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A new inflationary regime: Why the next decade could look different from the last

THERE MAY BE A REGIME CHANGE UNDERWAY as we move from a monetary policy-dominant environment last cycle to globally loose fiscal policy supported by dovish monetary policy. Many of the elements driving this transition were in place before this year, but responses to the COVID-19 pandemic may have accelerated the trend. We believe this development has increased the likelihood of the economy exiting the current deflationary regime. This evolution is globally applicable, but we will mostly focus this paper on the US, given its major role in the global financial system.

In our experience, it is very difficult to predict long-term inflation levels, as it is a complicated process with many offsetting forces that no one fully understands. Even the US Federal Reserve (Fed) recently effectively admitted they are unable to project inflation accurately, instead pledging to shift to an emphasis on average realized inflation. Forty years of disinflation appear to have chipped away at policymakers' fear of inflation. Congress seems no longer focused on the negative consequences of deficits and central bankers are more concentrated on generating inflation and tight labor markets than limiting upside to inflation. Importantly, while the COVID-19 response is hopefully a shorter-term dynamic, the change in policy preference could be more structural. We think this change increases the risk of a policy error leading to higher inflation as governments are running a real-time fiscal and monetary policy experiment with unknown outcomes.

We therefore believe that while deflationary outcomes remain a risk, the tail risk of structurally higher inflation is the greatest it has been in decades and isn't fully captured in current market pricing. In this paper, we outline the current policy landscape, the differences between this environment and what transpired after the global financial crisis (GFC), potential paths to higher inflation, key industry dynamics, and the investment implications of a new high-inflation regime, which could be dramatic given that the financial system has become levered to low inflation and low interest rates.

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A general framework for inflation

To put our current inflation outlook in perspective, let's first outline our framework for thinking about inflation sources and expectations. Prices are impacted by the intersection of supply and demand. Demand can move cyclically, creating periods of short-term inflation driven by factors ranging from credit cycles to fiscal policy. Historically, supply-driven inflation has been fueled by commodity market disruptions, by imported inflation through currency, by cheap capital (in recent years), and, for the last three decades, by a positive supply shock from an abundance of cheap labor through globalization. The balance of supply/demand can be structurally impacted by factors such as demographics, wealth inequality, and technology-driven productivity gains. The key question is whether the changes currently occurring will push the economy to a point where demand is sustainably higher than the supply of goods and labor.

Inflation expectations also play a critical role. All of the above factors tend to push inflation around a fairly stable level as long as inflation expectations are anchored via credible policy. For example, credit cycles are dampened by increases in interest rates, and rising goods prices are eventually slowed when they begin to impact demand. However, when rising inflation leads to rising inflation expectations, a more pernicious cycle can occur (**Figure 1**). In those cases, rising inflation expectations lead to escalating wage demands, which cause increasing costs that are passed on to consumers, leading to another round of rising prices (and so on). In our view, the primary achievement of central banking over the last 40 years was effectively anchoring inflation expectations in a world of pure fiat currency. But it's worth asking whether the current shift to loose fiscal policy supported by dovish monetary policy could pull inflation expectations in developed markets away from the 2% target to which they've long been anchored.

Figure 1
Inflation expectations could contribute to a pernicious cycle
Structural impact driven by expectations

Demand pull inflation
Caused by excess aggregate demand
- Money and credit cycle
- Demographics
- Wealth distribution
- Fiscal policy

Cost push inflation
Caused by decreased aggregate supply
- Rising wage costs
- Increased raw material cost (goods or commodities)
- Rising import cost from currency depreciation
- Cost of capital
- Technology/productivity

Administered prices
- Changes in regulated prices
- Changes in taxes and subsidies
- Changes in environmental taxes

Hyperinflation
- Loss of confidence in currency leads to depreciation
- Government has hard liabilities leading to increasing issuance to fund liabilities

Source: Wellington Management. For illustrative purposes only.

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We believe there have been some significant changes in policy focus that could lead to higher inflation in the future.

