Letter 34

Inflation, a threat or a mirage?

We had lost our memory of inflation: it had risen from 3.5% in the 60s to 10% during the 70s and 80s, with a peak in 1975, when the price of oil quadrupled, of 16% for the G7 countries and even 25% in the United Kingdom. Since then, inflation has averaged at 5% per year in OECD countries during the 90s, 3% in the 2000s and 2% after 2010. In recent years, particularly in Japan but also in Europe and the United States, the target of 2% set by the Central Bank has never been achieved.

It all started with a vigorous Chinese recovery in the 2nd half of 2020, amplified by an unprecedented sum of stimulus packages in the United States, exacerbated by the cumulative injections of liquidity by central banks, and exaggerated by the acceleration of energy transition. This was the genesis of inflation in recent months, an inflation that has been forgotten since the end of the 80s, an inflation temporarily preferred to unemployment by some central banks, an inflation hoped for by some, wrongly, because they believe they see it as a way to painlessly erase the debt while neglecting the risk of a rise in long-term rates. As pointed out by ***HEMINGWAY*** in Notes on the Next War in 1935***: "The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists."***

It only took two figures to worry the markets, to alarm the opinion of a possible return of inflation, to aggravate the tensions on long-term rates: the rise in producer prices in China, 6.8% in April, the American price index, for the same month of April at 3.6% and the index excluding energy and food, at 3.1%. This trend is corroborated by the Eurozone's inflation figure of 2% in May (but only 0.9% excluding energy) and by the expectations of US 1-year inflation, as measured by the University of Michigan, i.e., 4.6%.

As soon as these figures were published, they drew parallels with the acceleration of inflation in the 60s in OECD countries, leading analysts to denounce the laxity of monetary policies and accelerated a restructuring of portfolios on the stock exchange, with a reduction in growth stocks sensitive to rate increases and an accumulation of financial stocks, real estate, and commodity stocks, all of which are beneficiaries, within certain limits, of moderate inflation.

But from alert to anguish, from threat to uncontrolled drift, from apprehension to inflationary spiral, there is not a step but a gap. A paradigm shift not yet feared to date. There is a temporary acceleration of inflation but not a reversal of disinflationary trends, an intensification of upward pressure on metal prices, an increase in the price of agricultural products, the impact of protectionist measures, an increase in the wages of certain service professions, a consequence of temporary disruptions in production chains, but nothing perennial, nothing structural, nothing sustainable. These are all components that must be analyzed to try to reach a conclusion on a possible resurgence of inflation. The analysis will be focused on the United States because the inflationary threat there is greater than elsewhere.

- ***The inflationary impact of an increase in purchasing power, wages, and employment trends?***

More savings, a source of demand-side inflation? In the United States, purchasing power has been boosted by the $800 billion grants to households, specifically $700 billion in the form of additional unemployment benefits and a check of $1400/household. With increased confidence and a downward trend in the US unemployment rate towards 3.5% in February 2020, accumulated savings could spill

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over into additional consumption and, in the short term, trigger demand-side inflation. In France, too, the Banque de France estimates that €142 billion has been saved since the beginning of the crisis, the equivalent of 6% of the 2020 GDP. And this is the case in all the major countries.

But the phenomenon will be temporary and inflationary pressures could be reduced because there is every reason to expect a gradual use of these savings.

Job shortages, source of wage increases and cost inflation? The US unemployment rate is at 6.1%, far from the 3.5% before the crisis, but in some service sectors such as restaurants, companies are facing difficulties in hiring and may be required to offer more attractive wages.

Some analysts diagnose the current crisis as an acceleration of the digitalization of economies, a downgrading of part of the workforce, a voluntary or forced exit from the labor market of part of the working population and a factor of increasing wages. Others blame the additional unemployment benefit of $300/week as a brake to accepting a job. But this compensation will not last beyond September, with some Republican states wanting to abolish it as early as July, and it can also be seen as a way to give people time to find a job that is better suited to their qualifications, thereby generating potential productivity gains.

The United States had lost some 22 million jobs in the 2nd quarter of 2020, but it has now recreated nearly 15 million. Between retirements and the influx of young people into the labor market, another 8.2 million jobs must be created to return to the pre-crisis unemployment rate. Biden's proposed increase in the minimum wage from $7 to $15/hour could have a contagious effect outside the public sector, but the adoption of such a measure in Congress is unlikely. In the meantime, Amazon and McDonald's, faced with shortages of workers, are expected to give raises and this will be monitored closely. A rise in wages could encourage some to return to the market, and the participation rate could rise again.

