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ISG Insight: a mostly benign outlook for US inflation

November 2020

Key takeaways:

- Inflation has long been a negligible concern, but investors are now wondering whether historic fiscal and monetary stimulus could result in a return of inflation.
- In our view, significantly higher inflation is unlikely to materialise in the next few years as it will take time for unemployment to fall and demand for goods and services to exceed supply. In fact, US gross domestic product (GDP) is not expected to return to pre-pandemic levels until 2022.
- However, short-term rises in inflation are more likely. With low US Treasury yields providing little compensation for the associated risks, investors should focus on realising income and diversifying their fixed income portfolios.

The stabilisation of US economic growth amid unprecedented fiscal and monetary stimulus has raised questions about the likelihood of inflation returning. Jim Cielinski, Global Head of Fixed Income, and Andrew Mulliner, Head of Global Aggregate Strategies — both members of the Fixed Income Investment Strategy Group (ISG)* — explain why they do not see significant risks of sustained higher inflation materialising in the next few years, though caution that short-term spikes are possible and investors should evaluate the diversity that their fixed income portfolios provide.

For most investors, inflation has long been a negligible concern. For over two decades, US consumer price inflation (CPI) has wobbled around the 2% level, and while there have been a few significant deviations from that range both to the upside (in 2008 a spike in oil prices saw inflation rise above 5%) and to the downside (post the Global Financial Crisis (GFC) inflation fell to -2%), on average inflation has been stubbornly below target. Indeed the decade since the GFC has been dominated by global central banks trying to fuel their economies and coax their inflation rates back to target by lowering interest rates towards, or through, zero.

The unexpected shock of COVID-19 prompted the US Federal Reserve (Fed) to return its official policy rate to zero for the second time this century (the first was during the GFC) as CPI plummeted from c.2.4% to 1.2%. Across the developed world, central banks initiated unprecedented quantitative easing - the direct purchasing of bonds to inject liquidity into financial markets and ease financial conditions for both the private sector and to sustain the flow of credit to the real economy. Aware that it had largely failed to meet its inflation target to date and with monetary policy looking increasingly exhausted, the Fed has staked its credibility on the line and doubled down on the promise of being able to achieve its objective of stable prices. Over the summer, it announced that it would shift its target of 2% inflation to a long-term average of 2%. In addition, the Fed pledged to act to maximise employment opportunities; removing the previous approach of setting an expectation of maximum sustainable level of employment. The subtle distinction between the old and new, confirmed that the Fed did not intend to “lean against the wind” of the economy and raise interest rates again if it looked like inflation was on its way to 2%; instead, it would wait until inflation actually reached that level or maybe even went a little past it. In short, the Fed has moved to a ‘show me’ setting whereby only the reality of higher inflation would provoke a response.

Meanwhile, governments were enacting equally unprecedented ‘stimulus’ programmes, injecting trillions of dollars into their domestic economies. As the months past and economies began to stabilise, investors have increasingly begun to wonder: where is all this money going to end up? Will massive quantitative easing and historic fiscal spending result in a return of inflation?

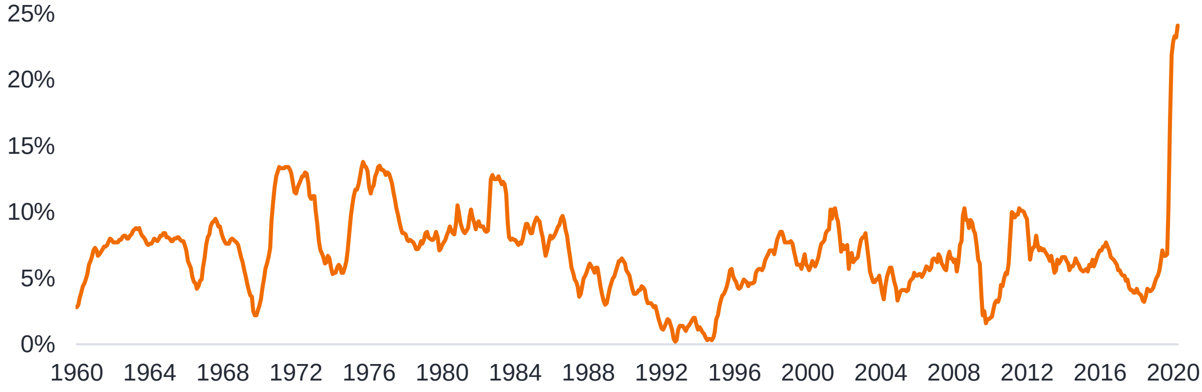
Will inflation rise meaningfully?

