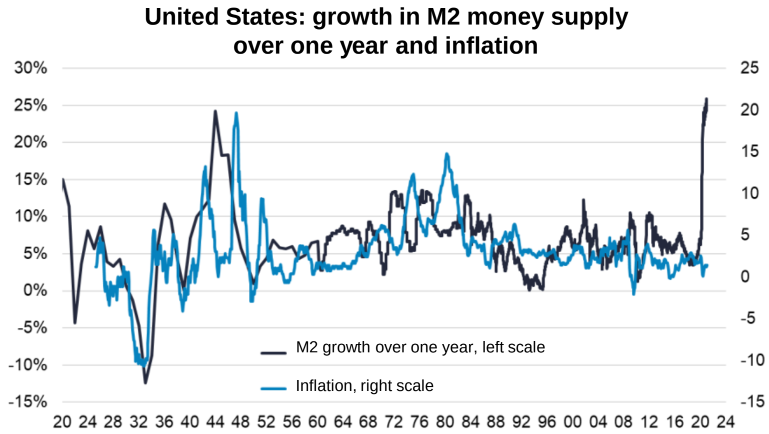
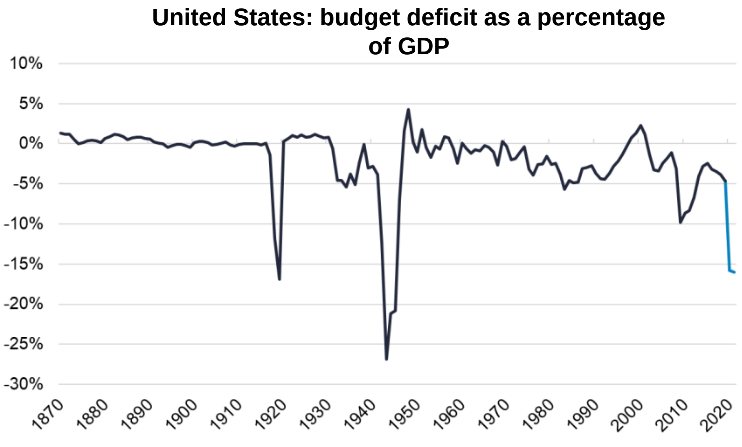
The Covid-19 crisis has led to monetary and fiscal policy interventions on a scale not seen since the Second World War. Given the extent of these actions, investors, savers and economists are concerned about the potential resurgence of inflationary risk, since history has demonstrated that phases of massive money creation have often generated very high inflation. This has been brought under control in recent decades by powerful deflationary trends, but could the flood of liquidity pouring out of public coffers cause the levee to break? This concern is undoubtedly most acute in the United States, given the measures taken there, particularly with the latest $1.9 trillion support package, which is set to be followed by an infrastructure plan partially financed by debt.

Here we assess the probability of various inflation scenarios, as well as their impacts for the Fed and on markets. We will see that in the Eurozone, the question of inflation is likely to arise at a later date. Given the high level of uncertainty over future developments, we will conclude by discussing the indicators to monitor.



source: Òscar Jordà, Moritz Schularick, and Alan M. Taylor 2017, Macrofinancial History and the New Business Cycles Facts, Bloomberg



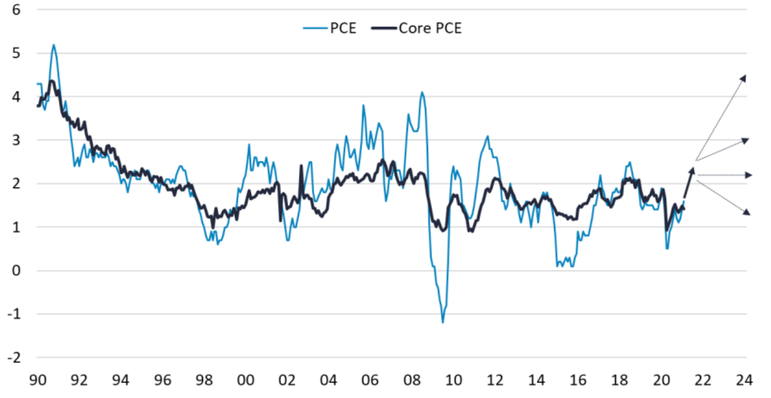
Source: Bloomberg. CBO, Jordo, Schubrik, Taylor 2017

[1] When Led Zeppelin recorded their song *When the Levee Breaks* in 1971, Western countries were about to enter a decade of unusually high inflation. The blues song, written in 1929 about the 1927 Mississippi flood, opens with the words: *"If it keeps on rainin', levee's goin' to break."*

The various inflation scenarios in the United States

Inflation is already certain in 2021 due to the significant base effects resulting from the slowdown in activity in 2020. The inflation trend for the post-2021 period is uncertain, however. This is an important question, as it will dictate the Federal Reserve's future monetary policy, which is currently very accommodating. If, after an initial acceleration, inflation returns to the low levels of recent years, this could undermine any prospect of monetary policy normalisation by the central bank. Unbridled inflation, on the other hand, would constitute a very negative scenario, forcing the Fed to consider strong actions to regain control. Between these two extreme scenarios, two other more moderate trajectories are possible: inflation remaining slightly above 2.0%, a scenario that would allow the central bank to complete its very gradual normalisation plan, and a scenario of more rapid acceleration, forcing it to step up its plan. Although we see the two extreme scenarios as unlikely, 2022 will be key to knowing which of the other two will prevail.

