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Investment Strategy Bulletin

Inflation (or lack thereof)

Investment Solutions

17 February 2021

- A sharp near-term acceleration in inflation reflecting base effects, the sharp recovery in commodity prices, and some supply chain disruptions might raise questions about the inflation outlook
- We note that these effects are transitory and will take US inflation above target only temporarily in Q2
- Subsequently, persisting slack in the economy will push inflation back below 2%. The gap will close only in 2022, when more sustained upward pressure begins
- It is important to distinguish the cyclical drivers of low inflation from the secular – those that predated the pandemic and are unlikely to disappear once it ends
- We do not expect "runaway" inflation, as most of the effects are one-off; expectations are very well anchored; and central banks possess the tools necessary to bring inflation lower
- The real risk would be a sharp rise in inflation that could push the Fed to tighten policy aggressively. But we believe such a phenomenon is unlikely – and more importantly, the Fed's new framework largely rules out such pre-emptive rate hikes

A near-term normalisation…

As the one-year anniversary of the pandemic's outbreak in the US approaches, the inflation rate is likely to pick up substantially as some of the big price contractions that occurred last spring drop out of the calculation (see chart I). This effect will add about 0.5% to the year-on-year print. This base effect, combined with recent increases in commodity prices and the expected consequences of the reopening in certain sectors as the healthcare situation improves, are likely to push inflation above 2% in Q2.

We would not interpret such a pick-up as a change in the inflation outlook: such one-off effects will only push inflation higher temporarily. Later on, inflation will face downward pressure from the slack in the economy –and especially in the labour market; we expect this pressure to persist for some time, despite our strong near-term growth expectations.

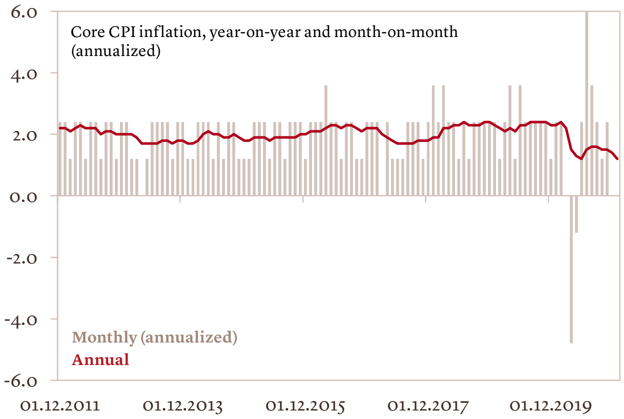
… but no sustained increases yet

While the connection between stronger growth and higher inflation seems straightforward, several other factors are worth keeping in mind. First, given the extent of the Covid crisis, the economy will continue to operate below its full potential even as it grows strongly this year. Even with our constructive growth forecast, US GDP is set to recover to its pre-crisis level around mid-2021, and will not return to its pre-crisis trend before year-end (see chart IV).

More importantly, recovery in employment typically tends to lag output: we do not expect the US economy to get back to full employment before H2 2022. We point out that during the long pre-pandemic expansion, despite large falls in unemployment, core PCE inflation[1] did not exceed the 2% mark until mid-2018 – and then only slightly. Against this backdrop, we now expect inflation to remain below 2% for most of 2021 (see chart II), and

[1] Core PCE inflation reflects the prices of personal consumer expenditures excluding food and energy.

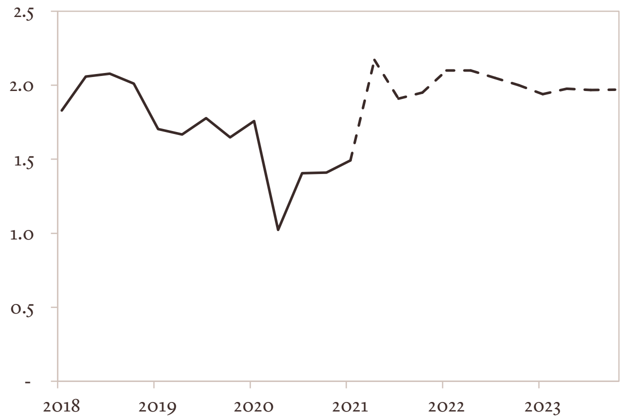
I. A purely statistical "base effect" will push near-term inflation prints higher as last year's large price falls drop out of the 12-month window



