Inflation and Disinflation: Debate Rekindled

Inflation and disinflation: Debate rekindled

The first quarter of 2021 brought inflation — or at least the fear of it — back into focus. Continuing the trend that started in November 2020 following good news on COVID-19 vaccines, inflation expectations (measured by breakeven inflation[1]) and intermediate- to longer-maturity government bond yields have been rising across the globe. In last year's *Beware of Inflation* paper,[2] we discussed the wider range of possible inflation outcomes.

In this article, we take a step back to acknowledge the two sides to the inflation debate and recognize that the range of economic and inflation outcomes in the post-COVID-19 world has increased. Portfolios must do a better job of incorporating tail risks instead of positioning solely for the base case.

When we think about the outlook of economic phenomena such as inflation, there is never an easy answer, especially in the aftermath of COVID-19. The long-term implications of the pandemic will take a while to be fully understood. Within Mercer, the never-ending debate between our inflationistas and deflationistas continues to rage, with both camps making compelling cases.

This article summarizes what both sides of the debate say around four themes that we believe are the key drivers of inflation or disinflation over the next three to five years. It serves as a reminder of the inherent degree of uncertainty around almost everything investors need to consider — and why it is wise to have a portfolio built not just for the base case but also for tail scenarios.

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[1] Referring to inflation expectations implied by the market, breakeven inflation is calculated by taking the difference in the yield for nominal and inflation-linked bonds of equivalent maturity. As nominal bonds compensate for an expected level of inflation, and inflation-linked yields pay the investor the actual realized inflation, the difference between the two reflects the inflation expected by market participants of the stated maturity.

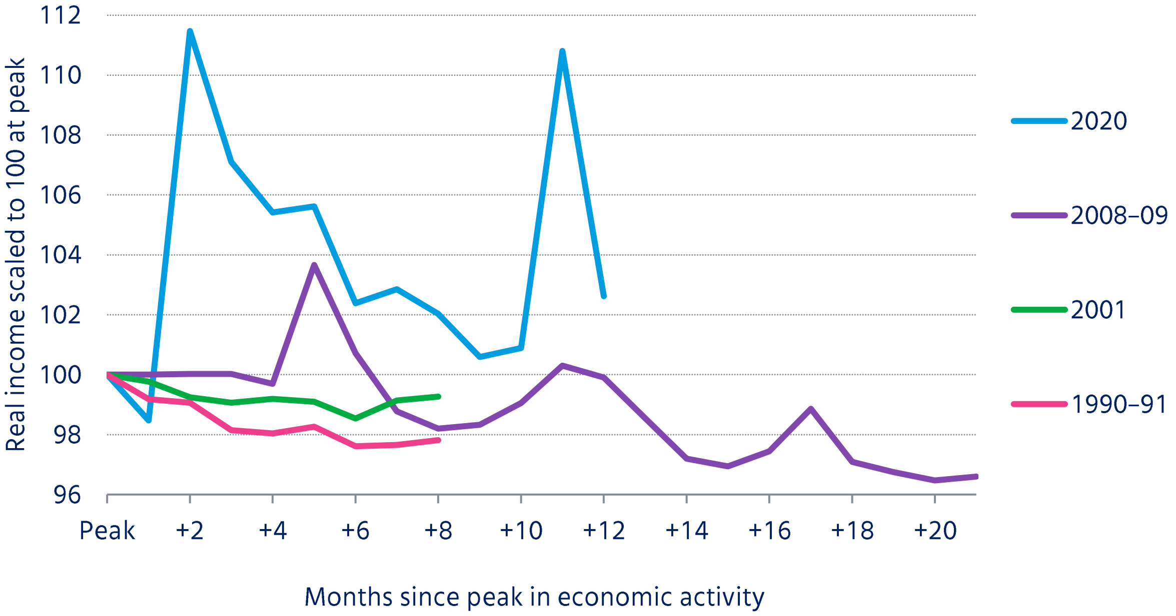
[2] Mercer. *Beware of Inflation: Assessing Risks and Investment Implications*, July 2020, available at https://www.mercer.com/content/dam/mercer/attachments/global/gl-2020-investmentforums-london-agenda-beware-of-Inflation.pdf.

