A Third Way for Inflation?

by Michael Kelly of PineBridge Investments, 8/12/21

Investors debating the path of inflation tend to fall into two camps: those who believe it will be truly temporary, resolving after a few more months of running hot; and those who expect a permanent structural shift toward higher, unhealthy inflation in the future. Most are not considering a third way lying between these binary views – that inflation will persist beyond year-end but ultimately segue into an investment-friendly reflationary regime.

Looking at the pessimistic view, what factors could cause a shift to persistently high and unhealthy inflation? Historically such problematic inflation has required years of nurturing. Today, it could take root if modern monetary theory (MMT) were to become structurally embedded in the policy mix, rather than remaining a response to crisis conditions.

On the monetary side, note that there is no sign of overt yield control from the Fed, which stood by as the US 10-year Treasury breached 1.25%, then 1.50%, and finally 1.75%[1]. With the Fed contemplating tapering quantitative easing (QE) later this year and ending it in 2022, its balance sheet should grow in line with nominal GDP. By the time QE ceases, it will have grown $6.5 trillion more than nominal GDP since March 2009[2], with that extra stock providing a source of permanent artificial demand for Treasuries relative to supply – and serving as a silent fourth partner to debt, demographics, and technology in keeping rates low. The Fed seems to be counting on this for some time.

The European Central Bank (ECB) and the Bank of Japan (BOJ) will likely exit their crisis-oriented policies a year or two later, should the US Treasury curve stay anchored at very low levels as the Fed stops growing its stock of QE.

On the fiscal side, only the US is pushing policy hard enough to potentially stoke inflation, and this relies on the Democrats holding Congress in the 2022 midterm elections. Germany's September elections may usher in more fiscal stimulus should a coalition government that includes the Greens spend more on climate initiatives. With Merkel leaving office, Draghi and Macron might be able to position for a more balanced European fiscal compact, with less austerity and more fiscal relevance.

However, even if this comes to pass, China's ongoing deleveraging will largely offset fiscal thrusts elsewhere. Overall, the fiscal and monetary picture suggests that inflation is unlikely to hit and remain at levels that would kill today's bull market.

What about the view that inflation is truly temporary? Central banks and markets appear to expect most supply logjams to clear in the fourth quarter, for some tangible reasons. In the US, lifestyle changes, childcare issues caused by school closures, and ongoing crisis-oriented unemployment benefits are among the reasons people are delaying a return to the workforce. Labor bottlenecks should start to clear as schools reopen and benefits expire.

The slow cresting of Asian exports is another sign that bottlenecks in US manufacturing are clearing. Yet anyone who has ever witnessed a factory system reopen after an extended shutdown knows it's an ugly process of identifying and clearing the most obvious bottlenecks, only to discover new ones. The process could well take longer than expected.

Taken together, conditions suggest that the reflationary 'third way' is more likely than a temporary inflation spike-and-retreat or problematic long-term levels.

During the 2009-2019 recovery, private investment and fiscal drags were so prevalent that output gaps took a decade to close. This kept growth uncomfortably slow and inflation below central bank targets. This time, governments and businesses are committing to investments to address housing demand and business model flaws exposed by the pandemic. Spending on climate change mitigation will also accelerate. All told, the world looks poised to close today's output gap in a just few years, pressuring wages and profits higher.

While reflation is investment-friendly, the most lucrative period of the economic cycle for markets, when growth is strongest, may have already passed. US economic growth appears to be peaking just as China is showing signs of a slowdown. Yet the global economy and fundamentals will likely keep growing at a faster pace than in 2009-2019.

This environment should still reward risk-taking, just to a lesser extent. While more aggressive portfolio positioning starting in May 2020 may have been warranted until recently, the case for dialing down risk now seems sensible.

This isn't to say there aren't bright spots. European and Japanese equities look compelling, with reopening still ramping up. These asset classes have attractive valuations with high beta to global growth. Opportunities can also be found in credit, which tends to thrive during slower but still positive growth. While the historical growth differential favoring emerging market equities looks poised to shrink, EM credit looks particularly compelling. By contrast, defensive equities are looking less attractive.

Markets should get more clarity in the second half of 2021, when the state of inflation either recedes to its previous 'too little,' awakens to 'too much,' or enters a reflationary period of 'just right.'

[1] Source – Daily Treasury Yield Curve Rates – 21.07.2021

[2] Source – Federal Reserve balance sheet trends - 21.07.2021