

Low-Inflation Nation: Untangling Misconceptions About Inflation and Predicting Its Path After COVID-19



Investors are preoccupied with inflation for good reason: It affects interest rates, public-equity valuations, private-equity access to capital and, ultimately, stock-price multiples. Yet confusion about inflation assumptions and forecasts could lead investors astray. In this report, Olga Bitel, partner, global strategist, discusses inflation and the factors that influence it. She explains why both aggregate demand growth and inflation may be higher over the next decade than in the 2010s, with major implications for asset allocation.

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Global Strategist
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Introduction



**D.J. Neiman, CFA,
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Inflation is a subject that can spur extreme opinions, often without evidence to support them. Misconceptions about inflation abound, particularly as the European Central Bank (ECB), U.S. Federal Reserve (Fed), and others have pursued unconventional monetary policies. Some investors have blamed central banks for slow economic growth between 2008 and 2019. Others predicted a surge in inflation that never materialized.

Investors are preoccupied with inflation for good reason: It affects interest rates, public-equity valuations, private-equity access to capital and, ultimately, stock-price multiples. The recent policy change announced by U.S. Fed Chairman Jerome H. Powell to allow inflation to run at an average rate of 2% over time, rather than setting that figure as a strict threshold, will fuel the debate about central-bank policy, inflation, and growth. Yet confusion about inflation assumptions and forecasts could lead investors astray.

Olga Bitel, global strategist at William Blair, developed this report to clarify the definition of inflation and the factors that influence it. She explains why both aggregate demand growth and inflation may be higher over the next decade than in the 2010s, with major implications for asset allocation. We hope this report helps investors sort through the competing claims surrounding inflation and become more confident in incorporating inflation predictions into their portfolios.

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Key takeaways:

- Inflation is determined by a confluence of factors in education and labor policies, and changes in infrastructure, regulation, and technology. Central banks do not create inflation; they respond to it.
- We believe a strong recovery after COVID-19 will not lead to sustained inflation. Supply will likely come back online to keep pace with increasing demand.
- The growth in the money supply is driven by an unprecedented collapse in economic activity—not only by central-bank decisions.
- Compared with the slow 2010s recovery, the 2020s are likely to experience broader economic growth and higher inflation.
- In coming years, the stocks of rapidly growing companies may lose some of their scarcity premium. Companies with improving earnings may become relatively more attractive.

1. First, let's agree about the definition of inflation.

What Inflation Is

When we measure inflation, we are really looking at changes in prices. Inflation is a *broad-based* and *sustained* increase in prices year-over-year. It occurs when demand—whether from the private sector or from the government—grows consistently in excess of supply.

Two variables determine aggregate demand growth: income growth and distribution of income. When widely distributed, income growth generates demand, but increasing income concentration suppresses growth in aggregate demand. Higher-income households have higher savings rates than lower-income households,

so as income is transferred from the bottom and middle of the distribution to the top, less of it is spent.

Supply can lag demand for many reasons, including restrictive labor laws or a lack of qualified workers, expensive or unavailable land, or high-priced utilities.

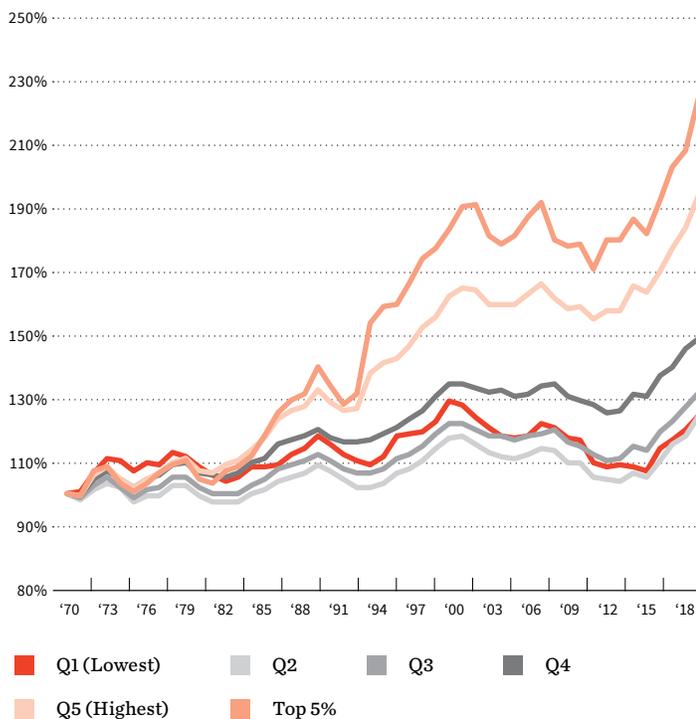
Overall, a multitude of complex, dynamic, and simultaneous interactions determine the balance of growth and inflation, including forces that affect regulation, tax policies, labor, education, transportation, energy, demographics, and technology.

