Inflation Isn’t Going Away!
What Happens Next - 10/25/2023

Larry Bernstein:
Welcome to What Happens Next. My name is Larry Bernstein. What Happens Next is a podcast which covers economics, political science, and culture.

Today’s topic is Inflation Isn’t Going Away!

Our speaker is Boris Vladimirov who is a market strategist at Goldman Sachs. I have been a close friend of Boris for over 15 years, and I met him when he was a bond speculator for the macro hedge fund Brevan Howard.

I asked Boris to speak about what caused the recent surge in long-term interest rates. I want to understand the risk that the Fed’s interest rate hikes will cause a recession. And I want to know if the public’s expectation of future inflation will go back to 2%.

Let’s get started.

Boris Vladimirov:
These are my personal opinions only and I do not represent Goldman Sachs where I'm a market strategist with the global markets team.

Larry Bernstein:
In the past few weeks, bond yields have surged higher, particularly for longer dated maturities, what happened?

Boris Vladimirov:
We had a significant repricing of term premium, something that we have been puzzled that didn't happen in the aftermath of the inflation surge a year ago. It was pretty much a straight line since summer.

Larry Bernstein:
Term premium is what bond investors need to be paid in incremental yield for buying bonds with a longer maturity. One quick way of looking at this is the yield spread between 10-year bonds and 2-year bonds. This part of the yield curve had been severely inverted for the past year, and it is now much less so. Why is that?

Boris Vladimirov:
The curve was very inverted, and you can argue that different segments of financial markets were pricing different probabilities of recession, that there are models that tie the inversion of the curve with the probability of recession one year ahead.

There is a debate between bond and equities. In our recession probability model, the equities were pricing a 5% probability of recession in June while fixed income was pricing a hundred. Now equities are pricing 15 to 20 and fixed income has gone to 80, so there is a dialogue in the market about whether the Fed is too tight. I like to think in terms of fiscal versus monetary because the two policy interact and we tend to focus a lot on monetary because it is easy to observe.

So, this comes back again to the term premium repricing. You can think about it as the extra price that investors require for long duration. In the past there has been a clear correlation, especially between 1965 and 1995 where we had big surges in inflation with inflation leading term premium by a year.

So, the biggest conundrum post- the inflation surge of 21/22 was that term premium did not rise immediately. And even now we have repriced only to an adequate level.

Larry Bernstein:
10-year US Treasury interest rates have risen to 4.75% which was your interest rate target.

Boris Vladimirov:
We reached that target. So can we go further? Yes, but we think it's going to be more of a range here in consolidation unless we see another round of inflation, which we don't think is that likely.

Larry Bernstein:
What caused the previous inflation surge?

Boris Vladimirov:
Well, we had a shock that nobody had seen, right? I mean Covid with complete seizure of labor markets, unemployment, shooting initial claims, still when I do work on initial claims, I remove the Covid part of the sample because it just distorts everything. So if a policymaker is in this environment, you think that you have to throw everything you have at it, right? And as monetary obviously was limited, the zero lower bound, fiscal had to do the heavy lifting in Covid. That is what triggered a substantial fiscal response, which in US probably was substantially larger and more direct than in Europe. European fiscal responses were more guarantees than direct transfers. Economists like Jason Furman was saying the shortfall in demand was probably something like one to one and a half trillion.

We did substantially more than that because the situation looked abyssal. Since then, supply has normalized and demand has remained stronger, which is not atypical after big fiscal stimuli.

Larry Bernstein:
There is an appropriate time to use Keynesian fiscal stimulus and there's the wrong time. The right time is when you are in the depths of a terrible recession and the wrong time would be when you're near full employment and you're are having supply constraints. In January 2021, the Biden Administration passed a massive stimulus bill and an infrastructure bill at a time when we were headed for full employment. Economists like Larry Summers said this was a policy error at the time because it would likely result in inflation. What happened?

Boris Vladimirov:
When you look at the balance of fiscal and monetary, the paradox is that in the post-Lehman period we were saying all the burden is on monetary and fiscal is tightening and not doing enough to support demand. And now, we are seeing very high real rates and fiscal not tightening enough.

If we're talking about getting inflation from three and a half to two, the optimal way would be 3% fiscal tightening and 200 basis points lower front-end real rates. That would be the soft landing cycle. And I will refer to the work of Claudio Borio, at the BIS in the latest annual report that elaborates on these fiscal monetary balances.

Larry Bernstein:
I want to push back on your comment that real interest rates are too high. For the benefit of our audience, the real rate is the difference between the nominal fixed rate interest rate and inflation. The Fed Funds rate is 5.3% and the annualized Core CPI rate was 4.3%; therefore, the real rate is just 1 percent. Why do you consider 1 percent real rates contractionary?