United States: price changes over one year



source: Bloomberg

Exclusion of extreme scenarios

The scale of the measures adopted would appear to us to greatly limit the risk of a further decline in inflation. The opposite scenario, of 1970s-style uncontrolled inflation, also seems unlikely.

The very high inflation of the 1970s was due to a combination of several factors. Following a phase of strong growth in the first half of the 1960s, productivity had begun to slow down. At the end of the 1960s, growth remained at a high level, particularly due to an increase in the budget deficit in 1968. Food price shocks then occurred. Inflation rose above 4.0% from 1968. The rate hike by the central bank and the normalisation of monetary policy led to a recession, causing inflation to slow to below 3.0% by the end of 1973. Following the recession of 1973-1975, real rates remained negative while the budget deficit increased in 1976, leading the average growth rate to return to 5.0%, which reflected an overheated economy in relation to the level of potential growth. Added to this were the effects of the monetary disarray resulting from the collapse of the Bretton Woods architecture, followed by the second oil shock – all in a context of significant indexation of prices to wages and therefore inflation expectations heavily reliant on past inflation.

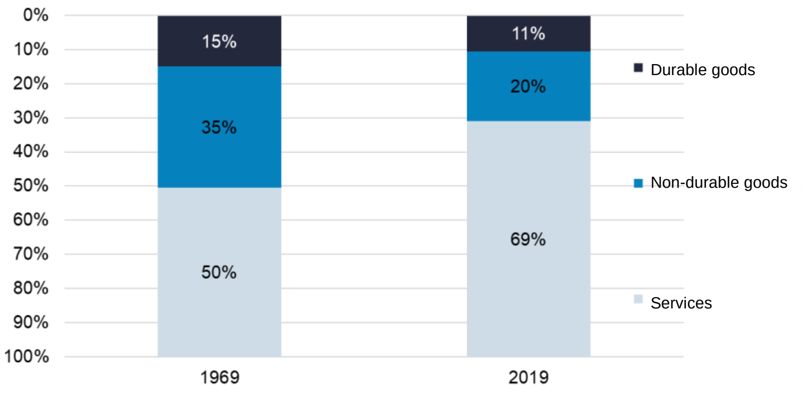
The current situation is very different. Firstly, due to structural changes, inflation has become much less persistent, meaning that an inflationary shock is less likely to generate sustained inflation.

United States: average correlation of quarterly inflation with the previous four quarters (5-year rolling average)

Source: Bloomberg

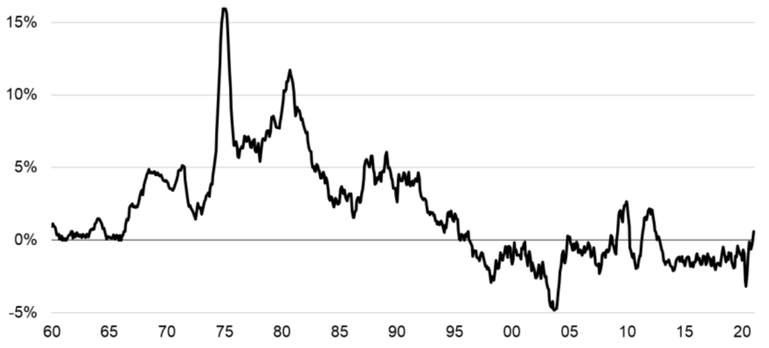
Secondly, the structure of the consumption basket has changed significantly with a much larger weighting of services. There are also additional structural pressures on the prices of goods due to globalisation and digitalisation. Globalisation may be partially in doubt, but the second trend is set to continue to limit future inflation.

United States: composition of household consumption



source: Bloomberg

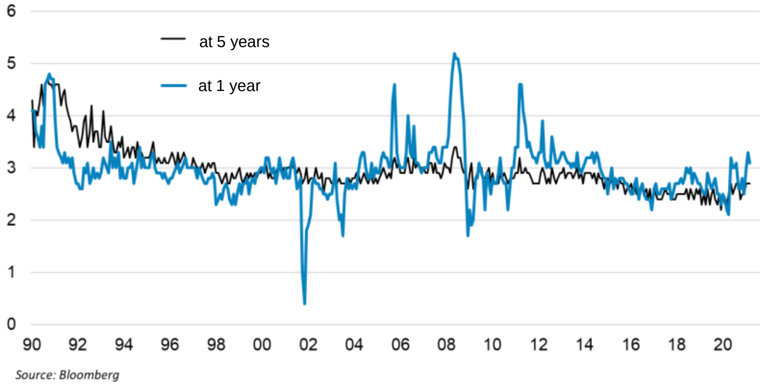
United States: change in the price of goods, excluding food and energy, over one year



source: Bloomberg, LFG calculations

Furthermore, inflation expectations are currently very low, both among consumers and on financial markets. Those expectations are still well below the levels prevalent before concerns emerged over potential deflation, although they have taken into account higher inflation in the short term.

United States: households' inflation expectations according to a survey by the University of Michigan



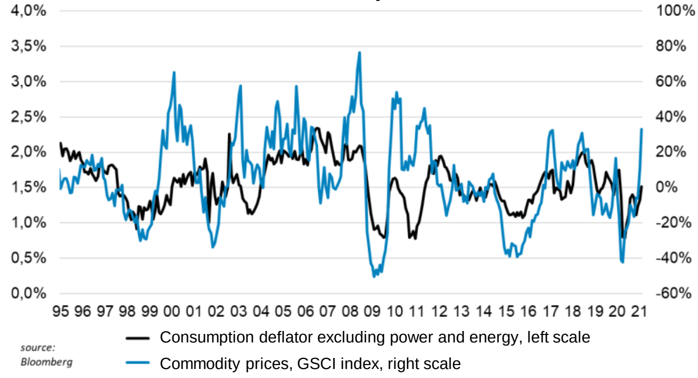
Source: Bloomberg

Finally, and arguably most importantly, central banks know the exorbitant cost of any loss of credibility. They will therefore show no hesitation in raising rates if they feel investor confidence in them is starting to erode.

