

Transient Inflation

What if the Consensus is Wrong?

Investment Insights Series



Suny Park, CFA, CPA
Head of Institutional
Client Strategy, North America

Inflation angst abounds despite the consensus view the recent spike in inflation will be temporary. The Federal Reserve (Fed) has been steadfast in reassuring financial markets the higher inflation we have witnessed for the last several months will be transient. But, how can anyone be so sure about the future? And what if the Fed and the market consensus are wrong? At the core of the inflation debate is the convergence of monetary and fiscal policies in the United States. On the monetary front, the Fed formalized flexible average inflation targeting (FAIT) as its long-run monetary strategy as follows on 27 August 2020:

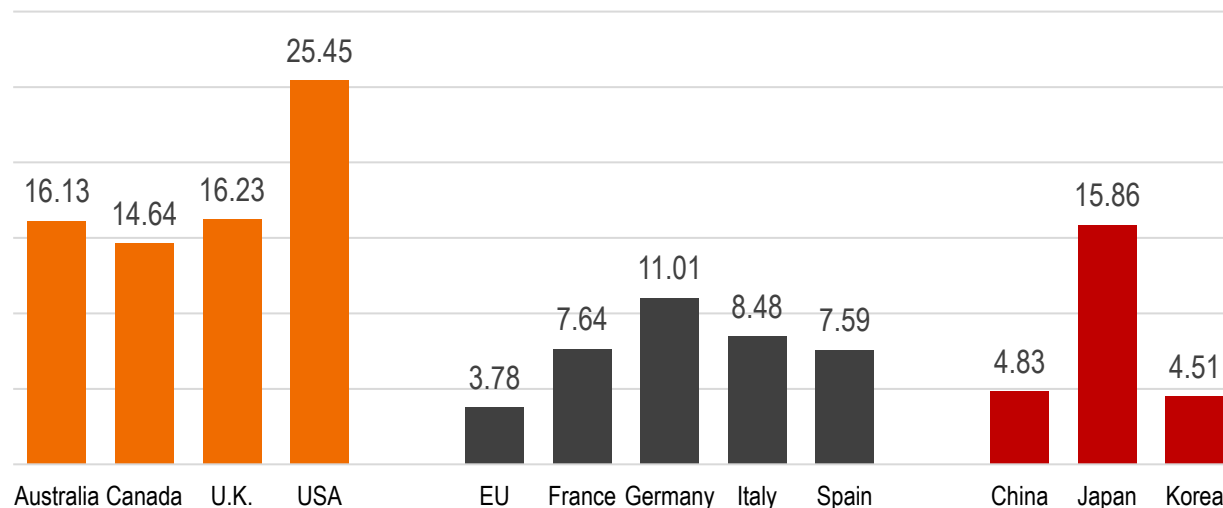
“In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.”¹

Whether FAIT represents a change in the Fed’s monetary policy strategy will influence one’s view on the future level of inflation: that is, if one believes FAIT represents a departure from past policy stance, then he may be more likely in the camp of a higher and sustained level of inflation; conversely, if one believes FAIT is just an adjustment of past policy stance, then she may be in the higher but transient camp on inflation.

On the fiscal front, to arrest a pandemic-induced crisis, the US Congress approved a series of fiscal stimulus – the aggregate size of which (25.5% of US GDP) is unparalleled in recent history. And, as shown below, the aggregate size of the US fiscal stimulus dwarfed those of other major economies around the globe.

Exhibit 1: U.S. Fiscal Stimulus: Go Big or Go Home

Fiscal stimulus as a percentage of GDP



Source: IMF Fiscal Monitor. Database of Country Fiscal Measures in Response to the COVID-19 Pandemic. As of 17 March 2021.

¹ FOMC Statement on Longer-Run Goals and Monetary Policy Strategy. Adopted effective January 24, 2012; as amended effective August 27, 2020.

At \$5.33 trillion, the size of the US fiscal stimulus is roughly equivalent to Japan's current gross domestic product. Viewed through a different lens, the year-over-year growth of money stock (as proxied by M2) in the US averaged 6.0%² for the prior 20 years leading up to the Covid-19 crisis, but 22.5%² between March 2020 and March 2021. Given this money-printing prowess by the US government, it is no wonder why some believe broad price increases are bound to materialize.

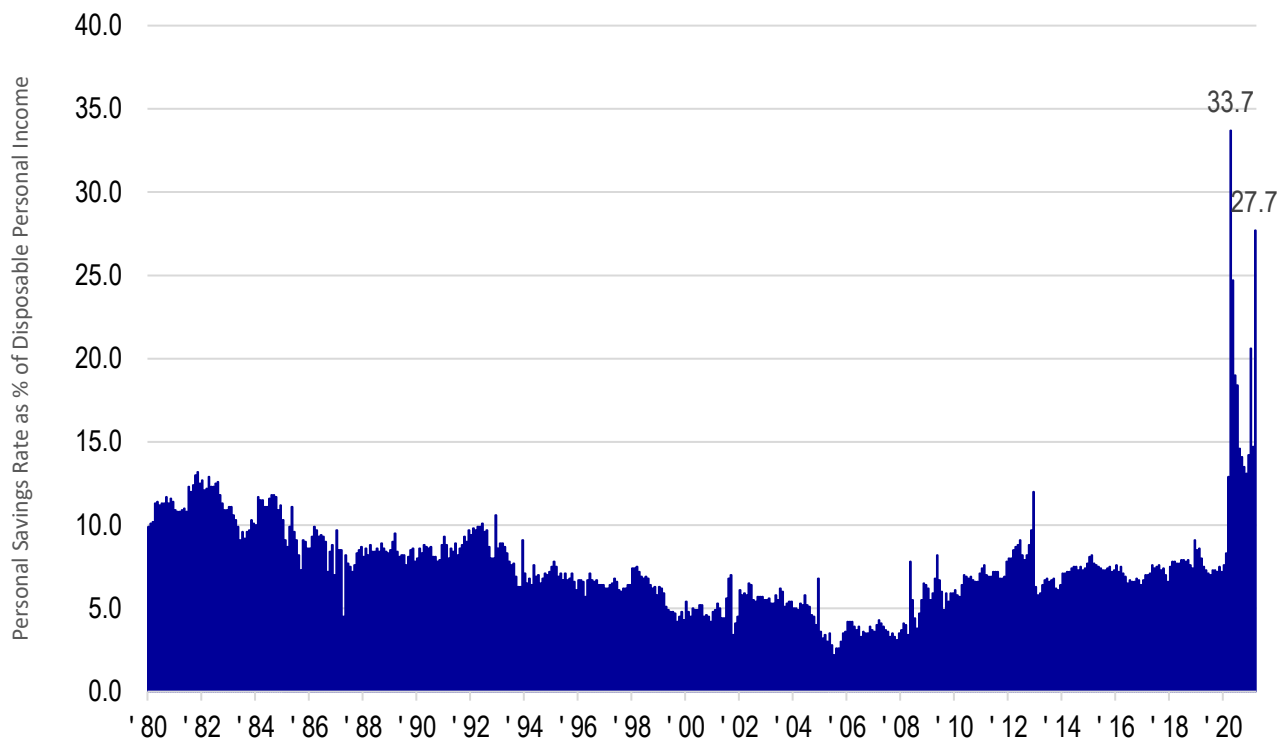
Investors on both sides of the inflation debate provide confirming evidence to validate their points of view. Opinions expressed with high confidence and conviction notwithstanding, no one knows what the inflation reading will be 12 months from now, three years from now, five years from now. Therefore, in the sections that follow, we provide supporting evidence for both transient inflation and a higher, sustained level of inflation, and let the readers form their own conclusions regarding the future level of inflation.

Arguments for Higher but Transient Inflation

1. Personal Savings Rate

For the US economy to witness a high and sustained level of inflation, there must be a noticeable pickup in consumer spending; however, that is not what we observe in consumer-related macroeconomic data. Due to pandemic-induced restrictions, it appears that consumers have been unable or unwilling to spend their disposable income, as evidenced by the high personal savings rate in Exhibit 2.

Exhibit 2: Personal Savings Rate Remains Elevated



Source: St. Louis Fed FRED. Data as of March 31, 2021.

