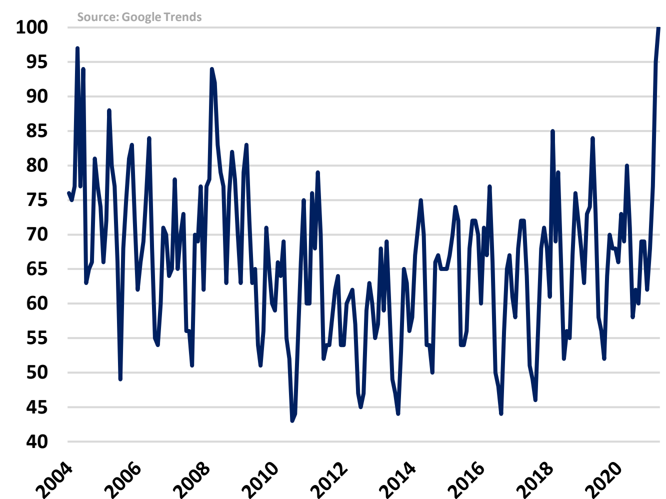
Preparing for Inflation Amid the Printer-Powered Recovery

Market Viewpoint: March 31, 2021

Summary: Inflation remains the hottest topic on investors' minds. Following the passage of the latest trillion-dollar stimulus package in March, web traffic, consumer surveys, and bond market indicators all show increased concern around price pressures in the year ahead. Though the White House wasted no time in rolling out plans for a new two-part plan to spend another $3 trillion in April, Fed policymakers continue to hold their collective poker face when faced with questions regarding the ripple effect of a rapidly expanding monetary base. Some FOMC voters are even prepared to let the economy "run hot" for a whole year – or longer. While this period of fiscal and monetary policy is unique in many ways, there is certainly some historical precedent to be explored.

March web queries for "inflation" jumped to their highest level since Google Trends began tracking the data in 2004. It is particularly remarkable given that the latest inflation numbers have been relatively benign. Concerns around price pressures have been particularly pronounced in fixed-income markets where traders constantly quantify the potential for future inflation based on actual market prices. Those expectations have soared in the past two months even as government officials keep assuring us that there is no current inflation problem.



The so-called breakeven rate of inflation – the difference between the yield-to-maturity of a conventional Treasury coupon bond and that of a Treasury Inflation-Protected Security (TIPS) bond of the same maturity term – has continued its steady march higher.

Last Friday, the 10-year Treasury breakeven, equivalent to inflation expectations for the five years beginning five years from now, broke out to 2.36%, its highest level since April 2013. The five-year breakeven rate, which implies what market participants expect average inflation to be in the next 5 years, has had an even more dramatic performance, recently touching 2.59%, its strongest reading since July 2008.

MRP has been highlighting the steady, upward march of breakeven rates for the better part of a year now. All the way back in August 2020, when breakeven inflation numbers first showed signs that inflation was being priced in, we were ringing the alarm bells about seemingly endless fiscal and monetary stimulus measures – as well as the Fed's policy shift toward "average inflation targeting", meaning it will allow inflation to run "moderately" above the Fed's 2% goal "for some time" before taking action on rates.

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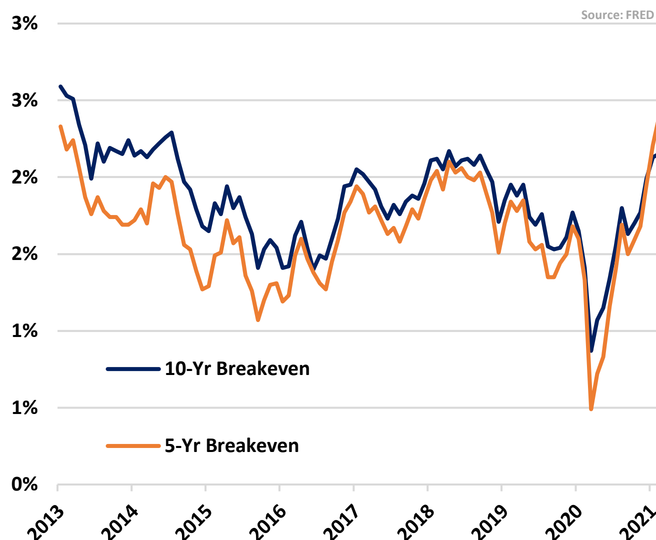
Inflation Signals Spotty, but Not Absent