Temporary shocks to put into perspective

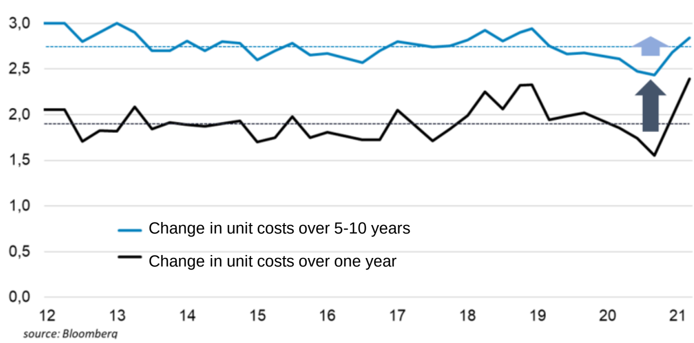
The rise in commodity prices is expected to gradually continue, becoming a lasting driver of inflation, although the impact of commodity prices on consumer prices is less significant than in the past. As the chart below shows, the last major upward cycle in commodity prices did not cause any notable deceleration in the aggregate consumer price index.

United States: commodity prices and consumer prices



Tensions are also evident on production chains in various sectors (semiconductors in automotive, freight costs, etc.) which may generate short-term inflation, although companies see these tensions as temporary judging from this indicator calculated by the Atlanta Fed.

United States: Atlanta Fed survey on company costs



The short-lived nature of the inflation therefore makes it unlikely that these shocks will have any lasting effect.

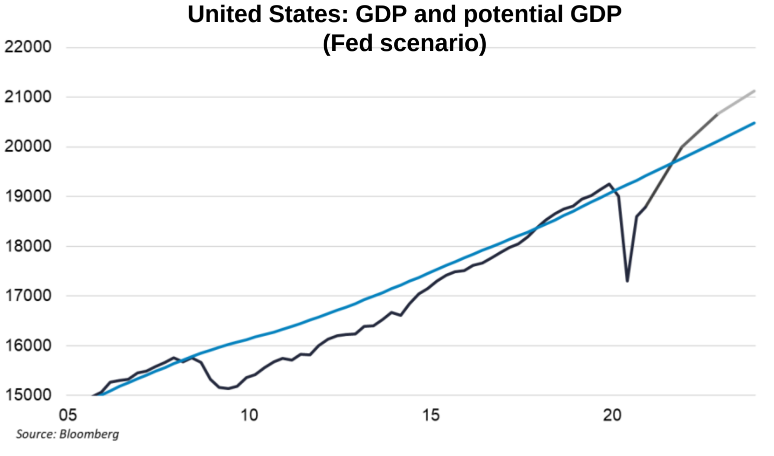
What would be the impact of a very rapid recovery in the American economy?

A return of the unemployment rate to pre-crisis levels could occur much more quickly as a result of the combined effects of the reopening of the economy and the support measures. The latest figures show that job creation is already very significant and activity surveys are reaching record levels in the United States.

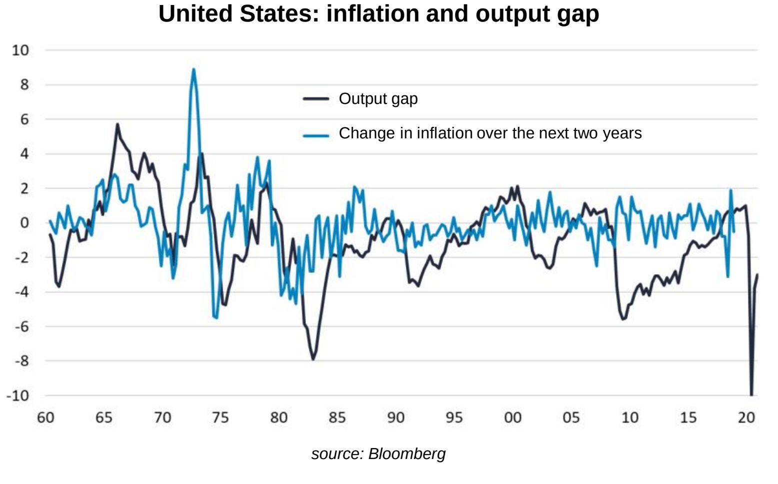
United States: unemployment rate

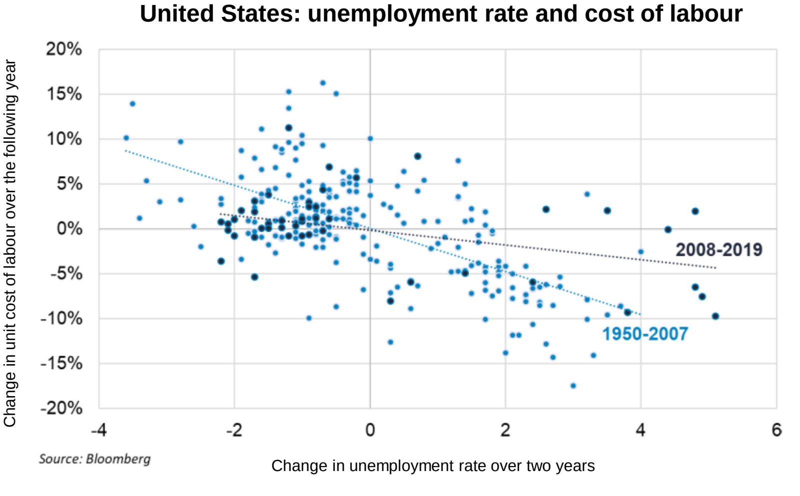
Source: Bloomberg

The scale of the stimulus measures could spur the economy to an unprecedented level of activity compared with its potential. Based on the Fed's forecasts, which are not the most optimistic regarding growth, the output gap, i.e. the difference between observed growth and potential growth, could return to positive territory at the end of the year.