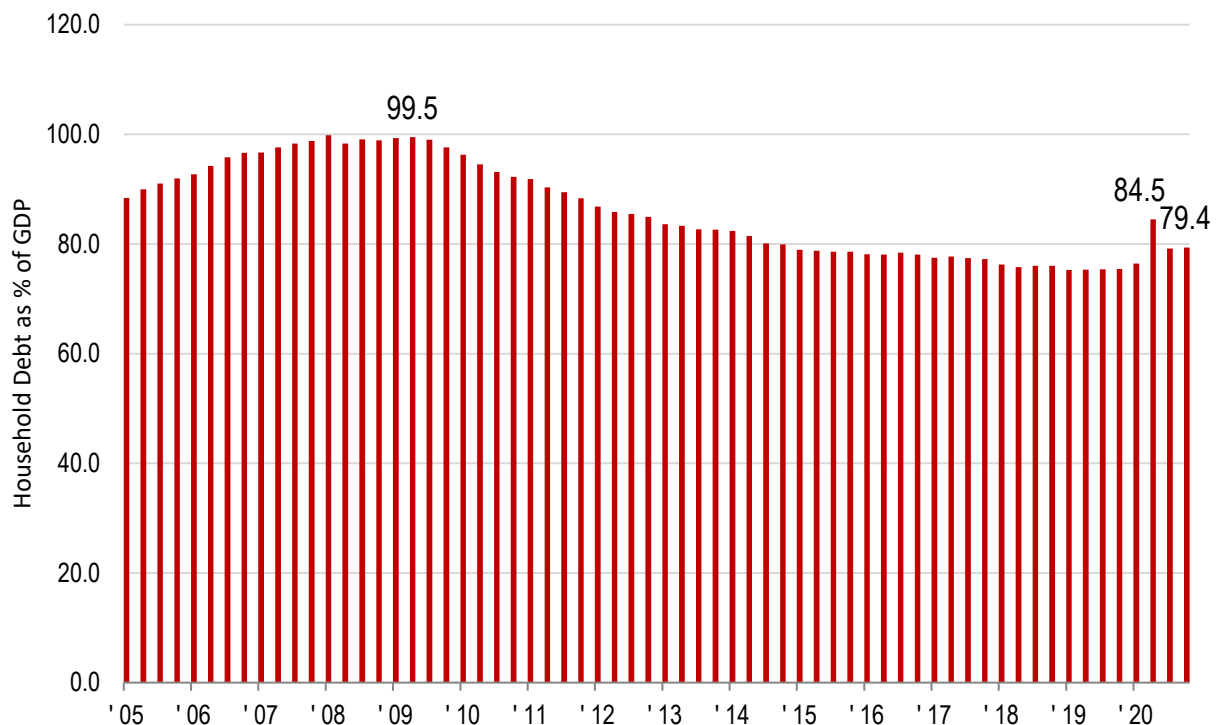
² Source: St. Louis Fed FRED, as of April 30, 2021

Shortly after the shuttering of the economy in March 2020, the personal savings rate peaked at 34%; but, even 12 months after the onset of the Covid-19 crisis, the personal savings rate remained elevated at 28% of disposable personal income. Therefore, unless consumers drastically change their spending behavior for the rest of 2021 and 2022, it is difficult to argue for a higher, sustained level of inflation.

2. Household Debt

Leading up to the 2008 Global Financial Crisis (GFC), US consumers supplemented their spending with borrowing. At the depth of the GFC, household debt as a percentage of GDP approached 100%. Contrast that to the current debt level: except for a small blip in the second quarter of 2020, household debt as a percentage of GDP has remained below 80% since 2015.

Exhibit 3: U.S. Households have been Financially Disciplined



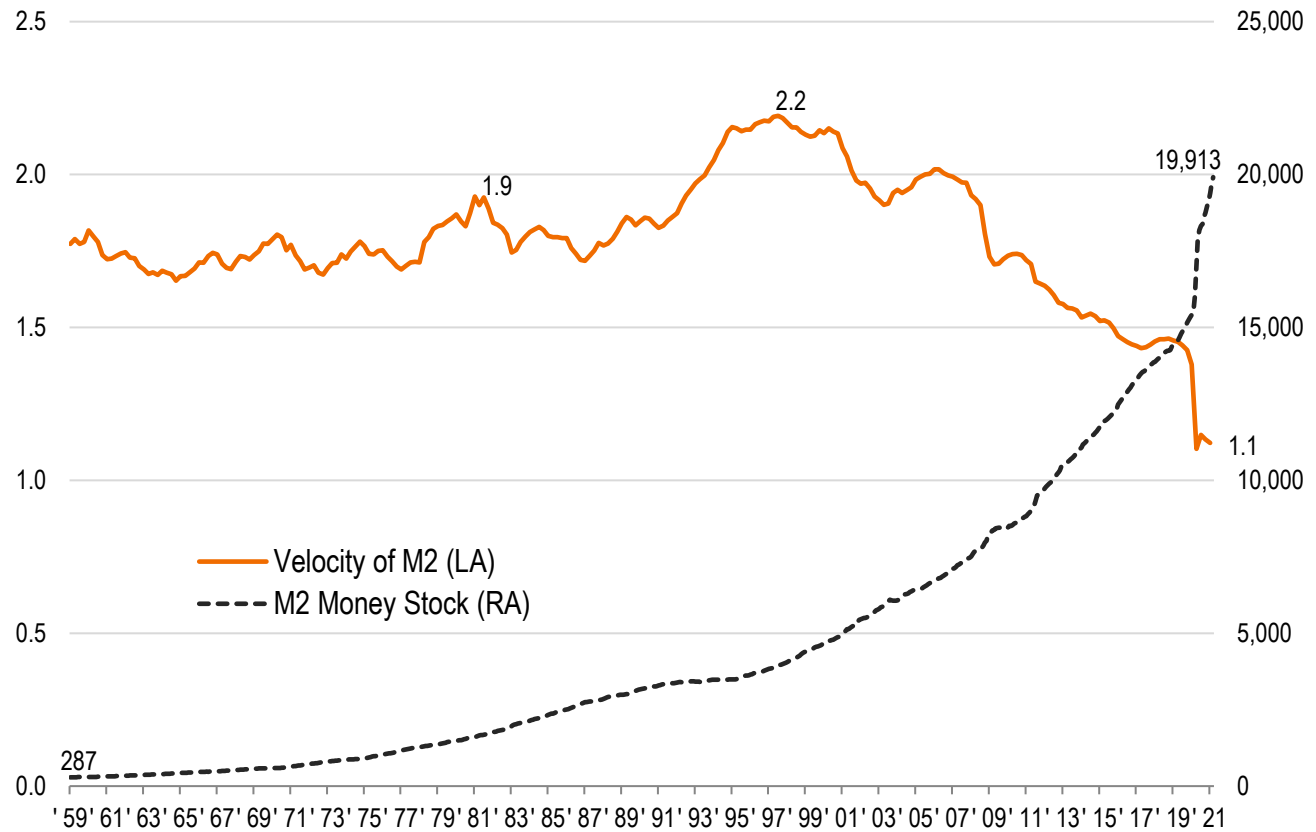
Source: Federal Reserve Bank of St. Louis FRED database. Data as of December 31, 2020.

For there to be a sustained level of inflation, aggregate demand for goods and services from consumers must accelerate, but that is not what we observe herein. The trend in household debt indicates consumers are living within their means. In stark contrast to the profligate ways of the US government, US households have been much more disciplined with their finances.

3. The Velocity of Money

According to Irving Fisher's algebraic equation of exchange, nominal expenditures in an economy (i.e., nominal prices times real expenditures for goods and services) equals money supply times money velocity.

Exhibit 4: Deceleration in Velocity of Money Negated the Explosion in Money Stock



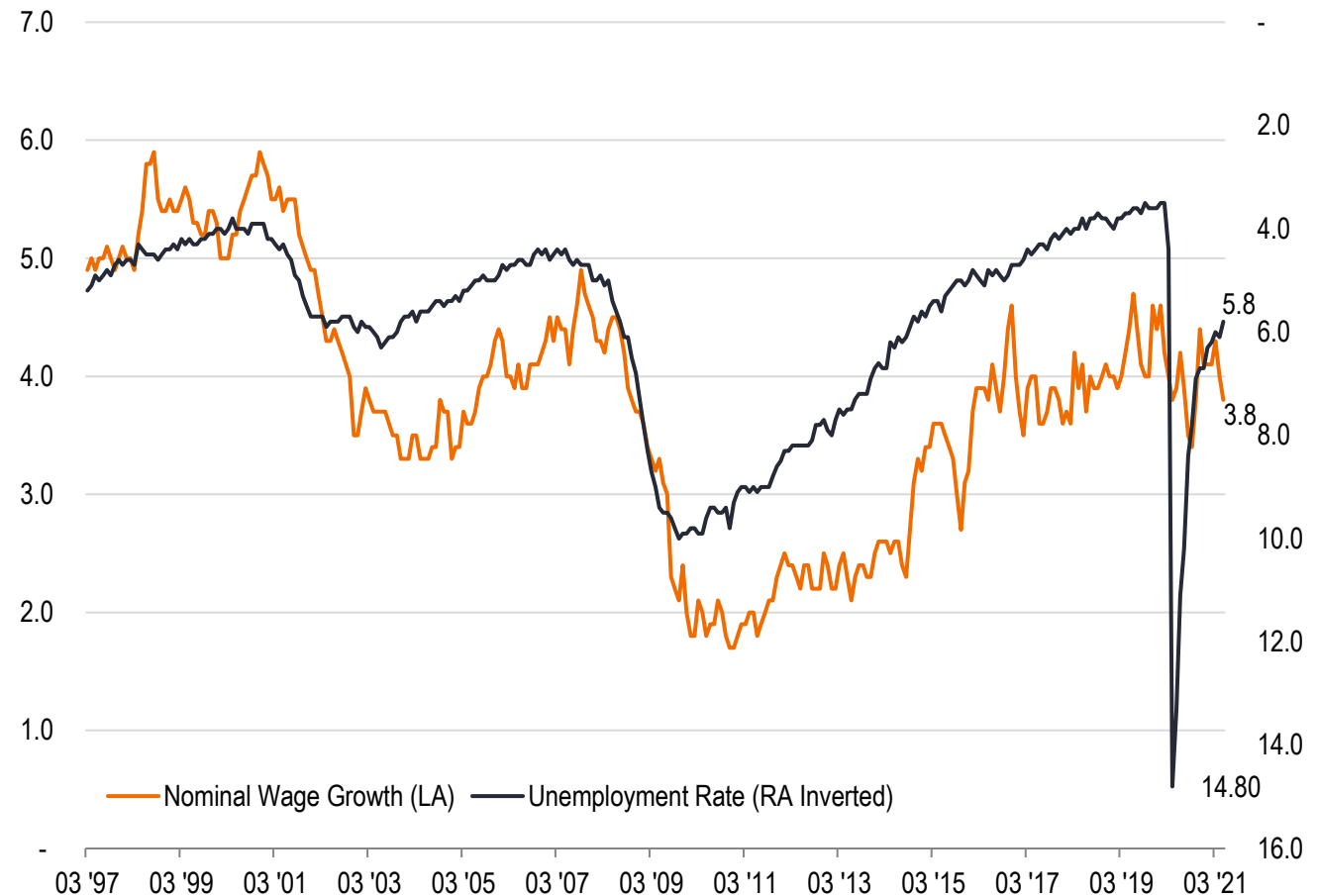
Source: St. Louis Fed FRED. Data as of March 31, 2021. Money Stock in Billions USD.

