AHE
Ad-Hoc Economics

WHITHER INFLATION?

The economic downturn that follows the Great Lockdown will be unlike any before it. Large sections of the economy were forcibly shut and there have been dramatic spikes in unemployment. Substantial economic support packages were introduced. Now, as economies reopen, whole sectors have to adapt their business models to meet social distancing requirements.

These countervailing forces make it difficult to accurately predict the path of inflation. Normally, a negative demand shock weighs down on prices, whereas a negative supply shock has the opposite effect. COVID-19 has adversely affected both demand and supply. The impact on inflation after other economic shocks has often been more straightforward to assess. The Great Depression was deeply deflationary as monetary policy was constrained by the gold standard. The 1973 oil crisis was highly inflationary due to a contraction in the supply of oil.

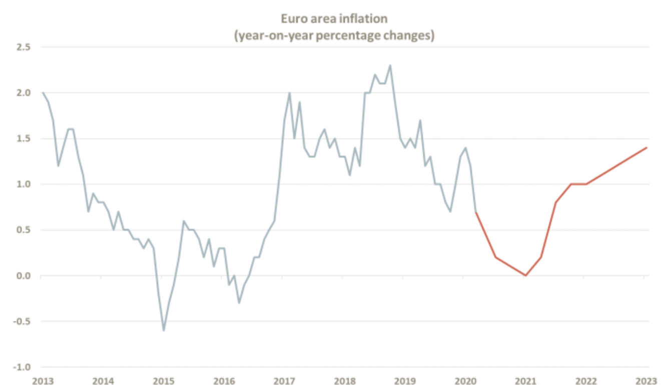
Job losses and falls in income

In March, many workers were sent home as the virus shuttered large parts of the economy. Governments stepped in to subsidize wages and enhance welfare payments. Despite this, many households have seen their incomes fall as furlough schemes only partially replaced wages. Many workers have also lost their jobs. In the US, the unemployment rate has hit 13.3% and is likely to remain high even as the economy reopens. With people out of work, pressures to raise wages are lower, suppressing costs and prices. Falls in household income will also reduce demand, meaning businesses are less able to raise prices. This will weigh down on inflation. Lower commodity prices will also feed through into lower prices. Commodity prices remain well below where they were at the beginning of the year, driven lower by reduced global demand and a Russian-Saudi oil price war. This will translate into lower consumer prices.

Economic uncertainty

Some have argued that pent-up demand will lead to inflation as lockdown restrictions are lifted (or after a vaccine is found) and lead to inflation (or after a vaccine is found). However, with ongoing uncertainty it is unlikely to temper any increase in demand. In the absence of a vaccine, people will remain wary of the virus. This fear won't vanish as lockdown restrictions are eased: demand for restaurants had fallen sharply even before legally enforced lockdowns were brought in, for example.

Any uncertainty about the virus will amplify economic uncertainty. As the path of the epidemic remains unknown, households will worry about future income and job prospects, moving to increase savings. Savings rates have jumped substantially during the lockdown, and Lawrence Summers, former advisor to President Obama, argues a higher savings rate will endure. Higher saving will reduce household spending, suppressing inflation. The European commission estimates that the household savings rate will rise to a record 19% this year (from 12.8% last year), before remaining high at 14.5% next year.



Source: FRED, ECB, Clarus Capital

The scale of economic interventions

There are also some who worry that the interventions introduced by governments and central banks will eventually fuel inflation. The Federal Reserve has increased its balance sheet by over 67% since the start of March, much of it by purchasing government debt.

There were similar fears that QE programmes after the Global Financial Crisis would cause runaway inflation. This didn't happen. Instead of increased lending, banks used central bank money to increase reserves and shore up balance sheets. Monetary stimulus didn't reach the real economy in the quantity needed to spur inflation. In addition, much of the increase in fiscal spending is temporary - wage subsidy schemes will be tapered away as economies recover, for example. The increased fiscal spending is intended to protect jobs and livelihoods during lockdown rather than to stimulate the economy. This makes it unlikely that fiscal spending will fuel inflation in the short term.

