Why We Doubt Inflationary Dynamics Will Revert to What They Were Pre-Pandemic

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GREG JENSEN
JASON ROTENBERG
NINA LOZINSKI

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We think the 2020s are unlikely to be anything like the 2010s, and yet, that is what is discounted when we look at the combination of low rates and inflation. The big change, in our view, is that policy makers are finding out how potent MP3 policies (aggressive fiscal policy accommodated by printing) are and that in the US, these policies have already transformed private sector balance sheets, changed the trajectory of the economy, and made the economy less reliant on low rates.

When we look through history, we see that the common pattern across decades is for big reversals. There are logical reasons for this, as excesses lead to extrapolation and busts, and vice versa. Policy makers also learn from their recent experience and/or are forced to react to intolerable conditions, and policy mistakes (in retrospect) are more likely to be in the opposite direction than the same one. The 2010s were a deleveraging deflationary decade when fiscal policy was tightened too fast, and central banks learned multiple times through trial and error that tightening wasn't yet possible. The economy was already looking different by the end of the last decade, and then the pandemic and, more importantly, the policy responses to it put these changes into hyperdrive. And we see the odds of an overshoot as being significantly higher than those of an undershoot. The table and charts below put into context the profound shift that has occurred in the underlying forces governing inflation. They show: a massive transformation in both sides of the household balance sheet (record-high wealth and very low debt service), more widely shared prosperity, the tightest labor market in decades, higher inflation (even excluding base effects), and the easiest monetary and fiscal policy ever, let alone into a booming economy. By comparison, interest rate markets are lagging the changes that we think are occurring, and setting up some of the best trades we've seen in a long time.

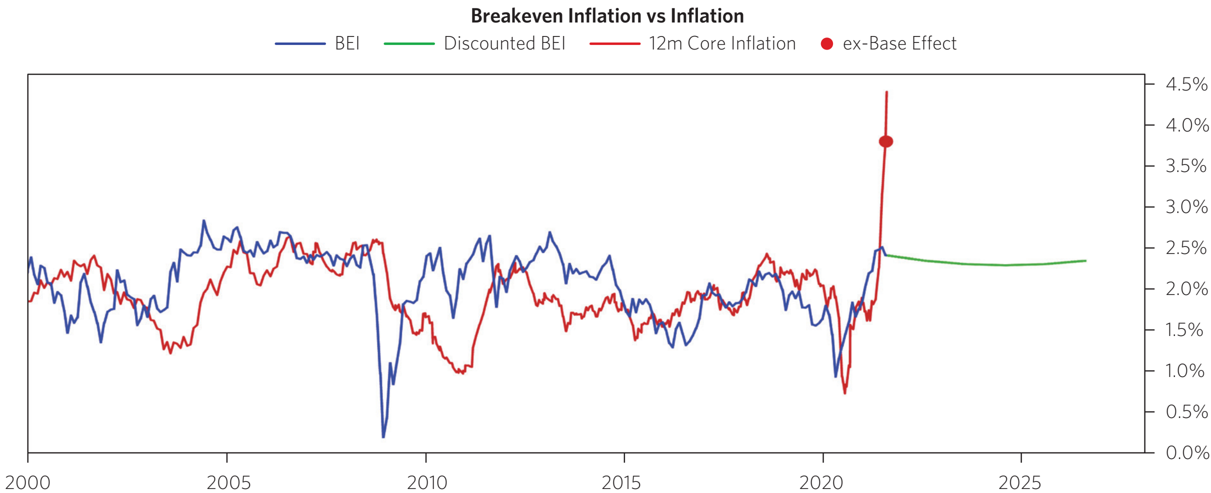
Inflation Dynamics: Today vs Pre-Pandemic