As remarked previously, the money supply in the US exploded after the shuttering of the economy; however, the former appears to have been completely negated by the deceleration in velocity of money. Therefore, as long as the velocity of money remains muted, one should not expect a high, sustained level of inflation. Notwithstanding, it is anyone's guess how the reopening of economies around the globe will impact the future velocity of money. Keeping two of the variables constant (i.e., money stock and real expenditures), if the velocity of money accelerates, then by definition nominal prices must increase to maintain equality in Fisher's equation of exchange.

4. Is the Phillips Curve Dead?

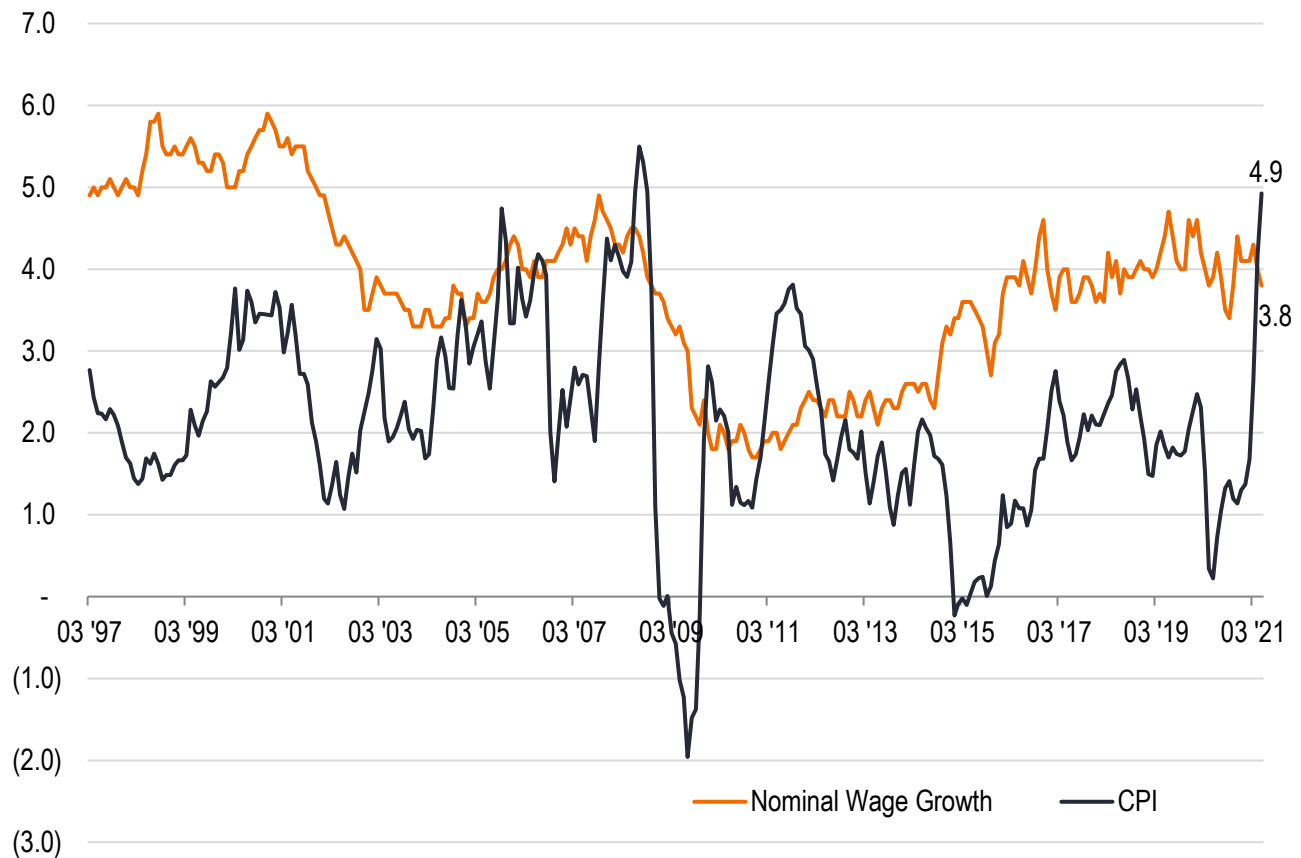
A deductive reasoning on the relationship between the labor market and inflation may follow this line of thought: a tight labor market should result in higher nominal wages and higher nominal wages, in turn, should result in higher inflation. As a result of this reasoning, many of us have heard this refrain: “unless we have wage increases, we can’t have price inflation.”

Exhibit 5A: The Phillips Curve (%)



Source: Federal Reserve Bank of Atlanta and Federal Reserve Bank of St. Louis FRED database. Data as of May 31, 2021.

Exhibit 5B: The Phillips Curve (%)



Source: Federal Reserve Bank of Atlanta and Federal Reserve Bank of St. Louis FRED database. Data as of May 31, 2021.

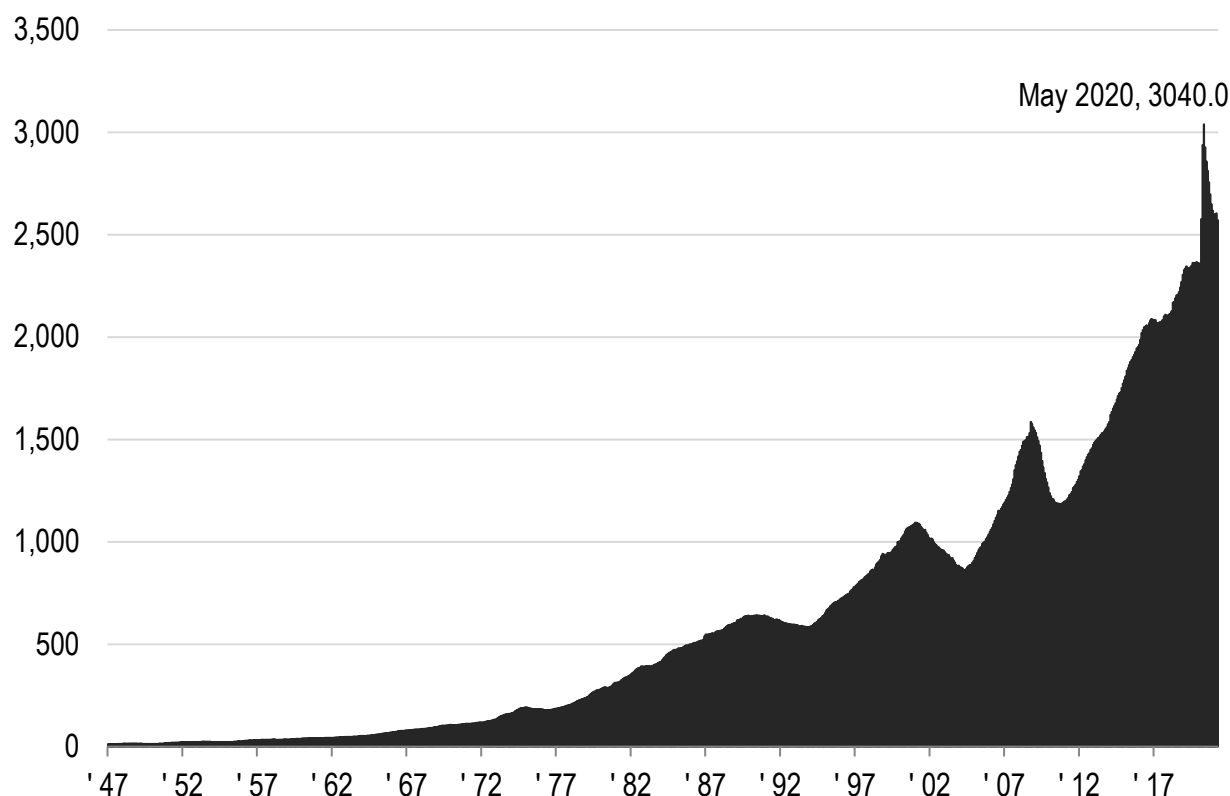
In Exhibit 5A, we set forth the relationship between the unemployment rate and nominal wage growth, and in Exhibit 5B the relationship between nominal wage growth and CPI. In 5A, it appears the first part of the deductive reasoning holds, while in 5B, the second part of the reasoning falls apart. As one can observe in 5B, there is no discernible relationship between nominal wage growth and CPI. While nominal wage growth has averaged about 4.0% since 2016, CPI has been all over the map during that time period. Therefore, a low employment rate resulting in higher nominal wage growth may or may not presage higher future inflation.

