2050 INVESTORS

THE KNOWN UNKNOWNS OF INFLATION

Hosted by Kokou Agbo-Bloua
Societe Generale's Head of Economics, Cross-Asset & Quant Research

EPISODE 2 - Featuring Albert Edwards, Societe Generale Cross Asset Research's Head of Global Strategy

High inflation is the Achilles heel of central bankers. Is the current increase in inflation transitory or permanent? And what do the energy transition and climate change priorities have to do with it? In the new episode of '2050 Investors', Kokou Agbo-Bloua looks into the implications of inflation, not only financial markets but on society as well.

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2050 INVESTORS – EPISODE 2 SCRIPT

(Opening credits for all episode of the podcast)

Welcome to 2050 Investors, the podcast that deciphers economic and market mega-trends to meet tomorrow's challenges.

I'm Kokou Agbo-Bloua, I head up Economics, Cross-Asset and Quant Research at Societe Generale.

In each episode of 2050 Investors, I'll investigate a key mega-trend that relates to the Economy, the Planet, Markets and You.

(Beginning of episode 2)

Inflation and its long-term impact on society. This is probably one of THE most important questions facing investors, governments, and central banks this year.

To prove it, let me just type inflation 2021 in Google. And wow. 172 million hits and counting including headlines like in The Wall street journal "US inflation is highest in 13 years as prices surge 5%" or in Forbes "Inflation Concerns growing in US".

Cleary, inflation matters. And don't get me started on what my clients and colleagues have to say about it.

And speaking of clients. I was crunching numbers for a client call last week and I saw that the US consumer price index year-over-year increase for the month of June was 5%. This was higher than the consensus expectation of 4.7% and higher than that of May where it reached 4.2%.

To put this into perspective, remember that the Fed inflation target is around 2%. They also said that they would intentionally let inflation overshoot their targets. And guess what it is happening.

The question now at hand is, really, is this the beginning of the end or the end of the beginning when it comes to the decades of subdued inflation, we have all come to be accustomed to?

A must-read book on this topic is "When money dies "by historian Adam Fergusson. I have it somewhere on my bookshelf …. One sec…. … ah … Here we go. Full of dust. The full title is "The nightmare of deficit spending, devaluation and hyperinflation in Weimar Germany".

"In 1923, with its currency effectively worthless (the exchange rate in December of that year was one dollar to 4,2 trillion marks), the German republic was all but reduced to a barter economy".

High Inflation is the Achilles' heel of central bankers. It's kryptonite. No one wants to go back into the horrors of runaway inflation when money dies.

Ok, let's just be clear. I am in no way saying that the dollar or the euro are about to die… BUT…and just between you and me, and please don't quote me on this, with all this stimulus fuelled money printing, they may catch a cold.

But, more seriously though, is this increase in inflation transitory or permanent? We just published an economic outlook report a few days ago that sums it up perfectly: “Inflation, transitory until proven permanent”.

Another major theme that pops up in this context is the energy transition. Are the energy transition, the climate change priorities and the 2050 net zero emission targets the culprits? I mean, building clean energy like wind farms or electric vehicles is indeed energy intensive. Could this be considered as un-intended consequences? Is the process of making the planet greener and more sustainable actually requiring some pollution in the short term and inflation in the long term?

But more importantly, what are the implications of this on society? Are we sowing the seeds for another wave of social unrest like the Arab Springs or the Yellow vest movement in France? the former started with high food prices and the latter with high gasoline prices.

And finally, with all the trillions of liquidity injected into the markets, are central banks about to make a significant policy mistake? Some portfolio managers seem to fear this. I mean look, Jean Claude Trichet, the former ECB’s president, did raise interest rates in 2008 because of inflation right before the Great Financial Crisis.

This reminds me of Mike Tyson’s famous quote “Everyone has a plan until they get punched in the mouth”. Ouch

Anyways, back to the ring and let’s start our investigation.

Before we start though, quick disclaimer. We don’t have to agree to agree and might even agree to disagree. Inflation is after all a polarised topic and much ink has been spilled over the question!

While there is a consensus that all of this is transitory and simply driven by the base effect from the pandemic recession in 2020, there are strong arguments on both sides.

Besides, to use the words of US General S Patton Junior, “If everyone is thinking alike, then somebody isn’t thinking”. Rest assured though, I have yet to have found that person.

In any case, the first point we need to figure out is: why are we seeing such mind-boggling price increases for goods and services? For oil, corn, copper, and semiconductors?

Well, the answer is straightforward. Base effects and lack of supply. When something goes down 50%, it needs to go up 100% or double to go back to where it was. But then this is only part of the story, because a lot of these commodities are reaching levels well above those of 2019.