Theme 1: The COVID-19 aftermath

Inflation case: *Getting back to the things we love*

For over a year, most of us have been unable to pursue leisure activities because of pandemic-related restrictions. At the same time, unlike in past recessions, household incomes did not fall in many countries because of income support programs that allowed affected (and also unaffected) households to get by — and, in the US, to actually pay down debt and build up savings.

Figure 1. US real personal income in recessions



Source: US Bureau of Economic Analysis, National Bureau of Economic Research. Data as at February 28, 2021.

As the share of the vaccinated population increases and economies reopen, people will be itching to get back to the things they love and the social interactions we as a species crave. Anecdotal evidence for how badly we need this is the Qantas sightseeing flight to nowhere, a seven-hour round trip from Sydney in October last year, with 150 passengers who just wanted to experience flying again. Tickets for this trip sold out in 10 minutes, the fastest ever in Qantas's history.[3] Carriers in Taiwan and Japan offered similar flights, whereas Singapore Airlines offered in-flight meals onboard a grounded jet.[4]

[3] Asaf S. "Qantas Flight to Nowhere Sells Out in 10 Minutes," *Business Traveller*, September 22, 2020, available at https://www.businesstraveller.com/business-travel/2020/09/22/Qantas-flight-to-nowhere-sells-out-in-10-minutes/.

[4] Hosie R. "Singapore Airlines has cancelled Its proposed 'flights to nowhere' after criticism from environmental campaigners," *Business Insider*, October 1, 2020, available at https://www.insider.com/singapore-airlines-drops-flights-to-nowhere-after-environmental-concerns-2020-10#:~:text=Singapore%20Airlines%20has%20scrapped%20its,land%20at%20Singapore's%20Changi%20Airport.

The financial firepower households are ready to deploy combined with the craving to again enjoy socializing, traveling and in-person entertainment is expected to unleash a wave of pent-up demand not seen since the end of World War II. Service providers will be more than keen to accommodate consumers. However, getting supply back overnight will be challenging, at least in the short term. Short-term demand outpacing supply could therefore be reflected in prices in certain sectors. This could lead to higher inflation through at least 2021, if not longer, depending on whether people's expectations are altered.

Disinflation case: *COVID-19 becomes a chronic condition*

But will the rebound really be that strong and fast?

The assumption that vaccine deployment will make COVID-19 disappear is popular and desirable yet flawed. We know that to achieve herd immunity, a large share of the global population needs to be vaccinated. In the most vaccine-positive countries, such as the UK, only around 80% are willing to get vaccinated,[5] and for countries like France, fewer than 60% are willing, which might not be enough for herd immunity.

Only the US, the UK and a few smaller countries are likely to vaccinate their entire populations by this summer (at least the first jab), leaving the rest of the globe still exposed to the virus and thus subject to restrictions. Although the frequently quoted vaccine efficacy rate of 90%–95% is encouraging, not all the vaccines are equally effective, and many believe this rate may be lower for COVID-19 variants that have emerged more recently. COVID-19, therefore, will still be around and may be sufficient to lead first to disappointment and then to ongoing fear that will deter many people, especially the elderly with significant purchasing power, from going back to the things they love. For the same reason, public officials will likely keep at least some capacity restrictions in place, especially for international travel. This suggests the "reopening party" might be more muted than many expect.[6]

Even if we assume the above to be temporary, there may also have been a permanent hit to trend growth in emerging markets due to skills destruction and in developed markets due to high debt. Official unemployment figures are still high and mask even higher unofficial unemployment via the decline in labor market participation, which captures those who have given up looking for a job.[7] Many of those workers have been permanently displaced by technological changes accelerated by the pandemic, and income support will soon wear off. Now that it has become clear how easily technology can eliminate lower-paid unskilled jobs and some higher-paying jobs as well, households may not go back to spending worry-free and betting on governments coming to the rescue in every future downturn. Instead, they are more likely to deleverage and maintain a high savings rate. Weak demand and lack of animal spirits could therefore leave us in a disinflationary environment.