5. Demand for Commercial & Industrial Loans

Demand for commercial and industrial loans seems consistent with consumer spending behavior. If businesses expected aggregate demand for goods and services to increase substantially, then one would expect to see a similar increase in demand for business credit, but that is not what we observe in Exhibit 6.

Exhibit 6: Demand for Commercial & Industrial Loans has been Cooling Off

C&I Loans Outstanding in Billions USD.



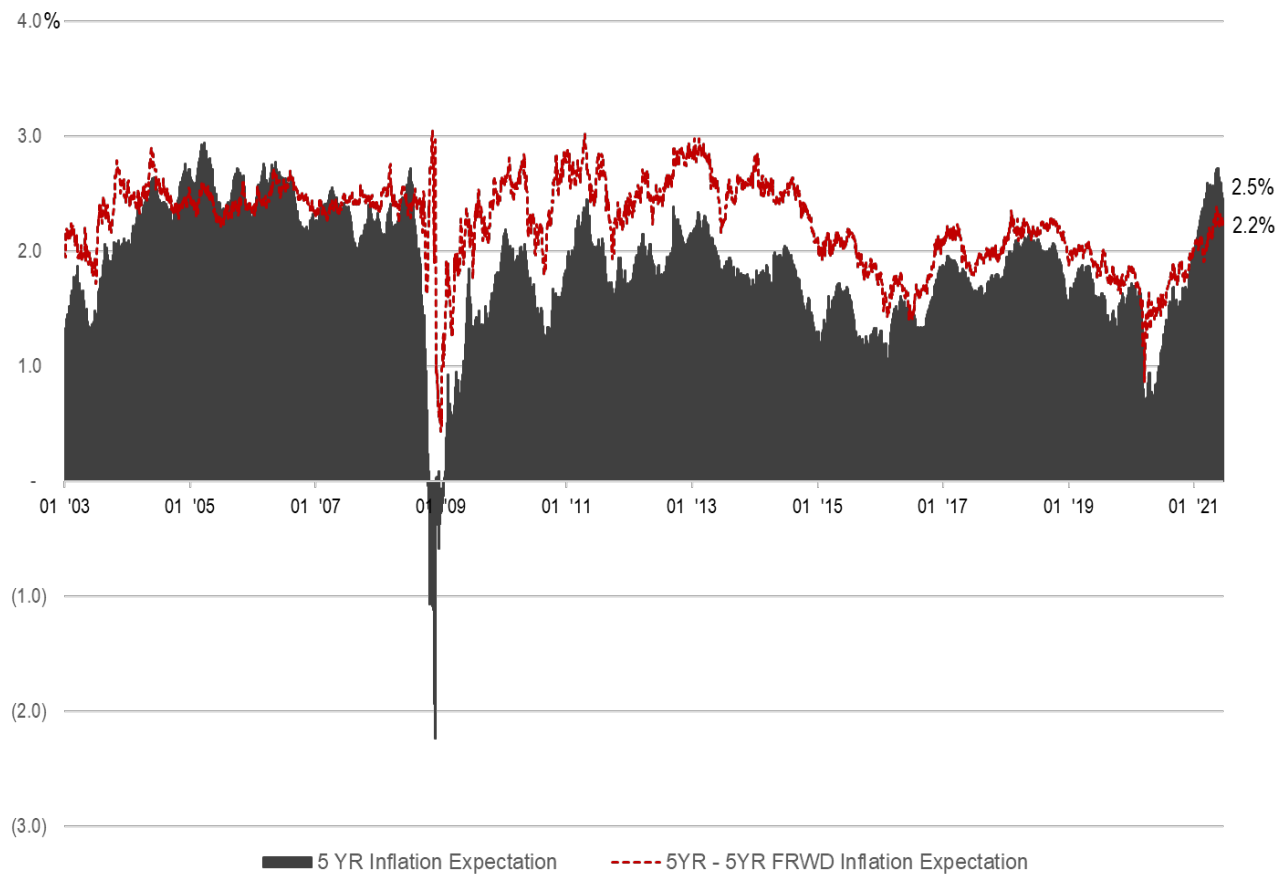
Source: Federal Reserve Bank of St. Louis FRED database. All Commercial Banks. Data as of April 30, 2021.

Shortly after the shutdown, it appears businesses borrowed to enhance their liquidity positions to weather the pandemic induced crisis. As uncertainty dissipated and the economy began to regain its footing, demand for Commercial and Industrial (C&I) loans waned. This pattern of business behavior does not seem to support an acceleration in consumer demand for goods and services that would result in high inflation.

6. Long-Term Inflation Expectation Still Anchored in Fed's Target of 2.0%

For the time being, it appears investors are giving the Fed the benefit of doubt. While, the breakeven inflation expectation for the next 5 years is moderately high at 2.5%, the inflation expectation for the following 5 years still remains close to the Fed's target of 2.0%.

Exhibit 7: 5-Year, 5-Year Forward Breakeven Inflation Still Anchored Around 2.0%



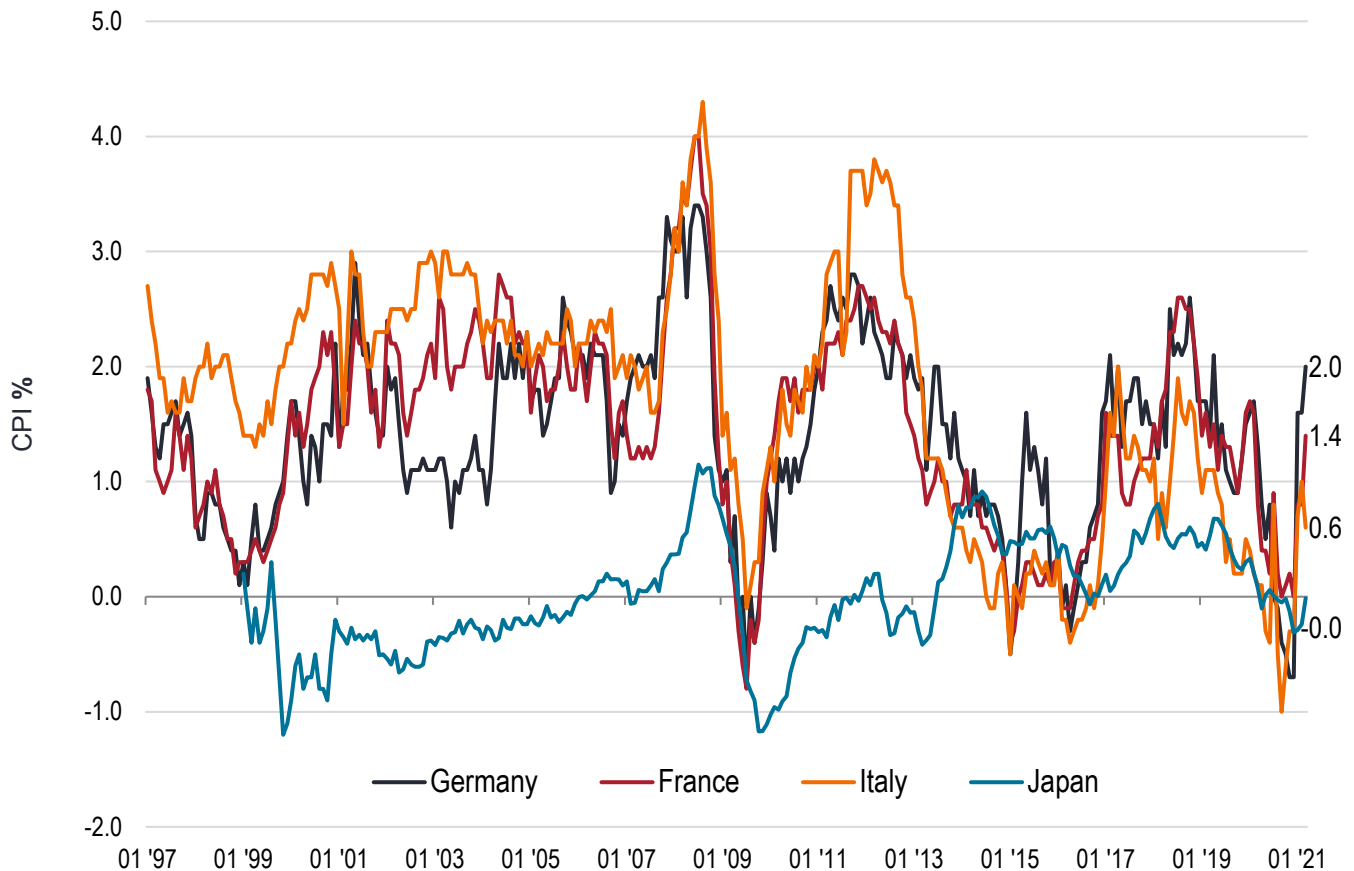
Source: St. Louis Fed FRED. Data as of June 30, 2021.

