Insights
Equities
Monetary Policy & Macroeconomics

Q2 2021

Putting the Global Inflation Surge in Perspective

Consumer price inflation is surging globally and an intense debate is raging as to whether this is merely a transient phenomenon reflecting abnormally low base effects or something of a more lasting nature. We see upside risks to inflation in the short term, but to us inflation is a process, not an event. Although we see incipient shifts that could push us into a higher inflation regime over time, it is not yet clear if something systemic is changing the inflation process itself.

Consumer price inflation (CPI) has accelerated sharply and broadly in recent months. US CPI inflation surged to 4.2% YoY in April, the highest level since 2008 and the core inflation measure hit 3.0% YoY, its highest level since 1995. The vast majority of central banks — particularly in developed markets (DM) — have expressed little worry in the face of rising inflation. Given the persistent inflation "deficit" of the last decade, a temporary inflation overshoot is seen as the desirable outcome. It is the goal enshrined in the US Fed's new policy framework of Average Inflation Targeting (AIT).

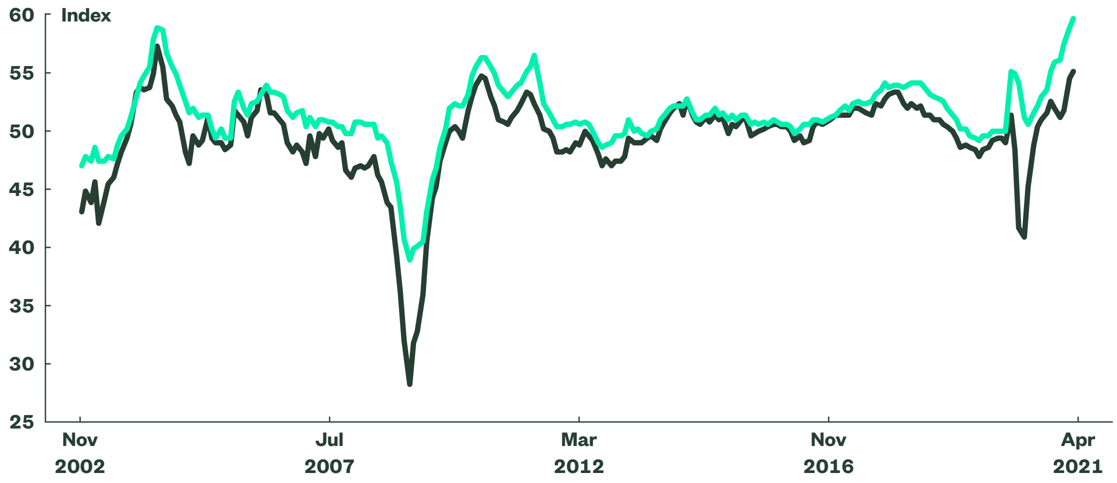
Central banks are probably right that most of the current inflation spike is transient in nature. However, even if this is true in general, there remains the possibility that, while transient, the inflation spike is either more severe in its intensity or slower to unwind than currently anticipated. Does "transient" imply normalisation within a three-, six- or twelve-month horizon? Or longer?

Tracking Global Inflation Indicators

Most leading inflation indicators, including commodity prices or shipping costs, remain in line with and do not yet indicate a break with prior post-recession recovery patterns. However, a few others suggest that something more acute is playing out at the moment. For example, global manufacturing supply chains appear more stretched today than in the aftermath of the Global Financial Crisis (GFC), with global manufacturing capacity utilisation at a record high and backlogs at the highest level since 2004 (Figure 1). It is a true testament to the strength of current demand that backlogs are so elevated despite record capacity utilisation.

Figure 1
Global Manufacturing Supply Chains Stretched

Manufacturing PMI Backlogs of Work Index
Manufacturing PMI Capacity Utilisation Index