	2010s Avg	Start of 2020	Today	Today vs 2020	
Inflation					
12m Core Inflation*	1.8%	1.9%	3.8%	1.9%	High inflation
Policy					
Nominal Short Rate	0.6%	1.6%	0.1%	-1.5%	Record levels of stimulation
US QE (%GDP)	1.0%	3.0%	7.0%	4.0%	
US Fiscal Support to Economy (%GDP)	0.0%	1.0%	9.0%	9.0%	
Pricing					
Nominal Long Rate	2.4%	1.9%	1.4%	-0.5%	Inflation priced to fall even as rates are discounted to be permanently low
Real Long Rate	0.5%	0.2%	-0.9%	-1.1%	
BEI	2.1%	1.9%	2.5%	0.6%	
Household Financial Conditions					
Household Net Wealth (%GDP)	488.0%	558.0%	625%	67.0%	Massive wealth levels and gains more widely shared; debt service at seculars lows
Net Worth of HHs in Bottom 60% by Income (%GDP)	50.0%	53.0%	62%	8.0%	
Savings Rate	8.0%	8.0%	20%	12.0%	
Household Debt Service (%GDP)	8.0%	8.0%	7.0%	-0.4%	
Labor Market					
Unemployment Rate	6.2%	3.6%	5.9%	2.3%	Tightest labor market ever; unemployment rate understates strength
Job Opening Rate (JOLTS)	3.5%	4.2%	6.0%	1.8%	
Voluntary Quit Rate (JOLTS)	1.9%	2.3%	2.5%	0.2%	
Avg Hourly Earnings (Y/Y)	2.4%	3.3%	4.4%	1.1%	

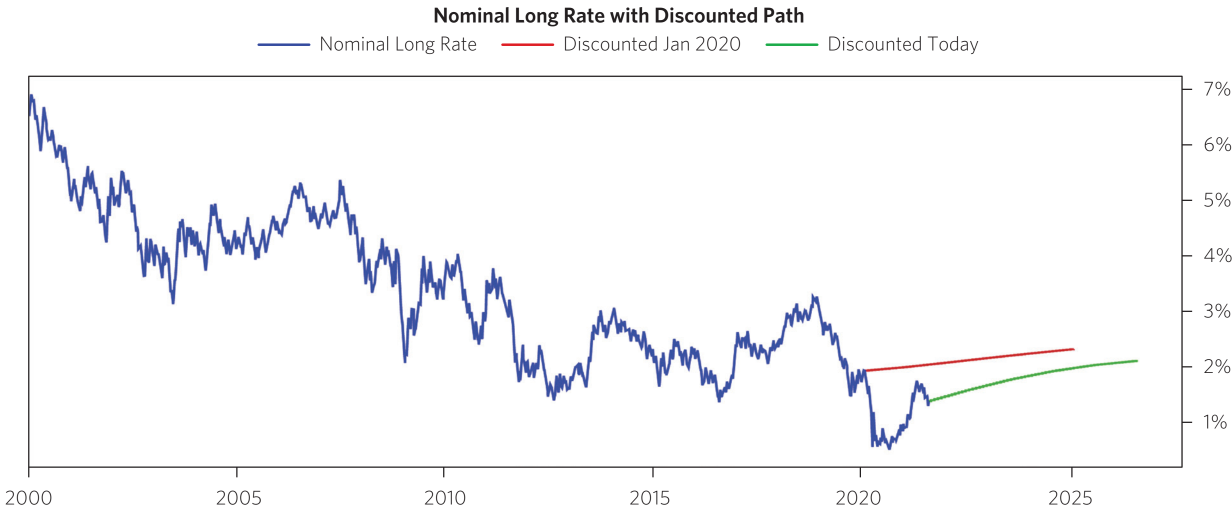
*Today's Inflation rate ex-base effects

Interest Rate Markets Are Discounting a Return to Normal

Despite what we see as fundamentally changed conditions, interest rate markets seem to be looking through current inflation, and pricing in very little chance of an overshoot. Core inflation, even excluding base effects, is already the highest it has been in decades. Yet breakeven inflation is priced to remain at levels similar to those seen over the last decade and well below current inflation rates.



Similarly, long rates are not priced to return to pre-pandemic levels for years.

