View from the Bridge – 1st September 2020

Inflation: Where is it? Is it a problem?

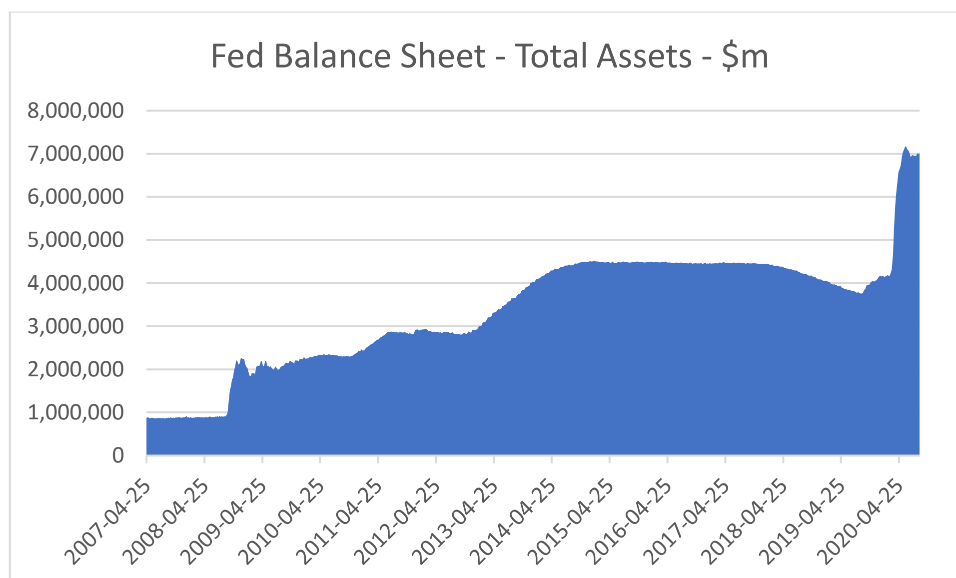
Here is Powell's recent Jackson Hole conference speech, in plain English:
"There is too much debt in the US and globally. It's hurting growth. This can be resolved one of two ways:

1. Widespread defaults (including sovereign debt forgiveness)
2. Inflate it away

Today we are accelerating option two"

So there we have it. The Fed want more inflation, but can they achieve it. The Bank of Japan (BoJ) has been trying this trick for the best part of 30 years without any success so why should the Fed fare any better? The post 1970s monetary regime is under immense strain; balanced government budgets and fiscal conservatives are on the run hounded by the MMT (Modern Monetary Theory / Magic Money Tree – take your pick) brigade who stipulate that a country with a sovereign currency ie the ability to print ad infinitum should in fact do just that.

The Fed, the Bank of England, the ECB and the Swiss National Bank along with the BoJ have been doing that for some time, but with the advent of COVID they have raised their game. Below is the Fed's balance sheet (in effect the money they have created by buying US Treasuries and mortgage backed securities – QE by another name) which has "exploded" to $7 trillion and, according to Morgan Stanley, is on the way to $20 trillion.



Source – Federal Reserve Bank of St Louis

MMT pronounces that money supply growth is not an issue unless and until we enter an inflationary environment and of itself increased money supply does not necessarily mean we will get inflation,

