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Investment Management

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POTENTIAL ‘SURGE ON INFLATION’

Medium/long-term outlook on inflation and implications for portfolios

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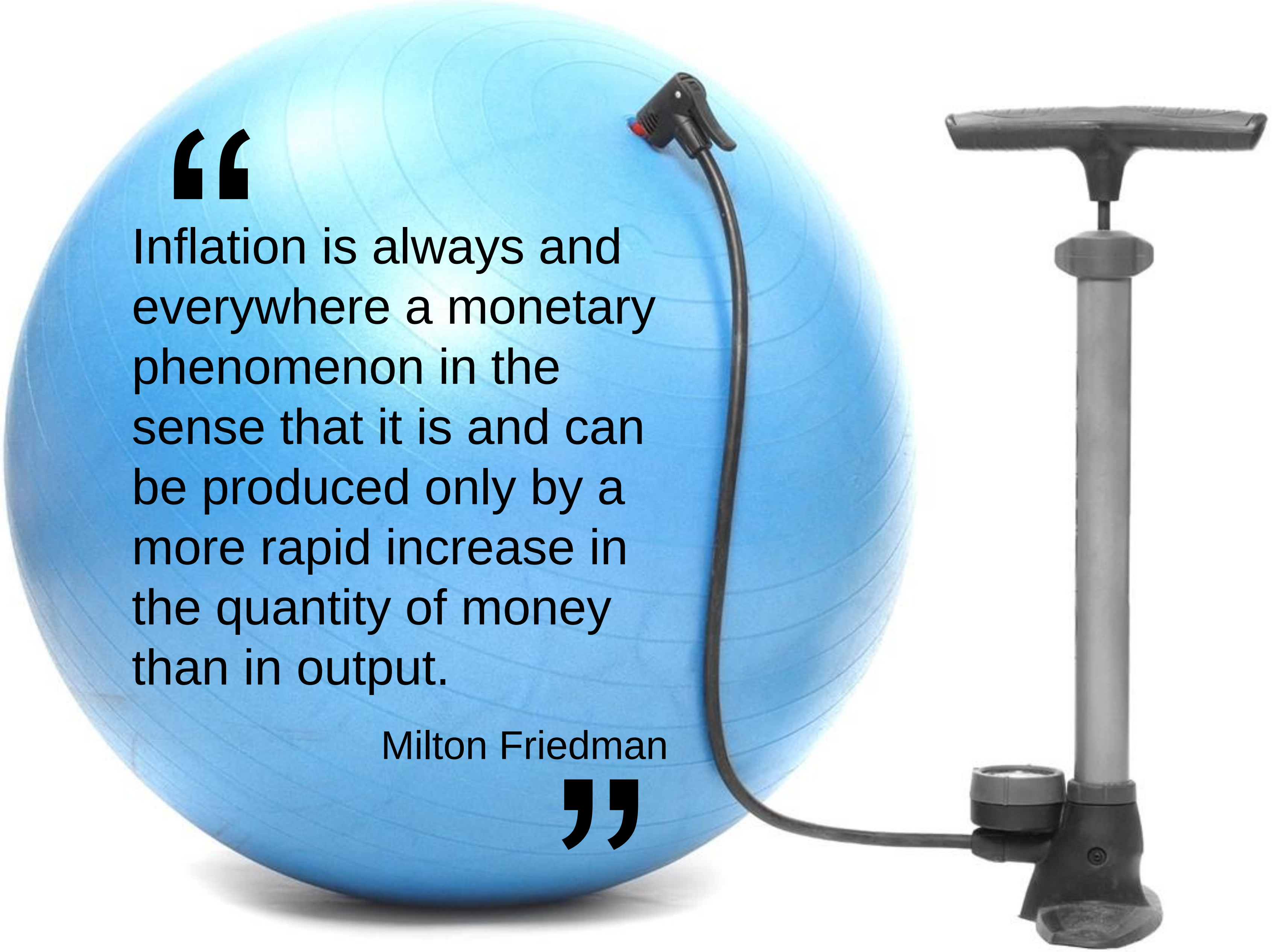
29 September 2021

