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Inflation: Grendel in Hiding

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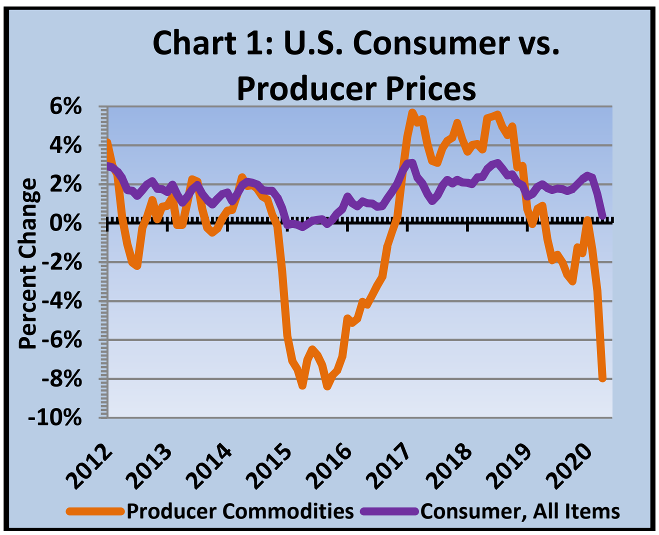
I've been re-reading Seamus Heaney's marvelous translation of the Old English epic *Beowulf* lately; with too much shelter-in-place time on my hands, I suppose I was hoping a literary adventure would enliven the hours. I was surprised when I discovered that Mr. Heaney's descriptions of the brutish antagonist Grendel took me in an entirely different direction. The poet introduces the monster thus:

> *… a fiend out of hell*
> *began to work his evil in the world.*
> *Grendel was the name of this grim demon*
> *haunting the marshes, marauding 'round the heath*
> *and the desolate fens; … [as] the day broke*
> *Grendel's powers of destruction were plain:…*
> *Malignant by nature, he never showed remorse.*
> *No counsellor could ever expect*
> *fair reparation from those rabid hands.*[1]

From my perspective as an investment manager, this depiction was instantly familiar: *Inflation.* Investors have been taught for generations to fear the unstoppable scourge of inflation, which could wipe out savings and ruin the incomes of millions of people quickly and without remorse; no investment counselor could ever expect to win that battle.

This may seem an odd time to be thinking about inflation; after all, the consumer and producer price index reports last week both showed inflation dropping sharply in the wake of record job losses and economic shutdown. The Consumer Price Index rose only 0.4% from a year ago, held back by plunging oil prices and by collapsing consumer spending. Three months ago, the CPI had been a healthy 2.4% (Chart 1). Worse, producer prices have fallen 8% over the past year, and the Producer Price Index hasn't been meaningfully above zero in a year. Inflation would seem to be the last thing worth discussing today.



