On the Minds of Investors

July 2020

Could the policy response to Covid-19 lead to a resurgence in inflation?

Central banks are printing money and governments are showering it round the economy. Government debts levels are eye-wateringly high. It's no wonder investors are questioning whether a resurgence in inflation is on the cards.

Inflation is caused by an excess of demand over supply. Too much money chasing too few goods. The outlook for inflation thus depends on how Covid-19 is affecting both demand and supply. We would argue that the relative shifts in demand and supply may alter over time. In this piece we argue that:

1. The most immediate impact of Covid-19 is overwhelmingly disinflationary.
2. As economies re-open the degree to which inflation recovers depends on whether demand is restored quickly and/or supply remains disrupted.
3. In the longer-term the impact on inflation should depend on whether policymakers manage demand appropriately. While our central expectation is that policymakers ease off the monetary and fiscal gas in a timely manner, there are risks to this benign scenario that investors should consider.

Inflation under lockdown

Both supply and demand have contracted during lockdowns, but demand has fallen by at least as much as supply in most key categories. This dynamic has led to a period of disinflation. The virus containment measures required globally led to a dramatic decline in consumer spending. With economies on pause, the hit to sectors such as retail, food and accommodation services has been most pronounced. Visa data for the UK shows that face-to-face spending in April fell by 45% year on year. Supply was also disrupted but not by as much as demand in some sectors. An April survey by the Office for National Statistics highlighted that 23% of businesses in the UK were forced to close or temporarily pause trading. While business closures were widespread in the hospitality and recreation sectors, other sectors were less affected and were able to begin reopening sooner. The purchasing managers' survey of manufacturing new orders fell by more than company inventories, again suggesting that the fall in demand exceeded the supply disruption.

AUTHOR

Jai Malhi
Global Market Strategist

The fall in the oil price also pushed headline inflation lower. The sudden decline in air and road traffic caused fuel demand to fall, while major oil producers initially increased production, leading to a historic decline in oil prices. With energy accounting for around 5%-7% of inflation baskets in Europe and the US, it's no surprise to see headline inflation falling towards zero. However, with oil prices already recovering, the worst of the drag from falling energy prices is likely to already be behind us.

The composition of inflation baskets also shows why inflation has been falling. Spending on household goods, including food, has remained resilient but the sectors experiencing meaningful declines in consumption make up a greater proportion of inflation baskets (**Exhibit 1**). It is worth noting that there are some technical issues, which make it difficult to accurately measure inflation in a period like this. For example, it's difficult to record prices for goods and services that we can't even buy. Meanwhile, inflation basket weights only adjust roughly once a year and so won't have accounted for the unique shift in recent spending patterns towards essential goods. This means that for many consumers this period won't have felt so disinflationary.

