

PGIM MARKETS

Insights on Events Moving the Financial Markets

INFLATION: SHORT-TERM ABERRATION OR LONGER-TERM THREAT?

The rapidly increasing administration of COVID-19 vaccines, coupled with the imminent flood of fiscal stimulus from the American Rescue Plan Act, has generated widespread expectations that the US economy will boom in the second half of 2021. Along with that optimism, however, comes concerns that inflation could spike, at least in the short term. In the Q&A below, Sushil Wadhwani, chief investment officer of QMA Wadhwani and former member of the Bank of England's Monetary Policy Committee, offers his thoughts on the inflation question and what an uptick in pricing pressures could mean for the performance of risk assets.



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Given the accelerating rollout of vaccines, new fiscal stimulus in the US and pent up consumer demand, what is your view on inflation both in the short term and the longer term?

There's an easier component to your question and a much more challenging one. In the short term, we're increasingly confident that inflation will spike higher for several reasons. The first reason has to do with the base effects in 2020. In the second quarter of 2020 with the global economy largely locked down, pricing was very subdued. Now the economy is more open, and so it's likely that measured inflation will go up just because prices were unusually subdued this time last year.

The second reason we're likely to see prices rise over the short-term is that we've seen commodity prices go meaningfully higher, so we're likely to see measured inflation, if not core inflation, increase as higher commodity prices feed into inflation.

The third reason is that if you look at savings ratios in the US and Europe, they are very high because people couldn't spend on services during lockdowns, so they sat at home and saved. The corollary to that is that there is considerable pent up demand, and we would expect people to spend at least some of those savings. Now the dispute among economists is how much, but I don't think anyone would disagree that some of these savings would be spent. And they will, in the very short run, meet, to some extent, supply constraints, so, therefore, you'd expect some upward pressure on prices from that source.

The fourth and final reason for a short-term spike in inflation is that you've had huge fiscal stimulus in both 2020 and now in 2021. With two years of fiscal stimulus of this size, its plausibly going to show up in some upward pricing pressure. It's just because of the size of the fiscal packages.

So, in your view, we can expect to see inflation climb over the short term. What about over the longer-term, say the next two to three years?

That's the more difficult question to answer. Looking beyond 2021 and early 2022, is inflation going to be sustainably higher? For Federal Reserve Chairman Powell, the answer is clear. He thinks this is not really inflation; he thinks it's just a one-off change in the price level and that the upward pressure on prices will abate. And I imagine that's partly because the base effects are, by definition, a one-off. Higher commodity prices are unlikely to affect core inflation and are not likely to be sustained, so that's another one-off. The pent-up demand is, by definition, a one-off. And with fiscal stimulus, it's highly likely that in 2022, we'll see fiscal tightening relative to 2021. So, for all of those good reasons, its plausible that inflation will decelerate into 2022 as per what Chairman Powell argues. The other argument supporting the notion that upward price pressure will be fleeting is that output gaps are still quite high. So, you can see where that view of just a temporary blip of inflation is coming from.

And what is the less optimistic view on inflation?

This brings us to the core question, which is whether inflation might prove to be persistent and whether that might elicit a reaction from central banks. And the reasons to be somewhat more conscious of these upside inflation risks include the following factors: first money supply growth has been unusually high. Money growth in the US has been off the charts. Strong money supply growth doesn't necessarily tell you inflation will be going higher; however, it tells you the central banks will potentially have a lot of work to prevent inflation becoming problematically high.

So, the question then is whether the central banks will do enough. One reason to be cautious is that the central banks have told us they're going to be patient. That, after all, is what the Fed's change of regime is all about—average inflation targeting. They're going to be more permissive; they're going to deliberately be behind the curve and perhaps let inflation drift higher for a while by design. That may be OK as long as they subsequently react, but the difficulty you have with them being patient against the backdrop of this huge expansion of fiscal policy is, first, we don't know whether inflation expectations will become dislodged (and if they do get dislodged, it will take a huge effort by central banks to bring inflation back down). The second thing we don't know is given high debt-to-GDP ratios globally is how much political pressure will be exerted by various governments around the world on central banks to keep interest rates low.

How would that pressure manifest itself?

It doesn't have to be overt political pressure. In some countries, governments can just change their instructions to central banks. If I take a parochial view and talk about the UK, (and I'm using this purely as an example for what could easily happen) in the UK there is talk of switching from a 2% inflation target to a nominal GDP target. And they're talking about a nominal GDP target of 4%. Well, with potential growth at 1.5%, that is implicitly raising the inflation target from 2% to 2.5%. And it's the sort of thing that this government could get away with because the vast majority of the British public won't understand that this means a rise in the inflation target, because it's just a technical thing, a technical switch in the target. But what it will do is make the central bank even more patient in terms of tightening monetary policy in the face of rising inflation, and therefore, will increase the risk of inflation expectations getting dislodged. And therein, lies the main risk in terms of upside surprises to inflation in 2022/2023 and beyond.

Inflation / Asset Class Scenarios

Asset Class	Scenario 1	Scenario 2	Scenario 3
Equities	RISE	FALL	FALL
Defensive Fixed Income	RISE	FALL	FALL
Gold	FALL	RISE	FALL
Yield Curves	FLATTEN	STEEPEN	FLATTEN
Industrial Metals	?	RISE	FALL

- **Scenario 1 – The Fed (Powell) view is correct:** the coming rise in (2021) inflation is a one-off change in the price level, but does not lead to second-round effects. So, price pressures diminish again in 2022 – and those who argue that the fiscal easing is “right-sized” prove to be correct.
- **Scenario 2 – A regime change occurs – with inflation “taking off”:** Inflation expectations “move up a gear” and policymakers remain “behind the curve” – leading to a “return to the 1970s” in some form: i.e. higher inflation hurting both equities and bonds.
- **Scenario 3 – Central banks belatedly becoming aggressive –** with central banks deciding they need to act aggressively (if late) to earn credibility. They therefore hike, pushing the economy into a recession. Again, a poor outcome for equities.