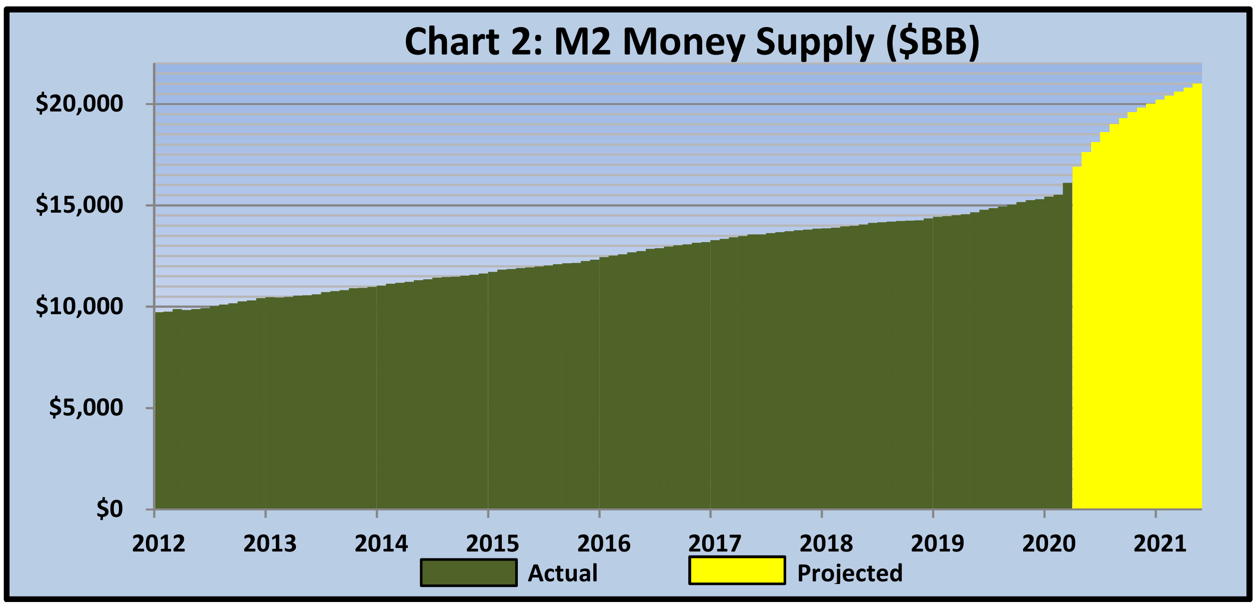
Source: Bureau of Labor Statistics

[1] Lines 100-104, 116-117, 137, 157-158.

The evidence in Chart 1 suggests that perhaps the SARS-CoV-2 virus has done what countless Beowulf wannabes at the Federal Reserve could not. *Grendel has been defeated! Inflation is dead!* But CPI has been near zero before, and PPI has been below -8% before, only to recover quickly; the most recent such episode was only five years ago when oil prices dropped from $110 to $26 per barrel and then bounced back.

In fact, there are several trillion reasons to think about inflation now, as the Federal Reserve and Congress have flooded the economy with money. Since the time of the Spanish conquest of Mexico and its gold, vast increases in the money supply have almost invariably led to disastrous inflationary episodes in which prices soared and standards of living plummeted. Modern examples include the interwar Weimar Republic in Germany, and 1990s Argentina before it pegged its peso to the U.S. dollar.

There's no question that the growth in the money supply has accelerated in response to fiscal and monetary response to Covid-19, as shown in Chart 2. As the full impact of the federal government's coordinated programs filters through the economy, the money supply is likely to surpass $20 trillion in fairly short order.

