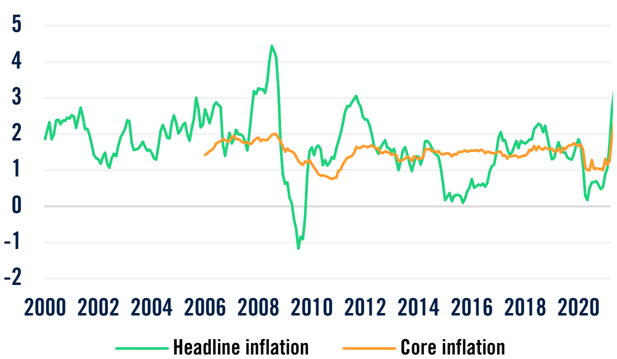
Inflation risks edge down, but still present

August 2021

The global monetary boom has started to ease, and in our view, this means inflation risks are slightly lower than they were a few months ago. A key factor behind this is a sharp decline in private sector borrowing. But inflation risks have not receded entirely, with large budget deficits and central bank asset purchases set to keep money supply growth high. Should inflation shift into a permanently higher range, this would have profound consequences for economies and financial markets, including asset allocation patterns.

Inflation has risen sharply across the world over recent months with the headline rate for advanced economies hitting 3.4% in June and the core rate 2.6% (see fig. 1). This has sparked concerns about a shift away from the low inflation regime enjoyed over recent decades. Such a shift would have profound consequences for economies and markets, so how likely is it?

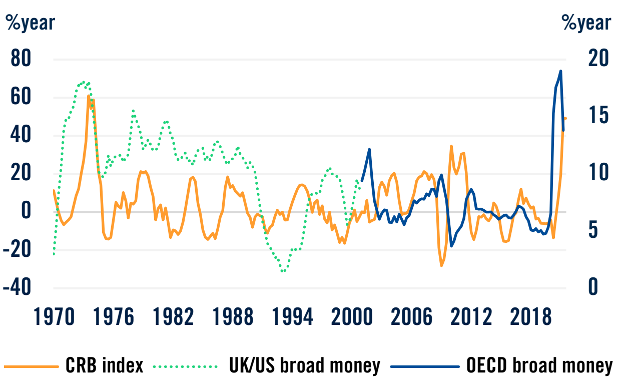
Fig. 1: Inflation in advanced economies



Source: Oxford Economics/ Haver Analytics

Key drivers of inflation concerns have been, for the short term, soaring commodity prices and, for the medium and longer term, very rapid growth in the money supply. Broad money growth in the advanced economies has been running at rates unseen for decades (see fig. 2).

Fig. 2: Commodity prices and broad money

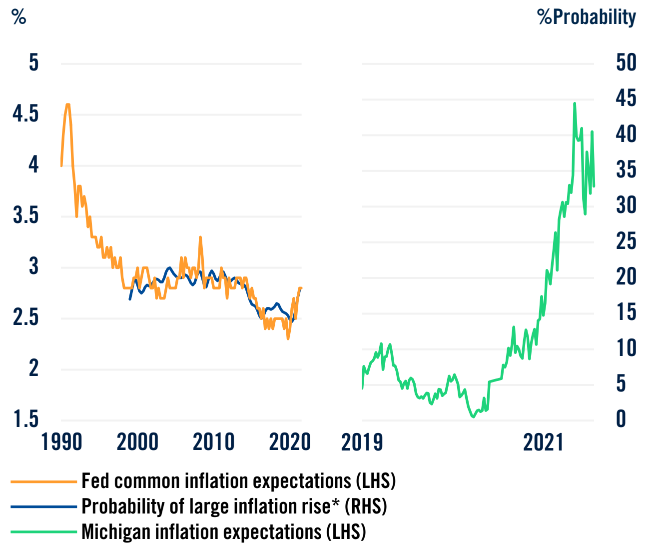


Source: Oxford Economics/ Haver Analytics

The danger is that high headline inflation rates, plus rapid monetary expansion, could push up long-term inflation expectations, thus 'locking in' higher inflation into the future. However, there has been some good news in recent weeks on some of the key inflation risk indicators.

First, after a notable rise, long-term inflation expectations seem to be stabilizing, or even edging lower. The University of Michigan and Federal Reserve measures have been steady in recent months at around 2.8% per year and the Minneapolis Fed's options-based estimate of the probability of a large inflation rise over the next five years has retreated from over 40% to 32% (see fig. 3). In Europe, the latest ECB survey of professional forecasters showed only an 8% probability of long-term inflation rates running at over 3%.