EXHIBIT 1

High-Income Earners Increase Their Lead Over The Rest

Income, adjusted for inflation, increasingly tilts toward the top 20% of the distribution—and those in the top 5% have pulled even further away from the majority of U.S. households.

Real Aggregate Income by Quintile, Indexed to 100 in 1970



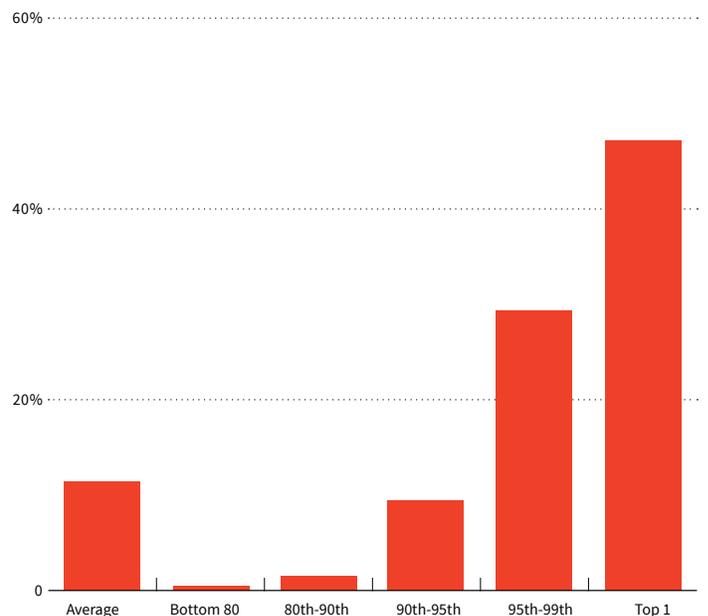
Source: U.S. Census Bureau, as of October 2020.

EXHIBIT 2

Most Households Save Little, While a Few Save a Lot

Households in the bottom 80% of the income distribution save almost nothing, while those in the top 1% save nearly half their income. This imbalance has dampened aggregate demand growth.

Savings as a Share of Income by Percentiles, 1989-2013 Averages



Source: Economic Policy Institute, as of 2013.