The point about supply constraints is key. At the worst point of the Covid-19 pandemic in 2020, when the world economy was put into hibernation, what did companies do to survive? Well, they literally liquidated their inventories to raise cash and lower their working capital.

If you can’t open your business, the worst thing you could do is to sit on unsold inventory. This is what you saw with car rental companies that sold their fleets for instance. Even oil price futures collapsed and even went negative.

The other important point is supply chain disruptions. The global supply chain model of the ‘just-in-time’ failed. The model was simply unable to cope with a sharp drop and then a sudden sharp increase in demand.

As our economies reopen, all of these businesses are now looking to rebuild their inventories at the same time. And this is causing a significant demand surge in a supply constrained context. A textbook supply and demand price squeeze here.

The big elephant in the room is the energy transition. Even the Economist talks about in a special Briefing titled “Conditions for Green Growth” in June. Copper, cobalt and other green energy intensive commodities are in big demand. And prices are rising.

Even more so now because of the trillions of dollars’ worth of infrastructure commitments by the Biden administration and the EU with its Green Deal. You would be mad not to build up your stocks in anticipation if you are a mining company or a steel producer.

The other crucial factor behind inflation, and particularly for services, is the demand-pull inflation. As discussed in our very first episode, the Covid crisis has resulted in massive cumulative excess savings on household bank accounts. It’s incredible, savings have reached 2.4 trillion dollars in the US alone. That’s 10% of US GDP. And now that economies are reopening, a lot of that cash is being earmarked for revenge spending. Revenge holiday making.

After all, humans are social animals and interacting with one another and meeting friends and relatives is a fundamental part of who we are.

So, all of this makes sense so far. But what I really don’t buy, is the permanent nature of inflation. Why? Because of supply and demand balancing forces. Because of the simple law of nature called DEMAND SATIETY. Because of the concavity of utility functions. In layman’s term, that 50th pina colada you imbibe might not be as enjoyable as the first one.

There are some exceptions where demand increases with price. Take luxury goods or addiction – no exposé needed here. If you’re French, you’ll remember that Renault Clio TV add. The son of a wealthy Emirati was impressed by the quality of that car and wanted to buy it. But his dad disapproved and said, “Not expensive enough my son”.

The bottom line is that when price of a commodity goes up, you generally have a supply response. And this has been the trend for the past few decades. We have lived with significant deflationary forces linked to automation, globalisation, cheaper cost of labour from emerging markets via outsourcing to name just a few.

Picture this, in 1956, 5 megabyte of data costed 1 million dollars and weighed one ton. Today 5 megabyte is the average size of a small iPhone picture. Technological innovation and disruptions have enabled better affordability. I mean just imagine having to walk around with a one-ton smart phone – not very handy (pun intended).

If you are still not convinced. You can dial it up a notch and invoke the almighty Newton's 3rd law of motion:

"Every action has an opposite and equal reaction"

In other words, actions in markets and in lives are not static, they are dynamic. It's all about causes and effects. Action and reaction. Like the butterfly effect.

This brings me that I point I raised on the link between inflation and social unrest. Can we have a repeat of the Arab Springs or the Yellow Vest movement in France? While it might contribute to it, it is unlikely in the short term to happen in developed markets because of the stimulus by governments and central banks.

In emerging countries though, this is less obvious. We are already seeing social tension build up. Particularly around vaccine nationalism and the inequality around vaccine availability. It is therefore not surprising that the G7 has just committed to sending 1 billion doses of vaccines to some of the poorest countries in the world.

Emerging countries could decouple from developed countries in a post covid world via deglobalisation. This is potentially another important theme. It clearly merits more scrutiny, but it is not the topic at hand today.

Ok. So, inflation is transitory until proven permanent. But back to Tyson's punch. What if central banks, governments, and most investors have it all wrong and inflation gets out of hand?

This was to some extent the experience of the 1970s when US inflation averaged 7%. It even reached 12-15% during the oil shocks of 1973 and the 1979 Iran/Iraq war. This was also the period of the Nixon shock where President Nixon decided a number of economic policies in response to increasing inflation. We're talking wage and price freezes and ending the convertibility of the US dollar to gold.

This massively debased the US dollar after a ruinous Vietnam war. This was a big move. The US dollar was at the time pegged to gold. As per the Bretton Woods parity, an ounce was worth 35 dollars.

Rather than face default, the US decided to devalue from 35 to 350 dollars an ounce. A devaluation of 10 to 1 and eventually they let it float. The dollar was now backed only by the "full faith and credit of the United States of America".

Richard Nixon also put pressure on the Fed Chair Arthur Burns to keep interest rates low, increasing liquidity in order to win the elections. He famously said, "we'll take inflation if necessary, but we can't take unemployment".

This period of stagflation only ended with Paul Volker's policy of much higher interest rates. Not a surprise that the Fed's independence and credibility are crucial with a dual mandate focused on price stability while maximizing employment.