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The combination of demand, supply, and expectations is central to whether we'll enter a new inflation regime. While many drivers of inflation are arguably shifting (lower commodity supply and a retreat from globalization, most notably), this paper primarily explores the implications of the evolving policy backdrop, which could potentially be a structural change that both spurs demand and alters inflation expectations.

The impact of recent policy

We have had a period of 40 years of disinflation-oriented policy. But, as noted above, we believe there have been some significant changes in policy focus that could lead to higher inflation in the future.

Monetary

The Fed has lowered rates to virtually zero and increased its balance sheet from 20% of GDP in 2019 to 33% as of the third quarter of 2020, in concert with Treasury programs seeking to effectively guarantee liquidity in the financial system. Notably, the Fed has also moved from a 2% inflation target to targeting an average of 2% over time, implying a desire for inflation of 2%+ for some period of time to make up for a shortfall in inflation over the past decade. In our view, the fact that the impetus for this change began before the global pandemic, while unemployment levels in the US were still very low, signals that the central bank was structurally changing its focus and had effectively abandoned its reliance on indicators of inflation such as the Phillips curve.

Instead, the Fed intends to maintain low rates until there is clear evidence of 2% inflation and maximum employment. We think this formalizes an evolution at the Fed in recent years in which officials have probed to see how low the unemployment rate can go without generating higher inflation. The Federal Open Market Committee (FOMC) has adopted a new pledge to review its framework every five years, allowing for more regular changes to monetary policy based on the transformation of the underlying economy. While the Fed seems keen to pursue average inflation over time, given the zero lower bound at which interest rates are pinned today, it is increasingly possible that it may accommodate an inflation overshoot in coming years.

Fiscal

The COVID-19 crisis unleashed a powerful fiscal response as Congress moved quickly and aggressively, spending US$2.4 trillion (roughly 12% of GDP) on aid to consumers, businesses, hospitals, and state and local governments. Checks in the mail, expanded unemployment benefits that extended coverage to gig-economy workers, and a boost in unemployment payments added up to a peculiar feature of this recession: Consumer incomes rose while output and employment declined. This stimulus has been critically important for jumpstarting the recovery as lockdowns have been eased. At the same time, small business owners received aid through Paycheck Protection Program (PPP) grants, and additional loan guarantees and aid were offered to companies in the travel and hospitality industries.

Of course, several measures lapsed as the partial opening of the economy continued and the US presidential election took center stage. The announcement of soon-to-be widely available vaccines provided much needed good news across the globe. Congress passed an additional US$900 billion package in December 2020 which should offer a bridge to those who are most affected by the winter lockdowns. Key measures include unemployment benefits and stimulus checks, which could increase

In our view, 2021 should prove to be a good year for US economic growth, with US consumer savings up US$1 trillion relative to the pre-COVID levels, perhaps signaling consumer spending increases to come.

the potential for demand to come back strongly on reopening. In addition, a similar amount has been assigned for PPP loans for small businesses to help them survive until vaccines can allow for normalization. It is also likely that the incoming US administration will focus its early days on additional help for the hardest hit parts of the economy.

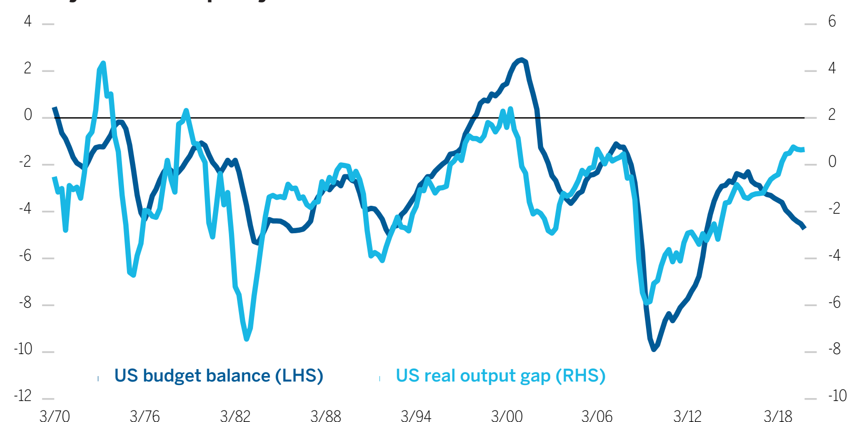
In our view, 2021 should prove to be a good year for US economic growth, with US consumer savings up US$1 trillion relative to the pre-COVID levels, perhaps signaling consumer spending increases to come. Finally, we believe any further measures that are passed by the new government would be especially additive if they were concentrated on improving economic productive capacity to help drive a multiyear expansion in the US.