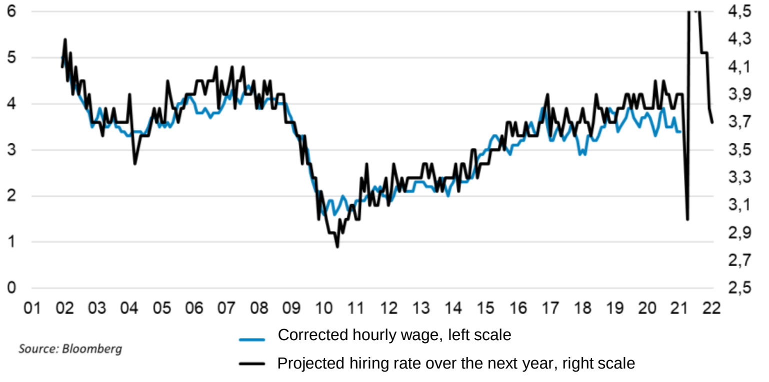
Admittedly, however, inflation is now much less sensitive to the economic cycle than previously. Until the mid-1980s, the output gap was a very accurate indicator of changes in inflation over the next 18 months, while that is much less the case today. This is no doubt explained by more grounded inflation expectations, as well as the lower sensitivity of wages to the economy. The Phillips curve certainly appears to have flattened.





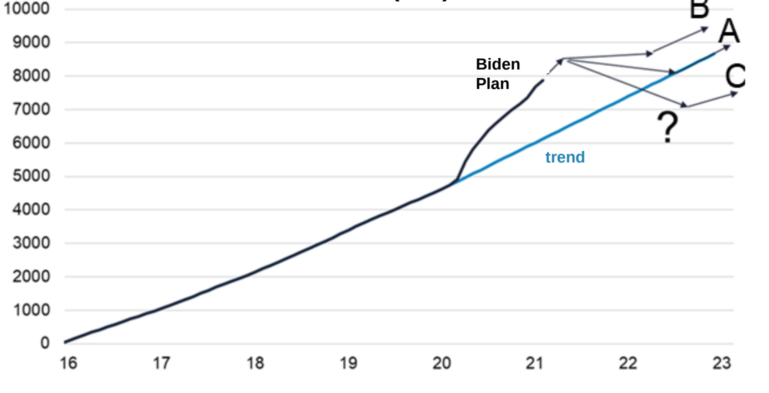
This is perhaps also explained by a non-linearity of the Phillips curve. It may be necessary to reach an unemployment rate even lower than the 3.5% achieved in early 2020, or to remain there longer, for the inflationary effects to start to be felt. One argument in favour of this hypothesis is that the hiring rate in the last cycle remained below the levels seen between 2006 and 2007.

United States: growth in adjusted hourly wages and hiring rate



Will the stimulus measures adopted achieve a sufficient level of activity to trigger inflation? The level of public aid is certainly unprecedented and has largely enabled low-income households to remain solvent. In total, the increase in savings over the past year has already reached the equivalent of a year and a half of normal savings. What will become of these additional savings pot is a key variable in the future scenario and depends on consumers' psychology. Will they spend all of it (scenario A on the graph) or only part (B)? Or even focus on the here and now and reduce their future savings rate to a lower level than it was before (C)?

United States: cumulative household savings since early 2016 ($bn)



United States: average amount of bank deposits of the least well-off 50% of households ($)

source: Bloomberg, Federal Reserve

It is very likely that the additional consumption will be partially absorbed by foreign production, weighing on the trade balance via an increase in imports. However, the US trade deficit excluding energy is already very high. In the absence of attractive capital factors in the United States, such as a very high interest rate differential, this could weigh on the dollar. We can estimate that a 10% fall in the dollar would increase inflation by 0.5 point.

Overall, there are good reasons to believe that the United States faces higher inflation than in recent years, although totally uncontrolled inflation can be excluded, while the scale of the measures adopted rules out the potential for a further slowdown in inflation. On the other hand, the potential emergence of disinflationary factors and the non-linearities probably present in the price-setting process make any attempt at precise forecasting rather futile. Not only is inflation uncertain, but so is the Fed's reaction to it.