1. First, let's agree about the definition of inflation. (continued)

What Inflation Is Not

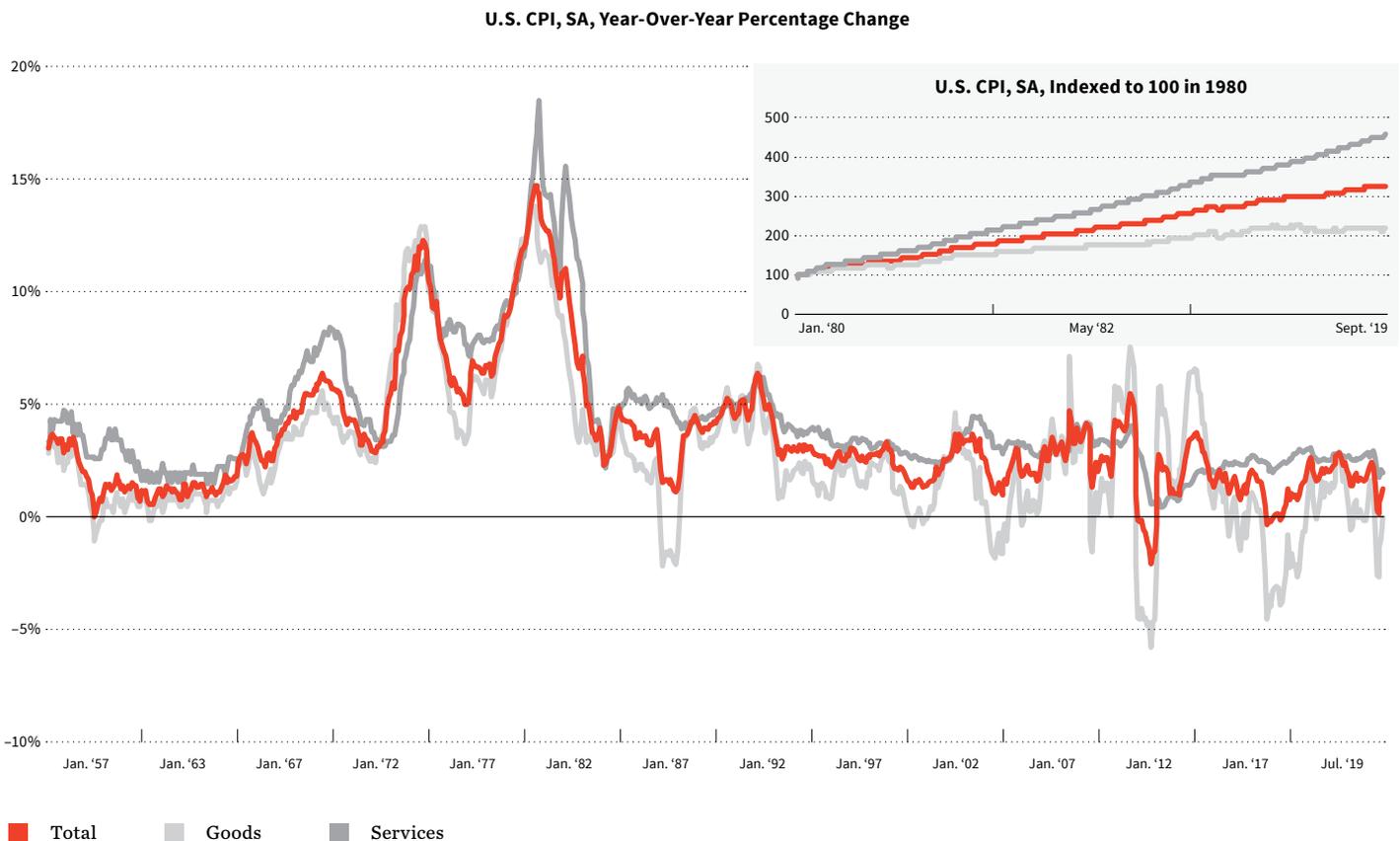
That explains what inflation is, but misconceptions still abound. Here are three things inflation is not.

- **Manufactured by central banks.** In a majority of economies today, inflation is determined by demand and supply dynamics in the real economy. Central banks respond to a cyclical upswing in inflation by increasing the price of money or interest rates, thereby reducing aggregate demand growth. They are mandated to ensure price stability, which in practice means inflation in the low single digits.
- **Measured by shifts in relative prices.** Such shifts occur constantly as economies evolve. Most recently, we have seen rapid growth in prices of financial assets and slow growth in prices of goods, but this does not mean the United States is in an inflationary environment.
- **Driven by one-time price changes due to tariff increases.** New or increased tariffs can cause short-term price spikes, but these do not produce *sustained* price increases that would signal inflation.

EXHIBIT 3

Small Changes in the Annual Inflation Rate Can Lead to Big Differences in Price Levels

In the primary chart, we see how year-over-year percentage changes in the U.S. Consumer Price Index measure how prices respond to changes in the balance between demand and supply. The inset chart shows how prices for services have outpaced prices for goods since 1980.



Sources: Macrobond and BLS, as of October 2020. SA refers to seasonally adjusted.

2. The money supply is surging because consumers cannot spend.

With very few exceptions, governments are not debasing money, and it is unlikely that inflation expectations are about to change dramatically, even following the shift in Fed policy, which largely formalizes its recent decisions rather than setting a surprising new course.

Then why are there concerns about the money supply? As a reminder, we measure the money supply by looking at M2, which consists of M1—currency in circulation and checking accounts—plus savings accounts.