The foregoing chart on current inflation expectation confirms the Fed's assertion that inflation will be higher in the near-term but the market believes it will settle down to its target of 2.0%.

7. Can the US be an Island of High Inflation?

As demonstrated in Exhibit 1, the US is not the only country that embarked on a massive fiscal stimulus to counter a pandemic-induced recession. Both Japan and Germany deployed large fiscal stimulus (16% and 11% of GDP, respectively) without generating much inflation.

Exhibit 8: Subdued Inflation in Major European Countries and Japan

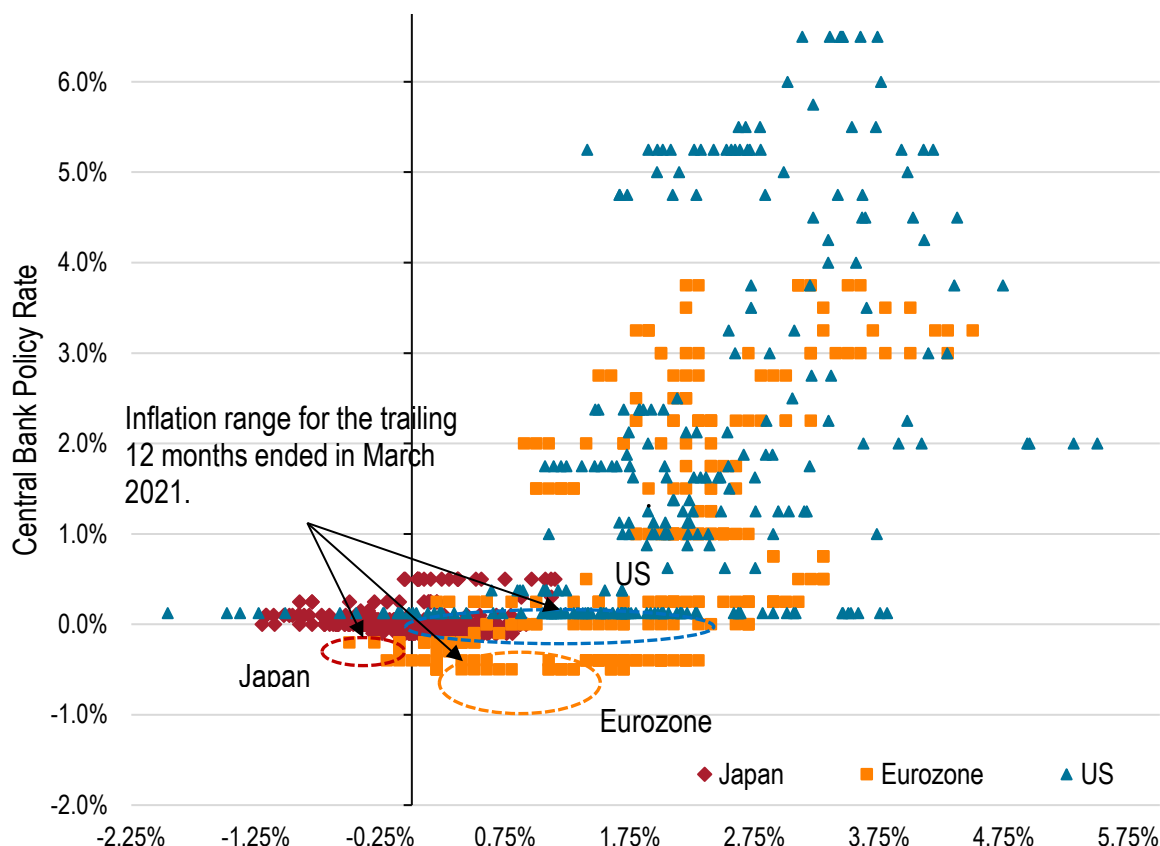


Source: Eurostat, Bank of Japan. Data as of March 31, 2021.

Therefore, it begs the question: can the US be an island of high inflation when other major economies struggle to generate any meaningful price inflation? As Exhibit 9 demonstrates, since 1999, there has never been an instance of high inflation for the US, Eurozone or Japan when central bank policy rates have been stuck at zero.³

³ Low inflation is the reason why the central banks have been able to maintain their zero or negative interest rate policies.

Exhibit 9: No Instance of High Inflation when Central Bank Policy Rate is Stuck at Zero



Source: BIS. Janus Henderson Investors. Bullard, James. "The Seven Faces of Peril." Federal Reserve Bank of St. Louis Review, September/October 2010, 92(5), pp. 339-52. Date as of March 31, 2021.

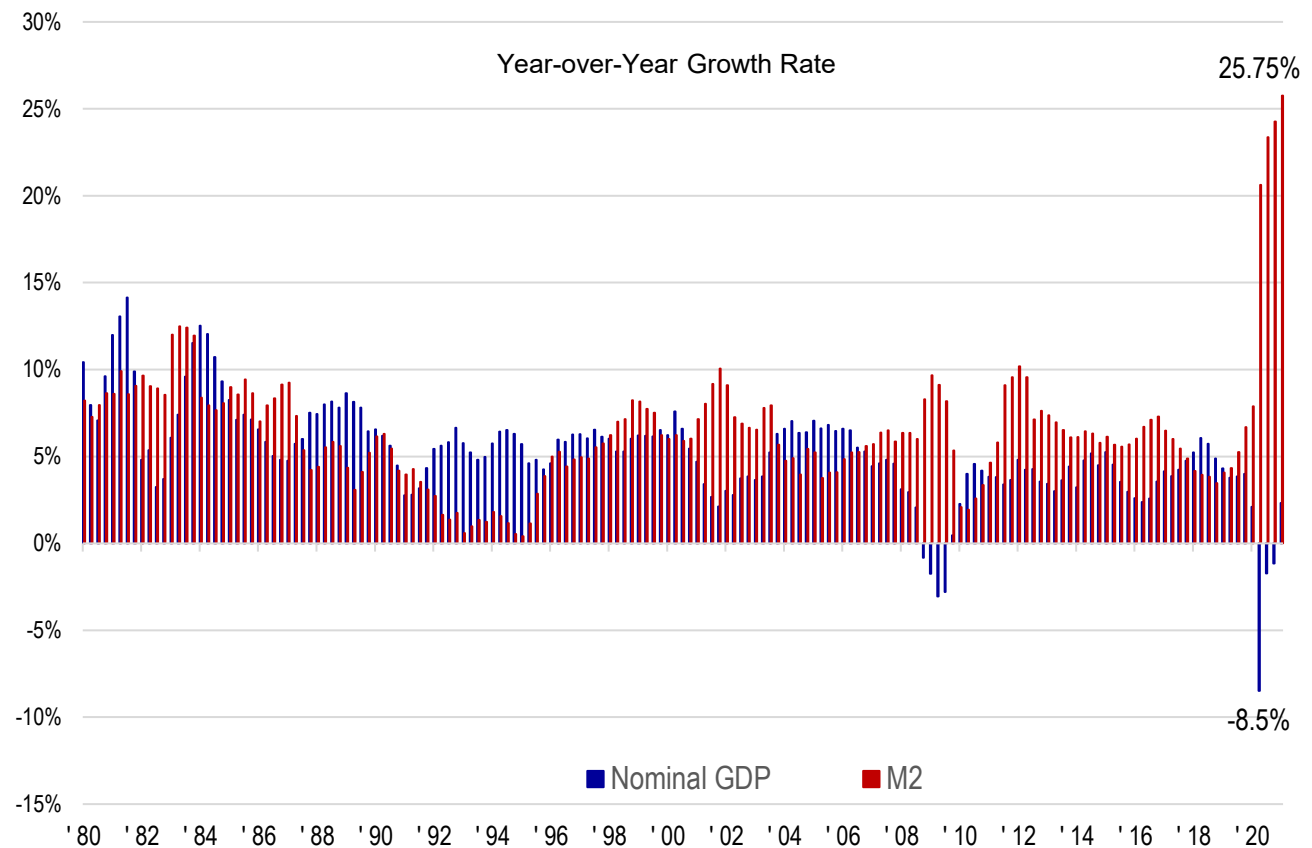
Japan has attempted for decades to generate inflation without success; and it appears Europe is not too far behind Japan in this regard. Central banks in the US, Europe and Japan would love to lift their policy rates above zero, but their hands appear tied due to persistent low levels of inflation.

