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DEGROOF PETERCAM ASSET MANAGEMENT

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INFLATION AT A **CROSSROADS**

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We recently came across an interesting paper on inflation written by Lyn Alden. In the first part of this article, we will review some of her findings, and in the second part, we will consider potential medium-term consequences.

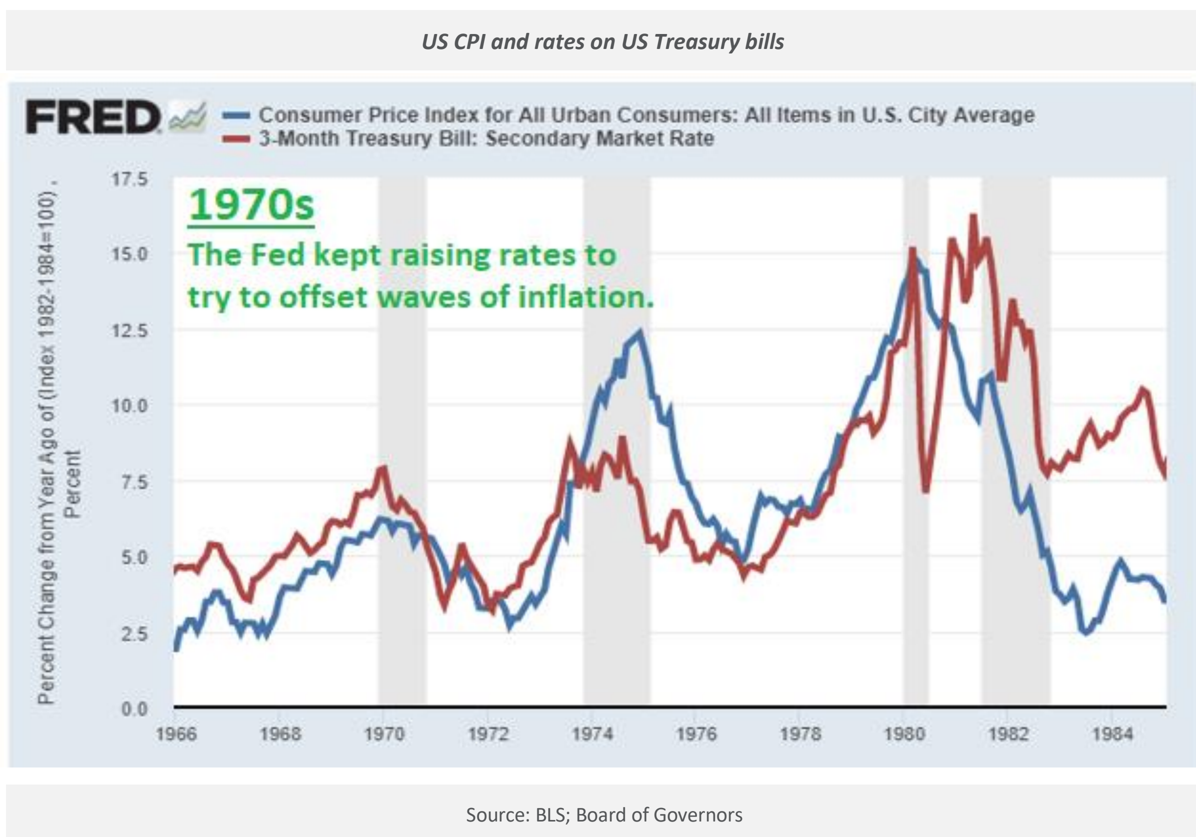
Generally speaking, there are two causes for money supply to go up quickly. On the one hand, banks can increase lending that creates deposits and expands the money multiplier. On the other hand, governments can run large fiscal deficits financed by central banks and commercial banks.

Money supply as such is not necessarily a reason for inflation but if it occurs alongside resource scarcity or supply chain limitations, a general rise in prices could be the result. It means that at the same time money velocity must rise or at least not fall.