Despite those rising expectations, however, the ongoing rise in the consumer price index (CPI) remains more of a gradual climb than a tidal wave.

Last month's headline CPI showed a rise of 1.7% YoY, the highest reading in a year. However, that uptick diverged from a downturn the core reading, which slipped from 1.4% to 1.3% between January and February.

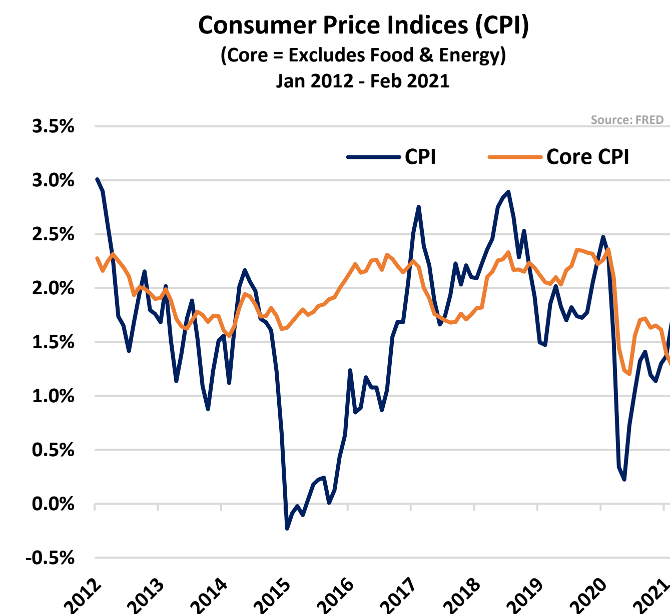


A declining core CPI, which strips out volatile food and energy prices from the index, shows us that stronger inflation is only present in certain portions of the economy, and absent in others.

But what if the bond market is right? The so called "Bond King" himself, Bill Gross, has even come out with a bold call on rising prices, recently telling Bloomberg that he believes inflation "is not going to be below 2% in the next few months… I see a 3% to 4% number ahead of us."

At this point, he's far from alone.

Though Fed policymakers continue to assure us all that there are scant signs of inflation, the central bank's own survey showed home-price inflation expectations at 4% last month, the highest level since May 2014. Expectations for the one-year change in gas prices rose to a record 9.6% from 6.2%. Median expectations for rent-cost growth similarly rose to a record 9% from 6.4%.



Rising housing and energy costs, which have been relentless since new home sales and oil demand bottomed out last April, show us that people are indeed spending much more on the cost of living, even if we aren't seeing it in discretionary spending yet.

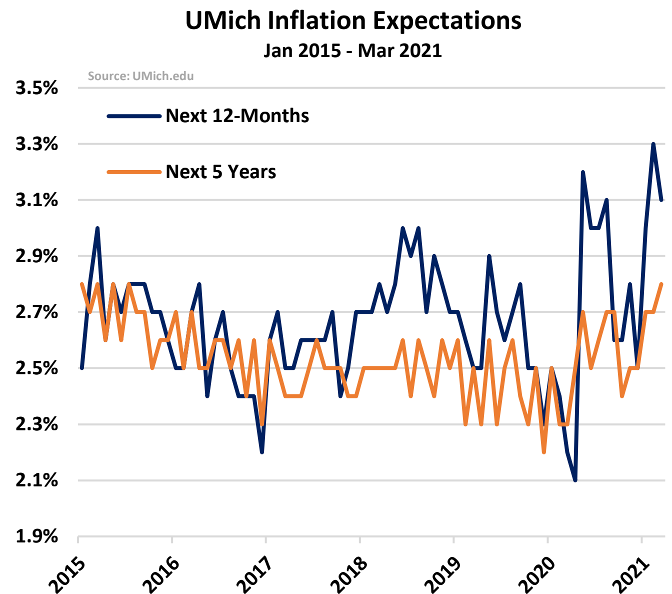
Runaway commodity pricing is also driving up the costs of food at home which saw an average increase of 3.5% in 2020, 75% higher than average over the last two decades of USDA data. Globally, food prices continued to rise by 2.4% in February, according to the Food and Agriculture Organization's Food Price Index. Earlier this month, MRP highlighted the potential for a weak US harvest and other catalysts that might send crop and meat pricing even higher.

