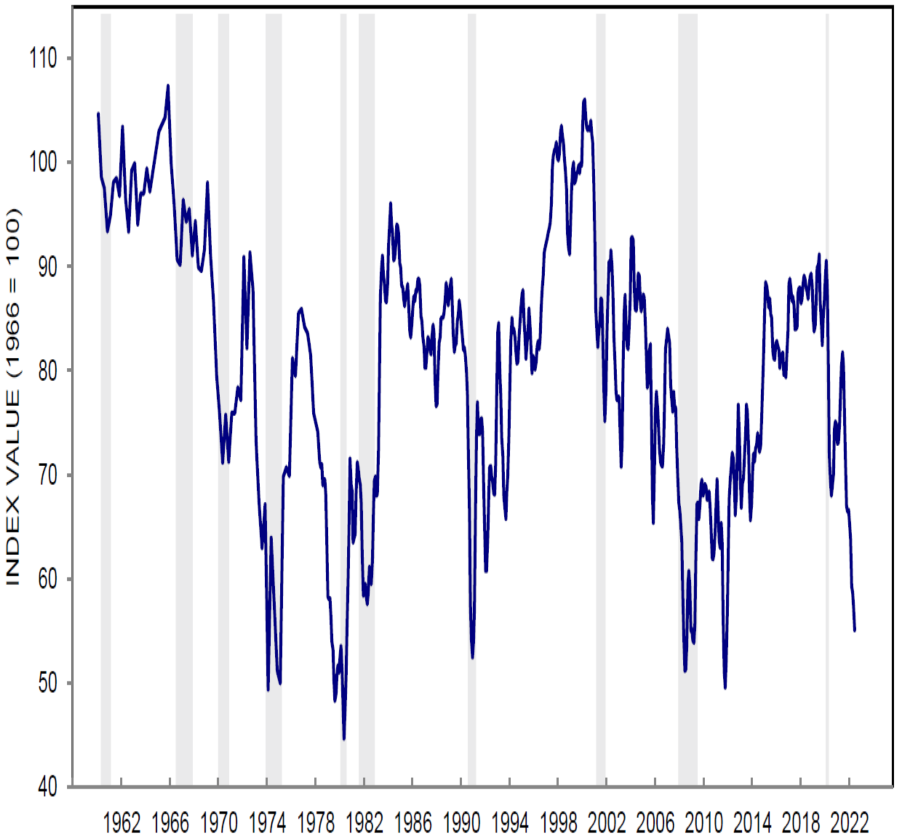
Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Exports	Imports	Change in net exp.	Change in CIPI
29-Apr	Initial nowcast	1.9	3.8	6.1	6.3	5.0	1.7	1.4	3.9	7.1	-45	-56
27-May	GDP (5/26), Pers Inc/PCE, NIPA tables, Adv Econ Indicators	1.9	4.7	2.8	7.4	2.0	-5.6	1.7	6.6	6.3	-22	-78
15-Jun	Retail trade, Import/Export Prices	0.0	2.6	0.6	7.8	-3.4	-8.5	0.9	9.8	7.6	-16	-86
16-Jun	Housing starts	0.0	2.6	0.4	7.8	-3.4	-7.7	0.9	9.8	7.5	-16	-86
17-Jun	Industrial Production	0.3	2.7	0.5	7.8	-1.9	-7.7	0.9	9.7	7.5	-15	-74
21-Jun	Existing home-sales	0.3	2.7	0.4	7.8	-1.9	-9.2	0.9	9.7	7.4	-15	-74
24-Jun	New home-sales	0.2	2.7	0.4	7.8	-1.9	-10.0	0.9	9.7	7.4	-15	-74
27-Jun	Advance M3 Manufacturing	0.3	2.7	-0.4	7.8	-1.9	-10.0	0.9	9.7	7.4	-15	-70
28-Jun	Advance Economic Indicators	0.7	2.7	-2.9	7.8	-1.9	-10.0	0.9	10.2	4.8	12	-63
30-Jun	GDP (6/29), Pers Inc/PCE, NIPA tables	-1.0	1.7	-1.5	7.7	-1.8	-10.1	0.8	10.2	4.7	13	-121
1-Jul	Construction spending, ISM Manuf.	-2.1	0.8	-4.5	7.5	-6.6	-12.0	0.6	8.0	3.1	16	-121
5-Jul	M3-2 Manufacturing, Auto Sales	-1.8	1.1	-3.7	7.5	-6.5	-11.8	0.6	8.2	3.2	16	-122
6-Jul	ISM Nonmanuf Index	-1.8	1.1	-3.6	7.6	-6.5	-11.7	0.6	8.3	3.3	16	-122
7-Jul	International Trade	-1.9	1.3	-3.7	7.6	-6.5	-11.7	0.6	7.6	3.9	6	-122
8-Jul	Employment situation, Wholesale trade	-1.2	1.9	-2.0	7.9	-5.4	-9.1	0.4	9.4	5.3	3	-123
Maximum forecast of real GDP growth												
17-May	Retail trade, Industrial production	2.5	4.8	8.8	6.9	2.2	1.1	1.6	5.1	8.6	-52	-60
Minimum forecast of real GDP growth												
1-Jul	Construction spending, ISM Manuf.	-2.1	0.8	-4.5	7.5	-6.6	-12.0	0.6	8.0	3.1	16	-121