INFLATION IN THE 1970S

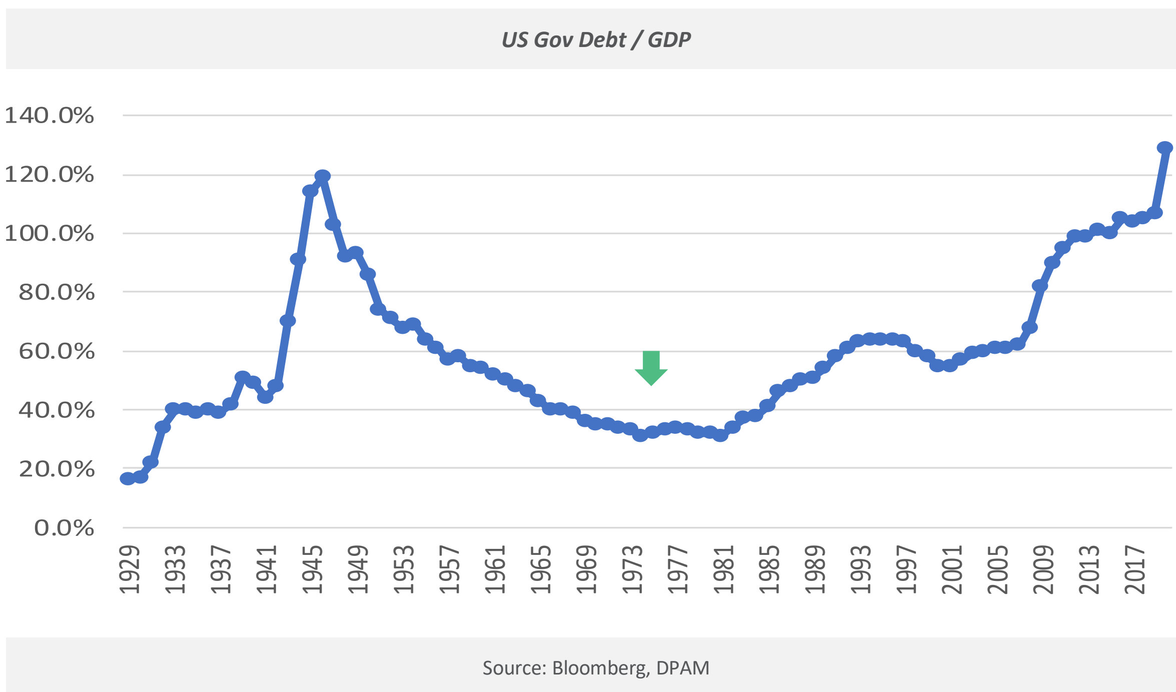
In the 1970s, baby boomers, believed to be more than 70 million in the US alone, were taking up jobs that came with favourable health and pension plans. As such, thanks to the security that was provided, they were 'free' to spend on different new products. **It was the age of a high standard of living for the middle class**. Public and private debt as a percentage of GDP was low. **Money supply was increasing especially as a result of bank lending**. The oil embargo led to a shock to the financial system and in the end, the Volcker Fed would kill accelerating inflation by raising short-term interest rates as high as 20%, which was possible in a low-indebted economy.

