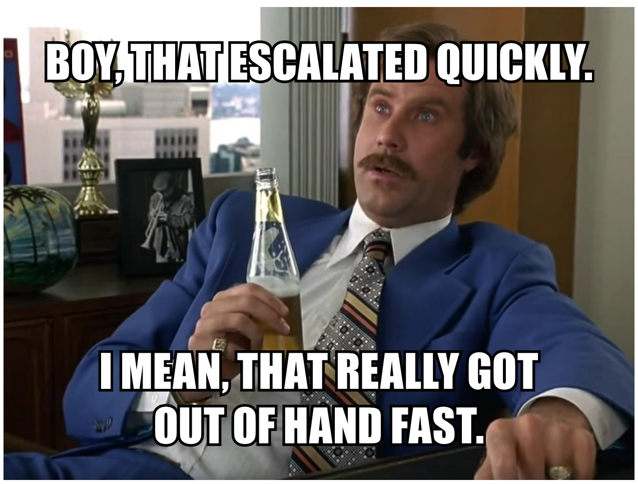
# That Escalated Quickly

**August 12, 2021** | Drew Schardt, Head of Global Investment Strategy & Head of Direct Credit

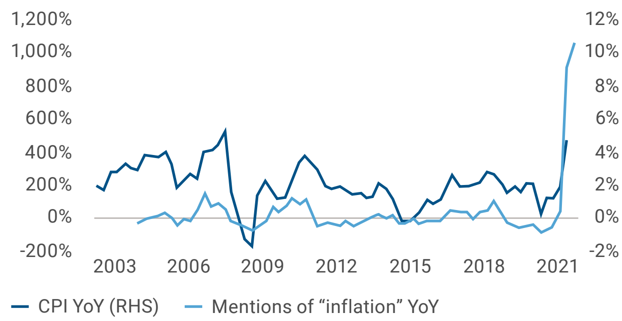



Who knew that the comedic genius of Mr. Ron Burgundy would capture the spirit of a multifaceted topic so well? And what is that topic, you ask? Well, what is nipping at the heels of COVID, QAnon, SPACs and WFH as the most discussed subject? Inflation. And the escalation of chatter around rising prices doesn't look like it will subside anytime soon.

Let's admit it, no one really saw that one coming a year ago. Yet, we somehow all still believe we can figure out what's going to happen six months from now. Don't believe it's the topic of the day? Our friends from Bank of America Global Research put together the chart to the right.

Inflation mentions on earnings calls are up a whopping 1000% compared to last year:

**Mentions of Inflation Rose Over 1000% YoY**
YoY change in S&P 500 companies' mentions of "inflation" per earnings call vs. CPI YoY (2003-present)




Source: BofA Global Research

Maybe that the subject has been dominating the financial headlines shouldn't be a surprise. After all, the prospect of experiencing sustained price increases – accompanied by the potential for rising interest rates – could meaningfully impact valuations, deal dynamics and behavior across the investment landscape. These impacts threaten to alter the surging recovery. In other words, a potential economic 'Debbie Downer' lingering on the horizon.

So let's address some of the moving pieces around the inflation debate.

### Highlights:

- Increased possibility of sustained U.S. inflation being driven by a multitude of factors, including renewed upward pressure on wages, supply chain disruptions/low inventory levels, and surging demand amid relatively synchronized global economic growth
- Greater expectation of rising interest rates and tighter monetary policy ahead, but counterbalanced by an economic recovery that's still early and fragile
- The global healthcare crisis and pandemic remain a massive wild card that could alter the current growth outlook and go-forward monetary/fiscal policy decision-making

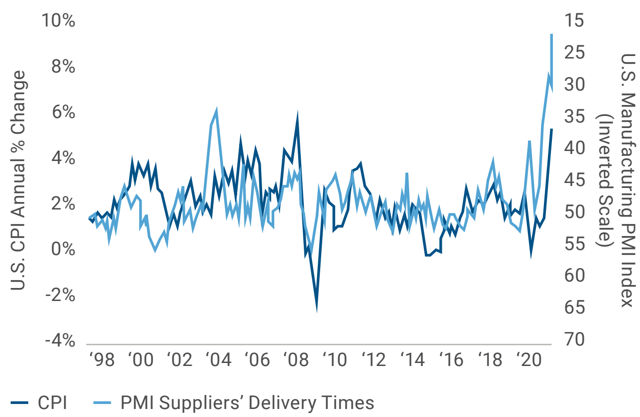
## Where are we now?