Boris Vladimirov:
The way we look at it is the one year ahead pricing for Fed Funds minus the one-year breakeven inflation as the short end real rate and that is lower. So, the one year breakeven gives you the market expectations for the next 12 months, which would be probably reflecting the investment decisions, wage setting decisions that rational agents will be doing.

Larry Bernstein:
For the benefit of our listeners there are many inflationary indexes. There is the core CPI that the Fed says is their favorite benchmark and then there is the headline CPI that incorporates all goods and services including volatile oil and food prices.

Boris Vladimirov:
Headline does matter for policy; core is the preferred objective function because it's less volatile and it reflects the underlying demand trends in the economy better. You don't want to over calibrate based on a volatile item, right?

Larry Bernstein:
The market can miss rising inflation. The bond market certainly got inflation wrong the past two years.

Boris Vladimirov:
I agree with you. I look at broader sources of inflation estimates, particularly like the equity market. What we've been doing recently is looking at price earnings ratios and their relationship to long-term real rates and there has been quite a bit of divergence. So, we take that historical relationship and re-estimate from their implied inflation break evens, and that come at closer to 4% than two point a half percent.

Larry Bernstein:
The composition of the stock market indices is much different than 40 years ago when manufacturing and cyclical companies dominated the index. Today a third of the S&P500 is Apple, Amazon, Google, Facebook, and NVIDIA. These companies are not as sensitive to changes in interest rates. Can we use historical PE ratios if we have such greater tech composition in the index?

Boris Vladimirov:
Great question. And some of those companies are actually big savers. Some of the big equity names that have large cash deposits; they would be a big beneficiary from a positive front-end real rate in terms of cashflow, right?

The equity market is a lot less cyclical. The high multiples that those tech companies trade on reflect expectations about the impact of technology on future growth.

Larry Bernstein:
I thought that the interest rate sensitive cyclical stocks would have gone way down after the big rate hikes. But the home builders and auto manufacturers have done remarkably well.

Boris Vladimirov:
The employment side of the economy is still strong, so wage income has allowed the economy to sustain demand for interest sensitive products like houses and autos.

Years down the road? Our models show that when front-end rates go up, two to three years later, you start getting meaningful impact on the interest rate sensitive sector. So, 2024 from Q2 we think the labor market can start weakening, things may start looking quite different in those two sectors that you mentioned. Credit creation has slowed down significantly, particularly through the bank channel and if we do get some fiscal consolidation, which seems to be the current trend then those effects together will slow down demand probably quite meaningfully in the first half of next year.

Larry Bernstein:
Stable inflationary expectations are a wonderful public good. That may be over. One aspect of inflation is that some workers will get pay increases at different times.

Autoworkers are currently striking and demanding a 50% hike in wages and benefits. If this happens, the cost of a car will go up in real terms and other workers will then demand greater wages. This wage pressure will be ongoing.

Boris Vladimirov:
This is what we call second round effects, and this is what German Bundesbank always is vigilant on. These processes obviously happen in the economy. It is a matter of sectoral bargaining negotiation. The more immigration an economy has the less those process happen. There is a post-pandemic effect on participation which shows that the labor market is tight everywhere. Eventually we will have some second round effects and the only way to prevent another wave of higher inflation, we do need to have slower demand and as central bankers would say, we need to come down along the Phillips curve to a more sustainable level of unemployment in terms of the inflation objectives.

Otherwise if we have another round of inflation, we'll probably then effect long-term-inflation expectations. The backend then will not be so well anchored. G-10 unit labor costs are growing, three and a half to five and this growth of unit labor costs is not consistent with 2% inflation target.

Larry Bernstein:
During the past few months, as the bond yields have surged, the sell-off was all in the TIPs inflation linked notes. Long-term inflationary expectations have been relatively unchanged at 2.3%, why is that?

Boris Vladimirov:
This is a bit of a conundrum.

Larry Bernstein:
When you say a conundrum, you mean that you think the market is wrong about where inflation is headed?

Boris Vladimirov:
I think it's wrong. Yes, yes, you could put it that way, but at the moment, inflation expectations seem well anchored. Why? Because the Fed has been hawkish. They have been credible in their pursuit to achieve 2% inflation. My question about the backend inflation breakevens is more about the question about the inflation target and whether in a structurally different world from the last 30 years we should still be using the 2% benchmark as our focal point.

