Episode 06

Inflation – Higher or a head fake?

Kara O'Halloran (00:05):

Welcome back to Fireside, podcast by FS Investments. I'm Kara O'Halloran, a member of our research team here. I am once again thrilled to be joined by my colleague, Lara Rhame, our chief US economist, who is quickly gaining the title of podcaster in chief. She is such a good guest. I think everyone at FS is constantly fighting for her time. Lara, thank you so much for carving some out for us today.

Lara Rhame (00:31):

Absolutely. I mean, it's so much more fun to talk to you than to stare at my screen and try to write something. Always happy to do this.

Kara O'Halloran (00:40):

Awesome. Well, I'm happy it's an audio medium, too. We're on a video call, so Lara can tell I am in the middle of moving, so I'm surrounded by cardboard boxes. We will see how that does for our acoustics, but I'm sure our team can fix any sound quality. I don't think we could consider ourselves an economics and markets related podcast without an episode on inflation. For the last six months or so, there has been a lot of talk about it, after a decade of really, as we all know, very little inflation. Today, we are going to get Lara's point of view on where she thinks inflation is headed, both in the near term, in the longer term. Is this another head fake? We will get into all of it, and of course we will tie in the market impacts as well. There is a lot to cover, so I'm sure we will barely scratch the surface here, but I would be surprised if this is the last time that we're talking about inflation in 2021.

Lara Rhame (01:36):

Yeah.

Kara O'Halloran (01:37):

Let's get into it. Lara, the pandemic has certainly had a huge impact on inflation. We really saw almost competing forces. We saw these deflationary pressures, as well as inflationary ones. Airline tickets last year were so cheap, understandably so, and yet my grocery bill has never been higher. I know I'm home a lot more, but it still seems a little high. Maybe to start out, you can talk through some of the impacts that we saw on inflation due to the pandemic and the economic shutdowns.

Lara Rhame (02:09):

Sure, happy to. I think, yeah, to your point Kara, inflation has probably never been more interesting than it is right now. It's exciting that it's reemerging, both in the near term, medium term, and long term as such a topic that really needs to be rethought, I think in a lot of ways. Okay, pandemic. Pandemic hits this time last year. From March 2020 to May 2020, we see energy prices get crushed. We see these small pockets that were really at the center of the target for the pandemic; airline prices, hotel prices just see steep declines. Then, on the other side of that, we saw food prices rise, durable goods prices, auto prices rose significantly right as the pandemic set in. That really did give us these competing forces.

Lara Rhame (03:09):

First of all, you just had the broad index fall significantly in those few months right as the pandemic intensified, and we've seen the overall, I think since the pandemic, one factor in and above all else has really kept inflation low, and that has been owner's equivalent rent. It is the government's attempt to [inaudible 00:03:39] to reflect the cost of shelter, and they do that through a proxy for rents. We've seen this before, this really odd dynamic where, when house prices rise and a lot of people are moving out of rental units into housing prices, and the pandemic intensified that because a lot of people moved out of high rent markets like New York and San Francisco into lower rent markets, the net effect being rents falling at the most macro level. All of that has, that index alone, that owner's equivalent rent is about a third of the share of the core CPI, or a quarter of headline CPI. That has really put a damper on inflation over the course of this year. A bunch of opposing factors there that have kind of left us with a muddy inflation picture in the near term.

Kara O'Halloran (04:42):

Then, we wouldn't be surprised to see these really work themselves out from these base effects. Right? I think we saw CPI jump in March already, so maybe can talk a little bit about that.

Lara Rhame (04:52):

Yes, and this is just a very technical feature that means that, we look at inflation on a year on your calculation, so you have a huge drop in one or three months. You then end up a year later, that same March, April, May of this year, we're going to see a huge surge in the year on your calculation, not necessarily in any one component, seeing price increases of that magnitude in this month. All that's to say, exactly your point. In March, we saw headline CPI jump from 1.7 to 2.6 year on year. That increase is greater than what we've had in over a decade. You're going to see that again over the next couple months. We could get CPI over 3%. By May, that's my expectation, and that would be the highest inflation in 10 years. That doesn't mean that, I think markets are rightly ignoring this, and it's a very technical measure that's going to make a lot of headlines. That's the important thing.

