EVERYTHING YOU NEVER WANTED TO KNOW ABOUT INFLATION AND WERE AFRAID TO ASK

James Montier

GMO

A STAGGERING 77% OF AMERICANS FEAR SOARING INFLATION

77%

72%

65%

50%

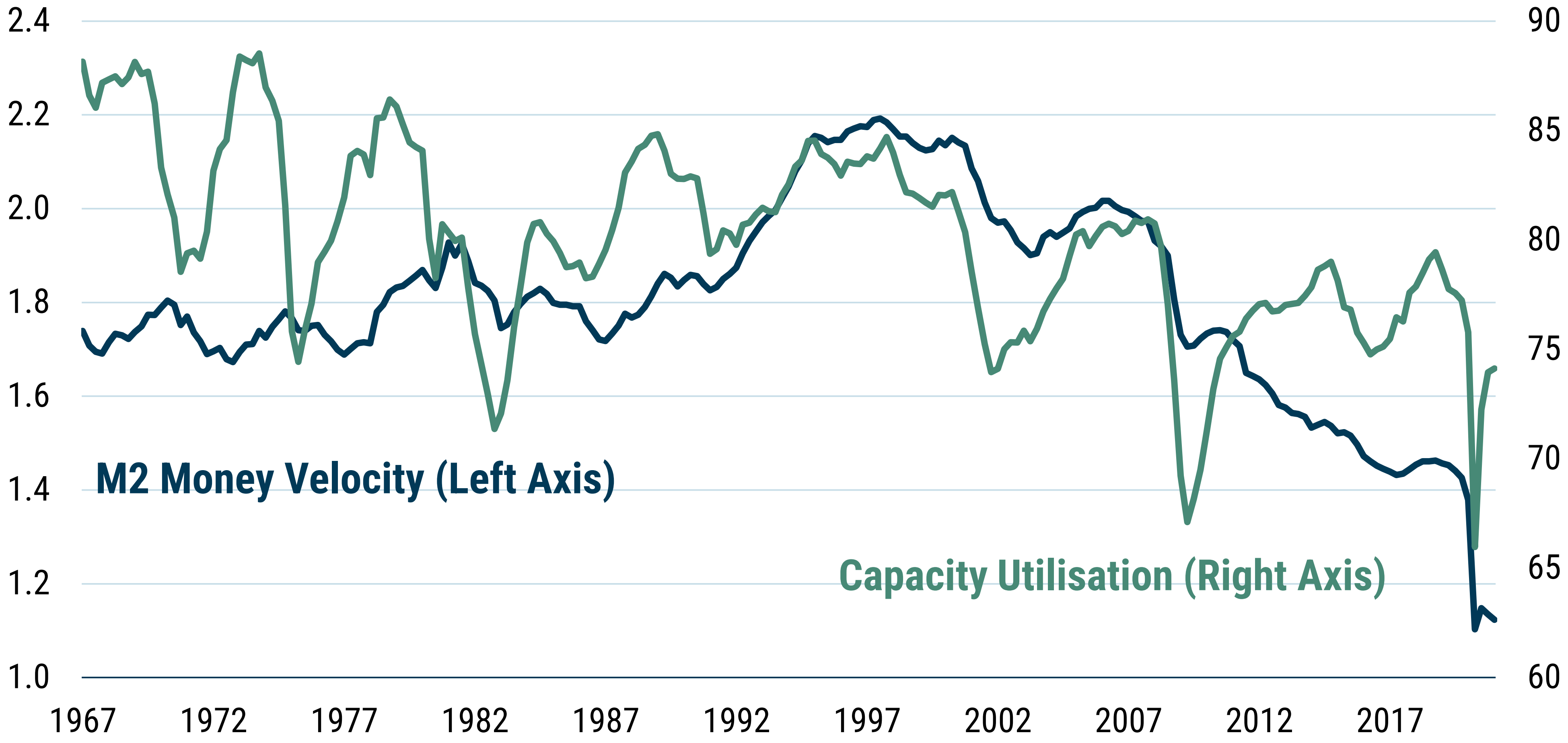
WHY SO SURE?

Well the money supply was exploding…. M2 YoY %

Source: FRED

MV≡PY

The equation of exchange really says that expenditure equals income

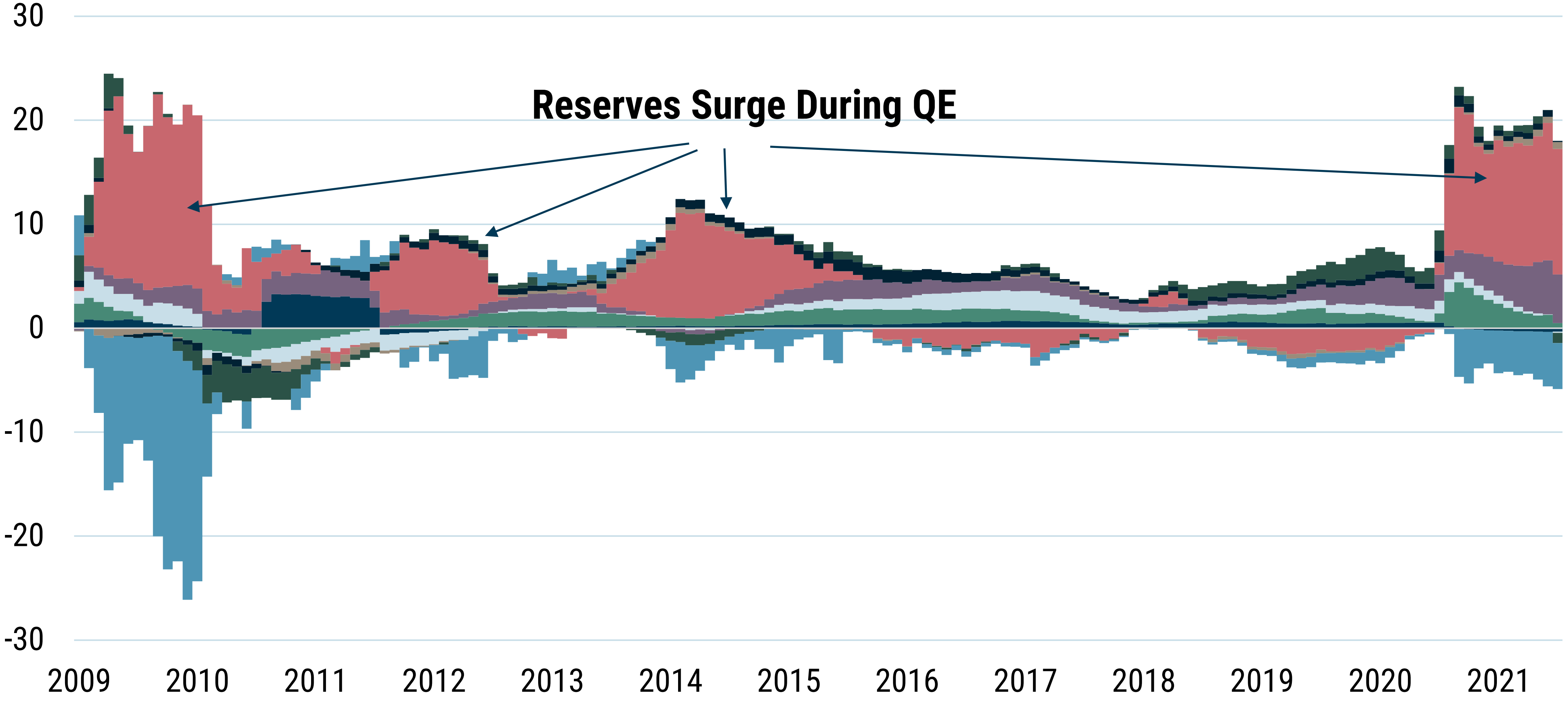


Source: FRED

BUT THIS IS REALLY ABOUT QE

And maturity transformation isn't likely to be inflationary

TOTAL BANK ASSETS (YOY)

