Investment Strategy Update

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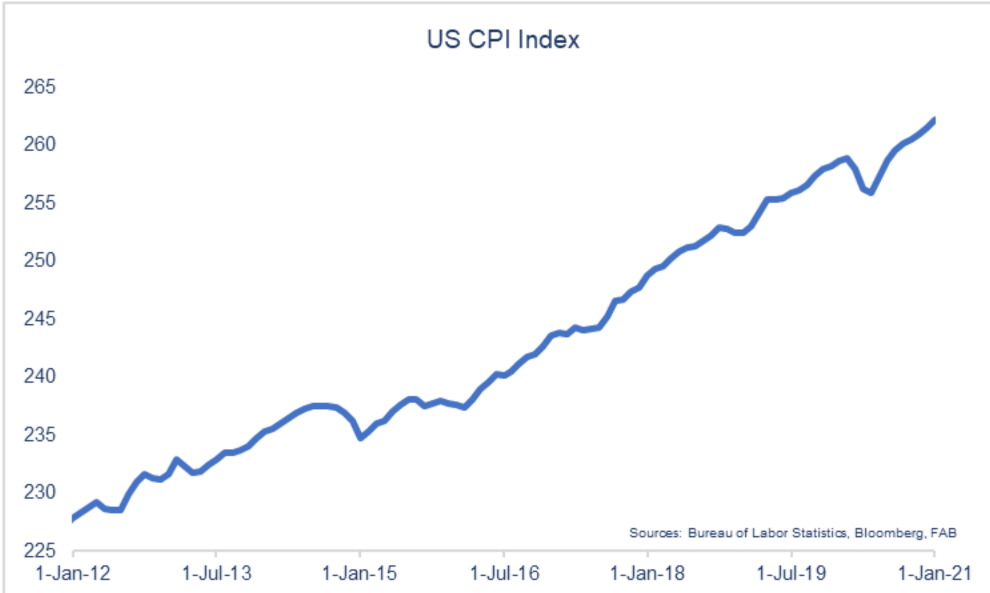
Yes, inflation will increase, but it probably will be temporary



♦ The drop in the consumer price index in the US during the second quarter of 2020 suggests year-on-year inflation could be as high as 3.2% by May.

♦ Inflation has, indeed, accelerated in the third and fourth quarter, but has started to slow again.

♦ The still high unemployment and low capacity utilization in the US both suggest that after this spike, inflation will fall back below 2%.

♦ Rising oil prices could prompt some more inflation than expected, but even that should be tame, and energy costs are likely to peak soon.

♦ The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight in alternatives.

Inflation has been the talk of the town lately. Assuming another US$1.9 trillion stimulus package, the total amount of fiscal stimulus in the past year alone would come to US$5.4 trillion, or 25% of US GDP as of 31 December. This is an unprecedented amount of money and some economists are suggesting such an increase in the quantity of dollars in the economy could translate into inflation.

Unfortunately, it is not so simple. First of all, not all of these dollars being 'printed' actually go into the economy. To put it in perspective, the US$3.5 trillion cumulative stimulus of last year has translated into a US$2 trillion increment in GDP. In other words, less than 60% of the money Washington has added to the economy has flowed back into it so far, with the rest probably going into investments.

If that pattern is repeated, the latest package could take the US economy to US$22.6 trillion by year-end, a year-on-year growth of 5%. This would be great, and helps underpin the bullish position in risk assets that the FAB Asset Allocation Committee has taken.

Yet, if the US economy had continued to expand at the same pace it was growing before the pandemic, it would have reached the end of this year at a size of US$23.6 trillion. That US$1 trillion difference is what economists call the 'output gap', the difference between what the economy is actually doing and how it is capable of performing.

An output gap is disinflationary, and therefore is likely to keep consumer prices on hold. To close the output gap, business spending and capacity utilization have to rise and unemployment has to fall. Fed projections suggest the US economy starts running hot when unemployment is below 4.1% — it is at 6.3% right now.

The drop in the US consumer price index last May suggests YoY inflation will peak soon

To go back below 4.1%, the US has to generate about 10 million jobs. Its long-term average monthly job creation is 136,000, so it could be three to four years before the labour market adds pressure to inflation. Capacity utilization recently peaked at about 80%, it is below 76% right now, so there is no pressure there either.

That said, the consumer price inflation index dropped to 255.4 in May of last year. If it continues at the current rate, it will probably be around 264 in May, creating a one-time year-on-year inflation print of about 3.2%. That, however, is likely to taper off and inflation is likely to trend back to 1.8%-1.9% year-on-year, below the Fed's target of 2% (unless the output gap is closed). Yes, inflation is returning, but it is far from a concern right now.

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