NATIXIS INVESTMENT MANAGERS

14 APRIL 2020

Insight

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Inflation: see it to believe it

Unprecedented times call for unprecedented measures. Facing a global health crisis that has morphed into a global economic crisis, central banks and governments around the world have announced massive stimulus measures in an attempt to avoid a full-blown financial crisis. This “money-pumping” is expected to lead to inflation, or even hyperinflation, but should we really be worried about this?

Avoiding depression & deflation

In the first instance, policymakers have decided it is more important to avoid an economic and financial disaster than it is to worry about potential future consequences. Indeed, with the global economy at a complete standstill, second round negative effects could be quick to materialise and swift action was required. Moreover, the market meltdown in itself was cause for concern and some confidence needed to be restored.

What about inflation? Central bankers would like inflation, and have been trying to boost inflation for years. And if they didn’t succeed with 3.5% unemployment in the US, it is unlikely to materialise with 15% unemployment. In such a context, we are unlikely to see spending sprees or credit growth.

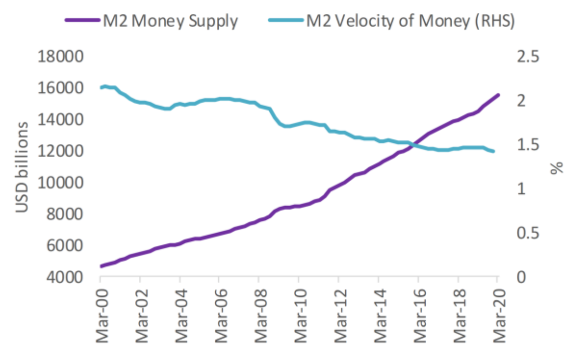
When looking at the components of inflation measures, many of the more expensive items are unlikely to see a sharp rise in demand in the short term. Looking at the PCE breakdown – the Federal Reserve’s (Fed) preferred measure – hotels, restaurants, transportation, automobiles and furniture are not likely to be the first items consumers spend on, especially given employment and income concerns.

In addition, inflation has faced structural headwinds in recent years, such as aging populations, technology, and the ‘Amazon effect’ as the price of everyday products has continued to fall.

What about all this stimulus?

Following previous rounds of fiscal and monetary stimulus during the global financial crisis, and especially with QE announcements, inflation fears had been touted as well. It didn’t happen then and we do not think it will happen now. That is because QE drives up banks’ excess reserves, but it does not guarantee they get deployed. If there is no appetite for these reserves, the velocity of money does not rise, which means inflation does not rise either.

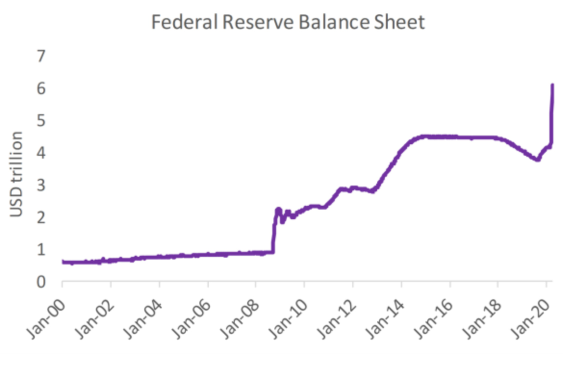
Yes, the magnitude of the Fed’s balance sheet expansion today is much larger than even in 2008, but it does not matter if there is no velocity of money. Indeed, M2 is rising rapidly, and the Fed’s balance sheet is likely to surpass USD10 trillion, but the velocity of M2 is actually slowing.



Source Bloomberg, Natixis IM Solutions, 14 April 2020

The same applies to fiscal stimulus. The numbers might be staggering, but the reality of the CARES Act is that it is income replacement, not additional spending. As such, it is unlikely to be inflationary, it is just avoiding a further fall in consumer spending as a result of stay-at-home orders and job losses.

The one caveat is if stimulus arrives too late and life is already 'back to normal': the pent up demand could meet supply constraints that lead to higher prices. But this is not our base case. And even if it does occur, it will likely be temporary as production ramps up again. We also believe that consumption behaviours will see some impact in the short term. The post-confinement reaction is likely to be cautious, especially as labour markets will have suffered significantly, and many businesses may have gone bankrupt.



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And Modern Monetary Theory (MMT)? Whether it admits it or not, the Fed is practicing MMT. That is, the government is spending as much as needed, with the Treasury issuing the debt and the Fed buying it. And the main criticism of MMT is that it generates inflation as you inject liquidity on a permanent basis. But here again, all this spending is not new money, it is replacement money and as such should be not prove inflationary as long as the Fed reins it its emergency programs in a timely manner.

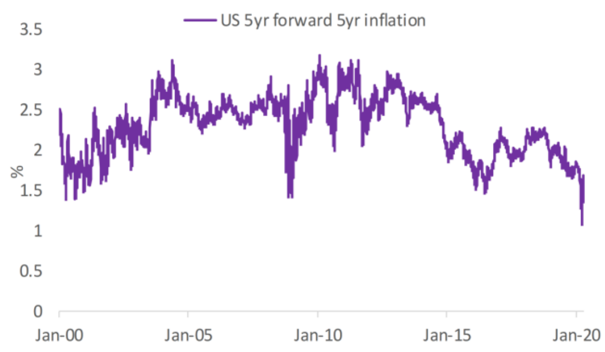
De-globalisation

Over the longer term, this pandemic could prove inflationary, but not from monetary stimulus or a sudden rise in money velocity.

One of the consequences of the crisis could be a move towards de-globalisation. Given the impact on supply chains from border closures and containment measures, many countries are likely to want to move production back onshore, or at least regionally. This is particularly the case for 'strategic' sectors such as healthcare and defence. Production costs and wages would go up and increased costs would likely be passed through to consumers. But this phenomenon, if we see it, would take years and will therefore not be a concern for some time.

Markets run ahead

As mentioned above, central banks would like to see some inflation. Indeed, inflation isn't bad, and it would help erode away some of the mountains of debt that will result from crisis measures. The concern with inflation is that it will force central banks to tighten monetary policy – raise rates and stop balance sheet expansion. Given current (too-low) inflation expectations and interest rates at zero, this transition could prove painful for markets.



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We've seen in previous instances that investors do not like quantitative tightening, suggesting a tricky balancing act: Will central banks manage to message this as normalisation to pre-COVID levels and not as 'growth-impacting rate hikes'? Moreover, markets typically front-run economic data, so we could see inflation fears come to the fore even if we are unlikely to see actual inflation materialise for a long time.

How to position

For now, we see little risk of inflation and we are not positioning for it. We will keep an eye on inflation expectations as markets could start to price in Fed moves, but we do not expect this to be a 2020 concern.

As such, we are not reducing fixed income allocations. Indeed, with yields set to remain low for longer, we believe the search for yield will continue for some time. Nonetheless, holding some inflation-linked bonds and gold makes sense.

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