MORNING BRIEFING
April 27, 2021

Inflation: The Japanese Model

Check out the accompanying chart collection.

(1) Something very Zen about Japan. (2) Japan's population is shrinking and aging rapidly. (3) Japanese government debt at 220% of GDP. (4) Flat nominal GDP for 24 years. (5) Prolonged period of deflation. (6) Japan has been doing MMT for at least a decade. (7) Used car prices soaring. (8) Missing chips. (9) Soaring home prices could soon boost rents. (10) PPI inflation rates heating up some more in US and Asia. (11) CPI inflation rates remain subdued in US, Eurozone, and Asia. (12) Extreme alternative inflation scenarios: Japan now vs Germany from 1921-23.

YRI Podcast. In our latest video *podcast*, Dr. Ed discusses the main points of today's *Morning Briefing.*

Inflation I: The Japanese Model. Debbie and I believe that Japan's economy continues to serve as a useful model for the likely course in coming years of the other major industrial economies around the world. If so, then CPI inflation rates are likely to remain relatively subdued in these countries. That doesn't rule out transitory post-pandemic rebounds in these inflation rates.

Why look to Japan's economy as a bellwether? Consider the following:

(1) *Population.* Japan has a rapidly declining and aging population. The 12-month sum of deaths has exceeded births since July 2007 (*Fig. 1*). The total population has decreased by 2.4 million since then through April, while the population aged 15 years and older is down 0.2 million through February, less than the total population has dropped because people are living longer (*Fig. 2*).

(2) *Fiscal policy.* The Japanese government has been running huge budget deficits for many years, mostly to offset the deflationary consequences of Japan's rapidly aging demographic profile. In effect, the government has been building bridges and roads to nowhere that nobody needs because old people don't venture out much. As a result, the national government debt has skyrocketed from 50% of nominal GDP during 1993 to 220% during Q4-2020 (*Fig. 3* and *Fig. 4*).

(3) *GDP.* Yet Japan's nominal GDP during Q4-2020 was only negligibly higher than it was during 1996 (*Fig. 5*). Amazingly, it has been virtually flat around ¥135 million over this entire 24-year period. While real GDP rose 2.5% over this period, the GDP deflator fell 11.5%. That's an extremely prolonged period of deflation in the face of so much fiscal stimulus.

(4) *Monetary policy.* The Bank of Japan (BOJ) joined the battle against deflation many years ago. The BOJ first introduced its zero interest-rate policy at the start of 1999 (*Fig. 6*). During the first half of the 2000s, the BOJ implemented its first round of quantitative easing (QE), resulting in a 69%

increase in the monetary base (*Fig. 7*).

The BOJ's second round of QE started during April 2013 and continues to this very day. The monetary base has increased 356% since then through March of this year. The ratio of the national government debt to the monetary base has dropped from 7.2 to 2.0 over this period (*Fig. 8*).

This implies that the BOJ in effect embraced Modern Monetary Theory (MMT) many years ahead of the other major central banks, which did so only after the pandemic started early last year! Yet inflation remains remarkably subdued near zero in Japan.

Could it be that MMT is actually the right policy response to the voluntary self-extinction of the human race in countries like Japan, where fertility rates have fallen below the population replacement rate? This has happened nearly everywhere around the world, mostly as a result of urbanization; the exceptions are India and Africa.

We will revisit this admittedly startling thesis in coming weeks. For now, let's have a look at the latest inflation indicators here and there.

Inflation II: More Signs of Trouble in US Auto Market. In the US, inflation may be starting to rear its ugly head. Once upon a time, before Covid-19, Fed officials often suggested that they would wait to see the whites of inflation's eyes before they would raise interest rates. Now, even though the pandemic is abating as the pace of vaccinations picks up and a V-shaped recovery is underway, officials seem set to hold off on raising rates until they see the back of inflation's head. Consider the following:

(1) *Used car prices soaring.* The whites of inflation's eyes are very easy to see in the headlights of used cars. The Manheim used vehicles value index rose 26.3% y/y during March (*Fig. 9*). That's the highest since the start of the data during 1996. This index is very highly corelated with the CPI for used cars and trucks, which was up 9.4% y/y during March. The former tends to lead the latter, especially during periods when used auto prices are moving sharply up or down.