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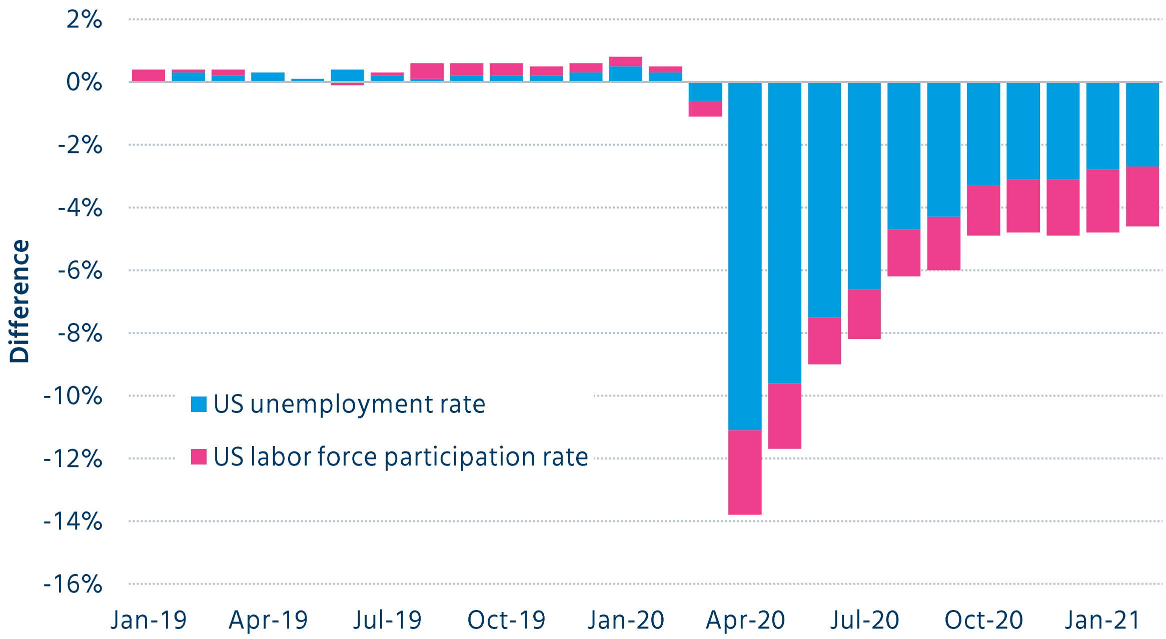
[5] Alford J. "Confidence in Coronavirus Vaccines Is Rising Globally, Survey Suggests," February 4, 2021, available at https://www.imperial.ac.uk/news/214074/confidence-coronavirus-vaccines-rising-globally-survey/.

[6] The reopening party might also be short-lived for another reason. After an initial spending spree, consumers might go back to nesting after having spent a year building out homes and backyards for more private entertainment spaces.

[7] There is, of course, a demographic element as well, with more people naturally dropping out of the labor force as they reach retirement age.

Figure 2. Year-over-year change in US employed population



Source: Bloomberg. Data as at February 28, 2021.

Theme 2: Technological disruption

Disinflation case: *Industry 4.0 revolutionizes manufacturing, working and shopping*

The pace at which technology has revolutionized the way we produce, consume and shop is breathtaking. Technology boosts productivity — in other words, we produce more goods with the same amount of labor per hour worked — most of which is not even fully captured in inflation statistics.[8] A VHS player cost about US$30,000 in the 1960s (about US$260,000 in today's money).[9] When movie rentals had finally become a mass-market item in the 1980s, rental fees were US$3–US$5[10] (US$9-US$15 in today's money) for one night per movie from the local video shop, and you had to drive there to get it. Today, it costs around US$8.99 per month to access thousands of movies at once via streaming services such as Netflix and Prime Video, and no special player is needed, just a smart TV. Even these cost a fraction of first-generation VHS players.