Interestingly, the Fed's US$3 trillion balance-sheet expansion matches the fiscal spend. So, the Fed has effectively enabled aggressive fiscal policy by minimizing the cost through interest-rate suppression. In our view, these policies make sense given the unique challenges of the government-mandated shutdowns, but they should not be seen as one-offs and certainly cannot be completely disassociated from the recent rise in prominence of Modern Monetary Theory (MMT).[1]

MMT-inspired ideas were already spreading pre-COVID, following four decades of disinflation and falling interest rates. This was apparent in 2018, when US officials elected to run a pro-cyclical fiscal deficit — the first since the 1960s (**Figure 2**). Then, in 2019, the Fed also appeared to reconsider their mandate after rate hikes led to a housing slowdown and equity sell-off in the fourth quarter of 2018. COVID-19 accelerated these trends and normalized policy actions that would have been hard to imagine a decade ago. We believe it may be difficult to reverse course given the imbalances in the economy, the limited capability of monetary policy to spur demand with interest rates reaching their lower bounds, and a lack of cost to aggressive fiscal policy thus far. We expect fiscal policy will continue to be used to spur demand in coming years, especially at any point when economic risks rise.

Figure 2

Pro-cyclical fiscal policy over time



The divergence in the output gap and budget balance demonstrate the pro-cyclical fiscal policy. | Sources: Bloomberg, US Treasury, Congressional Budget Office. | Chart data: 31 March 1970 – 31 December 2019.

[1]Under MMT, a government can engage in whatever level of deficit spending is necessary to achieve its economic aims; default risk is considered irrelevant because the government can always print money to repay its obligations.

With the backdrop of 2009's weak economy, we never reached a point where demand sustainably pressured supply. The setup today is quite different.

Why 2008 did not spur inflation (and how this time is different)

Today's crisis has a clear parallel to the immediate aftermath of the GFC, when concerns about inflation proved misplaced. It's easy to extrapolate that experience here, but we see potentially significant differences. It's therefore worth exploring why quantitative easing (QE) did not prove inflationary.

QE is often referred to as "money printing" as the Fed creates money to purchase assets — typically mortgage-backed securities (MBS) and Treasuries. However, if it was pure helicopter money, the seller would *still hold* the asset and have cash. The inflationary impact of QE rests on what the seller of that asset does with the money. If they decide to spend the money on goods and services, then money circulating in the economy will temporarily increase. QE is therefore very different from the image in one's mind of money printing as it relies heavily on indirect effects and is much more similar to traditional interest-rate policy.

In the GFC, two dynamics limited this policy's impact on the real economy. First, banks were distressed, and consumers were over-levered, which restrained any new lending. Instead banks increased reserves at the central bank by nearly US$3 trillion, thus decreasing the money multiplier in the economy. Second, as investors sold their Treasuries to the Fed and rates declined, they looked for other investment opportunities instead of spending the proceeds and were pushed out on the risk spectrum to other assets. This raised asset values and helped improve financial conditions, likely limiting the severity of the recession. However, it did not create excess demand for goods and services. The increase in stock prices mostly benefited wealthier individuals, who have a much lower propensity to spend additional income. With the backdrop of 2009's weak economy, we never reached a point where demand sustainably pressured supply.