US CPI and rates on US Treasury bills



Source: BLS; Board of Governors

US Gov Debt / GDP

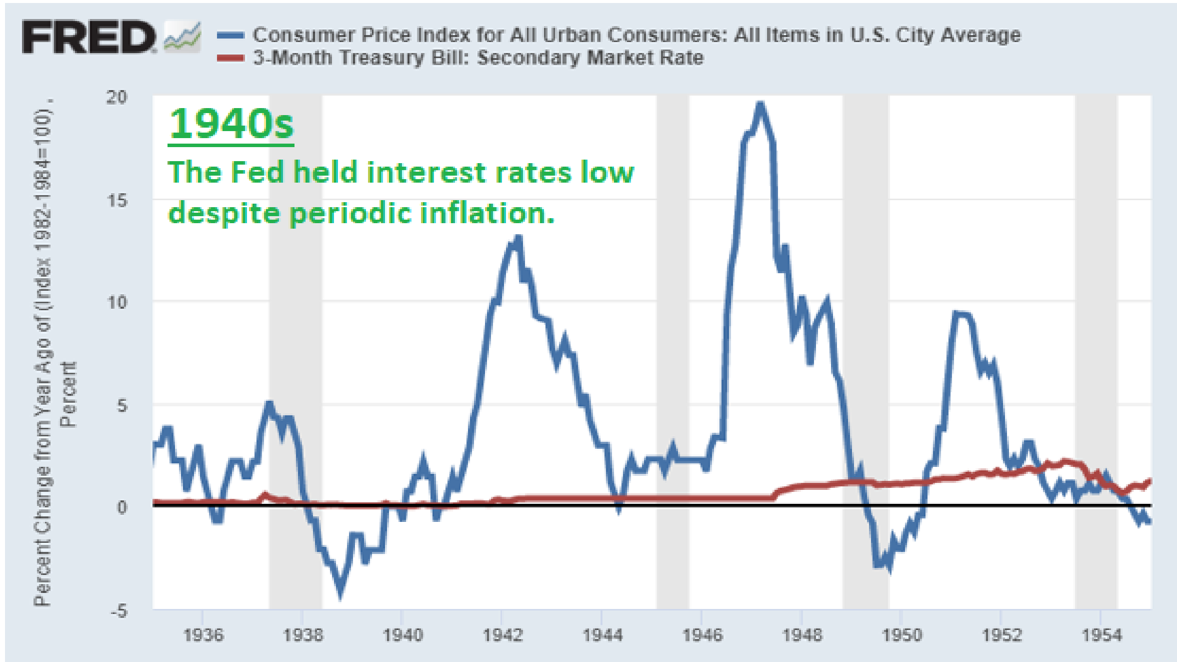


Source: Bloomberg, DPAM

INFLATION IN THE 1940S

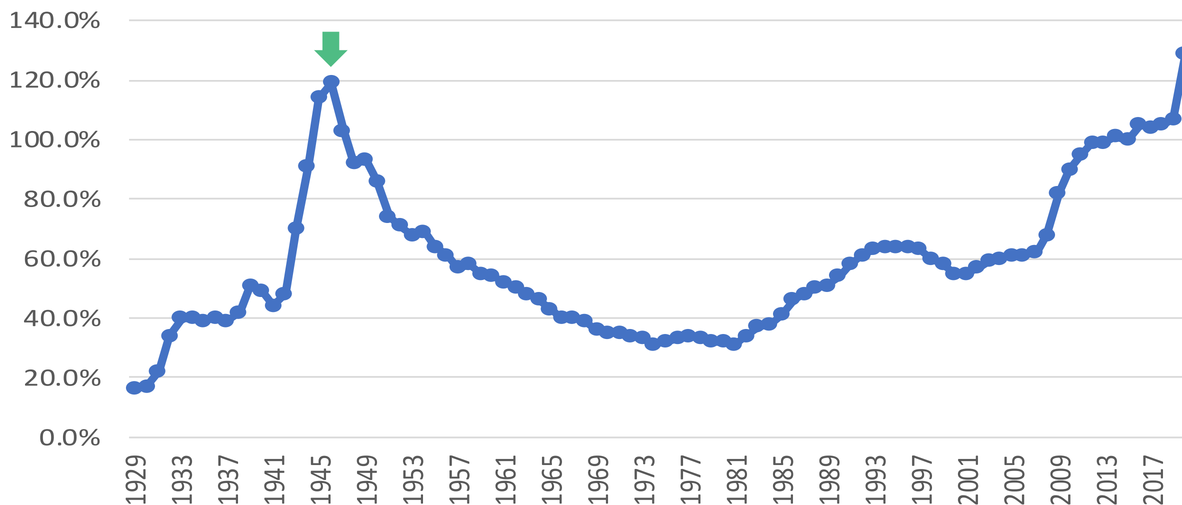
The 1940s **money supply growth was entirely due to massive fiscal deficits** rather than bank lending. Consumer price inflation was coming in periodic spikes from fiscal spending and changing wage/price controls. Another difference with the 1970s was the debt situation. US government debt as a % of GDP was very high. Even though inflation sporadically rose a lot, the Federal Reserve kept policy rates low and even capped long-term bond rates (at around 2.5%) through quantitative easing. The curve was sufficiently steep for banks to profit from this environment. All the while, **inflation recorded spikes with an average inflation of around 5%**. As a result, the debt pile was partially inflated away. At the same time, anyone holding cash or nominal bonds would not suffer in nominal terms but would have lost 30-50% in purchasing power between 1941 and 1951!