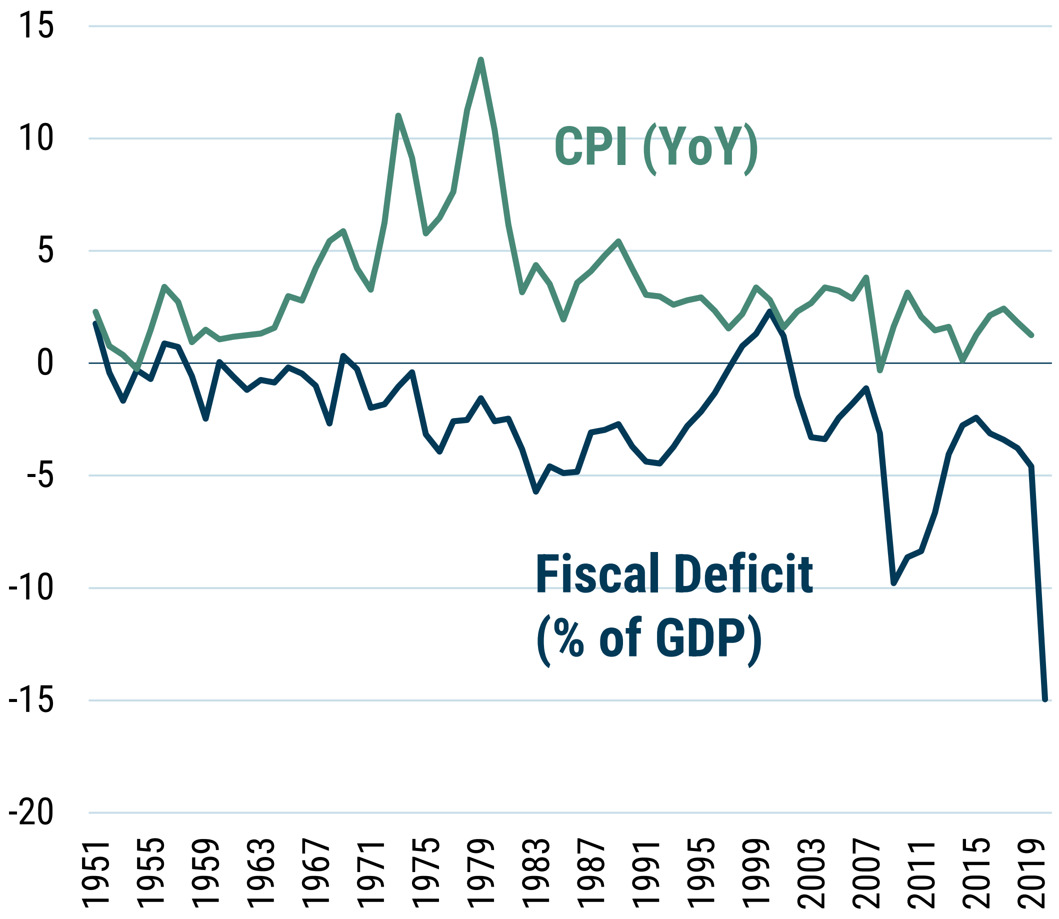


Source: GMO, FRED

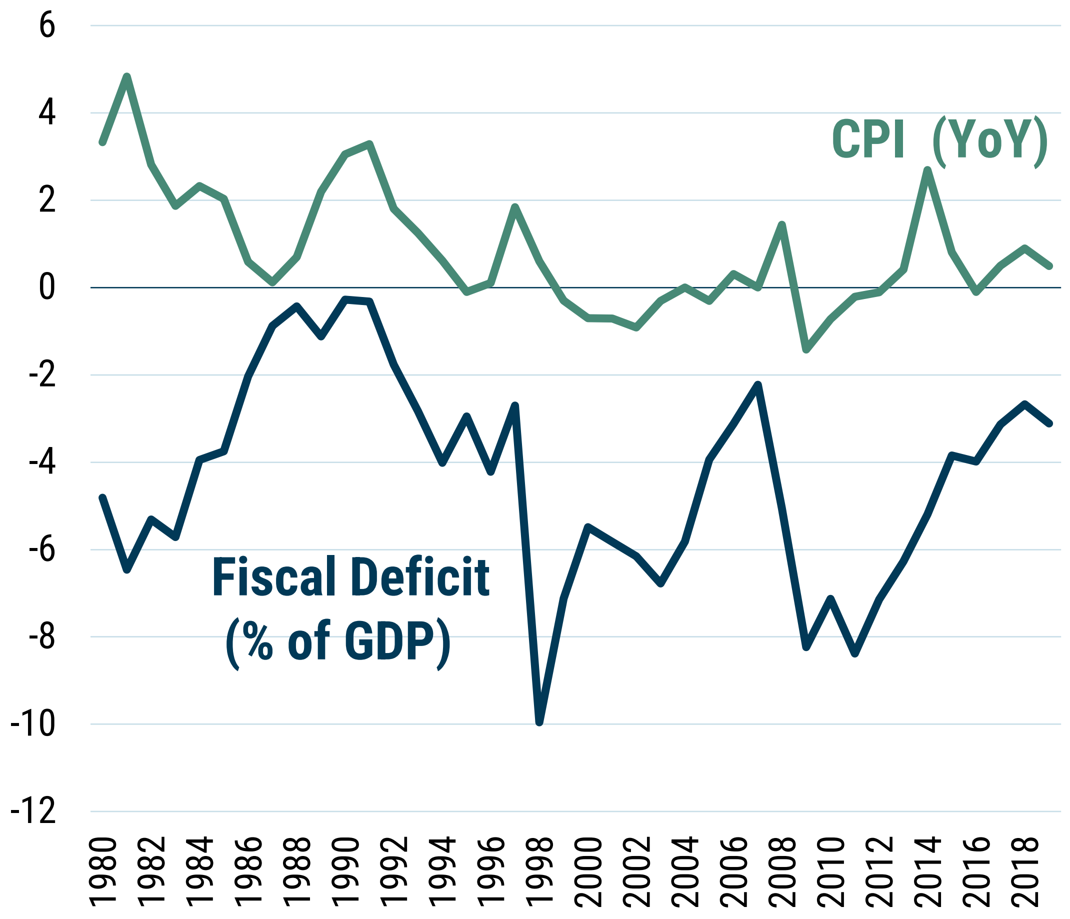
FISCAL FALLACIES

An economic bogey man

U.S.

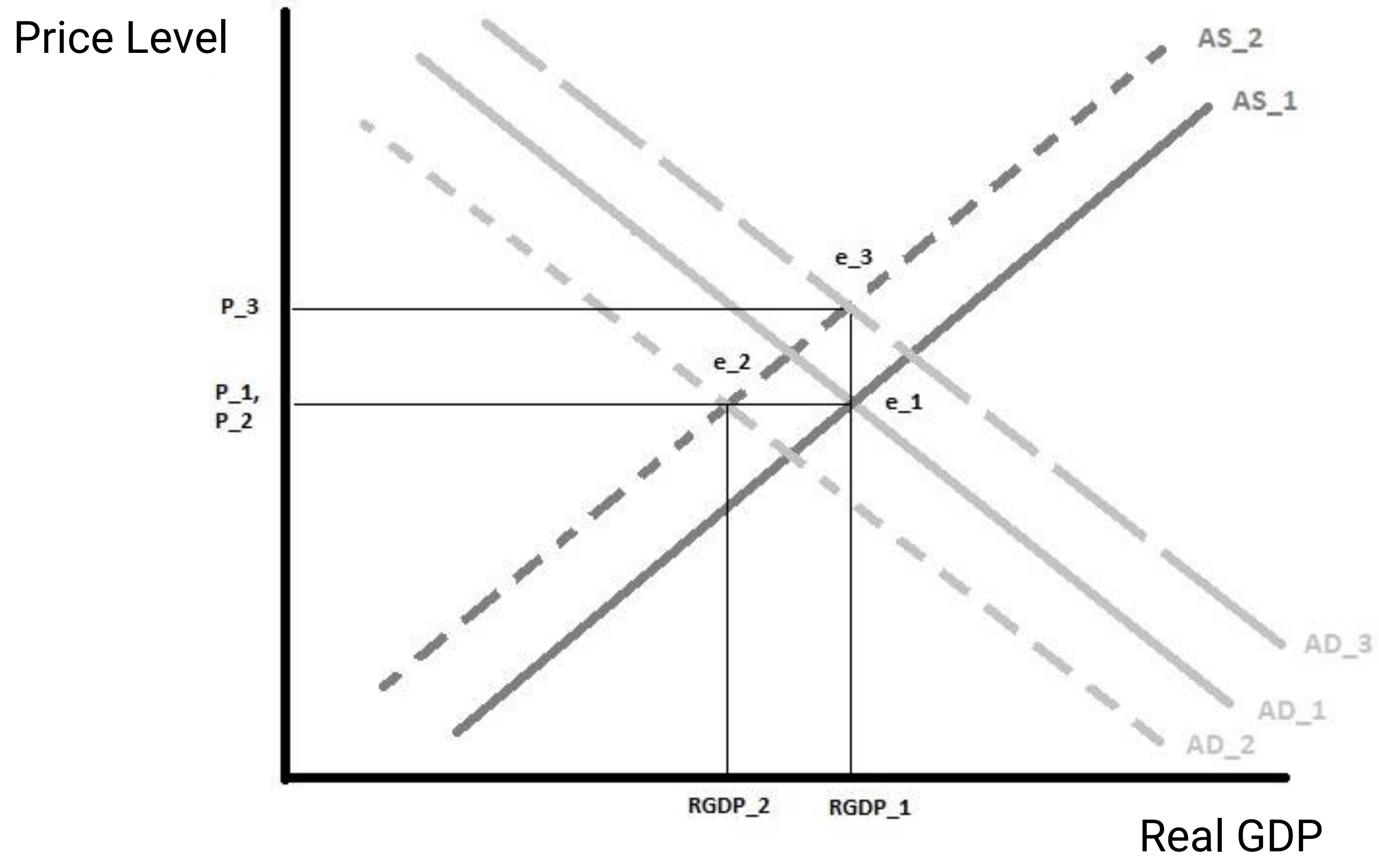


JAPAN



Source: GMO, Datastream

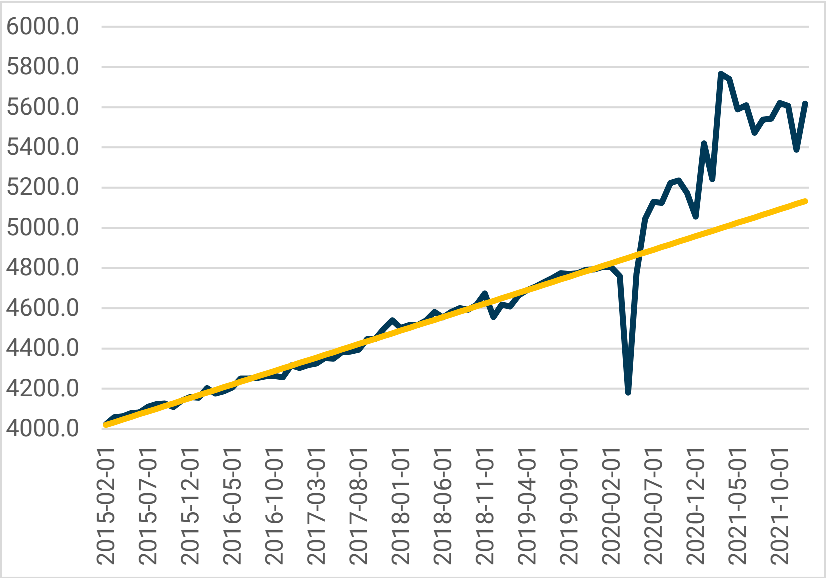
AGGREGATE SUPPLY SHOCK



Source: GMO

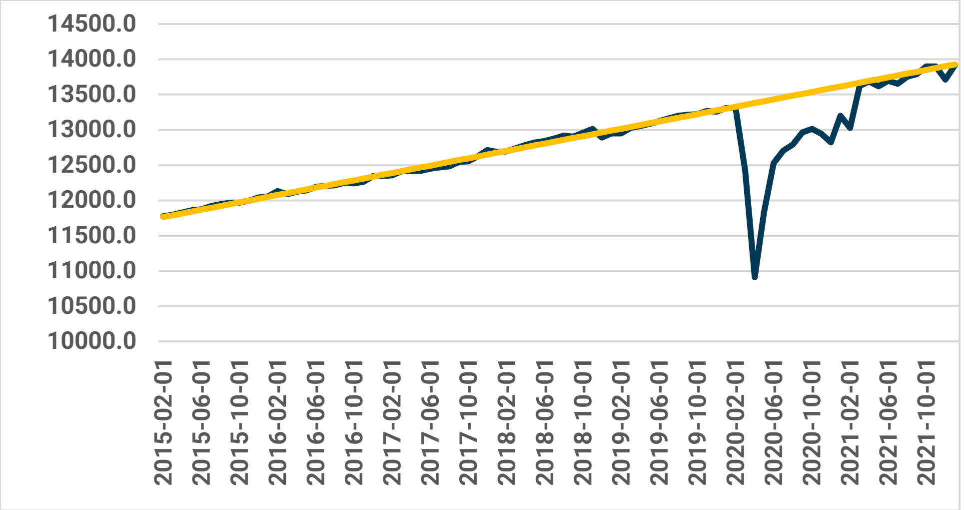
COVID SHIFTS SPENDING PATTERNS

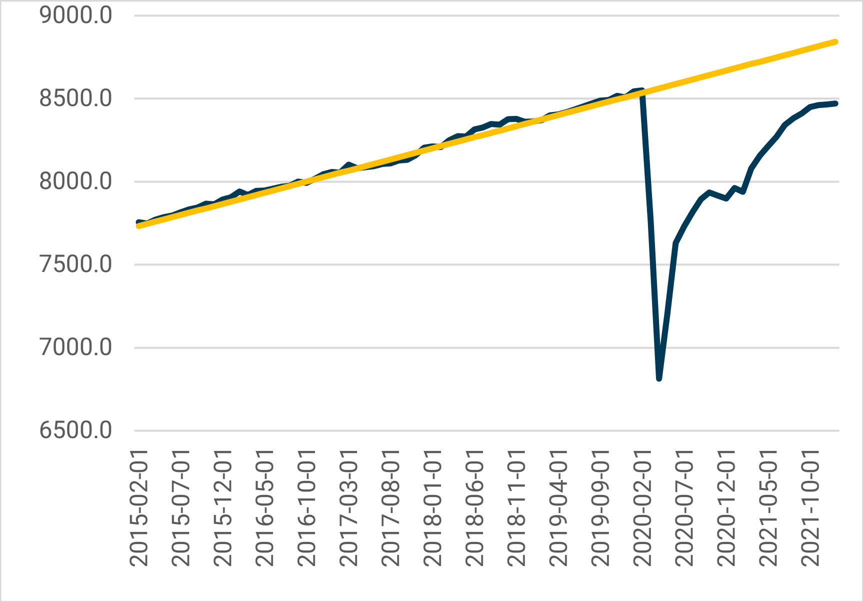
But not level – so this isn't aggregate demand driven inflation