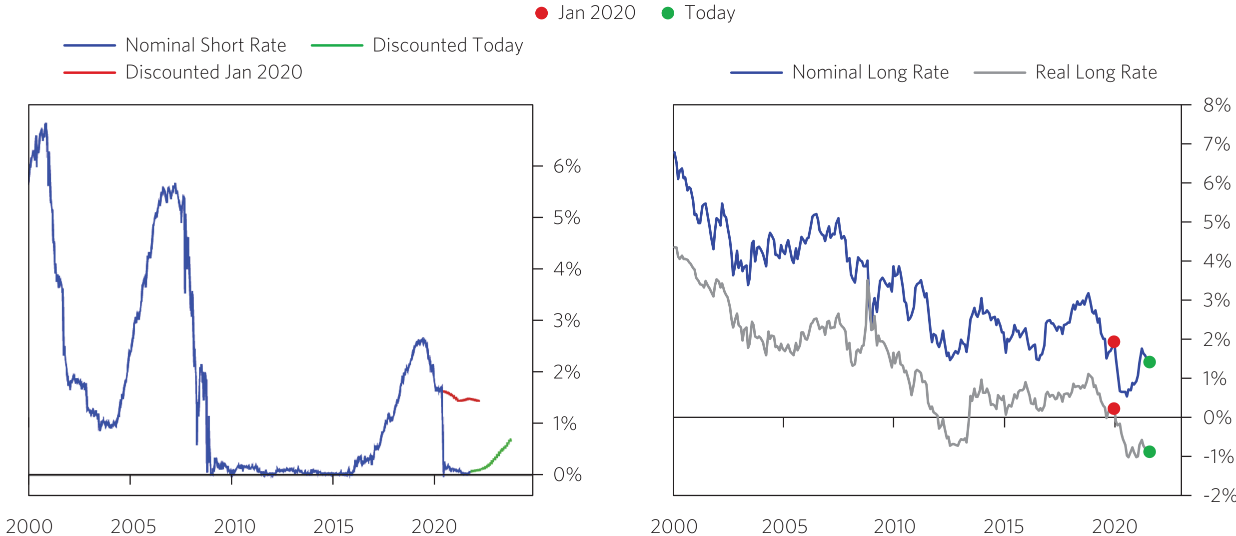


Overall, interest rate markets appear to be discounting a return to normal at the same time as underlying conditions have fundamentally changed, setting up some of the best trades we've seen in a long time. On top of that, rising interest rates are probably the biggest risk we see to most assets, so to us, a short treasury position has a high expected return and can probably hedge the biggest risk in financial markets today, which is that policy makers end up being limited by inflation/currency risk.

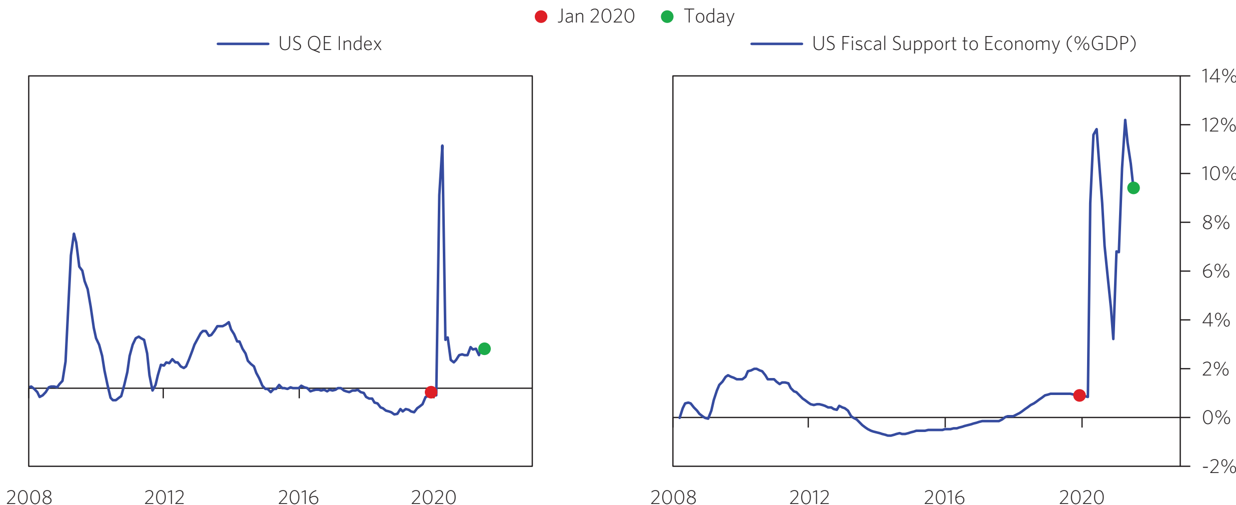
For more perspective on this pricing, below we walk through how radically different conditions are relative to what they were prior to the pandemic.

Monetary and Fiscal Policy Is Extremely Stimulative

As a result of the shift to the MP3 paradigm of near-zero interest rates and coordinated monetary and fiscal policy, the US economy now faces extremely stimulative policy relative to conditions. Short-term interest rates are near zero and priced to not change much for years. Long-term interest rates have fallen to lows, especially in real terms. This pricing is discounted to be much weaker than what had been priced in prior to the pandemic and does not reflect the huge underlying improvement that we are seeing across the economy.



