What Happens Next – Sunday May 9, 2021
Stupidity of War, Inflation, Brooklyn, Cultivating Influence, & Bottle Service
Lewis Alexander

Larry Bernstein:
We're going to move on to our second speaker now, Lewis Alexander, who is Chief US Economist and had a fixed income research for the Americas at Nomura Securities. He will be talking about inflation. Fire away, Lewis.

Lewis Alexander:
I'm going to make three broad points. The first point is that this question matters, in particular, it's very important for financial markets. The second point I want to make is inflation, in the short run, is going up and people need to be prepared for that. But the third point is this is a temporary thing, we think. This is not the beginning of a new inflationary era.

The broad arc of inflation in the US has been inflation accelerated in the mid-1960s, it accelerated through the 1970s. The turning point was really Volker's appointment to the Fed in '79. During the 1980s and 1990s, inflation was essentially trending lower under the Fed's guidance. But since around 2000, inflation has moved up and down over short periods of time, but the trend has been very stable.

During the '70s, '80s, and '90s, the Fed had to be focusing on containing inflation, but since 2000, the Fed has been able to focus more on stabilizing output. This shift in the Fed's focus has had a major impact on financial assets. Since roughly 2000, stock and bond prices have been negatively correlated. During this period when something bad happened, something that was bad for economic activity and corporate earnings, the Fed tended to lower interest rates and vice versa. Hence, the negative correlation between stock and bond prices.

Now, a negative correlation between the two primary asset classes lowers risk in diversified portfolios. Before 2000, stock and bond prices tended to move together. The shift in the stock-bond correlation has contributed to the long-term trend of declining risk premium across a wide range of assets. If in the future the Fed has to focus more on containing inflation, and consequently its less free to stabilize output, risk premium is likely to have to rise. This, I would argue, is why financial markets are so sensitive to this question, why they're so sensitive to the prospect of inflation.

Now, in the short run, inflation is definitely going up. On Wednesday, we are going to get new data for consumer prices for the month of April. We expect that the rate of inflation, excluding food and energy, measured over 12 months, in the data released on Wednesday is going to be 2.4%. That's up from just 1.3% in February. While the pace of this increase may seem alarming, it's important to recognize that it's being driven in part by what happened last year. Last spring, as the economy locked down, many prices fell sharply. Then, from June through August, they recovered substantially. The sharp declines from the height of the lockdown period in

essentially April and May of last year are starting to drop out of the 12-month window. Once we get beyond these sharp swings of April to August last year, we think the trend in inflation is going to move back to around 2%.

But while the acceleration we are seeing right now is to some degree a reflection of what happened last year, it's also a reflection on things that are happening right now. We expect the month-on-month change in core prices to be 0.4% for the month of April alone. Obviously if you annualized at that rate, that's around 5% for the year. We obviously don't think that's going to continue, but that's an indication of what's going on right now. This current surge reflects a variety of things.

First of all, COVID increased the demand for many things. That surge in demand has stretched existing supply chains beyond capacity. One example is semiconductors. COVID increased the demand for basic PCs, but semiconductors are also now critical inputs to many consumer products. In addition, there have been some odd things, like bad weather in Texas and a drought in Taiwan, that have disrupted critical parts of the semiconductor supply chain. The bottom line is a lack of supply of basic semiconductors is concerning production across a variety of sectors, everything from core IT goods to cars.

Now, a second factor that's driving up inflation right now is demand in COVID affected sectors, such as travel, is now recovering. We expect a recovery in prices in those sectors in coming quarters, and that's going to be part of this near-term surging inflation.

And finally, aggregate demand is just growing very rapidly right now. That is because as the concerns over COVID fade, you're seeing a kind of opening up, and that's generating a surge in aggregate demand, but also there's obviously been significant policy support for both monetary policy and importantly fiscal policy. All of those things are generating the surge. Now while inflation is going up in the short run, I do want to emphasize that we think that this is not a break of the pattern we've seen over the last 20 years. In other words, we expect this burst of inflation to be temporary.

Why do we think that? Well, first of all, the primary factors that are driving up inflation right now are likely to prove temporary. For example, the shortages of semiconductors, we think is probably going to be addressed by the fall. This is more extreme than we've seen in the semiconductor industry for a while, but we have seen this pattern in the past, and the industry is actually pretty flexible.

Another element which is important to our outlook is the fact that we think fiscal support is going to wane quickly. That really reflects the fact that all the fiscal support that's been provided up until now is going to spend out incredibly quickly. So, for example, the $1.9 trillion American recovery plan that Congress passed just a few weeks ago, CBO estimates that $1.2 trillion of the $1.9 trillion is going to spent out before the end of September. What that means

is we are on a very steep cliff, in terms of that support waning going forward. And in spite of everything that's going to be done from here going forward, that stuff is likely to spend out over a much longer period of time, and will just soften the blow.

Another important part of our judgment is that we think that the factors that have contained inflation over the last 20 years are likely to persist. That includes things like the shift of the economy to being focused on things like IT related services and the flexibility that that brings. We are no longer a goods dominated economy, and that services dominated economy, particularly IT services, is just fundamentally more flexible. Globalization, while we think it's going to be reduced to a degree, is largely, we think, going to be maintained. Moreover, I would argue the supply of low wage labor is something that is going to continue to help contain pressures. And while yes, there is a transition going on in China, we think places like India and, ultimately, potentially Africa can be a substitute.

In this context, we think inflation expectations are going to go up a bit, but we think they're going to remain broadly consistent with defense objectives, and that means the Fed can continue to focus on stabilizing output. I think it's worth remembering that in the two years before COVID, inflation was actually falling, in spite of the fact the US labor markets was very tight, in spite of the fact that we had very strong aggregate demand supported by fiscal stimulus because of the Trump tax cuts, and even with the supply disruptions that came from Trump's trade policy. So, we are in for a burst of inflation, but I don't think it's something that's going to persist.