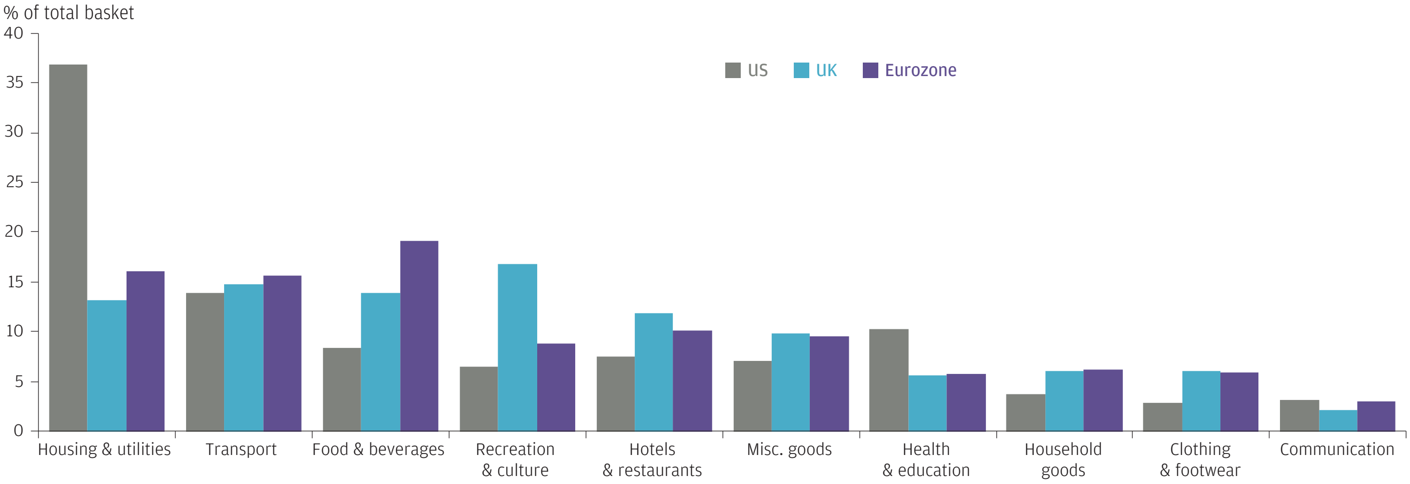
Getting back to a new normal

As lockdowns are relaxed it's plausible that we see a rebound in inflation. Consumers may look to unleash pent-up demand as they seek to make up for lost time at the same time as companies are struggling to get back to full capacity.

Mobility among the population is already rising in the UK and Europe as fear of the virus falls, though social distancing guidelines remain. A YouGov poll from the UK suggests that once coronavirus is less of a threat, consumers are looking forward to spending on eating out, domestic holidays and personal care – some of the luxuries that they have been deprived of over the course of the lockdowns. However, their ability to do so is clearly dependent on how well their incomes and jobs have been protected.

Between February and May consumer credit card balances have fallen by around 10% in both the UK and the US, as consumers paid down their debts. And despite falling employee compensation, disposable incomes in the US have actually risen meaningfully as a result of sizeable government benefits (**Exhibit 2**).

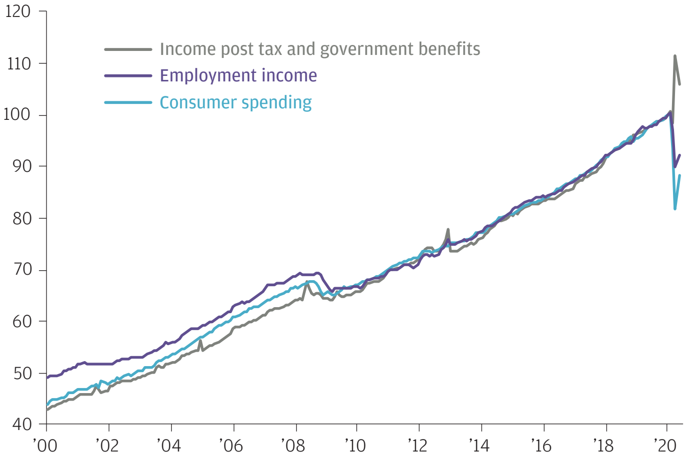
EXHIBIT 1: HEADLINE INFLATION SECTOR WEIGHTS



Source: BEA, Eurostat, OECD, ONS, Refinitiv Datastream, J.P. Morgan Asset Management. UK and eurozone inflation is Consumer Price Inflation (CPI). US inflation is CPI but includes owner occupiers' housing costs, hence the larger weight to housing in the US. Data as of 15 July 2020.

EXHIBIT 2: US CONSUMER INCOME AND SPENDING

Index level, rebased to 100 at February 2020



Source: BEA, Refinitiv Datastream, J.P. Morgan Asset Management. Income post tax and government benefits is equal to disposable income.
Guide to the Markets - UK & Europe. Data as of 15 July 2020.

On the supply side, companies may struggle to get capacity rapidly back to previous levels. Some will have made permanent layoffs and taken on higher debts, and some will even have closed permanently. The result is that any resumption in demand could outpace the recovery in supply – thus proving inflationary.