Moreover, the US has entered an era of MP3 policy, which we expect to stay with us. Even with the economy recovering, the government is running historically large peacetime deficits, funded by QE that is roughly on par with the peak levels in the 2010s. Looking ahead, we expect that we have turned a corner where each new downturn will be met with further rounds of stimulus. The $4 trillion package of infrastructure and social spending that is likely to be passed by Congress even as the economy rapidly recovers is an indication that the attitude toward fiscal stimulus has evolved.



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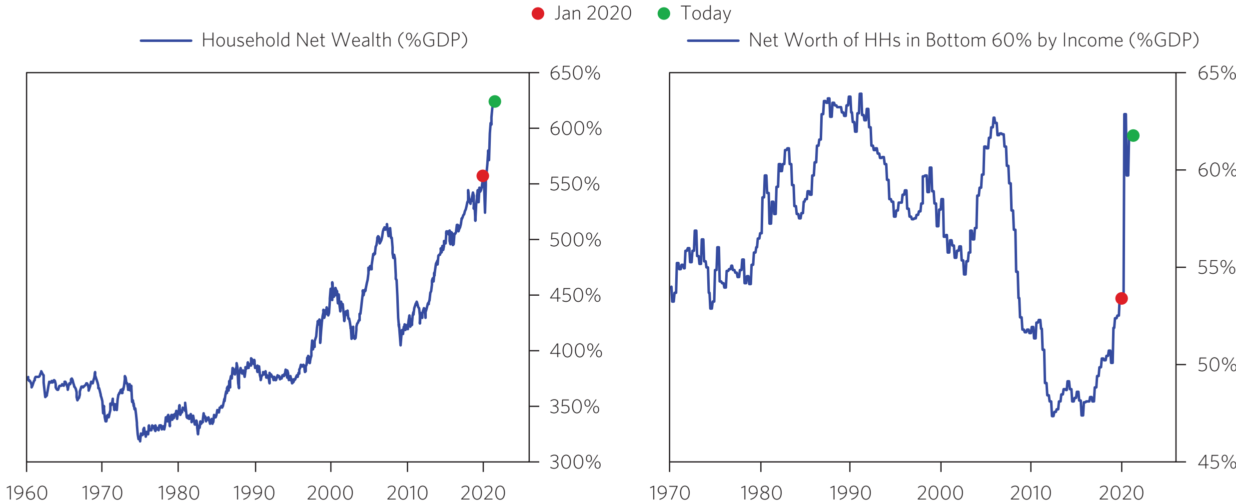
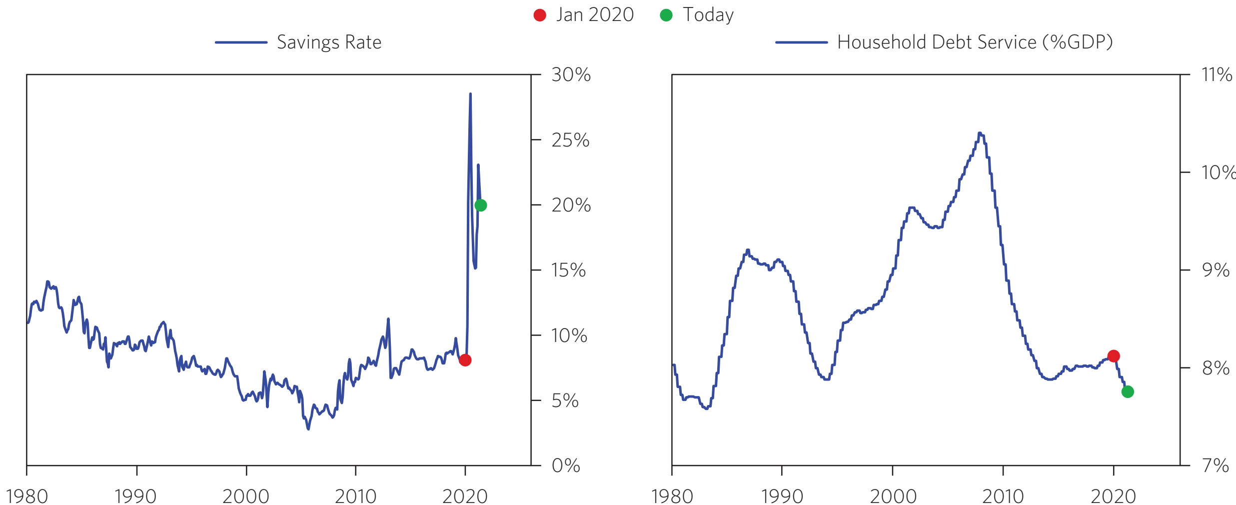
Policy Support Has Fueled Broad-Based Improvement in Household Balance Sheets