The setup today is quite different. The Fed, as we said, is effectively enabling loose fiscal policy, bypassing the role of the banking sector. For example, the US$1,200 checks mailed to individuals in 2020 were funded by an increased fiscal deficit, with the Fed simultaneously increasing bond purchases. This policy overcomes the shortcomings of standalone QE as it doesn't rely on consumers taking on increased debt to spur consumption and it disproportionately benefits those with lower incomes, who have a higher propensity to spend. Continued policies of this nature will, in our view, be much more effective at increasing demand and nominal GDP, but where and when that demand hits supply constraints will determine whether higher inflation is an outcome. In addition, relative to the GFC, a stronger banking sector, lower household debt, deglobalization, and a relatively expensive US dollar all aid in the case for inflation.

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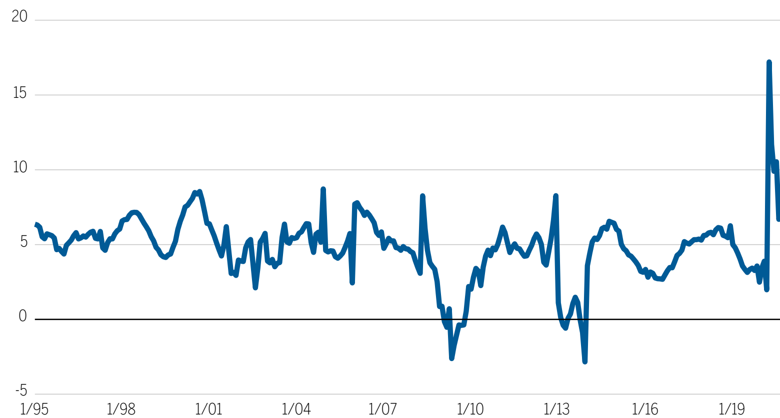
Arguably, whether we go the path of Japan or the US in the 1970s depends on how the consumer responds.

Figure 3

US after-tax disposable personal income

% change year-over-year



Source: Bureau of Economic Analysis. | Chart data: 31 January 1995 – 31 October 2020.

The path to inflation

What is the potential path to an inflationary regime? In the near term, we believe a closure of the output gap is the most significant dynamic to watch and will be dependent on a resolution to the pandemic, allowing demand to recover. It is possible to generate inflation without a closed output gap, as many emerging markets (EM) have experienced, amid currency crises, periods of hyperinflation, and commodity shocks. However, while some monetary and fiscal policies may appear extreme and unsustainable, the lack of hard liabilities in most developed countries makes a currency crisis unlikely. In addition, the potential for oil supply to come back at significantly higher prices (considering shale's short-cycle nature and OPEC spare capacity) makes prolonged commodity-supply-driven inflation an unlikely near-term concern.

As we've noted, our outlook for higher inflation is largely driven by the view that we've had a regime shift toward more persistent fiscal support, which could drive demand-pull inflation. The fiscal response to COVID-19 is already 2.5 times the response to the GFC and may continue to grow. While we expect volatility around near-term stimulus plans, the path to higher inflation will become clearer if we see additional consumer support (for example, another round of checks to households), a greater commitment to infrastructure spending, or, more globally, further progress on the European Green Deal, and/or persistent policy support in China. Additionally, continued momentum on policies that increase the spending power of lower-income workers will go a long way to spurring demand and inflation. This could include wage policies, which can increase potential demand, raise costs, and potentially spur the wage spiral mentioned earlier.

Consumer behavior is also important to watch. In theory, individuals could save more as they look ahead and assume that fiscal stimulus will need to be paid back in the form of higher taxes at some point, diluting the impact of fiscal expansion. In practice, it does not appear consumers are behaving this way. Money was spent freely when available in 2020, and any tax-hike risks seem centered on either corporations or wealthy individuals. Arguably, whether we go the path of Japan or the US in the 1970s depends on how the consumer responds. In Japan, inflation never took hold as any fiscal increases saw consumers retrench in expectation of higher taxes.

It's hard to overstate the impact of inflation expectations on the potential for a regime change.