US PCE (real) Goods

US PCE (real) Total



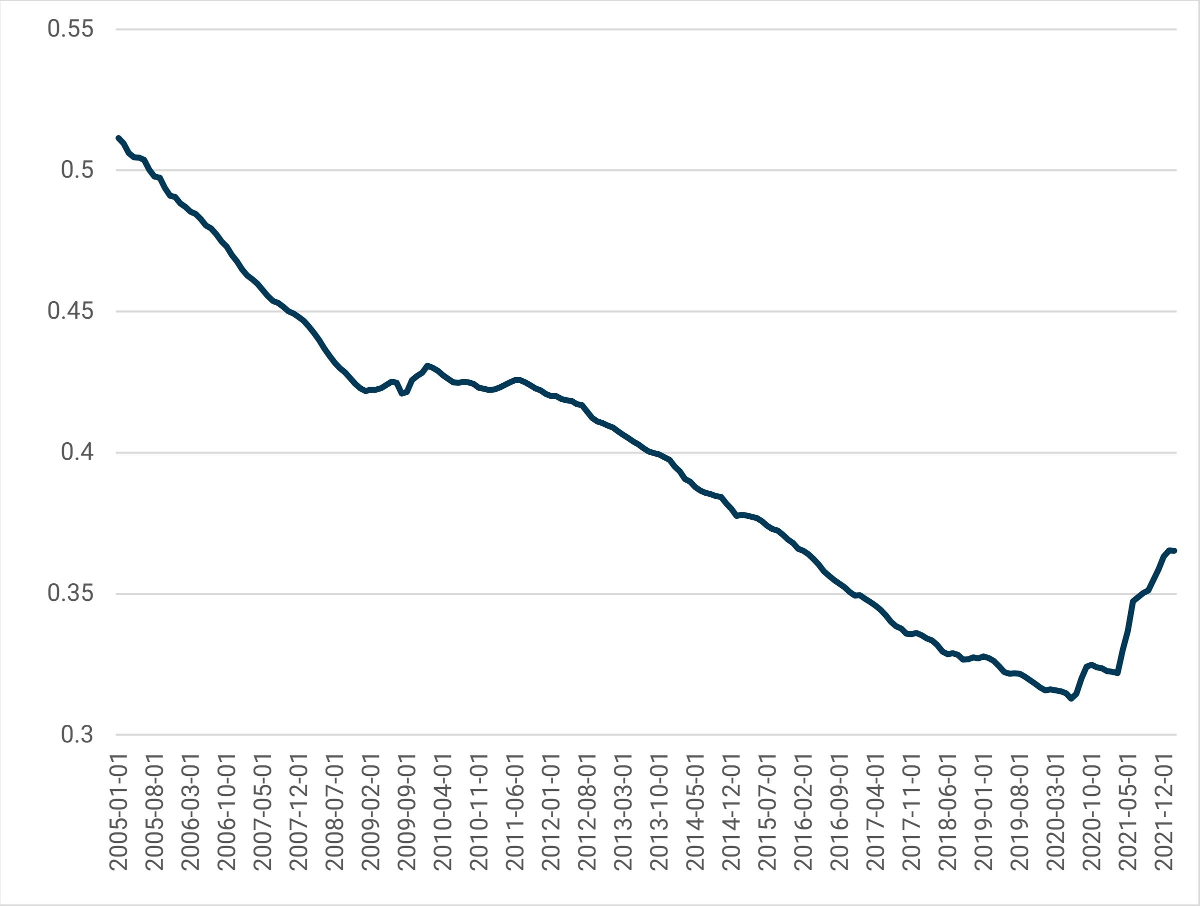


US PCE (real) Services

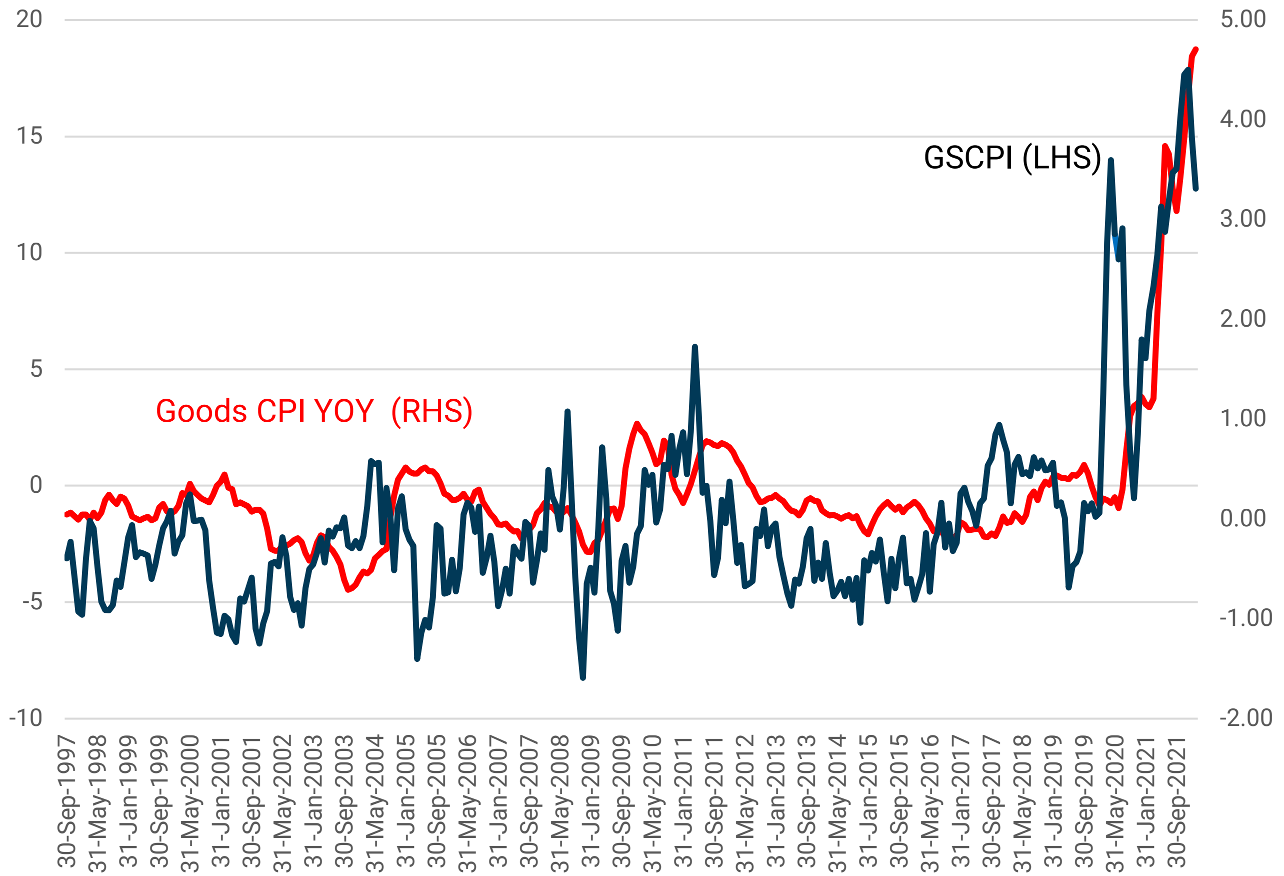
Source: FRED. GMO

WHEN SUPPLY AND DEMAND CLASH

Relative price: Goods vs Services (US)



Global Supply Chain Pressure and US Goods CPI



Source: FRED, NY Fed

PERMANENT OR TRANSITORY?

Is that the question?

INFLATION OVER TWO YEARS (% P.A.)

Source: GMO

THE MARKET AND THE FED AGREE

Unusual company for me!

5-YEAR, 5-YEAR FORWARD BREAK-EVEN INFLATION RATES

Source: FRED

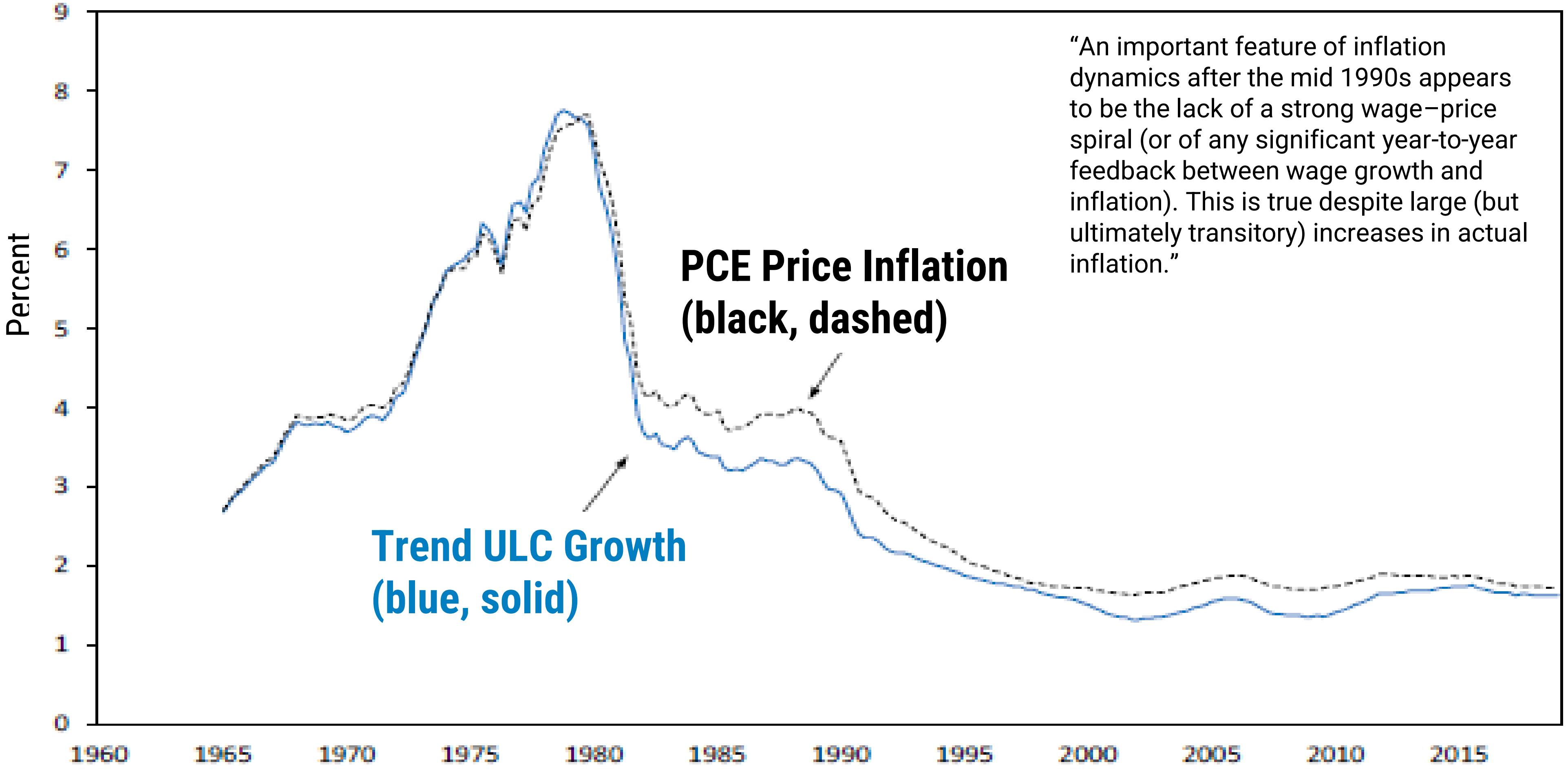
ULTIMATELY LONG-TERM SUSTAINED INFLATION IS “CUMULATIVE “

The interaction of prices and wages

“The general level of prices in an industrial economy
is determined by the general level of costs, and the
main influence upon costs is to be found in the relation
between money-wage and the output per unit of
employment.”