US CPI and rates on US Treasury bills



Source: BLS; Board of Governors

US Gov Debt / GDP



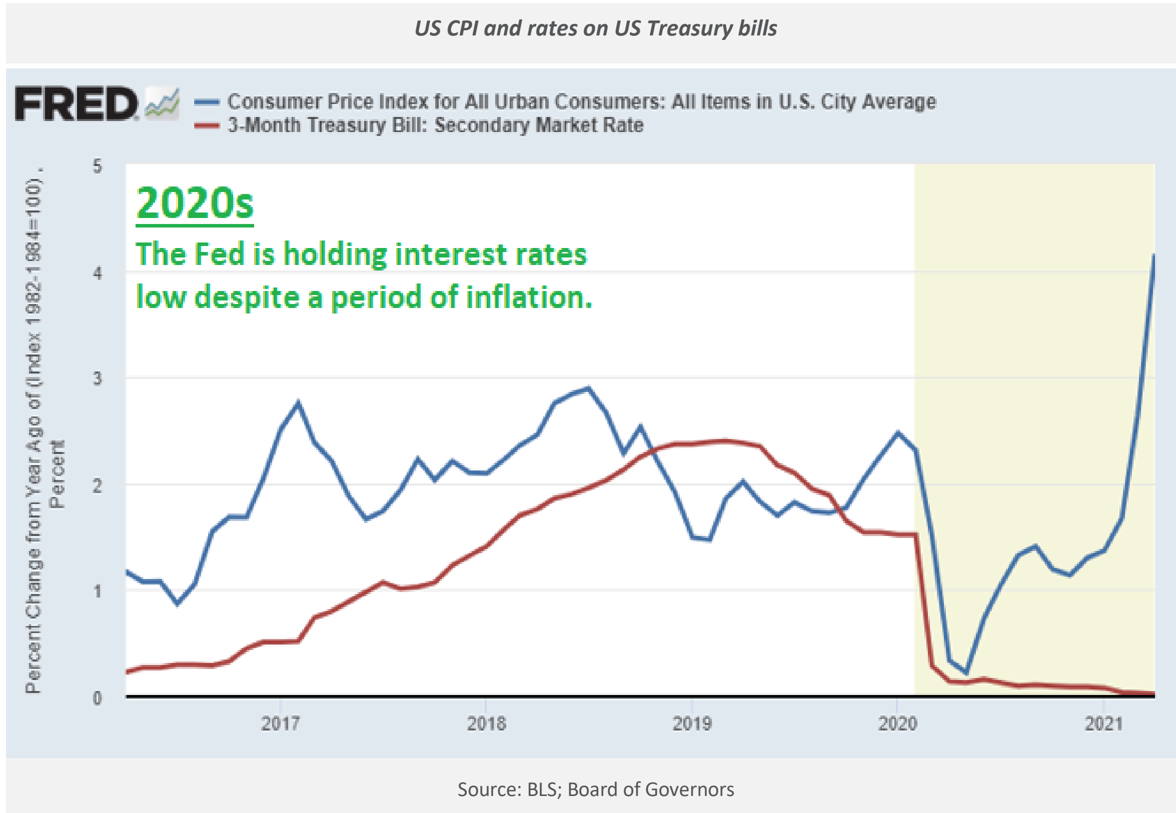
Source: Bloomberg, DPAM

INFLATION IN THE 2020S

Since 2019, the Federal Reserve has implemented a policy of Average Inflation Targeting in order to allow inflation to run somewhat hot for a period without too much intervention on the policy side in terms of rate hikes. Now that inflation is indeed at high levels, the Fed is emphasizing **the transitory nature of that inflation**

