MORNING BRIEFING
December 9, 2020

Inflation Was Sooo 1970s!

Check out the accompanying chart collection.

(1) Early disinflationist. (2) Fears of post-pandemic reflation. (3) Inflation outcome will make or break portfolio strategies. (4) Recalling the Great Inflation of the 1970s, when everything went wrong. (5) Food and oil price shocks, and a wage-price spiral. (6) The 4Ds vs M1. (7) US monetary aggregates are soaring. (8) Are the 4Ds still relevant? (9) More good news on the productivity front. (10) The war-and-peace model of inflation. (11) Not much inflation in US, Eurozone, Japan, and China. (12) Reflating or abating deflation? (13) Bonds, copper, and the dollar all showing more inflation than deflation now.

Inflation I: Post-Pandemic Worry. I was an early believer in "disinflation." I first used that word, which means falling inflation, in my June 1981 commentary titled "Well on the Road to Disinflation." The Consumer Price Index (CPI) inflation rate was 9.6% that month. I predicted that Federal Reserve Chair Paul Volcker would succeed in breaking the inflationary uptrend of the 1960s and 1970s, which he did.

Nevertheless, throughout my career, I've often fielded questions about the likelihood of a rebound in inflation from accounts who were worried that it just might make a comeback. After all, the Fed chairs who followed Volcker tended to favor stimulative monetary policies. This year, as a result of the unprecedented monetary and fiscal policy stimulus provided by governments around the world to offset the adverse financial and economic consequences of the Great Virus Crisis (GVC), I'm hearing more concern that inflation could come roaring back once the pandemic is over.

In this widely feared scenario, interest rates might soar. That would create all sorts of trouble. The mountains of debt accumulated by the public and private sectors would compound at a faster pace. The credit markets could seize up, causing a credit crunch and a recession, possibly worse than those of the Great Financial Crisis (GFC). Stock markets would fall into bear markets as earnings declined and valuation multiples tumbled. If inflation were to come roaring back, my upbeat Roaring 2020s outlook would be its biggest casualty.

Given the consequences of getting their expectations for inflation wrong, it's no wonder investors are worried about this bad-case scenario even if they aren't ready to do anything in response to it, other than talk about it more often. In any event, while I'm still a disinflationist, our YRI team is focused on watching out for signs of trouble on the inflation front. Before Debbie and I review what we are seeing, let's briefly recount what happened during the Great Inflation of the 1970s.

Inflation II: A Brief History of Inflation in the 1970s. Almost everything that could go wrong did so back then. I reviewed what happened in my 2020 book titled *Fed Watching for Fun and Profit*. For starters, on August 15, 1971, President Richard Nixon suspended the convertibility of the dollar into gold, which ended the Bretton Woods system that had kept the dollar's value at a constant $35 per ounce of gold since the system was established in 1944. The value of the dollar in foreign exchange markets suddenly plummeted, causing spikes in import prices as well as the prices of most commodities priced in dollars.

During the summer of 1971, Nixon imposed wage and price controls. They didn't work, and the controls were lifted in 1973. During 1972 and 1973, for the first time since the Korean War, farm and food prices began to contribute substantially to inflationary pressures in the economy. Also, there was a major oil price shock during 1973 and again in 1979 (*Fig. 1*).

Together, the two oil price shocks of the 1970s caused the price of a barrel of West Texas crude oil to soar 11-fold from $3.56 during July 1973 to a peak of $39.50 during mid-1980, using available monthly data (*Fig. 2*). As a result, the CPI inflation rate soared from 2.7% during June 1972 to a record high of 14.8% during March 1980. Even the core inflation rate (i.e., the rate excluding food and energy) jumped from 3.0% to 13.0% over this period as higher energy costs led to faster wage gains, which were passed through into prices economy-wide. During the 1970s, strong labor unions in the private sector succeeded in quickly boosting wages through cost-of-living clauses in their contracts. The result was an inflationary wage-price spiral (*Fig. 3*).

