Framed as a subtle shift in policy, U.S. Federal Reserve (Fed) Chair Jerome Powell recently announced an important, if widely expected, shift in the way it thinks about employment, inflation, and interest rates—with far-reaching implications for investors. Our Chief Economist Frances Donald shares her views.

# In focus: US inflation forces

When the Fed announced its decision to move toward "a flexible form of average inflation targeting," effectively confirming the central bank's desire to overshoot its official 2% inflation target,[1] the markets barely budged. However, it wouldn't be wise to mistake Wall Street's subdued response for disinterest—it's an announcement that's very relevant to investors, particularly those interested in inflation dynamics, specifically, *upside surprises* to inflation over the next three to six months. In our view, a structurally dovish Fed combined with stronger inflation data ahead effectively moves inflation expectations higher and moves real rates lower.

The inflation versus deflation discussion isn't necessarily binary in nature; it's filled with nuance, counterforces, and a number of unknowns. In truth, inflationary *and* deflationary pressures are at play simultaneously and as these opposing forces fluctuate, investors will likely go through periods during which they worry about deflation and other periods during which they'll fret about inflation. These are important investment considerations with different implications that could lead to different investment outcomes. In our view, there are four key ideas that are central to any debate about inflation.

## Framing the inflation debate: four key ideas

### 1. Timelines matter

We believe that a great deal of confusion surrounding the U.S. inflation outlook can be traced to difficulties in delineating the near-term inflation trajectory from its long-term path. There are inflationary and deflationary forces in every time horizon, but one will inevitably outweigh the other at different moments.

### 2 .Market expectations

It isn't just the level of inflation that markets care about: The *type* of inflation that's being generated (cost push versus demand pull) and the extent to which it deviates from expectations are just as important. It's also worth noting that what's considered unacceptably high inflation to one person can be different to another—for instance, millennials and Generation Z have never seen 3% inflation in their lifetime. Critically, it's important to recognize that mild to moderate inflation needn't be strictly negative for equities.

### 3. Regime shifts

We may be in the midst of a structural regime shift in terms of the drivers of inflation. We expect future inflation to be driven more by active fiscal policy and deglobalization, and less by monetary policy. Classic inflation models are therefore far less relevant and shouldn't be used to predict future inflationary pressures. This suggests old-school correlations, such as the Phillips curve, might not be as useful as they once were. And remember, economists generally don't have a good track record at predicting (or understanding) inflation.

### 4. Measurement issues

It's also important to note that classic CPI measures weren't able to accurately measure the cost of living in the United States for some time now—it isn't a new issue and we believe it's likely to be even less accurate now. Policymakers are increasingly looking to address this problem, and it's likely that both formal and informal measurements of inflation will need to be adjusted in the coming years, particularly with respect to housing costs and asset prices, which would likely push measured inflation higher.

## 10 near-term price pressures (next three to six months)

Given that the United States is in the middle of a pronounced recession, the idea of rising inflationary pressure within the next three to six months might seem counterintuitive. Shouldn't a recession lead to demand deflation typically associated with large output gaps? In theory, yes, but the current economic shock is fundamentally different from a regular recession, and we see 10 key near-term inflationary pressures that are likely to contribute to inflation moving quickly back to 2% or above before year end. Given the economy's weak growth profile, we think it's more accurate to characterize this tactical period as stagflation.

1 Although the United States and most economies worldwide are experiencing a massive demand shock, most data suggests that demand is coming back more quickly than supply. Unlike previous recessions, we expect the supply shock to be both more persistent and more painful. This is a scenario that's fundamentally inflationary, although there's a lid on how high inflation can rise when the output gap remains open and demand is still quite weak.

2 The Fed's shift toward average inflation targeting should help to keep inflation expectations much closer to 2%, potentially putting a floor under how far prices can fall. In addition, the Fed (and most economists) have long believed that inflation expectations themselves play a role in future actual inflation.[2]

3 We expect U.S. consumers to deploy the sizable buildup in personal savings accrued over the past few months—a result of government support such as stimulus checks and unemployment insurance top-ups. This is likely to increase money velocity temporarily.

4 Disrupted supply chains and a reduction in trade activity have contributed to reduced supply, but inventory shortages in several core products have exacerbated the impact. We expect this to persist until business confidence revs up in 2021. Until then, cost-push inflation is likely to materialize, presenting a new challenge for the U.S. economy. Tariffs on imports introduced over the last few years will also likely support price rises.