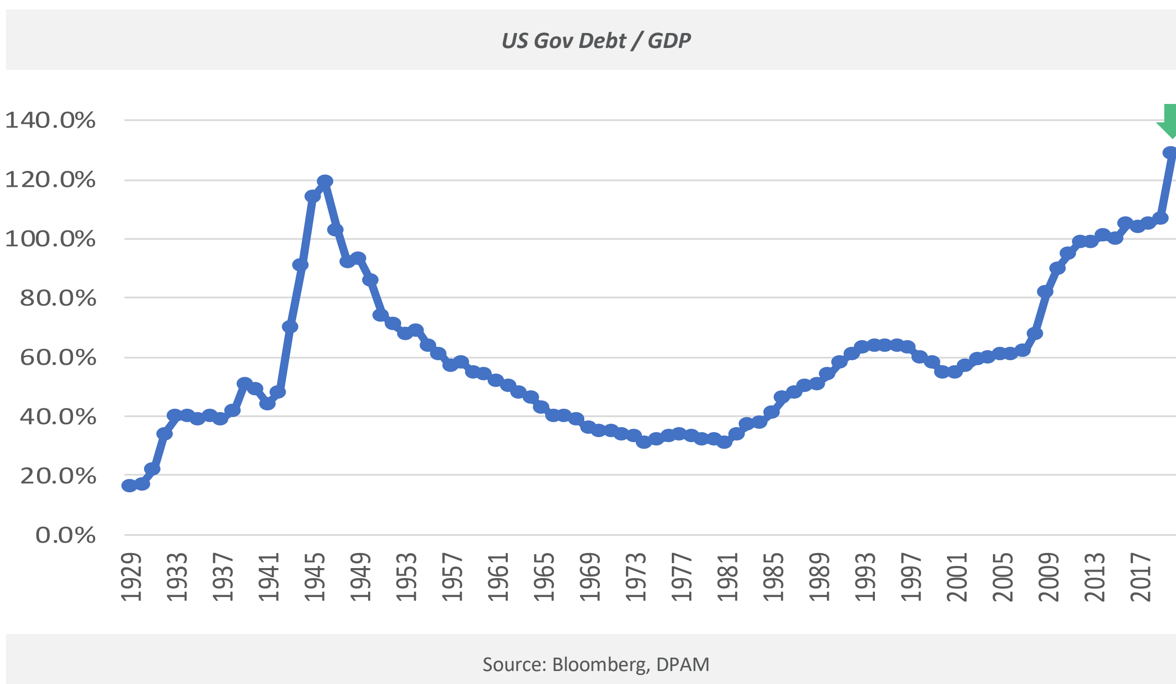
as a result of the budgetary stimulus, supply chain shortages and base effects. It does not have to intervene and turn hawkish because inflation is not loan-driven, and it actually cannot be too hawkish because US debt levels have been soaring to unseen federal debt to GDP ratio levels. So, policymakers have a strong incentive to keep rates low despite periodic inflationary events that may occur, just as in the 1940s.