FROM RUDD (SEPT 2021) – A MUST READ

4. STOCHASTIC TRENDS FOR PCE PRICE INFLATION AND TREND ULC GROWTH

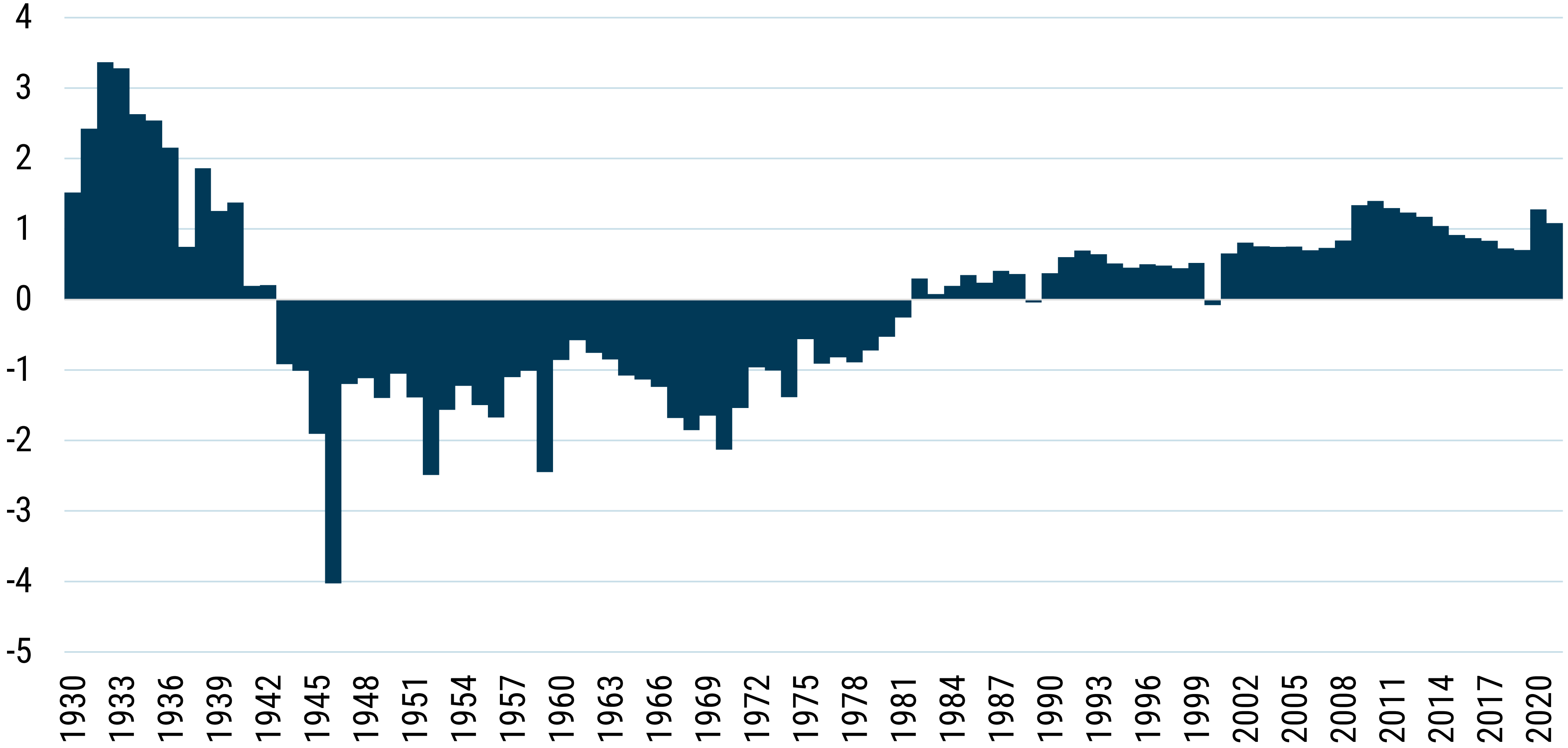


"An important feature of inflation dynamics after the mid 1990s appears to be the lack of a strong wage–price spiral (or of any significant year-to-year feedback between wage growth and inflation). This is true despite large (but ultimately transitory) increases in actual inflation."

Source: Rudd 2021

NO SIGN OF BIG SWING IN LABOUR BARGAINING POWER… YET

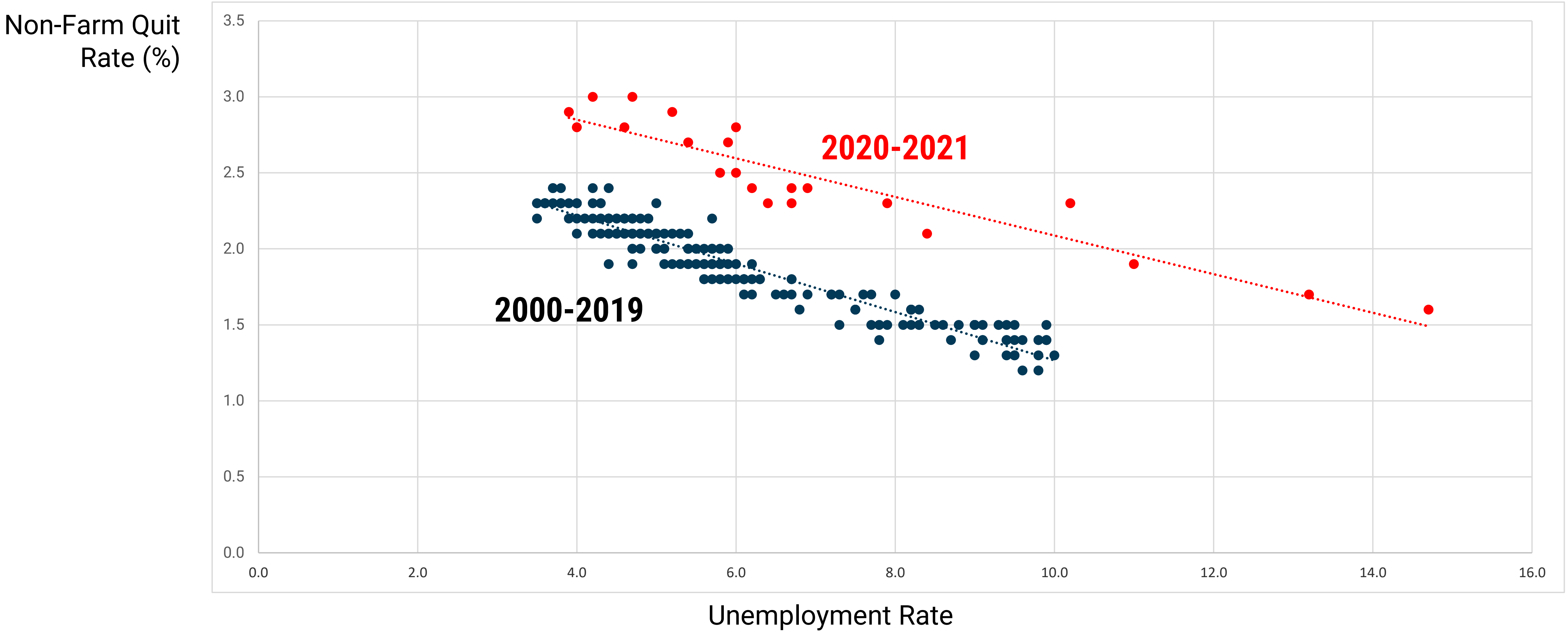
WORKER BARGAINING INDEX (US)



Source: GMO

BUT STRAWS IN THE WIND?