5 Prices for key components in the CPI basket such as air transit, hotels, and apparel bottomed in July,[3] which suggests the initially deflationary impact of the pandemic is now fading and is no longer directly contributing to negative month-over-month inflation prints.

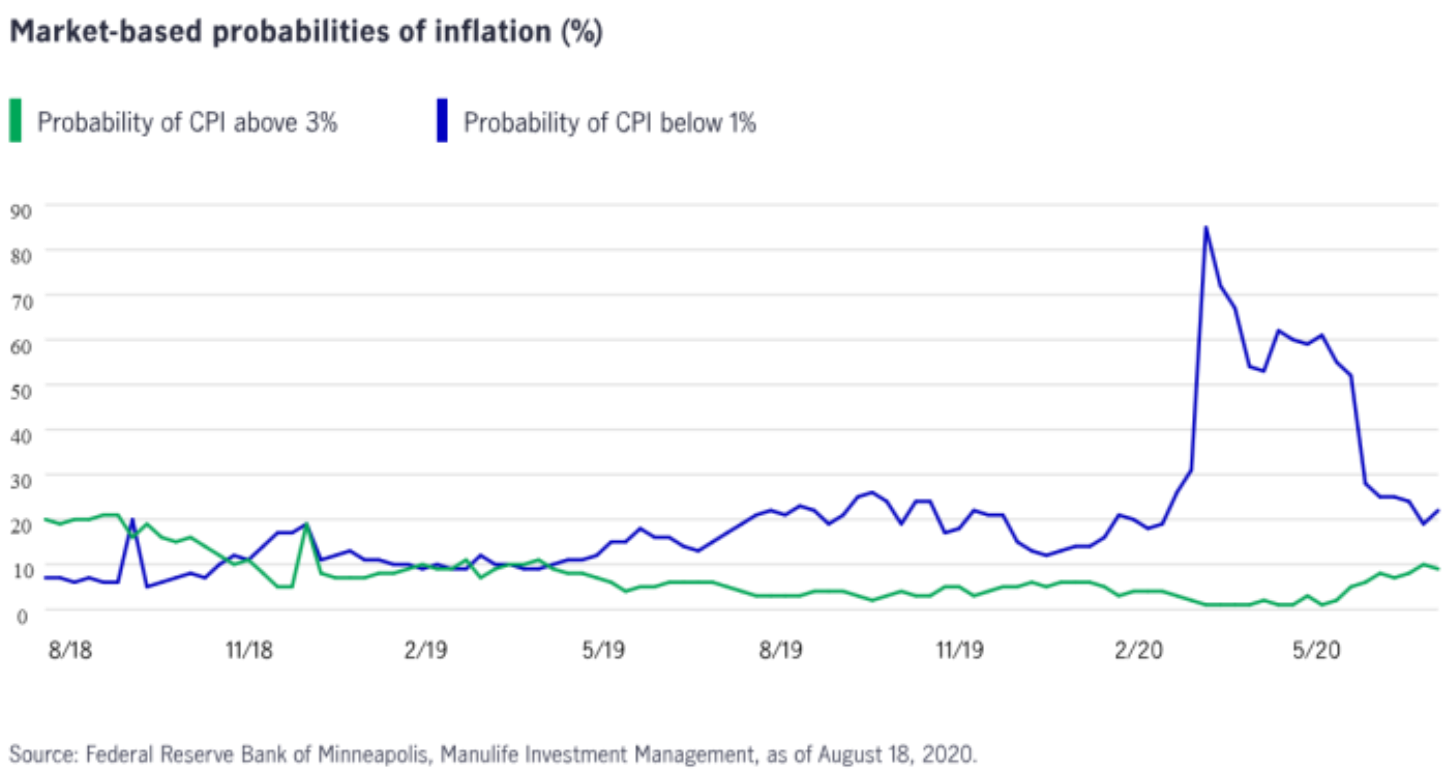
6 Commodity prices have risen sharply, including lumber, copper, and iron ore, over the past four months. Oil prices are no longer declining in year-over-year terms.

7 The U.S. dollar has weakened ~7% since its peak in March.[3] It's a development that's supportive of U.S. inflation, with a small lag.