Aggressive fiscal policy, low global interest rates, an emerging economic recovery and the US central bank telling us they will keep monetary policy accommodative until inflation actually rises, all suggest it will. But in our view higher global long-term inflation is a certainly a risk but not a certainty.

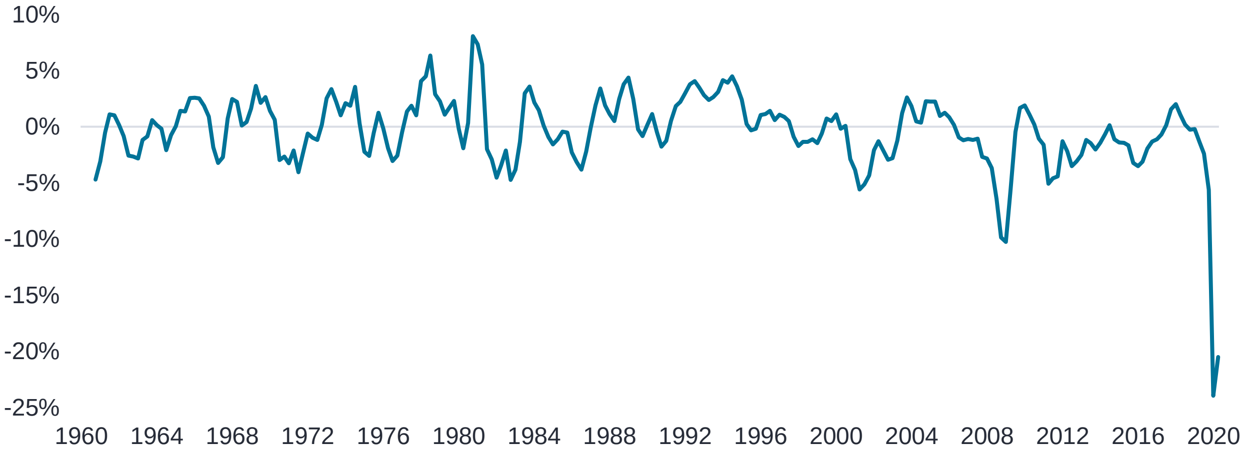
While it is true that money supply has surged globally (registering the fastest growth since World War II) how that money moves through the economy is as important as the amount. The charts in figure 1 show both the growth in money and its velocity and how fast that money multiplies through the real economy. To get large spikes in inflation (for example, the sustained rapid growth seen in the 1970s), economies need both easy money and the demand for that money to exceed supply for a long time. Low velocity of money signals low demand.

Figure 1: rise in narrow money offset by collapse in velocity
Inflation is always and everywhere a monetary phenomenon

M2 growth (yoy change)



M2 velocity (Q4 change)



Source: Bloomberg, Janus Henderson Investors, as at 30 September 2020.
Note: Velocity of Money Index (VELOM2)

If the increased supply of money were to start moving faster through the economy, the risk of inflation would rise. But creating demand for money, perhaps counterintuitively, is not as easy as creating its supply. The Fed can, with relative ease, cut interest rates and boost money supply. But creating demand for money requires a broad expectation that borrowing it, and investing it in the real economy, will pay off.

To date, the global economy has recovered, but there is still vastly more supply of, than demand for, goods and services across the developed world. The challenge is made harder by the fact that the current recession is of the most global in history; the exogenous shock of COVID-19 hit the economies of the world simultaneously. The worldwide output gap is currently large and global unemployment is high. Cost pressures (that is, inflation) are unlikely to arise until unemployment gets back to pre-pandemic levels and while employment is recovering, it has a long way to go.