Had it been any other country, it could have gone the Weimar republic route. But hey, that's the privilege of being the number one economy in the world with the global reserve currency. Going back to the book "When money dies", the US dollar is indeed still alive and kicking.

So long story short, I don't think we are anywhere close to the 1970s.

That said, if you need to keep an eye out on inflation, here are the main market drivers to watch:

First, to get permanent inflation, you need high wage inflation. It is a necessary but not sufficient condition.

Second, the China credit impulse. This is the change in corporate lending growth has been falling sharply over the past quarters. Therefore, China is not going to contribute to the global commodity demand as it did after the great financial crisis. At the time it spent 20% of its GDP in massive infrastructure spending.

Third, to quote economist Milton Friedman, inflation is "always and everywhere a monetary phenomenon". Money supply growth, a.k.a. helicopter money, is another necessary but not a sufficient condition to generate runaway inflation. To do that, money injected by central banks needs to find its way into the economy and turnover rapidly to generate inflation.

This is also referred to as the velocity of money. Over the past decade, the velocity of money has fallen sharply because all of the QE stayed within markets, creating asset price inflation. With government fiscal policies joining forces with central banks to aggressively inject liquidity in the economy, the velocity money has indeed picked up somewhat.

Hence the fear on permanent inflation and the need to taper all this liquidity sooner rather than later.

[Interview starts]

Kokou: Hi, Albert. I finally managed to track you down. Where are you?

Albert: Hey there, I was actually hiding from you. But you have finally tracked me down.

This is the famous Albert Edwards, also known as the Perma Bear. Societe Generale's Head of Global Strategy. He is well known on the street for his ice age thesis. I wanted to get your take. Is this the beginning of the end of your ice age cycle?

Albert: The thing is, which really worries me, Kokou. Is I don't think the central bankers have the foggiest idea? They talk a good story, sound as if they know what they're talking about. They can just pull the levers, and everything will work. They don't know. And that is the most worrying thing is they're overconfidence that it's transitory. David Roach, he's here. Morgan Stanley picked up in a recent article. He said he used to work for Arthur Burns, the Fed then Fed chair in the early Seventies. He was really clever guy. Saw inflation picking up, thought it was transitory excluded this, excluded that. And by the time he really realized he'd messed up; inflation had taken off. And I think possibly that's why, I mean; I think this current up surge due to reopening and Covid ending or getting back under control is transitory. Fed thinks that, policymakers think that, but my goodness, they can be totally wrong. But certainly, for the medium term, it's the policy framework shift, monetary and fiscal policy working together, the lack of austerity, the fact that general public will revolt if there's austerity now and the way they didn't do so much after the last priority, that is a permanent change.

[Interview ends]

Let’s hope for all of our sake that we are not going into a hyperinflation with 10% US 10-year bond yields!

Central banks will have an important role to play, ie. Save us from another Great Depression by intervening. Something the Fed did not do after the 1929 crash hoping that the invisible hand and market forces would sort things out.

Well, let’s just say it did not work.

That said, while we had the visible hand of monetary and fiscal policies injecting 25 trillion dollars this time around, we also want to avoid the visible fist.

But once again. Everyone has a plan until they get punched in the face. You may have noticed, I’m all about punches today. The real story is that last week, in my karate class, I had a plan: punch and block... and well, I got punched in the face. But don’t worry, it hasn’t stopped me thinking about inflation.

Like in investing and in life, you typically have two kinds of people or strategies. The Mohamed Ali approach “Float like a butterfly and sting like a bee” and the Rocky Balboa strategy “It is not about how hard you hit that matters, it is about how hard you get hit but keep moving forward”.

So, on the one hand you have an approach that is all about being tactical and strategic. And on the other, an approach that is about being resilient. Personally, I like Ali’s strategy. Not a surprise that he was the greatest after all! The morale of the story is: Don’t put all your golden eggs in the same baskets. The future is uncertain.

Remember Donald Rumsfeld? The retired US politician who served as secretary of defence under presidents Ford and George W Bush. He once declared “There are known knowns; there are things we know that we know. There are known unknowns; that is to say, there are things that we now know we don’t know. But there are also unknown unknowns – there are things we do not know we don’t know”.

Digging more into known unknowns is what makes brainstorming and investigation fun. The unknown unknows is what gives me a headache.

But hey, what do I know?

(Credits)

Thank you for listening to this episode of 2050 Investors and thanks to [Albert Edwards] for sharing some useful insights with us.

I hope this episode has helped you get a better glimpse of the future of finance! You can find the show on your regular streaming apps. Please subscribe, leave some stars on Apple Podcasts, leave comments anywhere you like and spread the word!

See you at the next episode!

(Disclaimer)

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