US CPI and rates on US Treasury bills



Source: BLS; Board of Governors

US Gov Debt / GDP



Source: Bloomberg, DPAM

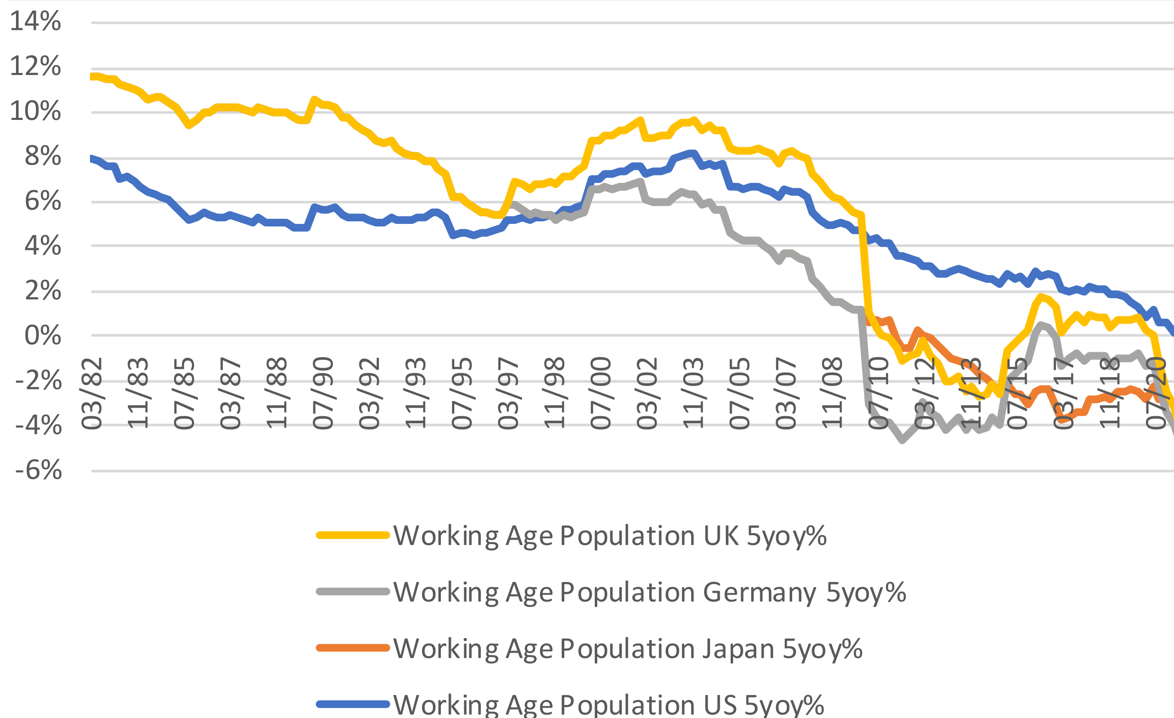
The last three recessions have always led to higher debt to GDP levels, while real GDP growth seems to be on a downtrend.

Average quarterly real GDP	
1991 - 2001	3.60%
2001 - 2007	2.52%
2008 - 2021	1.76%

Policymakers cannot continue along this road if a Japanese scenario is to be avoided. Either debt should go down (a strategy that did not properly work in the EU after the financial crisis) or policymakers should create an environment of high nominal GDP. This can be done by outgrowing debt or inflating debt away or a combination of both.

The graph below (OECD Labor Force Survey Working Age Population 15-64 years) shows the trend (% change over 5 years) for 4 countries. What the graph does not show is that **historically there is a correlation with real GDP**. Even China, which is not in the graph, is seeing its working age population fall. It seems a change in direction for most large countries is needed to halt the falling trend in working age population and thus in GDP.

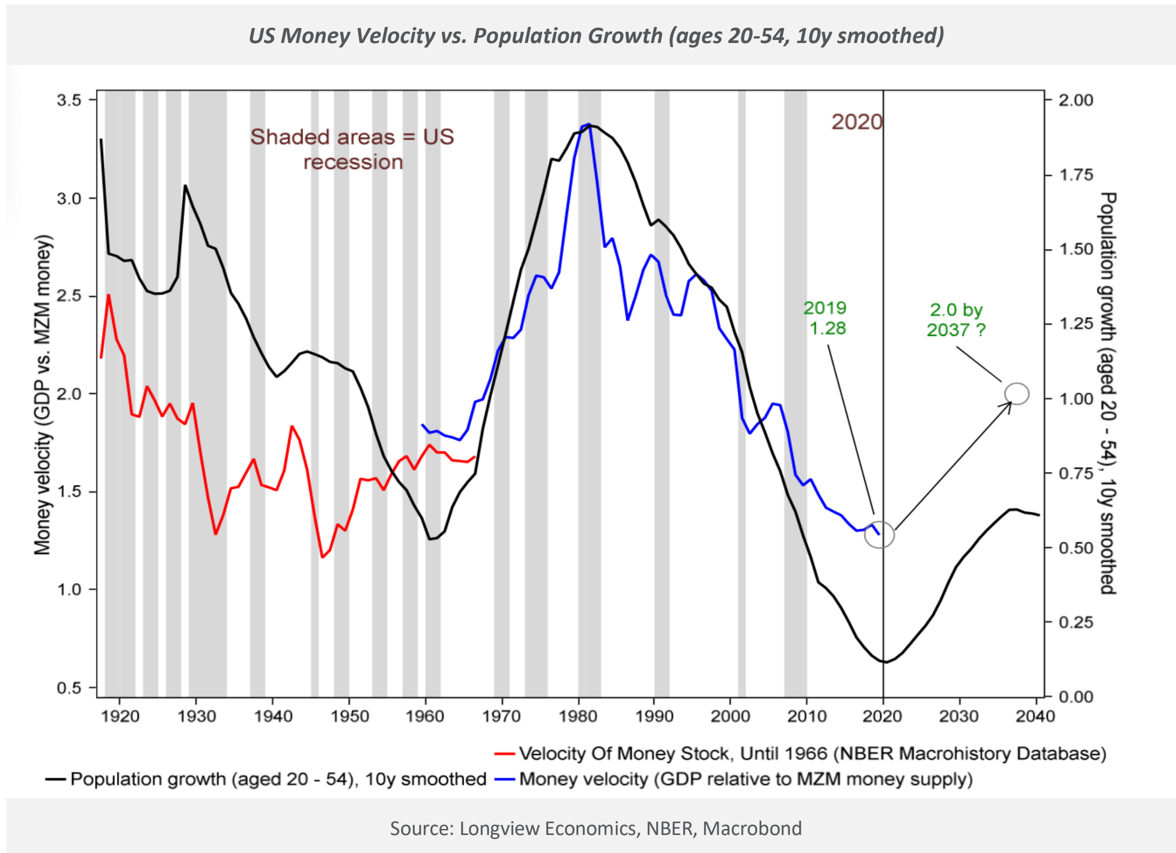
OECD Labor Force Survey Working Age Population 15-64 years (US, UK, Germany, Japan)