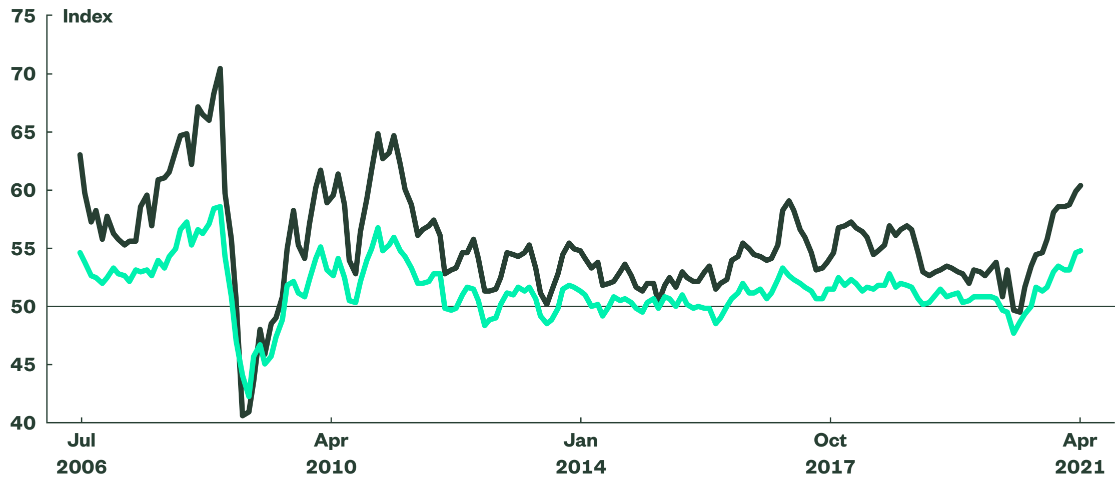


Source: See in image and linked in the web link https://ssga.com/us/en/individual/etfs/insights/putting-the-global-inflation-surge-in-perspective. Data as of 30/04/2021.

There are also important divergences beneath the top-line world aggregate metrics. For instance, while the input and output price indexes from the IHS Markit Composite Purchasing Managers' Indexes (PMI) for emerging markets (EM) are just at or closing in on their post-GFC highs (Figure 2), the same metrics for DM have long exceeded those levels (Figure 3). In other words, relative to history, these particular leading indicators of DM inflation are flashing a more intense red than at any time since the GFC.

Figure 2
Composite PMI Price Signals — Emerging Markets

Composite (M+S) PMI Input Prices Index
Composite (M+S) PMI Output Prices Index



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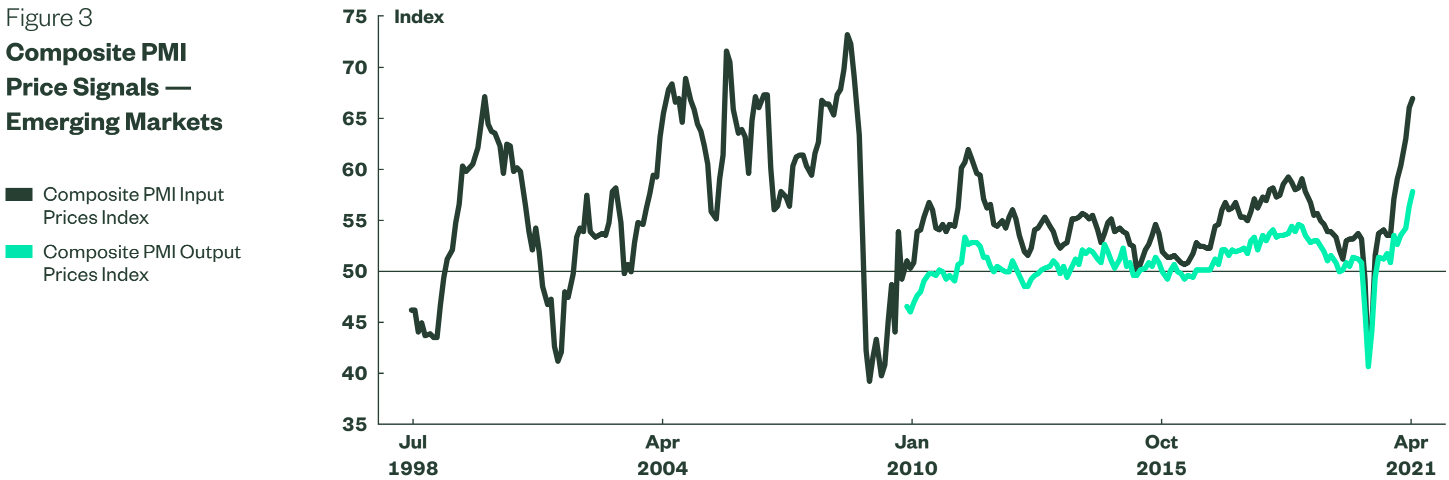
That cyclical inflationary pressures appear more acute in DM is an intriguing break from the past, but it makes sense given DM's lead in vaccine rollouts and their more aggressive fiscal/monetary policy support during the crisis. That US households today have nearly US$3 trillion in liquid savings (as of Q4, before the last round of stimulus checks) speak volumes about the demand backdrop and, by implication, the pricing power backdrop in which businesses operate today.

Pricing power may indeed be the most critical differentiator between the inflation experience coming out of the COVID-19 crisis and that of the post-GFC period. The unprecedented high levels of household savings, not only in the United States but also in Europe, make for a consumer who is better able to absorb and weather price increases. With severe strain on supply chains, skyrocketing input prices and severe constraints to labour supply, many businesses may have little choice but to raise prices.