Fed policy and market impact

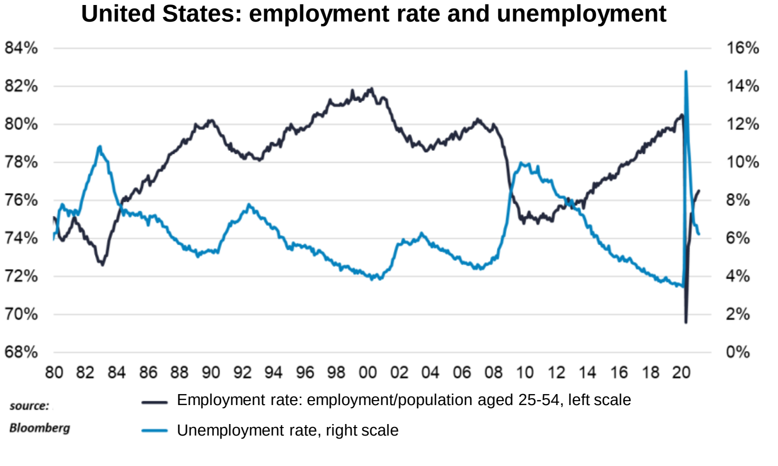
Following a long process of reflection and consultation, the Federal Reserve has revised its monetary policy framework. It will undoubtedly take some time for investors to take onboard this new operating approach. The policy of inflation targets which had gradually become established over the last 30 years has now been revised. The 2.0% target remains, but it is now symmetrical and takes into account an average over several years. Previously, the central bank acted pre-emptively when it expected inflation to accelerate. The start of a monetary tightening cycle was generally triggered by a fall in the unemployment rate below its equilibrium level, known as the NAIRU (non-accelerating inflation rate of unemployment). The Fed believed that it could control inflation by keeping the unemployment rate as close as possible to this equilibrium level by controlling the economy via interest-rate policy.

Over the past decade, however, the unemployment rate has fallen several times below the Fed's estimated equilibrium level without generating an acceleration in inflation. This has led the central bank to reconsider its approach. Furthermore, under the tenure of Janet Yellen, the idea emerged that placing the economy under high pressure actually has several benefits, particularly bringing previously excluded people into the labour market. The social climate has increased sensitivity towards the situation of minorities, including for the Fed. Various studies have shown that these communities take longer to benefit from economic recoveries.

The Fed has therefore replaced aiming for a target unemployment rate with a new objective of maximising the level of employment. Implementation of this policy is subject to changes in inflation, although inflation is now monitored based on actual rather than projected figures, and with greater tolerance to inflation temporarily exceeding its target.

The problem, however, is that the members of the monetary policy committee refused to define the average inflation to be monitored. Several estimates appear to co-exist of an acceptable deviation from the target. Is it 0.5%? Or 1.0%?

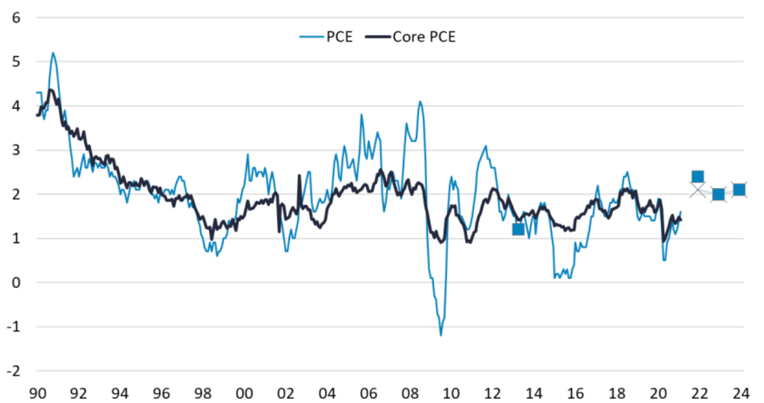
One thing is certain: the employment rate, particularly among minorities, has become at least as important a variable for the Fed as the unemployment rate.



In the short term, to quote Lael Brainard (Fed governor) in his speech of 23 March, "Although core and headline PCE inflation came in at 1.5% on a 12-month basis in January, the well-anticipated base effects [...] will cause inflation to move above 2% in April and May. It also seems likely that a surge of demand may be met by some transitory supply bottlenecks amid a rapid reopening of the economy, leading PCE inflation to rise somewhat above 2 percent on a transitory basis by the end of 2021. "

The Federal Reserve's latest forecasts estimate that inflation excluding food and energy will reach 2.2% at the end of 2021, before slowing to 2.0% at the end of 2022 and rising to 2.1% a year later. Indeed, for the Fed, to again quote Lael Brainard, "Entrenched inflation dynamics are likely to take over following the transitory pressures associated with reopening. Underlying trend inflation has been running persistently below 2% for many years. In addition, research suggests that although increasing labour market tightness may show through to wage inflation, the pass-through to price inflation has become highly attenuated. These results suggest that businesses tend to respond to increased labour costs by reducing margins rather than increasing prices later in the cycle. Thus, as resource utilisation continues to tighten over coming years, recent decades provide little evidence to suggest there will be a material non-linear effect on price inflation. "

United States: price changes over one year and Fed forecast



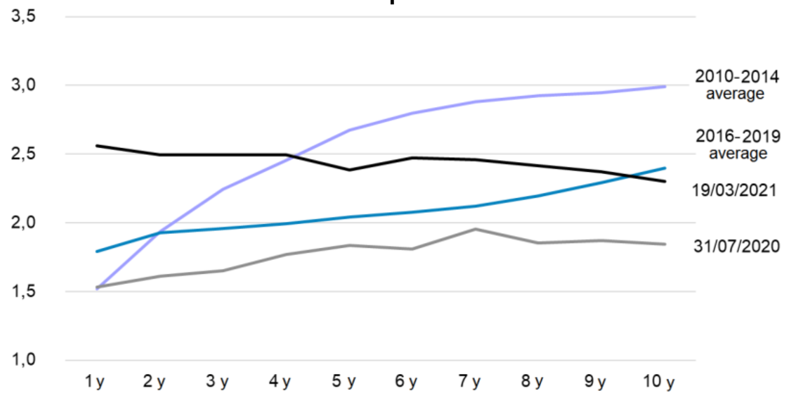
source: Bloomberg

Maintaining inflation at just above 2.0% would be the most favourable scenario for the Fed, allowing it to take its time to normalise monetary policy in an orderly fashion. If inflationary pressures prove to be more persistent and stronger with higher inflation figures (2.5%, 3.0%, 3.5%... ?), more decisive action would be required from the central bank. The markets would undoubtedly cast doubt on the new monetary policy framework, forcing the central bank to rapidly raise its key rates, which would constitute a major shock for all assets.

