InvestmentUpdate

23 March 2021

Brace for an inflation spike, but we don't see it lasting

A confluence of forces could drive inflation uncomfortably high before stability returns

Brace yourselves: inflation headlines could make for uncomfortable reading come spring. There's a perfect storm of proximate causes brewing, which we'll discuss below, but the key question to ask is: will this be a fleeting spike in inflation, or are there more profound underlying causes that could make it a lasting trend? Indeed, this is arguably the most important economic question of 2021. *Runaway* inflation would be a high-impact event, causing central banks to tighten monetary policy sooner than expected, driving bond yields higher and equity valuations potentially lower, especially those of the 'growth' stocks (companies expected to grow their earnings at relatively higher rates for a relatively longer period of time than the median company). 'Growth' stocks dominate global stock indices today. Fortunately, we think this is also a low-probability event, though there are some risks to this view, which we'll flesh out below.

Global investors are most concerned about US inflation and the Federal Reserve's (Fed's) reaction, given the bellwether effects of US interest rates. In the US, we expect consumer price index (CPI) inflation to breach 3% in April or May, and core personal consumption expenditure (PCE) inflation — the favoured measure of the Fed — to head towards 2.5%.

Fuelling the inflation spike

One of the main reasons inflation will spike in the spring is because prices were abnormally low in March and April last year. If you drive a car regularly, energy costs will be one of the more visible price rises. But their sharply increasing contribution to inflation — usually expressed as an *annual* rate of change — is more about abnormally low prices last year than it is about expensive energy this year, which is why we think energy inflation is likely to fade quickly.

Energy's contribution to the US CPI is quite easy to predict one month ahead. Changes in the spot prices of gasoline, heating oil and natural gas explain almost all of the variability over the last 30 years. Holding today's prices constant, it's clear we're in for a big spike, likely peaking in May, when we expect energy will add at least two percentage points to headline US CPI. The passthrough from commodity prices to consumer energy prices in the UK is harder to predict, but we estimate that they will add around 1%.

As noted, there is a large base effect from the big slump in prices a year ago. That said, our three spot prices surged in February as a result of the polar vortex freezing the pipes in America's biggest oil-producing region. Henry Hub Natural Gas prices rose more than 700% in the space of two weeks, but have quickly fallen back to January's levels. Gasoline and heating oil prices were not nearly so erratic, but are taking longer to normalise. Experts expect prices to normalise quickly with warmer weather, but any lasting effects could see energy inflation adding even more pressure to headline inflation.

The important point to note, however, is that huge increases in energy inflation have not translated into large spikes in core inflation over the last 40 years. We note that the correlation between energy and core inflation has been particularly weak when a sharp rise in energy inflation was caused predominantly by a dramatic plunge 12 months previously.

Rising costs for all those clicks?

Shipping costs are also causing some consternation, but we can't see them moving the dial on core inflation that much either. They haven't in the past. Our analysis shows the correlation of annual shipping cost with goods inflation is statistically non-existent. This is even the case in the UK, which has a much higher imported content of the inflation basket (25%) than most countries. In the US, it's only around 10%.

Shipping costs are typically volatile, regularly rising or falling by over 50% in a year. Capacity is fixed in the short term and moving ships from one route to another isn't straightforward. During the rapid phases of economic recoveries, it's normal for shipping costs to rise sharply. In 2010-11, the Harpex index of global shipping costs almost trebled, with no discernible impact on inflation. It's not expected to rise higher than the 2010-11 episode, nor do experts expect price rises to prove as persistent.

There's less competition in the shipping industry now after another decade of consolidation, and with air

freight still constrained, ship owners may have less incentive to reroute ships. That said, it's important to remember that global trade has already risen above pre-COVID levels and cost pressures should ease as consumers start to spend more on services relative to goods as lockdowns ease – services are less impacted by shipping costs.