NEWTON Investment Management

Overview

A MONETARY VIEW OF INFLATION

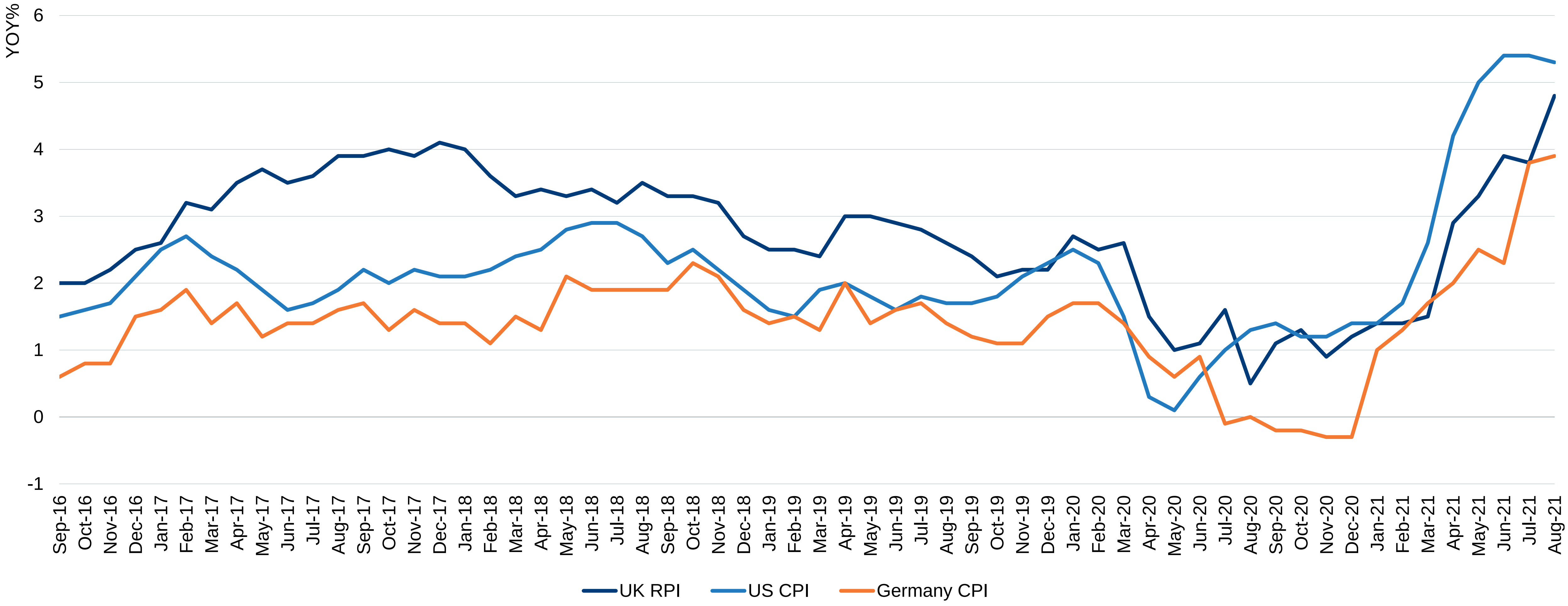
A monetarist view of inflation



> "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."
>
> Milton Friedman

A crisis-induced acceleration of inflation

Headline inflation measures



Source: Bloomberg, September 2021.

Transient or persistent?

How is money created?

