The Focus on Inflation

You will hear a lot of talk about inflation in the financial media. Here are some thoughts about it. I don’t think inflation will rise or if it does that it will be protracted. But I am keeping my interest rate sensitivity low and keeping a keen eye on inflation data. Asset markets have either recovered most of their declines or are even higher than they were before the COVID lockdowns. Given that many countries and industries will not recover their level of economic output until 2022 or 2023, this seems strange.

1. Central banks have been supporting markets, not just the economy. Central banks are not only buying their own debt, they are buying private debt as well.
2. Governments have implemented emergency spending, sending checks to people. Significant portions of this money are being saved which leads to investment in stocks and bonds.
3. Some industries like tech, stay-at-home industries like e-commerce, Cloud and media streaming, logistics and industrial real estate are flourishing. Some are rebounding such as the auto industry and banks. Retail and hospitality and other old economy industries continue to languish.

Item 3 gives us hope that human ingenuity will overcome whatever nature throws our way. This is true to a great extent.

Items 1 and 2 are very important to asset values. Governments can continue to pursue such policies with one caveat. Inflation must not rise out of hand. If it does, central banks will have to raise rates or stop buying bonds. Governments will have to be more fiscally prudent. Either of these will throw the current trend of rising asset prices into reverse.

Inflation snippets:

- Human ingenuity leads to lower inflation. A bet on higher inflation is a bet against human ingenuity, a risky bet.
- Efficiency X Robustness = Constant. Efficiency is disinflationary and robustness is inflationary. De-globalization (whether in the form of trade wars, re-shoring, self-sufficiency,) decreases efficiency and increases robustness.
- Monetary policy cannot influence the real rate of interest. This is determined by the efficiency of the economy. This is the natural real rate of interest.
- Cutting rates can weaken inflation. Cutting interest rates leads to immediately lower real interest rates. However, real interest rates then return to their natural rate. For this to happen, inflation must fall. Conversely, raising interest rates can increase inflation.
- QE is relatively disinflationary. QE is printing money pro rata to assets which is a net relative transfer from poor to rich, increasing the savings rate and decreasing the propensity to consume. This depresses inflation and interest rates.
- Where the national debt is high relative to GDP, countries need low interest rates to maintain manageable debt service. Central banks may take into account national debt service in monetary policy. If so, central banks will maintain low interest rates for the foreseeable future.
- US bond issuers tend to focus on funding up to 5 years, with 10 year and longer maturity issuance tapering off. It is important that the Fed keeps interest rates low up to 5 to 7 years. Maturities beyond that are less important.

- There is an excess of money supply for assets. This has resulted in asset inflation. There is a shortage of money supply for goods and services. This has resulted in low inflation. The Fed cannot differentiate between money for assets and money for goods and services; this is a distinction made by consumers and investors.
- Fiscal policy is marginally inflationary. If fiscal policy involves the net transfer of wealth from rich to poor, it will increase the propensity to consume, encouraging higher inflation. If policy is financed with increased progressive taxation, it could lower aggregate savings leading to weaker demand for assets.
- 24% of the US consumer price index basket is shelter: owners' equivalent rent. This quantity is flatlining even as other items are rising.
- Governments who have borrowed heavily should welcome inflation to erode the real value of their debts. Goods and services inflation is political risky, but asset inflation is mostly welcome by the people.
- Investors try to hedge against inflation by a) investing in commodities, b) investing in TIPS (inflation linked bonds), c) investing in stocks (tomorrow's output bought today), d) shorting long maturity bonds while buying short-dated bonds or e) buying floating rate debt.