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The Many Sources Of Inflation

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*"*Real knowledge is to know the extent of one's ignorance.*"*
Confucius (551 – 479 BCE), Chinese philosopher

Not too long ago the Fed and other central banks decided to expand considerable efforts on reinflating their respective economies. The arrival of the pandemic just served to reinforce the "urgency" of the matter, leading them to deploy quantitative easing and other aggressive measures similar to those used to counter the subprime crisis of the last decade. A perennial absence of inflation from the backstage then and now appears to have dimmed our collective memories of the economic hardships endured from the hyperinflationary years of the past[1]. The unusually weak inflation level that the global economies have been enduring for more than a decade now is taking place as entire sectors and industries are being overhauled by a major secular digital transformation process that has accelerated with the pandemic[2].

Could it be that digitization of the economy is somehow messing with the traditional mechanism through which demand and supply dynamics affect prices? Pandemic notwithstanding, the massive amounts of stimulus and liquidity injections into the economy would make you think that there might be some degree of complacency when it comes to inflation matters, making this phase of the recovery all the more delicate, if not uncertain. Combine the overconfidence with our cognitive flaws of tending to project events without taking into consideration the context in which they occur and you have the makings of not only turbulence, but of a potential crisis. If you were asked how you would react to losing 30% of your wealth through the stock markets, your response would depend in large part on your overall character, but will also be influenced by the mood you were in at that point in time[3].

And yet we can still end up being way off mark with how we think we are going to respond and how we actually do. This is because we tend to perceive events as occurring in a vacuum in which everything else is assumed to remain constant when they clearly almost never are. Things change once context is taken into consideration. A stock market that is correcting because valuations have been exaggerated for very long is going to provoke an entirely different response from the investor to one that is occurring in the midst of a global financial meltdown, major armed conflicts or a pandemic that threatens to wipe us from the face of the earth. Context matters greatly here, even if we almost never really know what type of context an event is going to play out in.

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[1] Even though most of the world's economies and especially developed markets have been spared the runaway inflations of decades past, there are few exceptions, such as Venezuela, where hyperinflation has been ravaging its economy, causing tremendous hardship to its population over the last couple of years.
[2] https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-covid-19-has-pushed-companies-over-the-technology-tipping-point-and-transformed-business-forever#
[3] https://behavioralscientist.org/a-conversation-with-daniel-kahneman-about-noise/

The point is that so much of the underlying "bedrock" has changed in this cycle that we may as well be navigating blindly or with faulty instruments. On the one hand, there is the nature of the surge in prices to consider: Inflation caused by supply shocks, such as the oil shocks of the 1970's, and those resulting from a more traditional "overheating" of the economy necessitate starkly different remedial approaches to counter. On the other hand, the context in which the current inflationary pressures are occurring (pandemic effect, deep digital transformations, spread of populism) are so unlike those of the past that it is almost impossible to predict how it will unravel. Supply shocks can create conditions that may seem paradoxical, for instance when unemployment rates continue to remain elevated during a strong recovery, a situation that the U.S. economy appears to be currently experiencing.

It could well be that generous stimulus paychecks, extended unemployment benefits and continued uncertainties posed by the ongoing pandemic are prompting a significant enough subset of the labor force to stay on the sidelines, causing greater inflationary pressure than would otherwise be expected. Then there is the multitude of other supply shocks that can occur in clusters, substantially amplifying their effects on prices. The massive container ship that blocked a key global transit route for almost a week, a fire at a plant in Japan that supplies critical microchips for many key manufacturers across the globe, or the freak winter storm in Texas: all happened within a two month time frame, just as the initial phase of the recovery was on its way. Such occasional "black swan" events are dangerous in the sense that they can stop a global recovery on its track.

With so much price pressure building up, it is normal that the Fed would appear to be slightly more hawkish, which also underscores the dilemma conditions that supply shocks tend to cause. Tighten rates too early and you risk plunging the economy into a deep recession, maintain stimulus for too long and you risk triggering "runaway" inflation, which leads to the same end results[4]. With not much room to maneuver for central banks, the longer the higher inflation conditions persist, the more likely households and businesses will start to adjust their price expectations accordingly, threatening the strength of the recovery in the long run.

Where Do We Go From Here?

The arrival of summer, combined with the sharp ramping up of vaccination campaigns across the globe, not to mention the fact that after months of trial and error we have become somewhat more resilient and effective in managing the pandemic than at the beginning, is contributing to the unprecedented surge in consumption demand. Households that have suffered from extended "confinement fatigue" are eager to regain a sense of normality and catch up on all those activities that had been forcibly put aside during the lockdowns. With signs of inflation popping up on almost every corner of the economy, markets are clearly entering a more "turbulent" phase of the cycle. There is still a great deal of uncertainty on how things will unravel from here, whether it be with regards to the strength of the surge in prices or its overall duration.

That is because the sources of inflation this time around (supply-chain bottlenecks, pandemic driven changes in consumption demand, wage bargaining power) appear to be very different from those of the past. The visibility is poor enough that volatility, which was until now confined to mainly stocks, has been spreading into bond markets. Investors are trying to make sense of all the conflicting figures and mixed Fed signals[5]. Expect this situation to linger on for some time to come, at least until visibility improves, which can only happen if supply ramps up soon enough to meet the surge in demand.

With bottlenecks having formed at multiple nodes of the supply chain, the price surge is going to affect markets across the globe, but it isn't as if any of this comes unexpected. We need to distinguish "transitory" inflation from changes in

[4] The Fed's dual mandate of stable prices and maintaining full employment certainly complicates matters further, as it means that it has its wings clipped if it cannot tighten rates to counter the inflation, because the unemployment rate is too high.
[5] https://www.ft.com/content/27ef38d2-7e0e-465f-932c-e73ea2c78ab3

"core" inflation, which is the type of inflation that, when left unchecked, can lead to serious trouble down the road. Most signs suggest that the type of price surge that is being observed in the present is transitory in nature, although this is nuanced by the fact that non-core (headline) inflation is typically comprised of food and energy, two sources that are not amongst the main contributors to the recent jump in prices.

Even if the inflation does end up being transitory, it won't prevent its effects from seeping into the broader markets. The dollar has been strengthening against its main trading partners, reflecting worries that price pressures are accelerating enough that the Fed will have to tighten earlier than anticipated. Further appreciation of the dollar would cause undue pressure on the emerging markets with high dollar borrowing exposures, and risks triggering a currency war, both sources of substantial turbulence for the markets. And then there is the whole COVID matter to contend with, because even if the remarkable progress made on many fronts in the last couple of months gives us much reason for hope, it is unlikely that we will ever see a return to pre-pandemic conditions.

No one can say that we won't experience a repeat of last fall, when more virulent forms of the virus forced the economies back into crippling partial shutdowns. In fact, as long as large swaths of populations remain unvaccinated, the increased risk of mutations means that COVID will continue to threaten the economies of the world. Adding yet another dimension and layer of complexity to an already complicated equation, the recent Biden-Putin summit in Geneva and signs of growing divergences in ideology and strategic interests between the west and China suggests that we may be at the brink of a new, technology-driven cold war that could carry deep seated repercussions.

There are so many variables to contend with, some of which carry the seeds of major instabilities, that the months ahead appear turbulent. And yet I'm somewhat confident that we will pull through, after the pandemic demonstrated the extent of our resilience, ingenuity and prowess. Our economies have become far more resistant to such threats thanks to the many wonderous technologies that we have been developing over time. Should we be positioning ourselves to hope for the best without compromising preparedness for the worst? Now that would sound like good advice from an investor worthy of his or her salt, don't you think?

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