Ageing as a cause of inflation? Beyond this economic crisis, some see the ageing of the population as a cause of weakening productivity gains and view the possible reduction of the active population as a seed for wage growth. Japan has been a living example of such a development over the past decade or so, but wages have hardly changed. Let us not neglect the increase in the participation rate of women, the postponement of the retirement age and the effects of robotization, all of which are factors to the decline of the active population.

- ***The inflationary impact of a rise in the price of oil?***

In a rolling year, we can highlight a price increase of $20/barrel to $69/barrel. An impressive swing but it is nothing more than a return to pre-crisis prices. In the short term, there is a surge in inflation, but energy only accounts for 5 to 7% of the price indices. The reduction in supply by "OPEC+" (OPEC, Russia, and some other countries) will still reach 6Mb/d at the end of July, 6% of pre-crisis demand. Iran, tomorrow, may be allowed to increase its exports from 0.5Mb/d to 2.5Mb/d, Libya may be more stable and able to offer 1Mb/d again. In other words, there is no indication of an oil shortage and there is no reason to fear a surge in oil prices.

- ***The inflationary impact of a rise in metal prices?***

Metal consumption is expected to rise sharply, for example 40% for copper by 2030. However, scalded by previous crises and, despite earnings being three times higher than in 2015, many producers are hesitant to invest, and prefer to satisfy their shareholders by increasing dividends. Compared to the situation during the previous demand boom, the investments by major miners are now a third lower while dividends are 2.5x higher. According to a study by Liberum Bank, dividends in 2020 accounted for almost 90% of the amounts invested.

Thus, between the time required to put a new mine into production, that is 10 to 15 years, and due to the weakness of inventories and the expected increase in demand, shortages can be feared for copper, cobalt and other metals benefiting from the "green revolution" of climate change. And in recent months, this has been the theme of focus in our investments.

This is not a universal concern. For some metals, the supply-demand balance is improving. This is the case for palladium that has moved from a deficit to a surplus situation.

Finally, China, a buyer of 50% of the world's production of the main metals, intends to take advantage of a slowdown in its growth to break the upward spiral in prices and, as a result, the price of iron ore recently fell from more than $230/tonne to $180/tonne.

- ***The inflationary impact of an increase in agricultural products?***

The rise in the prices of agricultural commodity prices was the result of both a drying up of supply, penalized by the drought in certain regions, and of an increase in Chinese demand because the country wanted to rebuild its livestock following the swine flu epidemic.

However, this inflation in agricultural products is expected to stabilize: the rise in prices is encouraging producers to increase their acreage and the weather conditions, which have been better than expected recently, have allowed for an increase in soybean production in the United States.

- ***The inflationary impact of monetary injections or the supposed laxity of central banks?***

Central banks have not skimped on the amount of money injected. Monetarists link the price increases to the amount of money in circulation, weighted by the speed of circulation. The abundance of liquidity injections is an inflationary seed, but a demand for credit is still needed and many companies are hesitant. Moreover, given the strength of the recovery, some central banks, like in Canada and the United Kingdom, are suggesting a halt in injections and New Zealand is even considering a rate hike in the 2nd half of 2022. In this vein, we can expect a similar shift by the FED at the end of this year and a reduction in ECB purchases at the end of Q1 2022.

- ***The inflationary impact of fiscal stimulus?***

The figures are unprecedented in history, but the expenditures are spread over time: the European plan of €750 billion over 6 years and the major plans proposed by Biden over 8 or 10 years. They are not voted upon and will be subject to downward revisions before their possible adoption in Congress. A few days ago, Biden had cut the infrastructure plan by $600 billion to $1600 billion.

While there have been two cheques distributed to the Americans in the last twelve months, part of it has been saved, part of it has been used to repay debts and only a fraction has triggered catch-up consumption.

A final word, on China: in 2009, it was distinguished by the realization of a fiscal support plan of some 13% of the GDP. Nothing of this sort has happened this year and we are already seeing a slowdown in the strength of the recovery, with consumption losing its momentum in April.

- ***Protectionist measures :***

Protectionist measures are obviously inflationary because retreating into one's territory, refusing the advantages of the division of labor, wanting to produce locally without having the critical size, increases production costs.

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In this arsenal, there is another measure, unhappily generalized by Trump, and that is the imposition of tariffs. A tariff against China is a cost borne by the American consumer or producer. Today, everyone is complaining about the 25% tax on steel or the 10% tax on aluminum. There has been no reduction in the US trade deficit, relocations are negligible, but taxes increase the price of final products and therefore hinder competitiveness compared to European or Japanese competitors.

Conclusion :

Never in the history of the world economy has there been, as in the 1st half of 2020, such a sudden global halt in supply and such an accumulation of savings. The recovery has begun, but inevitably, there will be breaks in the chain between supply and demand, inadequate stocks, shortages of components, higher commodities costs, and difficulties in hiring in service sectors. But these are effects that will last a few months.

