

## INFLATION - THIS TIME IT MAY BE DIFFERENT

The global recession currently underway from COVID-19 will be deeper than any other since the Great Depression. Record-breaking falls in production and spending figures, alongside the largest monthly increases in unemployment ever seen are being recorded across the globe.

It is only natural when faced with this bleak picture, that the already-low probability of inflation will go even lower. Like most, we expect the near-term outlook for inflation to be challenging. However, we think investors should start to consider the risks beyond next year as there are many features about the current crisis that could mark a structural shift in inflation dynamics. Just as the pandemic could likely result in permanent change to consumer and work life patterns, as well as the relative fortunes of some industries forever, it is also reshaping the policy landscape and potentially the economic regime of the past few decades.

### The return of fiscal dominance

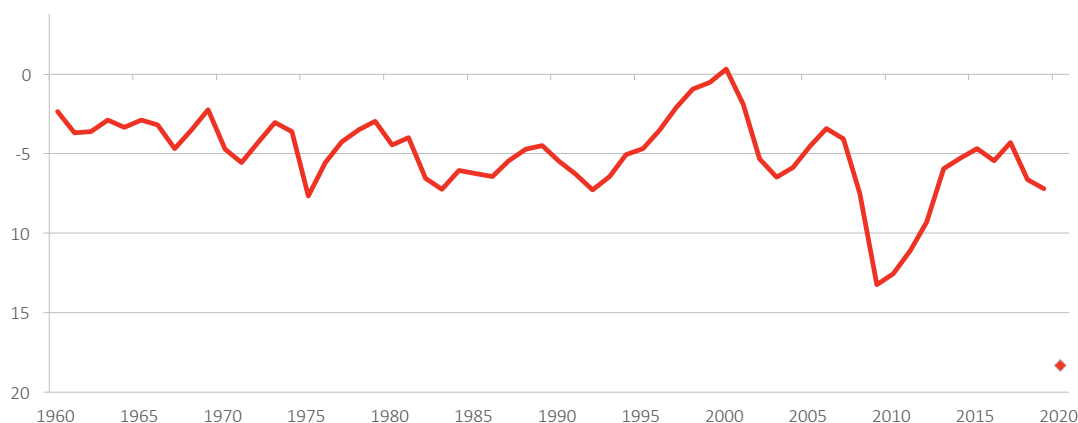
The global policy response to COVID-19 has been swift. Central banks learned many lessons from the experiments and mistakes of the post Global Financial Crisis (GFC) decade. This time, central banks have moved quickly and with force, unleashing the fastest pace of balance sheet expansion seen in the modern era. Crucially, fiscal policy has also stepped up to the plate, to provide a highly-needed economic 'bridge' to help compensate for the loss of incomes and employment.

It is easy to see why investors remain unconvinced about inflation. A decade of extraordinary monetary policy measures and balance sheet expansion could not deliver any kind of inflationary impulse. So why should now be any different? The key difference is that, this time, fiscal policy is also joining forces, instead of working against the central bank actions. While fiscal policy was utilised during the GFC, it was quick to retreat, with fiscal austerity a favoured theme after the GFC. Arguably, this transition towards fiscal dominance was inevitable, as central banks approached the effective lower bound. But the COVID-19 shock has accelerated the watershed shift from decades of central-bank dominated policy to one where fiscal policy will now dominate.

Fiscal policy can be a much more effective tool for stimulating growth than monetary policy. Even though central banks enabled a flood of easy liquidity during the GFC, much of that remained within the financial system. Fiscal policy can bypass the financial system and provide stimulus directly to businesses and households. Not only can that make the transmission faster, but also much more targeted towards those that need the assistance most. There is extensive research to show that fiscal multipliers can be at their most powerful during recessions, meaning the ripple effects of well-executed fiscal expansion can be highly successful.

Public sector debt globally is set to sky-rocket. In many cases, such as the US, fiscal deficits could exceed levels not seen since after World War Two (WW2) (see chart below).

### US - General government budget deficit (% of GDP)



Note: Diamond represents QIC forecast for 2020.

Source: Bureau of Economic Analysis as at May 2020. Forecast results are predictions only and may be affected by inaccurate assumptions and/or by known or unknown risks and uncertainties. Forecast results or returns may differ materially from results or returns ultimately achieved.