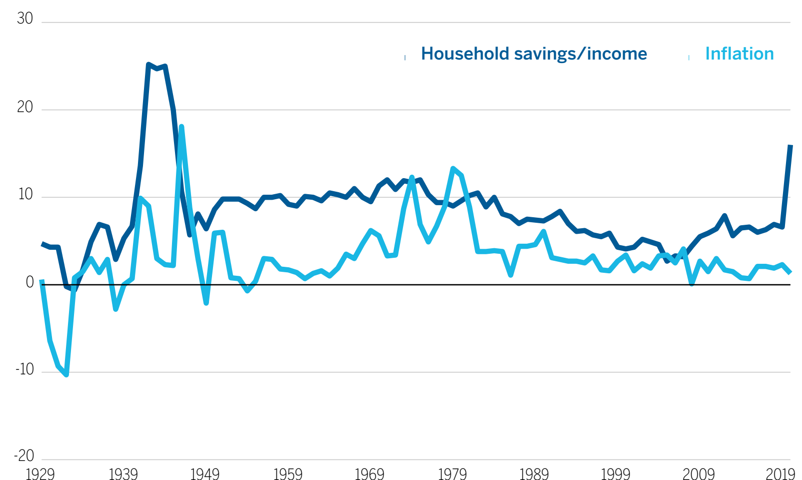
Conversely, in the late 1960s and into the 1970s, the US ran simultaneous public and private deficits, which, along with accommodating monetary policy, eventually led to inflation.

While our base case is that it would take time to close the output gap and generate more generalized inflation, it's possible this could occur more quickly than expected for a few reasons:

- In aggregate, there was a big increase in savings and bank deposits in 2020. This pent-up demand could quickly soak up spare capacity as the economy reopens, as it did post-World War II, the last time we had this type of forced saving (**Figure 4**). Just consider, as safety concerns recede, are consumers more likely to take a vacation after a year-plus of lockdowns than they otherwise would've been? What could that mean for jet-fuel demand?
- There has been significant damage to the supply side of the economy due to lockdowns. The impact has been evident in the shortages and price increases in industries where spending has been occurring (e.g., building products) and in some commodities (e.g., base metals).
- In 2020, core inflation fell by 1.2% from February to June, but then rebounded by 0.5% as of September. The decline through the first half of the year was less than during prior recessions and could, in fact, significantly overstate the weakness. It was primarily driven by industries such as airlines, where demand was shut down quite literally. Outside of industries directly impacted by COVID, pricing was remarkably stable.[2] Further, consumer inflation expectations rose during this recession, the first time they've done so since this data became available.[3]

Figure 4

Inflation and household savings/income (%)



Source: Haver Analytics. | Chart data: 31 December 1929 – 30 June 2020.

Lastly, it's hard to overstate the impact of inflation expectations on the potential for a regime change. These have been well-anchored around 2% for the last 25 years due to hard-won central bank credibility. With anchored expectations, when inflation deviates from target, economic actors assume it is a temporary phenomenon and, therefore, businesses don't raise prices and labor doesn't demand higher wages. Loose fiscal policy combined with the Fed's shift to average inflation targeting opens the door for this anchor to break. If some of the above sequences do play out

[2]Source: San Francisco Fed research. As of June 2020.

[3]Source: University of Michigan Consumer Sentiment Survey. As of November 2020.

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and we see realized and/or expected inflation start to rise well above 2%, the key test will be how policymakers respond. Only time will tell if they tighten policy as in 2018 and risk a slowdown and deflation of asset prices, or if they let the economy run hot and risk a regime change in inflation, unwinding the major success of central banking policy since Paul Volcker.

For now, some of the key dynamics we are watching are:

- Behavior of the US dollar. Starting from an elevated valuation and with real yields having collapsed, a falling US dollar could push up import prices in the US and historically tends to be globally reflationary.
- Continued fiscal support for consumers and continued willingness to spend.
- Supply-side damage. How quickly can affected industries ramp up production and how do inventory levels evolve?
- Health developments around COVID. Continued lockdowns, especially without adequate fiscal support, could lead to more long-term unemployment, which would put downward pressure on wages and raise deflation risk.