Arguments for Higher and Sustained inflation

1. Explosion of Money Stock

When the economy was shuttered due to the pandemic, the aggregate demand as proxied by nominal GDP contracted 8.5% on an annualized basis, as shown in Exhibit 10. The ensuing surge in money stock was triple the contraction in nominal GDP.

Exhibit 10: Money Stock Exploded Following the Covid-19 Crisis



It has been said: it is not the printing of money that results in high inflation, but rather the printing of too much money that results in high inflation. In recent history, we have never experienced this type of surge in money stock; and this is one of the main reasons why some believe that inflation will be higher for longer. At face value, it is difficult to argue against the printing of too much money by the US government.

2. Dollar Depreciation

Since the US has been much more prolific in printing money, one should expect the US dollar to depreciate against other major currencies. The dollar depreciation, in turn, should lead to higher prices of imported goods in theory.

Exhibit 11: Dollar Depreciation Since the Depth of the Covid-19 Crisis



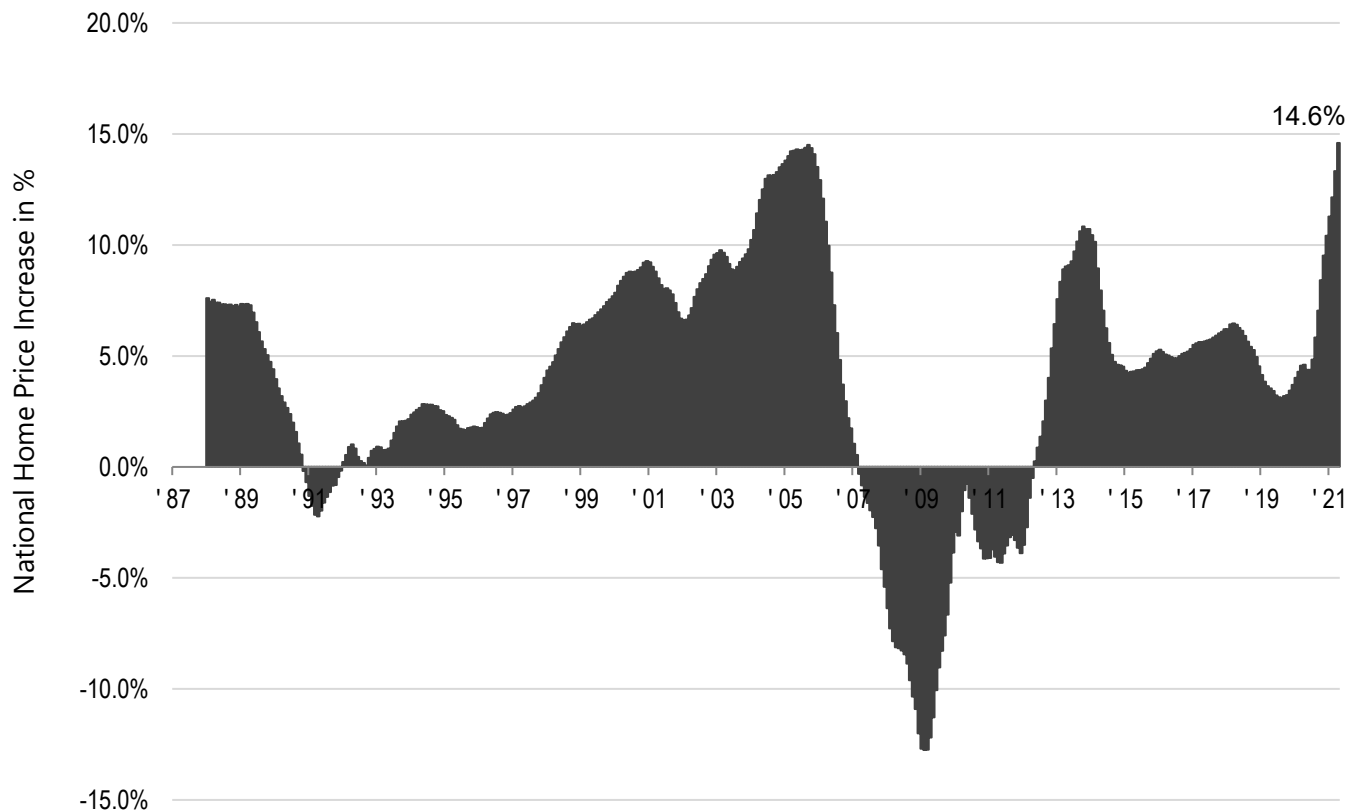
Source: St. Louis Fed FRED. Data as of June 30, 2021.

Since the nadir of the Covid-19 crisis, as proxied by the DXY Index, the US dollar has depreciated about 13% against other major currencies. Therefore, the argument that dollar depreciation leads to higher prices deserves some merit; however, for inflation to remain higher for longer, the dollar would have to continue to trend lower. For the time being, that is not what one observes in the underlying data: rather than trending lower, the dollar appears to have plateaued since January 2021.

3. Owner Equivalent Rent within CPI and PCE – a Made up Figure with a Lag

All of us have witnessed firsthand the meteoric rise in home prices throughout the United States. The year-over-year (YOY) change in US home prices (as represented by the S&P/Case Shiller U.S. National Home Price Index) jumped from 4.6% in March 2020 to 14.6% in April 2021 as shown in Exhibit 12.

Exhibit 12: Meteoric Rise in Home Prices



Source: St. Louis Fed FRED database. Data as of April 2021.

And yet, according to the US Bureau of Labor Statistics, the April 2021 YOY price increase for housing approximated 2.6%. What gives? Per Fannie Mae,

“Despite rapid house price gains over the past year, the housing components of the major inflation indices decelerated significantly from roughly a 3.5 percent annual pace pre-COVID to 2.0 percent in April 2021. Homes are considered long-lasting investment goods rather than consumption items. Therefore, inflation measures use an estimate of the cost of service that housing provides its occupant, referred to as shelter, as opposed to changes in the asset price. ... On a year-over-year basis, house price gains historically lead changes in the CPI shelter cost ... by about 5 quarters.”⁴

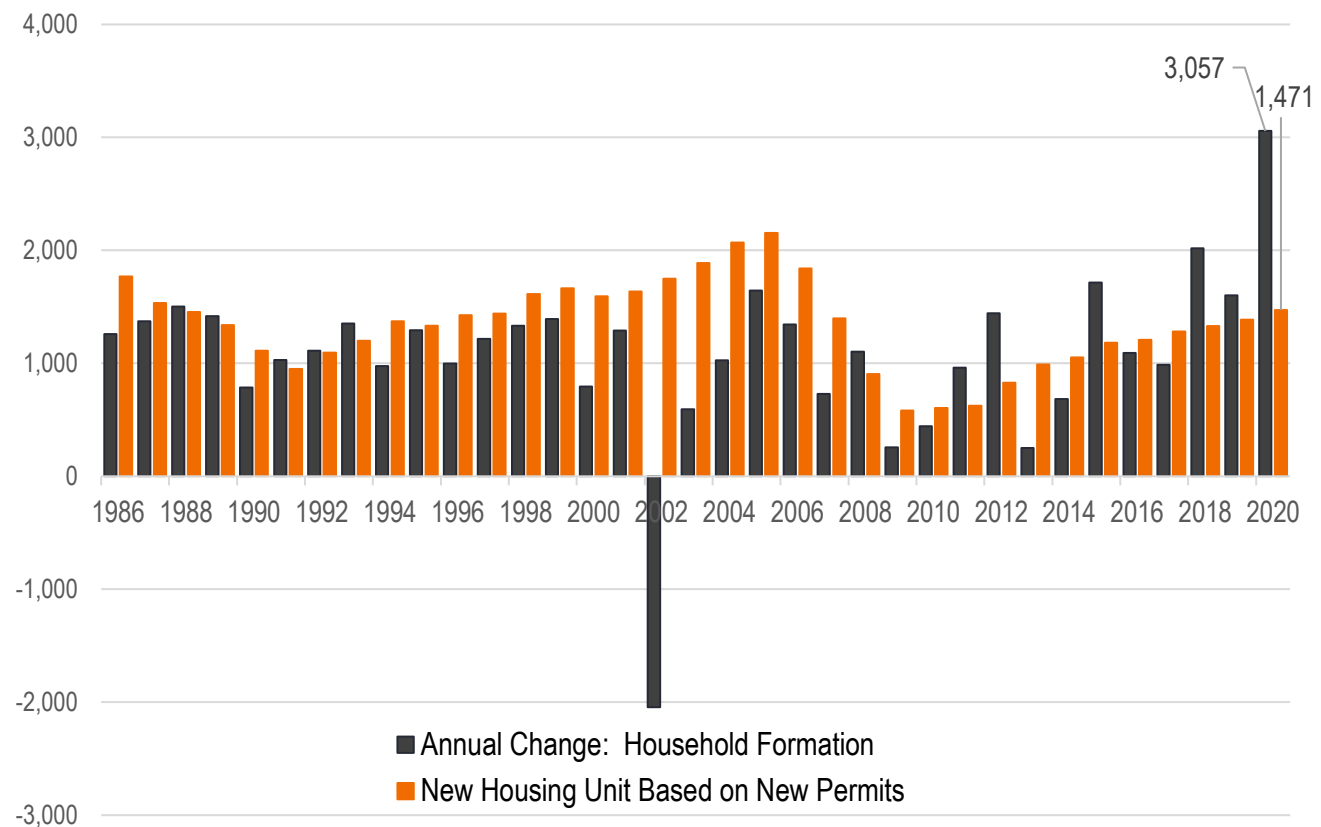
⁴ Brescia, Eric. Fannie Mae Housing Insights: “Housing Poised to Become Strong Driver of Inflation.” 08 June 2021.