This policy shift is already having a transformative effect on households' ability to spend as well as tolerate higher interest rates. In the last decade, the gains from QE (MP2) accrued mainly to wealthy asset holders, who were marginally less likely to convert gains into spending. Today, the shift to fiscal stimulus means that the gains are accruing to a much wider income distribution. As you can see in the chart below on the right, the net worth of households in the bottom 60% is increasing at the fastest pace relative to incomes in recent history.



High savings rates today tell us that households have not yet gone back to normal spending behavior due to a combination of having more cash thrown at them than they can spend quickly and lingering effects of the pandemic. On the right below we show debt service, which had already fallen to low levels before the pandemic due to both lower household debt levels and lower rates. As we get past the pandemic, we expect that the combination of radically improved balance sheets, elevated savings rates, and accumulated cash will unleash an inflationary wave of spending into the real economy.



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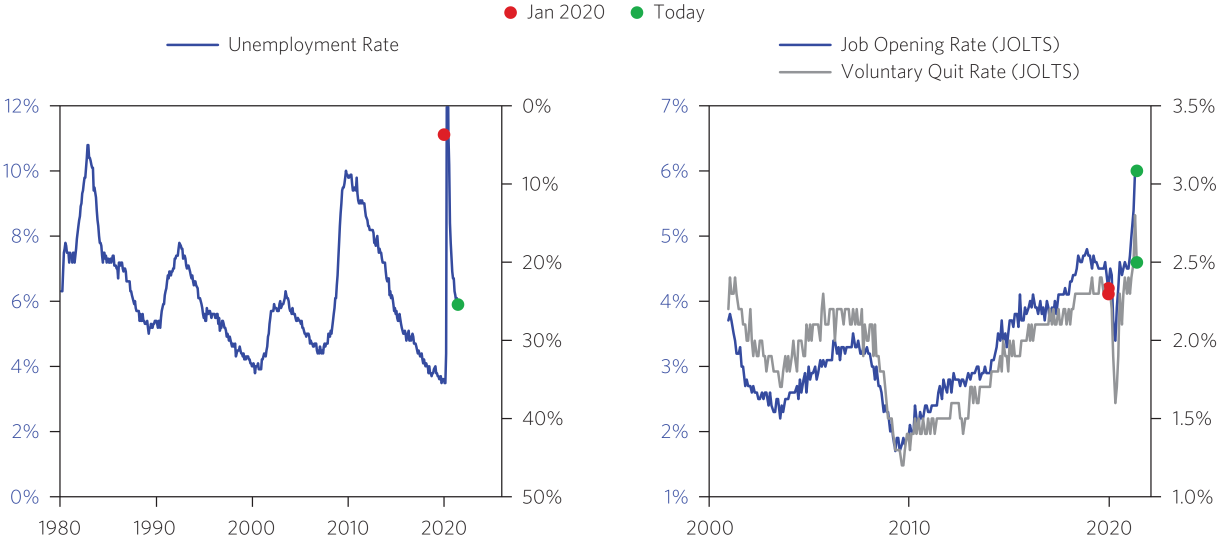
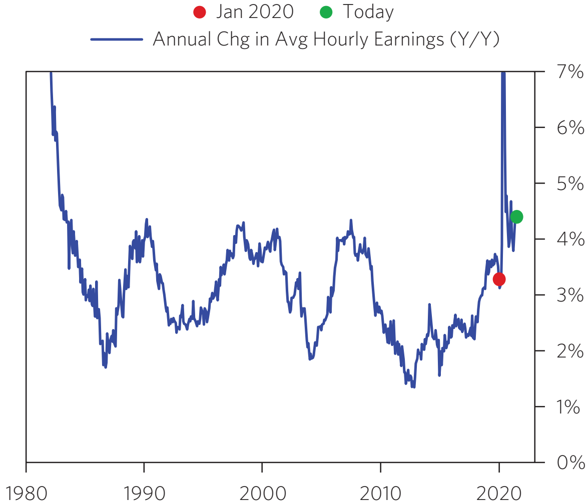
We Have the Tightest Labor Market in Decades

This wave of spending will hit labor markets that are already extremely tight, worsening the inflationary challenge. Despite unemployment being at 5.9%, job openings are at multidecade highs, as is the percentage of workers voluntarily quitting their jobs.