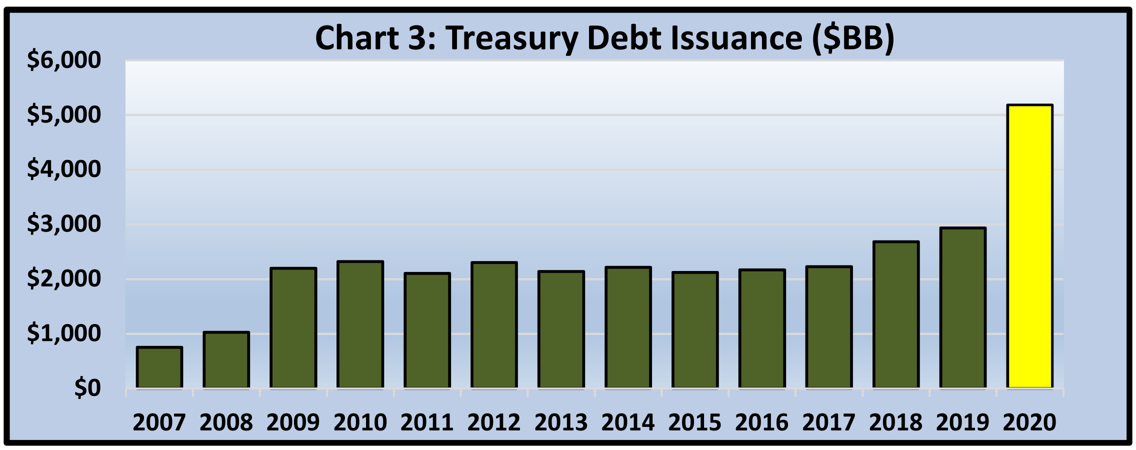


Source: Federal Reserve, Eastern Bank Wealth Management

The Federal Reserve has created or revived over a dozen major new programs in recent weeks designed to ensure the smooth functioning of the nation's banking and financial market systems. For the most part, they are open-ended: Chair Jerome Powell reiterated yesterday that the Fed has nearly unlimited capacity to "print" as much money as it thinks is needed, unlike in the 2008 financial crisis when the central bank's programs were capped. In 2008, the Fed's "quantitative easing" programs expanded its balance sheet from $600 billion to $4 trillion of securities held; aside from a brief period of "quantitative tightening" a couple of years ago, that's pretty much where the Fed started 2020. We think the Fed's intervention in U.S. securities markets and its new direct lending programs may collectively add another $6 trillion to the balance sheet (and the nation's money supply) by year-end 2021.

Congress is also committing enormous sums of money to get the economy back on track. The CARES Act provided for $2 trillion of lifeline payments and investments, and late Friday the House of Representatives passed a $3 trillion supplement. It seems highly unlikely that the Senate would agree to the new House bill, and President Trump has already signaled he would veto it. Even so, the states and municipalities desperately need help, so a modified version is likely to be enacted, perhaps "only" $1 trillion.

To pay for the CARES Act and possibly a second major bill, the Treasury must issue debt. As shown in Chart 3, the Treasury is on pace this year to double its previous record-high issuance of debt, and that's just for programs already enacted into law. Taking Congressional and Federal Reserve action together, the aggregate M2 measure of money supply may grow by as much as 50% over the course of the next 18 months to about $22 trillion. With output shrinking in a deep recession, how can that *not* lead to a massive bout of inflation?



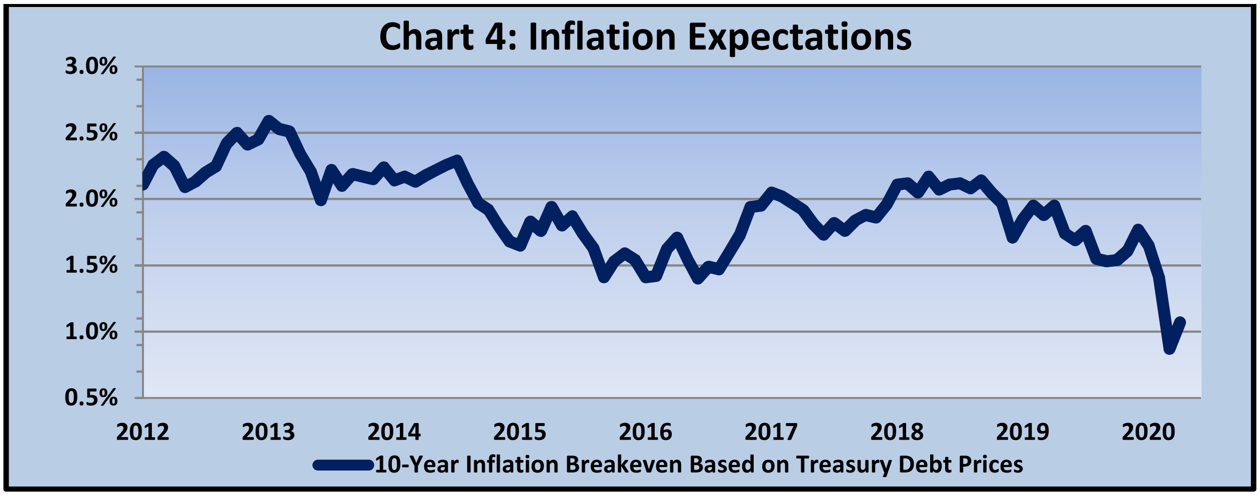
Source: Treasury Department, Eastern Bank Wealth Management

Yet despite the unprecedented increase in the money supply, investors and economists don't expect any uptick in inflation for the foreseeable future. The reason is that price changes depend on both the money supply and the pace at which money changes hands – the *velocity* of money. Consumer spending has fallen sharply (down about 23% from February to April), as supply remains elevated while demand has plunged. We still have plenty of things to buy; there is a huge excess supply of theater seats, retail merchandise, appointments for dental care, oil-derived products,[2] and so much more. But with the economy on lockdown, we can't use any of it.

