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Inflation Rebound

Last time inflation was as high on the agenda as it is today was probably in the early days of the QE experiment. Back then, quite a few investors and economist rang the alarm bells about the potential effects on the markets and the economy. Not only did we hear discussions and forecast of rising inflation but also hyperinflation and the demise of fiat[1] currencies altogether. These were all potential outcomes when central banks sailed into the unchartered waters of QE and negative interest rates.

But with the benefit of hindsight, we know that none of these fears materialised. The reasons for this are many and varied, and perhaps not all thoroughly understood. Some, like globalised supply chains deflationary effects, labour's shrinking share of productivity gains and lower bargaining power as a result, are widely accepted reasons.

Base effects

Now however, it seems like we are faced with 3 waves of inflation. The first are the obvious base effects from the covid induced economic slowdown a year ago. Since energy prices, interest rates and aggregated demand fell sharply last spring, inflation this year will be higher compared to then, as the economy have rebounded and somewhat normalized. This might lead to steeper curves as central banks tend to see through these kinds of transitory and technical inflation bursts, but the long end will, and to a certain extent already have, sold off. We will probably not see any swift central bank action and tightening monetary policy due to this kind of inflation. The time horizon for this is instant.

Fiscal stimulus gain traction

The second wave is more difficult to quantify. Inflation might be more durably pushed upwards due to the large fiscal stimulus packages that many governments have launched, or are planning, in response to the covid crisis.

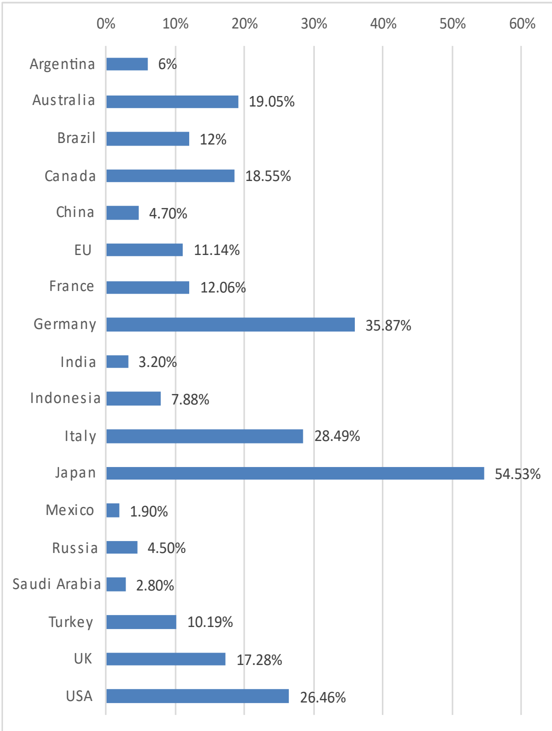

Figure 1. *Covid response. Fiscal stimulus relative to GDP. Source: Statista.com*

Above we see the unprecedented fiscal stimulus, in peace times, that governments around the world have put together.

[1] Fiat money is a government-issued currency that is not backed by a commodity such as gold. Fiat money gives central banks greater control over the economy because they can control how much money is printed. Most modern paper currencies, such as the U.S. dollar, are fiat currencies.

This could be compared with the last major fiscal boost, after the subprime crisis 2008. The world's governments responded in a slower and much less aggressive fashion back then. The stimulus then did obviously not spark any inflation, but now it is several times bigger. (See Table 1 below).

	2008	2009	2010	Total
Canada	0.0	1.5	1.3	2.7
China	0.4	2.0	2.0	4.4
France	0.0	0.7	0.7	1.3
Germany	0.0	1.5	2.0	3.4
India	0.0	0.5	n/a	0.5
Italy	0.0	0.2	0.1	0.3
Japan	0.4	1.4	0.4	2.2
U.K.	0.2	1.4	-0.1	1.5
U.S.	1.1	2.0	1.8	4.8
Average	0.5	1.6	1.3	3.4

Table 1. *Government response to the subprime crises 2008. Percent of GDP. Source: IMF*

The effect of the current stimulus has so far been noticeable in especially durable goods and housing.

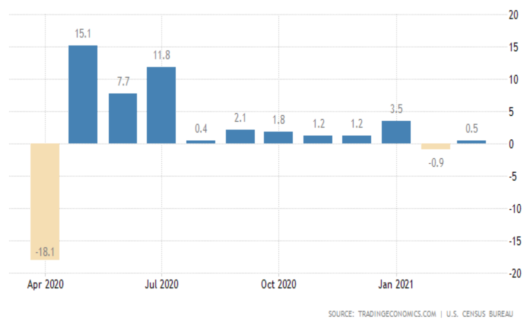

Figure 2. *Durable goods orders, USA. Source: US Census Bureau.*

Economists are expecting to see the highest US GDP growth in 40 years. It is quite possible that we will see shortages in raw materials and input goods as a result of this strong rebound in demand.