Key industry dynamics

Below we outline the impact of a few key industries on consumer price index (CPI) expectations in the current environment.

Housing (33% of CPI)

In general, housing can be split by type (e.g., multi-family and single-family) and by location (e.g., city-center versus suburbs/outlying areas). In recent years, construction has primarily been in higher-end multi-family urban developments, where the high prices and economies of scale can justify labor costs. COVID turned the preference for cities on its head as high-density areas quickly became undesirable.

Many will undoubtedly return to cities as the pandemic fades, but city living has certainly lost much of its allure. The housing benefits offered by working from home, young couples' desire to move to the suburbs, and retirees' reluctance to move to downtown apartments or assisted-living facilities could all begin to reverse the city-living trend. There may then be an overcapacity of apartments in city centers and rent levels could decline, but this will likely be more than offset by demand for suburban housing. The desire for single-family housing (with less efficient construction and maintenance) could cause the overall cost of living to inflate. While lower interest rates on mortgages may lower costs of ownership, higher house prices and construction costs in an already undersupplied industry will likely lead to inflation for this significant portion of CPI. It's also worth noting that we're seeing an increase in household formation that is very important for demand more broadly.

Restaurants (6% of CPI)

This industry has sustained a major disruption and may be altered indefinitely. Takeout and delivery-oriented restaurants are likely to have strong enough demand to stay in business and should have decent pricing power while demand is high. However, the cost equation has changed dramatically for struggling sit-down restaurants due to reduced demand and lower capacity to enable social distancing — especially considering fixed costs like rent. In general, supply will likely decrease and the higher costs of doing business will have to be passed onto customers for businesses to survive.

Energy/transport (18% of CPI)

Lockdowns obviously negated the need to travel, dramatically reducing demand for energy and transport services and, correspondingly, collapsing prices. The lockdowns are only temporary but spending patterns may be impacted for a lengthy period. For many months, if not years, those who can avoid public transport will do so — making price increases unlikely.

However, this should be offset by a major increase in personal transport — with a likely surge in demand for new/used cars and, accordingly, for gasoline. Though electric vehicles may become more popular, until battery prices drop substantially, energy and vehicle prices should remain well-supported for the short to medium term.

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The growth/yield backdrop will be an important high-level driver of which inflation-sensitive assets outperform in any coming inflation period.

Investment implications: Hedging the new inflation regime

The potential shift to a new high-inflation regime could be the most important dynamic to monitor for asset returns in 2021. Financial markets have been inflating incredibly as the economy has been in a Goldilocks period of rising growth with no prospect of monetary tightening. More broadly, the economy has become increasingly levered to low interest rates. For example, the sustainability of high government and corporate debt is underpinned by low interest rates. Rising inflation would disturb this balance and damage the assumptions underpinning high asset valuations and the economy.

The growth/yield backdrop will be an important high-level driver of which inflation-sensitive assets outperform in any coming inflation period. The near term seems to support rising inflation with low yields and likely falling or low real yields. In our view, some inflation assets are more levered to low yields and should do better in this environment. If, over time, we transition to more of a traditional reflation period with strong growth and rising yields, the implications will be quite different. We think the assets discussed below should be attractive in an inflationary period from here. Importantly, we believe diversifying across them can further leverage their differing dynamics.

Gold and gold equities — To the extent that monetary debasement is global, gold is the one currency left standing. It's not cheap at this point but its market cap is low compared to the potential flow if this theme gets going. The combination of financial repression with rising inflation is a supportive backdrop for gold as investors look for alternatives to cash and bonds. In our view, there is still plenty of upside — and diversification potential — if current structural trends continue. Further, gold miners were perhaps the worst-performing sector last cycle as overinvestment led to substantial losses. Management teams have responded by becoming far more conservative, allowing for stronger balance sheets, high free-cash-flow generation, and less risk of increased supply hurting prices.

