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Investment perspectives

Inflation: momentary or momentous?

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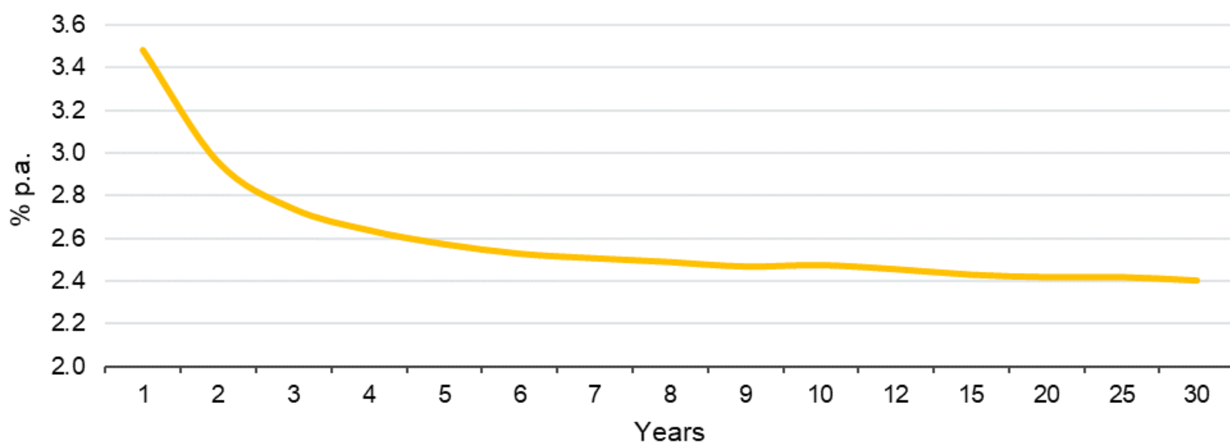
Global inflation is rising as economies re-open following the most severe economic shock since the great depression. Most forecasters suggest the surge in inflation pressures will prove transient, dissipating towards the end of 2021. Markets do not expect a sustained rise in inflation either – market expectations are for inflation to remain above target, but do not suggest current pressures will persist (Chart 1). However, the balance of risks around the inflationary outlook have shifted to the upside. Inflation running persistently hot may not be disastrous for economies but may still have implications for interest rates, yields and valuations, relative to current levels. A more profound shift to a high inflation environment is potentially more disruptive for both the global economy and markets. In this article we consider the risk of a momentary surge in inflation becoming a momentous shift to a prolonged period of high inflation.

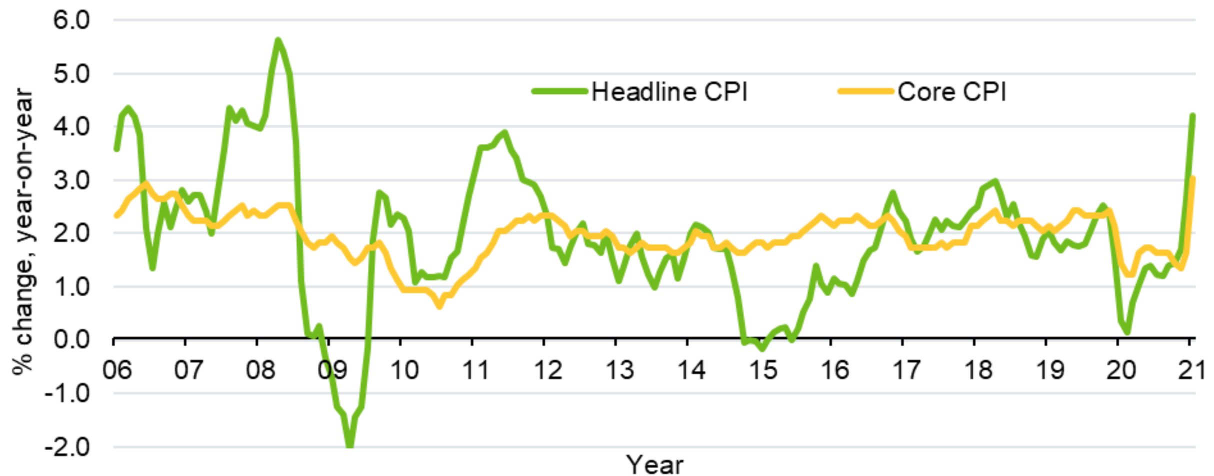
Chart 1: US inflation swaps



Background

A rise in US inflation was anticipated, but April's 4.2% year-on-year increase in headline CPI greatly exceeded expectations. US headline CPI was boosted by a recovery in oil prices but core CPI, which excludes volatile elements such as food and energy, also outstripped expectations, rising 3.1% (Chart 2).