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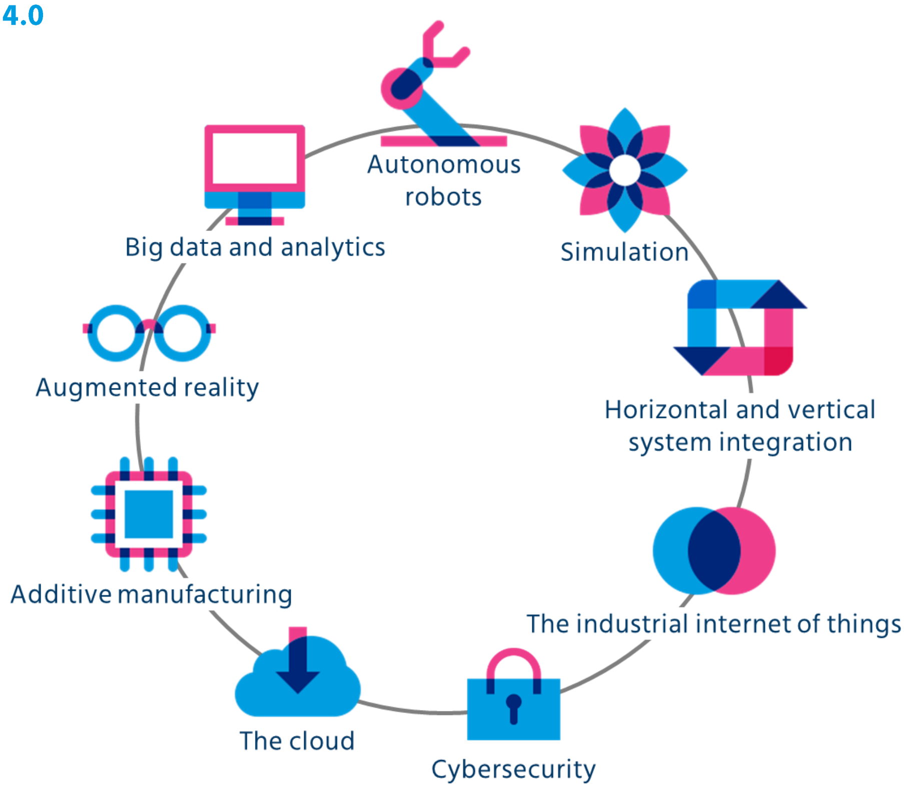
[8] Inflation statistics often do not capture quality improvements that increase the value of the good even if its price does not change. Also, many goods and services are only included after they have become widely used, which is usually after their prices have diminished significantly. This initial massive price drop will therefore not be captured by inflation indices.

[9] Livingstone J. "R.I.P. VHS," *Prospect Magazine*, July 14, 2014, available at https://www.prospectmagazine.co.uk/arts-and-books/vhs-history-of-video-revolution-michael-z-newman.

[10] This is a consensus figure from a straw poll with colleagues old enough to remember the Blockbuster days.

Free enterprise combined with technological progress has a track record of turning luxuries for a few into mass products the vast majority can afford, which is hugely disinflationary, because we pay less for what we consume, or we can consume more or differently. Now that the pandemic has forced the majority of businesses and individuals to adopt technology in all spheres of life, accelerating a process that would have taken many years otherwise, such benefits might accrue to consumers in the form of lower prices. Rather than just Generation Z before the pandemic, even grandpa has now been through the digital boot camp, and many small businesses were forced to build an online presence to survive. It therefore has become much harder for uncompetitive retailers to pass on their inefficiencies via higher prices, as consumers have learned to shop where it is cheapest with the swipe of a smartphone. The argument is that we have no reason to worry about inflation — rather the opposite.

