Absolute Return Partners

The Absolute Return Letter

April 2022

10% Inflation to Come?

"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."

Ronald Reagan

10%? Really?

As if inflation wasn't already on everyone's radar screen, Russia's invasion of Ukraine has elevated inflation fears to levels we haven't (or, at least, I haven't) experienced since the 1970s when I, as a teenager in Denmark, could ride my bike on the local highway on the car-free Sundays. That was one of the more intriguing ramifications of high inflation back then. Far less amusing was it when, a few years later, I moved away from home and had to pay 19% in annual interest on my first mortgage. Only a few of the young people I have shared this story with actually believe me!

Now, fast forward to 2022. The Russians are destroying a peaceful country, and the West has responded with powerful sanctions. These sanctions have already had, and will continue to have, a drastic impact on energy prices. Consequently, many OECD countries will, in a few months' time, be flirting with inflation levels that, only weeks ago, were considered unthinkable.

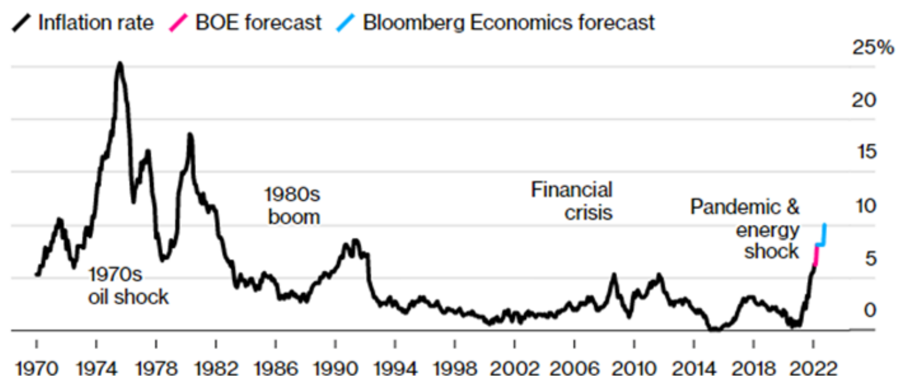

Exhibit 1: UK consumer price inflation

Sources: Bloomberg, Bank of England, ONS

Take for example the United Kingdom. Consumer price inflation in the UK is already 6.2% (as of February 2022, i.e. before Russia invaded Ukraine), and the economists at Bloomberg now think it will hit 10% in the next few months (Exhibit 1). As you can see, the Bank of England have somewhat lower expectations, but don't forget that BoE have a vested interest in not raising inflation expectations.

Virtually all countries around the world are affected by the war but some more than others. From a national security point-of-view, the USA may not be that affected but, from an inflation point-of-view, it is. Tight labour markets had already begun to have an impact on inflation, and the invasion has only made it worse.

I note that tight labour markets are one of the most reliable leading indicators of inflation. When unemployment is low, workers shop around for higher salaries. Consequently, their current employer is forced to meet the higher salary level if they want to hold on to existing staff. I suggest you take a look at Exhibit 2 below. As you can see, before the invasion, US salaries were already advancing more than 5% year-on-year, and I am sure the next wage report will show an even sharper rise.

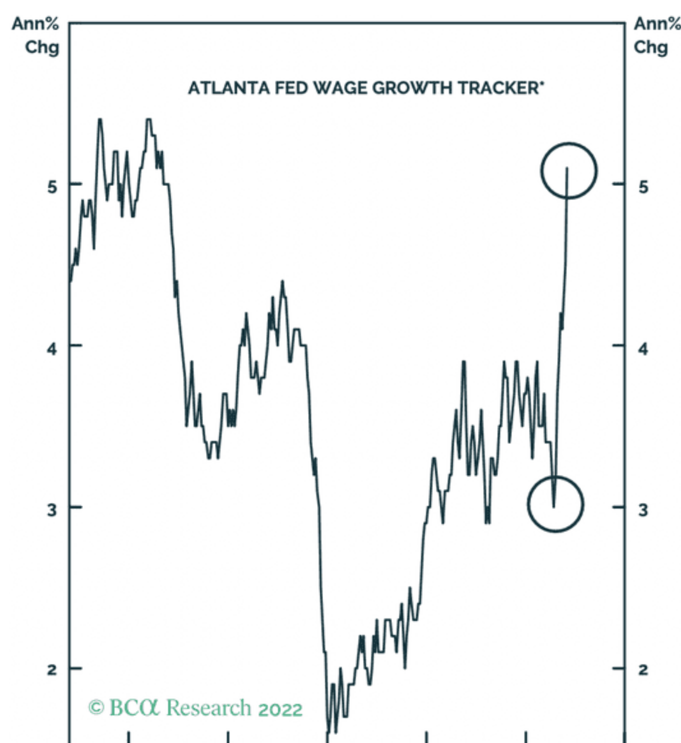

Exhibit 2: Atlanta Fed Wage Growth Tracker
Source: BCA Research

So far, the Fed's response has been surprisingly muted. A couple of weeks ago, the Fed raised the policy rate – but only by 25 bps. It is pretty obvious that the US economy is facing an ugly rise in inflation unless more drastic action is taken. Yes, I do know that no less than eight 25 bps hikes are already fully priced in before the end of 2022, but that will only take the Fed Funds rate to 2.4% at the end of the year. Will that be enough to kill inflation? I don't think so.