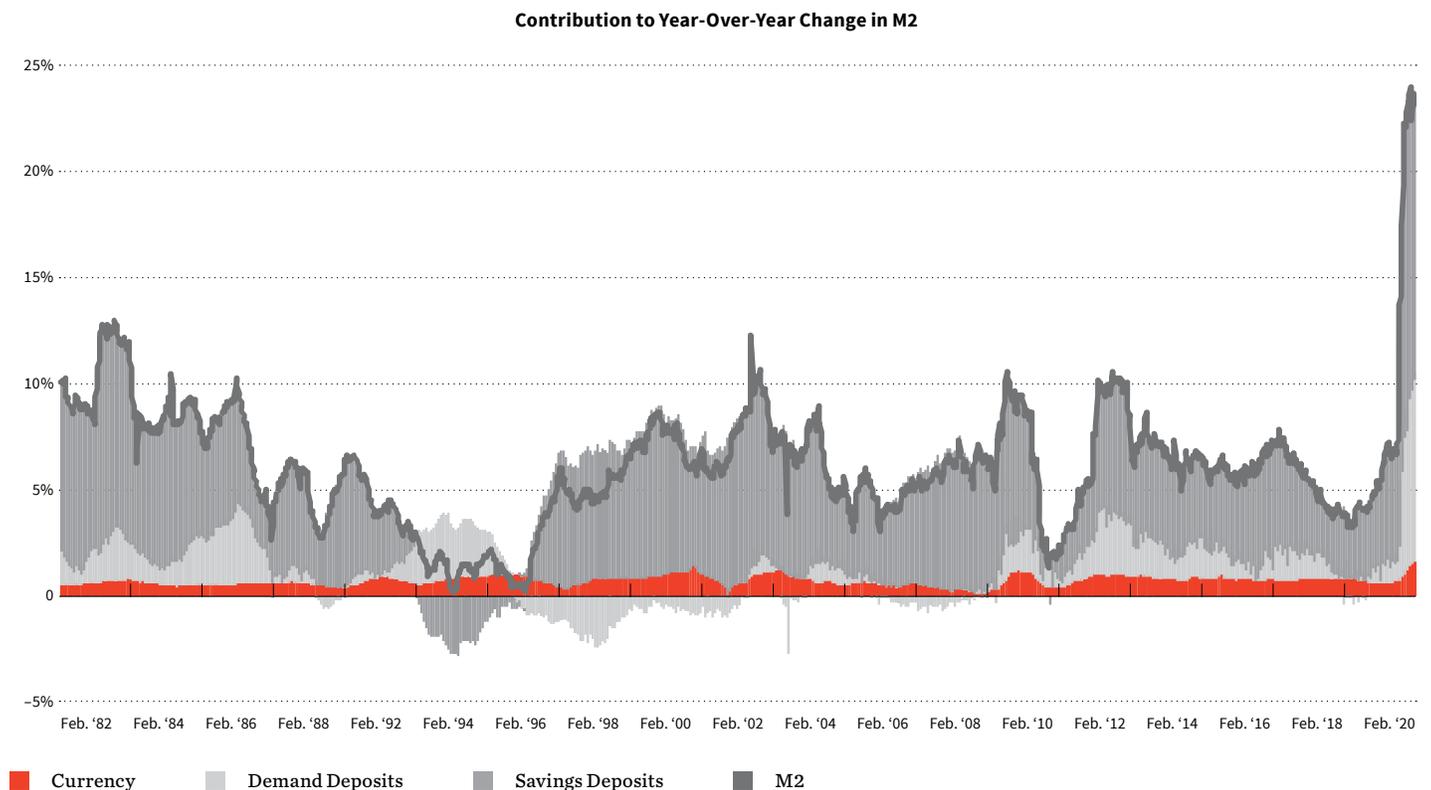
There is a sharp increase in the money supply because people literally have not been able to spend since late March. The large checking and savings account balances they are accumulating show up as a surge in M2.

In fact, U.S. retail deposits have increased by 7% of annual disposable household income in just two months, reflecting that spending flows are roughly 30% below income. As the economy reopens, consumers will likely spend these balances, and the growth in M2 should taper.

EXHIBIT 4

Consumers Are Sitting on Piles of Cash

The dramatic increase in the money supply (M2) is the result of COVID-19 suppressing economic activity worldwide, leaving consumers with few short-term opportunities to spend.



Sources: Macrobond and Federal Reserve, as of October 2020.

2. The money supply is surging because consumers cannot spend. (continued)

In my view, it is not worth worrying about hyperinflation. The fiat money system—in which currency is backed by faith in the issuing government, not by gold or some other physical asset—is based on trust. When a government is unable to raise funds and resorts to “creating” money to finance its policies, it breaks that trust. This decision has been the path to every hyperinflation episode in history.

In today’s world of abundant data, it is virtually impossible for a government of a developed-market economy to take this path toward hyperinflation. The U.S. Fed reports all data on the money supply every week. Any move to dramatically expand it beyond the telegraphed policies would be immediately recognized.