The April 2021 CPI reading of 4.2% included unusually low and lagged estimates of rents. If Fannie Mae is indeed correct in its estimation of the time lag between home price increases and shelter costs, then it necessarily follows inflation will continue to trend upward, especially since shelter accounts for 40% of core CPI and 18% of Core PCE.⁵

4. Structural Imbalance in the Housing Market

In our opinion, the recent increase in home prices will not abate anytime soon for the following reason: leading up to the 2008 collapse in the housing market, the supply of new housing units outpaced the new household formation. In the aftermath of the collapse in the housing market, the new supply of housing units has not kept pace with the new household formation; this is especially noticeable beginning in 2018.

Exhibit 13: The New Household Formation Meaningfully Outpaced the New Supply of Housing Units in Recent Years (000s)



Source: Federal Reserve Bank of St. Louis FRED database, as of December 31, 2020.

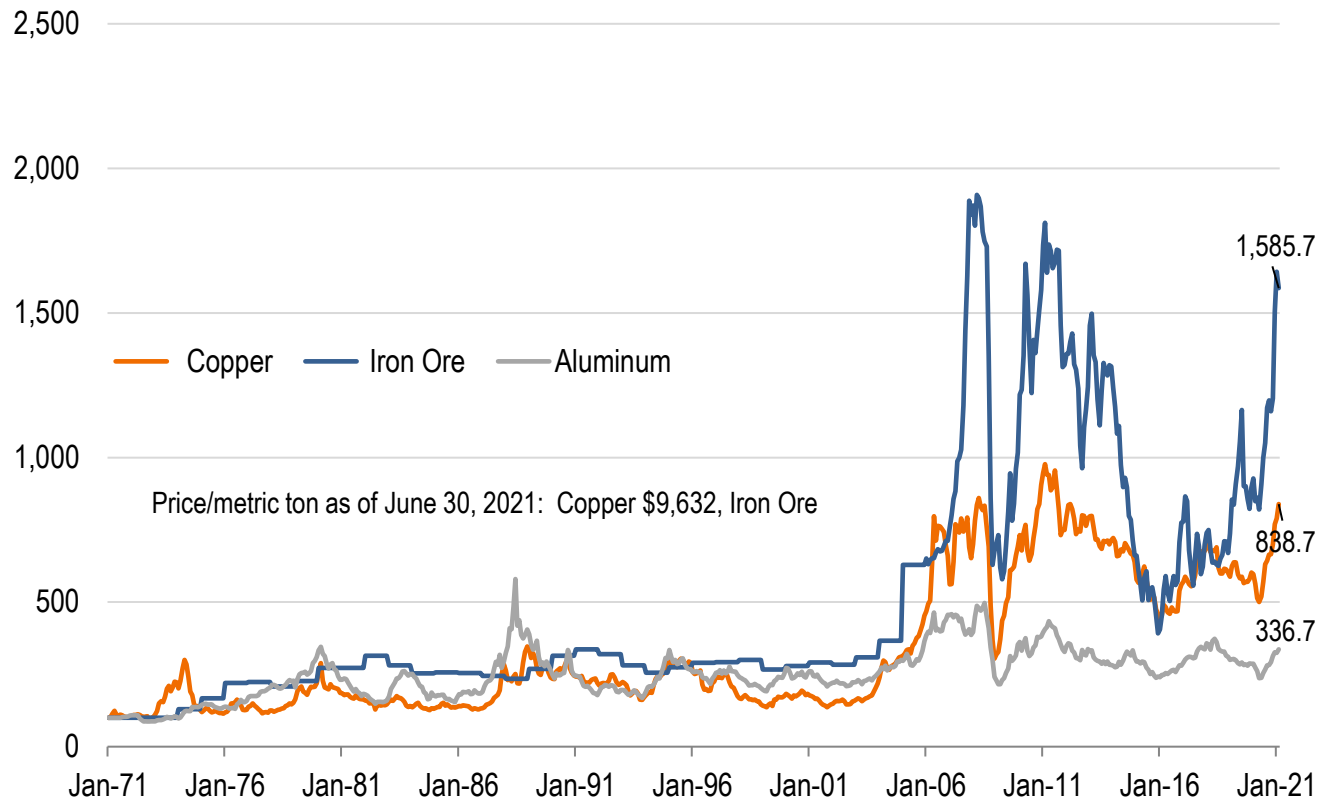
Therefore, as long as demand continues to outpace supply for new housing units, it is difficult to see how this structural pricing pressure in the housing market will abate anytime soon. And as remarked in the previous section, this pricing pressure in the housing market will eventually manifest itself via increases in estimates of owner equivalent rent.

⁵ As an aside, due to the difference in weight assigned to shelter (40% vs. 18%), PCE will most likely continue to under report inflation vis-à-vis CPI.

5. All Zero Net Carbon and Renewable Roads Lead to Metals and Mining

With global warming becoming a major environmental issue, limiting a carbon footprint and developing renewable sources of energy (renewables) have taken on renewed urgency. However, as it has become apparent to most, one cannot limit metals and mining activity to preserve the natural environment, while at the same time pushing for faster development and greater adoption of renewables.

Exhibit 14: The Upswing in Industrial Metals may Last for Several Years



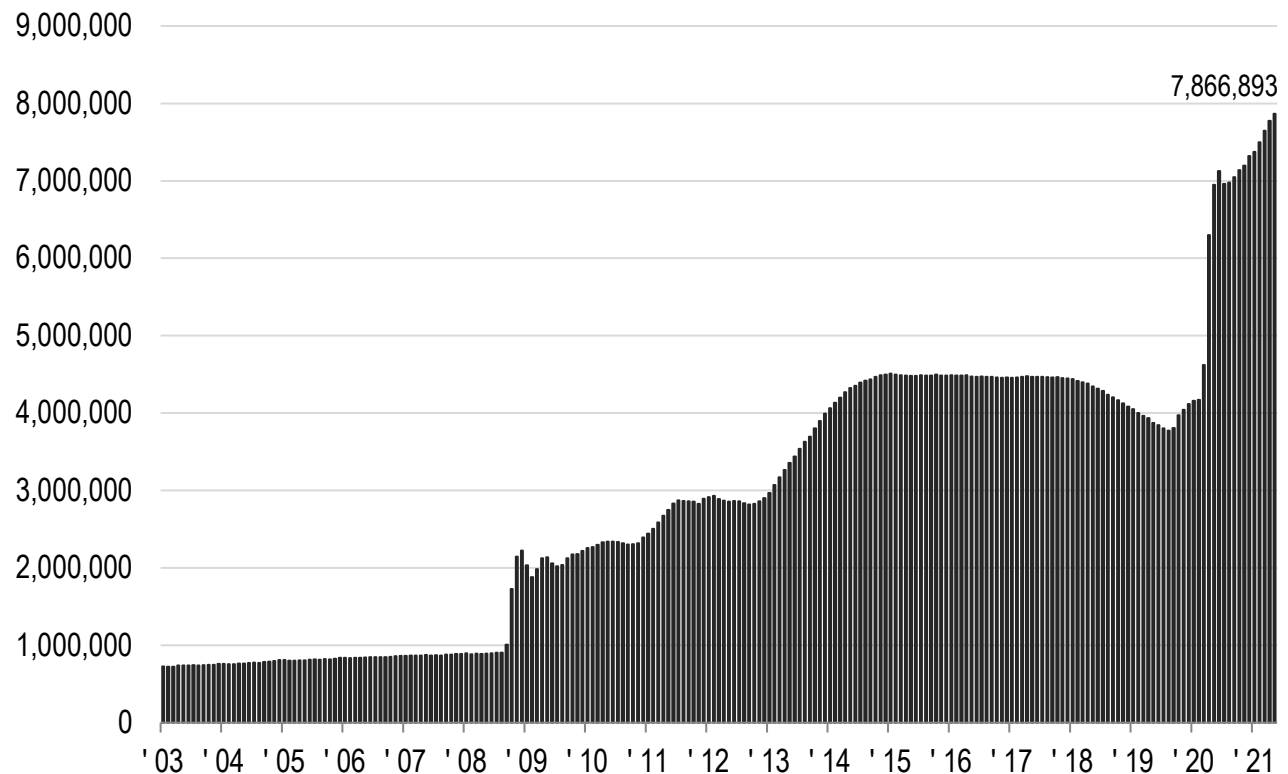
Note: Prices for copper, Iron ore and aluminum have been indexed to 100 for comparability purposes
Source: Bloomberg. Data as of June 30, 2021.

