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Weekly Commentary

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Macro View

By Hubert Marleau

Is Inflation Coming Back?

Submitted February 7, 2021

A Snapshot of the Week Ended February 5, 2021:

The market remunerated the speculators who believed that the precipitous fall in stock prices caused by the raiding frenzy in misfit stocks was an unsustainable event and just too crazy to last. Michael Harnett called the idiosyncratic episode a "tempest in a teapot". The S&P 500 regained previous week's loss and registered a whopping weekly gain of 4.7%, as strong earnings underpinned the market. Meanwhile, the economic prints were either on side with expectations or much better than consensus. The Atlanta Fed's GDPNow model has a new Q1 growth estimate of 6.0%, up from 5.2% on January 29. Interestingly, the plunge in the VIX, a reliable indicator of forthcoming volatility, from 33.2 to 20.87, is a clear sign of optimism. The enthusiasm of the market makes sense. Why?

Actually, the market believes that the already strong economic numbers are expected to be even stronger in the coming quarters because 1) the vaccination program, which is ramping up will likely contain the coronavirus, allowing big cities to ease restrictions, 2) the Biden stimulus plan will significantly increase personal income, and 3) the Fed will accommodate and partially finance the budget deficits with low interest rates and quantitative easing. In this regard, the markets are more likely to trade on inflation data. Indeed, a market debate about whether the huge fiscal impulse funded with the help of the Fed will emerge into a new narrative that will make headline news over the coming months. Thus, the growth path of the economy and the process by which the Fed will navigate its monetary stance will determine the outlook for inflation along with the level of bond yields, the shape of the yield curve and the gap between the natural rate of interest and the Fed's policy rate. A good place to start is with the current state of the economy.

Macro View cont.

By Hubert Marleau

The Current State of the U.S.Economy: Growth-Employment-Productivity-Inflation

R-GDP totalled $18780.3tn in Q4 registering an annual decrease of $473.7 billion which suggested that the economy would have to grow by 2.5% to reach the pre-pandemic level of 19,254.0tn. However, closing this gap is not enough. The U.S. economy needs to overshoot in order to repair the damage of the pandemic. If we were to make the plausible assumption that the economy was operating near full employment in the later months of 2019 and had there not been a pandemic, the level of real economic activity in 2020 and 2021would have probably not grown around 2.0% per year. Based on this simple but realistic conjecture, R-GDP would need to increase 7.5% by Q4/2021 to $20,188.8tn from the level reported a year earlier in order to be where we ought to be.

In January last, the level of employment totalled 150.031million. That's 8.701 million less jobs than the pre-pandemic high of 158.732 million. Disregarding the labour participation rate which has fallen in the past year, 8.817 million jobs would have to be created over the next 12 months to match the employment situation of last February. Put simply, an increase of 5.9% in job creation in the next twelve months is needed to return to full employment.

Productivity (R-GDP/Employment) registered a y/y increase of 3.0% in Q4. There is plenty of empirical evidence that productivity tends to rise above its historical average when economic slack starts to diminish. Industries which are currently affected with supply chain disruptions, shipment delays and rising input costs, are investing huge amounts of money in information processing equipment, research and development and robotic products. Businesses invested more than $1.3tn in Q4/2020 in productivity enhancement, the largest amount on record and up 9.0 y/y. If the economy were to reach full employment in the early months of 2022, productivity would only have to increase by 1.6% over the coming year for it to generate a y/y Q/4 R-GDP growth of 7.5%.

On the inflation front, prices that are received by providers of goods and services have been stable. The core PCE which excludes food and energy, was up 1.5% y/y in December whereas overall prices increased only 1.3%. Viewed through another set of indices, the price that producers must pay for industrial components and raw commodities have risen considerably from depths of the pandemic. It appears that the application of technology, the employment slack, the output gap and fast-rising corporate revenues are working their positive magic on inflation. There is no sign that cost pressures stemming from import prices and intermediate industrial prices are boosting prices at this point.

Biden's Fiscal Plan:
Dealing with an abundance of amendments and a tie breaking vote cast by Kamala Harris, the stage is now set for the Democrats to forge ahead on Biden's fiscal relief and rescue plan. There will be a reconciliation process and a lot of push back on the part of the GOP. The Republicans are likely to be cordial, but they have no appetite to

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enlarge their $618bn proposal. Consequently, it's unclear what the final product will entail because of potential leeway, but contrary to my earlier estimates President Biden looks likely to push through his plan.

