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Economic Perspective

August 24, 2020

RECORD-LOW INFLATION: LONG-TERM IMPLICATIONS

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A several-year period of low inflation will provide the Federal Reserve with the pretext it needs to maintain an ultra-accommodative policy for an extended period. Under normal circumstances, the Fed would begin to raise short-term interest rates when inflation — currently at 1% — reaches its long-term target of 2%. However, the combination of a persistently high unemployment rate, lingering economic risks, and an unusually high level of business failures will cause the Fed to defer tightening of monetary conditions for at least the next two years.

Summary and Major Conclusions:

- The outlook for inflation is heavily dependent upon time horizon. In the medium term, the combination of economic weakness and underutilization of productive resources should exert downward pressure on selling prices.

- Beyond the next two years, unprecedented fiscal and monetary policy stimulus could be a source of inflation in the long term. The ultimate path of inflation beyond next year is dependent upon Federal Reserve policy in 2021 and 2022.

- My forecast assumes a core consumer inflation rate of 1.5% over the next 12 months not exceeding 2% until later next year. While investors need to be vigilant for a rise in long-term inflationary expectations, this risk is not likely within the next two years.

- An extended period of low inflation would have a significant impact on both the real economy and financial markets. Most importantly, a several-year period of low inflation would allow the Federal Reserve to maintain an ultra-accommodative policy for an extended period.

- Households will be the primary beneficiaries of exceptionally low borrowing costs, especially for purchases of homes and consumer durables. As the quintessential credit-sensitive sector, housing could be the primary beneficiary of persistent low inflation and interest rates.

- The nonfinancial business sector should also benefit from low borrowing costs through issuance of new low-cost debt and redemption of existing high-cost debt. A reduced cost of capital should also spark a rise in business capital investment.

- On the basis of both history and economic theory, business profitability is inversely related to the rate of inflation. History shows that wages tend to rise faster than selling prices during periods of rising inflation, thereby squeezing margins.

- An examination of business cycles over the past 50 years reveals that inflation has been the primary catalyst for recessions because it triggers a harsh tightening in monetary policy. The current economic expansion could potentially extend for many years, depending upon the path of inflation in 2023 and 2024.

- The economic emergency resulting from COVID-19 triggered an unprecedented fiscal policy response, driving the federal deficit and national debt to record levels. The ability of the US Treasury to effectively service its debt will depend upon the strength of the economy and the level of interest rates.

- Both the real yield and the inflation premium on government bonds should drift modestly higher over the next year, but ten-year US Treasury bond yields should remain below 1.5%. Investment returns in the fixed-income market could remain depressed for many years.
- The stock/bond ratio measures relative returns between the equity and fixed-income market from a historical perspective. With temporary interruptions along the way, this ratio should remain in a general uptrend through 2022.
- Finance theory postulates that the present value of any income-producing asset is equal to the sum of future income streams discounted back to the present. Falling market yields on government bonds should automatically translate into a rising present value (market price), all else equal.
- There is a consistent inverse relationship between equity price-to-earnings (P/E) ratios and government bond yields. In a climate of Treasury yields of 1.5% or lower, a P/E ratio of 20x seems warranted, suggesting that the S&P 500 is only modestly overvalued at current prices.
- Because of the collapse in long-term bond yields, a major shift in long-term strategic asset allocation models is possible because of the exceptionally low expected returns from the fixed-income market. The large gap in expected rates of return could result in a large shift in the traditional 60%/40% mix between stocks and bonds in favor of stocks.
- An examination of market history reveals that all asset bubbles begin with very low interest rates, easy money, and negative inflation-adjusted (real) bond yields. The most likely candidates for asset bubbles over the next several years include gold and silver, residential property, farmland, industrial commodities, common stocks, and raw land.

The outlook for inflation is heavily dependent upon time horizon. In the medium term, the combination of persistent economic weakness and underutilization of resources should exert downward pressure on selling prices. Beyond the next two years, unprecedented fiscal and monetary policy stimulus since the onset of the pandemic ***could*** be a source of inflation in the long term. *The ultimate path of inflation beyond next year is dependent upon policies by the Federal Reserve in 2021 and 2022*.

Focusing on the short-to-medium term, I have assembled a list of potentially significant implications of a sustained low rate of inflation for the US economy and financial markets. Specifically, this week's *Economic Perspective* discusses the potential ramifications of low inflation for monetary policy, borrowing costs, the business cycle, the housing market, equity market valuations, strategic asset allocation, and federal budget financing.

INFLATION TRENDS AND OUTLOOK

Unsurprisingly, the economic crisis resulted in a precipitous decline in inflation beginning in March. Core consumer inflation has increased by only 1% over the past year and by an annual rate of less than 0.5% over the past six months. *These are the lowest inflation rates in decades*. And with an unemployment rate in excess of 11%, wages are rising at only a 2% annual rate.

The worst of the deflation scare appears to have passed, thanks in large measure to unprecedented monetary and fiscal stimulus. Nonetheless, inflation is likely to remain dormant for an extended period. My forecast assumes a core consumer inflation rate of 1.5% over the next year, and remaining below 2% until later next year. While investors need to be vigilant for a rise in long-term inflationary expectations, this risk is not likely within the next two years.

ECONOMIC IMPLICATIONS

- **Monetary Policy:** A several-year period of low inflation will provide the Federal Reserve with the pretext it needs to maintain an ultra-accommodative policy for an extended period. Under normal circumstances, the Fed would begin to raise short-term interest rates when inflation — currently at 1% — reaches its long-term target of 2%. However, the combination of a persistently high unemployment rate, lingering economic risks, and an unusually high rate of business failures will cause the Fed to defer tightening of monetary conditions for at least the next two years.