Fig. 3: Inflation expectations



Source: Oxford Economics/Haver Analytics. *Options-based, from Minneapolis Fed (probability of inflation over 3% in next five years)

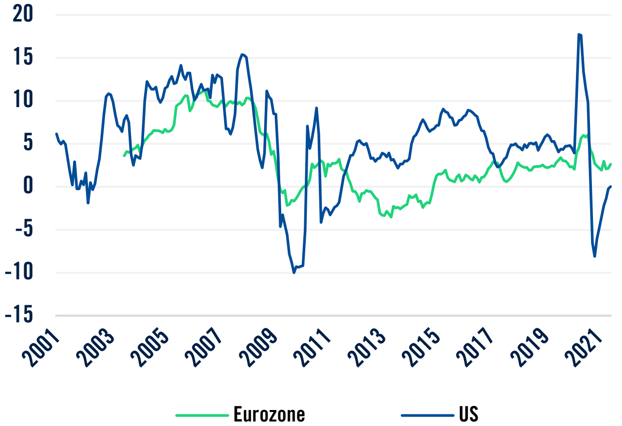
Second, money supply growth, while still high, also seems to be starting to level off. OECD broad money growth has eased from a peak of 19% y/y to below 14% and within this, eurozone money supply growth has dropped back to under 8% (from a peak of 12%).

A key factor behind slower money supply growth is a weakening of bank lending to the private sector. Lending was boosted sharply last year mostly due to emergency loans to firms, but many firms are now repaying earlier borrowings.

As a result, eurozone private sector borrowing growth has eased from a peak of 6% (on a six-month annualized basis) to around 2.6%. In the US, the slowdown has been even more dramatic, from a peak of over 15% to slightly negative in recent months (see fig. 4). Indeed, corporate borrowing in the US is now a significant drag on overall private credit and money supply growth — in the six months to June, it fell at an 8% annualized pace.

Fig. 4: Bank lending to private sector

%, 6-month annualized



Source: Oxford Economics/Haver Analytics

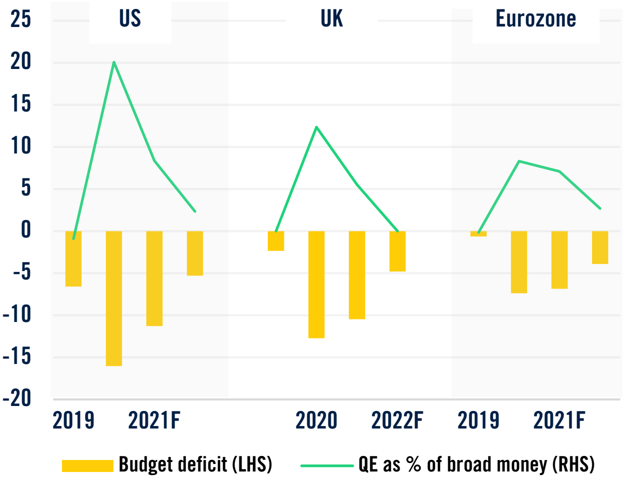
So far, so good. But inflation risks have not receded entirely. While corporate borrowing is receding as a risk factor, borrowing by households is showing signs of picking up. Surveys of bank credit standards showed a sharp tightening of mortgage credit availability after the pandemic hit, but recent surveys have shown standards loosening again. Actual mortgage lending has picked up to around 4.5% y/y, on average, across the US, UK and eurozone and seems likely to pick up further given the trends in credit standards and the rapid growth in housing prices.

Heavy government borrowing and quantitative easing (QE) by central banks also remain inflation risk factors. Over the last year and half, this combination of factors has been the most important influence on broad money supply growth, and this is likely to remain the case.

Stronger GDP growth has improved our forecasts for budget deficits in the major economies in recent months, implying less upward pressure on money growth. But the change has not been large, and QE is set to continue at a strong pace this year. Our forecasts suggest the flow of QE will be enough to add 6-8 percentage points to broad money growth in the US, UK, and eurozone (see fig. 5). This is likely to keep money growth at a high-enough pace to sustain concerns about inflation.

Fig. 5: Budget deficits and QE

% of GDP



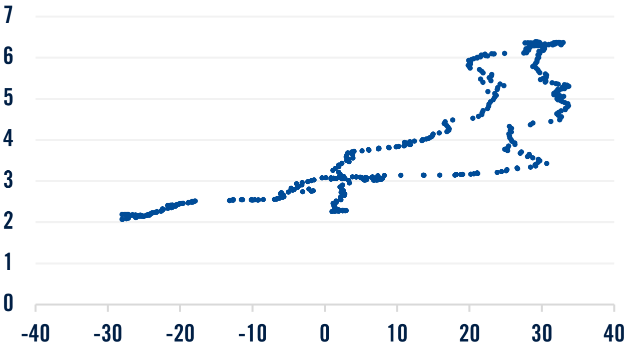
Source: Oxford Economics/Haver Analytics

In our view, the risk of a shift to permanently higher inflation — of say 5% or more a year — remains moderate. We would give this a 10% probability for the advanced economies, and perhaps 15% for the US. But if such a shift did occur, it would have major implications. Economically, it would imply a stronger link between the economic cycle and inflation and necessitate more interventionist central banks as these seek to minimize deviations of inflation from target. So short term rates would be higher and more volatile.

For financial markets, low and stable inflation underpins the negative correlation between equities and fixed income, ensuring that a typical 60% equities, 40% bond portfolio provides some diversification. If we move to a higher inflation regime (i.e., consistently above 3% based on fig. 6). then a standard portfolio's returns will become dangerously susceptible to the economic cycle — a high-impact scenario for investors.

Fig. 6: Inflation and asset returns

20-year US stock/bond return correlation



Source: Oxford Economics/Haver Analytics

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