While social distancing is still required supply capacity will be limited, which could push prices higher in some sectors. Opentable data shows that in some countries, such as Germany, restaurant bookings are virtually back to normal. Imagine though, trying to get a table at a trendy restaurant in the UK that is required to operate with half the usual number of tables – it's likely to be more difficult and possibly more expensive. Even in a world with a readily available vaccine, inflationary pressures may come through in sectors where business capacity has been more permanently impaired. For example, if some airlines haven't managed to survive then less competition between airlines could make flights more expensive.

However, this potential pick-up in inflation is highly contingent on government measures succeeding in at least neutralising the impact of Covid-19 on consumer incomes and, on the whole, minimising long-term unemployment. Government schemes have been implemented in Europe and the UK to help protect jobs, while more generous than usual unemployment benefits and stimulus cheques boosted US incomes. However, if these government schemes are not sufficient or are removed too soon then we could be looking at a more long lasting loss of demand, which could drag on core inflation. We will also be watching for signs that companies are using the unprecedented nature of this downturn to implement outright cuts in wages – something that in the past has rarely happened.

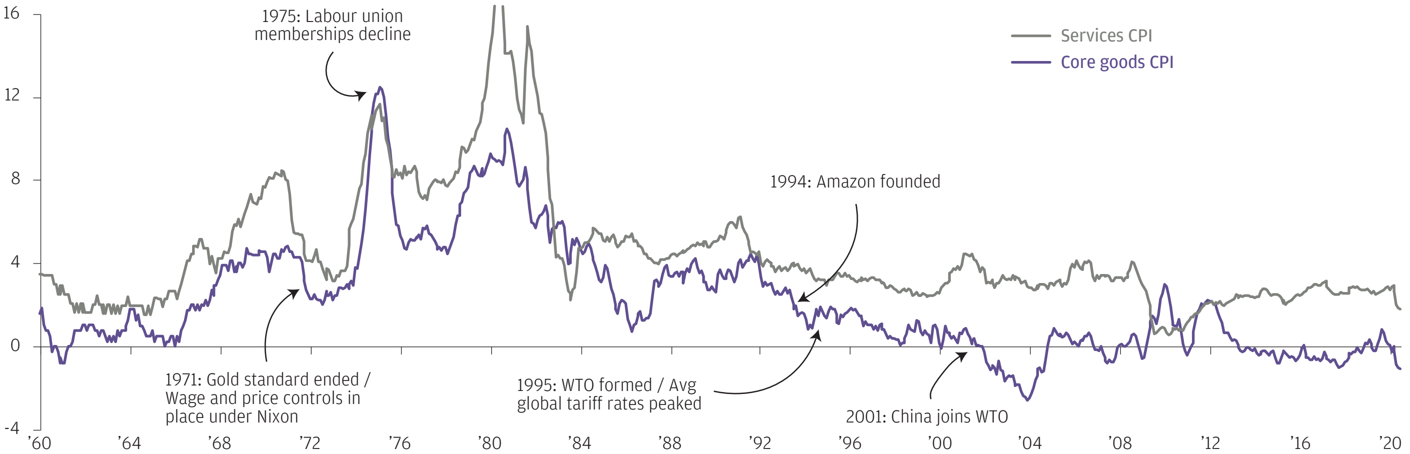
The long-term balancing act

Over the longer term what matters is how policymakers work to balance supply and demand. The sheer size of the policy response to Covid-19 could lift demand in excess of supply if sustained. If in the future policymakers overcook the stimulus or they don't take their foot off the accelerator at the right time, then we could be looking at a period of demand exceeding supply, leading to higher inflation.

In recent years, supply side factors have made it difficult for policymakers to generate enough inflation. Globalisation, growing international trade and lower import tariffs, the declining power of unions, growth of technology and automation and the gig economy have all been disinflationary, particularly for physical goods (**Exhibit 3**).

EXHIBIT 3: US SERVICES AND CORE GOODS INFLATION

% change year on year



Source: BLS, Refinitiv Datastream, J.P. Morgan Asset Management. CPI is the Consumer Price Index. Core goods CPI is defined as goods CPI excluding food and energy.
Guide to the Markets - UK & Europe. Data as of 15 July 2020.

