



NEWSLETTER

An inconvenient truth: No one has a clue where US inflation is going over the next decade.

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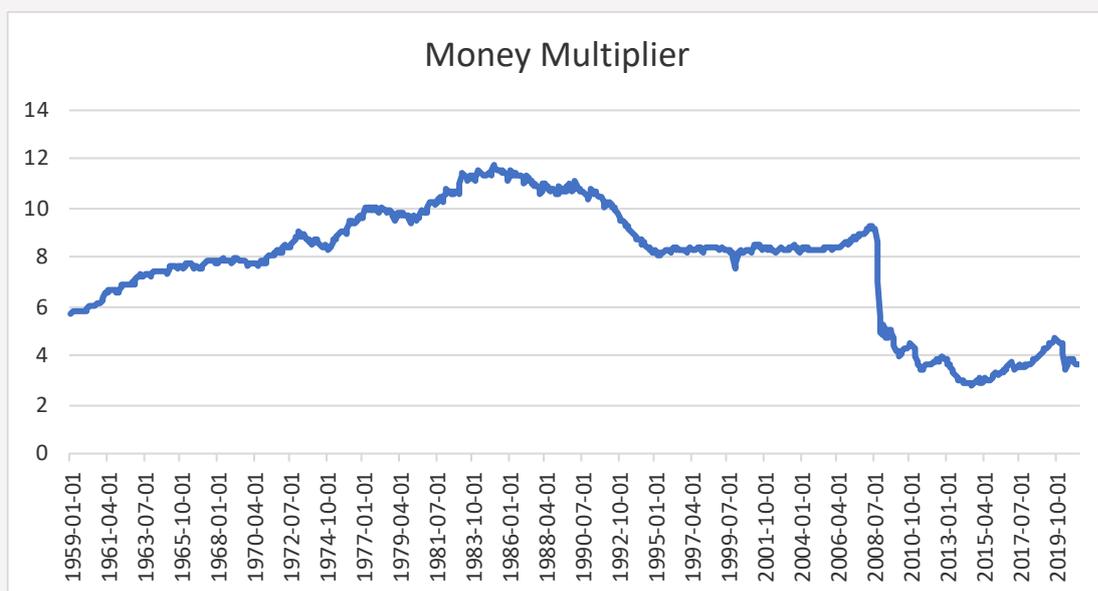
The yield of the 10-year US government bond is perhaps the most important price in the world when it comes to capital markets. The price, of course, is not being set by a free market, since the biggest buyer of treasury liabilities is the federal reserve – for now. The Fed is not price sensitive and is not trying to invest capital rationally to maximize a utility function based off a risk/reward trade off. They are therefore suppressing the price but at the risk of greater inflation down the road.

In the three fiscal years ending September 2020, 2021 and 2022, a period which we are halfway through, the US federal government will likely run a total fiscal deficit of slightly over USD8 trillion. That is the equivalent of 40% of pre-Pandemic GDP. Yet 10-year bond yields in the US, at 1.6%, remain at the same level they were on the eve of the pandemic. The market basically seems to be saying that the US will get away with financing such a huge deficit without incurring any increase in nominal borrowing costs. The breakeven inflation rate has however risen from about 1.6% to 2.3% implying a 70 bps per year increase in inflation expectations and therefore a real rate of financing that is 70 bps lower than before. Why?

