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Inflation at last? The long-term effect of the Covid-19 pandemic

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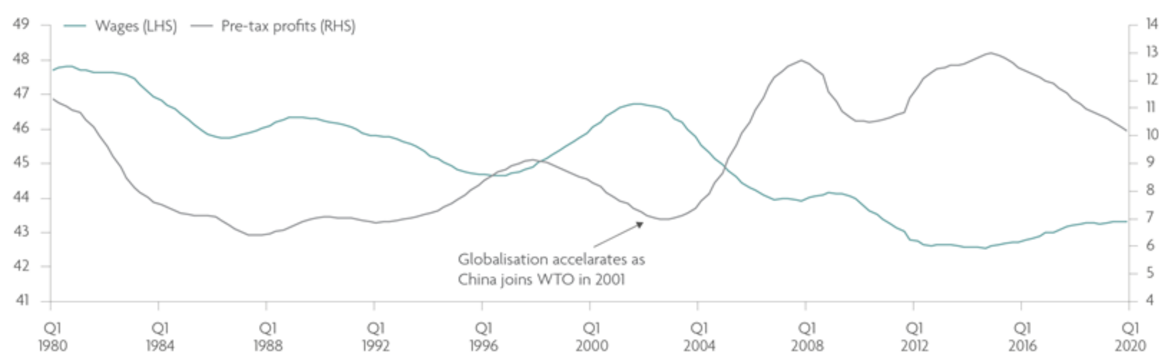
- **Coronavirus impact a massive demand shock across global economy; may take years to unwind**
- **Structural deflationary factors remain, but a period of higher inflation more likely than not**
- **Assets such as gold, inflation-linked bonds and curve steepeners can do well in more inflationary environment**

Since the global financial crisis, inflation has been stuck well below historical levels and central bank targets, averaging 1.3% in the Eurozone, and 1.6% in the US.[1] This is despite exceptionally easy financial conditions, as countries tried to combat deflation using things like negative rates and quantitative easing. The Federal Reserve balance sheet reached a peak of $14.5 trillion as the central bank bought bonds in the market, but inflation remained subdued.[2]

What has kept inflation low?

A combination of structural factors has been keeping inflation low. Ageing populations save more and spend less. Globalisation and deindustrialisation have reduced the collective bargaining power of a de-unionising workforce, and added a plentiful supply of cheaper labour to the global economy. Advances in technology have put downward pressure on costs. The chart below shows how the combined effect has been to inflate corporate profits at the expense of wages, which reached their lowest share of GDP in the US since 1929, putting heavy downward pressure on inflation.

% of US GDP, 3-year average



Source: Refinitiv, 22 April 2020.

What is different this time?
The impact of the coronavirus shock has been a massive demand shock across the global economy. The response from policymakers has been an enormous injection of monetary and fiscal stimulus. But this is a health crisis and a medical solution is required for economies to fully recover. Until that point, partial re-opening will lead to spluttering economies, timid investment and anaemic consumption.

Once economies are fully reopen, the stimulus in place will start to act as a tailwind for global growth and it will be a difficult challenge for policymakers to reduce the amount of liquidity in economies. This has led many to suggest we may see inflation rebound.
Are we to believe that this time it's different? Structural deflationary factors remain. Population ageing continues to accelerate, sovereign indebtedness will be even greater after the crisis, and technology continues to evolve. Huge amounts of stimulus didn't cause inflation after the last crisis.

Nevertheless, we think a period of moderately higher inflation is likely. We don't think this is imminent: the demand shock caused by the pandemic may take years to unwind. Deep recessions are always deflationary. We are already seeing this in the extraordinary collapse in oil prices.

However, we need to keep one eye on the longer-term view, with inflation driven by both demand-pull and cost -push factors. Governments and central banks will find it difficult to unwind policies initiated in the crisis. Budget deficits are likely to be structurally higher and furloughed workers could return to work quicker than after the depths of a typical business cycle, leading to a more rapid closing of the output gap. Central banks are likely to tolerate or even aim for above-target inflation, partly to compensate for years of missing targets, partly to help inflate away sovereign debt.

We also expect that the nature of the crisis and the policy response will impose additional costs on economies as supply chains are reconfigured and the trade-off between capital and labour reassessed. Similarly, some of the structural deflationary factors may abate.

Globalisation was already being undermined by trade tensions. The pandemic has shown some of the vulnerabilities inherent in globalised supply chains, and we expect politicians to bring key areas of production back onshore. The crisis has also shown the reliance of societies on relatively low paid key workers, not just in healthcare but across the public and private sector. Public support for better pay and conditions could undergo a structural shift. This can help reverse the trend shown in the chart above, and a higher share of GDP accruing to wages can help bolster inflation.

We can't underestimate the scale of the demand shock caused by the Covid-19 economic shutdown across the globe. Deflationary concerns from the crisis will dominate markets for the short to medium term. However, even though structural deflationary forces still exist, they are weakening, and as economies eventually do recover we think it more likely than not that we will see moderate levels of inflation return to the global economy in the medium to long term.

What assets may do well in a moderately more inflationary environment?
For investors this means keeping an eye on investments like gold, inflation linked bonds, curve steepeners, and those parts of the equity market able to sustain margins in an inflationary environment. However, the deflationary impact of the virus crisis is likely to be with us for some time yet, so the entry point for some of these investment ideas is likely to be important.

[1] Eurozone HICP, US Core PCE, 31 March 2008-29 February 2020. Source: Bloomberg.
[2] www.federalreserve.gov/monetarypolicy

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