It's plausible that we get some degree of de-globalisation as companies increase production at home for political reasons or because of higher tariffs and regulatory alignment some emerging markets may begin to export inflation to developed countries. While some production may be repatriated, a significant reversal of globalisation isn't a part of our core scenario because corporates and consumers are unlikely to tolerate the higher costs that come with moving production back home. Possibly more important is the fact that companies will want to ensure that they maintain production near to the growing consumer base abroad, particularly in the emerging markets. It's not clear to us that any of the other factors are likely to reverse in the near term either. Technology, for example, appears set to grow rather than shrink in importance as a result of the pandemic, while the gig economy is probably here to stay.

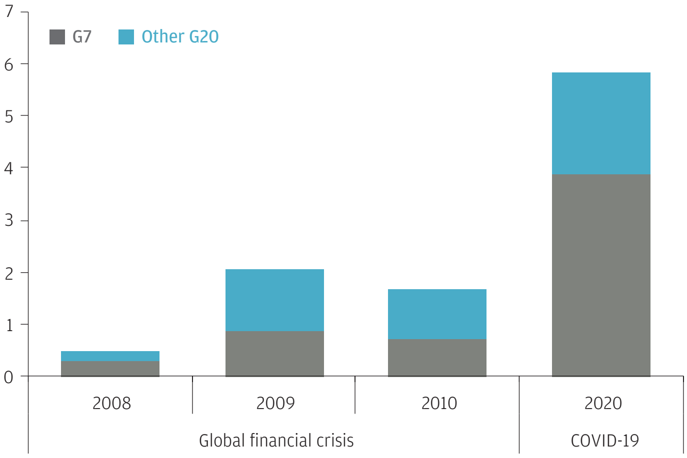
The key question remains, however. Will governments and central banks overcook demand over the medium-term? In our view it is the fact that both central banks and governments are working together that leads to potential inflationary risks. In the wake of the 2008 financial crisis, central banks largely worked alone. The expansion of base money was supposed to reach consumers via bank lending and the wealth effect. But caution among banks to extend credit, higher regulatory scrutiny and wealth mainly concentrated among those with lower propensities to consume, all reduced the effectiveness of quantitative easing.

Consumers had also run up huge debts prior to the financial crisis and governments subsequently took on greater debts to support the financial system. This led to significant deleveraging in the household sector and austerity in the public sector. It's very hard to get inflation going when a significant proportion of the workforce that works in the public sector is on a pay freeze (**Exhibit 4**).

Fast forward ten years and it's unlikely to be a case of déjà vu. Despite very high levels of government debt, fiscal hawks are in the minority. The fiscal expansion has been enormous (**Exhibit 5**). Meanwhile, consumer debts are also in a much better place relative to pre-Covid incomes.