Sources: BLS, Bloomberg, Lombard Odier calculations

II. Expect a temporary rise in Q2, but the remaining slack in the economy should push inflation back below target for the rest of 2021

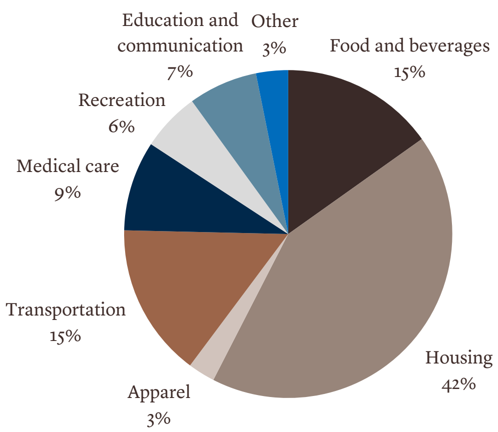
US core PCE inflation, in percent (actual inflation 2018-20; LO forecast 2021-onwards)



Source: BEA, Oxford Economics, Lombard Odier calculations

III. The composition of the inflation basket matters: large components such as shelter and healthcare face downward pressures

CPI inflation components



Sources: BLS, Lombard Odier calculations

to only rise on a more sustained basis once slack has largely been eliminated.

Specific drivers

At a more micro level, key drivers of US inflation such as healthcare and shelter (combined, they account for slightly under half of the core PCE basket – see chart III) will also be facing some downward pressures, in some cases for policy-related reasons.

Healthcare inflation is currently being boosted by policy measures such as add-on payments for Covid treatments that have been implemented by relief legislation. With these policies likely to expire as the current healthcare crisis abates, the opposite effect will materialise next year. Meanwhile, a possible expansion of Obamacare, as proposed by the Biden campaign, would exert additional downward pressure on medical services inflation – exacerbating a trend that has been in place since the Affordable Care Act was implemented in 2010.

Shelter inflation has been on a sharp downtrend since the outset of the crisis. Part of this relates to policy measures such as eviction moratoria and rent forgiveness. But shelter inflation also has strong cyclical characteristics, meaning this trend has further to run – some substantial employment and wage gains would be needed for rents to start rising again.

Finally, tariff reductions on imported goods would also result in a near-term drag on inflation if they were to materialise. While not a certainty, we do regard them as a possibility given the Biden administration's diverging approach on trade policy.

Stimulus and overheating risks

Recent inflation discussion has centred on the Biden administration's USD 1.9 trn stimulus plan and its potential to cause overheating. We think it is important to place this in the right context. The Biden plan is undoubtedly large (although we think it is likely to be scaled down before enactment), and it has been a key element in our recent growth forecasts.

Even so, we must remember that the US economy has lost about 4.5 million jobs during this crisis (see chart V). If we also consider the natural creation of over 100,000 jobs per month that is required for the US economy to keep up with population growth, this brings us to an even larger employment gap. Overheating looks like a particularly remote prospect in these circumstances.

Of note also, we think the risk of overheating is particularly low from measures in the stimulus plan that are one-offs (like the USD 1,400 cheques to individuals) or from those that are self-limiting in nature (such as unemployment benefits that will decrease as the labour market improves). Relief funds that help finance the vaccination campaign or prevent state and local governments from resorting to layoffs to counter their falling revenues are even less likely to cause overheating.

Structural forces and policy implications

Finally, a key aspect of our inflation outlook is that many of the disinflationary forces of recent years are structural in nature, and a sharp recovery from the Covid crisis will not change this. Among the driving forces of low inflation in recent decades we would include demographics, globalisation, technology, reduced union participation, increased central bank credibility, and low inflation expectations. A sharp recovery from a deep crisis is unlikely to affect most of these.

From an investment standpoint, we think two key variables matter: the path of inflation, as well as –crucially – central bank reaction. We see very limited risk of inflation spinning out of control and prompting the Fed to overreact. We are decades away from the last time anything similar occurred in an advanced economy with a credible central bank. Inflation expectations are well anchored (see chart VI); it is clear that central banks possess the tools to control high inflation (while it's less clear they can be effective in preventing deflation). This enhances policy credibility, anchoring inflation expectations further; the process operates as a virtuous cycle. Critically, while central banks have sometimes overreacted to small transitory inflation increases in the past, this is unlikely to happen now. In a separate note, we discuss the implications of the Fed's new policy framework.