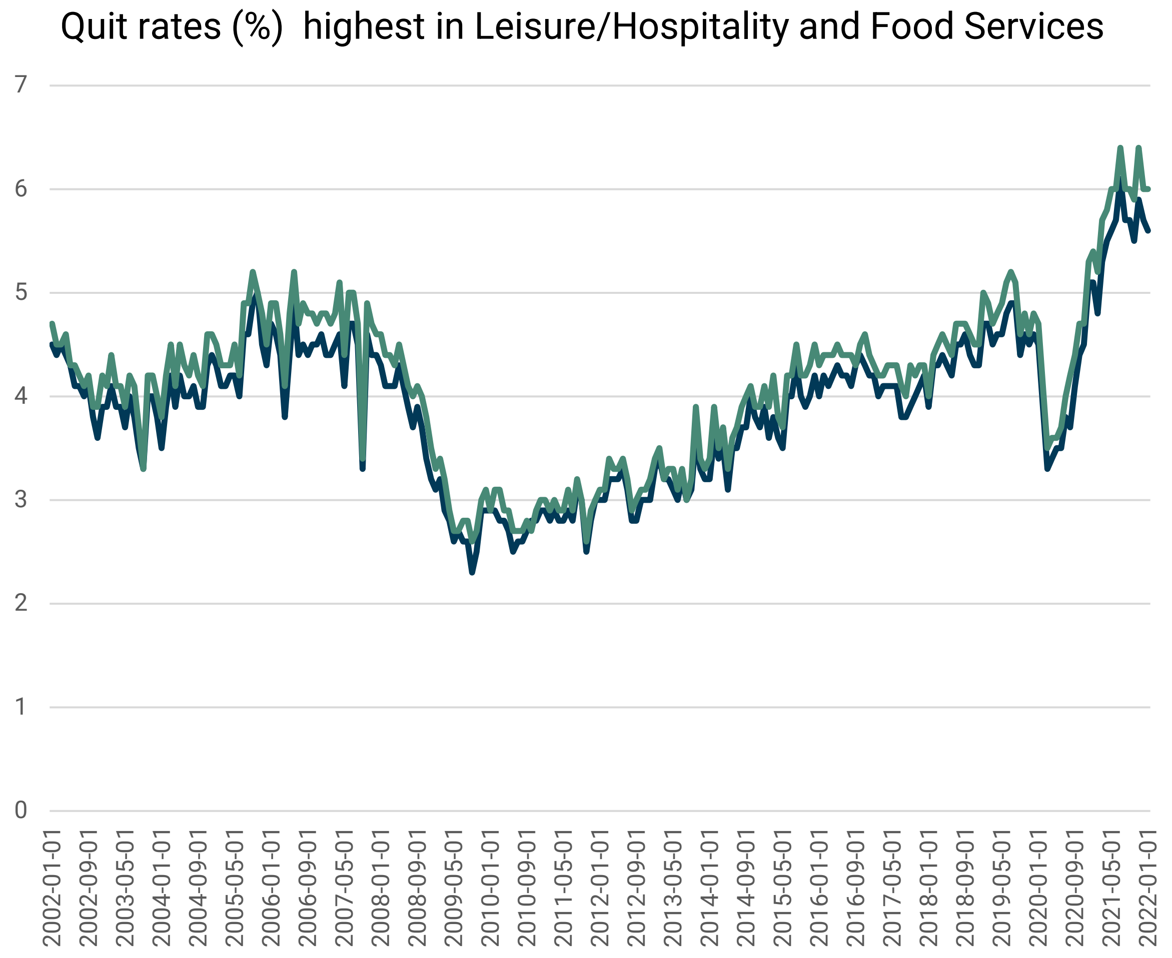
Labour power in a de-unionised world

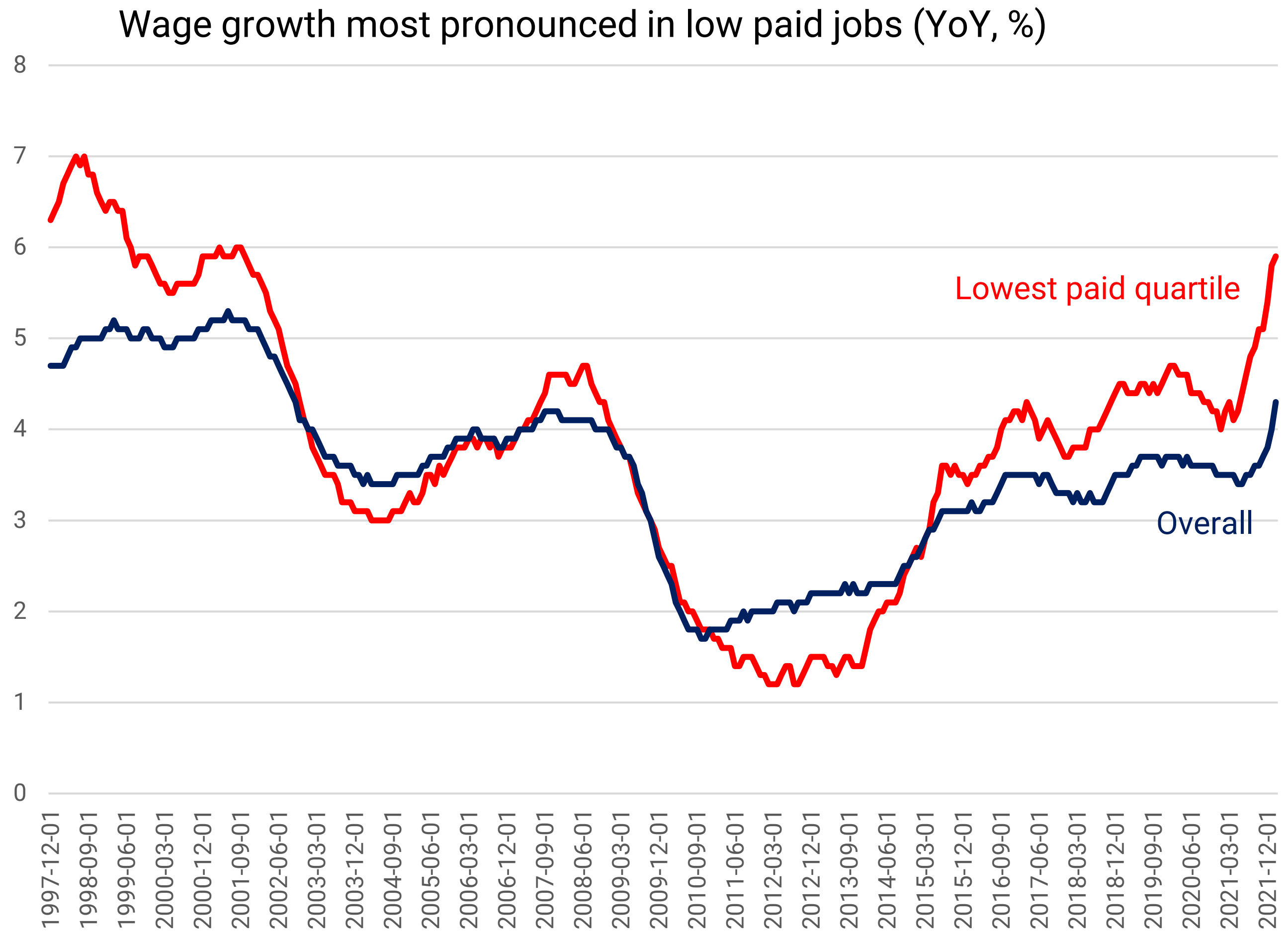


Source: GMO, FRED

A LITTLE DEEPER BEHIND THE NUMBERS

US



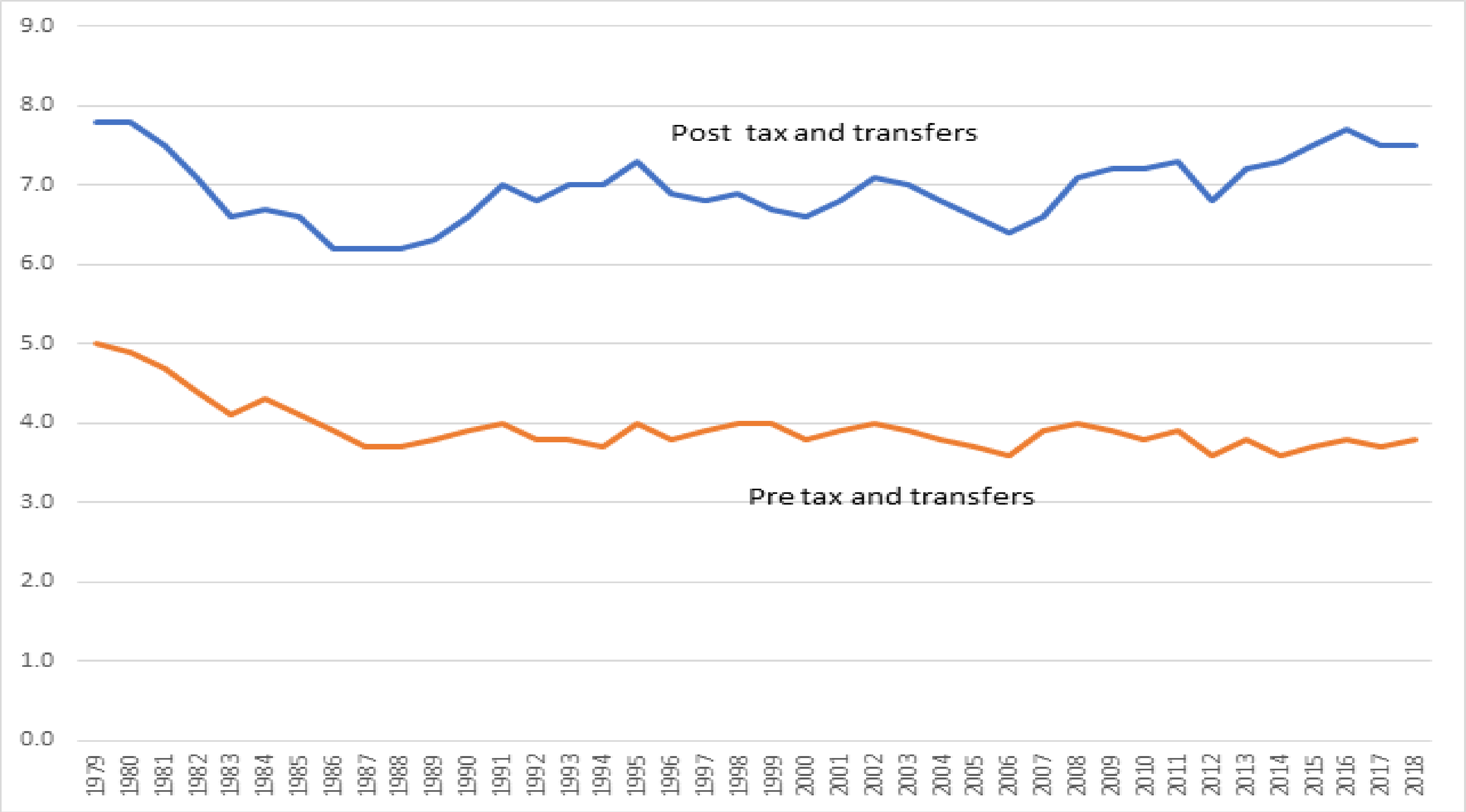


Source@ Datastream, Atlanta Fed

BUT THE LOW PAID DON'T MAKE UP MUCH OF TOTAL INCOME

So again, not really evidence of "Too much demand"

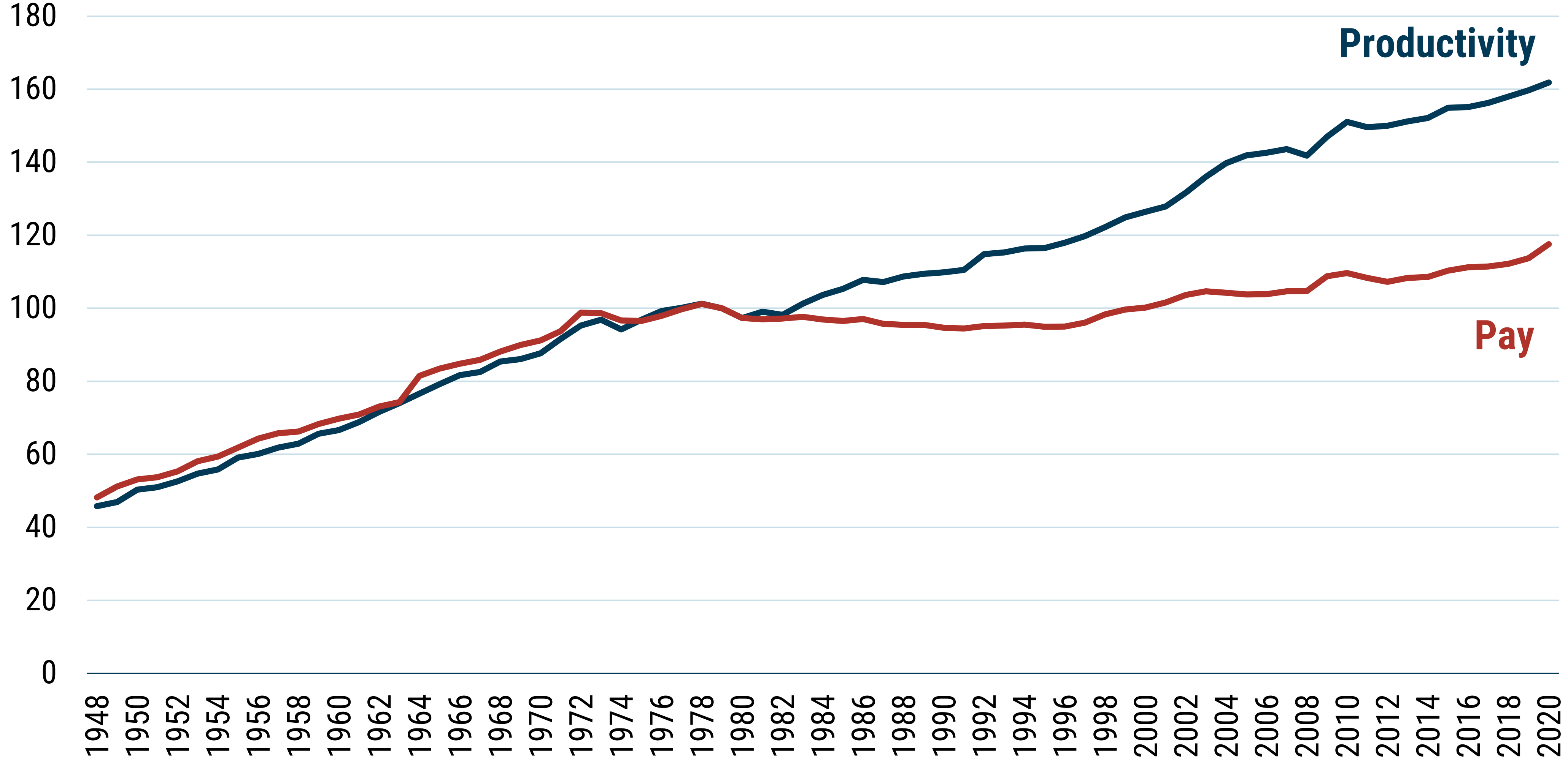
% share of total income by the bottom 25%