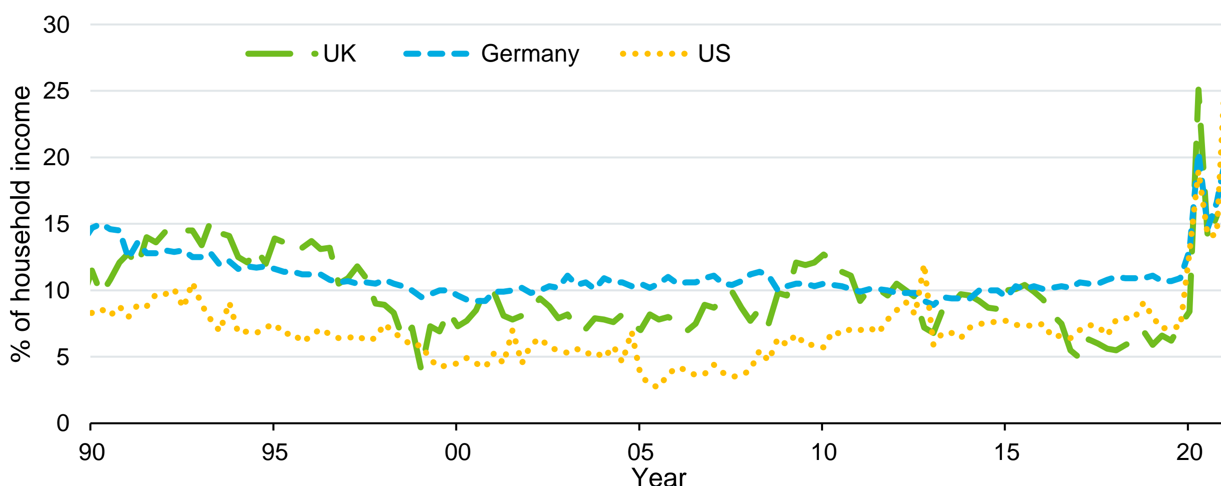
Chart 2: Realised US Inflation



Indeed, inflation is rising sharply across the world with a notable increase in the global median inflation rate in April. Recent Purchasing Managers Index surveys for the major advanced economies highlight businesses facing supply shortages and difficulties filling vacancies. Across the board, surveys are showing extensive shortfalls in supply relative to demand and average selling prices for goods and services rising at unprecedented rates.

Recent inflation readings largely reflect base effects, relating to the timing of last year's lockdowns, and price hikes due to pandemic-induced shortages. While there remains a great deal of uncertainty as to how long it will take global business and trade to return to normal functioning, most forecasters expect the inflationary spike to prove temporary: supply-chain pressures should dissipate, companies have scope to increase production and the one-off boost to consumer spending from stimulus cheques and pandemic savings (Chart 3) will likely pass, and temporarily more generous US unemployment benefits will expire.

