INVESTMENT BRIEF

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Strategic Investment Group®

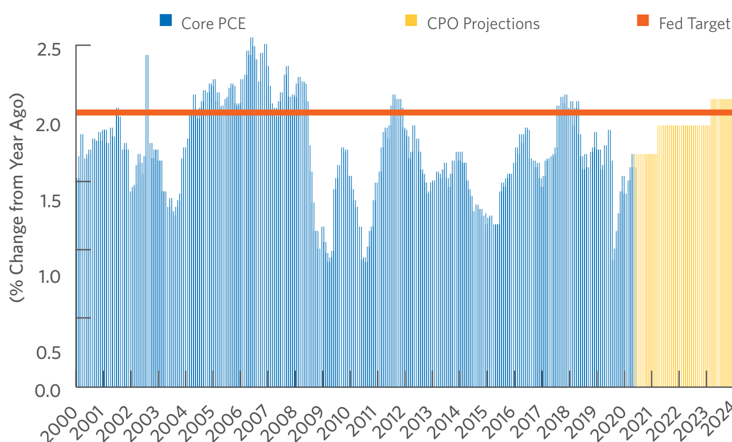
Inflation

There are mounting concerns that decades of price stability may give way to higher inflation as the global economy recovers from the COVID-19 crisis. We consider below the sources of inflationary pressure and their market implications.

Changing Inflationary Dynamics

Inflation has remained low and mostly below the Fed target for over two decades (Exhibit 1). Massive intervention by the Fed has so far not succeeded in pushing inflation above its 2% policy target. The CBO projects that the inflation rate will increase gradually and remain well anchored as the current slack in the economy is absorbed.

EXHIBIT 1:
Inflation Has Remained Low Despite Massive Stimulus
Sources: FRED and CBO.



Powerful forces are increasing the risk of future inflation. First, the liquidity trap that prevented monetary stimulus from having its desired effect following the GFC is not a constraint. Money has been put directly in the hands of households and businesses. The money supply is way up and the Fed has said that it will remain easy even if inflation goes above 2%. Bank balance sheets are strong and banks have the wherewithal to increase lending. Second, vaccine distribution is ramping up quickly. Once fear of infection recedes, spending will increase. Household savings is up. Pent up demand is high. Households have money to spend. Third, increased demand will hit constrained supply, at least initially. It will take time to ramp up production. Bottlenecks in supply chains, transportation, and labor markets will trigger price spikes in particular goods and services and could lead to generalized price inflation. Fourth, the disinflationary benefits of trade globalization appear poised to ebb and perhaps partially reverse as resiliency and nationalism assume greater priority. Finally, the Federal fiscal deficit is at its highest level since WWII. Swelled by stimulus and infrastructure initiatives, government spending is way up and seems set to rise further, adding to demand.

Of course, there are mitigating factors that could keep inflation from increasing significantly. There are currently 8.5 million fewer people employed than just prior to the pandemic. Participation rates are low, wage growth remains weak, and labor's bargaining power is limited. The ascent of "scalable" business models may permit a longer runway to accelerate activity without encountering constraints. The CBO projects that the economy will continue to have slack through 2025. In addition, inflation inertia is typically very strong. On balance, however, despite these mitigating factors, we believe that inflationary spikes are likely in the coming months.

Market Implications of Increased Inflation

The long recent experience of low inflation is helping form expectations that inflation will remain low. These expectations become self-fulfilling as they are embedded in contracts that affect future inflation outcomes. If a spike in inflation is considered to be transitory and largely attributable to base effects or temporary disruption to supply while factories get back to full capacity, then the impact on markets is likely to be benign. If, in contrast, a spike in inflation is perceived to be the beginning of an inflationary spiral, the consequences could be much more severe. Inflation expectations would become unanchored by inertia and confidence in the Fed to maintain price stability. Uncertainty would increase. The range of possible market implications is wide and includes the following.

An increase in inflation accompanied by a strong economic recovery that boosts output, employment, household earnings, and corporate profitability could result in strong portfolio gains as traded and private equity investments benefit from the improved outlook for earnings.

If the increase in inflation is expected to be followed by yet more increases driven by excessive fiscal and monetary stimulus, total portfolio returns would suffer. In this case, the Fed would be seen to be "behind the curve." The credibility of the Fed's policy objective of price stability would be lost, the inertial forces helping keep inflation in check would be broken, and uncertainty would increase.

The worst case would be a return to 1970s style stagflation. In this scenario, supply bottlenecks would persist and be combined with intensified trade tensions and a loss of the efficiency gains of globalization. Persistent supply constraints, reduced productivity, and pent up demand would collide, increasing inflation. Yields would increase, but not earnings growth, calling into question the sustainability of high debt loads and potentially triggering a renewed financial crisis. The impact of this scenario on portfolio returns would be severe.

While inflationary spikes appear inevitable in the short-term, they are likely to be short-lived, although disruptive to particular industries. With yields still quite low and inflationary pressure building, we retain a solid underweight to duration.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.

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