Kara O'Halloran (06:05):

Yeah, I know, I think we're going to get those "highest inflation in a decade" clickbait.

Lara Rhame (06:10):

Right, exactly. My dad's going to be calling me worried about it, and it's like, "No, no, no, no, it's okay. It's just kind of going to wash out by the summer," but to just steel yourself for those headlines that are going to be coming at you.

Kara O'Halloran (06:22):

Right. But, in March, markets didn't really react. Right?

Lara Rhame (06:25):

That's right.

Kara O'Halloran (06:26):

In fact, we saw interest rates decline recently.

Lara Rhame (06:28):

Ignore, ignore, ignore. That's exactly right. It's just a scary headline for those who aren't prepared for it.

Kara O'Halloran (06:34):

Right, okay. I'm actually going to physically ignore the phone calls when people call asking about inflation.

Lara Rhame (06:41):

100%.

Kara O'Halloran (06:41):

That's what that button is for. Let's talk about the coming months after May, so after we see these base effects really work themselves out, looking at the great reopening, if you will. It feels like we really have the stars aligning here. If we think about the definition of demand-pull inflation, we have all the components. Right? We have the central bank increasing the money supply. The economy has been largely shut down for a year, so definitely wouldn't say that we have seen an increase in the production of goods or services. We're seeing capacity issues as well in production, so seeing pricing pressure on the supply side as well.

Kara O'Halloran (07:19):

We basically have a reopening situation where there's going to be a lot of demand. I still think we're going to see some capacity constraints. I don't think that we'll see some limitations at restaurants or events or resorts, not just going to completely flip a switch back to 100% capacity, or at least not everywhere in the country. Basically, long story short is that this feels like the definition of too many dollars chasing too few goods. I feel like there has to be some sort of pricing pressure there. Right?

Lara Rhame (07:48):

Yes. You put it perfectly. I should start interviewing you about inflation. Yes. If you look at the growth rates that we're expecting, this quarter is supposed to be growth of 12%. This year, 2021, the consensus forecast is growth north of 6%. Next year, it's supposed to growth of consensus estimate 4%. These are two to four times higher than our underlying potential growth rate, as it's estimated by the Federal Reserve. If this isn't an environment where you could see inflation, I don't know what is. We've already seen energy prices recover significantly. You're still seeing very high commodity prices, and input costs are rising. I want to just talk about two separate things.

Lara Rhame (08:43):

One is, and what we've seen previously is input prices rising, energy prices rising, and we've seen a history of this. Companies being unable to pass that along to the bottom line, the consumer prices. I want to just be clear, this does have an impact on margin. Companies, in the face of very little pricing power end up just seeing their margins erode somewhat. We saw this for the last 15 years, and especially right before the pandemic hit, we saw, for example, labor costs rising. But, companies really weren't able to pass that along to the bottom line. We've seen energy surge higher, retreat, surge higher again, and companies have been unable to pass that along.

Lara Rhame (09:40):

I think the real question is whether or not that'll change this time around. But, you are for sure seeing it in goods. You're seeing nondurable goods prices recovering very strongly. You're seeing, again, all those durable goods prices higher, and services prices are normalizing. Whether or not it all happens at once or if it sort of slowly grows over the course of this year, the reality is we could be seeing inflation coming at us from several different directions. I think the real issue is whether, A, company's will be able to pass along the higher prices that they're

seeing to the consumer, and B, whether or not the consumer will really view this as temporary or markets will view this as sort of a one to two year phenomenon, or whether they'll view this as a long term shift to a higher inflationary regime.

Kara O'Halloran (10:43):

Yeah.

Lara Rhame (10:44):

That to me is the real issue.