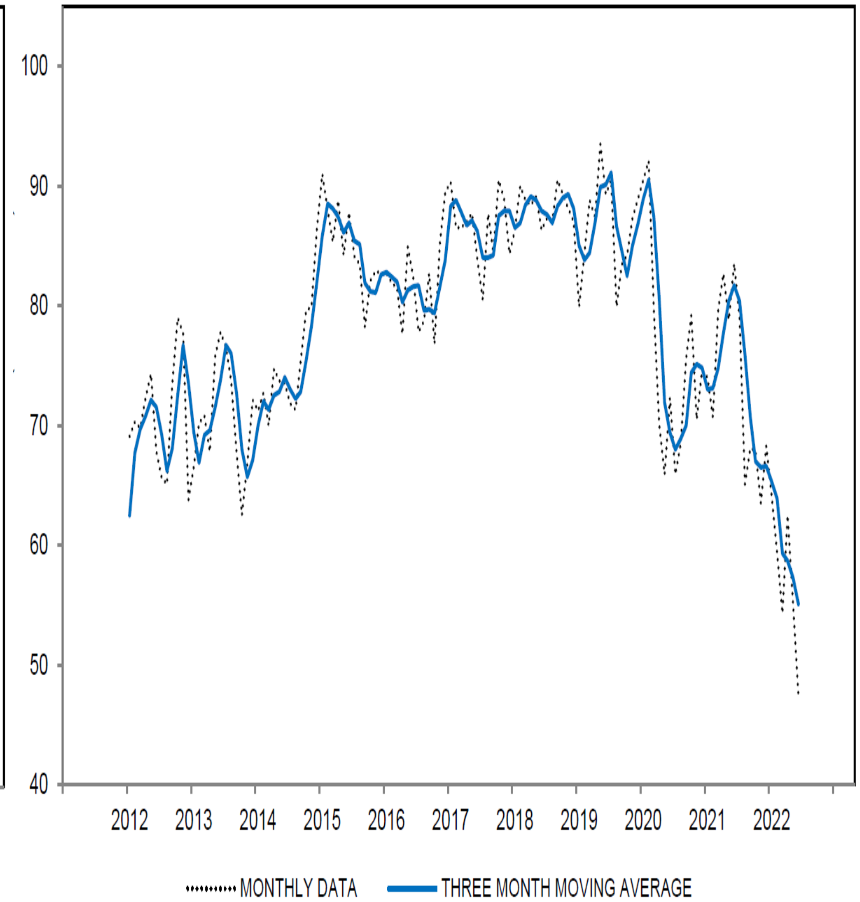
Note: CIPI is "change in private inventories." Changes in net exports and CIPI are both in billions of 2012 dollars (SAAR).