The latest surge in shipping costs has been mainly about the China to Europe haul – a container cost less than $1,500 a year ago, but it's more than $8,000 today. The cost of Chinese freight to West Coast America actually trebled between spring to autumn 2020, without a noticeable impact on inflation, and has risen more modestly in the last few months – so if it's US inflation and the Fed's response to it that investors should be most worried about, that's really important to note.

Finally, consultancy Oxford Economics notes that the shipping cost of a small, high-value item such as a smartphone is insignificant at less than 0.1% of the final price. For something lower in value and bulky, such as a budget fridge, they estimate that prices would need to rise 20% to recoup the surge in China to Europe shipping costs. The good news is that CPI baskets aren't overflowing with budget fridges. All told, shipping is unlikely to add more than a few tenths to inflation over the next few months.

As we said in the introduction, there are other reasons why inflation will spike in the spring, many of which are already impacting producers' input costs (bottlenecks in the supply chain, for example). The surge in the input cost sub-indices of various purchasing managers' surveys has excited inflation hawks. They have risen to a level not seen since 2009. But today's elevated levels were normal in the 2000s, when inflation did not get out of hand. Moreover, while these indices are a very good leading indicator of inflation, despite being a bit noisy, today's levels are only consistent with about 2.5% core PCE inflation (the Fed's favoured measure, as mentioned above). This would be welcomed by the Fed, not tightened against (more on that later).

Bigger constraints

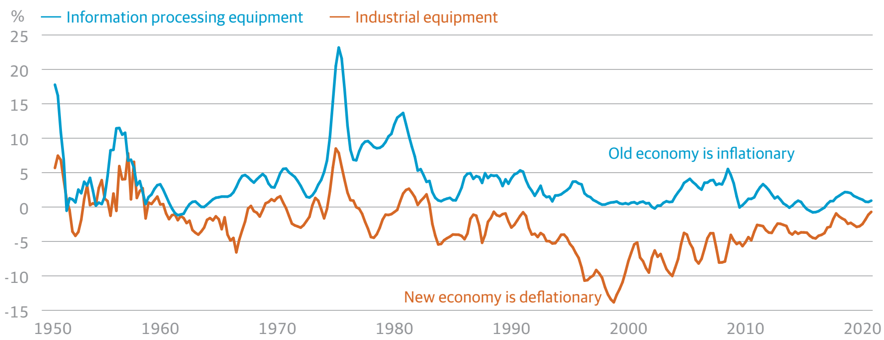
In the remainder of this note, we restate our thesis on why such 'cost-push inflation' (what economists call inflation caused by rising input costs) is unlikely to turn into a worryingly persistent rise in prices over the next 18 months or so, bolstering it with some new evidence. We set out this thesis on inflation most fully in our July Investment*Update*, and reviewed it again in our latest *Quarterly* Investment*Update*. You can also recap by watching the replay of our recent client investment seminar (the 12 minutes on inflation starts shortly after the 29-minute mark).

In theory, inflation results from an imbalance between the demand for goods and services and their supply. For now, there's ample spare production capacity: even though global GDP is likely to surpass the pre-COVID level by the end of 2021, it will probably take a few years before it surpasses the pre-COVID trend (i.e. what the economy would be producing had COVID not occurred). Sure, there may have been some permanent destruction of supply – the UK and eurozone are unlikely to ever catch up to their pre-COVID potential (see our update on the Budget) – but, at the same time, capacity in some sectors was likely boosted by the catalysation of technological change. As figure 1 illustrates, a greater role for the digital economy means greater disinflationary pressures.