The problem in a nutshell is that core inflation (i.e. inflation ex. food and energy) is far higher in the US than it is in the rest of the OECD. Although

it is also becoming uncomfortably high in one or two other OECD countries, for example in the UK, in most of them, core inflation is virtually non-existent (Exhibit 3). In the chart below, think of "other" as core inflation.

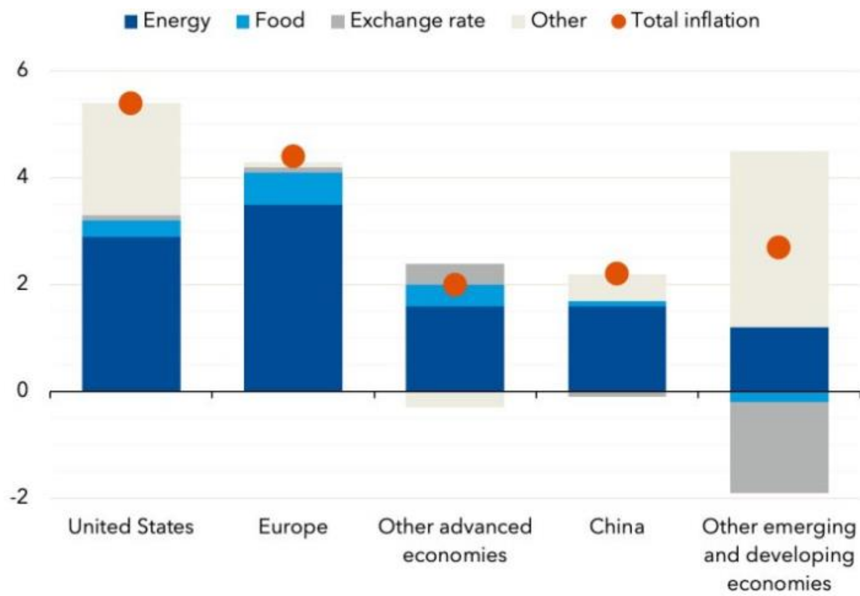

Exhibit 3: Consumer price inflation in various regions, December 2021
Source: [imf.org]

The implications

If my analysis proves correct, US inflation will turn out to be more sticky than inflation elsewhere. As we have seen over the years, rising food and energy prices are manageable, but once those price increases begin to affect inflation expectations – and I believe that has already happened in the US – then, suddenly, things become a great deal more complicated.

Exhibit 4 is a good illustration of how awkward the situation is for US central bankers right now. The gap between core inflation and real interest rates over there is now a mind-blowing 12% - not quite an all-time high (February 1975 was worse) but bad enough to raise the red flag. How it will all pan out is hard to say, but every single possible outcome that I can think of has negative implications for US equity markets.

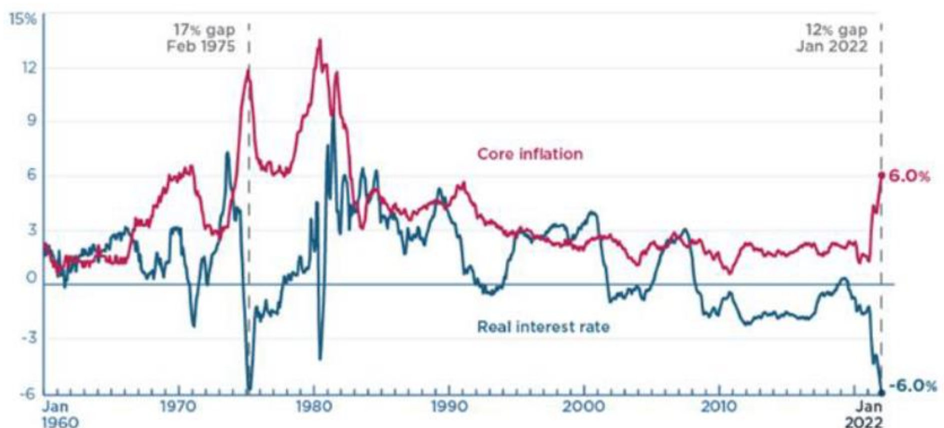

Exhibit 4: US core inflation vs. real interest rates
Source: *Petersen Institute, PGIM Wadhwani*

Final few words

If you are a subscriber to ARP+ and didn't attend the spring webinar earlier this week, I would recommend you spend ten minutes on the presentation, which was about inflation in the context of the war in Ukraine. You can find the presentation here.

Finally, I should mention that, a couple of weeks ago, I attended an IC meeting, where a prominent UK economist shared his thoughts on the inflation outlook. His thinking was startling if not entirely surprising. As he said to us (and I paraphrase), this is so much like the late 1960s, when a combination of easy monetary policy, generous fiscal expansion and the Vietnam war created the foundation for a decade of serious inflation problems in the 1970s. Even more problematic, he said, the younger people in our industry think we (i.e. those of us who worry) are just a bunch of old farts who have lost all touch. Well – we shall see!

Niels C. Jensen
1 April 2022

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Absolute Return Letter contributors:

Niels C. Jensen	nj@arpinvestments.com	T +44 20 8939 2901
Mark Moloney	mm@arpinvestments.com	T +44 20 8939 2902
Rishanth Ramanathan	rr@arpinvestments.com	T +44 20 8939 2909
Chirag Jasani	cj@arpinvestments.com	T +44 20 8939 2906