Figure 3
Composite PMI Price Signals — Emerging Markets



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There is broad anecdotal evidence of a shift in this direction. Respondent comments in the ISM surveys indicate that broad and intense price pressures across supply chains are forcing firms to pass some price increases to their customers. Warren Buffet was recently quoted by the Wall Street Journal stating: "we're rising prices, people are rising prices on us, and it's being accepted".[1]

How quickly inflation subsides from its peak will depend largely on how long this acceptance persists in the marketplace. We lean toward an extended unwind to cyclical inflation pressures on the basis that exhausting the huge pent-up demand will take more than just a few quarters. Even if inflation pressures were to eventually subside on the manufacturing side, new waves of pressure could develop in services as we reach full normalisation. The eventual recovery in the rental market, which was disrupted during the pandemic, should also put a floor under inflation next year.

Is the Inflation Process Changing?

While a correct appreciation of the full cyclical intensity of inflation over the next few quarters is critical for optimal tactical asset allocation decisions, long-term investors are most concerned about the structural inflation backdrop. In this regard, they are quite similar to central bankers, who also downplay short-term inflation volatility, focusing instead on long-term trends. After all, if today's elevated inflation is primarily driven by pent-up demand and supply chain strains, we know that those issues will eventually be resolved and taken out of the equation. We therefore must ask: what is left to drive inflation in the future?

Here we come to a point often reiterated in the past: inflation is a process, not an event. In order to assess whether something is structurally changing on the inflation front, we must consider whether the inflation "process" itself is being sustainably altered. There are several trend shifts that suggest we might indeed be on the verge of such a change. The challenge, however, is that these changes are too recent to be confidently extrapolated into the future. Moreover, many are also subject to political risk that could either slow or accelerate them in coming years.

This dependency on political outcomes is critically important because inflation expectations themselves are central to the inflation process. Inflation expectations are unlikely to move sustainably higher unless businesses and consumers believe that the forces conducive to higher inflation are here to stay. Besides, inflation itself is highly unlikely to remain elevated in the absence of higher inflation expectations.

As frustrating as this may be, the reality is that the answers to the structural inflation questions are simply not yet available. Not just to us, or to investors in general, but not even to policy makers. It is a wait-and-see game, all part of the new experiential approach to monetary and fiscal policy making that has become so broadly embraced during the COVID-19 recession. Perhaps the best approach for investors is to be willing to entertain the possibility that a new inflation regime may be brewing, and to actively monitor incoming data and policy actions that could indicate such a shift is indeed taking hold.

Thus, what are we monitoring? The list below is by no means comprehensive, but these are some of the forces that we not only consider as highly influential but also see as indicative of an inflection point relative to the past fifteen years.

1 **A new, more experiential approach to macroeconomic policy.** The AIT/ Modern Monetary Theory (MMT) combo is an extraordinary departure from the old thought process around appropriate macro policy. So far, the US Fed is the only central bank to have formally adopted AIT, but there is broader sympathy for the idea that policy settings should be driven more by actual economic outcomes than model-driven forecasts. The same is true of fiscal policy — there is an evolving view of what sustainable debt levels are and more willingness to soften the rigid fiscal discipline rules of the past.

   Importantly, one need not go all the way down the MMT path to make a real-life impact here. The crux of the matter is that today's macro policy orientation is materially more dovish than during past recoveries. Economies seem poised to run hotter for longer, and, presumably, more inflationary pressures should result from this.

2 **Equity and inclusion as stated macroeconomic goals.** Policy makers are broadening the goals of economic policy and the metrics by which their progress is tracked. A good example is the Fed's evolving "full employment" goal, which has become a much more multi-dimensional definition, with inclusiveness as a new priority. The emphasis on inclusion and equitable growth permeates all areas of macro policy, including tax and labor policies.

   The intent is to reduce economic disparities through various means, including income redistribution. To the extent that such actions put more money in places where they are likely to be spent rather than saved, the resulting boost to demand could prove inflationary, at least until such time as supply adjustments bring about a new equilibrium.

3 **Shifting global supply chains/peak globalisation.** Globalisation has been a major contributor to the disinflation trend of the past two decades. The shift in global supply chains to lower-cost locations (a structural shift dominated by China) has allowed firms to cushion profit margins without needing to raise selling prices. However, labour cost differentials between China and DM have shrunk greatly, and there is much less scope for additional disinflationary benefits over the next few years.

India's economic ascent could offer another sizable disinflationary opportunity, but only further down the line. In the context of the US-China strategic rivalry and the supply chain vulnerabilities exposed by the COVID-19 crisis, we expect to see supply chains move incrementally toward higher-cost, rather than lower-cost, locations in the next few years. It remains an open question whether higher labour costs could be offset by increased automation or other types of technology upscaling. Nonetheless, peak globalisation would appear inflationary.