A lagging recovery in employment (figure 2) is also likely to suppress

Figure 1: The digital economy means greater disinflationary pressures

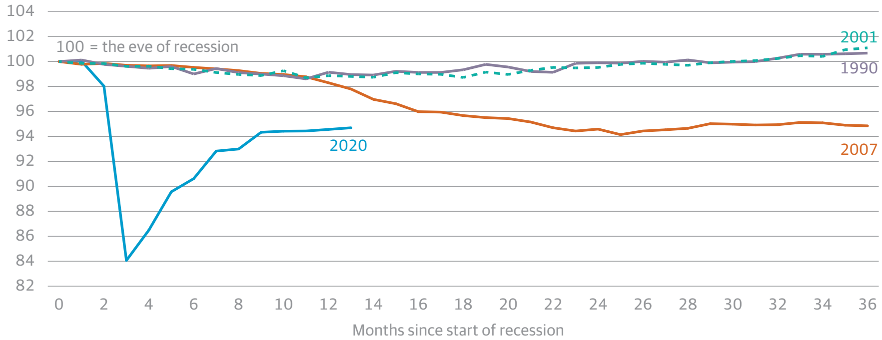
Fixed asset price change, % year-on-year.



Source: Rathbones.

Figure 2: Post-recession employment levels

Employment levels are lagging compared with other post-recession periods.



Source: Rathbones.

As spending on services normalises, we'll spend less on goods than we have in a socially distanced world.

inflation. The US economy still counts 9.5 million fewer jobs than in February 2020. Remember that wage pressures were moderate at best when the unemployment rate hit a 51-year low of 3.5% before COVID, even after President Trump unleashed a trillion-dollar tax cut in 2018. Concerns about future job prospects are keeping consumer confidence depressed today, and that is likely to contribute to keeping the private sector savings rate above the pre-crisis norm.

Yes, a wall of cash was amassed last year. But a one-off splurge doesn't necessarily translate into higher inflation, especially when there is still room to increase supply from the spare capacity that remains in the economy. Moreover, evidence from academic studies and the US Census Bureau suggests that lower-income households didn't amass any savings anyway, and wealthier households may not have much need to draw them down because they spend more on services, which are less easily pent up (there are only so many holidays a working household can take). A stronger argument can be made for the wall of cash fuelling more asset price inflation — just look at the US housing market.

As spending on services normalises, we'll spend less on goods than we have in a socially distanced world. Pressures from oil, shipping and other input costs related to goods prices will begin to be offset somewhat by falling demand. Indeed, HSBC estimates core goods inflation will fall to near zero in the second half of this year (it was negative for most of the seven years before the pandemic). Services prices will increase but are starting from very depressed levels; we think it will take a while for them to bounce back. Taiwan, for example, had very few deaths from COVID, and normal activity has been permitted for some time now. Yet its entertainment inflation sub-index is still extremely depressed.

Survey evidence for firms suggests they will prioritise repaying emergency credit lines and even pre-existing debt, and therefore the business sector may also contribute to a higher savings rate and add a concomitant disinflationary impulse. In the UK in particular, the Deloitte CFO survey shows how conserving cash is a priority. Our analysis has shown that equity investors favoured stronger balance sheets last year, as they have done frequently over the last 25 years, even as interest costs have fallen, and chief executives may strategise with that in mind. To be clear, 2020 wasn't a so-called balance sheet recession, like 2008's, and we don't expect an associated profound period of debt reduction from households and businesses — that's why we're not forecasting worryingly low levels of inflation. Still, survey evidence suggests banks do not intend to ease credit availability this year and that will help keep the newly printed government money from 'multiplying' into inflation.

Expectations: big hat, no cattle

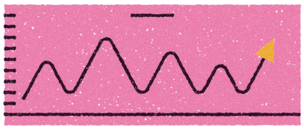
Finally, the biggest driver of inflation is inflation expectations, which are still well-anchored. A market-based measure of inflation expectations, based on the difference in yield between nominal and inflation-protected five-year US government bonds, has risen back to normal levels. Although this measure doesn't predict the five-year average very well, it is a decent guide to inflation over the next 12 months. Some commentators worry that it is in fact *higher* than where it has been since 2013, but we are more sanguine. Over the last decade, it has been too *little* inflation that has induced headaches among policymakers.
They actively want to see inflation expectations move above their recent average. Rather than tightening policy to counter it, they would welcome it as a sign that their new efforts are having more success. Of course, they do not want to see inflation expectations rocket, but that's not where we are today. Indeed, for all the inflationistas' talk of runaway inflation over the last month, most market-derived measures of medium-term inflation haven't risen since early February. The American phrase 'big hat, no cattle' springs to mind.