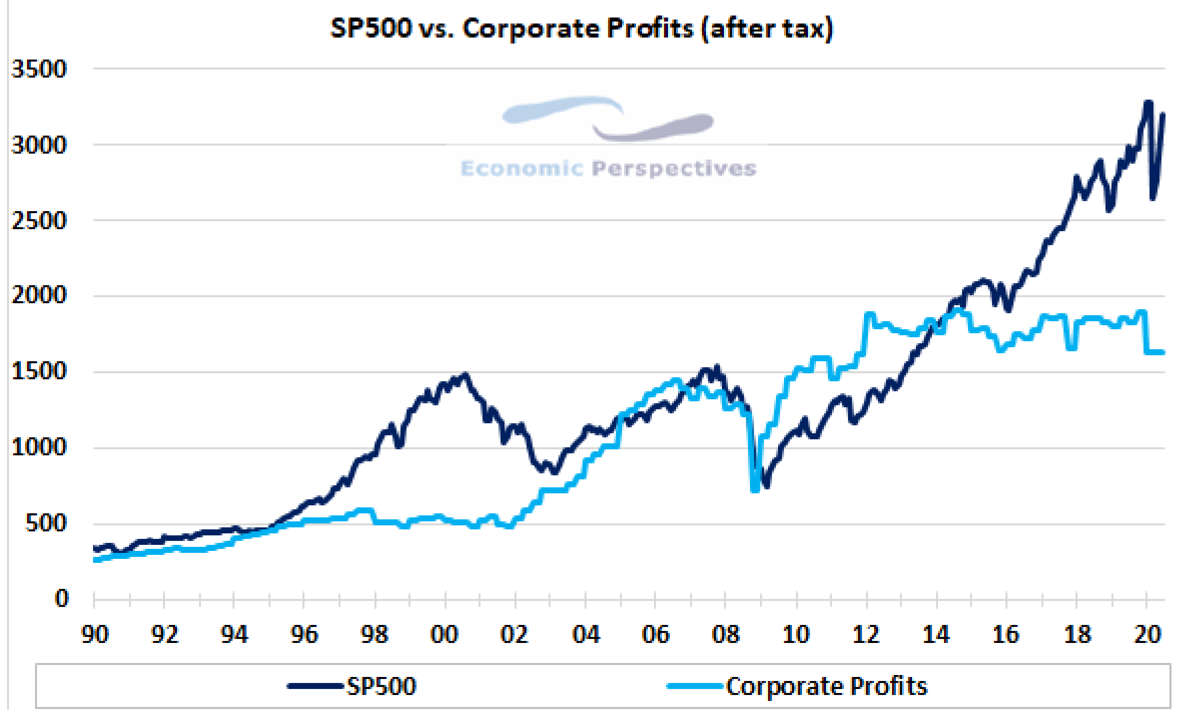
but given the huge and ongoing expansion of currency to absorb the ever growing issuance of US Treasuries it just might!

Covid 19 presents an existential threat to a weakened monetary regime. QE has driven a wedge between deficits and bond issuance to be absorbed by the private sector so the central bank has to take up the slack especially as foreigners, notably China and Russia are no longer accumulating USTs. The petrodollar regime in existence since Nixon took the US off the gold standard in 1971 is crumbling as the Chinese in particular are now moving to renminbi based contacts for oil and other raw materials.

The Fed can try to control the inflation rate, but in reality it is not in their gift. Inflation and exchange rates are the only free variables in the system as financial repression holds bond, credit and equity prices in a state of suspended animation. So inflation targets are irrelevant! During periods of institutional and political stability, inflation models work quite well but during periods of regime change, which we are beginning to see now, models fail and the “black box” blows up.

Whilst the current environment appears deflationary there is plenty of scope for a near term inflation surprise. Supply side dynamics play a key role: both lockdown and social distancing are negative supply shocks with inflationary connotations. Inventories are depleted and will not easily be replenished, which will lead to price rises, not to mention the sheer scale and scope of government intervention and price support. Over 20% of total US income comes from government sources and without continued support the already fragile economy will be facing a depression not a recession.

One of the key issues for the economy is whether there will be a recovery in real rather than nominal terms. In a real recovery profitability matters. As Alfred Rappaport said, “Profits are an opinion; cash is a fact.”



Source; Economic Perspectives

The private credit system is impaired but has not imploded because of loan guarantees and tax/interest forbearance: so we are not seeing a repeat of 2008…yet. Bankruptcies and debt defaults would be deflationary for a while, but the current assumption is that the Fed will support bond market liquidity although default would be a solvency issue. They find themselves on yet another tightrope.

Not only could we be staring down inflation, but stagflation, which we haven't witnessed since the 1970s; a moribund economy and inflation. Governments cannot sustain income replacement transfers, subsidies and loan guarantees indefinitely. There is also a distinct risk that the private sector recovery will peter out by next spring and the stalled debt delinquency and default cycle will resume.

Governments will increasingly have to monetise their budget deficits and existing debts opening the way for the conjunction of faster inflation and stagnant output in 2021 23. Global growth and inflation appear positively correlated, but the association rests on very few data points At the national level, the correlation evaporates; disinflationary growth and stagflation occur much more prevalent.

Why does any of this matter? Inflation is bad news for the dollar which will find its "safe asset" status eroded, helped by de-dollarisation in other economies notably China. Weaker dollar, higher import costs, higher inflation. High inflation is also likely to be negative for stocks (see above) as well as bonds. This will make it harder for conventional portfolios, historically relying on a blend of equities and bonds, to reach their return expectations.

Deflation could reappear in 2021 if the economic recovery stalls but we expect heroic public works programmes on a grand scale regardless of who wins the US election, but stagflation is still the most likely outcome for the next three years.

An inter-generational monetary reset is underway and coping with inflation will be big part of this. The time to start preparing is when everyone else is looking the other way; like now. What are our options? We will discuss that in next month's Under the Hat.

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