Through the expansion of bank balance sheets

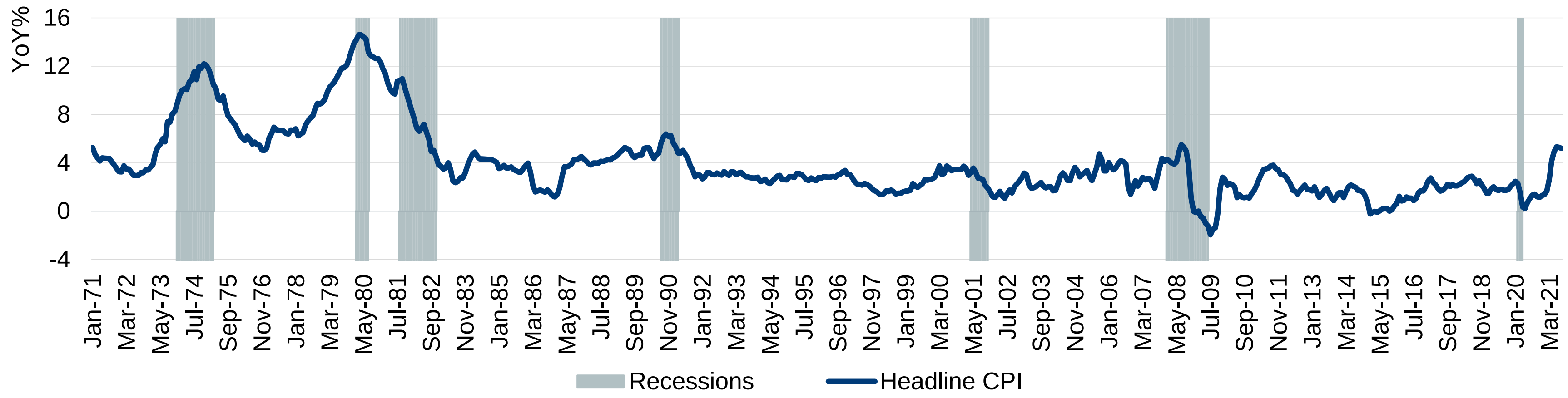
Commercial banks

Central banks

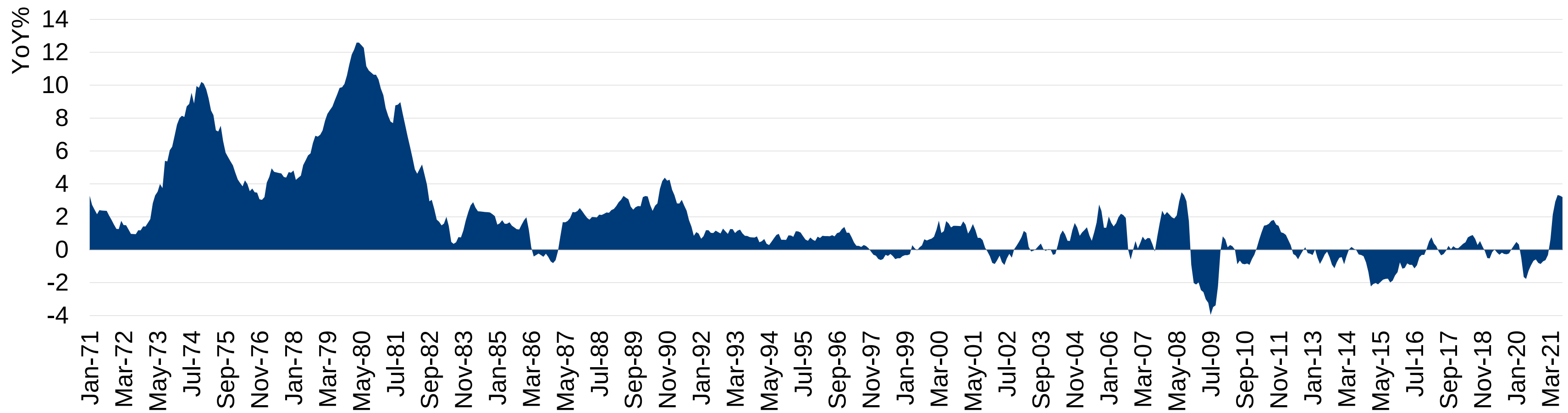
Monetary expansion creates nominal purchasing power

History to repeat itself?

United States - CPI YoY%



Headline CPI - 2%



"Inflation didn't budge during or after the Fed's purchases in the 2007-09 crisis. Despite warnings by critics that moves would destroy the purchasing power of dollars, inflation has remained below the Fed's 2% target for most of the decade. Interest rates also stayed low"