Figure 3. Industry 4.0



Inflation case: *Social media and talking refrigerators are hardly the same as the lightbulb*

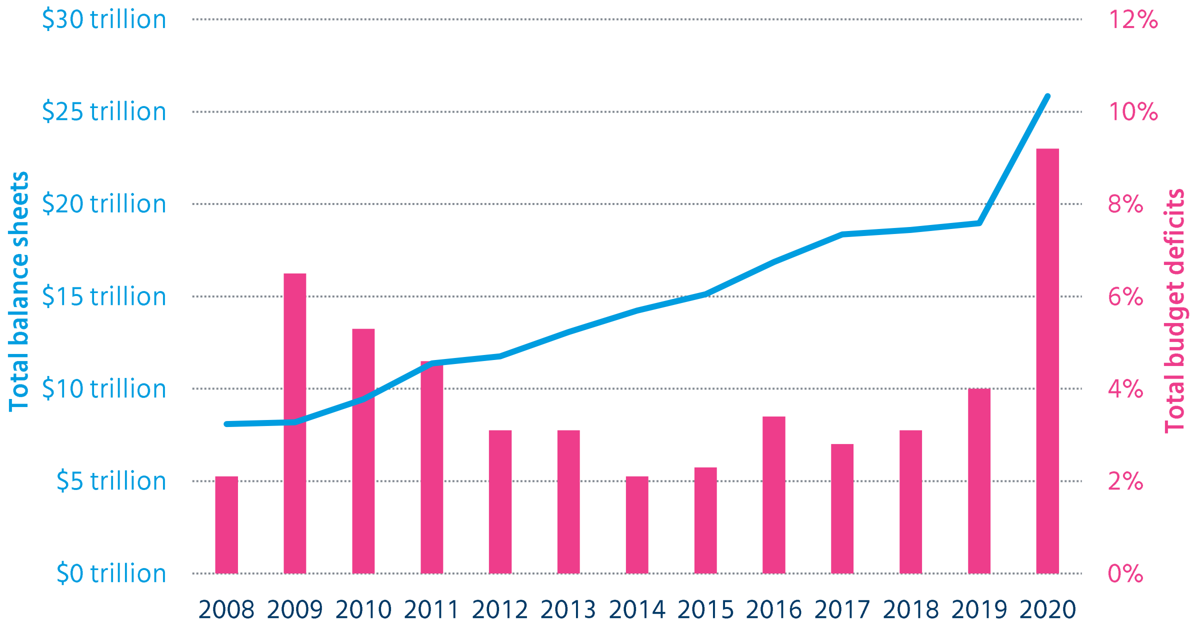
Not all that is modern and contemporary is good or productivity-enhancing. Businesses will compete more but are still bound by their production costs. Higher retail competition does not mean production costs as a whole have fallen, especially for services. Technology these days may move the needle by much less than in the past — think of electric light allowing people to work after dark, which could double the amount of hours worked in winter, or the steam engine allowing mass manufacturing, and compare these to innovations like social media. Granted, social media has opened new frontiers for companies in terms of reaching consumers, but this might not be as impactful for productivity as electricity and the steam engine once were. One could even go further and argue that social media has been turned into a new conduit for populism that has led to an increase in trade barriers in recent years. This is inflationary because it prevents efficient capital allocation. The key takeaway is that technological progress does not always have to be disinflationary per se — its disinflationary impact on productivity may be more limited than we think, or it may even be inflationary at times.