Source: Federal Reserve Bank of Atlanta

U. of Michigan index of consumer expectations is dire

- Expect consumer pullback in Q3



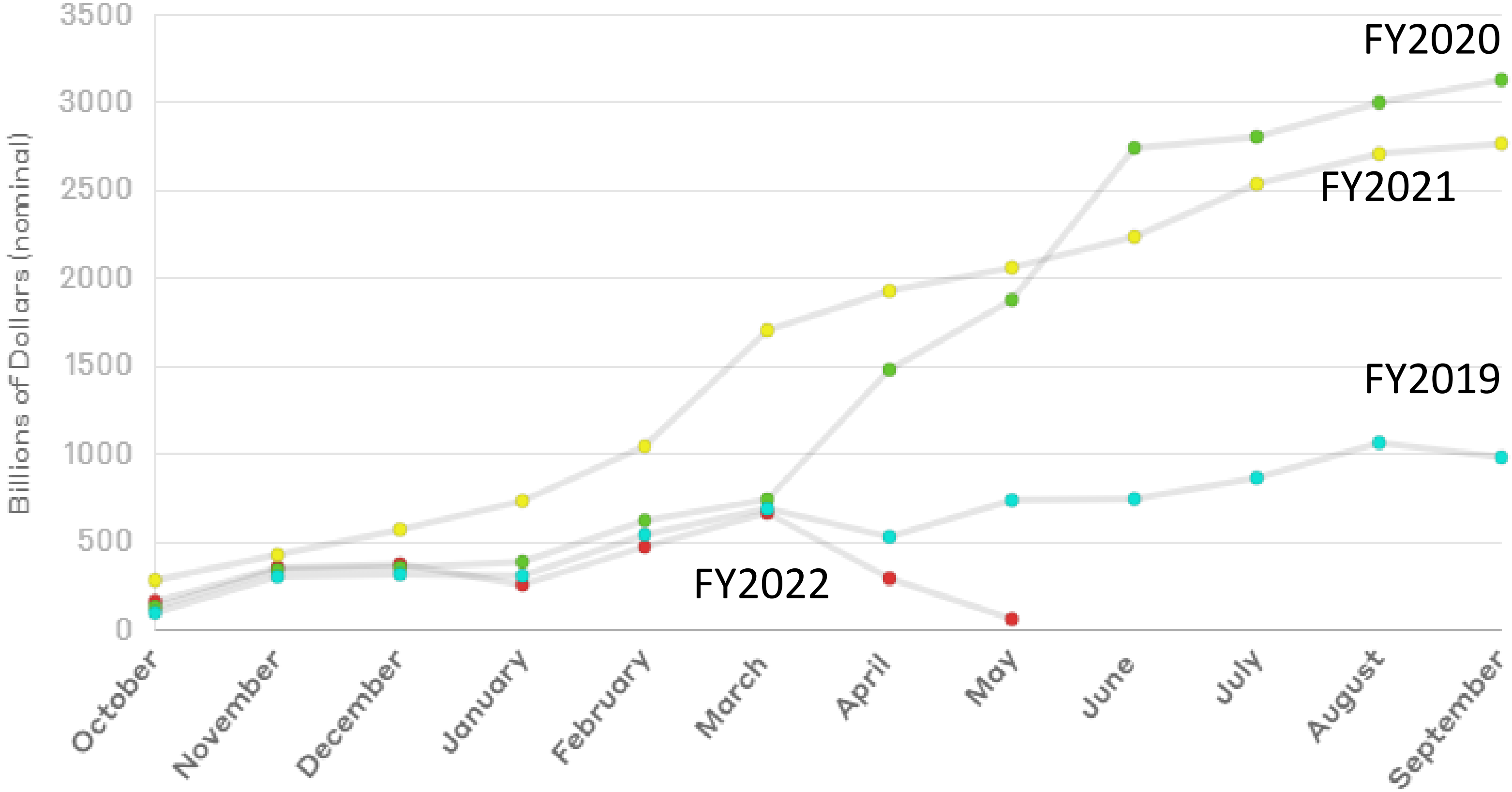


US fiscal tightening has pre-empted monetary tightening

- In first 8 months of FY22, federal government ran a deficit of US$423bn – one-fifth of the $2.1trn over the same period of FY21.
- Revenues up 29% - higher individual payroll receipts, corporate tax revenues , UI receipts and customs duties (due to higher imports).
- Outlays were 18% lower as pandemic relief (esp. refundable tax credits) spending dwindled, unemployment compensation outlays fell sharply.
- However, mandatory spending programs increased by 7% and debt interest was up by 29%.