Source: Distributional accounts

PLENTY OF ROOM FOR WAGES TO INCREASE

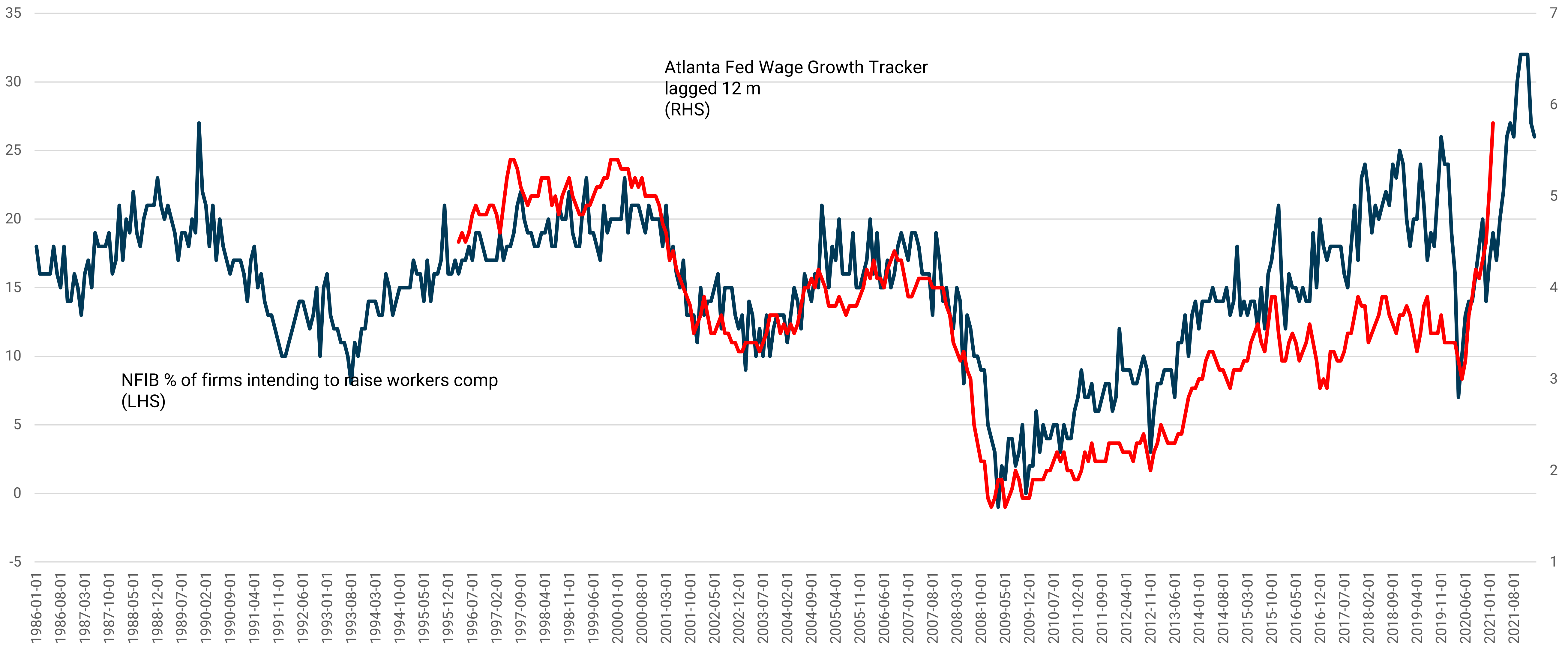
U.S.



Source: EPI

THE SCARIEST CHART I COULD CREATE

Perhaps not so scary anymore…



Source: GMO, FRED, FRB Atlanta

But what if I'm wrong…

The need for robust portfolios

TAIL RISK INSURANCE

Five questions to ask about insurance

1. What risk are you trying to hedge?
2. Why are you hedging?
3. How will you hedge?
   - Which instruments will work?
   - How much will it cost?
4. Who will you hedge from?
5. How much will you hedge?

HEDGING VS STORE OF VALUE

An important distinction

Hedging – tight correlation with the underlying risk

- Think TIPS, Inflation Caps, etc.

Store of value – capable to generating returns in the event of the underlying risk

- Think Equities, etc.

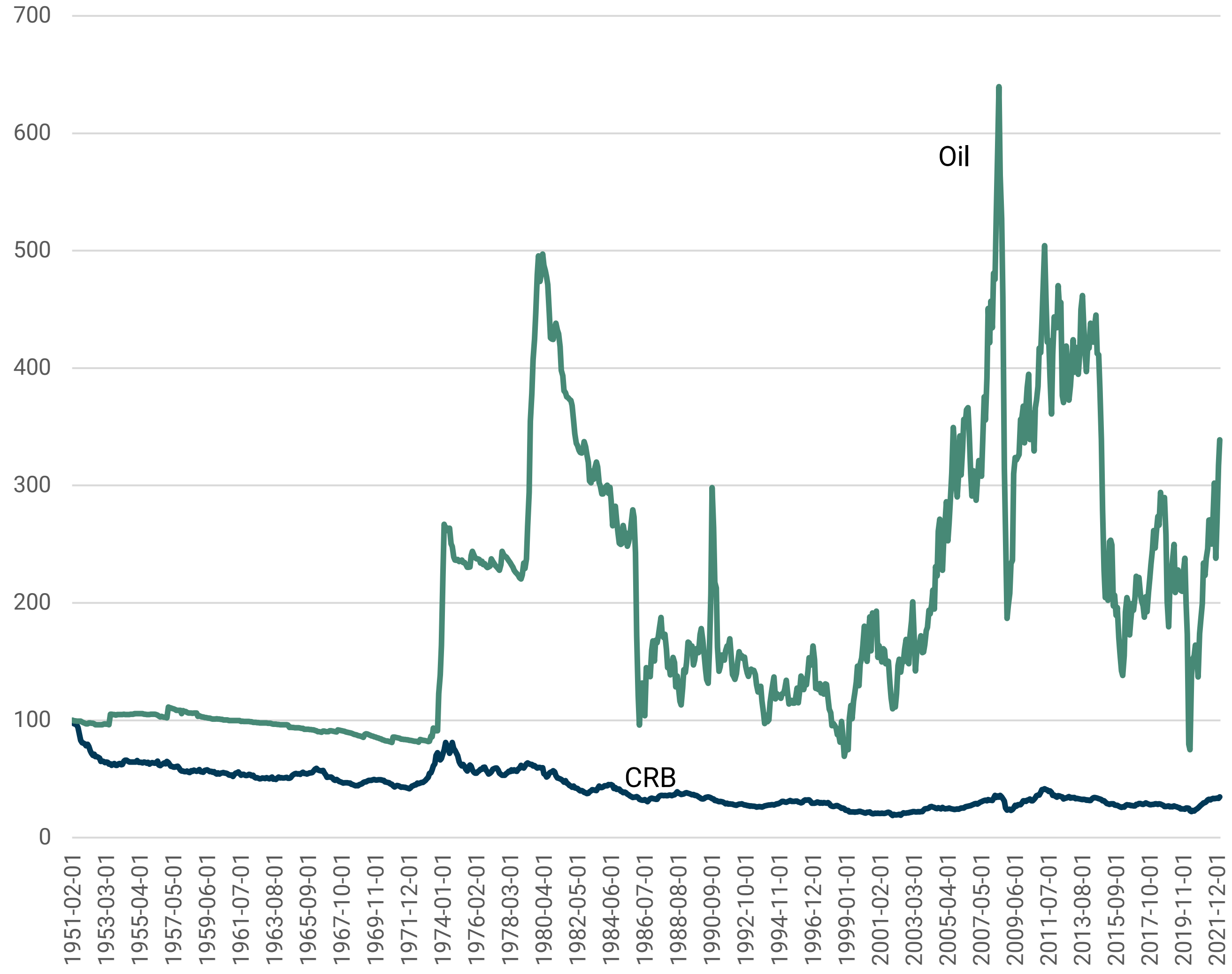
U.S. 10Y TIPS AND INFLATION CAPS

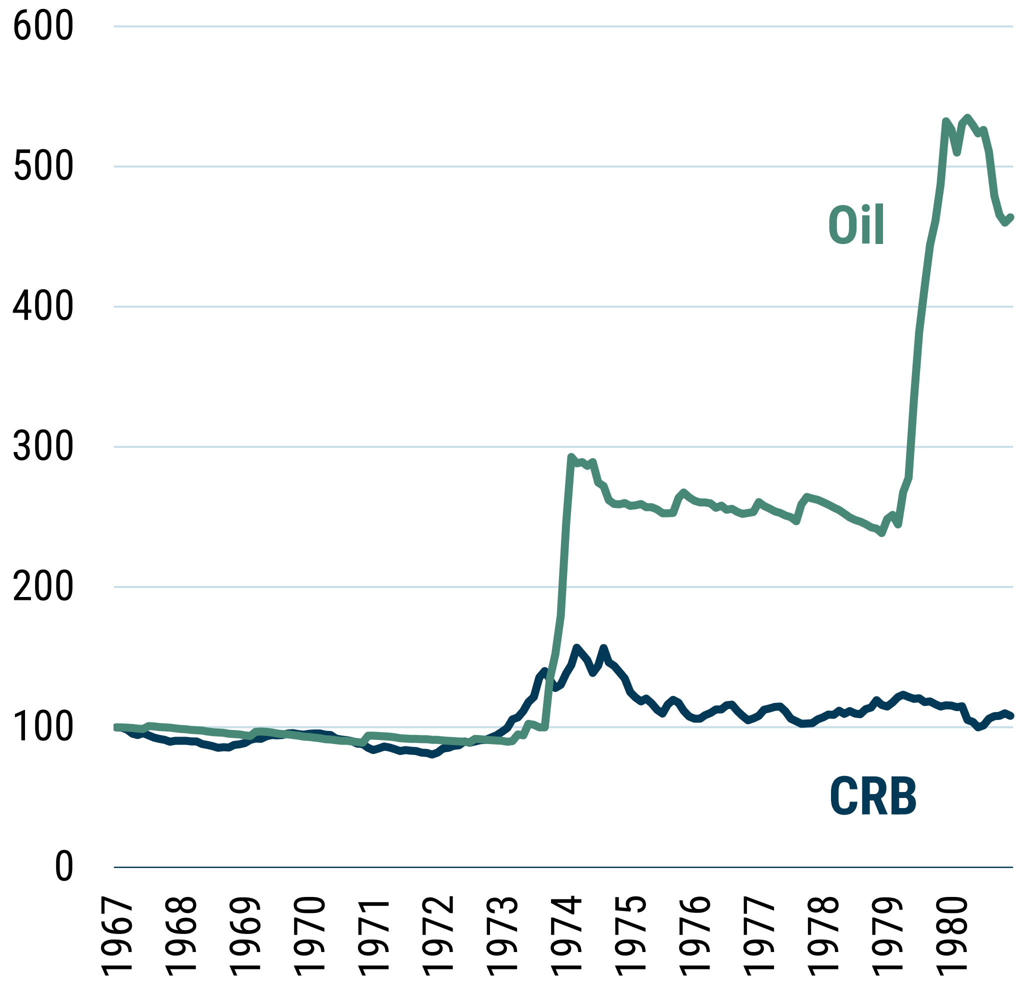
Hedges

Source: Bloomberg

COMMODITIES (REAL SPOT PRICES)