(2) *Easy credit.* Manheim has a database of more than five million used vehicle transactions annually. The company has developed a measurement of used vehicle prices that is independent of underlying shifts in the characteristics of vehicles being sold. (View the *index methodology*.) Manheim recently reported: "Using a rolling seven-day estimate of used retail days' supply based on vAuto data, we see that used retail supply is below normal levels, at 33 days. Wholesale supply is down to 17 days for the most recent seven-day period, when normal supply is 23."

Furthermore, the company recently reported: "Our Dealertrack Auto Credit Index measured loosening of credit in September, October, November, and December, and again in February and March after tightening in January. Credit remains modestly tighter than February 2020 before the pandemic began."

(3) *Plant closings.* The problem is that the supply of new cars is very tight (*Fig. 10*). That's boosting the demand for and the prices of used cars. There are continuing interruptions in global supply chains. The result has been plant closings and shortages of popular models. New car inventories won't be back to normal for a while. The biggest bottleneck is a global shortage of microchips.

They are critical for everything from car engines to infotainment systems. Unfortunately, they're also used in every other consumer electronic device, and the booming car industry has to compete for a limited supply of chips.

(4) *Buying bigger better.* According to industry analysts at J.D. Power, the average price of new vehicles reached $37,314 in Q1-2021. Compared to Q1-2020, the price is $3,000 higher. Compared to Q1-2019, it's $4,000 higher. Of course, much of the price difference comes from the types of vehicles consumers are choosing. The new car market has shifted strongly away from affordable compact and midsize cars to more costly SUVs and pickups (*Fig. 11*).

(5) *My kingdom for a chip.* An April 19 *US News & World Report* *article* observed that "[a]utomakers are prioritizing their production by using microchip supplies for their most profitable models—namely, full-size pickups and SUVs. Many automakers—including GM, Ford, and Stellantis (formerly Fiat Chrysler Automobiles)—are closing plants or reducing shifts. Ford is building 2021 Ford F-150 pickups without vital components and parking the unfinished vehicles until the right parts arrive. General Motors is building (and selling) 2021 Chevrolet Silverado and 2021 GMC Sierra pickups without their Active Fuel Management cylinder deactivation systems, which will lower their fuel economy."

(6) *Set for upside surprise.* The CPI for new vehicles has remained subdued despite the surge in used car prices (*Fig. 12*). The former was up just 1.5% y/y during March. However, it could surprise on the upside, much as it did during 2009 coming out of the Great Financial Crisis.

Inflation III: US Rents Subdued While Home Prices Soar. The median price for an existing single-family home rose 18.4% y/y during March to a record high of $334,500 over the past 12 months (*Fig. 13*). A year ago, this inflation rate was 8.1%. This jump clearly is not attributable to a "base effect" but rather to a pandemic-related surge in demand and a severe shortage in the supply of existing and new homes for sale. The Fed boosted demand with its ultra-easy monetary policy in response to the pandemic, which caused mortgage rates to fall to record lows last year. They've been rising in recent months.

The supply of new and existing homes for sale was at 1.21 million units during March, little changed from January's record low of 1.17 million units (*Fig. 14*). Home prices are not included in the CPI. However, a shortage of homes for sale combined with rising home prices and mortgage rates could frustrate lots of would-be homebuyers and convince them to continue to rent instead. That could start putting upward pressure on rent inflation, which is a major component of the CPI (*Fig. 15*).

Inflation IV: Comparing PPIs and CPIs in the US and Asia. The cold war between the US and China has been heating up since President Donald Trump was in the White House. However, their two economies remain very codependent. That's evident in the very high correlation between China's PPI for total industrial products and America's PPI for final demand of goods (*Fig. 16*). During March, China's was up 4.4% y/y while the US's was up 7.0%; both have been heating up over the past year.