Larry Bernstein:
I want to push back about the Fed's credibility. The Fed has a 2% inflation target, and the US CPI headline hit 10 percent. The next year we are going to get 5%. The Fed said inflation was transitory for nearly a year before raising rates materially. We are still significantly above target. You just mentioned changing the Fed's targeted inflation rate. What credibility are you talking about?

Boris Vladimirov:
The memory of the current existing market participants doesn't stretch back to the seventies and 2% inflation is all they've seen, and that shock is not taken as a paradigm shift. It's taken as a one that is going to reverse.

The truth is that there is no equilibrium level of inflation in the economy. There is equilibrium level of real growth. You can reset an economy to any inflation level you want. Just to take an example, a recent MIT paper on financing deficits saying that you don't have to have high taxes as long as you run loose fiscal long enough, your growth is going to catch up to your debt levels and your debt to GDP is not going to be unsustainable. This has one caveat. This happens at higher and higher and higher inflation rate if you do that strategy. We've seen that in a number of emerging market economies.

Larry Bernstein:
So, if you print enough money then you can payoff your debt with worthless currency. That sounds like a recipe for disaster.

Boris Vladimirov:
Turkey in the previous monetary administrations what they were doing is they were lending generously to state banks, which were lending to the economy. What was happening? Inflation went from seven to 16, from 16 to 25, then from 25 to 60.

Larry Bernstein:
Anyone in Turkey believe they'll get back to the 2% target?

Boris Vladimirov:
I think that probably is a stretch, but I think under the current policy administration there is a good reason to believe that they're going to start rolling down from 60 to 30 that would be a major achievement and then from 30 to 15 and the big fight will be to get it below 10%. It's always the big fight.

Larry Bernstein:
Are there any long-term structural issues that will impact the level of long-term inflation?

Boris Vladimirov:
Deglobalization will be splitting the global economy in two halves; trade will be disrupted. So we need to invest in the two blocks and that will also mean that unit labor costs will not equalize as fast as they did during the globalization period adding to some higher inflation. Automation and artificial intelligence are important deflationary forces. I am a skeptic to that as the impact of the Baumol effect, which stipulates that the productive sectors of the economy shrink.
If you go back to a hundred years, agriculture was 85% of GDP, 90% of employment. If you went back in time and told them in 200 years, you'll be 1% of employment and 4% of GDP.

Larry Bernstein:
What are people going to do?

Boris Vladimirov:
It's crazy, right? Agriculture was the biggest positive productivity shock that we've seen. So, which industries are going to be affected by AI in that respect? And you can argue that there'll be plenty of them and that there are relative share will have to shrink and new industries will emerge. I don't think that we can make a credible expectation about inflation expectations on the basis of our AI assumptions.

Larry Bernstein:
The Bureau of Labor Statistics released the September employment report last Friday and the headline number showed an increase in employment of 336,000. The labor market has been incredibly strong and resilient despite the dramatic increase in short term interest rates. The JOLT survey of job openings still suggests that there are millions of job openings, what is going on?

Boris Vladimirov:
JOLTs are still way too high, even though the interest rate sensitive sectors are shedding a bit more labor than before, those workers are finding a new job quite quickly. However, wage growth has started to moderate. So, if you look at average hourly earnings, they have started to print 0.2% increases/month.

Larry Bernstein:
Boris, any speculative recommendations for the fixed income market?

Boris Vladimirov:
Paying 10-year inflation swaps that's the bottom line.

Larry Bernstein:
Just to clarify what that means for our audience, based on current market prices, the expected headline CPI for the next 10 years is 2.3%. Boris thinks that inflation will be higher than that. For those of you at home with a bond portfolio who cannot enter into derivative transactions, Boris would be recommending that you invest more money in TIPS which are inflation indexed bonds than fixed rate bonds.

Boris Vladimirov:
Look, I don't want to make any investment advice here. I'm not in that function.

Larry Bernstein:
That said, should we be buying stocks now that you think interest rates are range bound?

Boris Vladimirov:
I probably can be a bit patient there to get a bit more of the quantitative tightening going through over the next six months, but I would say get ready next March and April in the seasonal dip in stocks to buy some.

Larry Bernstein:
Thank you very much.

Boris Vladimirov:
Pleasure as always.

Larry Bernstein:
Thanks to Boris for joining us today.

If you missed last week's show, check it out. The podcast was Running for President!

Our guest was Asa Hutchinson who is the former Governor of the State of Arkansas. Asa is running for the Republican Nomination for President of the United States. Asa described what it takes to run for president in this election, what the critical policy issues will be, and how to beat the front-runner, Donald Trump.

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Thank you for joining us today, good-bye.