Lumber futures have rebounded toward their all-time high of $1004 per thousand board feet after a slight reprieve earlier this month. Though copper futures also slipped a bit in March, closing just shy of $4 per lb last week, they're still almost 85% higher than this time last year. Copper, copper miners, and lumber producers are all currently on MRP's list of active themes.

Iron ore prices remain close to the heights of 2011, while tin, aluminium, and even lithium carbonate, have also broken out toward multi-year highs.

Though we won't see it in the CPI data until next month, it's also worth noting that IHS Markit's Flash US Services PMI release noted that there have been reports of ongoing supply chain issues leading to marked hikes in input costs across the service sector in March. The rate of input price inflation was the sharpest since IHS Markit began collection the data in late-2009.

The University of Michigan's data on consumer sentiment showed a bit of a turnaround in March, rising to 84.9 from 76.8 in the previous month. However, UMich's measure of inflation expectations also jumped to a 7-year high of 3.3% in February. Though that slipped back to 3.1% in March, the gauge's 5-year expectations ticked up to 2.8%, their highest level since 2015.



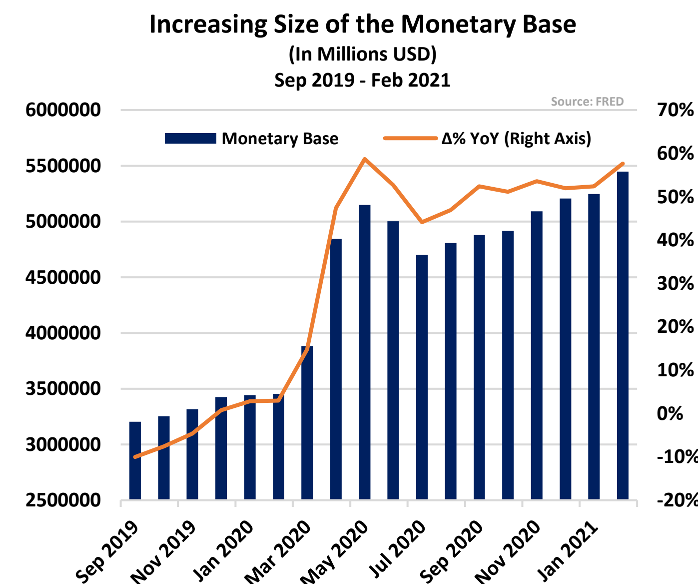
Even the general population is feeling growing anxiety about a potential surge in prices. A recent survey from data firm CivicScience showed that 77% of 2,535 Americans surveyed are concerned about inflation. Further, 42% of those respondents said they were "very concerned," which was more than double the 17% who responded "not at all concerned".

The sheer amount of cash being injected into the economy can no longer be ignored by anyone.

No Breaks on These Money Printers

A doubling of the Federal Reserve's balance sheet has led to a related explosion in the US monetary base; the sum of currency in circulation and reserve balances (deposits held by banks and other depository institutions in their accounts at the Federal Reserve).

In February, the base grew at a rate of almost 58% YoY, the fastest rate of expansion since May 2020.