Commodities versus equities — Commodities have had an epic bear market, especially in the context of an equity bull market, leaving valuations attractive. A shift toward a weaker US dollar and a preference for shorter-duration assets and real assets broadly could reverse this trend. Importantly, high equity valuations historically have been a function of low/stable inflation, which allows for low discount rates and a low risk premium. Higher inflation could increase economic volatility as well as discount rates. Renewed interest in commodities, as demand for money declines due to inflation, could significantly push up prices. More fundamentally, supply conditions are very favorable as capex has been constrained for several years due to the bear market, and in some cases new demand sources are becoming apparent (e.g., in metals, which could be a key component in various green spending areas). Notably, negative roll yields have historically been a major headwind to compounding gains, so we think investments in the space should be focused on mitigating that impact while maintaining the inflation sensitivity.

TIPS — With 10-year real yields at -1%,[4] Treasury inflation-protected securities (TIPS) aren't a particularly appealing allocation in isolation. However, real yields could easily continue to fall in the short term, and over the longer term, TIPS could significantly outperform nominal fixed income in an inflationary period. This could be an attractive risk-off hedge compared to traditional fixed income. Exposure to breakeven inflation looks

[4]Data as of 30 November 2020.

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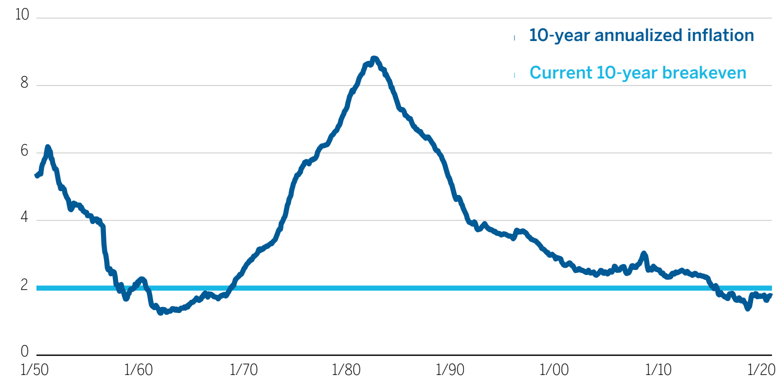
especially attractive as a hedge. Inflation expectations rallied throughout the second half of 2020 and have now reached more normal levels at 2% (**Figure 5**). Given that this remains toward the low end of historical realized inflation, we believe there is still significant upside in an inflationary environment.

Figure 5

10-year inflation and breakevens (%)

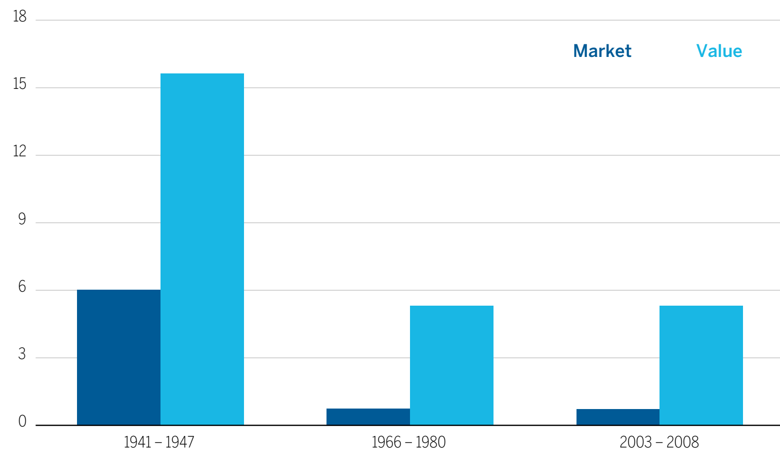


Sources: Bureau of Labor Statistics, Bloomberg. | Chart data: January 1950 – September 2020.

