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CIO Viewpoint

How much is too much: can US stimulus trigger inflation?

Investment Solutions

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A year after the Covid pandemic recorded its first US fatalities, markets are wondering just how much monetary and fiscal spending is needed to spark inflation. Will the Biden administration's plan to inject USD 1.9 trillion into the US economy and vaccination programmes be enough to both trigger a recovery and the re-emergence of inflation?

Inflation used to be predictable. Too much money chasing too few goods pushed up prices as high employment and rising wages let firms pass on higher costs. Yet inflation has more or less vanished from advanced economies. In the Great Financial Crisis of 2007-09, higher unemployment failed to lead to lower inflation. Then, as the job market improved, and US unemployment hit a 50-year low in 2019, inflation failed to rise.

On the face of it, the classic ingredients of an overheating US economy and inflationary environment are on the horizon. America's inflation should rise above 2% in the second quarter of this year as the impact of price declines seen a year ago fades. This statistical 'base effect' reflects the country's economic recovery from the worst of the pandemic, as unemployment falls, oil prices rise and supply chains shake-off temporary disruptions.

While a little inflation might look welcome in our persistent low-yield, low-growth cycle of the past decade or more, an overheating US economy would quickly make much corporate debt unsustainable and have a devastating impact on emerging economies. Most central banks have settled on using interest rates to keep inflation around 2% per year, offering economies predictable long-term borrowing costs.

Has the outlook for a sustained increase in inflation over the full year changed then? The answer is no. We expect inflation in the US to remain under 2% for most of 2021, despite possible transitory and economically healthy increases that are a necessary part of a recovery.

Improvements in employment numbers have a long way to go. The US economy lost at least 4.5 million jobs during the pandemic and would need to create more than 100,000 jobs per month just to keep pace with population growth. In addition, as the pandemic's effects start to ebb, economies re-open and global trade accelerates, supply-chain issues should ease, stabilising price pressures.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- In the short run, the US will experience a temporary spike in inflation as prices including commodities recover compared with a year ago
- The Fed looks unlikely to tighten monetary policy in response
- Fears of damaging inflation look premature in 2021 and the outlook remains subdued as long as economic slack persists
- The Fed should manage to guide bond market expectations while equities offer a partial inflation hedge.

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Unemployment challenges

Federal Reserve chair Jerome Powell said on 10 February that it may be "many years" before the damage of high and persistent levels of unemployment is behind us. With unemployment through the pandemic disproportionately affecting the young, ethnic minorities and women, the impacts of are likely to be long-term. Mr Powell suggested that the Fed would take account of the different impacts on each demographic group to reach a broader assessment of jobless numbers.

"Achieving and sustaining maximum employment," he said, "will require more than supportive monetary policy." In addition, Mr Powell pointed out that even before the pandemic, when unemployment was at a five-decade low of 3.5%, there were few signs of inflation. The Fed left monetary policy unchanged after its meeting this month, while keeping its options open. If Treasury bond yields rise and the curve steepens, the central bank could buy more longer-dated securities, and fewer mortgages.

Concerns around inflation remain mostly centred on the US. The eurozone's interest rate has stayed unchanged throughout the pandemic and inflation has been negative since August 2020. The European Central Bank's minutes, released last week, suggest a determination to communicate a clear distinction between a short-lived jump in inflation and a more enduring rise. "A temporary boost to inflation should not be mistaken for a sustained increase," read the minutes. In Germany, which temporarily cut its value added tax last month, the consumer price index increased by 1% in January, compared with a year earlier, and by 0.8% compared with December 2020.

Monetary caution

Central banks' experiences over the past decade have made them more cautious. The ECB increased interest rates in April and July 2011 in response to an uptick in inflation, as the eurozone crisis intensified. In 2013, the Fed changed its outlook for interest rates, triggering the so-called taper tantrum. Markets interpreted the slowdown in asset purchases to mean rate hikes were imminent. As last month's ECB minutes say, there is a "risk of a cliff-edge effect from a premature removal of fiscal stimulus."

We believe that once economic activity levels have returned to their pre-pandemic levels on the back of more sustained output and employment, there is little structural impetus for stronger inflationary pressures. We will still be living with the same low-inflation regime we have experienced since the Great Financial Crisis. Although we expect to see inflationary spikes, as with Germany in January, we nevertheless expect the US and eurozone economies to continue to underperform their long-term potential. The same pre-pandemic structural factors of ageing populations, stalled productivity and globalised supply chains remain in place.

The main risk would be an overreaction from the Fed to signs of inflation with a rapid hike in interest rates. But even that has been ruled out from a practical point of view with its new average inflation targeting approach.

For bond investors, rising inflation is always a challenge and we remain underweight in fixed income globally, and in high quality credit and sovereign debt in particular. The US yield curve could steepen more than in past economic recoveries, as strong forward guidance from the Fed would keep short-dated debt yields close to zero. At the same time, average inflation targeting is likely to fuel an inflation premium for long-dated bond maturities. However, if necessary the Fed could avoid surging financing costs and a sharp bond market sell-off by potentially increasing its asset purchases.

Equity markets remain supported by the current environment as stocks offer a natural, if partial, inflation hedge. This should hold true as long as price rises do not undermine corporate margins, which tends to be the case as long as inflation stays below 3%. Inevitably, a reflationary period will demand careful selection of those companies and sectors poised to outperform the wider market.

How much is too much?

In the end, the US economy is testing the question 'how much is too much stimulus?' No one yet knows and as the Biden administration proposals work through the approval process, political compromise will undoubtedly reduce the initial figures.

However, we believe that the current spending measures more closely resemble an economic rescue package than traditional economic stimulus, designed to boost a particular sector or region through a short-lived downturn. That means its impact is inevitably less inflationary and monetary policy will take a much more cautious approach than in the wake of the Great Financial Crisis.

In any case, given that the Fed has plenty of room to raise rates in response to any signs of more persistent inflation, worrying about its reappearance looks premature. At least for 2021.

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