On the micro level we have already seen anecdotal evidence form companies complaining about input goods in short supply. Some car companies have even decreased production due to the lack of chips and semiconductors. If the high demand and the shortage situation continues, producers will inevitably need to hike prices.

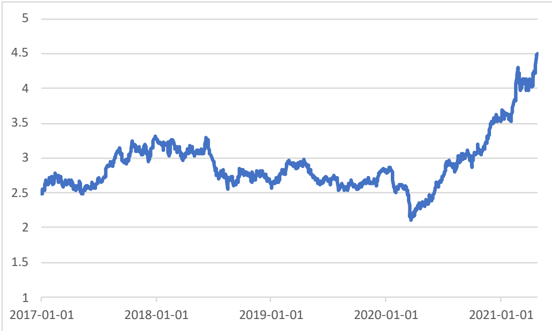

Figure 4. *Copper price, USD per pound, NYSE, Nasdaq*

Shortages is not isolated to the electronics sector. Lately we have seen astonishing price movements in other input goods such as lumber and also in base metals.

P&G, Whirlpool, Kimberly-Clark and Coca Cola, among other ones, have flagged for rising prices going forward. The range indicated for the coming price increases was mid to high single digits.

Figure 3. *Lumber prices, USD per 1k board feet, NYSE, Nasdaq.*

This kind of demand-pulled inflation is exactly what central banks tend to dislike, contrary to cost-push inflation. This is due to the fact that demand-pulled inflation risks sparking a wage-price spiral seen in the 70-ies and 80-ies.

A cost-push inflation, from say rising energy prices, tend to be seen more as a tax on consumption, and hence as being counter cyclical.

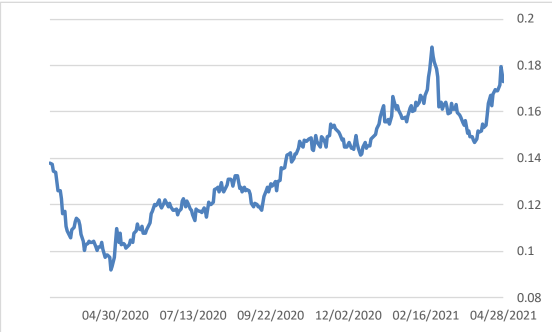

Figure 5. *Sugar No. 11 Price, NYSE, Nasdaq*

The time horizon for inflation to materialise at CPI level, after a situation like the current one, with higher demand than supply, is normally 1-2 years.

Changed and diversified supply lines

The third wave of rising inflation pressure will probably be due to longer-term effects of deglobalisation. The price pressure will stem from companies diversifying supply chains and bringing some production back home. The reasons for this began with the Trump trade wars and the trend then accelerated on the back of the current covid crisis. It has become obvious for many companies that they had far too much business risk when only producing their goods in a few low-cost countries. Changing this will inevitably lead to higher production costs.

Another long term, potentially inflationary, driver might be the so-called Stake holder economy. This might shift wage growth permanently higher and fuel a wage-price spiral.

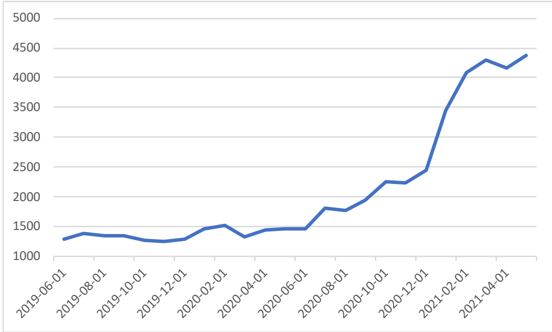

Figure 6, *FBX Index, Container shipping costs are up some 200%. Source: Freightos FBX index.*

However, it would be surprising if we got the vicious spirals seen historically when every country was a silo cut off to the rest of the world by high tariffs and even capital controls. It would probably be difficult to put the globalization genie back into the bottle, so even though global trade will be damped by a change in supply lines, it will likely still be significant. And if domestic production prices increase too much, a re-acceleration in world trade could emerge.

All in all, there are limited arguments for further deflationary pressures during the coming years. A relaised inflation at or moderately above central banks targets (2-4%) is more likely. This will mean a bleak future for government bonds currently trading in negative territory as far out as 10 years in some countries.

The risk for a runaway inflation is low however, given the current high leverage in both private and sovereign balance sheets. As well as shorten maturity in many countries mortgage markets. At any sign of overheated economies, central banks only need to hike marginally in order to dampen economic activity.

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