US federal deficit has collapsed in FY22

- Brutal pace of adjustment is taking its toll



Thunder and lightning

- This scenario differs from the fairytale consensus in expecting a severe, imminent impact on consumer demand from the real income squeeze.
- Expects the Fed to hold its nerve and to follow through on its policy tightening despite the appearance of a consumer recession.
- Inflation is tamed by a bout of demand destruction that relieves pressure on supply chains and switches the goods inventory position from shortage to glut.
- Budget deficit rises, but for cyclical reasons only.

Thunder and lightning

- The economic and financial storm extends into 2023 and the return of capital discipline brings a wave of debt delinquency and default.
- The storm abates as plunging inflation and rising unemployment provides the cover for Fed easing.
- By 2024, the storm has passed and the economy is ready to respond to cheaper credit again.
- Deep bear market in equities, but bonds take heart from the drastic transformation in the inflation outlook.
- Budget deficit remains large, but slowly shrinking.

Persistent inflation: the radical scenario

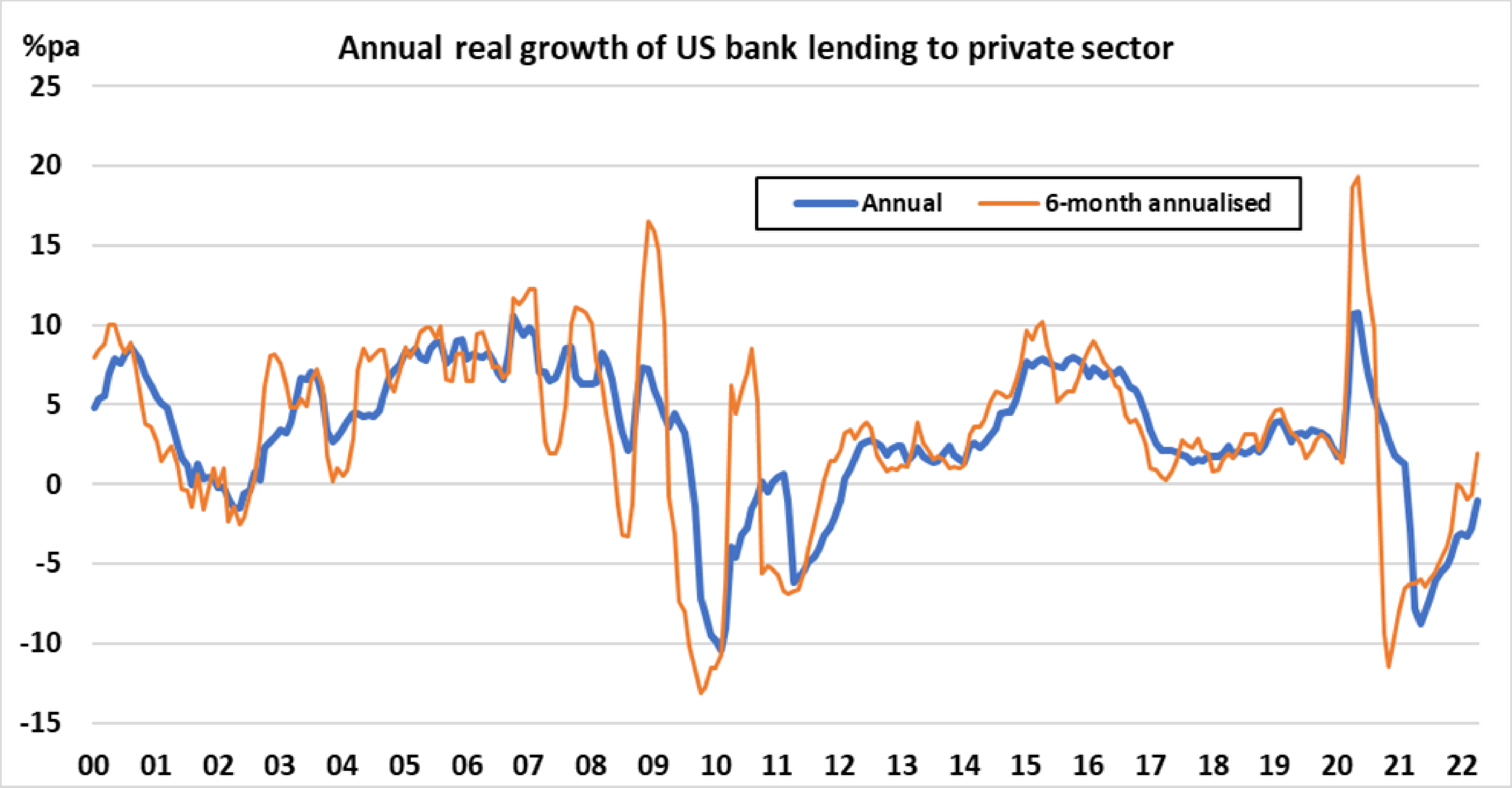
- Shares the perception of near-term threat that is characteristic of the ‘thunder and lightning’ scenario, but sees inflationary forces as more powerful and resilient.
- US economy contracts in 2022-23 and inflation falls back into 3%-5% range, but the distributional impacts of food, energy and shelter inflation force the administration to reintroduce emergency support measures.
- Fed lacks the moral authority to keep tightening into a downturn, even though inflation is excessive.