Why are measures of inflation expectations increasing? Indices published by the University of Michigan and others show *rising consumer-inflation expectations*¹. But these expectations are highly influenced by food prices, which have increased because of higher demand at grocery stores, and higher production and transportation costs due to COVID-19.

Inflation expectations are an extrapolation of recent experience—not a reliable indicator of what inflation will be in 5, 10, or 30 years. Financial instruments such as inflation futures, swaps, or Treasury Inflation Protected Securities (TIPS) are useful in telling policymakers what markets think about future inflation today. However, they are almost uniformly wrong in predicting actual inflation in the future.

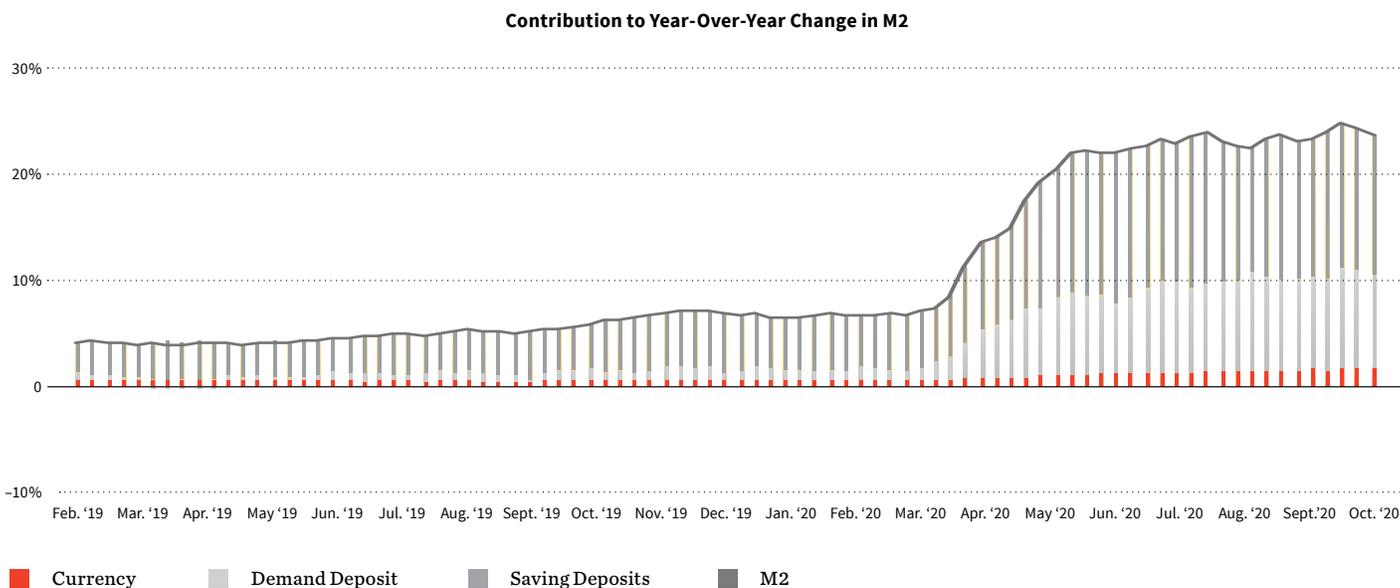
“Inflation is a real-time manifestation of the workings of an economy. The U.S. Fed cannot consistently deliver a randomly selected rate of inflation.”

Olga Bitel, Partner

¹ Inflation Expectations Are Wrong, Which Is Good.” *The Wall Street Journal*. July 14, 2020.

EXHIBIT 5

A Closer Look at the Money Supply



Sources: Macrobond and Federal Reserve, as of October 2020.

3. Government responses to inflation fears have suppressed demand growth for decades.

Inflation is highly redistributive: Even small changes in year-over-year prices add up to a noticeable loss in purchasing power. When consumers recognize this loss, they tend to withdraw support from the political structure, so governments are naturally preoccupied with limiting inflation.

But efforts to control inflation affect growth, and political responses to the stagflation of the 1970s created or exacerbated the economic imbalances of today. The so-called neoliberal orthodoxy of the 1980s attempted to reverse a dramatic decline in corporate profitability. Governments cut corporate taxes and shifted the burden onto employees and households. Corporate taxes as a share of total federal tax revenue collapsed in the United States, from an average of 21% in the 1960s to about 10% since the 1980s. Politicians shunned fiscal policy as counterproductive.

