

"Team transitory versus team permanent": two perspectives on inflation

17 January 2022 – Marc Brüttsch, Chief Economist, Swiss Life

"Next to a great forest there lived a poor woodcutter with his wife and his two children. The boy's name was Hansel and the girl's name was Gretel. He had but little to eat, and once, when great inflation came to the land, he could no longer provide even their daily bread."

Not only in fairy tales, but also in real life, has inflation been a recurring spectre in the history of humanity. One hundred years ago, Germany lapsed into hyperinflation and now inflation is on everyone's lips again at the start of 2022.

The discussion about the future for inflation centres around two schools of thought: one – known as team transitory in the US – which views the latest rise in inflation as largely transitory, and a second – known as team permanent, which warns of lasting change in the inflation regime.

Even if there were voices after the financial crisis of 2008 warning that bond-purchasing programmes and the central banks' zero interest rate policy would lead to inflation, these prophecies remained unfulfilled until 2021. That makes the clamour all the louder among those who now believe they have finally been proven right. The media are now focusing on inflation and broad sections of society in Germany now seem to be extremely concerned, based on the record-high Internet searches with key word "inflation".

It may come as a surprise that most economists identify with team transitory in their 2022 forecasts for inflation in Germany: according to a consensus survey by London-based company Consensus Economics, the average inflation rate is set to reach 2.7% in 2022. For this to happen inflation, which currently stands above 5%, needs to fall below 2% by the fourth quarter of 2022. Is the spectre of inflation really fading so rapidly? Team transitory will score some points over the next few months. In 2021, the inflation rate in Germany had the added boost of special tax measures, such as the

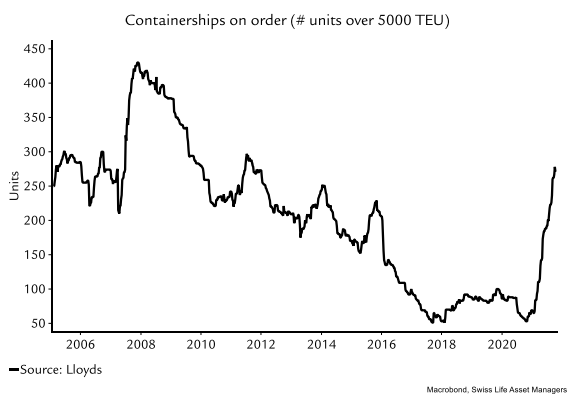
new CO₂ tax and the return to normal VAT rates. The elimination of these base effects will lead to significantly lower inflation rates in the first quarter. At the same time, inflation is not purely a German issue, nor can it be explained solely by changing tax rates. So, what about the other drivers of inflation and their impact on future price development? Further analysis requires distinguishing broadly between the three causes of inflation: demand-side effects, supply-side causes and structural reasons.

Demand can drive prices if monetary and fiscal policy simultaneously stimulate activity. That is what happened in response to the pandemic and in contrast to 2008. Monetary and fiscal policy have been a major source of demand in rich developed economies over the past two years. Although monetary policy was eased to combat the financial crisis in 2008, many countries simultaneously adopted austerity measures preventing higher inflation. Another significant demand side difference is commercial bank lending, which collapsed after the financial crisis as banks focused on restoring their balance sheets. At the end of 2021, however, credit volume in the US grew higher than average, so the central bank's liquidity injections are reaching the real economy.

Will it go on like this? No. In order to cope with the economic damage caused by the measures deployed to combat the pandemic, fiscal and monetary policy had to be expansionary in 2020. The authorities thus prevented the supply shock during the lockdown turning into another credit crisis. However, the fiscal impulse is now ebbing and the monetary policy tailwind is also easing. Key interest rates were raised in many

emerging markets in 2021, while a phase of monetary policy normalisation is now beginning in the United Kingdom and the US. Those who expect continued high inflation rates ignore the fact that the demand-side impulses are already waning and, if necessary, can be dampened further.

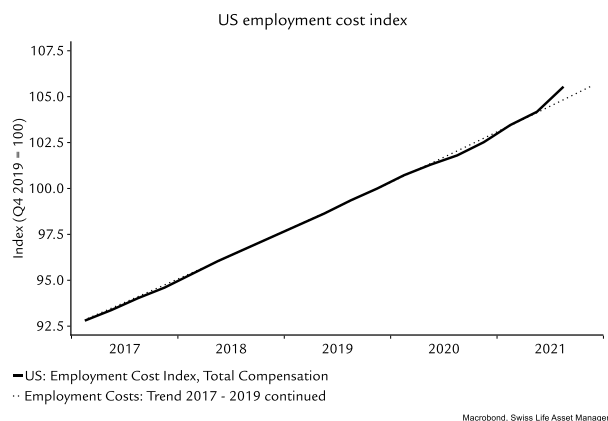
Let us look at supply-side factors to understand the latest rise in consumer prices. These, too, are directly attributable to the pandemic. Interrupted supply chains continue to impact goods production and international trade in many areas. Suppliers need time to meet the high demand level. However, there are increasing signs that the bottlenecks are now dissolving. Semiconductors are being produced in record numbers and new factories are increasing capacity in the US, Japan and the EU. Microchip prices are already falling again and figures from the automotive industry show a strong increase in production in the last two months of 2021. Three times as many transport containers have recently been produced for shipping as in normal times, while order volume for cargo ships has risen to its highest level in over ten years. Freight costs are reacting accordingly and have been falling again since October. Where possible, the automatic market economy safety mechanisms in the form of adjusted supply and demand, seem to ensure that new, lower, equilibrium prices are quickly established.