It's my view that the 1970s were uniquely inflation prone. Paul Volcker stopped the inflationary wage-price spiral by tightening monetary policy significantly during the late 1970s and early 1980s, causing a severe recession. However, inflation continued to trend lower since then through today, mostly because of the four deflationary forces (i.e., the "4Ds"), which we have discussed many times along the way. (For a summary, see the excerpt from my 2020 book titled *Four Deflationary Forces Keeping a Lid on Inflation.*)

Inflation III: Will the 4Ds Drown in M1's Tsunami? The question for us today is whether the 4Ds are still relevant or whether they've met their inflationary match in the extraordinary monetary and fiscal policy responses to the pandemic. The 12-month federal deficit rose to a record high of $3.3 trillion through October, while the Fed's purchases of Treasury securities totaled a record $2.4 trillion over the same period (*Fig. 4*). Most of those expansions occurred since the week of March 23, when the Fed and the Treasury essentially embraced Modern Monetary Theory and morphed into "T-Fed" in response to the GVC.

Contrary to Milton Friedman's claim that inflation is essentially a monetary phenomenon, it has remained subdued ever since the GFC notwithstanding the ultra-easy monetary policies of the major central banks. We soon should find out if money matters to the inflation outlook given that the GVC has resulted in ultra-easy monetary policies on steroids and speed combined! In the US, M1 has increased by $2.3 trillion since the last week of February to a record $6.2 trillion during the week of November 23 (*Fig. 5*). It is up an astonishing and unprecedented $498 billion during the latest week and 57% y/y! MZM and M2 are up 28% and 25% y/y (*Fig. 6*).

Our money is on the 4Ds. They should continue to keep a lid on inflation. Here is our current bottom lines on each of the 4Ds:

(1) *Détente*. In the grand sweep of economic history, inflation tends to occur during relatively short and infrequent episodes, i.e., during war times. The more common experience has been either very low inflation or outright deflation during peacetimes.

Periods of globalization follow wartimes. During peacetimes, national markets become increasingly integrated through trade and capital flows. The result is more global competition, which is inherently deflationary. The worsening Cold War between the US and China is a threat to globalization, but probably won't heat up to the point of causing inflation now that a regime change is coming to Washington. In any event, China's exports during November edged back up to the record high hit during July notwithstanding Trump's trade war with that country (*Fig. 7*).

(2) *Technological Disruption.* Nevertheless, recent global trade tensions and the pandemic are likely to cause businesses to diversify their offshore supply chains away from China and to onshore more of them. That could be costly and inflationary. It could also be cost effective now

that labor shortages attributable to global demographic trends are stimulating technological innovations in automation, robotics, artificial intelligence, and 3D manufacturing. These all enable onshoring and boost productivity to boot.

Nonfarm productivity jumped 4.0% y/y during Q3, the fastest pace since Q1-2010. We are expecting a secular rebound in productivity growth during the Roaring 2020s. So far, so good: The 20-quarter growth rate of productivity (at an annual rate) is up from a recent low of 0.6% during Q4-2015 to 1.7% during Q3 (*Fig. 8*). Jackie and I believe that the pandemic accelerated the pace of applying new technologies to boost efficiency and profit margins, as we will discuss more fully tomorrow.

(3) *Demographics.* Fertility rates have plunged below population replacement in recent decades around the world as urbanization has changed the economics of having children. Instead of being an important source of labor and elder care, as they were in agrarian communities, children are all cost in urban settings. Nursing homes have few vacancies, while maternity wards have plenty. Increasingly geriatric demographic profiles are inherently deflationary.

(4) *Debt*. During the 1960s through the 1980s, debt was stimulative; more of it stimulated more demand and added to inflationary pressures. Now, easy credit conditions aren't as stimulative to demand as in the past because so many consumers have so much debt already. However, easy monetary conditions are a lifeline to zombie companies, enabling them to raise funds to stay in business and add to global supplies of goods and services, which is deflationary.

Inflation IV: By the Numbers. Now let's review the latest inflation data around the world. Inflation remains remarkably subdued, as it has been since the mid-1990s. Consider the following:

(1) *G7.* The core CPI inflation rate among the seven major industrial economies has fluctuated in a flat range between a high of 2.2% and a low of 0.7% since 1997 (*Fig. 9*). The core rate was only 1.1% during October. Here are the latest core CPI inflation rates for the US (1.6%), Eurozone (0.2), and Japan (-0.4) (*Fig. 10*).