Chart 3: Personal savings as a proportion of income

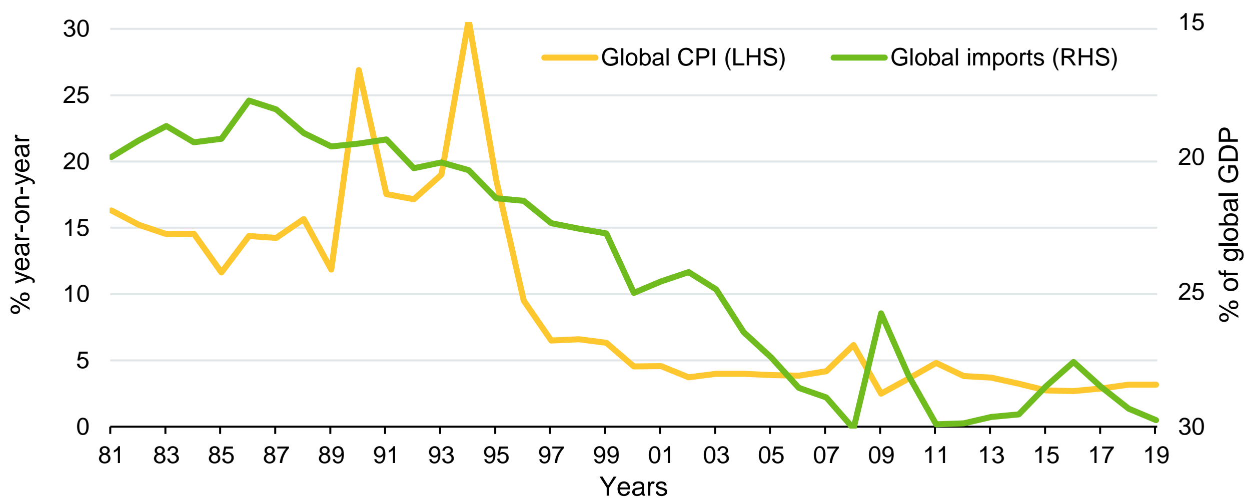


"Low-flation" of the last three decades

Inflation in most advanced economies has been on a declining trend for the past three decades, owing to a number of structural factors including globalisation, anchored inflation expectations, demographics, and advances in technology:

- Globalisation and advances in technology have greatly reduced input costs over the last 30 to 40 years – a massive shift in manufacturing to lower-wage labour markets has greatly reduced manufacturing costs. Greater competition has been a consistent deflationary force – global imports as a share of global GDP increased rapidly between the 1970s and the Global Financial Crisis (Chart 4).

Chart 4: Global CPI and global trade



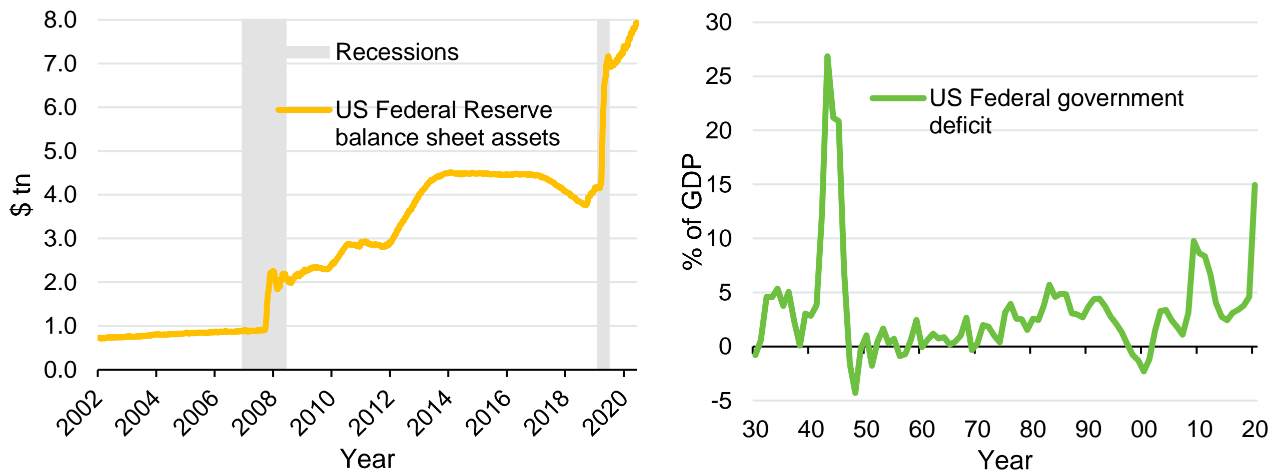
- The introduction of independent central banks and inflation targeting have led to lower and more predictable inflation expectations in recent decades. However, if government commitment to control inflation lacks credibility then shifts to a higher inflation environment are more likely.

- Ageing populations in advanced economies have placed downwards pressure on inflation over the last 40 years by lowering expectations of future growth and increasing levels of savings. While retiring "baby boomers" are starting to place downwards pressure on savings, increasing life expectancy will offset this to an extent as people save more for retirement during their working lives.

Why this time could be different

Some of these factors are expected to remain in place, but some commentators point to reasons why the risk of a shift to a higher inflation environment has increased, including central bank policy, de-globalisation, and the possibility that current labour shortages become more ingrained. As central banks expect the current rise in inflation to be temporary, they are adopting a less pre-emptive stance. Additionally, following a decade of undershooting targets, central banks are likely to tolerate a degree of overshoot – in August 2020 the Fed officially adopted a new Flexible Average Inflation Targeting framework, allowing inflation to overshoot to make up for periods of below-target inflation. Coordinated monetary and fiscal policy responses, particularly in the US where we believe the risk of a more persistent policy overshoot is greatest, are unprecedented. Major central bank policy interest rates remain at record lows and central bank balance sheets have rapidly expanded while budget deficits have swelled (Charts 5&6).

