August 2021 Newsletter

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US Inflation: A Transitory Story

As countries around the world slowly begin to open their doors most investors have turned their attention to the US Federal Reserve and their continuing levels of immense monetary support. The question of looming inflation has dominated market headlines, with many participants questioning the Fed's assertion that any inflation increases will prove transitory and eventually subside. The effects of inflation, if realised, will be far-reaching and will put substantial pressure on the US Central bank to quell the negative effects of accelerated price increases.

Understanding Inflation

Inflation is most often described as the general decline in purchasing power of a given currency over time. This purchasing power decline is most clearly reflected through the overall increase in price of a basket of selected goods and services within an economy from one period to another. This general rise in price levels, most often reflected in percentage terms, results in a unit of currency purchasing less than it did in the past. As the given currency loses value, the general public experiences a loss of purchasing power and an overall decline in their sustainable levels of expenditure. To give an historical example of the tangible effects of inflation let us consider how the price of a cup of coffee has risen over time. In the 1970's the average cup of coffee cost consumers about $0.25. Today the average cup costs around $2.50. This represents a 900% increase in price over a 50yr period, which equates to a 90% drop in purchasing power for consumers. Ultimately, this drop in purchasing power leads to a decline in consumer spending, which in turn leads to a deceleration in economic growth. Most academic literature acknowledges that the root cause of sustained inflation occurs when a country's money supply growth exceeds its economic growth. This generally leads to the central bank stepping in to manage the supply of money and to bring inflation back within its targeted limits.

An increase in money supply can ensue for several reasons, the most common and far-reaching of which occurs when central banks loan new money into existence through the purchase of government bonds from banks in the secondary market. This is no more apparent than the US Fed's current Bond-Buying Program, where since June 2020 the Federal Reserve has been purchasing Treasury bonds to the tune of $80bn in addition to $40bn in mortgage-backed securities every month. This monumental injection of liquidity into the US economy has seen the US government more than double its leverage relative to the levels it took in the 2008 Global Financial Crisis. It should therefore not come as a surprise that market participants are concerned about inflation potentially rearing its head in the US in the near future. As the Economic and Investment Strategy Provider TS Lombard stated in a July article, " What happens when a wall of money hits a bunch of businesses that have been starved of revenue for 15 months? – the bars and restaurants (etc.) raise their prices, sharply."

Inflation Worries in the USA

The sharp rise in US inflation over the last few months has caught many investors and economists off-guard, questioning the Fed's ability to keep the figure sustained at its targeted 2% level. The concern surrounding the inflation expectations is that the central bank will be forced to start removing liquidity from the system to combat the ensuing inflationary pressures. If the US Fed reverses its monetary policy and begins to raise rates (in order to maintain a positive real interest rate), it will enable investors to shift into less risky, higher yielding bonds to achieve their investment return targets. This will consequently put downward pressure on equities, which are currently trading at expensive levels.

From the first mention of inflation in the US, Federal Reserve Chair Jay Powell has maintained a dovish policy stance and has stated that the Fed is not planning to renew their bond buying program, and gave no indication that they would raise rates anytime soon. As such, any inflationary pressures in the US economy were deemed "transitory".

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In a note released by global asset manager Canaccord Genuity, they asserted that the Fed remains "focused on outcomes (getting unemployment down to the lowest possible level) rather than outlook (whether growth or inflation may rise further). This helped keep markets somewhat less concerned about a surging CPI in the US."

Many market participants, however, have opposed the Fed's perceived complacent stance surrounding inflationary risks. Mohamed El-Erian, chief economic advisor at Allianz and former CIO of PIMCO, stated that "there is a fundamental misunderstanding about inflation today because most people haven't actually lived through it." He, along with several other market doyens (including CEO of Berkshire Hathaway Warren Buffet and Bridgewater Associates Founder Ray Dalio), expect inflation to run higher than suggested by the Fed.

During the FOMC meeting which took place in late July, Powell, who had previously asserted that the Fed has been merely "talking about talking about tapering", announced that the Fed will soon begin considering dialing back on their monthly bond purchases (currently at a whopping level of $120bn every month). The meeting also saw Powell acknowledge that near term inflationary risks are to the upside and that the recent price hikes are not going to reverse in the short term. The Fed's Dot Plot, which is used to signal its outlook for the path interest rates will take, continues to signal no rate hikes this year, with median estimates forecasting two rate hikes by the end of 2023.

Effects Of Inflation

Despite the present concern in the market surrounding the anticipated inflation, investors should remember that inflation, in and of itself, can manifest in both positive as well as negative ways. For example, holders of tangible assets that are priced in currency (e.g property or commodities) may enjoy a moderate amount of inflation as it will increase the price of their assets, which they can later sell at a higher level. Consequently, the buyers of such assets may not be as happy, as they will be required to spend more money.

Conversely, holders of assets denominated in currency, such as cash or bonds, may see the real value of their assets erode due to inflation. This can prove positive for the overall economy, however, as it encourages investors to spend their money as opposed to saving it and seeing it decline in value. This increased spending boosts economic activity within a country. Overall, economists agree that a balanced approach to inflation is best for long-term growth within an economy.

Assessing the global economy, and particularly that of the US, the onset of inflation will have negative immediate effects for consumers and will somewhat diminish the effect of the stimulus being pumped into the financial system.

On the Local Front

The South African Reserve Bank kept the repo rate unchanged at 3.5% in an unanimous decision at the latest MPC meeting in late July. This marks a year since the last adjustment to local interest rates and reflects the MPC's intention to keep the GDP growth outlook unchanged for the next three years. While the forecast of local interest rates is skewed to the upside, the Reserve Bank will aim to avoid any short-term tightening of rates which could disrupt the current growth trend.

Local headline inflation remains anchored around the 5% level whilst core inflation, which excludes food and fuel items, currently resides at 3.2% y/y. The stability of the interest and inflation rates comes as a welcome relief to investors, particularly in lieu of the current surge in commodity prices coupled with the recent weakening of the rand. Both these factors could potentially be indicative of a looming rise in inflation and could herald the onset of an inflationary cycle in South Africa.

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