Kara O'Halloran (10:45):

No, and I think that's interesting. I'm curious to see, I think about the last decade, and we didn't have much inflation. Right? If you get a small spike, if I were a company, I'm going to be hesitant to pass that on to consumers, because growth was so sluggish as it was. I don't want to lose my customer in that kind of environment.

Lara Rhame (11:06):

No, and technology, globalization, all of those are things which really forced competition and pricing power to really erode significantly, and those have not really gone away.

Kara O'Halloran (11:20):

That's true, that's true. We'll see. If we do, we cannot have an economist on the show without talking about the Fed.

Lara Rhame (11:31):

Yeah.

Kara O'Halloran (11:32):

Lara, put on your Powell hat. What, if anything, is the Fed going to do this year, if we do see any sort of rising inflation?

Lara Rhame (11:42):

Yeah. I mean, the conversation about inflation is directly applicable to monetary policy. The Fed right now has, during COVID it was ill timed, because they had begun their framework review, which is a fancy way of saying they wanted to really change the way that they are supposed to use policy to react to inflation. Because, the Fed has finally woken up to what markets have been telling them for a long time, which is that we're in a lower inflation regime, and we've seen decades of falling inflation. It's been 20 years now that the Fed has been unable to hit their 2% inflation target. They raised rates aggressively in 2017, and that in retrospect was a mistake that they had to unwind, because they tried to preemptively circumvent in a rise in inflation that never came. They had to unwind those rate hikes.

Lara Rhame (12:47):

They want to change their reaction going forward to inflation, and this is going to be the true test of that. If we get inflation higher over the course of this year, which we may very well, if we get inflation hitting sort of consistently above 2%, and we get long run inflation expectations rising above 2%, is that going to cause the Fed to race to tighten, or is it going to cause them, as their framework review would suggest, to let it kind of run hot? I put that in air quotes, because that's what you're here a lot. To let the economy run hot for years, to just kind of help to re-normalize after decades of chronically low inflation.

Lara Rhame (13:46):

This is going to be a really true test, and it's going to be, I think something. To me, I think they are going to err on the side of caution when it comes to rate hikes. They may very well, I think that the clear next step for monetary policy is to roll back their asset purchases, to reduce those, and offer less support just through pure monetary liquidity to the market. But, the inflation question drives straight to the heart of Fed credibility, and I think they're going to have a pretty big test coming over the next year, year and a half.

Kara O'Halloran (14:28):

Lara, how do we connect all of this back to markets?

Lara Rhame (14:32):

Well, clearly interest rates are where the rubber meets the road when it comes to the inflation consumers are facing and businesses are facing and how it impacts interest rates. Here's where we just all need to pause and really appreciate the fact that, with these astronomical growth rates, and consensus around these exceptionally strong growth rates, we're still seeing long term interest rates, what, today at 155, 150. That is just extraordinary to me. It means that there's either very little long term conviction that we're going to see growth higher than potential, or very little long run conviction that we're going to see inflation meaningfully higher in any way. Any way you slice it, it's a continuation of the interest rates at or near historic lows. That's what we've been writing about for a long time, Kara. I have no reason to change that outlook.

Lara Rhame (15:39):

Could interest rates, the 10 year treasury, could it get as high as 2% this year? Maybe. I think the more important question here is where, honestly, I look to you for the expert advice on how to navigate this for investors. What does chronically low interest rates mean for markets? I mean, that's really, I think, where this goes. Because, no matter what inflation does over the next year and a half, markets over the long term seem convinced that interest rates are, they have continued to drive interest rates very low.

Kara O'Halloran (16:17):

Yeah, absolutely. I mean, I think the first thing I'll say is that I do think it's become clear from our conversation that inflation is a pretty muddled picture going forward. I do think, touching on the inflation issue first, that some sort of inflation protection right now is an important component in a diversified portfolio. I think one of the first places people go to for that is commodities or other real assets, so real estate has been resilient. I think it's a great option right now, if landlords can pass along some of those price increases to their tenants.