Meanwhile, U.S. courts and government agencies reinterpreted competition or antitrust laws to prioritize lower consumer prices in the very near term. So long as a company could demonstrate that buying a competitor allowed it to reduce prices, mergers and buyouts would be approved.

The emphasis on corporate profitability and the new interpretation of antitrust law unleashed massive consolidation. Today, many industries are deemed oligopolies or monopolies. Corporate concentration has *suppressed wages for high-tech workers*² and *increased shortages of qualified nurses*³. It has increased prices, depressed aggregate demand growth, and concentrated income and political power.

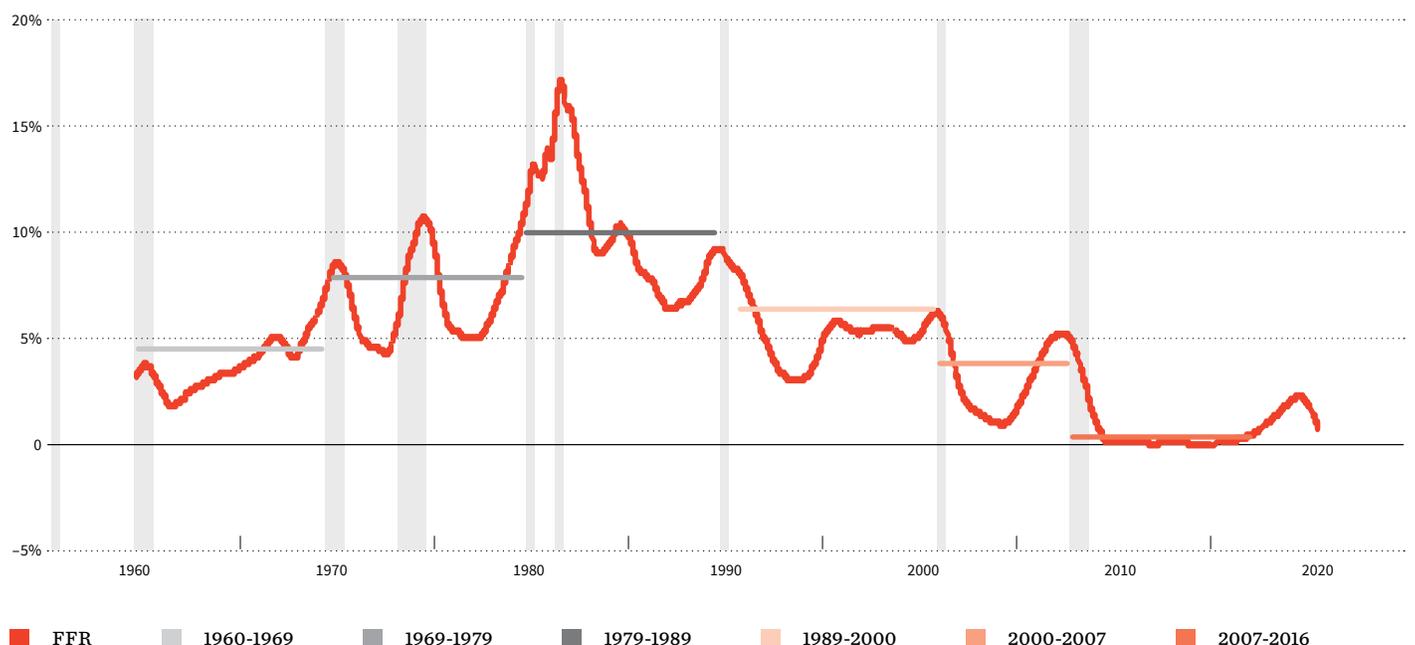
2 "Apple, Google Agree to Pay Over \$300 Million to Settle Conspiracy Lawsuit." Yahoo! Finance. April 24, 2014.

3 "Patient Deaths Tied to Lack of Nurses." *The New York Times*. August 8, 2002.

EXHIBIT 6

A Downward Trend in the Effective Federal Funds Rate

Since the 1980s, an emphasis on corporate profitability and new interpretations of antitrust law have held down inflation by reducing growth in aggregate demand.



Sources: Macrobond and Federal Reserve Bank of New York, as of October 2020. Data are quarterly averages. Horizontal lines are averages over dates indicated.

4. Inflation is unlikely to accelerate after the COVID recession ends.

In the next 6 to 18 months, cyclical forces will likely hold down inflation. Most supply has not been destroyed, but mothballed, so it can be mobilized quickly to meet recovering demand.

