The Risk of High Inflation

As the world starts its exit from the COVID-19 pandemic, demand for goods and services is surging, and triggering worries about inflation.

The US consumer price index for April ‘21 showed a 4.2% annual increase.

That is the largest year-on-year increase in prices since September 2008, and significantly more than the 1.2% increase that was being reported in December 2020.

Meanwhile, the White House Council of Economic Advisors warned recently that ‘measured inflation’ is likely to increase over the next few months. And the price of petrol (gasoline) which may be one of the most obvious signals of rising prices, has been steadily increasing since the start of the year.

So, are we about to see the rampant inflation of the 1970s?

Well, if we cast our minds back to April 2020, the globe essentially went into lockdown. Companies were more concerned with cash-flow than profits, and the attitude was very much ‘If we have one in stock, it’s discounted and it’s yours!’ This combination of global slowdown and Covid lockdown slowed the economy, and between February and April 2020, US GDP fell about 10%.

Clearly, nobody was buying much petrol – there was nowhere to go; aeroplanes were parked up, with few passengers, either domestic or international; the global shipping of raw materials and finished goods almost ceased.

Even the microchip makers slowed or stopped production (creating havoc once the chips were suddenly needed by manufacturers again in early 2021). We have seen the car industry restart, but on a very short rein, as it is now held back by the dearth of chips.

It is little wonder we are seeing huge inflation numbers For April 2021!

US petrol, like many other commodities, was not needed 12 months ago, when there was plenty to be had. A year on, and high demand is driving prices up. US petrol in particular, has also been impacted by the recent Colonial pipeline shutdown, caused by hackers, and promptly pushing every SUV driver in the Southern USA to fill their tank to the brim. (I wonder how many extra barrels of fuel that represents compared to last April, when most SUV's sat on the drive long enough to flatten the battery)?

David Beckworth, a former Treasury Department economist now with the Mercatus Center at George Mason University said 'For now, the fear (of hyperinflation) is probably premature. The economic indicators aren't flashing any red alerts right now, but the political economy is more worrying.'

A good indicator of future inflation is the 'breakeven inflation rate', which measures the difference in yield between inflation-linked bonds and those that are not. The five-year breakeven inflation rate, or 'what level of inflation investors are anticipating over the next five years' has been increasing, but is only slightly higher than its post–Great Recession average.

Even if inflation spikes in the short term, nobody seems to expect historical highs over the course of several years.

The rising CPI might not be a major issue, either. Because it effectively looks backwards a year, and compares prices today to what they were a year ago, it is snaring some of the economic weirdness created by the pandemic last spring, when prices fell as demand sank and much of the world entered lockdown.

The biggest contributor to the rising CPI in March and April was the surge in petrol (gasoline) prices, which were up about 30% from last year.

But that says as much about last year's drop in prices (due to the sudden glut of supply) as it does about where things are now.

Similarly, most travel plans were cancelled last summer, and that backlogged demand will probably be unleashed in the coming months as an ever more-vaccinated population reunites with their distant families and friends. A sudden increase in demand where supply can't rapidly be increased to match, is bound to mean higher prices. That, however, is only short-term, not a long-term increase likely to destroy standards of living and retirement plans.

White House economists conclude that longer-term inflation is likely to be around the 2% target, following the next few months of temporarily higher figures.

That's the economic side of the inflation situation. It should provide some comfort. The political side is a different story.

What may cause inflation to take off is a sustained increase in the growth of US government spending. The US government pumped $1.9 trillion (as a one-time injection) into the economy in March. However, the Biden administration is also proposing permanent increases to the baseline federal budget and pushing for a $2.3 trillion infrastructure package, partly financed with deficit spending. Some argue that this is unnecessary, and all a bit too much.

From where I sit, both major US parties have abandoned any concern about overspending.

The alarm bell of a rising CPI might be the only warning of higher inflation in the medium or longer term, but the alarm bell isn't ringing just yet.

We need to hope that global band of politicians sit up and take notice, should the alarm sound in the coming months.

In the meantime, the media frenzy of the last few weeks about inflation is almost certainly overblown, and is a function of last year, not the present. As usual, there are many opposing views, and all present what seem to be very logical arguments for their particular view.

The likelihood of hyperinflation, on a global scale seems very slim in the near-term. Moderate inflation is typically good for equity investors, so stay calm despite the short-term noise, and look forward to healthy returns in the longer run.