Of course, like after the GFC, fiscal spending could retreat quickly once the COVID-19 situation normalises. But the fiscal Rubicon has been crossed, with all governments globally now facing similar prospects. With central banks able to ensure that bond yields remain low in the face of ballooning government debt, ongoing fiscal policy may be more successful at returning inflation to target. Indeed, there is even a risk that public pressure may demand that fiscal policy remains easy for even longer. Rising discontent about inequality has intensified in recent years, and the latest crisis has disproportionately impacted lower wage workers further. Fiscal policy is much more effective at addressing the inequality gap than monetary policy. The big question for investors is whether political leaders around the world, if assisted by central banks, will continue to deploy aggressive fiscal policy, even as conditions begin to normalise from COVID-19. If so, then upside risks to inflation could arise.

### How can inflation rise when we are experiencing the deepest recession in almost a century?

It may seem anomalous to consider inflation risks now, in the midst of some of the most dire economic data seen during this lifetime. Like most, we forecast weaker inflation in the coming quarters, as the loss of economic activity bears down on prices in many sectors. But the key to inflation risk is understanding that this recession is not like a normal recession. A normal recession is usually characterised by a sharp fall in demand. In the current circumstance, it is not a fall in demand that has caused the loss of activity, but rather government directives to restrict activity. In other words, supply has been sharply cut also. While the eventual outcome will depend greatly on how quickly economies re-open and employment begins to resume, there is a possibility that demand may resume much faster than supply in some cases, causing pockets of price pressure. And unlike a typical recession, growth is likely to rebound much faster, even if all sectors do not normalise at an even pace.

The longer-lasting supply impacts of the current shock may not be known for some time. There are likely to be permanent shifts in consumer behaviour and industry trends, as well as shifts in global supply chains and labour markets. Globalisation is understood to have played a key role in the downward trend in inflation over the past few decades. The recent experience has re-escalated a more widespread questioning of the location of supply chains and access to items such as pharmaceuticals and medical equipment. It will be some time before we know the full impact of whether the supply side of the economy has incurred permanent change.

### Isn't Japanification inevitable?

With most of the world's major central banks now effectively at the lower bound and likely to remain there for several years, there has been a general theme in financial markets that many economies could fall into a similar state of deflation and stagnant growth as Japan. However, the experience of Japan is somewhat different to the current juncture. In particular, the speed and magnitude of Japan's policy response, which was not only painfully slow in Japan, was also very sporadic. At times, monetary and fiscal policies were not working in tandem. And importantly most easing measures occurred well after consumer inflation expectations had already become de-anchored. Interestingly, while the 'experts' expect lower global inflation in the next year, consumers<sup>1</sup> are expecting the opposite. Timely consumer surveys in the US have recently shown among their sharpest jumps on record for year-ahead inflation.

### Consumer expectations of inflation in 1 year's time



Source: Bloomberg, Conference Board Consumer confidence survey as at May 2020

1 For example, the two most widely published monthly surveys of consumer expectations in the US, the Conference Board and University of Michigan sentiment surveys.

### What does this mean for asset markets?

Financial markets show little concern about the prospect of higher inflation. Market pricing of inflation in Australia and around the world remains at very depressed levels, and is well below central bank target ranges. For example, Australian 10yr BEIs at current levels are consistent with Australian CPI averaging just 1% for the next 10 years (see chart) – over 150bps below the RBA's target band and well below historical average levels in the inflation market. Long-end bond yields remain at historically low levels, and yield curves show little hint of any significant risk premium for inflation. We are not making a case for a resumption of hyper-inflation, but markets are not expecting even the chance of a more moderate return of inflation, which we do expect.

### Australian 10-year inflation breakeven rate



Source: Bloomberg, data as at June 2020

Investors have been told that inflation is coming for years and it hasn't happened, but investors should not be complacent. The low probability of inflation returning to normal currently priced into market presents an opportunity for investors. While central banks are suppressing nominal bond yields and volatility (at least in the shorter-end of the yield curve), not all fixed income markets are so predictable. At current extremely low levels of market inflation pricing, there is not only an excellent investment opportunity for capital gains in inflation markets, but it may also be a wise time to consider broader portfolio hedges at cheap levels. Fixed income securities such as inflation-linked bonds as well as synthetic exposures to inflation swaps can provide targeted and nimble protection from rising inflation.

Consensus did not foresee how much disinflation would emerge over the past few decades, largely because many of the slow-moving and unobservable supply-side factors are difficult to pinpoint until well after the fact. As a result, forecasters can be slow to pick up changes in regimes. Inflation is unlikely to move higher in the short-run, but inflation may be a topic investors will hear more and more about it in the years ahead. Investors should start to consider how to position for possible upside risks to inflation now.



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