- *Historically,* inflation is rarer than deflation and more frequently affects emerging countries. Deflation prevailed at the beginning of the twentieth century, was prominent during the 1929 crisis and has been emerging in several countries and sectors in recent years. Inflation was low between the end of the Second World War and the 60s. Then there were 10 years of rampant inflation, moderate but increasing year after year, in the United States in particular, with the burden of financing the Vietnam War, in a context of wage indexation, job protection, powerful trade union forces, and an extensive public sector. Finally, there was the inflation caused by the two oil shocks in 1974 and 1980.

  Since 1982, disinflation has prevailed, encouraged by the vigilance of central banks, globalization, the emergence of Chinese competition, the substitution of capital for labor, automation, the loss of influence of trade unions, the development of part-time work, the multiplication of self-employed workers and, in recent years, the impact of the digitalization of the economy.

- *From an economic point of view*, price pressures are the result of a rapid economic recovery after a sudden interruption, in other words, a temporary disruption of production and transmission lines, and temporary imbalances between supply and demand. Over the next few months, the morale of US manufacturers, at its highest level in 50 years, may augur a resumption of investment, and therefore pressure component prices, as seen in the price index for the fourth quarter. At the same time, the slowdown in the Chinese economy is a sensitive factor because China buys around 50% of the commodities produced in the world. A relaxation in the prices of metals and agricultural products is all the more conceivable since an increase in supply is foreseeable for certain products.

- *From a forecast perspective,* in the very short term, inflation is the result of temporary base effects, compared with the first half of 2020. Over the next few years, energy transition will be inflationary because asset depreciation will be necessary, because alternative energies are more expensive than fossil fuels, because investments will be required in these new sectors, but we can bet that technical progress will brings costs down. In the longer term, a study by the BIS 1870-2016 on 22 countries, highlights the inflationary nature of an increase in the number of dependent persons because there is a scarcity of labor and stimulation of consumption, but this remains moderate. Therefore, the only factor for a possible structural return to inflation would be a populist push, massive repatriations of activities, increased protectionism, the appointment, as in Turkey recently, of submissive central bankers, and demagogic measures.

- *From a trade point of view*, we do not believe in the scenario of deglobalization and of protectionist withdrawal. It would inevitably be inflationary, but recent international trade figures show a rapid recovery in trade and developed economies remain very intertwined in trade, with exports representing up to 50% of GDP.

- *From a bond perspective*, the $1400 billion in bond purchases by the FED in 2021 are holding 10-year yields at 1.60%, but what will happen next? The acceleration, even if temporary, of inflation is a bad thing, especially for the high-yield bonds of the most indebted companies. As a result of higher inflation, real rates are more negative than they were a few months ago, so we can expect nominal rates to rise. This is not the worst of it, however, because higher rates can be associated with economic recovery, and therefore with the improvement of conditions for companies.

- *From a monetary point of view*, an increase in the speed of currency circulation should also be inflationary in a context where central banks are more focused on restoring full employment than on inflation. We can observe bubbles in the price of cryptos, real estate and other financial assets. But the FED could reduce and then stop its purchases from the end of this year.

- *From a company perspective,* an NBER study of wage increases at McDonald's between 2016 and 2020 shows the impact of wage increases on product sales prices. It is therefore important to assess the competitive position of companies, their ability to absorb an increase in wage costs in the event of a scarcity of labor, and their ability to pass on increases in intermediate costs, such as, recently, those of commodities (copper, iron ore such as soybeans and maize, all at the highest level since 2011 or 2012), transport costs (the Baltic dry index, which has risen by 700% since April 2020), and semiconductors.

In short, "***Go your way without worrying***", wrote ***Verlaine*** in Sagesse, the stock market can continue to appreciate and accommodate inflation temporarily between 2 and 4% in developed countries, and between 6 and 9% in emerging countries, but not an uncontrolled slide, nor a spiral, as in the 70s. Let us remember the stock market does not perform badly in a context of moderate inflation. It is possible to protect oneself against this increase with the buying of financial, real estate, commodity-linked securities, and companies in a dominant position capable of passing on increases in intermediate costs. On the other hand, one should be wary of companies that are sensitive to rising long-term interest rates: infrastructure stocks, consumer staples, yield stocks, and growth stocks, even if they have already lost some of their overvaluation.

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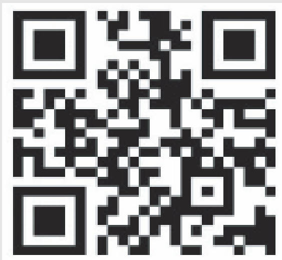

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