Not what you might expect – not a good store of value

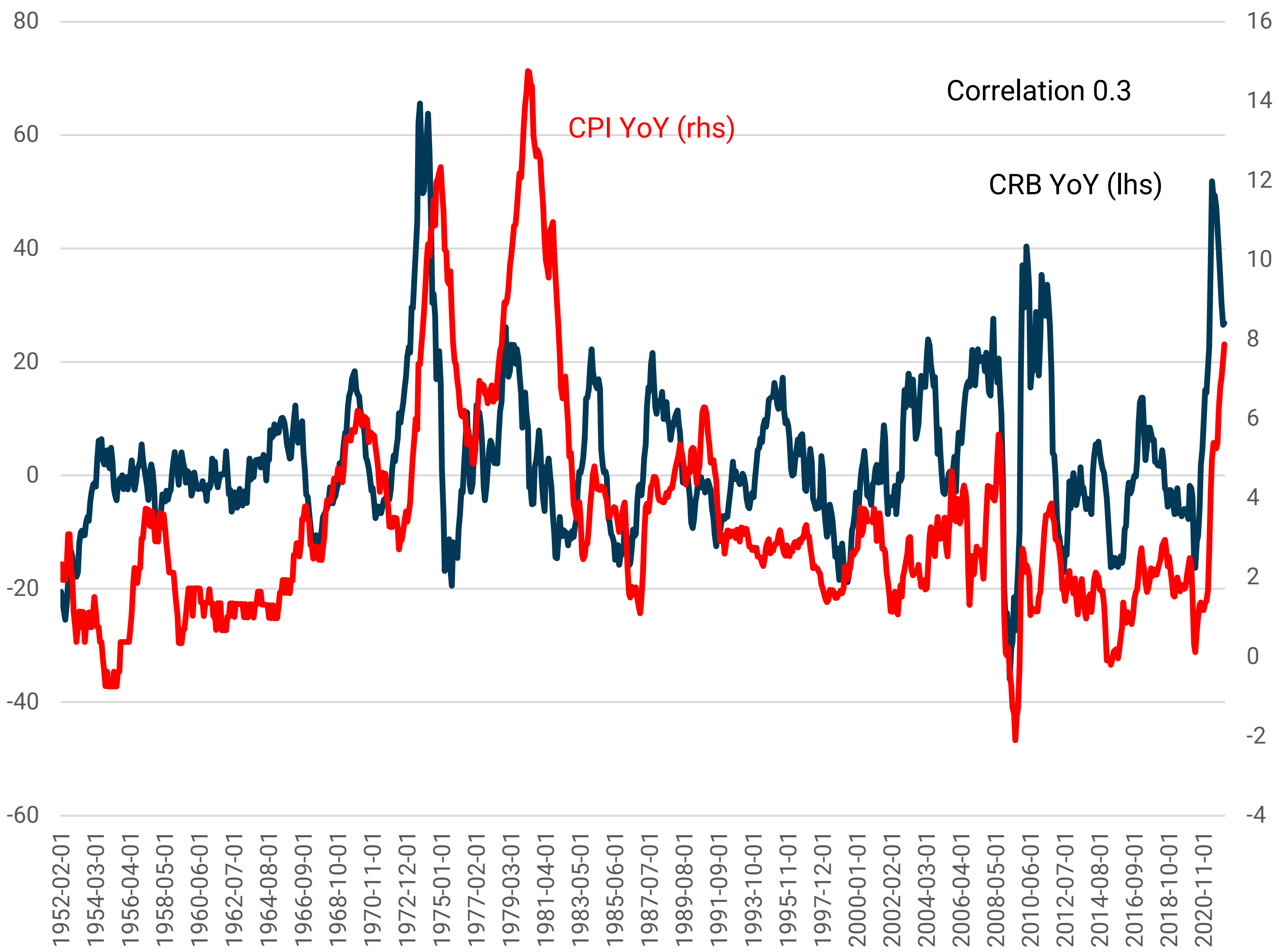


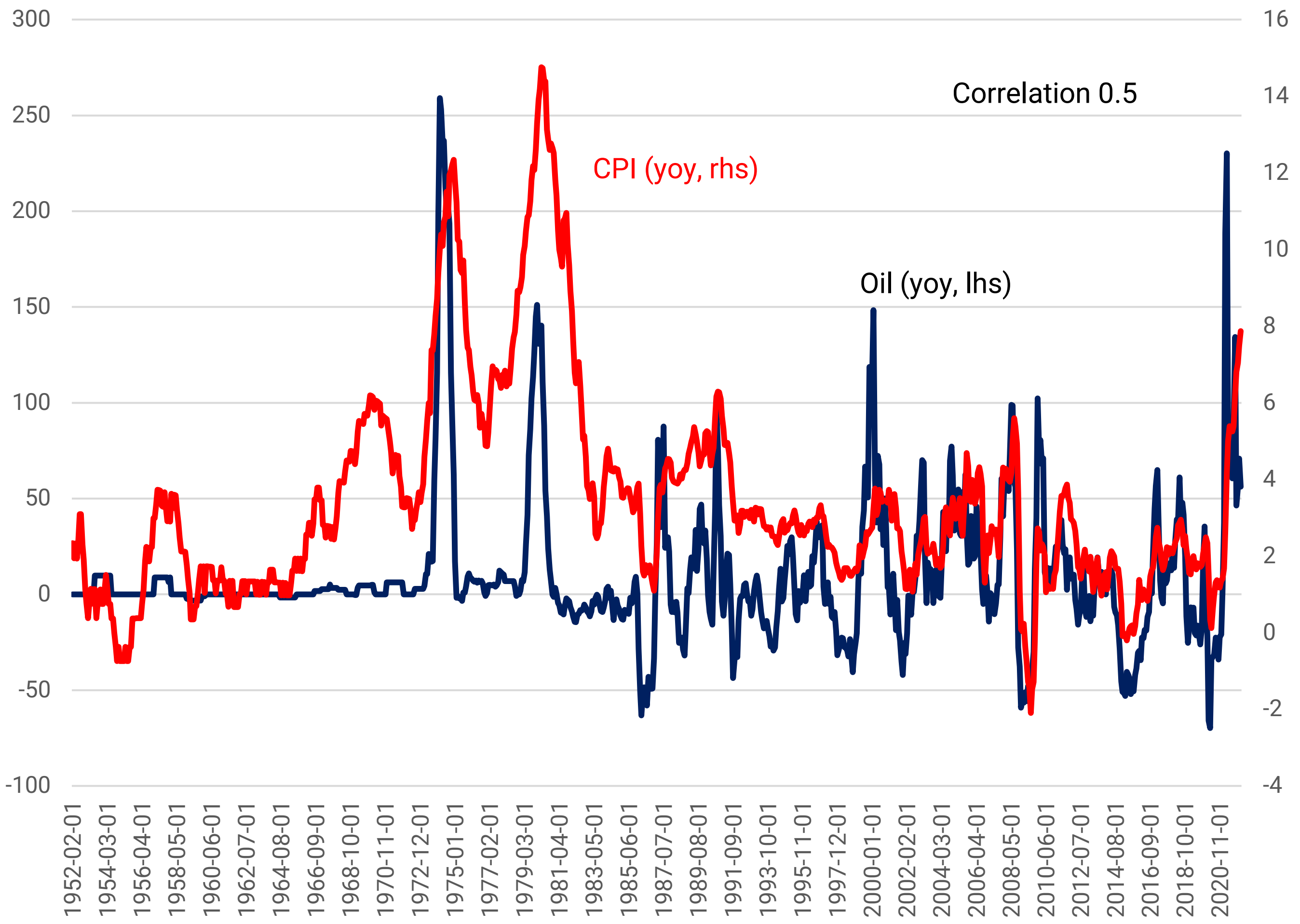


Source: GFD

OIL: A REASONABLE HEDGE

Because it is part of the CPI

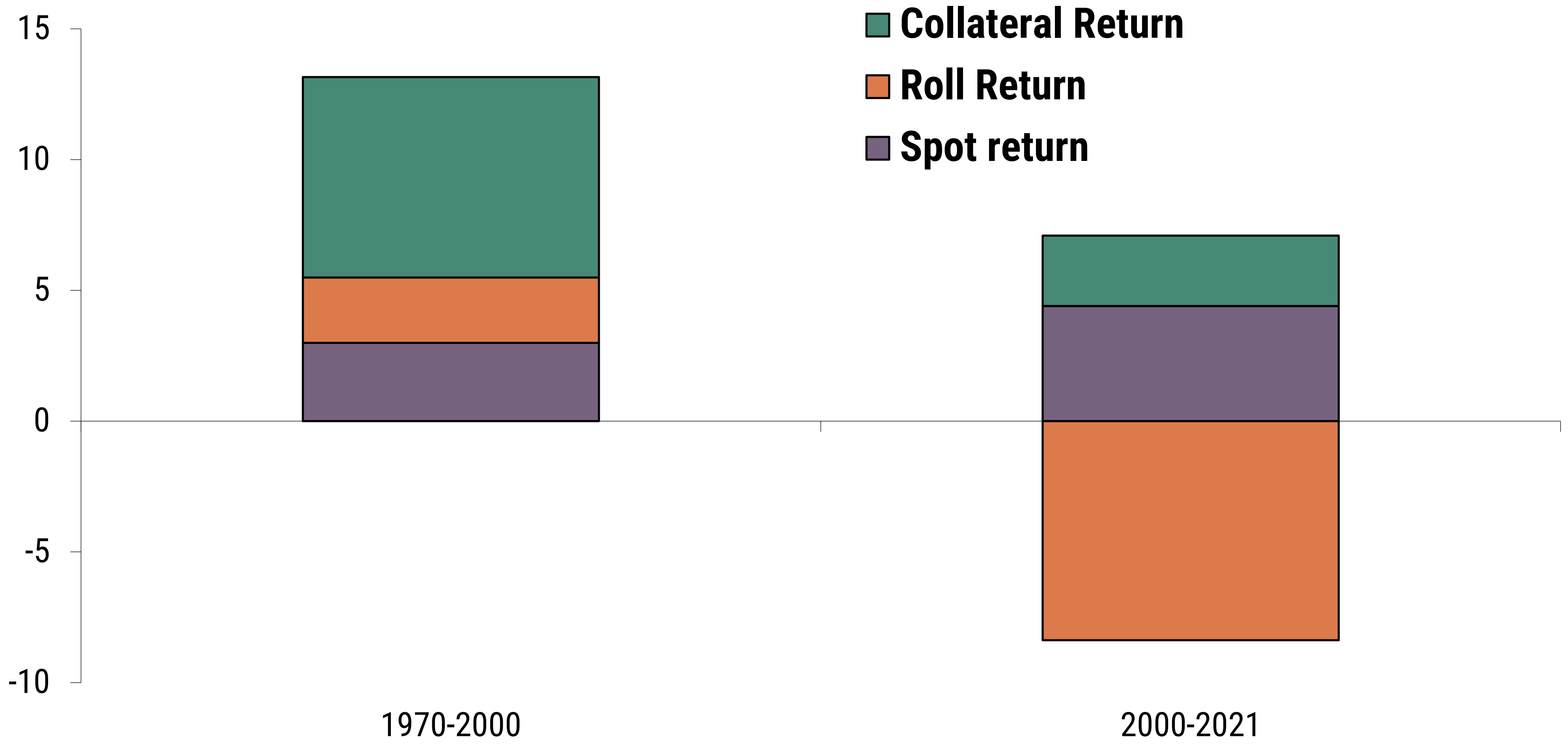




Source: GFD

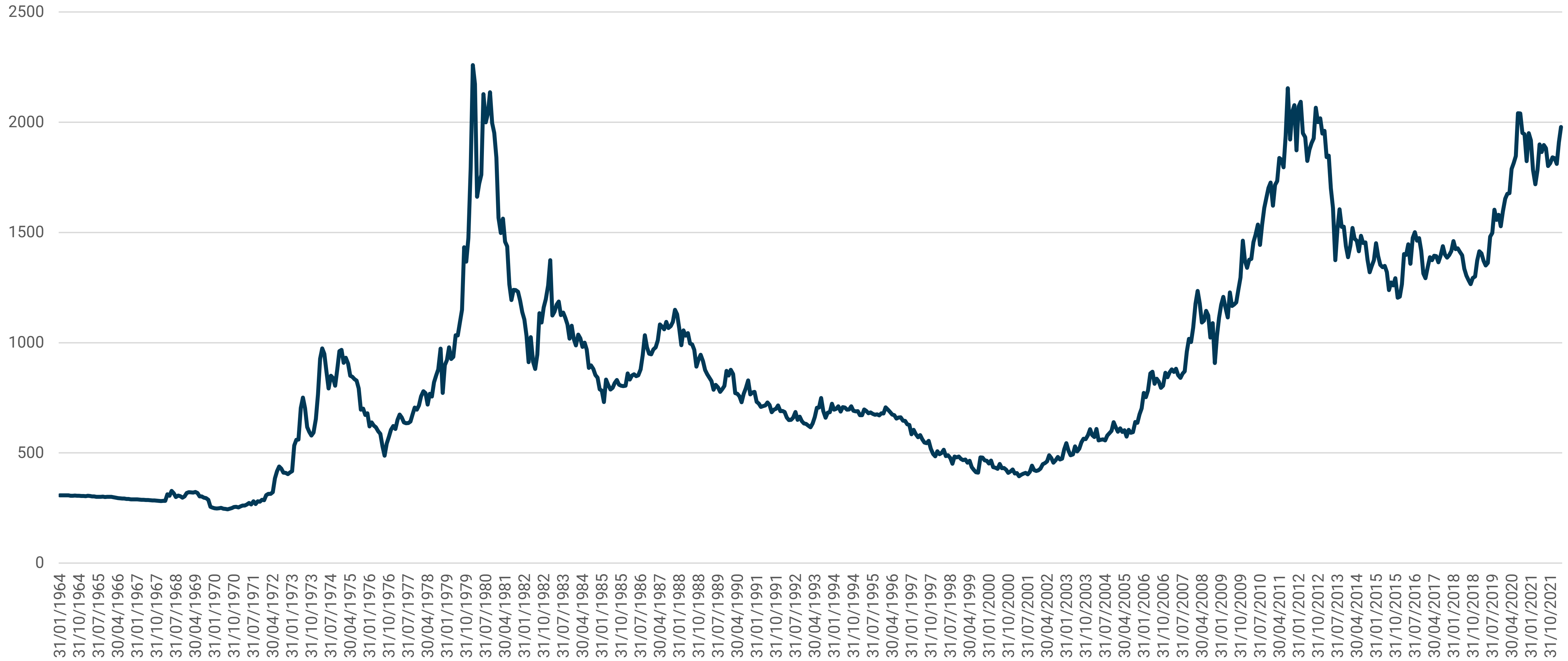
COMPLICATIONS STEMMING FROM FUTURES