Given the risk of loss of credibility, we believe that we can rule out a scenario in which the Fed – faced with serious inflationary pressures – would not raise rates or indeed seek to counter the increase in long-term rates.

A rise in long-term rates may be desirable from the Fed's perspective, allowing financial conditions to be gradually and automatically normalised.

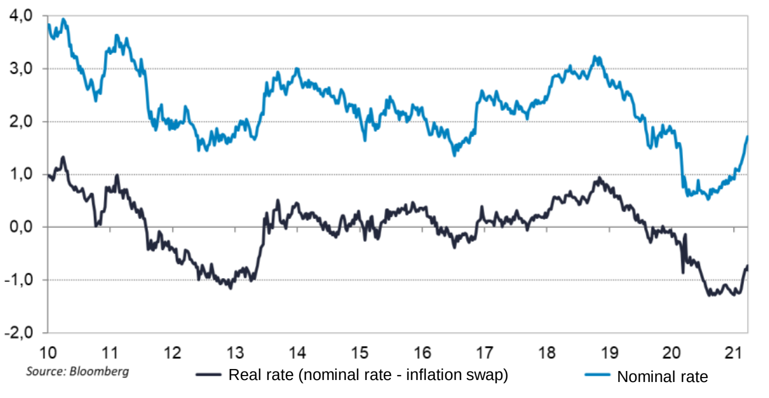
United States: level of forward inflation based on the swap curve



The normalisation of inflation expectations since last summer actually conceals very high expectations of short-term inflation, although relatively low in the long term. The current expectations curve (see graph above) is therefore descending, which is very unusual. The normalisation of short-term expectations could offset the gap compared with long-term expectations, however.

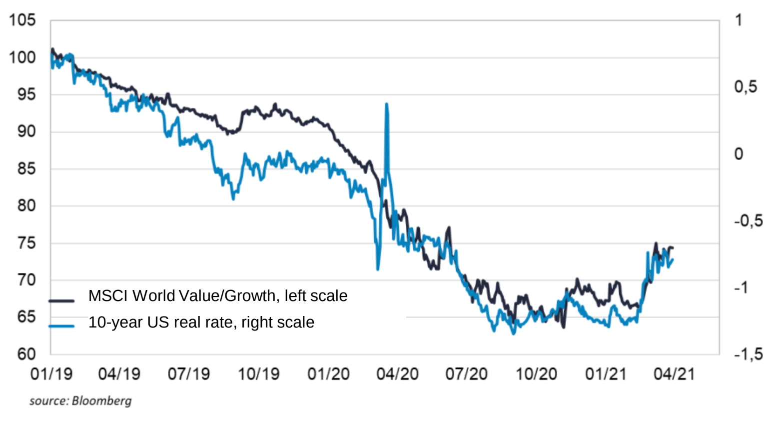
The bulk of the adjustment in long-term sovereign rates will therefore likely come from real rates which are currently at extremely low levels, particularly since the term premium – compensating the risk of higher future rates – is very low. In a context in which central banks tolerate the possibility of slightly higher inflation, it is likely that long-term rates will have to rise to offset this risk.

United States: 10-year interest rate

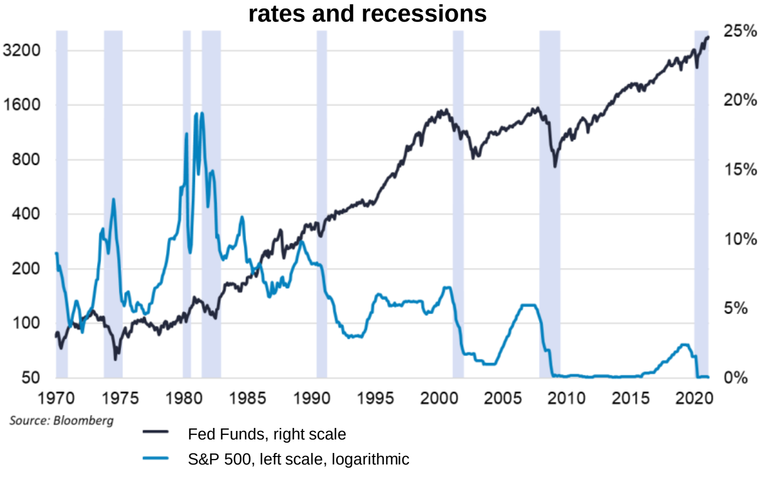


The rise in long-term rates will have an impact on stock markets, but undoubtedly more so on the relative performance of the different market segments between "value" stocks and "growth" stocks. These have greatly benefited from the steady lowering of rates. On the other hand, a rate hike is unlikely to halt the progress of the stock market as a whole. In fact, major market reversals generally occur during reversals in the economic cycle, which in turn generally only occur when rates reach a level that weighs on activity, which is unlikely to happen for several quarters to come.