Those who expect sustained high inflation rates ignore the fact that the supply side has entered a hog cycle in key areas, which will lead to lower, not higher, prices in the medium term.

On the supply side, particular attention should be paid to the labour market. A wage-price spiral was ultimately (partly) responsible for Germany's high inflation from 1921 to 1923 and for the inflation at the beginning of the 1970s. Today people are again talking about salary increases and warning that the pandemic broke the

cycle. Unfortunately, labour market data are lagging economic indicators, we have only limited reliable data references for general salary increases in 2021. For the US, the latest available data for the third quarter of 2021 suggests that labour cost growth most recently accelerated relative to the multi-year trend before the pandemic. Year-on-year, the Employment Cost Index rose by 3.7%.



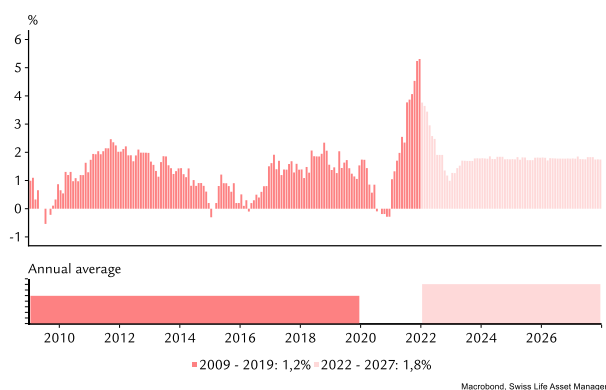
That is just one data point, it remains to be seen whether this development will continue. Nevertheless, it did serve as a wake-up call for the US Federal Reserve. The Fed referred to higher labour costs and declining productivity to justify its decision to phase out the bond-buying programme ahead of schedule and its willingness to increase rates earlier than originally expected. No accelerated wage growth has been discernible in Europe so far, on the contrary: standard wages rose by just 1.4% in the third quarter of 2021 year-on-year. Employment-weighted wage growth from wage agreements in Germany was under 3% in 2022. As with credit growth, labour market development shows that the risk of persistently higher inflation is higher on the other side of the Atlantic. Structural causes remain can also cause lasting higher inflation. These include regulatory causes, monopoly situations or a loss of confidence among foreign lenders in a country's economic stability.

The pandemic has not fundamentally changed the discussion about the pricing power of monopolists. Then again, the role of monopolies does not play a major role in the current inflation debate. Similarly, international creditworthiness in conjunction with a twin deficit is currently a problem for Turkey, but not for Germany. And yet there is one structural price driver largely responsible for the latest rise in inflation: efforts to decarbonise the economy finally received a price tag

in 2021. In Germany, not only did the phased introduction of a CO₂ tax increase consumer prices, but energy prices also continued to rise on the international commodity markets from the spring. Unlike semiconductors or shipping, the price rises no longer provides incentives to ramp up the supply of fossil fuels. The additional emissions would have to be compensated by purchasing carbon offsets, which have also become more expensive. As a result, the price of oil price has not yet come down, as in earlier cycles. Hence energy prices are the main driver of the high inflation. They accounted for more than half of the high inflation rates in Europe until the end of 2021. This is known as greenflation, i.e. a politically motivated price shift in favour of more sustainable energy sources.

High energy prices and the ECB's continued generous supply of liquidity remain the main reasons why inflation will remain higher for longer. Swiss Life Asset Managers forecasts an average inflation rate of 1.8% over the next five years in Germany. In the medium term, therefore, inflation will settle close to the European Central Bank's target of "below but close to 2%." This initially sounds like the all-clear, especially in view of current inflation numbers. However, as in the recent past, inflation in this scenario will remain noticeable in everyday life. In the ten years leading up to the pandemic, average annual inflation in Germany was just 1.2%.

Germany: inflation rate with long-term forecast



How can investors protect themselves against higher medium-term inflation and negative real interest rates for their savings? We recently examined long-term trends for the US, Japan, UK, Germany and France and Switzerland. The findings are clear: in times of rising inflation, investments in fixed-interest government bonds fare worse than investments in real assets. Among the latter, real estate investments have outperformed equities in times of rising inflation since 1870.

The above expectations outline what we consider the most likely scenario, i.e. we are on team transitory. However, the outcome of the current inflation debate remains uncertain, while other scenarios also impact our investment processes.

But we know how Hansel and Gretel turned out. As befits a fairy tale, it comes to a happy end: the children returned to their father with plenty of pearls and precious stones. To date, real assets remain the first choice in times of rising inflation. Hansel and Gretel would invest their assets in equities, infrastructure and real estate in 2022. So that at the end of the story we can still say: "Then all their problems were over, and they lived happily ever after."

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