WSG 10 April 2020

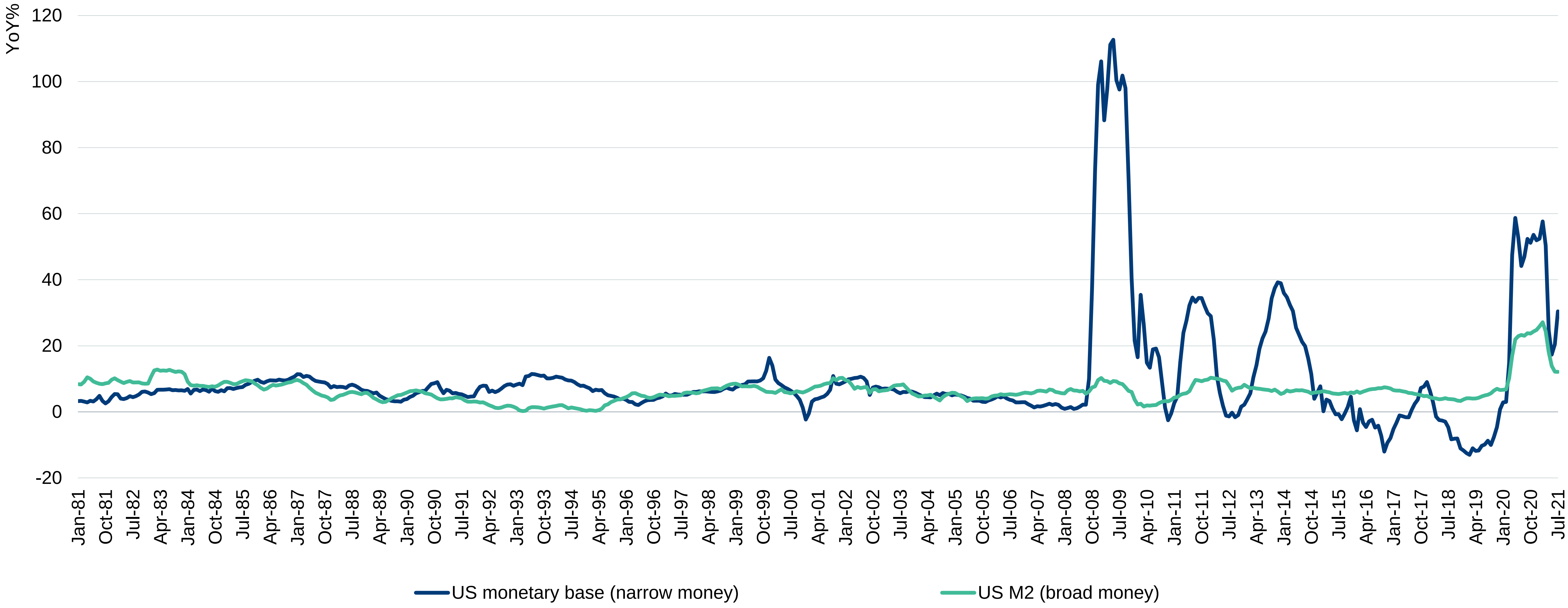
Source: Bloomberg, September 2021

So was Friedman wrong?

Why QE wasn't 'inflationary'

Commercial banks were insolvent

US broad & narrow money



Source: Bloomberg, September 2021.

There was no surge in bank lending / money creation

Why QE wasn't 'inflationary'

There was no massive expansion of money supply

FEDERAL RESERVE

- Purchased $3.7tn of securities
- Only 75% from non-bank counterparties = $2.8tn

COMMERCIAL BANKS

- Wrote off bad debts of $1.4tn
- Increased net loss-absorbing capital by $1tn
- Total $1.4tn

NET IMPACT ON BROAD MONEY SUPPLY

- Increased by $400bn

- Commercial banks had to rebuild their balance sheets
- Over the 2009-14 QE period board money supply only increased by +11%

- Headline CPI +12%
- Core CPI +10%
- All annualised at 2.0-2.2%

Incorrect to conclude that QE/ money printing is not inflationary

Source: Federal Reserve, Newton calculations

Deflationary depression averted

01 Without QE, US broad money supply would have contracted by $2.8tn

02 Equal to -20.8% of pre-GFC broad money supply

03 This is before self-reinforcing dynamics kicked in (averted by QE) which would have amplified the contraction in broad money