Powell's Monetary Plan:
The main objective of the Fed is no longer price stability at the original inflation target rate of 2.0%. The monetary authorities have clearly indicated that they would not mind if inflation were to rise above 2.0% for an indefinite period of time. The main objective is now full employment. In this respect, it's not logical for the Fed to either taper its asset purchases or reduce its policy rate.

Is Inflation Coming Back?

Based on the aforementioned observations, the idea of pushing the economy at maximum speed to drive down unemployment, is clearly the overriding economic goal of the current cohort of policy makers. It's an imperative that will shape economic and monetary policies over the next few years. In order to produce a 7.5% increase in R-GDP as quickly as possible, a major change in economic thinking at the policy level is necessary. The beacon must change from what used to be "low and stable inflation" to "low and stable unemployment". This new thinking rests on two isolated observations—the late 1940s and early 1990's— and on three theoretical arguments. The marginal propensity of spending is higher with lower income earners. An overheating economy usually leads to wage increases that tend to broaden prosperity. The economy needs to exceed its potential to escape the liquidity trap.

After WW11, concerns that the economy would slump led the Treasury to bolster aggregate demand with income supplements and the Fed to freeze interest rates at a low level. From 1946 to 1948 N-GDP increased 15%. Contrary to expectation at the time, a surge of pent-up savings and massive Fed liquidity surprisingly resulted in strong economic growth.

The new administration is stacked with officials who have spent a lifetime focussing on the labour market. Its motto is to "go big" to stop the Covid-19, revive the job market, avoid the scars of long-term unemployment and keep small businesses alive for another day. The Democrats want a winning song sheet and a pleasing melody for the 2022 Congressional elections. On this one a victorious formula is a strong economy. A mini boom would conquer even the majority of the independents.

Thus, they are willing to push for a post-covid boom because they are not concerned that their aspirations will revive inflation. They are of the opinion that the interplay between jobs and inflation no longer holds. The long-thought idea that as unemployment falls, inflation pressures build is discredited by the experience of the last 20

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years. It is true that before the pandemic, the Fed watched the jobless rate fall to 3.4% with no obvious impact on inflation, which has run around a half a point below the official 2% target. Given that inflation is out of vogue, Powell and Biden see no reasons to hold back. They are favouring a Post-Covid boom. Fed Vice Chair Richard Clarida suggested that policymakers take a “whites of their eyes” approach: wait until there is rising inflation and an obvious shortage of workers before pulling out.

I understand that with money coming, it will tide workers and small employers over until the health crisis passes. Unfortunately, there is an unquantifiable chance that the policy makers may be blindsided this time around by an unwelcoming burst in inflation. The aim of reducing joblessness as fast as they can to its lowest denominator without spurring some inflation, is a hypothetical nirvana that may prove to be difficult to achieve. The sheer magnitude of the fiscal and monetary plans which could total as much as $3.8tn in 2021, representing 18% of the N-GDP, is one concern. Another concern is the way these programs are implemented, they will have a direct and affirmative effect on household savings which are already $1.6tn more than they should be and on the money supply, which is already racing up at an annual clip of 28%. I don’t know whether these vigorously energetic injections of money in the private components of the economic system will bring excesses and imbalances—but it will clearly reduce the output gap and raise the inflation odds.

It would be juvenile for investors not to take account of where things stand and assume that the rule of very low inflation is permanent. The inflation risk ought not be taken lightly. The problem is one of timing. It’s possible that business will not be able to meet consumer demand. A continuously overstimulated economy should reinforce the business cycle and at the least invigorate the inflation narrative.

Jeff Currie, the head of commodity research at Goldman Sachs, has put together a research paper claiming that over stimulation combined with Biden’s priorities for a “Green Economy” will bring forth a new bull-market super cycle for commodities that will manifest itself in a price boom in oil and several key industrial commodities. His bullish conjecture will be fortified by the ongoing retreat in raw material investments and political effort to change the economic redistribution equation. The investment implications of this view are intriguing. I’m keeping my high growth technology exposure and reducing my thematic EFT schemes; but I’m putting all new-found money from dividends and savings into a variety of companies that produce or mine strategic commodities.

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