In our view, confidence in the global economy will grow as treatments and vaccines for the COVID-19 virus are developed. But even with optimistic scenarios for its distribution, it will take a few years of strong economic growth to close the gap between supply and demand. Of the world's major economies, only China is expected to fully recover to the pre COVID-19 levels of GDP by the end of the year, with the US the year after that and Europe not until between 2022 and 2024.**

A modest rise is likely

While we do not see the economic conditions for sustained higher inflation globally, we do believe inflation could see periodic steps higher. The shock to the global economy has been severe and there are individual sectors where supply disruptions could result in some higher inflation. Additionally, governments will have to navigate the hand off of fiscal stimulus to private sector growth and the timing will not be perfect. Authorities, including the central banks, are more likely to be generous than cautious, creating the possibility of excess stimulus for fear of creating too little.

We believe US lawmakers will continue to pass additional fiscal stimulus to help revive economic growth as long as the COVID-19 pandemic persists. However, after the US election, the size of that spending could be more modest than the market was anticipating. US$1 trillion over the next few years is now more likely than the projected US$2-3 trillion forecasts had the Democratic party taken control of Congress and the Presidency. But in our view the rate of change in stimulus is more important than the headline numbers. Indeed, if there was no additional stimulus in the remainder of the year, the existing programmes that have begun to roll off could create a significantly negative rate of change, depressing recovery and inflation.

Ultimately, we expect US CPI could reach 2.0-2.5% in the first half of next year, not far from where it was before the pandemic. While such a figure would be a significant increase from current levels, we see it as a one-off 'step' higher: CPI is quoted as a-year-on-year percentage change and the 2020 base is low, whether because of the (albeit brief) negative oil prices in early 2020 or the collapse in demand for goods and services. As such, headline inflation is likely to be higher year-on-year into 2021, but this should not be confused with a regime shift to higher inflation.

A little inflation reducing the bigger risk of deflation

Policy rates globally have been trending lower for decades. Yet a level of rates that can succeed in creating sustained credit demand has not been found. If the current recovery in Europe and the US cannot become self-sustaining, if there is not an accommodative enough monetary policy setting to spur either growth or inflation, then secular stagnation, already entrenched in Japan and Europe, would then become a larger concern with an unclear solution in the US.

The alternative, some inflation, would go a long way to reassuring central banks and the market that long-term economic growth is not at risk of stagnating. More practically, zero and negative interest rates limit central banks' ability to manage their economies through monetary policy. Thus, some inflation, allowing higher nominal interest rates (while keeping real interest rates low) would be welcomed by central banks. This is particularly true outside of the US, as long-standing disinflationary forces are more entrenched in Europe and Japan.

What we are watching

The trouble with inflation is that by the time it is present, it is already too late do anything about it. In the near term, with unemployment rates elevated and economies still recovering lost output, the prospect of high inflation seems unlikely. However, as the recovery progresses, we need to keep an eye out for signposts that could warn of a more inflationary outlook.

Money supply growth and the velocity of that supply are both timely and easily available indicators. Milton Friedman one the chief acolytes of monetarist economics is quoted as saying that "inflation is always and everywhere a monetary phenomenon". In its simplest form, this branch of economics states that as supply of money goes up, the price level in the economy will rise (assuming that the volume of transactions and economic value remains constant). Or to put it very crudely, if you double the money supply, then all things being equal, expect inflation.