- **Borrowing Costs:** Households will be the primary beneficiaries of exceptionally low borrowing costs, especially for purchases of homes and consumer durables. A combination of very low inflation and unprecedented monetary accommodation will also greatly reduce the cost of capital for businesses. The result could be continued refinancing of old high-cost debt, thereby reducing interest expenses, along with increased demand for capital goods.

- **Housing Market:** As the quintessential credit-sensitive sector, housing could be a major beneficiary of persistently low inflation and interest rates. Although the direct contribution to GDP from residential construction is less than 5%, the ***indirect impact*** on GDP through accelerated purchases of housing-related goods and services is approximately 15%, a result of the exceptionally large ***multiplier effect*** associated with housing construction.

- **Corporate Profit Margins:** Based upon both history and economic theory, business profitability is inversely related to the rate of inflation. The history of the past 50 years reveals that company profit margins were lowest during periods of double-digit inflation — as in the late 1970s and early 1980s — and highest during the past decade, when inflation averaged only 1.6%. History reveals that wages tend to rise faster than selling prices during periods of rising inflation, thereby squeezing margins.

- **Business Expansion Cycles:** An examination of business cycles over the past 50 years reveals that inflation has been the primary catalyst for recessions because it inevitably triggers a harsh tightening in monetary policy. The exceptionally long expansions of the 1960s, 1990s, and 2010s benefitted from an extended period of low and stable inflation. The current economic expansion could potentially extend for many years, depending upon the path of inflation in 2023 and 2024.

- **Financing the National Debt:** The economic emergency resulting from COVID-19 triggered an unprecedented fiscal policy response of nearly $3 trillion, driving the federal deficit and national debt to record levels. The ability of the US Treasury to effectively service its debt will depend upon the strength of the economy and the level of interest rates. *Mathematically, the US will avoid a debt crisis as long as interest rates remain below the annual growth rate in nominal GDP*.

INVESTMENT IMPLICATIONS

- **Low Bond Yields:** The level of bond yields is comprised of two components: (a) A real rate component, reflecting supply and demand for credit; and (b) A measure of inflationary expectations. The latter can be best understood as compensation for bond investors for the risk of future inflation. Each of these components is expected to drift modestly higher over the next year, but the nominal yield on ten-year US Treasury bonds — currently at 0.75% — should remain below 1.5%. Investment returns in the fixed-income market could remain disappointing for many years.

- **Rising Stock/Bond Ratio:** The stock/bond ratio measures the relative returns between the equity and fixed-income markets from a historical perspective. This ratio fell during February and most of March and has been in a steep incline since the end of March. With temporary interruptions along the way resulting from equity market consolidations, this ratio should remain in an uptrend through 2022.

- **Low Discount Rates:** Basic finance theory postulates that the present value of a business — or any income-producing asset — can be estimated as the sum of future income streams discounted back to the present. The discount rate is typically a long-duration US Treasury security along with an adjustment for risk. In simple terms, falling market yields on government bonds should automatically enhance the present value of future cash flows, thereby exerting upward pressure on market prices, all else equal.

- **Equity Valuations:** The market yield on ten-year Treasury bonds has declined to 0.75%, from 2% one year ago and 3% in 2018. Treasury yields appear likely to remain historically depressed for at least the next two years. As a result, it is reasonable to assume that equity market valuations could remain elevated relative to history until yields move decisively higher. The price-to-earnings (P/E) ratio for the S&P 500 has averaged 17x over the past decade, during which time US Treasury bond yields averaged 3.5%. In a climate of Treasury yields of 1.5% or lower, a P/E ratio of 20x seems warranted.

- **Asset Allocation Models:** There exists the potential for a major shift in long-term strategic asset allocation models because of the exceptionally low expected returns from the fixed-income market. For example, rather than the traditional balanced portfolio mix of 60% equities and 40% bonds, a shift by balanced fund managers to an allocation of, say, 75% stocks and 25% bonds could become standard.

- **From Bonds to Stocks:** Such a shift in asset allocation would be consistent with current expected relative long-term returns in the equity and fixed-income markets. If so, trillions of dollars of funds in balanced portfolios could be transferred from bonds to stocks over the next three years, with a significant impact on relative market values.

- **Asset Bubbles:** An examination of market history reveals that all asset bubbles begin with very low interest rates, easy money, and negative inflation-adjusted (real) bond yields. As economic conditions steadily improve over the next several years, investor risk aversion will gradually diminish and speculative activity could increase. Under these conditions, investors tend to lose sight of traditional valuations. The most likely candidates for asset bubbles over the next several years include gold and silver, residential property, private equity, farmland, industrial commodities, and raw land.

INVESTMENT CONCLUSIONS

Inflation is likely to remain at exceptionally low levels over the next two years, at a minimum, with important economic and investment implications. The most significant ramifications pertain to Federal Reserve policy and the bond market. A reduced threat of high inflation will allow the Federal Reserve to maintain a highly accommodative policy for an extended period, suppressing long-term interest rates. The rate of return on stocks should easily outperform that of bonds over the next two years, at a minimum.

Historically low bond yields should also reduce private sector borrowing costs, most notably for residential mortgage loans. Construction of single-family homes should be at the forefront of economic growth over the next several years. Equity valuations should also benefit from low bond yields, which could also be a catalyst for a shift in asset allocation in balanced portfolios from bonds to global equities.

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