Charts 5&6: US Federal Reserve Bank balance sheet and US Federal government deficit



At a time when policy remains unprecedently loose, the consequences of error could not be greater: If inflation expectations become de-anchored and workers demand wage rises, central banks may have to raise rates more aggressively down the line to stave off a self-fulfilling inflationary spiral.

The pace of globalisation has slowed since the Global Financial Crisis and a reversal seems unlikely. The creeping protectionism of the 2010s seems to be gaining momentum as global political tensions increase. Additionally, the pandemic has placed global supply chains under fresh scrutiny which may lead to reshoring, potentially increasing input costs.

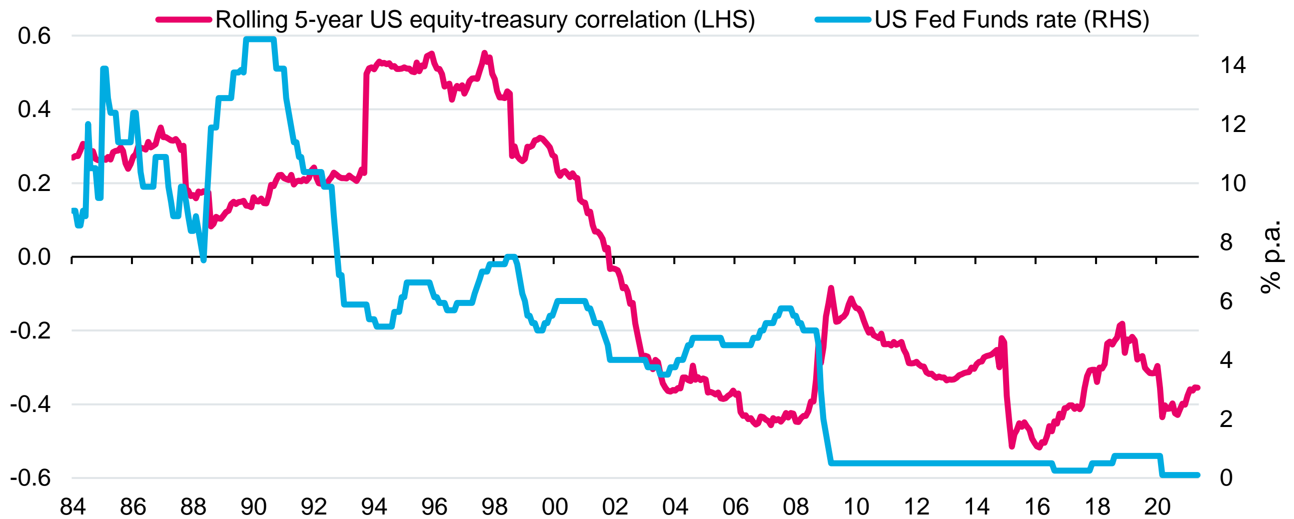
A further medium to long-term upside risk to inflation would be if labour shortages prove more sustained than expected and short-term wage pressures become ingrained.

What a shift to a higher inflation environment would mean for the economy and markets?

In the past, central banks have not been able to reverse profound and persistent rises in inflation without causing recessions and large increases in unemployment. The trade-off between unemployment and inflation (the Phillips curve) has weakened in recent decades. A re-emergence of this relationship would require more interventionist central bank policy to control inflation. Given levels of government and non-financial corporate debt, large interest rate rises could severely impact the financial system.

A high inflation environment may pose challenges for portfolio construction as correlations between equities and sovereign bonds have historically been more positive in higher inflation/interest rate environments (Chart 7), reducing diversification and making a traditional balanced portfolio more susceptible to the economic cycle.

Chart 7: US equity-treasury correlation and Fed Funds rate



A more persistent rise in inflation and subsequent rate rises would dent government and corporate bond prices, pushing up yields. Yield rises may potentially increase refinancing risk, particularly for speculative-grade credit and hard currency emerging market debt issuers. Higher inflation may also negatively impact equity earnings while higher government bond yields would weight on valuations, particularly in longer-duration sectors, such as technology.

Conclusion

Inflation was always expected to rise in 2021 as economies emerged from lockdowns, but recent inflation prints have surpassed expectations as global supply and labour shortages exacerbate base effects. Structural forces, particularly demographics, will continue to weigh on inflation over the longer-term but unprecedented monetary and fiscal policy, a slowdown in globalisation, and more patient central banks pose upside risks of a shift towards a higher inflation environment. Consensus expectations are for more severe inflationary pressures to ease as we enter 2022 and for inflation to return to levels not dissimilar to those of the past few decades. However, there has been a clear shift from the tail risk being one of deflation to one of high inflation, a scenario that could have profound consequences for the global economy and markets.

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