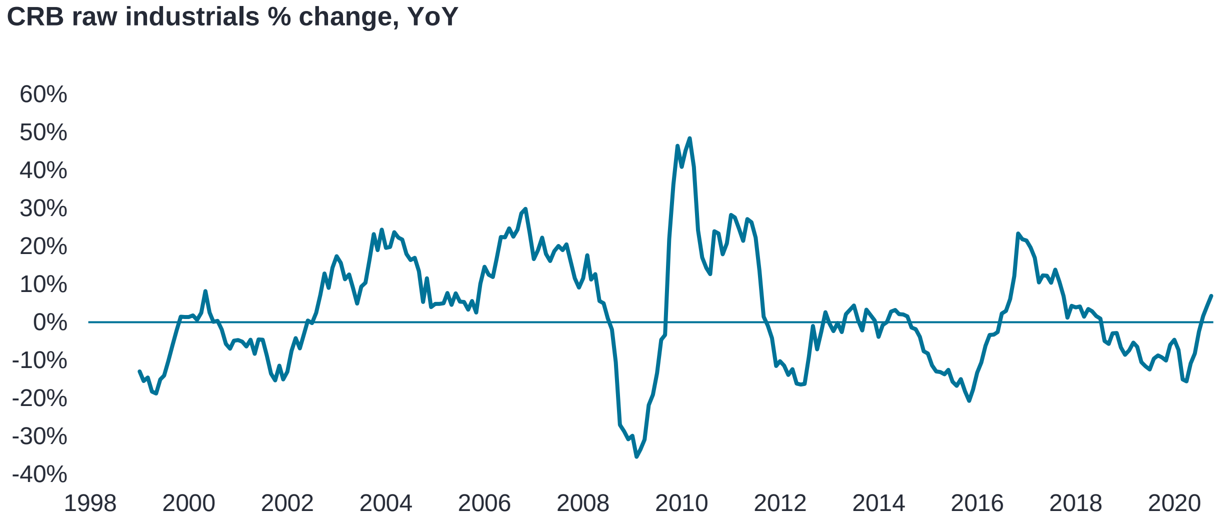
As discussed above, while money supply has surged globally as a result of monetary and fiscal measures, velocity has fallen by an equal and offsetting amount. As the economy recovers, we should expect to see both a fall in money supply growth as well as an increase in velocity. Should we see money supply growth persist at high levels in spite of a normalisation of velocity, we should be wary of the outlook for inflation in the months ahead.

Another, albeit less likely, indicator of rising inflation risks is political. The US election looks most likely to result in the political parties sharing control over economic policy with a Republican controlled Senate limiting the ability of Democrats to spend. However, it remains possible that the Democratic party gains control of the Senate and embraces a view that low interest rates are a consequence free way to spend.

In fact, and in spite of a reputation to the contrary, the existing Republican administration was already running the largest budget deficit on record in 2019, so large amounts of debt fuelled public spending may be on the cards in any case. This move towards unfettered public spending even has its own newer and still controversial branch of economics known as modern monetary theory (MMT), which states that the government of a country with its own currency is limited in its ability to spend only by inflation. As we said earlier though, by the time inflation appears it is already too late and bond investors are notoriously sceptical of politicians' ability to restrain themselves under such conditions. Should the market begin to suspect an abandonment of fiscal responsibility, it could begin to price in higher inflation expectations.

Another variable to watch, in our view, is commodity prices. As the fundamental input to goods pricing, commodities can be seen as a leading indicator of CPI. The chart in figure 2 shows an index of raw materials prices and it looks to have not only set a cyclical low, but to be rising rapidly. It is important to note however, that while commodity prices alone can drive up the level of inflation within an economy, without a concomitant increase in incomes to afford the increased prices, these moves become ultimately self-limiting as they act as a tax on spending.

Figure 2: commodity raw material prices look to be rising rapidly



Source: Bloomberg, Janus Henderson Investors, 1 January 1998 to 31 October 2020
Note: CRB raw industrials, monthly data percentage change yoy