Even as the economy reopens, we may just not *want* any of it, for the eminently logical reason that we're scared to open our wallets. Demand disappears when we lose our jobs or our salaries are cut. More than 36 million Americans are now out of work, and millions more have accepted pay cuts from cash-strapped employers. The vicious cycle worsens, as absence of demand leads to surplus capacity being removed from the economy: Shops and restaurants close, oil wells are plugged, theaters go dark, more jobs are lost. Fear of bankruptcy is genuine and rational. Stalled money velocity, in other words, offsets higher money supply, and so inflation remains low.

[2] The colossally stupid timing of the Russo-Saudi spat sent oil production soaring at precisely the time that it should have been shrinking; the resulting collapse in the price of oil will take a long time to resolve.

This isn't just a short-term adjustment to temporary conditions. Investors expect that current disinflationary trends will remain in place for a long time to come. Chart 4 shows the expected ten-years-forward level of inflation. By comparing the prices of 10-year Treasury bonds and TIPS at any given point in time, it's possible to infer the inflation rate that investors expect over the following ten years from that point. In recent years, Treasury and TIPS prices implied between 1.5% and 2.5% inflation over the following decade; today, it's down to 1.0%.



Source: Federal Reserve

The bond market is telling us that extremely low inflation will persist not just through the remainder of this recession, but throughout the next ten years. Markets are sometimes wrong, of course, but perception can alter reality: Merely expecting low inflation can perpetuate low inflation, even when conditions might otherwise allow for faster price increases.

And yet … perhaps Grendel is merely hiding in his den, awaiting a more propitious time to wreak his pervasive and pernicious predation on our purchasing power. People have a natural tendency to extrapolate current conditions into the future, when sometimes it is more likely that conditions will change before too long. During times of relatively high inflation, the inflation-expectations gauge in Chart 4 tends to overestimate future CPI, and during times of relatively low inflation (like today), these measures have usually missed to the low side.

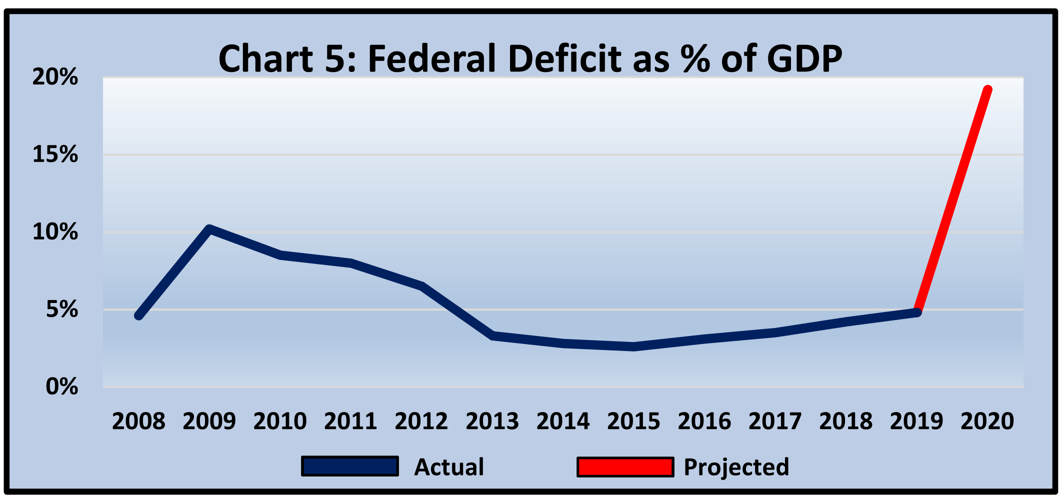
Indeed, it's not hard to imagine why inflation might accelerate rapidly once the economy is back at full strength. If money supply is the kindling wood, we see at least four possible matches that could spark the fire. From the most immediate to the most long-term, these catalysts are:

- **Supply chain problems.** As the world's economies reopen, several companies have reported that demand for their products is improving rapidly, but that they are having difficulty sourcing needed components and materials to keep their production lines moving. Shortages of some critical items can lead to price gouging for those items and to downstream shortages of the products that contain them – which leads to price hikes for those downstream products, too. If demand returns more quickly than companies can work out these supply chain issues, consumers may see higher prices very quickly.