According to our natural resources research analysts, increasing the supply of industrial metals such as copper, iron and aluminum is not as simple as turning on a spigot. Due to strict environmental laws and regulations, permitting requirements, and development of necessary infrastructure to support new mining projects, it may take five to seven years for new supplies to come online. Therefore, the upswing in industrial metal prices shown in Exhibit 14 may persist for multiple years. Since they represent key inputs to many goods, including renewables, their persistent price increases support a sustained, not transient, increase in inflation for years to come.

6. Left Side of the Fed's Balance Sheet

Since the dawn of the GFC, the Fed's balance sheet has increased eightfold, from less than \$1 trillion to almost \$8 trillion.

Exhibit 15: The Fed's Total Assets Jumped Eightfold Since 2008 (in MMs)



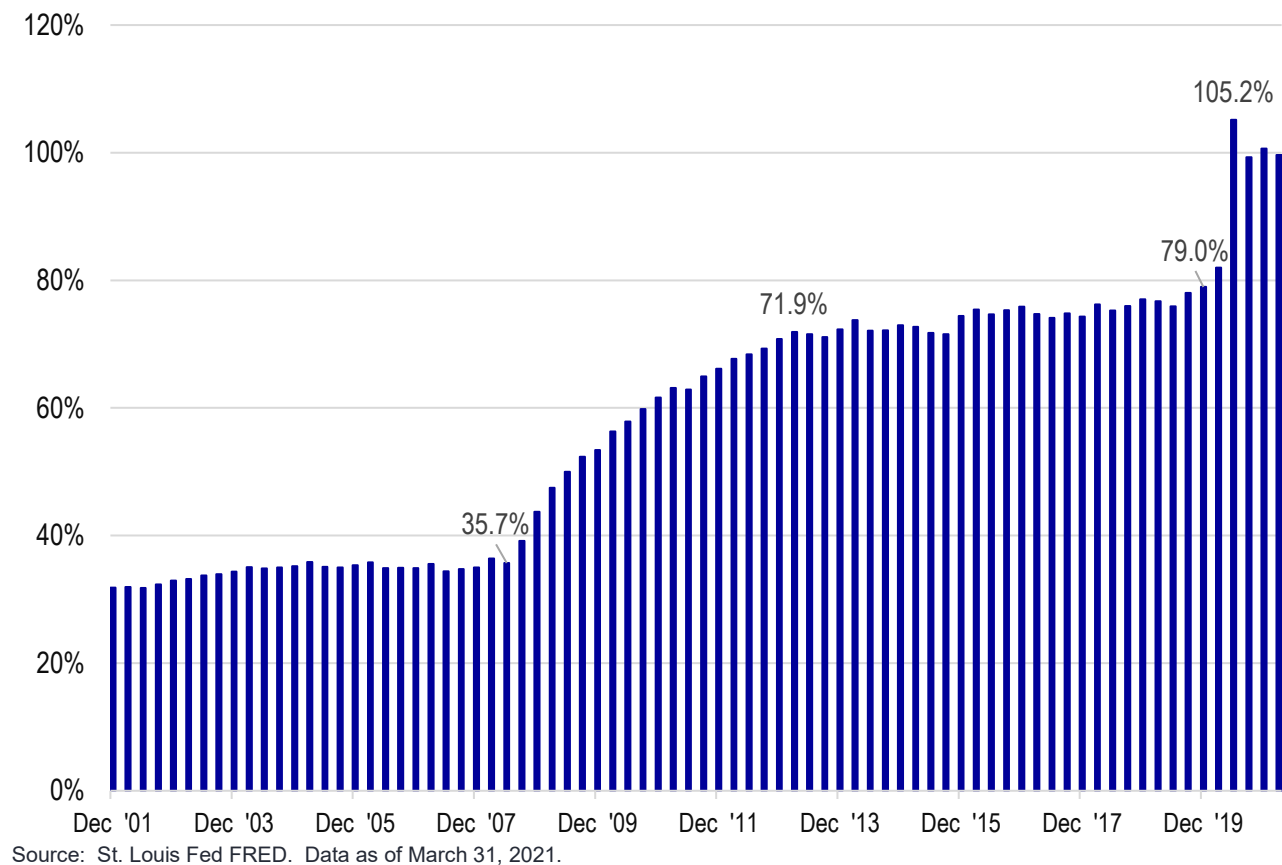
Source: Federal Reserve Bank of St. Louis FRED database. Data as of May 2021.

Some have asserted the overabundant liquidity from the Fed's never ending quantitative easing (QE) programs will eventually spill over to the real economy and contribute to higher inflation. We are doubtful. While excess liquidity from QE has certainly contributed to price inflation on Wall Street, we see no evidence of QE leading to higher inflation on Main Street. Therefore, while QE data is presented herein, in our opinion, this represents a tenuous argument for higher inflation.

7. US Debt-to-GDP: Over the 100% Threshold

Profligate spending by the US government has resulted in the US debt to GDP ratio breaching the 100% threshold, and we see no end in sight to government spending. (The debt ratio increases to about 130% of GDP if one includes US Treasuries held by the Fed.)

Exhibit 16: US Debt-to-GDP Crossed the 100% Threshold



A high debt-to-GDP level by itself, however, does not necessarily translate to higher interest rates and high inflation as demonstrated by Japan, Italy and Greece – countries with high debt ratios but low interest rates and low inflation. It is only when investors lose faith in the creditworthiness of the United States and the reserve currency status of the US dollar that one should fear a rise in interest rates and inflation. Given the dynamism of the US economy, the loss of creditworthiness or reserve currency status of the dollar seems implausible for the foreseeable future. Again, this represents a tenuous argument for higher inflation.

Could the Consensus View on Inflation be Wrong?

Since the early '90s (that is, for the past three decades), we have been living and investing in a period of moderate to low inflation. For many, a high-inflation environment is something one reads about in history books or that exists in developing countries with poor fiscal discipline and poor governance. Three decades represent the entire investing experience for many investors. Therefore, the risk for most institutional investors is to outright dismiss the current bout of higher inflation as transitory because we have not lived in or invested in a high-inflation environment for a long time.

To quote Rita Dove, an American poet:

“You have to imagine it possible before you can see something. You can have the evidence right in front of you, but if you can't imagine something that has never existed before, it's impossible.”

For many of us, it is difficult to imagine a world with a high, sustained level of inflation. And we validate this view through confirmation bias: we uphold evidence that supports our view while dismissing evidence that contradicts that view. The real danger is that we dismiss the evidence right in front of us.

When Paul Volcker took over the reins of the Federal Reserve in 1979, price stability took center stage and maximum sustainable employment played second fiddle. Under the current Fed leadership, the two mandates appear to have reversed their positions: maximum sustainable employment occupies the center stage and price stability plays second fiddle.

As the reader can infer from the preceding, I believe inflation will be higher for longer. The explosion in money stock, the demand-supply imbalance in the housing market that will result in higher estimated shelter costs, the sustained and increasing demand for industrial metals due to the structural increase in demand for renewables, and the high and persistent fiscal deficit run by the US government, I believe, will eventually manifest in a high and sustained level of inflation. Notwithstanding, the foregoing is just an opinion, and, as remarked at the beginning, no one knows where inflation will eventually settle.

For those who believe inflation is a risk that must be actively managed on a go forward basis – in a follow-up paper – we will propose an allocation to an inflation protection portfolio that assesses the merits of inflation-hedging assets and investment strategies such as real estate, TIPS, commodities, and dynamic trend-following strategies.

The opinions and views expressed are as of the date published and are subject to change. They are for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation to buy, sell or hold any security, investment strategy or market sector. No forecasts can be guaranteed. Opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent and may not reflect the views of others in the organization. It is not intended to indicate or imply that any illustration/example mentioned is now or was ever held in any portfolio. Janus Henderson Group plc through its subsidiaries may manage investment products with a financial interest in securities mentioned herein and any comments should not be construed as a reflection on the past or future profitability. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties with regards to the results obtained from its use. Past performance is no guarantee of future results. Investing involves risk, including the possible loss of principal and fluctuation of value.

Janus Henderson is a trademark of Janus Henderson Group plc or one of its subsidiaries. © Janus Henderson Group plc.

C-0721-39123 12-30-22

FOR INSTITUTIONAL INVESTOR USE ONLY / NOT FOR PUBLIC VIEWING OR DISTRIBUTION