Persistent inflation: the radical scenario

- The *de facto* tightening of credit conditions – as lenders shut up shop and borrowers face less attractive terms – and financial conditions raises concerns over financial stability.
- Fed is compelled to cut short *both* its programme of funds rate increases and its quantitative tightening.
- It no longer has the freedom to pursue its inflation objective. Inflation is unfettered, a free variable in the system.
- Structural elements of inflation persist, relating to market structures, protectionism and geopolitics.

US bank lending growth has been negative in real terms

- A spirited lending recovery is expected to fizzle out



Persistent inflation: the radical scenario

- In this scenario, there is no prospect of a return to pre-Covid ‘normality’.
- The ‘policy box’ is broken: no way back to a balanced budget; no way back to a full funding rule, as QE becomes an essential tool; Fed loses its capacity to pursue the objective of low inflation; and markets are segmented and fragmented.
- Political imperatives push towards inflationary budget finance as a pragmatic response to the post-Covid stagflation. Fighting to preserve the social contract at expense of fiscal probity.

Recognising the damage to the supply side

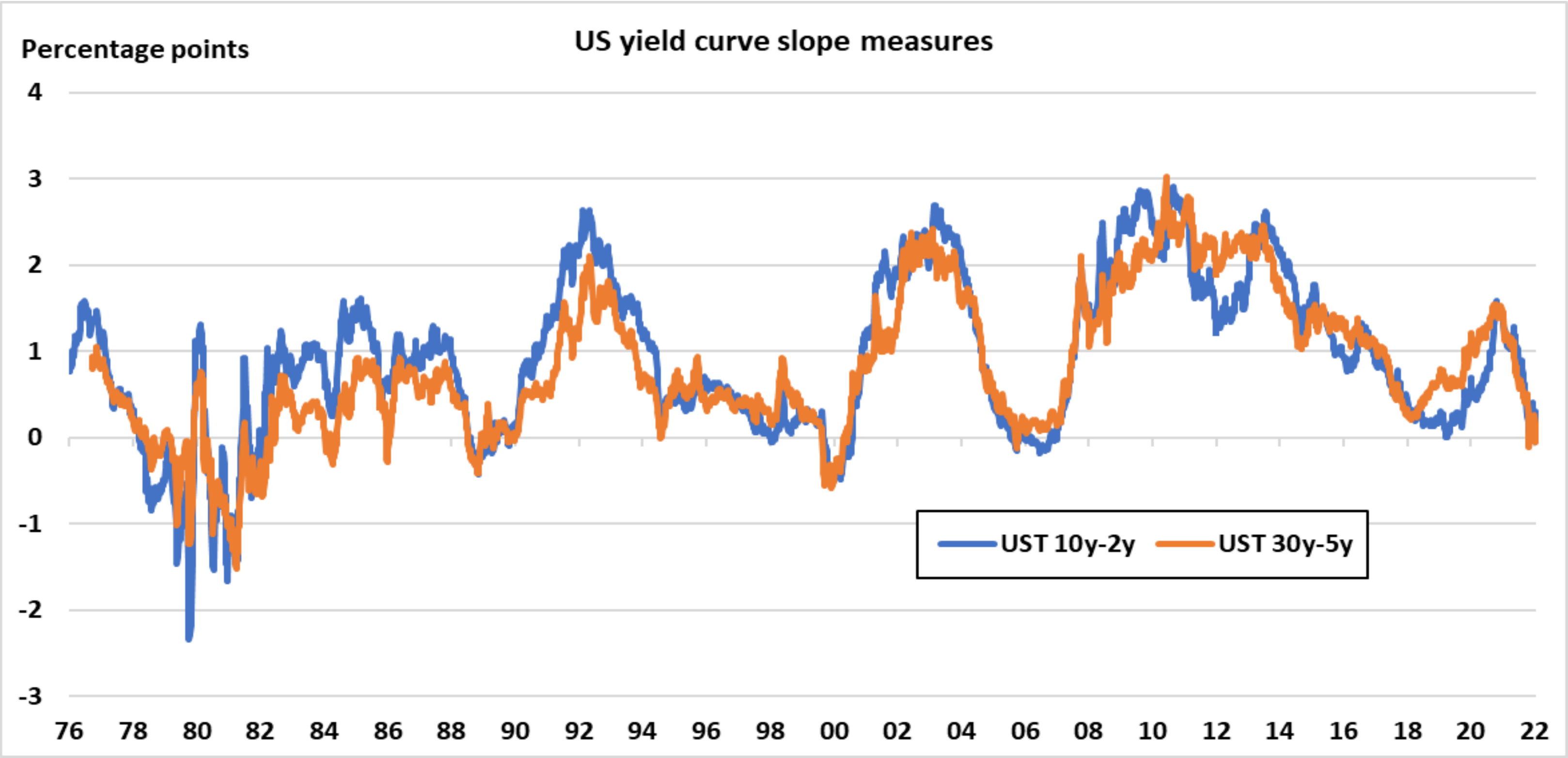
- Argument for persistent inflation rests on
  a) the lack of political willpower to mount a successful anti-inflation campaign
  b) the failure of higher prices to call forth additional supply.
- Food and agriculture.
- Fossil fuel dilemma and resulting underinvestment.
- Demographics of truckers and engineers.
- Tightness in shipping markets – slow steaming, use of ships as floating storage, additional demands of offshore wind industry, etc.

The imperative of an upward sloping yield curve

- For financial stability reasons, the curve must not be allowed to invert.
- US yield curve has broken into 2 parts: a monetary expectations segment and an asset purchase segment.
- Unless rates beyond 5 years keep rising, then the scope for monetary tightening is capped.
- Loss of economic momentum is typically associated with fixed income rallies.
- Strong possibility that the Fed will abort its planned rate hikes in next 3 months.