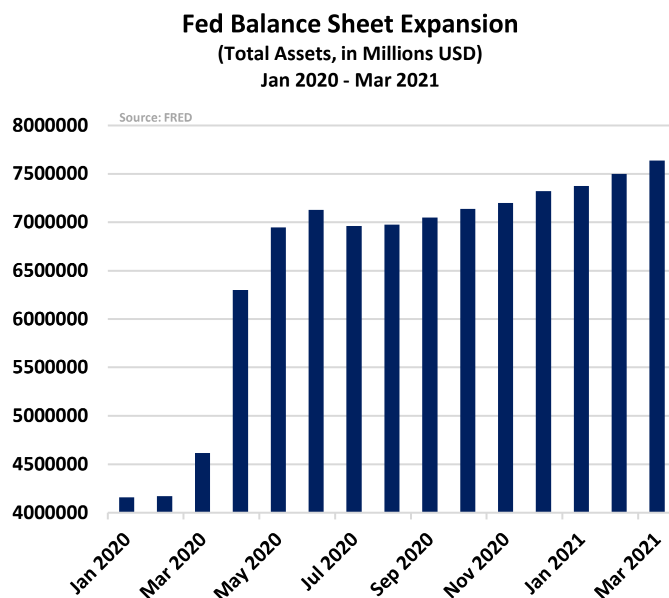
The expansion of the base will undoubtedly continue when we have the data for March, following passage and distribution of the $1.9 trillion American Rescue Plan.

Despite that, a new round of stimulus is already in the works at the White House. Americans can expect a two-part plan that begins with a proposal for infrastructure spending in early April, tacking on investments in healthcare and childcare later in the month. All-in-all, the price tag for these measures is expected to reach $3 trillion.

An increasingly prominent critic of Biden's spending plans has been former Chief Economist of the World Bank, Larry Summers. A neo-Keynesian economist, Summers isn't exactly a deficit hawk – openly admitting

that President Barack Obama's 2009 stimulus package, which he played a key role in as Director of the National Economic Council, was too small at $831 billion.

But in the wake of multiple stimulus bills rolling out one after another, Summers has characterized the approach toward this recovery as "the least responsible macroeconomic policy we've had in the last 40 years". Further, Summers believes "There's a one-third chance that we won't see inflation, but that the reason we won't see it is that the Fed hits the brakes hard, markets get very unstable, and the economy skids closer down to a recession".



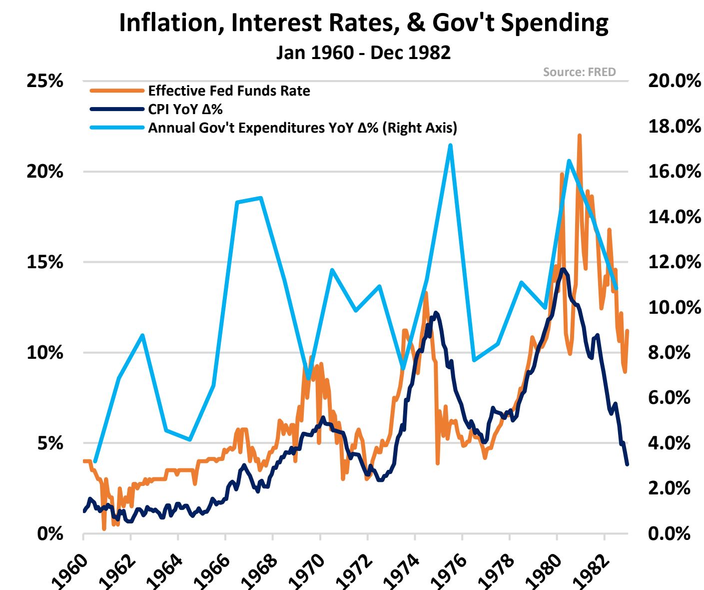
Financing these gigantic spending projects will require the Fed to continue expanding its balance sheet, which has already more than doubled since the central bank suspended a steady unwinding of their assets in the third quarter of 2019.