So far, the rebound in China's PPI hasn't shown up in the country's CPI, which rose only 0.4% y/y through March (*Fig. 17*). The correlation between the two countries' CPIs isn't as high as between their PPIs (*Fig. 18*). Surprisingly, the US CPI inflation rate has tended to be below that of the comparable Chinese inflation rate since 2007.

By the way, it's not surprising to see that PPI inflation rates in South Korea and Taiwan are highly correlated with China's PPI inflation rate (*Fig. 19*). The same can be said for the CPI inflation rates of these three Asian economies (*Fig. 20*). The CPI inflation rate in South Korea was 1.5% during March, up from 1.0% a year ago. The comparable inflation rate was 1.3% in Taiwan during March, up from zero a year ago.

Inflation V: In Eurozone and Japan, CPIs Remain Subdued. In the Eurozone, CPI inflation has rebounded in recent months but remains subdued well below the ECB's 2.0% target, at 1.3% for the March headline rate and 0.9% for the core rate (*Fig. 21*).

Here are the headline and core March inflation rates for Germany (2.0%, 1.6%), France (1.4, 1.0), Italy (0.6, 0.7), Spain (1.2, 0.0), Portugal (0.1, -0.3), Greece (-2.0, -3.2), and Ireland (0.1, -0.1).

Japan stands out among the G7 countries as the one with the lowest headline and core inflation rates, with both at -0.1% during March (*Fig. 22*). Let's hope that Japan's experience with inflation in recent years is a harbinger of things to come for the rest of us. The alternative extreme scenario is Germany's hyperinflation from 1921-23. Let's not go there.

Calendars

US: Tues: Consumer Confidence 112.1, Richmond Fed Manufacturing Index, S&P Cash-Shiller Home Price Index 11.6% y/y, API Crude Oil Inventories. **Wed:** MBA Mortgage Applications, Goods Trade Balance Advance, Wholesale Inventories, EIA Crude Oil Inventories. (DailyFX estimates)

Global: Tues: Italy Consumer & Business Confidence 102.3/102.8, Japan Retail Sales 4.7% y/y, Australia CPI 1.4% y/y. **Wed:** Germany Germany Gfk Consumer Confidence -3.5, France Consumer Confidence 94, Canada Retail Sales Total & Ex Autos 4.0%/3.7%, Fed Interest Rate Decision 0.25%. (DailyFX estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes last week and were at record highs simultaneously for a seventh week and the first time since October 2018. LargeCap's was at a record high for an eighth straight week, MidCap's for an 11th week, and SmallCap's for the 11th time in 12 weeks. In what has shaped up to be a typical V-shaped recovery, LargeCap's forward earnings has risen during 48 of the past 49 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 45 of the past 47 weeks, and SmallCap's posted 45 gains in the past 48 weeks. LargeCap's forward earnings is now up 33.0% from its lowest level since August 2017; MidCap's has risen 66.1% from its lowest level since May 2015; and SmallCap's is up 100.1% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings improved to an 11-year high of 28.1% y/y from 22.6%. That's up from mid-May's -19.3%, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings rose w/w to a record high of 46.4% y/y from 38.5% y/y and is up from a record low of -32.7% at the end of May. SmallCap's rate turned higher too, rising to a record high of 67.9% y/y from 56.9% y/y; it is up from a record low of -41.5% in early June. Analysts' y/y earnings growth forecasts have been improving since July as companies have been easily beating consensus estimates since the Q2-2020 earnings season. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (28.9%, 13.7%), MidCap (46.8, 13.5), and SmallCap (71.6, 20.4).