Relative performance MSCI World Value/Growth



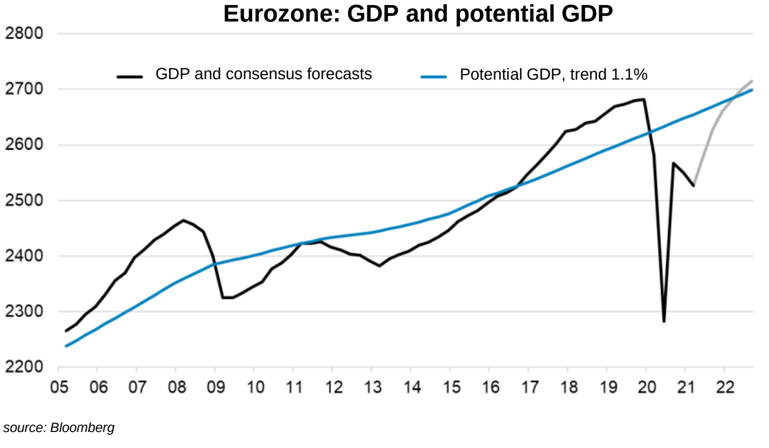
United States: stock markets, Fed funds rates and recessions



What about the situation in Europe?

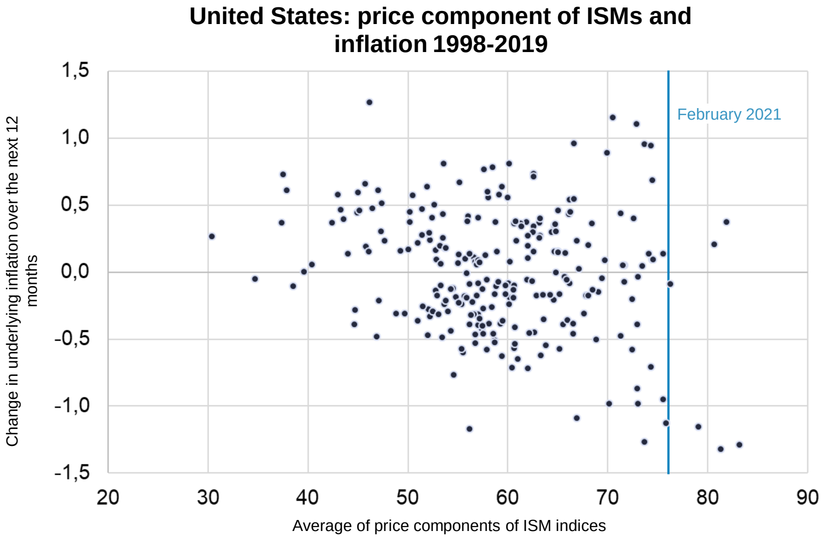
In the Eurozone, base effects will also push inflation up in 2021, probably peaking in around September. Beyond that, everything will depend on the economic recovery. Will enough pressure be placed on the economy to generate inflation? The measures announced so far are not on the same scale as in the United States, although the lower level of stimulus is offset by the presence of automatic stabilisers, starting with unemployment insurance mechanisms, leading to an automatic increase in public spending in the event of a deterioration in the economy.

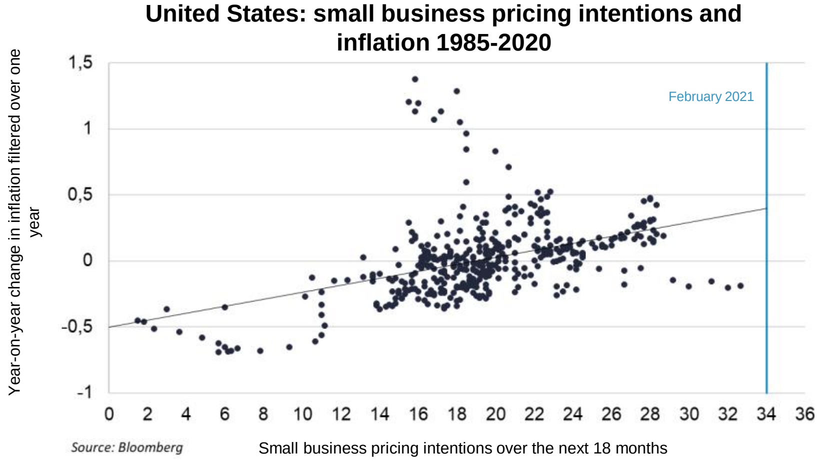
In addition to these stabilisers, the European recovery plan is due to be implemented in the second half of the year. The unemployment rate in the Eurozone had also reached a record low before the Covid-19 crisis and increased much less sharply in 2020 than it did on the other side of the Atlantic. Will the recovery allow new record lows to be reached? This would restore employees' bargaining power and therefore potentially trigger wage rises. But that will not be until sometime in 2022.