The global recovery is roaring. For now, anyway. Most major economies are expecting mid-to-high single-digit real GDP growth in 2021, culminating in current consensus forecasts of approximately 6% global growth this year. We haven't seen this level of annualized growth since the mid-1980s. Yowser. To put that into context, that's right about the time when Frankie Goes to Hollywood was topping the charts with 'Relax.'

Regions around the world are now seeing the unwinding of pent-up demand as businesses and consumers try to get back to 'normal' following a year of lockdowns. That said, recovery levels and growth outlooks across regions are uneven and closely correlated to vaccination and case rates.

Still, it should be all coming up roses, right? Not so fast. Enter the debate of heightened inflationary pressure points. Inflation on its own isn't necessarily a bad thing. Concerns come from the risk of sustained price increases above long-term targeted ranges. Ultimately that could create forces requiring policy makers to shift their accommodating stance, particularly regarding interest rates. That latter point is really where the ultimate focus on the impact of inflation resides, especially within investor spheres.

If you've tried to purchase or rent a car, buy a home, hire a contractor, go on a vacation, or visit your favorite restaurant recently, it probably won't shock you to hear that things are generally more expensive than they were a year ago. In fact, June's CPI measurement was 5.4%, its highest rate since just before the GFC. Similarly, producers are experiencing supply chain issues, labor shortages and longer delivery times. These supply and demand dynamics have manifested in the higher prices we are seeing currently.




Source: BofA Global Research

How long will prices remain elevated and to what magnitude? Are current forces transitory? We know that the current economic recovery is still early – and still fragile. The world's central bankers also understand this and will likely be cautious about intervening with rising interest rate policies unless it is absolutely necessary. So the key question is: Will prices remain elevated for long enough to make monetary policy experts blink?

One must acknowledge that, to date, this discussion is largely about the U.S. It may become an issue elsewhere, but the world is focused on U.S. inflation because of the idea that it might export elsewhere and/or the impact of rising rates in the U.S. has ripple effects on the rest of the world.

## The Debate

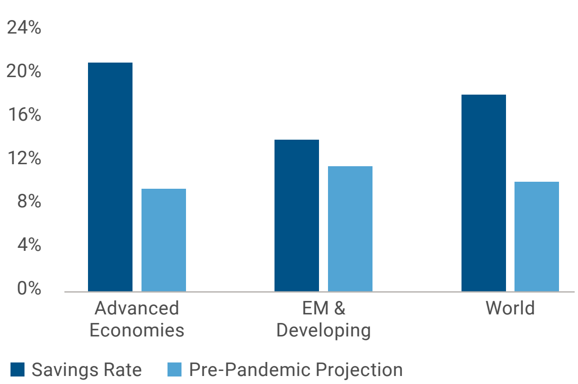
Let's evaluate both sides of the topic. Perhaps channeling the spirit of our inner Paul Volcker to warn of the causes for concern and impeding longer-term inflationary risks. To counter that, I'll add perspectives on why inflation/rising rate chatter is overblown. Perhaps this is the voice of those touting Modern Monetary Theory; let's call them the MMTers.

> "Cash Rules Everything Around Me; C.R.E.A.M. get the money; dollar dollar bill y'all."
>
> - WuTang Clan

Wow, bet you didn't see that transition coming.

**Volcker Perspective:** Generally speaking, both the consumer and businesses have emerged from the most recent downturn in great shape, with each being 'flush with cash.' Positive contributors on the consumer side include household savings rates at all-time highs, a robust housing market/net worth appreciation, and ongoing impact of stimulus. Take a look at the World Bank chart below summarizing personal savings rate estimates today compared to where we were pre-pandemic:

**Savings Rates as % of Disposable Income**




Source: World Bank

**MMTers' Perspective:** Increasing savings doesn't translate into monetary velocity. That velocity is slowing and growing savings rates actually have a deflationary impact on the economy. In fact, consumer stimulus capital has had a more muted impact on consumption than government policy makers would have hoped. In other words, consumers are stashing most of the cash or using it to pay down their debts; not spending it. A recent Fed study showed that only about a quarter of stimulus capital was going toward consumption.