Decomposition of returns (nominal, % p.a)



GOLD

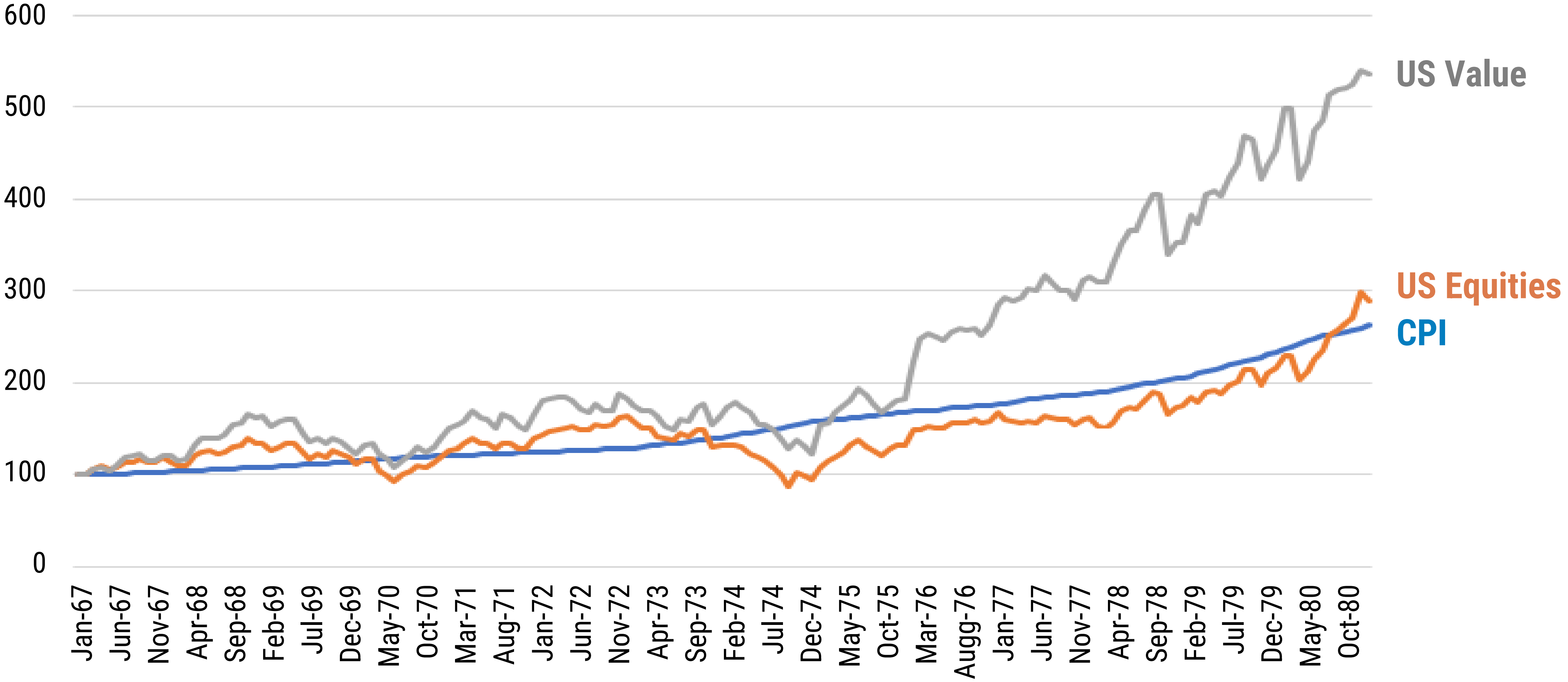
Real gold price – what is in the price?



Source: GFD, GMO

REAL ASSETS AS A STORE OF VALUE

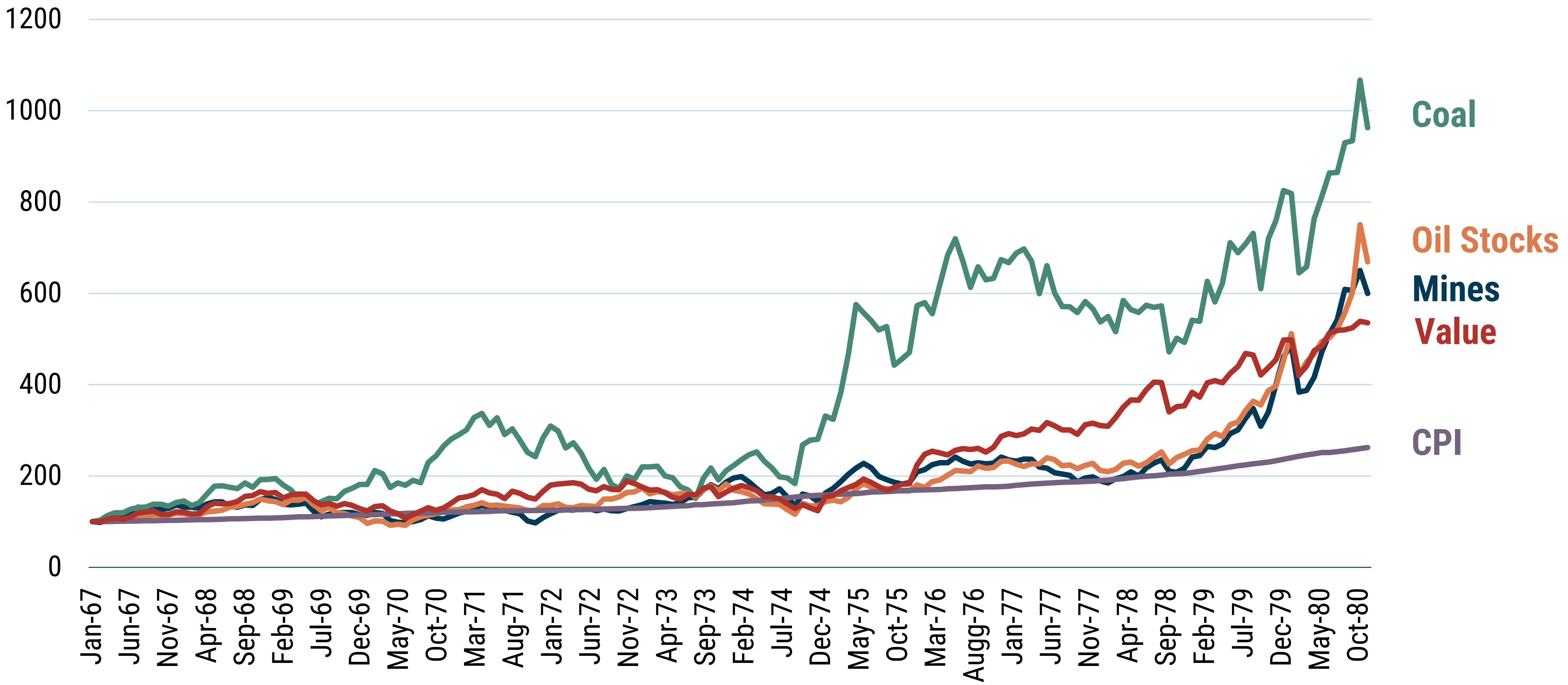
Cheap real assets are even better



Source: French, Datastream

RESOURCE EQUITIES DID WELL

Because they were cheap



Source: French, Datastream