Value equities — Historically, value equities have tended to perform well in inflationary periods like the 1940s, 1970s, and 2000s (**Figure 6**). Their valuations tend to be less impacted by higher rates due to the typically shorter duration of their future cash flows. Inflation can also be a fundamental tailwind as it helps debtors and increases the value of their previously developed physical assets. With value equities trading around an all-time discount on most metrics following a decade of disinflation, a turn in the macro environment could lead to substantial outperformance. Some targeted areas within this universe could deliver improved pricing and may benefit from the evolving macro backdrop, including staffing, transportation and delivery, and climate-adaption securities.

Figure 6

Value in prior inflation regimes (%)

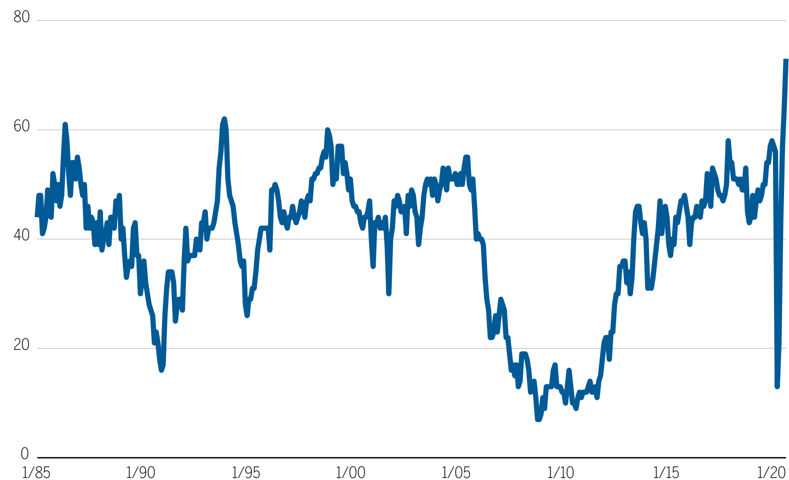


Market represents all NYSE, AMEX, and NASDAQ companies where data is available. Value represents the cheapest 30% of stocks as measured by price/book. Start and end dates represent when 12-month smoothed CPI inflation passed 2%, until the month that CPI peaked. | Source: Fama French.

Residential housing — Real estate broadly stands to benefit, in our view, especially if paired with low yields. Commercial real estate is experiencing a difficult period, with sectors such as physical retail and office facing weak demand. We see residential real estate as a clearer beneficiary with low mortgage rates, increased demand from demographic shifts and deurbanization, and years of muted supply following the GFC. Residential equity REITs, home builders, timber REITs, and housing suppliers are a few potential beneficiaries from these trends.

FIGURE 7

Traffic of prospective new home buyers



Sources: National Association of Home Builders, NAHB/Wells Fargo National and Regional Housing Market Index. | Chart data: January 1985 – September 2020.

The current market backdrop, the impact of recent policy changes, and significant differences from prior crises signal that the risk of a regime change toward higher inflation is at its highest level in years.

Materials equities — We think materials broadly stand to benefit from this backdrop. Industrial metals stocks, in particular, are potentially very well positioned due to cheap valuations, a weaker US dollar, infrastructure spending, and improved industry discipline. Historically, these areas tend to perform best in a reflationary period.

Energy equities — This is likely the most controversial potential beneficiary given the sector's long-term demand challenges and ESG headwinds and cyclical demand challenges due to COVID. We believe this suggests a lower weight than in past inflation episodes. However, oil remains among the most correlated assets to CPI changes, supply is responding as capital has dried up due to low historical returns and ESG pressures, and valuations are very attractive.

Bottom line

In our view, economic uncertainty is high, and a wide range of outcomes is possible for the global economy in the coming years. However, the current market backdrop, the impact of recent policy changes, and significant differences from prior crises signal that the risk of a regime change toward higher inflation is at its highest level in years. Typically, recessions indicate changes in market leadership, with significant upside for those who identify the major structural shifts as other investors anchor to the prior cycle's regime. While numerous factors will need to be watched to confirm the path we are on, we believe the market remains predominantly focused on a repeat of the prior 10 years of secular stagnation, creating risk for portfolios geared toward that environment and offering numerous attractive investment opportunities if a shift is underway.

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