4 **Transition to a green economy.** Accelerating the transition toward a green economy could prove to be inflationary in the interim. Such a transition will inevitably render some part of the existing capital stock obsolete and require the parallel development of alternative production processes. As firms make that transition, their cost of doing business is likely to temporarily increase. Again, whether these higher costs are passed on to consumers in the form of higher prices is unknown at this time, but we have yet another potential driver of higher inflation.

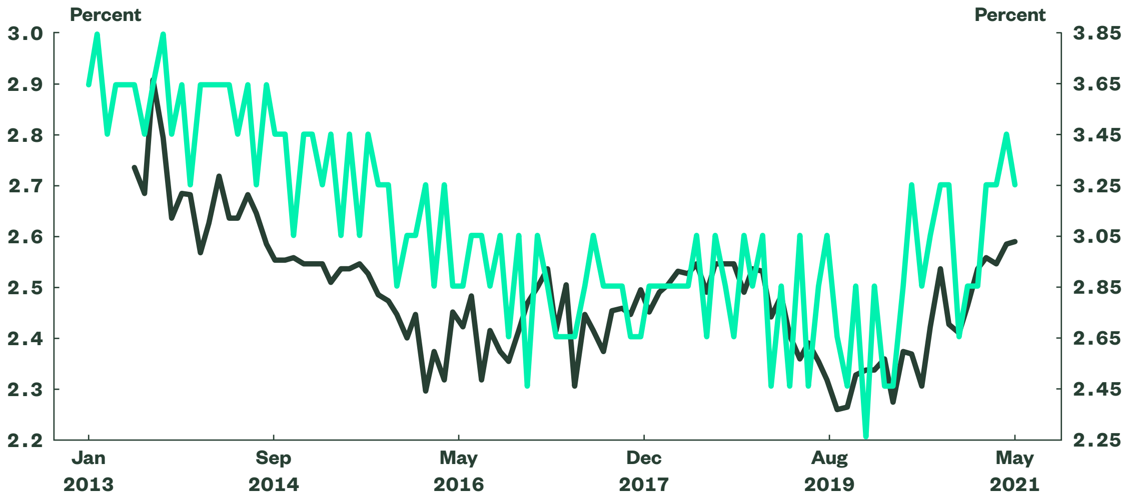
5 **Inflation expectations.** Finally, we are watching closely to see whether inflation expectations are drifting higher. A change in inflation expectations could alter consumer behavior and create a more inflationary environment almost irrespective of the other factors noted above. It is too soon to assert that inflation expectations are sustainably rising, but they have clearly moved off their lows.

It does appear that the multi-year decline in inflation expectations that took hold after the GFC has come to an end (Figure 4). US Fed Chair Jerome Powell noted that inflation expectations have moved closer to levels consistent with the central bank's inflation goal. The implication is twofold: they need to rise further and need to stay at those elevated levels.

Figure 4
Inflation Expectations of US Consumers Seem to Have Bottomed

New York Fed, CPI EXpectations, Median 3-Years Ahead, SA (RHS)

University of Michigan Expected Changes in Inflation Rates, 5-Years (LHS)



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Is Sustained Higher Inflation Inevitable?

Despite the inflationary forces discussed above, we do not believe that higher sustained inflation is inevitable. This is because just as structural inflationary forces may be intensifying, they are encountering powerful structural deflationary forces at play. Technology, demographics and debt are powerful constraints to high inflation. Moreover, high inflation is ultimately a policy choice, and policy settings can and most likely will be adjusted down the line to keep inflation in check. After all, the AIT framework allows only for a temporary inflation overshoot above 2.0%.

Investment Implications

Given the multiple moving pieces (short- and longer-term) around inflation, it is reasonable to expect that the volatility of inflation expectations will increase going forward. As that occurs, it is possible that the yield sensitivity to future inflation shocks actually declines. The intuition here is that as additional inflation shocks occur within that higher-inflation-expectation environment, each such event should have less of a signal component and therefore should drive a smaller yield reaction.

A higher-inflation environment — especially against a backdrop of strong demand — could be broadly supportive for equities. It would seem to imply a favourable pricing environment for firms and would therefore be supportive of corporate earnings. As always, though, investors must recognise that not all sectors of the economy — and certainly not all firms — would be equally well positioned to capitalise on this favourable macroeconomic backdrop. Finding champions in the right sectors may not be easy, but it would certainly be profitable!

Endnote

1 Kang, J. (2021, May 9). Higher Prices Leave Consumers Feeling the Pinch. The Wall Street Journal.

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Exp. Date: 31/03/2022