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# Weekly Commentary

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# Macro View

*By Hubert Marleau*

# The Inflation Question: What's Next, 7-Up?

Submitted January 16, 2022

Yes, there are several reasons to worry about inflation; and I do. The labour market is tight, demand is strong, the supply chain has not healed and the trajectory of Covid is uncertain. Yet I'm still confident that hyperinflation is out of the question and that the inflation rate will abate in 2022.

The US consumer price index increased 7% year-on-year last month, the fastest pace in almost four decades. Core inflation, which strips out volatile items such as food and energy, accelerated to an annual rate of 5.5% from 4.9% in November. There is a scarcity of goods and services in the economy because consumers are willing to pay up with their extra personal savings, accumulated during the pandemic. The main reason behind this struggle has been the inability and/or unwillingness of business to raise output to meet booming demand. They have been reluctant to make the necessary investments to catch up, anticipating that the boom will soon or eventually pass. Thus, inflationary pressure will abate only when the rapid rate of increase in demand stops. That can only happen if inflation eats enough of these extra savings to hurt consumer sentiment, reducing demand and when the pandemic turns endemic, relieving shortages.

Marthew Klein, of the Overshoot newsletter observed a few months ago: "The huge pandemic stimulus had three possible outcomes. Companies and citizens might have taken the government handouts and nervously saved them, in which case the magic money would have failed to spark a recovery. At the other extreme, the private sector could have spent the handouts all at once, in which case there would have been hyperinflation. Instead, the economy followed a middle path." The output recovered fast, but so did inflation. If it had not been for the rise in the exchange value of the dollar and the increase in productivity, the overall result would have been far from ideal.

In the two years ended December 2021, the GDP, expressed in real dollars increased 3.5% with 2.0% less employment. Thus productivity must have done very well. Meanwhile, the DXY index, which is the value of

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the dollar relative to a basket of US trade partners' currencies, rose from 89.50 to 96.00, registering an increase of 7.3%. My guess is that without those increases, the inflation rate would have been much higher.

I'm not going to give an account of the internals behind the December 2021 CPI increase: but, I am daring enough to predict that the 7.0% rise will be the peak. January surveys done by the University of Michigan on consumer sentiment, and by the Institute of Purchasing Managers on economic conditions, indicate that both an easing of demand and of cost pressures are on their way. US producer prices rose half as much as expected in December and import prices fell 0.2% m/m versus an expectation of +0.3%. Meanwhile, retail sales dropped by 1.9% m/m, whereas industrial production hardly budged. Perhaps the market for durables is coming into balance.

Omair Sharif, of Inflation Insights, made this highly interesting point that between September and December 2021, new and used cars contributed nearly 60 basis points of the 150 basis point rise in y/y core CPI. That's roughly 40% of the move just in autos. During the span of March to June meanwhile, autos contributed nearly 50% of the increase in core CPI, per Sharif's calculations. Obviously cars aren't everything. But the fact remains that this specific issue may get resolved when the chip shortage eases.

Nevertheless the situation with inflation is still uncertain. Adjusted for inflation, wages are down 2.4% from a year ago, and there is little evidence that we are about to get a sticky wage-price spiral. Olivier Blanchard of the Peterson Institute, put this problem in an email to the FT: "If I am a worker, I look at 2021, and conclude I have lost quite a bit of real income (actually based on my perception of the prices I see every day, I believe inflation has been substantially more than 7%). The labour market is tight, good time to ask for a wage increase, or threaten to quit, or if there is any kind of union go on strike. This is the wage price loop." Of course, not everybody would agree with him. White collar wage earners may be willing to accept the same pay in return for staying home on Mondays and Fridays. It's much cheaper to stay home and to work from there than incur the cost of going to work. According to the Atlanta Fed's Wage Growth Tracker, overall wage growth is up 4.5%. Interestingly, the part-time, non-white, female, low skilled and young workers are the ones who are enjoying superior wage gains. That's where wage growth is keeping up with inflation. A paper released by the Becker Friedman Institute of the University of Chicago found that the biggest beneficiaries of tight labour markets are those who traditionally lose out on jobs and wages.

However, we are not going back to 2.0% anytime soon even though Lael Brainard, who testified on Thursday to the Senate as part of another confirmation hearing to become Federal Reserve vice-chair, told the lawmakers that the central bank's goal is to get inflation back down to 2.0%. The NY Fed has an underlying inflation gauge (UGI) that captures sustained movements in inflation from information contained in a broad

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set of price, real activity, and financial data. Currently, trend CPI inflation is estimated to be in the 4.5% to 4.8% range. The jolt to expectations from the current inflation blip and the ongoing transition to green energy will likely raise the cost of capital.