Early in the pandemic, the wage numbers were heavily distorted by lower-wage workers falling out of the labor force. But increasingly, this labor market tightness is starting to lead employers to raise wages in order to attract workers. A labor shortage with rising wages would present additional inflation risks.



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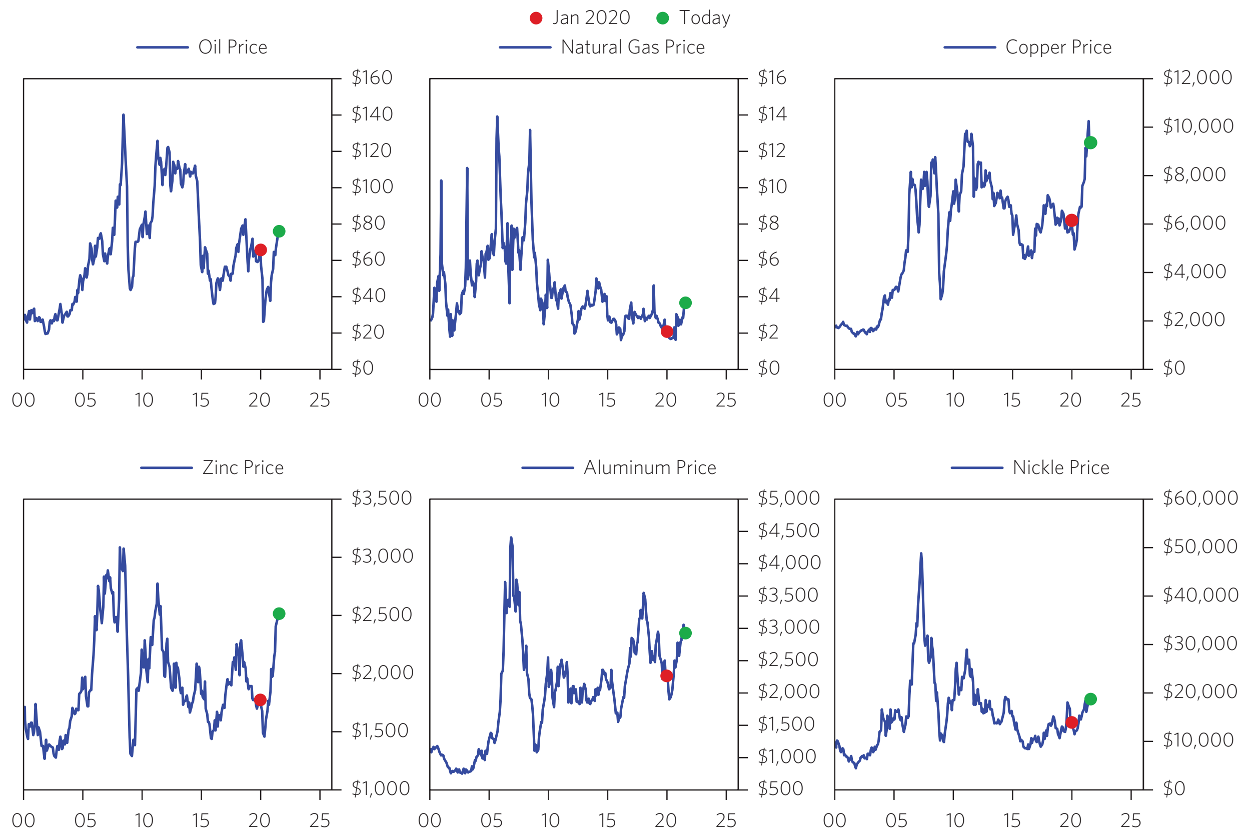
Commodity Prices Already Reflect Building Pressures

The rally across commodities over the last year both reflects and adds to these inflationary risks. On average, commodities are up 35% since the beginning of 2020, relative to 5% for a broad commodity index throughout the entire 2010s. The breadth of this year's rally across commodity markets only underscores the fundamental nature of inflationary pressures today. Prices of some commodities are still not as high as they were during the Chinese boom in the years following China's entry into the WTO, but they are all much higher than they were in the last decade.



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