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How do your views on medium-term inflation risks impact your forecast for different asset class returns?

I think the answer to that question depends on the inflation scenario that each investor thinks is the most plausible. From our point of view, there are three scenarios that are relevant.

The first scenario is the one which we were talking about a few minutes ago where this rise in inflation turns out to be entirely temporary, where the temporary factors I outlined go away and inflation just subsides without any policy action being needed. The big output gap we have, globally, becomes important, and inflation just automatically comes down by itself. And in that scenario—the Goldilocks scenario—obviously, equities and bonds are likely to do well.

There's scenario two where inflation persists into 2022 and 2023, and central banks remain patient. They may remain patient because of government instruction, but they may also remain patient because they've announced they're going to be behind the curve. Now, that scenario, where inflation expectations rise and get embedded, could actually be quite subversive of both bonds and equities, because clearly with higher inflation expectations, other things being equal, bond yields will go up. If higher inflation expectations lead to higher nominal bond yields, you may get a higher earnings yield, i.e., a lower price/earnings ratio, so you could get multiple contractions in the equity market as inflation goes up. And that means equities and bonds fall together. So, that's scenario one where inflation expectations are dislodged.

Scenario three is, as former Federal Reserve Chair Janet Yellen has told us, that the US won't allow inflation expectations to be dislodged because if the Fed thinks they're about to be dislodged, it will respond, and it will respond forcefully and promptly. So, that's my third scenario. That's a scenario where there is inflationary pressure in the economy, but the central bank then responds aggressively. Now, at the beginning of this year, the markets weren't expecting a rate hike until well into 2023, late in 2023. Now those expectations have been brought forward into early 2023. But I would say on the Janet Yellen scenario, the Fed may end up having to hike in late 2022. It may be that if we see building inflationary pressure, the Fed may well respond, especially if inflation has a three handle through 2022, which is not at all implausible. So, if the Fed suddenly starts tightening at the end of 2022, you've got to believe that both equities and bonds will go down meaningfully.

So, we have to choose between these scenarios and that, to some extent, is what all the modeling work we do attempts to do, but it is clear that what happened in February this year is that the markets went from believing my first scenario was a 90% plus probability to thinking that maybe scenarios two and three had meaningful probability and that scenario one wasn't a done deal. And that's why I would say that the yield curve steepened and real rates rose.

In your opinion, which scenario is most likely to materialize?

In our view, both growth and inflation are likely to surprise the consensus on the upside during 2021, in part because there is a behavioral tendency for forecasters to underestimate the impact of special factors like pent-up demand when preparing their numbers. If these surprises do eventuate, we feel there will be a tendency for the markets to assign a higher probability to either scenario two or three materializing. Since neither scenario is good for a traditional 60/40 portfolio, our best guess is that investors should seek diversification. Once we get into 2022, if inflation fails to come down sufficiently, I suspect that the Federal Reserve will “do the right thing” and, in that sense, scenario three is more likely than the second scenario within which inflation becomes embedded within the system. Of course, were the Fed to turn aggressive in the second half of 2022, then equities, bonds, gold and inflation-linkers would all fall together.

IN OTHER NEWS...

PGIM Fixed Income contributed the following analysis.

- Given the more gradual pace of vaccine rollouts in Europe, combined with some pauses in the AstraZeneca/Oxford vaccine introduction, the European Central Bank assumes more stringent containment efforts through the first half of 2021. Thus, more forecasters are seeing broadly similar growth in 2021 and 2022. For our part, we see real GDP growth of 5.1% this year and a moderation to 3.5% in 2022. Europe is also expected to see an inflation “mirage” in 2021 as higher oil prices may lift headline inflation to the cusp of the ECB’s target of below, but close to, 2% before a precipitous decline by the end of the year towards 1.0%. Therefore, euro area inflation will likely remain well below the ECB’s target into 2023.
- While real US GDP growth is set to lead the developed market economies in 2021 (6.4% vs. the developed-market average of 5.4%), a significant question looms as to how much momentum the economy will carry into 2022. For example, a survey of sell side real GDP forecasts estimates that US growth will peak in Q2 2021 at 9.6% amid the base effects from the spring of 2020, before sequentially declining thereafter to an average of 1.7% by Q4 2022, which would be more consistent with the pre-virus growth pace.
- Similarly, the US inflation picture continues to evolve, as well. It’s possible that monthly core PCE inflation could exceed 0.20% as the year progresses, which could place the 12-month reading in a range of 2.25-2.40% as the year concludes. However, we see the monthly pace then subsiding to 0.15%, which would bring the 12-month rate back down towards the 1.80% level in early 2022.
- One of the key items from this week’s Fed decision will be the summary of economic projections. In all likelihood, the GDP and inflation forecasts from some of the participants will shift higher, which could complicate the consistency of Chair Powell’s messaging during the press conference. In particular, the Fed previously stated that it aims for inflation moderately above 2% for “some time” under its flexible average inflation targeting regime, and reconciling higher inflation forecasts with the heretofore dovish rhetoric and the vagueness of the time horizon could become an increasingly challenging message to convey.

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