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CIO Viewpoint

Post-pandemic inflation: now you see it, now you don't

Investment Solutions

14 June 2021

Last month, US headline inflation recorded its biggest single jump in 13 years with a 5% gain from May 2020. In the wake of the global pandemic, rising vehicle prices, flight tickets, car insurance and hotels reflect a recovery in travel and higher oil prices. Is this just a post-pandemic price catch-up, or the early phases of an overheating economy? Either way, investors' portfolios need to be ready.

Americans shopping for a second-hand truck are suffering sticker shock. Used car prices in the US have leapt by almost one-fifth this year and 30% year-on-year. Truecar.com, for example, offers a 2018 Ford F-150 pickup for sale in Texas with 224,000 kilometres on the clock, at just under USD 26,000. For USD 10,000 more, Ford lists a new version of the same model with no accident history, if you can wait.

Rising car prices, old and new, reflect a number of factors. First, a shortage of semiconductors is slowing new car production. Both Ford Motor Co., and General Motors Co. have already idled factories as lead times lengthen and American carmakers may lose as much as USD 110 billion in sales this year, according to one estimate. Second, rental companies buying vehicles to rebuild their fleets are squeezing the used car market and third, consumers are dipping into savings boosted by government cheques.

The question is whether overlapping factors of supply shortages, increased demand and more spending power are temporary, or will prove more persistent. This hinges on the impact of 'base effects,' or the mechanical increase in inflation due to re-opening economies after last year's historic price contraction. For now, the rebound is mostly affecting those sections of the economy re-awakening from enforced shutdowns, reflecting oil prices and supply chains that have not yet shaken-off their shortages.

The car market, plus airfares, account for as much as three-fifths of May's 5% consumer price inflation (CPI) rise over the year. While that was higher than expectations, the increases remain limited to only a few sectors.

We believe that the inflation spikes of the coming months should remain limited to the sectors that suffered most, before returning to more recognisable pre-pandemic patterns. It is inevitable that the most violent economic shock in decades should then post equally dramatic rebounds once the economic foot comes off the brake.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- US headline inflation in May jumped the most since 2008 as prices continued to recover in the worst-hit industries
- We believe this is transitory and inflation will return to pre-pandemic patterns
- The US job market, a key Fed condition for raising interest rates, remains far from fully recovered
- Since inflation will normalise, risk assets should continue to perform, keeping the US dollar rather weak.

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The US has already experienced three quarters of strong growth and, as it continues to recover, we expect record levels of fiscal spending to help the US expand by 6.0% this year. In addition, we know that historically when inflation is truly persistent, it is visible everywhere. The inflation spikes that we are witnessing are not across all sectors or even widespread. Some components of the index, such as rents, rose 1.8% in May compared with the same month a year earlier and 'food at home' has only risen by 0.7% over the same period.

Pocket money

Historically, inflation was the predictable result of more money in consumers' pockets chasing fewer goods and so increasing prices. That changed in the wake of the Great Financial Crisis of 2007-09, as higher monetary support in the form of central bank asset purchases supported market prices, but did not trickle down into consumers' pockets. As a result, inflation disappeared from most developed economies through the 2010's because higher liquidity in the monetary system did not create more cash in the 'real' economy.

Now however, in response to the Covid crisis, governments' fiscal support has joined with monetary support to create more direct cash for individuals, coupled with the accumulated savings of frustrated consumers unable to travel or dine out for more than a year.

Taper timing

The strengthening economy is also reflected in the improving job market. Last week US unemployment claims fell to their lowest level since mid-March 2020. While that is around half the numbers of a year ago, more than 15 million Americans continue to receive unemployment benefit. As a result, the Federal Reserve still emphasises that it is watching for a broad recovery in jobs before tapering its asset purchases and starting to raise interest rates, which we do not expect before the end of 2022 (see table). Until then, we expect the US central bank to keep going with its USD 120 billion per month asset purchases.

Inflation worries are not just a US question. However, because the US and European Central Bank measure different baskets of goods, their numbers are not directly comparable (see charts page 3). The ECB said last week that it expects full-year 2021 inflation to reach 1.9%.

"We don't see much by way of service prices going up," ECB President Christine Lagarde told a press briefing on 10 June, "and that is because wages have not increased significantly." The ECB is assuming, she added, that the supply bottlenecks now visible in the eurozone "will gradually phase out." In addition, for the first time since December 2018, the ECB sees risks to growth outlook for the region as "broadly balanced."

The central bank increased the eurozone's gross domestic product (GDP) forecast to 4.6% for the full-year 2021, from 4.0% as the pace of the region's recovery picks up, and reassured markets that the positive outlook does not change the commitment to increase its asset purchases.