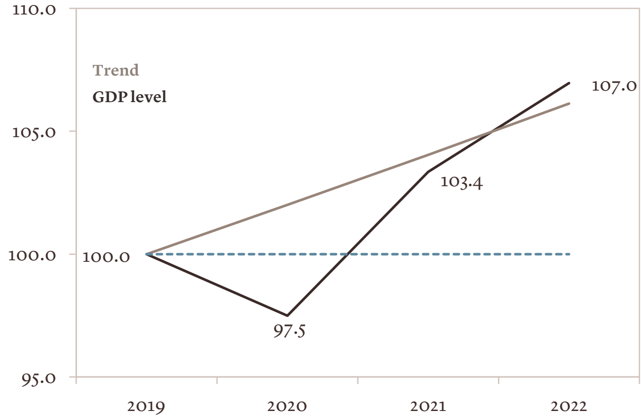
Global outlook

The focus of this publication is inflation in the US – because this is the major advanced economy where we expect the recovery to be fastest and the signs of inflation to appear first. It was also the economy in which an interest rate "normalisation" cycle took place pre-crisis (the Fed raised its policy rate from 0.25% in 2015 to 2.50% in 2018. In most other major economies, as inflation looks set to remain very low for a while, this may only be a topic for a future day.

Bill Papadakis, Macro Strategist

IV. Even on our bullish outlook, the level of output will not catch up to its pre-crisis trend before year-end; employment will take longer

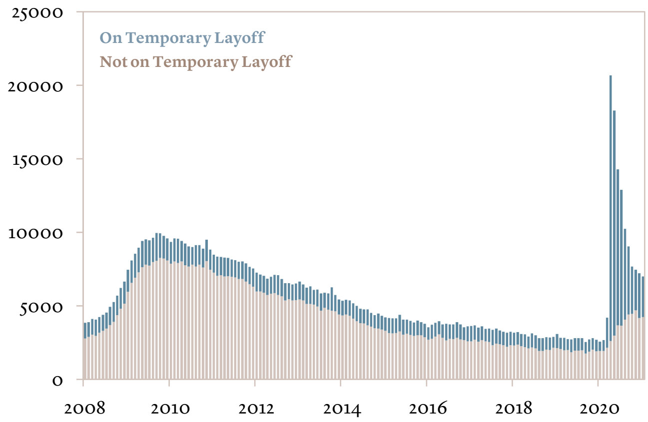
Level of US real GDP (based on LO forecasts) vs. pre-crisis trend



Source: BEA, Lombard Odier calculations

V. A large employment gap: the US economy is still 4.5mm jobs short of the pre-crisis starting point

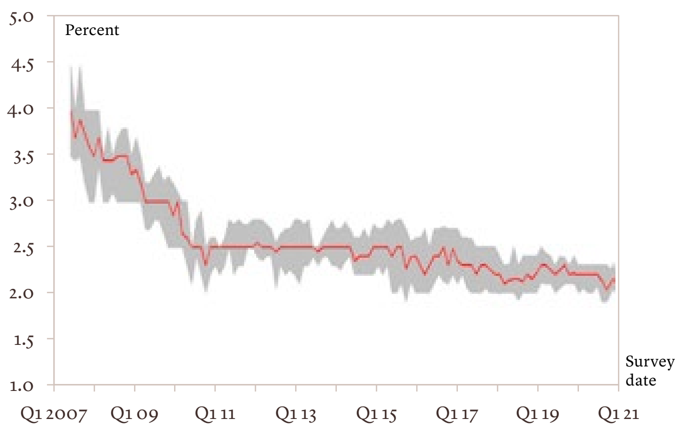
US job losses (permanent and temporary), in thousands



Source: BLS, Bloomberg, Lombard Odier calculations

VI. Inflation expectations have been well-anchored for decades – a sharp recovery from a deep crisis is unlikely to change this

Projections for 10-year annual-average rate of CPI inflation (median and interquartile range)



Source : Survey of Professional Forecasters, Philadelphia Fed

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