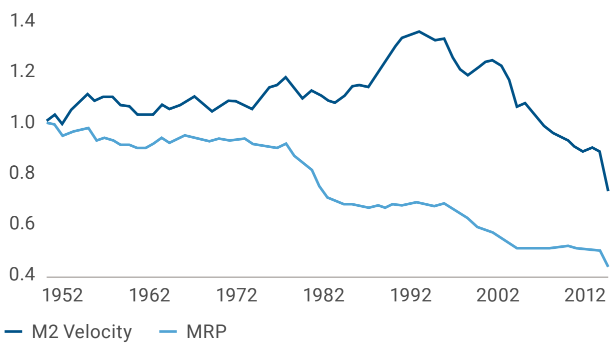
**Volcker:** Things are humming for corporate entities as well. In addition to experiencing a sharp top-line demand recovery back to pre-pandemic levels in most sectors, businesses have benefited from a secular decline in corporate tax rates over the better part of the past two decades as well as persistently low interest rates over that time frame. This has translated into record profitability and healthy balance sheets broadly. Default rates are at cycle lows, while enterprise valuation multiples are near all-time highs. Finally, inventory levels in many sectors of the economy are depleted due to ongoing global supply chain disruptions, a trend toward less globalization, and surging demand. This will drive a need for these businesses to replenish supply and likely increases in purchasing, labor costs, and capital expenditures to keep pace with a higher rate of expected growth.

These factors create a perfect storm for increased and sustained pricing growth.

**MMTers:** On the business side, remember to take any 2021 vs. 2020 growth statistic with a grain of salt. 2020 was an outlier and it is too early to tell if some of the more recent CPI statistics are sustainable as the pent-up demand works its way through the system. Supply chain pressure is likely to dissipate over the next 12 months as things 'normalize.' And corporate tax rates – especially in the U.S. – are likely to reverse course, potentially creating an earnings margin headwind over the next several years.


Importantly, debt levels are also at all-time highs for consumers and businesses. While debt issuance can create capital supply, it needs to be invested to generate a return and growth. The chart below shows diminishing returns on debt creation over time. And don't forget, all that debt needs to be repaid eventually and that too is deflationary. Repaying debt takes money out of the system.

**Money Velocity and the Marginal Revenue Product of Debt**
1952-2020 Indexed Annually

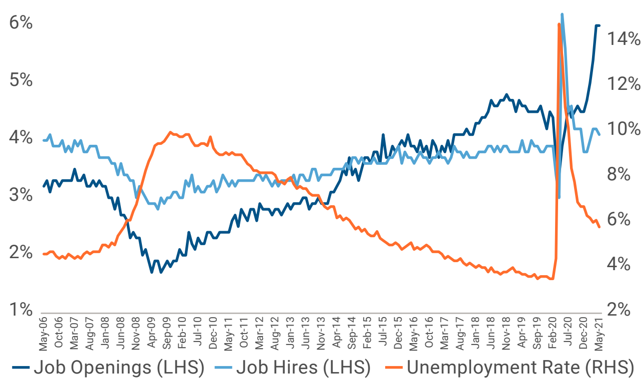



Source: Federal Reserve Board. Through 2020.

## Wage Pressure

One major impact of the current economic growth trajectory is the significant upward pressure it places on wages and labor costs. Many businesses have struggled to keep up with accelerating demand for goods and services through this recovery. For example, in the United States, even as the unemployment rate has fallen from its peak during the pandemic of 14.8% to a more normalized 5.8% currently, the number of job openings from May 2020 to May 2021 has grown by nearly 70% to approximately 9.2 million unfilled positions, its highest level in the last 20 years. This is outpacing the rate of new hires. Similarly, the rates of voluntary turnover are also at their highest level in two decades, potentially due to stimulus and other fiscal policy impact. So, expect salaries and wages to rise in response.

**Job Openings, New Hiring and Unemployment Rate**



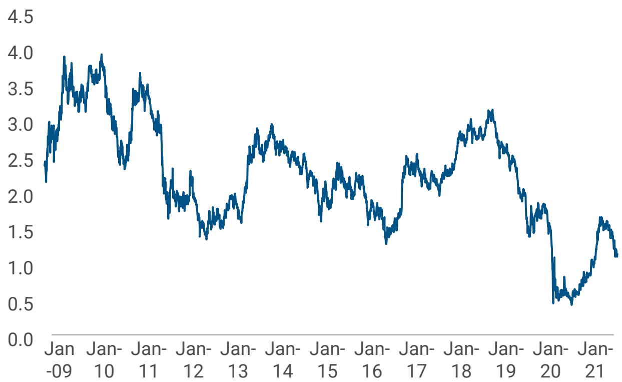

Source: U.S. Bureau of Labor Statistics

**Volcker:** See, another set of factors poised to drive pricing higher over the long term. Look at those gaps. Wages and disposable income have to increase to help fill the void. Importantly, wage growth is generally considered to be 'sticky,' thus most of these increases are likely to remain elevated and create greater levels of disposable household income. Plus, unemployment has already come down to a more normalized zone for policy makers. So, with the confluence of a surging recovery and its ripple effects on supply chains, sustained upward pressure on wages and prices is inevitable. Correspondingly, an increase in interest rates is now firmly on the horizon.