Presently, both the bond market and monetary authorities anticipate that at the peak of this cycle, the Fed's policy rate will be around 2.0%. The big question is whether that will be enough: the drama is far from over. It depends on where the neutral rate is (the rate that would keep the economy growing with price stability), and this elusive estimate is all over the place. I believe that the future performance of the dollar and the money supply will determine where the neutral rate will be. And where it rests will in turn determine the magnitude of the Fed's monetary stance, a good gauge of which is the yield on five-year notes. On Friday, these notes were trading around 1.50%. Given the low level of interest rates and the huge amount of public debt, convexity is high. Thus, the neutral rate may be much lower than 1.50%. A few days ago, Andrew Lees, of Macro Strategy Partnership, showed in a chart that the inflation-adjusted rate is 0.40%. In nominal terms, I suspect this means that the rate, where full employment coexists with stable inflation, is only 1.10%.

This elusive neutral rate will be a function of what people are going to do with the $2.5 trillion of extra savings that they've accumulated during the pandemic. If supply shortages were to subside as expected, and if a big part of these extra savings doesn't get spent, measured tightening may turn out to be enough. A disproportionate amount of the extra savings is in the pockets of the wealthier cohort, whose marginal propensity to spend is relatively low. The Economist brought to light that in the decade before Covid-19, the wealthiest 1% of Americans had, in aggregate, about twice as much cash and checkable bank deposits as the bottom 50%. The pandemic has skewed this further: the top 1% now has four times as much as the bottom half.

In a weird way, all of that could be a good thing. On the one hand, the extra savings combined with a higher return on capital, could enhance the prospect of a possible multi-pronged, multi-year investment boom. What is not spent gets invested. The timing is great. Corporate profits are excellent, funding conditions are easy, and industrial capacity is tight. Fixed capital formation brings productivity gains. On the other hand, the ongoing redressing of inequality should keep the spending afloat. The poorest-paid workers, whose marginal propensity to spend their income is near 100%, are the ones who are getting the largest pay-raise.

In the week ended January 15, 2022, the S&P 500 was down 0.4% or 19 points, 2.8% from the all-time high of 4797. It appears that U.S. equities are firmly in a 300-point trading range between 4800 and 4500. Either way it will take surprises on earnings or a breakout in 10-year yields to take the stock market out of this trading range.

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The earnings season began in earnest on Friday morning. JPMorganChase, Citigroup, Wells Fargo and BlackRock kicked things off. They all reported better than expected earnings but they've been on a sugar high in the last few months underwhelming the results. (Wells Fargo was an exception).

In any case, money flows are confirming that retail investors are stepping in to buy the dips. It looks as if the retail put will stay in place. A new survey of 1600 respondents from Investing.com showed that 86% of last year's first-time stock buyers plan to keep buying in 2022. According to Bespoke Investment Group, between 1978 and 1982, there was a streak of 7%-plus year-over-year gains in the consumer price index. The S&P 500 advanced just 15.1% over that four-year period. It was quick to add that the experience was very different in 1951, when inflation was not as entrenched. The S&P 500 ended that year with a 11.4% gain. ClearBridge Investment, in a webcast to clients, showed that the S&P 500 has a tendency to rise before a rate hike, but tends to decline a bit afterwards for a short period of three months. But over the medium term - that is 6, 12 and 18 months- equities have, on average, increased 2.8%, 5.3% and 10.5% respectively.

The bottom line is that we are in an inflationary boom and therefore overweight in Materials, REITS, Financials and Energy as the inflationary content of the Misery Index testifies. There are four types of economic scenarios: Inflationary Expansion (low unemployment rate and high inflation rate), Inflationary Contraction (high unemployment rate and high Inflation rate), Deflationary Expansion (low unemployment rate and low inflation rate), and Deflationary Contraction (high unemployment rate and low Inflation rate).

I've started to look at risky growth stocks that have long durations, especially those that tend to swing with structural trends like demographics and productivity because I think that we will eventually, perhaps in 2023 or 2024, return to a deflationary expansion phase. There are several category killers and household names in various sectors whose products or services are in high demand on an everyday basis. Companies like ZM, TDOC, SHOP, ROKU, QCOM, PYPL, NVEI, NFLX, LSPD, LRCX, KSV, DOCU, CIEN, AFRM, ADBE name just a few. They may soon be worthy of consideration because we are back to the days when making money in the stock market was about buying growth at the right price.

Ben Snider, in a note to clients of Goldman Sachs, wrote that at the peak of the Tech Bubble in 2001, growth EPS yield was scant 100bps above real 10-year Treasury yield compared to today's 550 bps. Since 1990, growth EPS yield averaged about 500bps above real yield. Although I do not expect the gap to go back anywhere near the all-time 950bps gap that was registered in 2011, I decided to cautiously tiptoe in the growth sector for now, wishing for another 5% to 10% rout.

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