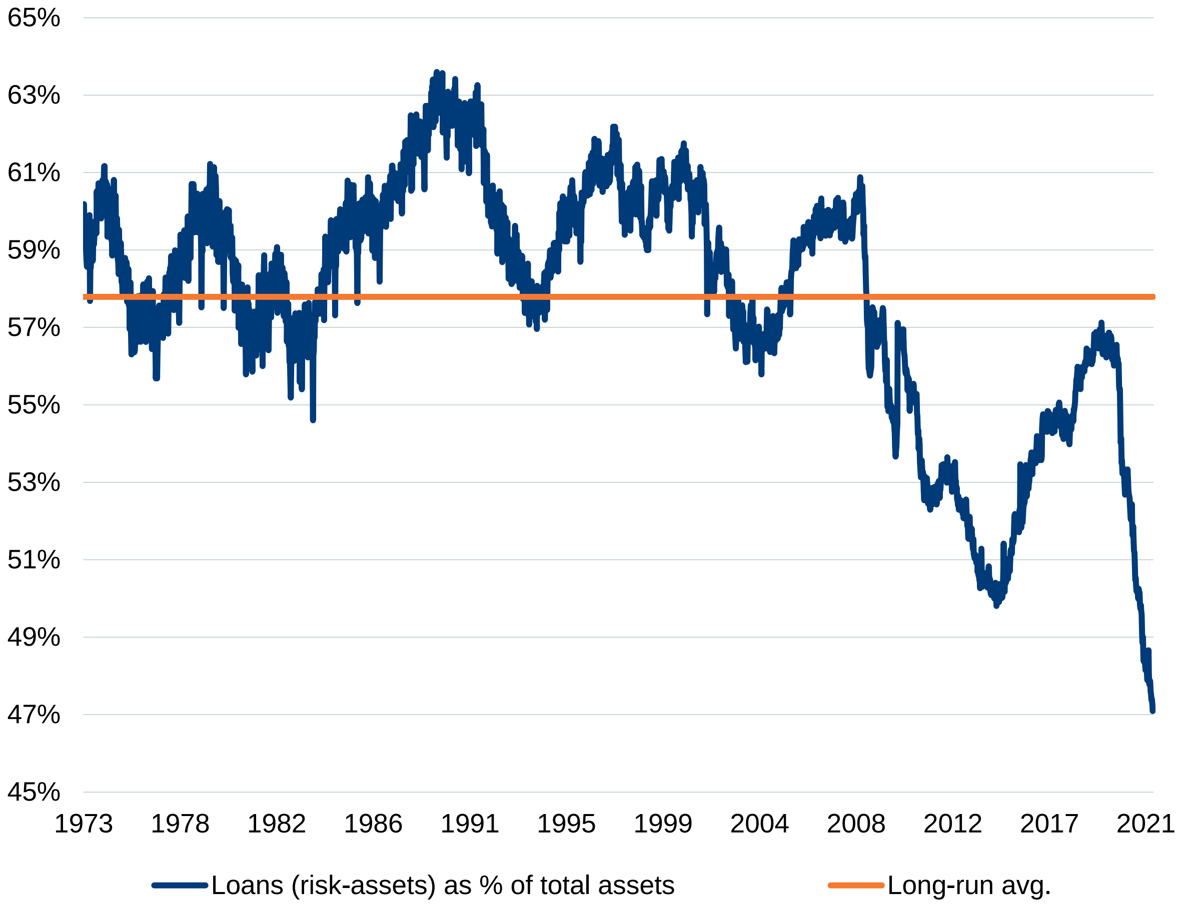
04 This is comparable to the -38% contraction of broad money during the Great Depression (Friedman & Schwartz)