EXHIBIT 5: DISCRETIONARY FISCAL SPENDING IN RESPONSE TO FINANCIAL CRISIS AND COVID-19

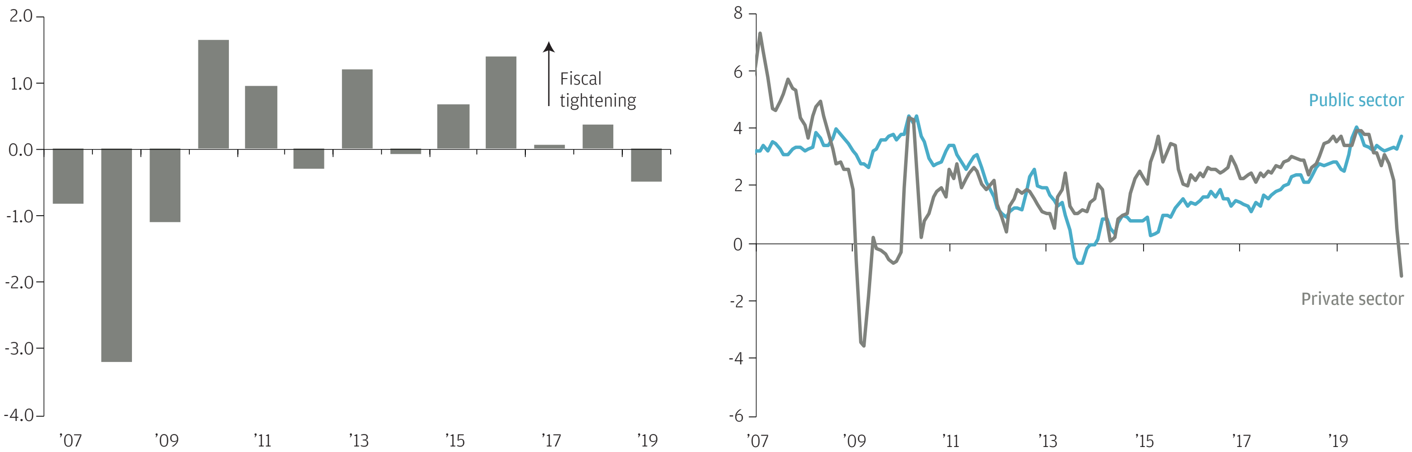
% of G20 GDP



Source: IMF Fiscal Monitor, J.P. Morgan Asset Management. Numbers reflect discretionary spending measures only and do not include fiscal spending via automatic stabilisers. Data as of 15 July 2020.

EXHIBIT 4: CHANGE IN UK CYCLICALLY ADJUSTED PRIMARY BALANCE AND UK WAGE GROWTH

Annual change as % of potential GDP, by fiscal year (LHS); % change year on year, three-month moving average (RHS)



Source: OBR, ONS, Refinitiv Datastream, J.P. Morgan Asset Management. Public and private sector wage growth refers to total pay. Data as of 15 July 2020.

If governments keep the taps on, the question then becomes one of whether central banks tighten in a timely manner in line with their inflation mandates. Even prior to Covid-19 the central banking community was discussing the merits of average inflation targeting. This is a regime in which "bygones are not bygones". Any past periods of inflation undershoot must be compensated for by a period of overshoot in the future. We think it is likely that central banks will in the coming years move to average inflation targeting frameworks and so will tolerate a period of inflationary overshoot. The Federal Reserve may move as early as this year.

While this regime may be perfectly sensible to ensure inflation expectations are anchored near their respective targets, it will be a difficult balancing act to convince investors that this tolerance for overshoot is limited. Given debt levels are so high across the private and public sector, investors may become concerned if that tolerance appears to be more than one of moderately higher inflation over the short term.

In summary, while central banks printing money is not necessarily a precursor to higher inflation, we believe that the velocity of base money in the coming expansion will be consistently higher on the assumption that governments will not revert to austerity. Our central expectation is that central banks maintain a focus on low inflation over the medium term but there are risks to this and so we will be watching for signs of political influence over monetary policy committees and decisions.

Which assets can help protect against rising inflation?

Long-term government bond yields are at historical lows. Any pick-up in inflation would nibble away at the already low real yields on offer. Inflation protected bonds, as their name suggests, protect returns against unexpected inflation, and are usually a go to asset class when investors fear a rise in inflation. With medium-term inflation expectations as low as 1.3% in the US, were some of the upside inflation scenarios to come to fruition then Treasury inflation-protected securities (TIPS) would at least protect against rising inflation.

Investors could consider adding real assets to portfolios, including core infrastructure and selective core real estate. Gold may also protect against rising inflation. If central banks continue to print money extensively to fund fiscal stimulus, real yields could be pushed lower as inflation expectations rise, but nominal government bond yields are kept low via quantitative easing and/or yield curve control and financial repression. A low real yield environment would likely be positive for gold.

Equities could also act as an inflation hedge but would work best in an environment where inflation is neither too low nor too high. Stocks typically protect better against rising inflation than fixed income. Rising prices are usually positive for corporate profits, as long as companies are able to pass on rising costs to consumers. Historically, equities have performed well in modestly positive inflation environments with inflation between 1% and 3% but less so when inflation is very high. In very high inflation environments firms can struggle to pass on rising costs fully, while central banks work in the opposite direction to dampen demand and increase interest costs, all of which can squeeze profits.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions. For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

LV-JPM54853 | 07/20 | 0903c02a82972297

J.P.Morgan
Asset Management