- **Capacity utilization.** Aside from some short-term shortages, incremental demand growth as the world emerges from lockdown can easily be met, because we have plenty of slack production capacity. An uptick in demand in most cases therefore won't lead to higher prices. But as that slack production capacity is put to use, eventually a new capital spending cycle will begin. Whether it's restaurant seats or new cars, demand may rebound faster than supply can adjust, especially if structural changes (like plexiglass shields, wider spacing of theater seats, extra time for cleaning, etc.) are required. This may occur sooner than some people think, since so much productive capacity will have been removed from the economy during the recession.

- **Productivity.** Inflation has been on a downward trend for 30 years, despite three long economic expansions during that period. One reason is the explosion of productivity tools as more of our economic activity has shifted online. Services like Google and Amazon (and hundreds more), along with better energy efficiency, have enabled us to get more for less, offsetting price increases in areas like health care, shelter, and wages. Covid-19 may have interrupted this long-term trend. Politics may also disrupt productivity, especially if Congress or the courts attempt to break up large tech companies.

- **Modern Monetary Theory.** An increasingly popular concept in the academy, MMT suggests that governments can run deficits forever if they control their own currency. An implicit assumption is that investors will always buy newly issued debt because they know that governments can print new money and thus won't default on the debt. This effectively leads to "monetization" of the national debt, i.e. forcing inflation higher to cover the government's debt service costs.[3] Chart 5 shows that MMT is alive and well, as the federal deficit has soared this year in relation to the overall size of the U.S. economy.



Source: Morgan Stanley

[3] The fallacy underlying MMT is that investors may one day decide *not* to buy new government debt issues, if they begin to fear that the government won't be able to pay the coupons without triggering inflation. That can lead to stagflation, i.e. higher prices combined with economic recession. Like "portfolio insurance" in the 1980s, MMT probably will work well until suddenly and spectacularly it doesn't; instead of a 22% one-day 1987 stock market crash, the failure of MMT might be seen on some future day in a spike in interest rates and plunge in bond prices.

As the U.S. economy begins to reopen, investors will be watchful to see how these factors begin to play out: how quickly unemployed workers are rehired (our guess: more slowly and at lower wages than before Covid-19); whether and how we resume our old spending habits; whether American companies hit snags as they ramp up their production levels; how the bond market responds to massive issuance of Treasury debt; and how the politicians treat the tech behemoths.

We know that inflation can come back; Grendel isn't dead. We also know that if inflation does return, the ravages would be widespread:

> *All were endangered; young and old*
> *were hunted down by that dark death-shadow*
> *who lurked and swooped in the long nights*
> *on the misty moors; nobody knows*
> *where this reaver from hell roams on his errands.*[4]

Congress can act against a hypothecated surge in inflation. The 2017 tax cuts are slated to expire in 2025, and one way to slow inflation would be to accelerate that schedule: Raising taxes would brake inflationary pressures and show investors that the government takes its creditworthiness seriously, but at the cost of restraining economic growth. It's doubtful that Congress could assemble enough votes to enact a timely tax hike to forestall an inflationary spiral.

So where will we Geats find Beowulf when we may need him? Fed Chair Powell is well armed for battle with Grendel. If evidence begins to emerge that the velocity of money is beginning to accelerate – that is, if the bloated money supply begins to translate into higher prices – the Fed has ample tools to keep inflation in check. It can sell some of its securities holdings back into the marketplace; that would siphon cash out of the economy, raise interest rates, and slow the pace of price increases. It can re-impose tighter controls on banks, which would serve to reduce leverage and borrowings, to the same effect. Indeed, it can reverse any or all of the extraordinary measures it has implemented to preserve smoothly functioning markets during the pandemic.

Ultimately, the bond markets probably have it right: The economy is too weak today to sustain any inflation in the next few years, and a watchful Fed is well able to handle any future threat as well. We have many economic problems on our radar, but inflation just isn't one of them.

[4] Lines 159-163.