Positioning in a low yield, modest inflation, world

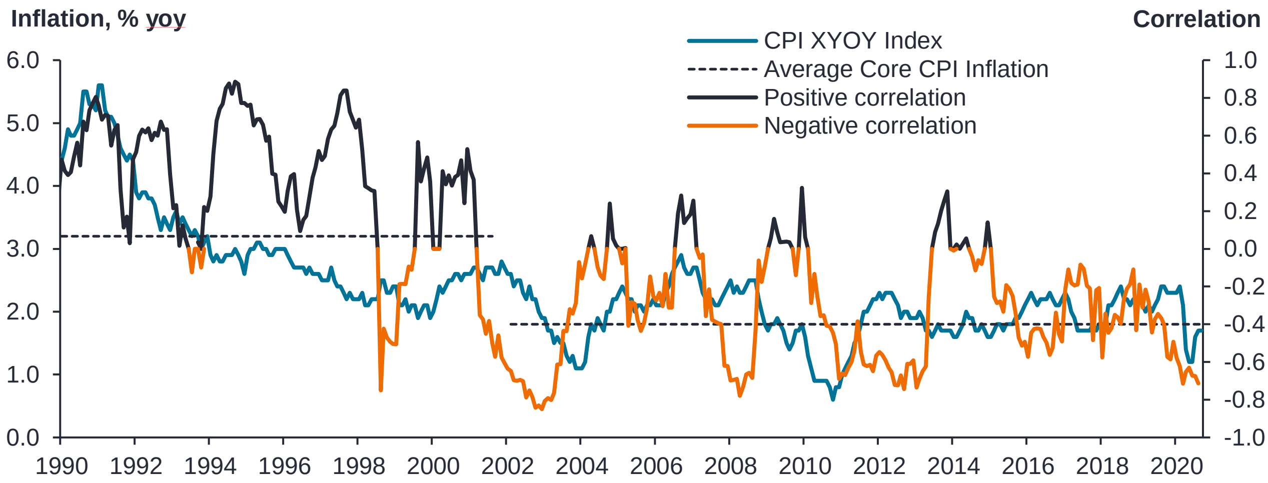
As it will take time to close the gap between supply and demand, and the Fed will likely want to see the gap turn negative before raising interest rates, we expect monetary policy will stay accommodative until it does. Normally, the intent to create higher inflation would put pressure on longer maturity interest rates, and we do think the 10-year US Treasury note could reach 1% or a bit above as the economy, and inflation, recover. But we believe significantly higher levels are unlikely in the near term given the Fed's promise to keep rates low to support the economic recovery and employment.

However, higher yields are possible. If the prospect of significant and prolonged deficit financed spending, supported by quantitative easing, becomes entrenched, the markets could be spooked, pushing 10-year yields towards the 1.25-1.50% range and possibly beyond. Regardless of the probability of this or other scenarios materialising, we think investors should carefully consider their exposure to higher interest rates. The absolute levels of yields are historically low and thus do not provide much compensation for the risks of rising inflation, or rising yields, regardless of the cause. Investors, in our view, should carefully consider the components of their portfolios, redoubling their focus on realising income and achieving diversity.

Floating rate exposure or instruments like Treasury Inflation-Protected Securities (TIPS) could help hedge against the prospects of higher rates induced by increased inflation expectations. Credit markets, including corporate bond markets and securitised sectors like mortgage-backed securities (MBS), could flourish in an environment where inflation is modestly higher and the demand for yield remains strong. While the duration of investment grade corporate bonds is relatively high by historical standards, combining these exposures with lower duration products could result in better risk-adjusted portfolios.

Investors should also consider the overall bond and stock balance when assessing the risks and diversity within their total portfolios. There is some indication that the long-standing correlation between stocks and bonds is subject to levels of inflation. Figure 3 demonstrates the higher degree of negative correlation (that is, diversity) between stocks and bonds as inflation has trended lower. Further decline could see the correlation wane further while rising inflation could result in the correlation turning more positive, reducing the advantages of a ‘diversified’ portfolio of stocks and bonds.

Figure 3: correlation between US equities and 10-year Treasuries



Source: Bloomberg, Janus Henderson Investors, as at 30 September 2020.
Note: Inflation based on US CPI Urban Consumers less Food & Energy, yoy, NSA; US equities refers to the S&P500 Index, generic US 10-year Treasuries, correlation based on previous 12-months.
The above are the teams’ views and should not be construed as advice and may not reflect the other opinions in the organisation.

As we ultimately have both a positive view on the outlook for the global economy and believe inflation is likely to remain constrained for now, we believe returns from the higher quality bonds may not be ruffled too much by such an outcome. However, the starting valuations will make it difficult to generate stellar returns and will likely lead many investors to embrace the sectors that both benefit from a slight rise in inflation and provide extra income.

* The Investment Strategy Group (ISG) brings together investment professionals from across the global fixed income platform and other Janus Henderson teams, providing a forum for research and debate on the key areas of fixed income asset allocation and macro (including rates and currency). The two sub-groups are designed to bring together our best ideas globally, aiding decision-making by portfolio managers around portfolio positioning and risk allocation.

The ISG Insight seeks to provide a summary of recent debate within the group.

**Deutsche Bank, Janus Henderson Investors, Bloomberg, as at October 2020.

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