US yield curve is almost flat beyond 2 years

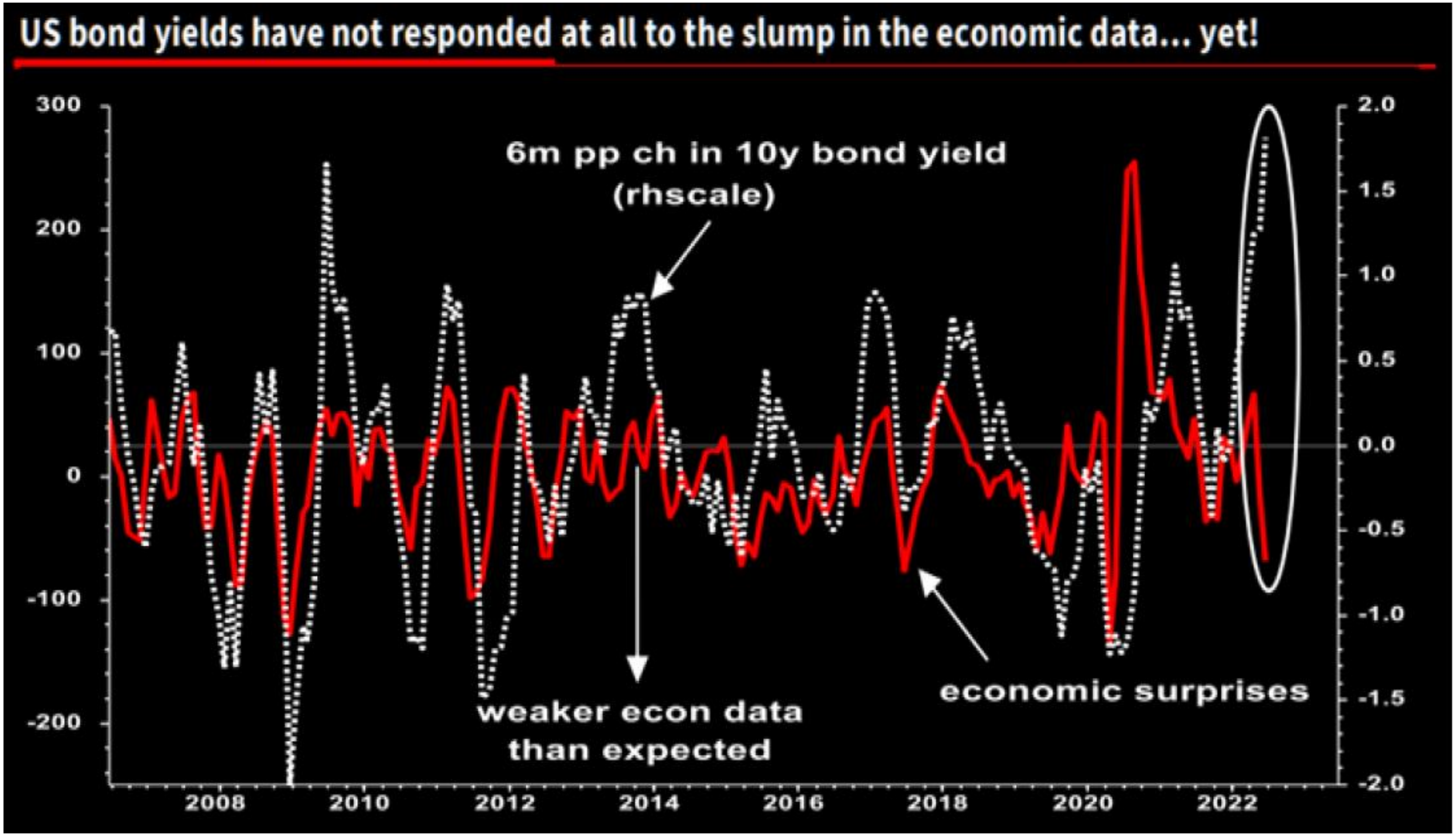
- Putting maturity transformation out of business



Source: FRED

Market pricing accords high probability to Fed freedom

- Plenty of scope for economic surprises to worsen



Source: Stargazer Asset Management

Has the tide turned already?

- 3m Eurodollar futures have rallied powerfully

How will the US yield curve evolve?

- Are UST rallies to be trusted?

Current 1 month Libor Forward Curve			
	Fairytale	Thunder & Lightning	Persistent Inflation
Current	1.65	1.65	1.65
12mo	3.96	1.25	2.34
24mo	3.40	0.55	1.55
36mo	3.22	0.95	1.37
60mo	2.96	1.65	1.80
10 Year UST Forward Curve forecast			
Current	3.10	3.10	3.10
12mo	4.50	2.75	4.50
24mo	4.00	2.50	5.50
36mo	3.75	2.50	5.25
60mo	3.50	3.00	4.00

Recapping the "Tottering Twenties"

- Inflation likely to remain elevated for a few years, resulting in a significant reset of the general price level for Western countries.
- As global economy weakens, CBs will turn out to be paper tigers and inflation expectations will adjust (upwards) to the new reality.
- CBs will focus their attention on financial stability and the suppression of credit spreads.
- Currencies will become increasingly volatile as countries' perceived risk profiles shift around.

Predictions

- The Fed ‘put’ will be reinstated once the S&P500 has lost 25%-35% from its highs
- The mounting risk of financial instability will take precedence over near-term inflation control
- The administration will relax the fiscal stance, out of necessity.
- Credit spreads will widen appreciably and debt delinquencies and defaults will jump.
- Bond rallies will be powerful, but temporary; UST 10Y yield to peak at more than 5% in 2024-25.

Economic Perspectives

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