Theme 3: New policy horizons

Inflation case: *What do you expect from a Zimbabwe-style monetary and fiscal expansion?*

This year, policymakers definitely crossed the Rubicon, with central bank balance sheet expansion dwarfing the post-global financial crisis (GFC) experience and government deficits reaching their highest levels since post-WWII. Last year, by shifting to an average-inflation-targeting regime, the Federal Reserve implicitly expressed that it would rather risk higher inflation than a deflationary spiral. Other central banks may follow suit in the coming years.[11] Unlike the approach taken during the GFC, this time, stimulus has reached consumers directly rather than fixing bank balance sheets or being partly offset by fiscal consolidation. Monetary and fiscal coordination, enabled this time by debt monetization — or, in plain English, money printing — could be ahead for the decade. This surely will be inflationary as it has often been in the past whenever money supply increased at a significantly faster pace than the supply of goods and was sitting in the pockets of consumers.

Figure 4. Monetary and fiscal stimulus measures



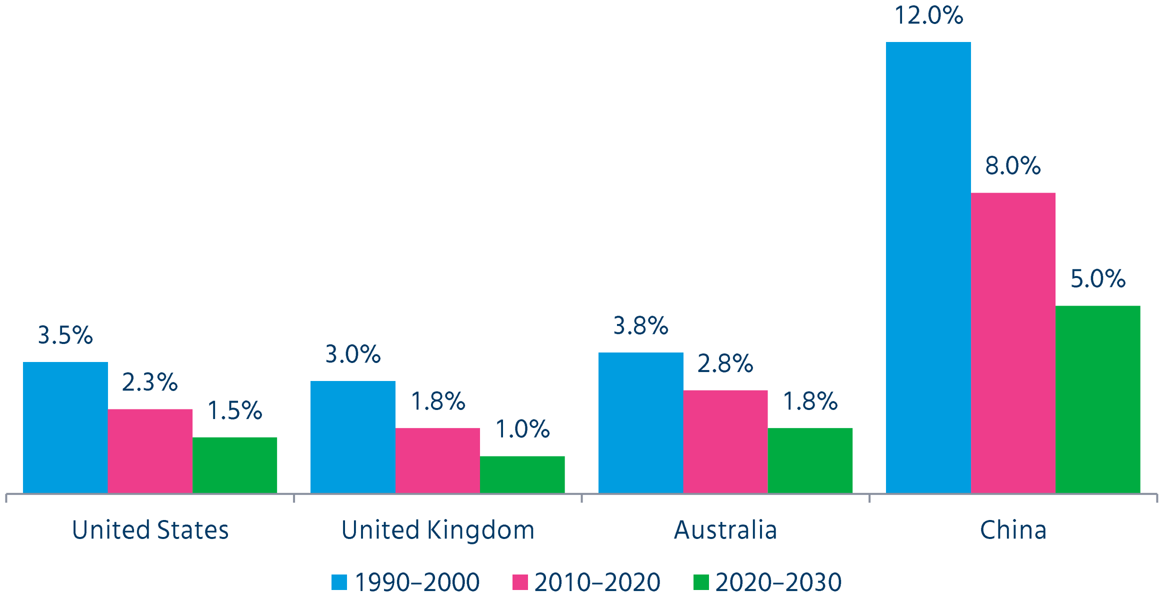
Source: Bloomberg for central bank balances sheets. Haver Analytics, CEIC, Morgan Stanley Research forecasts for budget deficits. Total balance sheet figures represent data from the Bank of Japan, the European Central Bank. Balance sheet data is at December 31 of each year. Budget deficit data for 2020 is estimated.

[11] The Reserve Bank of Australia is using such a framework already, the Bank of Japan is committed to overshooting its inflation target of 2% and the European Central Bank is also considering an average inflation target as it reviews its monetary policy framework this year.

***Disinflation case:** Aggressive monetary policy and fiscal spending did not help Japan*

On the other hand, the long-term growth rates in Western countries are believed to have permanently fallen long before COVID-19. In spite of all the stimulus, the post-GFC recovery was lackluster, and stimulus could never be fully withdrawn, as the late-2018 experience attests. Printing money and borrowing against the future does not magically accelerate growth, otherwise Japan should have been one of the fastest-growing economies over the last decade after it introduced such policies from the end of 2012. If an increase in the money supply is offset by an increase in money demand (that is, a preference for holding cash over consuming or investing), stimulus will not be inflationary but rather neutral.