(2) *China.* While China's economy has staged a significant recovery from its lockdown recession at the start of the year, the CPI inflation rate dropped from a recent peak of 5.8%

during February to only 0.5% during October. The Producer Price Index was down 2.1% y/y during October.

(3) *US.* The pandemic has had a dramatic inflationary impact on only one component of the CPI: Used car and truck prices are up 11.5% y/y through October (*Fig. 11*). (They are up 14.4% in the PCED, or personal consumption expenditure deflator, measure.) This is a category with little weight in the CPI.

Rent of shelter has a much bigger weight, and its inflation rate has been falling sharply as a result of the pandemic because of two phenomena: people unable to pay their rent and renters becoming homeowners. This CPI item's inflation rate is down from 3.4% at the start of the year to 2.1% during October (*Fig. 12*). It does include hotel and motel fees, which should reflate once a vaccine is widely distributed.

Inflation V: Bonds, the Dollar & Commodity Prices. Notwithstanding all the above, the financial markets seem to be signaling that inflationary pressures are making a comeback of sorts. More likely, in our opinion, is that they're simply signaling that the deflationary pressures initially unleashed by the pandemic are abating as the global economy continues to recover. Consider the following:

(1) *Expected inflation rebounds.* The 10-year US Treasury bond yield has been relatively flat just below 1.00% recently, while the comparable TIPS yield has been edging lower again following a smallish and shortish rebound from its fall earlier this year (*Fig. 13*). As a result, the yield spread between the two, which is widely used as a proxy for the average annual 10-year expected inflation rate, has rebounded from this year's low of 0.5% on March 19 to 1.9% on Monday (*Fig. 14*).

(2) *Copper is red hot.* The price of copper has rebounded dramatically along with China's economy as auto sales in China rose for a fourth straight month in October. The price of the red metal is up 65.5% since the year's low on March 23 from $2.12 per pound to $3.51 on Monday (*Fig. 15*). The two previous rebounds that exceeded the current one since 2004 were not associated with rising CPI inflation.

Meanwhile, the ratio of the nearby futures prices of copper to gold continues to signal that the bond yield should be closer to 2.00% than to 1.00% (*Fig. 16*). There's been a tight fit between the ratio (multiplied by 10) and the yield since 2004. Without the Fed's open market purchases

of Treasury notes and bonds, the yield would probably be higher, boosting the expected inflation proxy over 2.00%.

By the way, the reason why the copper/gold ratio tracks the nominal yield so closely is that the price of copper is highly correlated with the yield spread inflation proxy, while the price of gold is highly correlated with the inverse of the 10-year TIPS yield (*Fig. 17* and *Fig. 18*).

(3) *The dollar's descent.* Yet another interesting set of correlations is the ones between the inverse of the dollar versus the price of copper and versus expected inflation (*Fig. 19* and *Fig. 20*). All three variables are consistent with rising inflation pressures. However, similar past episodes in recent years signaled that deflationary pressures were abating rather than inflation rebounding.

CALENDARS

US: Wed: Job Openings 6.3m, MBA Mortgage Applications, Wholesale Trade Inventories 0.9%. **Thurs:** Headline & Core CPI 1.1%/1.6% y/y, Initial & Continuous Jobless Claims 725k/5.3m, Monthly Budget Statement, EIA Natural Gas Storage. (DailyFX estimates)

Global: Wed: Germany Trade Balance €18b, Japan PPI 0.0%m/m/-2.2%y/y, BOC Rate Decision 0.25%, BOE Financial Stability Report, BOE FPC Record. **Thurs:** UK GDP 0.4%m/m//10.1%(3m average)/-8.3%y/y, Headline & Manufacturing Industrial Production -6.5%/-8.4% y/y, France Industrial Production 0.4%, ECB Interest Rate Decision & Deposit Facility Rates 0.0%/ -0.5%, European Council Meeting. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index leads ytd through Monday's close with a gain of 29.1% versus a 2.4% decline for Value. Since their low for the year on 3/23, Growth's 73.3% gain is well above the 54.0% rise for Value. Growth has been making new record highs since early July, while Value has recovered to 3.6% below its 2/19 record. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) than Value over the next 12 months, but Value is forecasted to deliver higher earnings growth (STEG) than Growth. Specifically, 10.7% STRG and 17.8% STEG are projected for Growth, respectively, versus 5.0% and 19.1% for Value. Through Monday's close, Growth's P/E of 28.0 is up down from its 15-month low of 16.8 on 3/23, but down from a 19-year high of 30.2 on 9/2. Growth's valuation previously peaked at 24.2 on 2/19, which was then its highest