AHE
Ad-Hoc Economics

Inflation, however, might build up in the longer term if monetary policy were to become subordinate to fiscal policy. A situation might arise where economies had begun to recover making it necessary for central banks to tighten policy. Given the level of debt accrued by governments, any raising of rates would make these debts more costly to bear and might prove unpopular with politicians. Olivier Blanchard, former chief economist at the IMF, has suggested that if central banks were to buckle to political pressure, they might not increase rates, choosing instead to keep government debt service costs low. Central banks would renounce their independence, economies would overheat, and inflation would follow.

Deflationary prospects

Even before COVID-19, many central banks were struggling to hit their inflation targets. While interventions by governments and central banks have supported incomes, weak economic conditions, uncertainty and lower commodity prices make it likely central banks will continue to have trouble meeting their targets in the short term.

Although not a perfect gauge of inflation expectations, markets are indeed pricing in lower inflation. Expectations are for inflation in the US to average below 1% over the next five years. A drop in inflation is also forecast for the eurozone, with growth in prices not much above zero over the next 12 months. Indeed, there are worries that economies might slip into deflation. This would harm recovery and make debt burdens less sustainable. A deflationary spiral would also be hard to break if Japan's experience over the last 3 decades is anything to go by. Compared to the prospect of deflation, higher than expected inflation might be welcomed.

Written by Thomas Schiller, Ad-Hoc Economics

http://www.adhoc-economics.ch

DISCLAIMER

This document has been prepared by Clarus Capital Group AG ("Clarus Capital"). This document and the information contained herein are provided solely for information and marketing purposes. It is not to be regarded as investment research, sales prospectus, an offer or a solicitation of an offer to enter in any investment activity or contractual relation. Please note that Clarus Capital retains the right to change the range of services, the products and the prices at any time without notice and that all information and opinions contained herein are subject to change.

This document is not a complete statement of the markets and developments referred to herein. Past performance and forecasts are not a reliable indicator of future performance. Investment decisions should always be taken in a portfolio context and make allowance for your personal situation and consequent risk appetite and risk tolerance. This document and the products and services described herein are generic in nature and do not consider specific investment objectives, financial situation or particular needs of any specific recipient. Investors should note that security values may fluctuate, and that each security's price or value may rise or fall. Accordingly, investors may receive back less than originally invested. Individual client accounts may vary. Investing in any security involves certain risks called non-diversifiable risk. These risks may include market risk, interest-rate risk, inflation risk, and event risk. These risks are in addition to any specific, or diversifiable, risks associated with particular investment styles or strategies.

Clarus Capital does not provide legal or tax advice and makes no representations as to the tax treatment of assets or the investment returns thereon, either in general or with reference to specific client's circumstances and needs. Recipients should obtain independent legal and tax advice on the implications of the products and services in the respective jurisdiction before investing. Certain services and products are subject to legal provisions and cannot be offered world-wide on an unrestricted basis. In particular, this document is not intended for distribution in jurisdictions where its distribution by Clarus Capital would be restricted. Clarus Capital specifically prohibits the redistribution of this document in whole or in part without the written permission of Clarus Capital and Clarus Capital accepts no liability whatsoever for the actions of third parties in this respect. Neither Clarus Capital nor any of its partners, employees or finders accepts any liability for any loss or damage arising out of the use of all or any part of this document. Source of all information is Clarus Capital unless otherwise stated. Clarus Capital makes no representation or warranty relating to any information herein which is derived from independent sources. Please consult your client advisor if you have any questions.

IMPRESSUM

IN COOPERATION WITH CLARUS CAPITAL GROUP AG, GUTENBERGSTRASSE 10, CH-8002 ZURICH, RESEARCH@CLARUSCAPITAL.CH, WWW.CLARUSCAPITAL.CH

ROGER GANZ, HEAD ASSET MANAGEMENT, DEJAN RISTIC, HEAD EQUITY & FX, MARKUS METTIER, HEAD FIXED INCOME