Figure 5. Potential growth rates by country



Source: Bloomberg, Mercer estimates. Data as at March 31, 2021.

Theme 4: Trade and (de-)globalization

Inflation case: *De-globalization brings manufacturing closer to home at a heavy price*

De-globalization was a trend long before COVID-19 and will likely have been accelerated through the COVID-19 experience. Shortfalls in the supply of medical equipment and the temporary imposition of purchase limits amid panic-buying of food and household items (there never were long-lasting shortfalls, but it is perception that matters) has led to some degree of national self-sufficiency becoming popular again. The Biden administration may bring back a certain amount of multilateralism following the Trump administration's more confrontational approach, but a return to the free-trade agenda of the 1990s is unlikely.[12] This matters for living standards and thus prices — reshoring production or preventing supply chains from expanding globally could reduce efficiency and therefore increase production costs and hence inflation.

Disinflation case: *Asia-Pacific and Africa are smarter than that, and the West might be sobering up too*

However, when we look at de-globalization trends, our Western perspective might bias us. It may well be true that the Western world is going through a phase of self-doubt at the moment and lashing out at free enterprise and free trade. This has not prevented Asia-Pacific countries from embracing free trade regionally, as can be seen by the signing of the RCEP in late 2020, the largest free-trade agreement in history, which encompasses 15 countries, including China, Japan and South Korea. Even in Western countries, recent developments suggest there is some consensus that free trade is the best way to improve living standards — maintaining tariff-free trade was the main goal of Brexit negotiations that culminated in such a deal, and Germany pushed the EU to conclude an investment deal with China. African countries have just completed a treaty creating an African Union free-trade zone that seeks to lower or eliminate cross-border tariffs on most goods once fully in force by 2030.[13] These are encouraging signs that we are not entering a 1930s-style era of de-globalization but rather the opposite. Although perhaps more reliant on regional free-trade zones, the disinflationary pressures from free trade might be here to stay.

[12] Hoyama T and Nakamura Y. "US and Allies to Build 'China-Free' Tech Supply Chain," *Nikkei Asia*, February 24, 2021, available at https://asia.nikkei.com/Politics/International-relations/Biden-s-Asia-policy/US-and-allies-to-build-China-free-tech-supply-chain.

[13] Reuters. "African free trade tariff rules should be completed by July – official," Reuters, January 11, 2021, available at https://www.reuters.com/article/uk-africa-economy-idUSKBN29G1CD

The jury is out

Arguments for both inflation and disinflation are compelling. We carefully considered both sides in developing our house view last year,[14] which we continue to reassess regularly.

On balance, we have settled for inflation risk exceeding disinflation risk over the next three to five years and possibly beyond.

Although the base case of moderate inflation around central bank targets for most regions has not moved, the range of outcomes has become wider as a direct consequence of COVID-19 and its aftermath. Inflation risks have shifted to the upside, and the scenario of inflation materially overshooting official targets during this decade is now more likely than before the pandemic.

Investors therefore need to watch for inflationary surprises, which many portfolios may not be well protected against. The disinflationary environment seen over the past three decades may have biased allocators to underestimate inflation risk.

The most sensible option is to review your inflation-sensitive portfolio sleeve to ensure your total portfolio will perform well if there is a moderate increase in inflation (low to mid-single digits) over the next three to five years or if there is an inflation surprise.

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[14] Mercer. *Beware of Inflation: Assessing Risks and Investment Implications*, July 2020, available at https://www.mercer.com/content/dam/mercer/attachments/global/gl-2020-investmentforums-london-agenda-beware-of-Inflation.pdf.

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