Watching the Fed

The minutes from the Fed's February monetary policy meeting showed its voting members are well aware of what's coming in the spring. Their opinion echoes ours: '*Many participants stressed the importance of distinguishing between such one-time changes in relative prices and changes in the underlying trend for inflation.*' Looking beyond the spring, the minutes indicated that Fed officials remained sceptical about sustained underlying price pressures.

Fed Chair Jerome Powell has gone further in recent interviews and said that talk of tapering its quantitative easing (bond buying) programme is 'premature'. He is '*not even thinking about removing accommodation*'. Even historically hawkish officials such as Dallas Fed President Robert Kaplan suggest further price increases due to a one-time, vaccine-fuelled boost in demand would not be concerning. Typically dovish Chicago Fed President Charles Evans indicated that 2.5% inflation would be 'welcome' and 3.0% would not be troubling.

We live in a new Fed order (see our recent Investment*Insights* article highlighting this shift). 25 years of disinflationary pressures has ushered in an average inflation targeting framework. This allows for greater patience in waiting to see a sustained rise in inflation before raising rates. We're talking average core PCE inflation of over 2% for at least 12 months, according to Vice Chair Richard Clarida.



Some investors have questioned if the Democrats' first stimulus bill is already too much for the economy to bear. This depends on the so-called fiscal multiplier – how many dollars of spending occur for every dollar of fiscal stimulus. We don't expect it to be high.

Keeping a close eye on the risks

There are four main risks to our sanguine view on inflation:

i. Behavioural change – households and businesses save less than ever before because they now assume the government will always bail them out.
ii. Greater damage to the supply-side of the economy than anticipated.
iii. Unanticipated fiscal stimulus – the recently passed COVID relief bill was largely anticipated. There will be greater risks around another one if it is unprompted by deteriorating conditions.
iv. Frontloaded rises in the US minimum wage to $15 an hour.

We need to monitor for all of them. For the first, we need to keep a close eye on surveys and also credit demand. The extent to which households spend the $1,400 stimulus cheques being mailed out as we write will also be an important clue. We note that Trump's final $600 stimulus checks, which were received in early January, together with the uplift to unemployment benefits, resulted in a $2 trillion month-on-month increase in government transfer payments in January. Without them, total personal income would have been more or less unchanged. Yet consumer spending increased by just $350 billion. For sure, consumers are often a little shy in January after the holiday season's hedonism, but February's retail sales decreased by 3% despite the substantial easing of stay-at-home orders.

Our analysis confirms what many of you will already know: a rising rate of inflation is not necessarily a bad thing for equity markets. The same goes for rising bond yields. Both tend to be indicative of expanding economies and rising earnings.

For the second risk, we should look at measures of capacity utilisation and wage pressure (the Federal Reserve Bank of Atlanta's wage tracker is our favourite gauge as it looks at people continuously employed). Of course, greater damage to economic capacity would also mean protracted long-term unemployment, and therefore the inflationary impulse could be partially offset by a disinflationary side-effect via lower aggregate demand.

Risks three and four require a lot of policy watching. The Democrats' stimulus package was passed using the reconciliation procedure, which requires only 50 votes in the Senate rather than 60. They can only use that once every fiscal year, which means another splurge before October would require significant Republican support. That seems unlikely. The exception might be an infrastructure bill. But the proceeds of that would likely be spread out over many years and should also augment the economy's production capabilities (faster broadband, faster roads, etc.), which should offset the inflationary fiscal impulse over time.