IT’S DIFFERENT THIS TIME

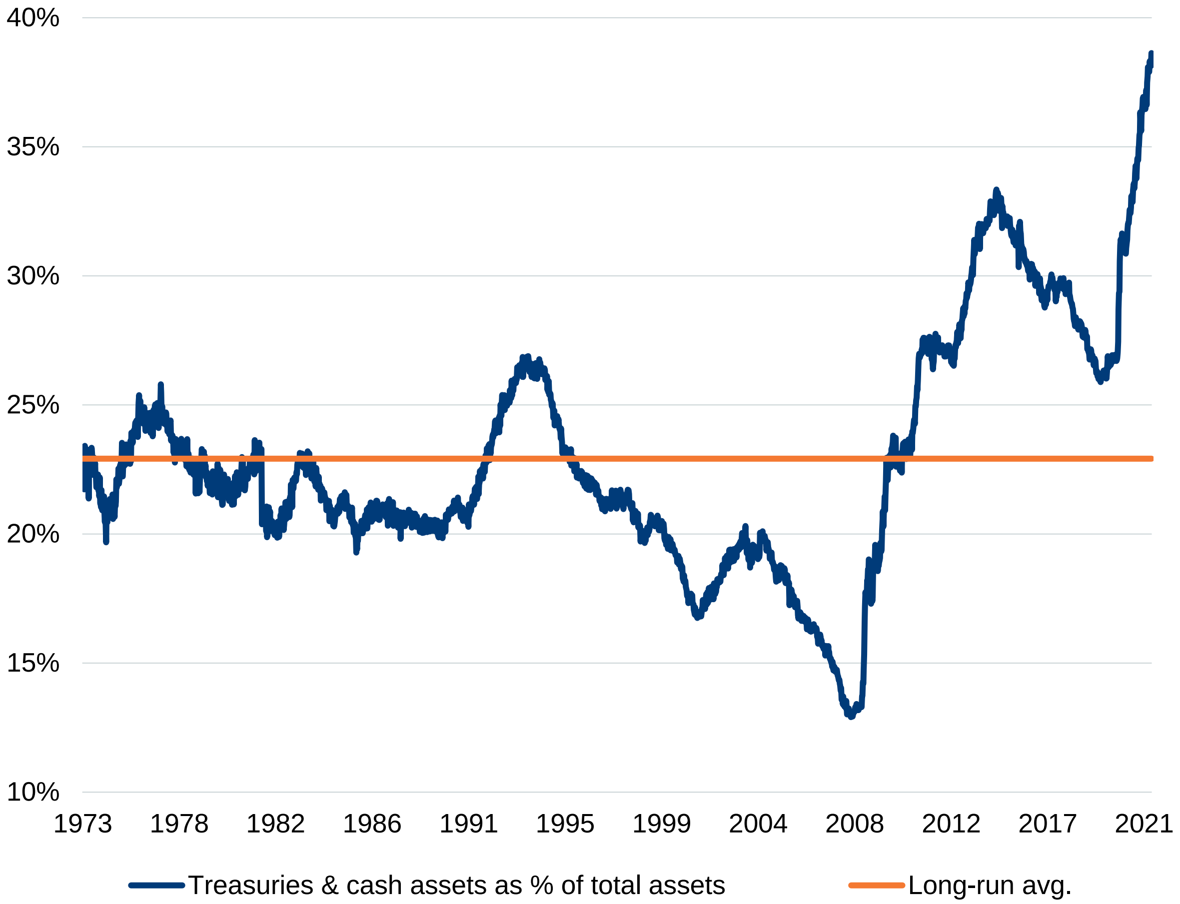
It's different this time

The government response to the economic lockdowns prevented a systemic credit event

US commercial banks - loans (risk-assets) as % of total bank assets



US commercial banks – liquid assets as % of total bank assets



Money printing today is not offset by commercial banks rebuilding their balance sheets

Source: Bloomberg, Newton calculations, September 2021

Supply side

Just because commercial banks are in better shape and in a position to lend into any economic recovery does not mean we will see a sustained acceleration of inflation

Need to consider the supply side as well

If supply were to increase roughly in line with demand, there will be no sustained acceleration of inflation

From supply-side to demand-side economics

The defining features of the post-GFC period are:

1. Increased deficit-funded government
2. Financial repression
3. Rising monopolistic power
4. Suppression of price discovery

This has arguably started before the GFC but the move has accelerated since and has accelerated further with the covid crisis

There is a demand amongst electorates for this shift and unsurprisingly politicians are willing to respond

Governments are taking increasing control of the social technology that is money

Bernholz showed logically and empirically that the necessary condition for a sustained acceleration of inflation is the monetary financing of fiscal deficits

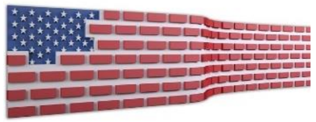
From supply-side to demand-side economics

The focus of state intervention will vary from country-to-country and through time

There are already some common threads emerging

- Rebuilding ‘green’ economies
- Backlash against globalisation and support of localised production
- Increasing transfers to lower earners

A fast-evolving backdrop

	HUMANS	ROBOTS	
	GLOBALISATION	ISOLATIONISM	
	BONUSES	UNIVERSAL BASIC INCOME	
	FREE TRADE	PROTECTIONISM	
	LOW TAXES	HIGH TAXES	
	ELITISM	POPULISM	
	DEFLATION	INFLATION	

Source: BAML/Newton, 2021.

IMPLICATIONS FOR MARKETS

Follow the money

Liquidity to be increasingly challenged to 'real' economy at the expense of the financial economy

- The dominance of supply-side economics has coincided with remarkable returns for investors
- From a fundamental perspective the massive expansion of global output has seen a huge expansion of aggregate corporate earnings
- From a cost of capital perspective, laissez faire monetary policy (clearing up after bubbles burst rather than seeking to preventing imbalances) has been central to the massive expansion of liquidity that has inflated asset prices
- Side note – CPI statistics have so poorly captured the real impact of the expansion of money since the US took the world of the gold standard in 1973 because assets are not included in CPI baskets while an increasing quantity of money has been put to work in the 'real financial economy over the 'real economy'

Follow the money

Liquidity to be increasingly challenged to 'real' economy at the expense of the financial economy

If, at the margin, liquidity is increasingly channelled into the real economy at the expense of the financial economy there will be major consequences for financial markets

1. Shifts in earnings growth differentials between companies/industries
2. Cost of capital
3. Less demand for financial assets
4. Increased volatility
5. Decreased capacity for leverage

This is intentional high level

We should not pretend we know more than we can

The key point is that the distribution of possible outcomes is expanding

Importantly, consensus thinking informed by extrapolating the trends of the last three decades should be viewed with caution

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