8 We're seeing evidence that labor costs are rising, both through the need for top-up pay for essential workers and higher wages to lure workers back into work. While this is likely the most transitory of inflationary pressures, we believe investors should also factor in the possibility of a higher federal minimum wage in the next year.

9 We expect corporates to enjoy higher pricing power in an environment of reduced supply—this is particularly true for the goods sector, although the effect may not be uniform across all sectors. Put differently, the rising costs of inputs like intermediary goods and labor can be passed on, at least in part, to end consumers.

10 We expect shelter costs to rise as U.S. housing continues to perform well thanks to low rates. There is also a general consensus that housing inflation in the United States might be *under* calculated in the CPI and statistical bureaus have discussed improving the calculation. It's worth noting that shelter accounts for 34% of the CPI basket.




Source: Federal Reserve Bank of Minneapolis, Manulife Investment Management, as of August 18, 2020.

While markets may already be awakening to the inflation upside narrative, we see evidence that inflation may still be underpriced. U.S. bond markets may have nudged inflation expectations higher, but we believe the rise has more to do with improved liquidity conditions and the term premium than a surge in expectations of higher prices. In addition, both the Minneapolis Fed's measure of market expectations for inflation (which remains extremely asymmetric, suggesting a 22% probability of inflation falling below 1% and only a 9% probability of inflation rising above 3%) and the Citi Inflation Surprise Index (which remains below 0) suggests there's considerable scope for an upside surprise.

## Market implications

Given the Fed's formal shift to average inflation targeting, the bond markets aren't likely to associate higher inflation with higher nominal rates—at least not for now. As a result, as inflation rises, nominal yields are likely to remain around current levels even as real rates fall deeper into negative territory.

We also expect the yield curve to continue to steepen, particularly between the belly of the curve and the long end—the Fed's constant references to yield curve control, which it isn't likely to implement just yet, has the effect of keeping the front end of the yield low. Finally, mild inflation is historically correlated with a *positive* rerating of equities (well, until about 3%). In our view, investors shouldn't view higher inflation by itself as a cause for an equity market sell-off. For the time being, it might be useful for investors to start embracing a new reality and get used to slightly higher levels of nominal inflation, even if it makes us all slightly uncomfortable.

## Timing the inflation call

We believe it can be helpful to visualize how inflationary and disinflationary pressures can evolve over three different timelines: within the next 3 to 6 months, within the next 18 months, and beyond the next 3 years. In our view, it'd make sense for investors to draw a clear distinction between long-term deflationary pressures and short-term inflationary pressures given the evolving macro landscape that we find ourselves in.

1 "New Economic Challenges and the Fed's Monetary Policy Review," federalreserve.gov, August 27, 2020. 2 "Measures of Expected Inflation," Federal Reserve Bank of Cleveland, accessed August 27, 2020. 3 Bloomberg, as of August 27, 2020.

**Inflation outlook**

| | Key view | Inflationary pressures | Disinflationary pressures |
|---|---|---|---|
| **Near term** (3 to 6 months) | Cost-push inflation reverses deflationary pressure and drives inflation back toward—and possibly—above 2.0% | • Supply shock dominates<br>• Release of savings<br>• Weaker U.S. dollar<br>• Waning impact arising from the COVID-19 shock<br>• Higher commodity prices | Demand-side shock with a large output gap |
| **Medium term** (18 months) | Demand-pull inflation (in 2021/2022) pushes inflation toward 3.0%, but peaks as disinflationary forces regain dominance | • Base effects of Q2 2020 deflation unwind<br>• Growth reaccelerates in early 2021on the back of inventory rebuild<br>• Pent-up investment drives demand higher<br>• Positive effects of fiscal policy response begin to emerge<br>• Monetary policy response with lag | • Wage growth softens<br>• Output gap remains open<br>• Structural forces keep a lid on the upside to inflation<br>• Previous rise in real rates begins to weigh on growth near the end of this period |
| **Longer term** (3+ years) | Opposing forces result in long run 1.5% to 2.0% inflation | • Inflationary pressure stemming from implemented fiscal policies persists; deglobalization/reshoring lead to higher prices<br>• Precautionary savings rise creating deflationary demand | Concerns about persistent debt, demographics, and the impact of digitalization weigh on demand |

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