Furthermore, the trend in upward pricing movement is here and gaining momentum. Breaking down the June CPI number further, the 'Core' CPI, which removes food and energy prices from this calculation, the statistic still measured a whopping 4.5%. And even the hardest hit segments like travel and hospitality have seen a recovery in demand and pricing. The world's central bankers have taken note, too. The increase in prices, as noted by the Federal Reserve minutes, has been greater than anticipated through 1H 2021. And while any movements are likely to be well signaled, policy makers globally have started to shift to a more cautious tone regarding inflationary risks.

**MMTers:** The proof is in the pudding. Or at least in what the market is telling us. Just take a look at what treasury yields – a good barometer for long-term interest rate expectations – are saying today. The market is clearly not thinking that inflation will be an issue in the longer term. While we started to see the 10-year U.S. treasury yield approaching the 2% threshold earlier this year, this metric has capitulated to roughly 1.2%. If there is a risk of longer-term inflation on the rise, why would the curve be moving in this direction?

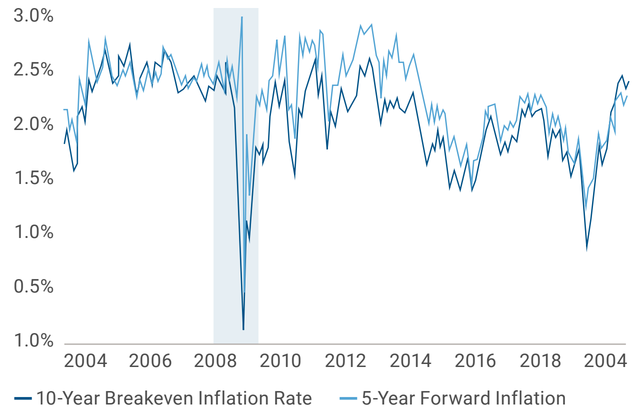
10-Year U.S. Treasury Yield %




Source: Bloomberg

It is because the Fed and others won't act in raising rates unless their hand is forced. The lingering pandemic-related economic risks create a need for continued accommodating monetary and fiscal policy. 'Kicking the can down the road' also gives policy makers optionality to evaluate pricing trends and to see if other forces normalize.

That notion is further supported by the chart to the right showing medium to long-term inflation expectations remain in a manageable 2-2.5% range. This suggests that policy, stimulus and other tools – which have already been factored in – are producing an acceptable level of long-term inflation. Lastly, policy makers recognize that it is more challenging to reverse an interest rate increase once underway, thus they won't want to go to that inflection point unless it is absolutely necessary.




Source: Federal Reserve Bank of St. Louis

End scene.

## What is next?

From a magnitude perspective, it is too early to tell where the inflation trend will end up. Our view is that the most likely outcome is that we will see pricing continue to spike for the next several months before settling into a more manageable range over the next year. And while the longer-term inflation statistics will likely remain slightly higher than the Fed would prefer – and its targeted ~2% rate – we think it is unlikely that the Fed will act or move rates higher at least in the medium-term. So maybe Frankie had it right, we should all just relax.

That said, if the past 15 months have shown us anything, it's that we can never fully predict things in a linear fashion. Uncertainties always exist. That is especially true regarding this topic for one simple reason – no one knows with any certainty. And we haven't really experienced this. A meaningful increase in rates hasn't happened for the past 14 years, which means if you're under the age of 35, investment decisions have taken place within a mostly 'benign' rate environment. To have total conviction one way or the other on where rates end up is either foolish or, at the very least, providing a false sense of accuracy.

However, just because you can’t predict something, doesn’t mean you shouldn’t be preparing for it. The extended low-interest rate environment has been a ‘rising tide’ for most markets and asset classes. A reversal to this trend will undoubtedly have an impact on valuations, growth dynamics and longer-term corporate profitability, amid other factors. Similarly, investor strategy and portfolio construction may also need to be reconsidered. In future updates, we will attempt to assess some of these investment implications as well.