level since April 2002 when the Tech bubble was deflating. Value's forward P/E of 17.4 is down from 18.6 on 6/8, about the time that its forward earnings bottomed at a three-year low. That's still up from 10.0 on 3/23, which was its lowest reading since November 2011. Regarding NERI, Growth's was positive in November for a fourth straight month, but ticked down to 17.9% from 18.6% in October. That compares to a corporate tax-cut boosted record high of 22.3% in March 2018. Value's NERI was also positive in November for a fourth month, but improved to 14.7% from 13.6%; that compares to a record high of 21.2% in March 2018. The Tax Cuts and Jobs Act (TCJA) sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value in 2018. Growth's forward profit margin of 16.0% on 11/26 is still above the 14.4% prior to the TCJA's passage but down from its record high of 16.7% during September 2018. Value's forward profit margin of 8.9% is up from a nine-year low of 8.0% on 5/28. That's still down sharply from a record high of 10.5% in December 2018, and a tad below the 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index (*link*): "Small business owners are still facing major uncertainties, including the COVID-19 crisis and the upcoming Georgia runoff election, which is shaping how they're viewing future business conditions," said Bill Dunkelberg, NFIB's chief economist. "The recovery will remain uneven as long as we see state and local mandates that target business conditions and disproportionately affect small businesses." The Small Business Optimism Index (SBOI) fell 2.6 points in November to 101.4 after holding steady at 104.0 in October—still well above the 47-year historical average of 98.0; it had increased steadily from 90.9 in April to 104.0 by September. Six of the 10 components of the SBOI fell in November, while four rose. Once again, owners expecting business conditions to improve over the next six months took the biggest hit—falling 19ppts last month alone and 24ppts the past two months to 8. Also dragging the SBOI lower were plans to increase inventories (to 5% from 12%) and earnings trends (-7 from -3), followed by capital spending plans (26 from 27), sales expectations (10 from 11), and now is a good time to expand (12 from 13) which all ticked down a percentage point. Hiring plans (to 21% from 18%) was the biggest positive contributor to the SBOI, with current job openings (34 from 33), current inventories (5 from 4), and expected credit conditions (-3 from -4) all up a percentage point. Of the owners surveyed, quality of labor (24%) remained the top business problem, followed by taxes (20), government requirements (14), and poor sales (13)—with concerns about the quality of labor rebounding 9ppts the past seven months and taxes up 4ppts the past three months. The Uncertainty Index

dipped 90 in November—still a historically high reading—after climbing from 75 in April to 98 in October—the highest since November 2016.

Productivity & Unit Labor Costs (*link*): Revisions show nonfarm productivity expanded 4.6% during Q3, slightly smaller than the 4.9% gain previously reported; this followed a record 10.6% jump during Q2. The revision reflects an slight upward revision to hours worked (to 37.1% from 36.8%), while output (43.4 from 43.5) barely budge from the prior estimate. Meanwhile, unit labor costs (to -6.6% from -8.9%) declined at a slower rate, along with hourly compensation (-2.3 from -4.4). Manufacturing (to 19.9% from 19.0%) productivity rose at a slightly faster pace than the prior estimate as output (56.2 from 54.8) was stronger and hours worked (30.3 from 30.1) showed little change from the previous estimate. The increase in manufacturing productivity follows a record 14.0% Covid-related drop during Q2 with output and hours worked down 46.5% and 37.8%, respectively. Manufacturing unit labor costs (to -12.1% from -18.2%), in the meantime, recorded a positive swing of 6.1ppts during Q3 as costs fell at a slower pace than previously reported; the upward revision to hourly compensation (5.3 from -2.6) was partially offset by the upward revision to productivity. Over the past four quarters, nonfarm productivity increased 4.0%—its best pace since the start of 2010, with output and hours worked falling 3.4% and 7.1%, respectively; unit labor costs climbed 4.0% y/y. The same drill for manufacturing shows productivity climbing 1.0% with output and hours worked down 5.8% and 6.7%, respectively, with unit labor costs rising 8.9%.

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