Some investors have questioned if the Democrats' first stimulus bill is already too much for the economy to bear. If it pushes aggregate demand for goods and services very far above their potential supply it could result in alarmingly high price pressures. Such an outcome depends on the so-called fiscal multiplier – how many dollars of spending occur for every dollar of fiscal stimulus. But this is unknowable ahead of time; the economic literature is very inconsistent on the matter. Higher multiples can occur when fiscal stimulus can be readily spent, when lower-income households receive relatively more transfers, and when credit is constrained – all the case today. However, multiples tend to be low (and sometimes negative) if the economy is already expanding, if the stimulus doesn't target ailing sectors specifically, or if it doesn't encourage capital investment – also all the case today. Weighing the evidence, we do not expect the multiplier to be high enough to result in a dangerously overheated economy, for many of the reasons discussed above. But we must acknowledge the uncertainty.

Biden wants to raise the federal minimum wage to $15 an hour by 2025. Democrats tried to sneak this into their stimulus bill, but it didn't have the support of the moderates in their party. Joe Manchin of West Virginia has said he would only support an increase to perhaps $11 by 2025. Legal experts have questioned whether you could use reconciliation for this legislation, in which case any increase would require Republican votes and that would also make only a moderate increase likely.

Changes to the minimum wage are primarily about redistributing national income and it is unlikely to raise GDP substantially (another recent study from the Congressional Budget Office supported this view, as have Capital Economics). As we wrote in our pre-election report, higher state and city minimum wages mean that very few workers actually earn the federal minimum (around 2%), and if the increases were spread across a number of years the impact wouldn't be very inflationary (companies local to the southern states would be more affected). Of course, over 20% of workers earn less than $15, so if progress towards that target was frontloaded into the next year, cost pressures would be more profound.

Investment implications

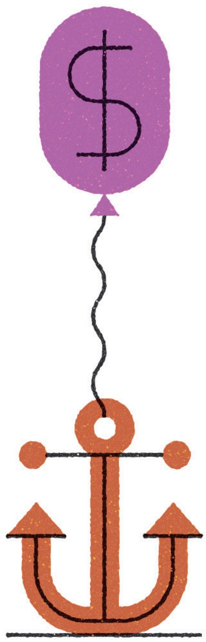
Our analysis confirms what many of you will already know: a rising rate of inflation is not necessarily a bad thing for equity markets. The same goes for rising bond yields. Both tend to be indicative of expanding economies and rising earnings. While there is a mechanical link between higher inflation, higher bond yields and lower equity valuations — because bond yields are used to discount tomorrow's earnings into today's price — the effect is usually offset by stronger earnings expectations. We've found that equity markets tend to do well until inflation rises above 3.5%.

Rising short-term interest rates are a different matter: they are the scourge that flay the backs of equity investors; particularly when they rise above the neutral rate (the theoretical rate of interest consistent with an economy operating steadily at full employment). In other words, central bankers tightening rates too far are much scarier than the 'bond vigilantes' pressuring up long-term government yields. Short-term inflation-adjusted rates are actually lower today than they were three months ago, even if we look out as far as the yields on 5-year inflation-protected Treasury bonds. And, as we have set out, central banks are highly unlikely to raise short-term policy rates over the next 12 months, even as inflation spikes in the spring.

There is more risk that inflation surprises to the upside than the downside. So it is important that investors concentrate on looking for companies with good pricing power or in industries that typically benefit, at least on a relative basis, from rising inflation and bond yields, such as basic materials and other cyclical sectors.

It's always important to think what we should do if we were completely wrong. If inflation does spiral, equities in general are likely to do poorly. Real assets with inflation-linked rents may do better, particularly if they are leveraged as inflation would eat away at the real value of their debt. Gold could help, but it depends on how far real yields rise: if interest rates rise more than inflation, gold and other commodities may struggle.

We'll set out our analysis more fully in our next quarterly Investment*Update* at the end of this month.



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