Other factors, such as impaired balance sheets, higher unemployment, and wage and hiring freezes, are likely to repress income and, therefore, demand growth. We are unlikely to see demand growth persistently outpacing supply, leading to broad-based and sustainable price increases that indicate accelerating inflation. Inflation should stay muted, similar to other recent recoveries.

What could change the inflation outlook over the next three to five years? One-time checks to workers idled by COVID-19 are not enough to spur inflation. If the bottom 60% of the population received substantial, sustained wage and salary increases, and there were significant supply constraints, we could see persistent excess demand leading to inflation.

EXHIBIT 7

One-Time Stimulus Checks Briefly Boost U.S. Wages

Average weekly earnings received a bump from federal stimulus checks, but the effect will be short-lived.



Sources: BLS and BEA, as of October 2020.

4. Inflation is unlikely to accelerate after the COVID recession ends.

(continued)

Yet sustained supply constraints are unlikely in a market economy, where supply responds to demand. Constructive and consistent fiscal policy can encourage healthy supply expansion. Fiscal policy can promote costly investments, such as building new airports and developing foundational technologies, that economies need, but private markets rarely finance.

In recent decades, the misguided focus on fiscal austerity has reduced such investments, undermining aggregate demand growth in many developed-market economies. It also placed an undue burden of economic policy adjustments on monetary policy, which is an inappropriate tool to address such issues.

Fiscal policy is shaping up to play a more prominent role in the current recovery—see the *German*⁴ and *French*⁵ stimulus packages, as well as the recent *pan-European deal*⁶. So far, the policies aim at reducing the corporate tax burden and incentivizing a shift in demand toward electric vehicles. Investment in select industries, while welcome, is too limited to drive inflation.

Three more trends could impact inflation:

- **Deglobalization or localization** would leave everyone poorer by reducing aggregate income and demand, as well as corporate margins. While imposing tariffs and duplicating supply chains can spur short-term inflation, over time, both supply and demand adjust. The net effect is lower demand and, often, lower margins for producers, and higher prices for consumers. It is unlikely that price growth would accelerate every year to create higher inflation.
- **Aging populations** have been disinflationary in the past because older adults tended to consume less. Today, with people maintaining better health and energy levels later in life, this relationship may no longer hold true. Developed-market societies are aging quickly because fertility rates are below replacement, but the fertility rate is a function of economic growth and opportunity, and it can respond to government policy.
- **Technological gains** will likely continue to be disinflationary. Education and healthcare have been the biggest contributors to service inflation in the United States, but this has more to do with their current structure than their inherent nature. Some of this structure is already shifting; during COVID-19, more students are *taking online general classes at community colleges*⁷, which are less expensive than private, four-year universities.

“Technological advances improve efficiencies and reduce costs. They will likely continue to be disinflationary.”

Olga Bitel, Partner

⁴ “Germany Is Finally Ready to Spend.” *Foreign Policy (FP)*. June 22, 2020.

⁵ “France Primes Fresh Stimulus to Boost Jobs, Cut Taxes on Firms.” *Bloomberg*. July 13, 2020.

⁶ “E.U. Adopts Groundbreaking Stimulus to Fight Coronavirus Recession.” *The New York Times*. July 20, 2020.

⁷ “With Higher Ed in Limbo, Students Are Switching to Community Colleges.” *The Hechinger Report*. May 20, 2020.

5. Investment opportunities likely will look different in the 2020s.

We envision the decade ahead marked by rebounding supply to match the resurgence in demand that will likely follow COVID-19. With strong fiscal support, austerity should no longer handcuff growth, and investments by the private sector and governments can spur a healthy recovery.

It is likely that economic growth will be broader than during the recovery of the 2010s. If so, and if inflation remains in the 2% to 3% annualized range, investors in public equities will likely have more opportunities for profitable growth than in recent years. The stocks of rapidly growing companies may lose some of their scarcity premium, and companies with improving earnings may become relatively more attractive.

Despite the recent furor around central-bank policies, their decisions are not causing inflation. Economic recovery after COVID-19 has the potential to benefit a wide swath of consumers and companies, with inflation likely to remain in a low and sustainable range.

“Consistent investment in infrastructure and innovation—not periodic handouts around elections—can improve our growth without significantly higher inflation.”

Olga Bitel, Partner

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