Source: Bloomberg, DPAM

This is exactly what might come next. When looking further ahead, population growth (20-54 years) could turn around and when this age cohort reaches working age, could also increase money velocity!

US Money Velocity vs. Population Growth (ages 20-54, 10y smoothed)

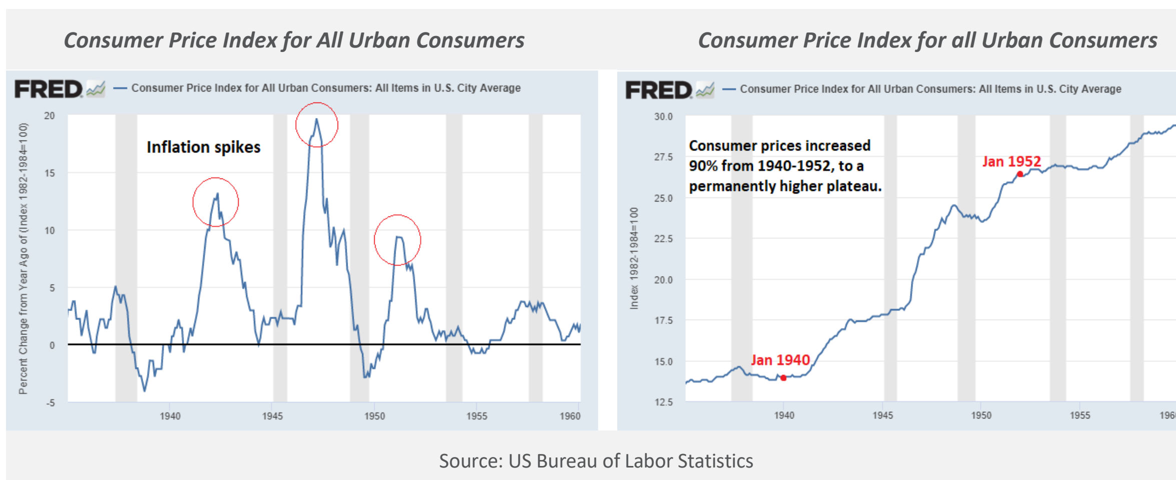


Source: Longview Economics, NBER, Macrobond

INFLATION SPIKES AND PERSISTENT INFLATION

There is a significant difference between year-over-year inflation spikes and consistently higher inflation. The first are transitory in nature but the second can have important implications for capital preservation over the medium-term. Inflation that comes and goes but remains relatively high in absolute terms over the years is detrimental to investors that stick to cash, bills and bonds!

Consumer Price Index for All Urban Consumers *Consumer Price Index for all Urban Consumers*



Source: US Bureau of Labor Statistics

While the Federal Reserve is sticking to the transitory inflation narrative, the consequences will be important in terms of strategic allocation if inflation in absolute terms remains high (3% or more) for some years.