The latest Fed data shows total assets (less eliminations from consolidation) at more than $7.6 trillion.

According to Fitch Ratings's March Global Economic Outlook, the Fed is unlikely to start discussing tapering until after the summer. Following $2.98 billion of asset purchases in 2020, Fitch expects a further $1.4 billion in 2021 and $700 billion in 2022.

The 1970s Are Back in Fashion

This level of spending has some reminiscing about the breakout inflation of the 1970s and early 1980s when inflation exploded to a high point of nearly 15% – just about equal with where the yield on the 10-year treasury was topping out. To tamp down the rapid price increases, Fed Chair Paul Volcker famously spearheaded the most hawkish monetary policy of all time, pushing the federal funds rate all the way up to 22%.



On that topic, Treasury Secretary Janet Yellen has said, "To get a sustained high inflation like we had in the 1970's, I absolutely don't expect that. We've had a very well anchored inflation expectations, and a Federal Reserve that's learned about how to manage inflation. So, I don't think it's a significant risk and if it materializes, we'll certainly monitor for it, but we have tools to address it". While Yellen expects some inflation, she has called it "a temporary movement in prices".

Nobel Laureate economist Paul Krugman has also spoken out on the 70s comparisons, shooting them down in a recent op-ed for the New York times. Krugman prefers comparisons to what he terms "the inflation scare of 2010-2011" where, for a few months, the CPI broke out to 4% as wholesale inflation went into double digits on the back of surging commodities like oil and soybeans.

However, shifting prices in commodity markets are "easy come, easy go" and not always indicative of sustained inflation taking hold.

In an interview with Bloomberg TV, Krugman elaborated further on why he believes the 70s could not happen again, stating that "it took really more than a decade of screwing things up – year after year – to get to that pass, and I don't think we're going to do that again".

To assume our policymakers at the Fed haven't screwed some things up in the past decade is presumptuous, but Krugman does bring up a great point that is often forgotten about when discussing the 70s; the explosive inflation of that decade began brewing in the 1960s – a period when Keynesian deficit spending and inflation really started to take off.

When thinking about it in those terms, maybe the 60s is more of an historic parallel for our current situation, ushering in an age of inflation that grinds upward at a moderate pace, but then explodes all at once.

Fed Content to Let Inflation Run Hot, But Long-Term Rates Will Bite Profits

As mentioned at the outset of this report, the Fed is certainly expecting some increase in price pressures, updating their policy in 2020 to allow for inflation to run above the long-standing 2% target for some time. Though Fed Chair Jerome Powell has noted that we may see "some upward pressure on prices", he stresses that "the effect on inflation will be neither particularly large nor persistent".

Some voting members of the Federal Open Markets Committee (FOMC) have been more specific on this issue – particularly Chicago Federal Reserve President Charles Evans.

On a recent press call, Evans said that a burst of inflation for six months "is not nearly enough... patience is something we are going to have to grapple with, probably… We should be comfortable with a sustainable 2.5% inflation rate for a year; I don't really get nervous until it starts creeping up to 3%, and even then, I'd like to know how that's how that's being achieved."

However, even if the Fed doesn't budge on short rates, MRP noted last month that market yields for intermediate and longer-term debt would likely rise higher than anticipated from the same macro forces that would be producing the surge in earnings. It's easy to forget that just two years ago, the 10-year treasury was yielding 3%.

We believe the bond rout is not yet over and, according to analysts polled by Reuters, we are not the only ones. As part of a March 18-25 survey, more than 70 fixed-income strategists pointed to a marginal rise in major sovereign bond yields over the coming year. In response to an additional question 34 of 45 strategists said another sell-off in bond markets is likely in the next three months, including four who said it was very likely.

Those yields will continue to be a significant headwind for growth stocks with extended valuations, due to higher discount rate being priced into their future earnings. As a result, MRP continues to believe that capital will largely continue its rotation toward cyclical and value-oriented stocks.

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