S&P 500/400/600 Valuation (*link*): Valuations edged lower for two of these three indexes last week. LargeCap's forward P/E fell 0.3pt to 22.4. The prior week's reading of 22.7 had matched its 19-year high from early January and was up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's remained steady w/w at 20.0, but is down from a seven-month high of 20.5 in early March. Its current level is 2.9pts below its record high of 22.9 in early June. SmallCap's ticked down 0.1pt w/w to 20.1. It's now down 6.6pts from its record high of 26.7 in early June. That compares to MidCap's 10.7 and SmallCap's 11.1 in March 2020, which were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 33rd week. That's the longest stretch at a discount since May and during 2002-03. SmallCap's P/E had been mostly below from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a premium to MidCap's for a 15th week after 11 weeks at a discount. At the beginning of the year, it had been at the steepest discount to that index since January 2006.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. In the latest week, the S&P 500's Q1-2021 estimate showed another upside hook as it rose 110 cents to $42.69. That $42.69 estimate for Q1-2021 represents a gain of 28.9% y/y on a frozen actual basis and a 33.9% y/y gain on a pro forma basis. That marks the first quarter of double-digit percentage growth since Q4-2018 and compares to a pro forma 3.8% gain in Q4-2020. Eight sectors are currently expected to post positive y/y earnings growth in Q1-2021, but the final results are likely to be positive y/y for all but the Industrials sector. Here are the S&P 500 sectors' latest expected blended earnings growth rates for Q1-2021 versus their final Q4-2020 growth rates: Financials (121.5% in Q1-2021 versus 20.4% in Q4-2020), Consumer Discretionary (105.4, -5.0), Materials (50.6, 22.7), S&P 500 (33.9, 3.8), Information Technology (26.7, 20.4), Health Care (22.5, 10.6), Communication Services (17.0, 10.1), Consumer Staples (4.1, 5.4), Utilities (0.1, -2.6), Real Estate (-0.1, -10.7), Energy (-1.6, -105.0), and Industrials (-15.1, -37.7).

US Economic Indicators

Durable Goods Orders & Shipments (*link*): Both core capital goods orders and shipments reached new record highs in March after a brief weather-related setback in February. Nondefense capital goods orders ex aircraft (a proxy for future business investment) rose for the 10th time in 11 months since bottoming last April, climbing 0.9% m/m and 19.4% over the period. Core capital goods shipments (used in calculating GDP) advanced 1.3% and 17.9% over the comparable periods. Orders for total durable goods also rose in March—for the 10th time in 11 months—by 0.5% m/m and 53.0% over the 11 months through March. Last month's gain would have been triple that if not for the sharp drop in aircraft orders. Durable goods orders ex transportation jumped 1.6% in March and is up 23.1% since bottoming last April. Supply shortages continue to make it difficult for manufacturers to keep up with demand. IHS Markit's April report shows manufacturing activity remained strong this month, with its M-PMI reaching a series high of 60.6, though manufacturers continued battling the headwinds from unprecedented supply-chain delays.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "Both the third wave of infections and bottlenecks in intermediate products are impeding Germany's economic recovery," said Ifo President Clemens Fuest, though "the demand situation is still very good." Ifo's Business Climate Index rose in April for the third successive month to a 22-month high of 96.8 from 90.3 in January—with 6.3 of the 6.5-point increase occurring during February and March. The present situation (to 94.1 from 89.2 in January) component climbed 4.9 points over the three-month period, while the expectations component ticked down to 99.5 this month after climbing from 91.3 in January to nearly a three-year high of 100.3 by March. By sector, April's manufacturing index advanced for the 11th time in 12 months, by 66.7 points (to 25.3 from -41.4)—which was the highest level since May 2018. The sector's present situation (27.1 from -43.2) component advanced for the 10th straight month, by 70.3 points, to its highest level in just over two years. The manufacturing sector's expectations component ticked down to 23.4 in April from 25.3 in March, which was the highest since November 2010. The service sector, which was hardest hit by the pandemic slipped to 3.5 this month, after moving back into positive territory in March (to 6.5 from -2.1). Both of the sector's components—present situation (to 7.4 from 8.4) and expectations (-0.3 from 4.8)—took a step back this month, with the latter dipping back into negative territory. The business climate index for construction continues to bounce around zero, falling to 0.4 this month from 2.4 and -2.9 the prior two months. Construction's present situation (to 23.7 from 26.5) component continues to move sideways in positive territory, while its expectations (-20.5 from -19.1) component is in a relative flat trend in negative territory.

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