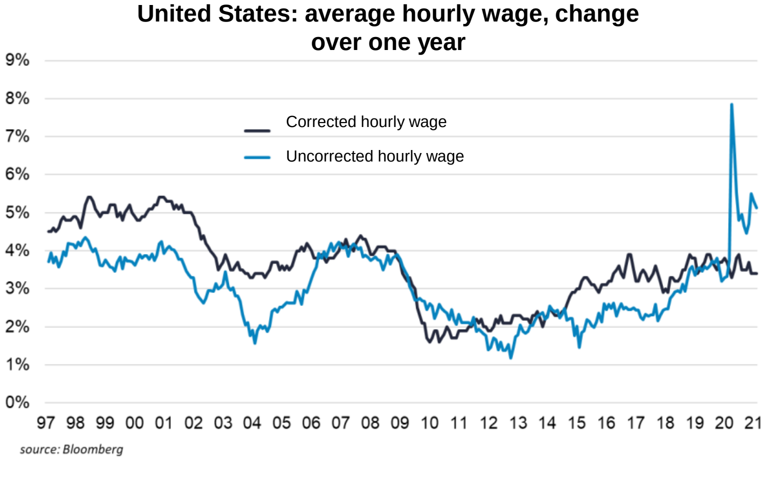
Indicators to watch

In a context in which non-linearities and economic uncertainty make inflation forecasting extremely complicated, it is undoubtedly preferable to focus on indicators of more persistent inflation. Price components of business confidence surveys should be treated with caution. To take the Institute for Supply Management as an example, their correlation with future inflation movements is sometimes very weak. Some indicators, such as the US National Federal of Independent Business (NFIB) Small Business Optimism Index, would appear to be more relevant.



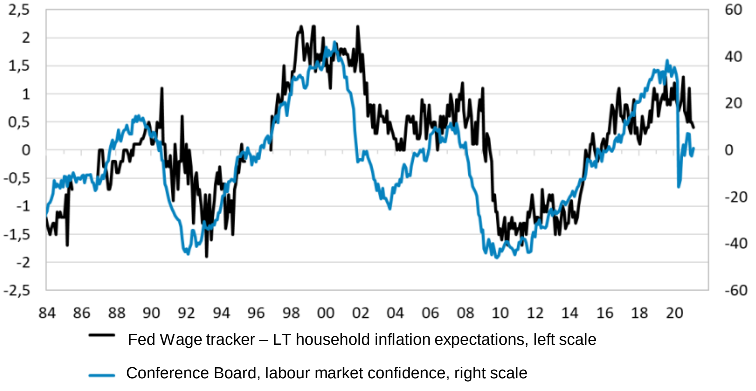


Data concerning the labour market will undoubtedly be most relevant. Change in hourly wage is a key factor, although it has unfortunately been very disrupted by the changes to the employment structure since the Covid-19 crisis. This indicator simply corresponds to average salary data, but the crisis has essentially destroyed low-skilled and therefore low-paid jobs. The best measure of labour cost therefore remains the labour cost index, published quarterly by the Bureau of Labor Statistics, which corrects for all these composition effects. The Atlanta Federal Reserve releases a monthly cost of employment index adjusted for composition effects.



Household labour market confidence will also be a decisive factor. Indeed, wages corrected for inflation expectations closely mirror household labour market confidence. If household confidence is rapidly restored, they will be quicker to negotiate salary increases. Companies may then eventually have to pass on these cost increases.

Household confidence in the labour market



Obviously, we will need to monitor actual inflation data, since the Fed has announced it will be watching more closely from now on. The emergence of a clear trend could generate nervousness among members of the Monetary Policy Board. Any change in the Fed's message will therefore have to be watched.

Conclusion

The question of inflation really becomes an issue in 2022. Stimulus packages are so large that inflationary pressures are more than likely to emerge in the United States. However, non-linearities make it hard to predict a level of inflation.
It would appear difficult to judge in advance whether inflation will remain within the Fed's comfort zone – a zone that remains to be defined – or whether it will force the Fed to attempt to slam the brakes on the cycle. We believe we can rule out a 1970s style free-fall. The deflationary trends that have contained it for decades remain present for now.

In the Eurozone, pressures likely to accelerate inflation will take longer to emerge.

The question of inflation therefore currently remains undecided, but has little impact on the asset allocation we currently favour. We continue to favour risky assets and a clear under-sensitivity to interest-rate risk on bond markets. Changes to inflation will be important, however, in defining the asset allocation for 2022. The impact of higher inflation from next year would undoubtedly be negative. It would force the Fed to raise rates quickly in an attempt to catch up, which would upset the market and weigh more heavily on the economy.

Matthieu Grouès
Managing Partner, Director of Institutional Management

Julien-Pierre Nouen, CFA
Director of Economic Studies and Diversified Management

Notes
Photo source: Shutterstock

Information
The opinion expressed above is dated 15 April 2021 and is subject to change. Most recent data at the publication date.
This document has no pre-contractual or contractual value. It is provided for information purposes only.
It contains analysis and descriptions prepared by Lazard Frères Gestion SAS on the basis of publicly available historical data and general information. The opinion expressed above is up to date as of the date of this document and is subject to change.
These elements are supplied purely for indicative purposes and in no way provide a guarantee as to future performance. These analyses and descriptions may be subject to interpretation depending on the methods used.
The analyses and/or descriptions contained in this document should not be interpreted as advice or recommendations from Lazard Frères Gestion SAS. This document does not constitute a recommendation to buy or sell, nor an invitation to invest in the instruments or securities mentioned.
Any management method described in this document is not an exclusive approach, and Lazard Frères Gestion SAS reserves the right to use any other method it deems appropriate. This document is the intellectual property of Lazard Frères Gestion SAS.

LAZARD FRERES GESTION – Simplified joint-stock company under French law with capital of €14,487,500 – no. 352 213 599 on the Paris Trade and Companies Register
25, RUE DE COURCELLES - 75008 PARIS

FOLLOW
& SHARE
news from Lazard Frères Gestion

Website
www.lazardfreresgestion.fr

Blog
www.lazardfreresgestion-tribune.com

Twitter
@LazardGestion

LinkedIn
Lazard Frères Gestion