Is there any indication about where inflation will be beyond 2021? The trend model (graph below) currently points to above 3% inflation going forward, while the peak in inflation is probably behind us.

USA Inflation Forecast

Source: Bloomberg, DPAM

CONCLUSION

While all eyes are currently on inflation, **it is not by definition certain that inflation will remain durably high**. There are enough important forces, such as demography, technology and the high debt rate that point to a continuation of the disinflationary environment. Moreover, **the natural state of capitalism is a disinflationary boom** whereby every entrepreneur tries to produce more with less.

But if inflation is at a crossroads and remains durably high -a potential regime shift-, it is most likely that a 1940s type of reaction to inflation will happen rather than the 1970s type of reaction that occurred for the reasons mentioned above. Policymakers would probably continue to use similar tools as in the 1940s, which basically means a continuation of Financial Repression. Thus, investors should steer their asset allocation accordingly for the next couple of years. Cash or fixed income might be the weaker spots in real terms, while some investors will not notice it in nominal terms. **Within fixed income, it would continue to make sense to have exposure to inflation-linked bonds in case inflation surprises to the upside**. At the same time, it also makes sense to invest in those countries / currencies that favor a strong currency, which seems to be the case for China.

Preferred Fixed Income Plays

Region	Nominal bonds	Inflation Linked
Eurozone		X
US		X
China*	X	
Norway*	X	
Canada*	X	
Emerging	X	

* Expected to have stronger currencies

Overall shorter duration

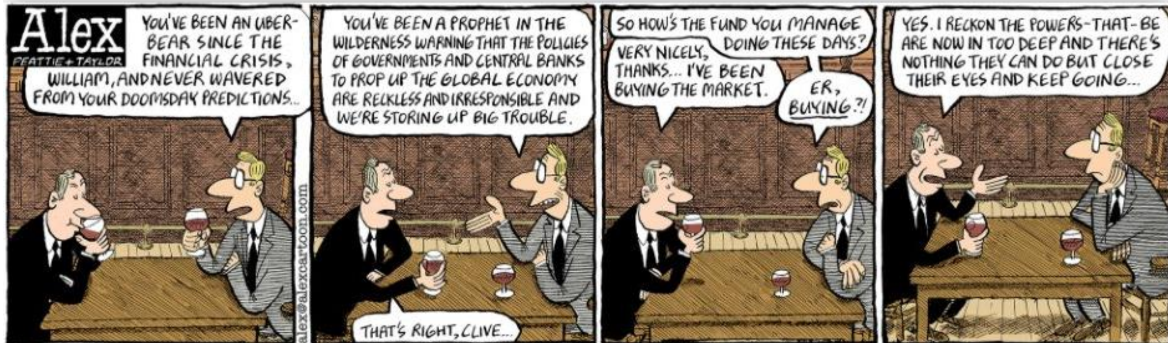
When taking other asset classes into consideration as well, the view of our team is as follows: probabilities are added to each possible scenario. The table also points to potential effects on the different asset classes.

Investment Implications

Macro	Reaction	Probability	Equity	Fixed Income	Gold
High Inflation	Hawkish Fed	20%	-	-	+
High Inflation	Dovish Fed	50%	+	-	+/-
Low inflation	Dovish Fed	30%	+	+	-

Source: DPAM

Some investors find it unwise to invest in bonds, while others do not understand the fuss about crypto. And at the same time, some investors wonder who is buying real estate assets or stocks at these levels. The cartoon below might provide answers to the latter question:



Source: Alex, Soc Gen

Are we today in a classic bubble as is often mentioned? Maybe we are, but much will depend on the large trends like demographics and how policymakers react to these trends. As investors, our job is to understand these dynamics, see how policymakers react and make an educated guess on what this will do to the various asset classes. It seems that there is a significant possibility that **it is too soon to label this market a bubble**. Most likely, it will be important to take a decent amount of risk to protect capital. While that seems to be a contradiction, the 1940s taught us that it is exactly what needs to be done. **As Mark Twain said so well, "history does not repeat itself, but it often rhymes".**

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