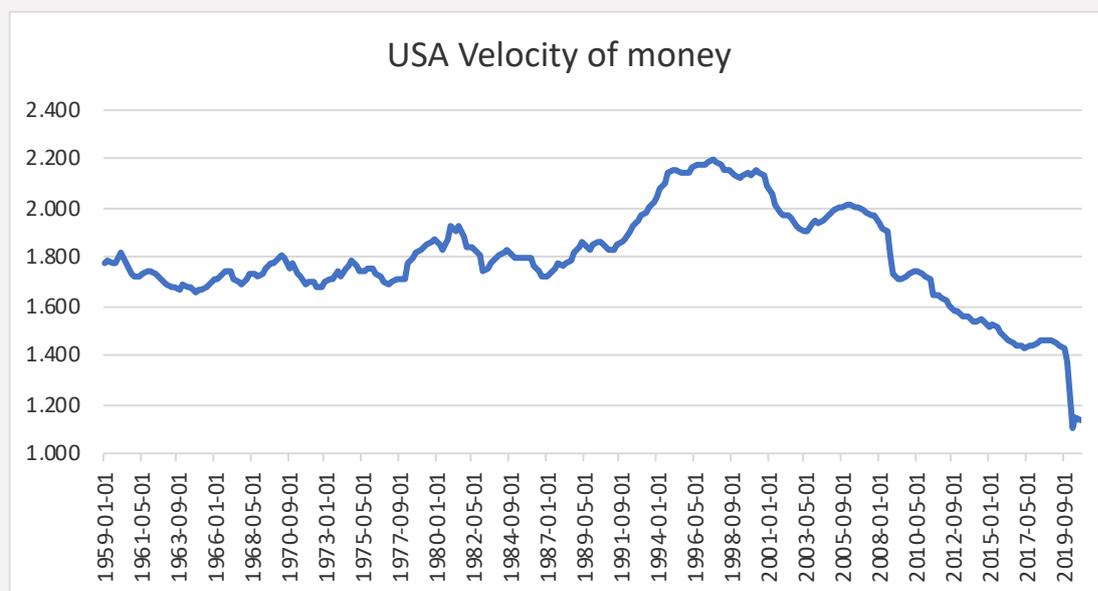
The main reason why nominal rates have not responded to the massive borrowing requirement is perhaps that the Federal Reserve Banks have done much of the heavy lifting in terms of absorbing supply. This combined with a disbelief in the quantity theory of money – that inflation is ultimately linked to the amount of money in the economy – appear to account for the modest rise in inflation expectations, and the low nominal yield. The alternative view is that other assets are going to produce even worse real returns and so Treasuries offer the least bad alternative.

During the course of 2020, Federal debt rose by USD4.5 trillion but USD2.5 trillion of that was bought by Federal reserve banks. Precautionary saving elsewhere in the economy together with foreign flows absorbed the rest of the supply. The current rate of treasury purchases is running at an annualized USD960bn a year, but rises to USD1.44 trillion if agency debt is included. The question of course is when will the Fed reign these purchases back for fear that they are creating an inflationary time bomb.

Chart: M2/Monetary base – the money multiplier.



In this regard, recent history is not particularly helpful because the two major tenets of monetarism have broken down. The first is the belief that the central bank can control broad money supply by controlling high-powered money. As the chart above shows, the ratio between the two (the money multiplier) has been in structural decline making it hard to judge the magnitude of impact that Fed monetization of federal debt will have on broader money. The second is the velocity of money – usually assumed to be a constant – it has proved extremely variable and has been in structural decline. Taken together, these two factors mean that it is frankly anyone's guess what impact the debt monetization by the Fed and the consequent growth in monetary base will have on inflation once the output gap has closed. Some scenario analysis might prove helpful though in considering the possible outcomes.

Chart: GDP/M2 – velocity of money.

Scenario analysis

Our underlying assumptions are that the labour market has normalized by September 2022 with Non-farm payrolls by then having regained their trend at about 131 million and that the output gap has closed. This is the point of maximum risk for inflation and bonds although obviously the market will move to discount the outcome ahead of time. At that juncture we look at three scenarios. In the low case Fed tapering means that Monetary base has “only” risen by an additional USD1 trillion. In the high case there is no tapering and so the full USD2.16 trillion of asset purchases over 18 months have come to fruition and the central case has Fed purchases at USD1.5 trillion. In the high case the Money multiplier trends to its pre-covid level and so does the velocity of money. In the low case they remain where they are now and in the central case they regain half of what they lost during the pandemic. The spread of outcomes is indicative of how high uncertainty about the future course of inflation should be.

USD Trillions	Now	Low	Central	High
Monetary Base	\$5.4tr	\$6.4tr	\$6.9tr	\$7.6tr
Money multiplier	3.61x	3.6x	4.1x	4.6x
M2	\$19.7tr	\$23.2tr	\$28.5tr	\$35.0tr
Velocity	1.09x	1.09x	1.24x	1.38x
Nominal GDP	\$21.5tr	\$25.3tr	\$35.3tr	\$48.2tr
Nominal GDP growth		18%	64%	125%
Real GDP to trend		8%	8%	8%
Deflator growth (ie inflation)			9%	52%
				108%

To be clear, we are not forecasting a 108% rise in the GDP deflator by end 2022. What we are saying is that the future course of M2 growth relative to Mo, and the relationship between M2 and nominal GDP need to be watched very carefully because they are highly unpredictable.

ble and small movements will have outsized impacts on inflation. We are not aware of anyone who has been able to accurately forecast their short run direction and the magnitude of their change. The inconvenient truth is that global capital markets are being valued based on a nominal cost of capital in the United States that could change very dramatically depending on the future course of inflation and we would venture to suggest that no one has a clue how high the GDP deflator could rise over the coming 2 or 3 years let alone the decade that will determine the real return investors get on a purchase of a 10-year treasury today.