When discussing inflation, we also have to keep an eye on the wider world and longer-term dynamics. Economies that are further along the road to economic recovery, such as China and Israel, are not recording more than modest inflation. Elsewhere, inflation remains below central bankers' 2% targets in Switzerland, Japan and the eurozone.

Despite disparities between developed and emerging economies, globalisation remains deflationary. The pandemic has not altered that the world's population is still aging, the impact of technological innovations and global competition. Furthermore, this positive outlook is supported by more flexible monetary policy. Last year the Fed shifted to 'average inflation targeting.' Concretely that lets policymakers ignore short-term spikes above their 2% target to look at the wider economy.

Possible Fed tapering / lift-off timetable	
September 2021 – year end	Tapering announcement, possible as early as the first FOMC meeting on 21-22 September, after the Jackson Hole Economic Symposium (26-28 August)
2022	Tapering cuts of between USD 10 and 20 billion per month from the Fed's USD 120 bn/month asset purchases
End 2022 - mid-2023	First interest rate hike

Source: US Bureau of Labor Statistics and Eurostat.

Spiralling wages threat

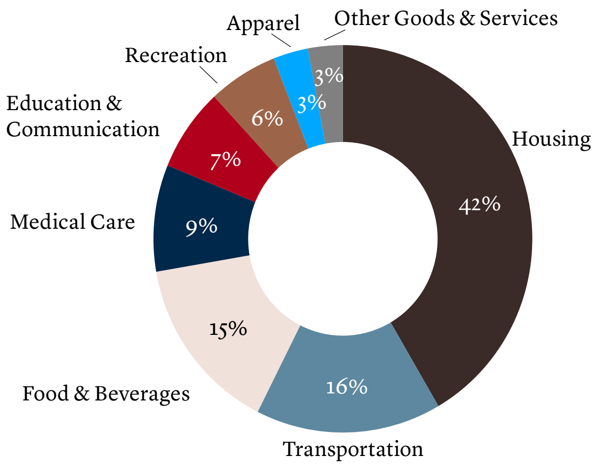
The main threat to this view comes from the labour market. Where price rises in truck parts or hotel rooms will not continue, an overheating job market could change the long-term outlook. If consumer demand, supported by monetary and fiscal stimulus, creates persistent labour shortages and companies then anticipate high demand and pass on higher wage costs, inflation expectations would be very different.

Spiralling wage increases would raise inflation expectations, especially since markets know that the Fed will tolerate higher prices for a time. Any move to raise interest rates to contain persistent inflation is unlikely to be a smooth process for assets as they price-in expectations.

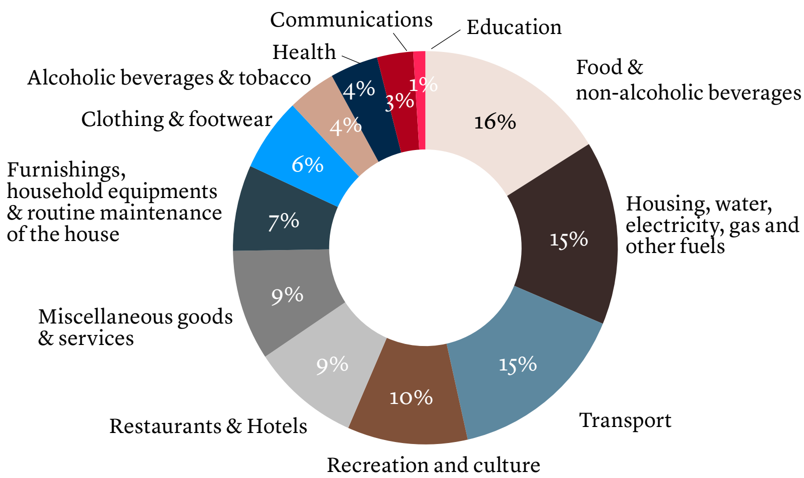
Such an inflation surge, sustained by strong labour markets, would shift the economic parameters and force a new approach from central banks. If that were to happen, it would make sense to further reduce the duration of fixed income allocations, and favour strategies that benefit from a steepening yield curve. Over time in this scenario, equity markets should hold up well, outperforming bond markets in the medium term, as long as investors prefer value stocks that can pass on rising costs to their customers. In alternative assets, industrial metals, infrastructure and real estate all offer some portfolio cushion for rapidly rising inflation.

This said, with US labour markets still showing much slack, the chances are high that inflation is normalising rather than shifting paradigm. This environment should keep risk assets performing and the US dollar rather weak. Our current portfolio positioning reflects this thinking.

US Consumer Price Index



Eurozone Harmonised Index of Consumer Prices (HICP)



Source: US Bureau of Labor Statistics and Eurostat.

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