Kara O'Halloran (16:52):

Looking at equities, I think first, I will instantly direct listeners to the podcast that Ryan Caldwell recorded last week, as it will go much more into depth. But, if the long term goal of your portfolios to generate a return in excess of inflation, then equities probably have the most upside. There are a lot of nuances there, but at the end of the day, if we do see some sustained pickup in inflation and the economy is growing above trend and earnings are growing, that's fundamentally good for equities. I think if you can find the sectors or companies with pricing power, and we talked about how tough that is, but if you can find those, then that's a good spot to be.

Kara O'Halloran (17:30):

To your point, I think the more immediate term that you have to talk about in the inflation conversation is interest rates. If we do see some of these interest rate spikes because we see

inflation expectations rising, like we saw at the end of February and early March, whether these spikes were due solely to inflation expectations is unclear. But, we do know that these long term interest rate spikes have had a lot of impacts across markets and portfolios, and not just on the fixed income side. A lot of equities are really duration sensitive as well, and trying to keep that in mind. Then of course, the fixed income side of things continues to be such a challenge, whether we see inflation or not. Lara, as you said, this is the issue of chronically low interest rates. Investors are really stuck between a rock and a hard place. You're stuck with-

Lara Rhame (18:22):

Yeah, there's nowhere to go.

Kara O'Halloran (18:23):

No, you're stuck with either a really low yielding core fixed income market that is uber sensitive to even these tiny changes in rates, or if we do see inflation rise and interest rates rise as well, your core fixed income isn't going to do so well. This is not a new story. We've seen this play out all year. Maybe investors are moving some of their fixed income portfolios into sub-investment grade to get some more income, some less duration sensitivity.

Kara O'Halloran (18:51):

Within credit, and Lara, as you know, that's where I spend the bulk of my time. But, people often look to senior secured loans when rates are rising. I have feelings about that asset class. I think structured products like CLOs are a really interesting way to play the floating rate story. If you are looking for something floating rate, I think there's a lot of opportunity in that market still on the income side, and on a total return basis, and I've written about that a lot recently as well. Then of course, we've talked about on the podcast before, about how high yield bonds are much less interest rate sensitive than many would believe, and in fact do pretty well during periods of rising rates.

Lara Rhame (19:34):

Yeah.

Kara O'Halloran (19:34):

I just think, I mean, it's tough. Right? Chronically low interest rates, it's a challenge on all sides of your portfolio, and I think one that I would say is not going away anytime soon.

Lara Rhame (19:51):

Yeah. I think, Kara, the recommendations you suggest are so important as hedges, as any sensible forward-looking investor needs to really consider. To me, I think this is where we all need to be conscious of the fact that, should we really see inflation play out, inflation return to what it was in the 1990s, say, of 2.3%, interest rates at that time, long term initiatives were 5.5%. That is a wholeheartedly different landscape than we're playing in right now. That would imply the need for an enormous rotation in your allocation.

Lara Rhame (20:39):

I think that is where, when I hear people talking about inflation, we've had so many one to two year increases in inflation that have been temporary, and we have been sort of slumped right back into this disinflationary funk, I think to me, you really have to, before you get concerned about anything more significant like that, you really need to sort of, I've been saying you need to wait to see the whites of its eyes for inflation. Because, we have had so many head fakes that have not panned out with a real long term increase in inflation or increase in interest rates. I think what you do need to do is, to your point, you need to make sure that if we do see something temporary for your interest rates rising for a year, you're not allowing that to erode

your performance at the margin. You really need to sensibly allocate your portfolio to prepare for that.

Kara O'Halloran (21:42):

Absolutely, absolutely. I think that is a good place to wrap up. I think this was a really great conversation, Lara. Thank you as always for joining us.

Lara Rhame (21:53):

Sure.

Kara O'Halloran (21:54):

I'm sure we'll have you back on soon. Thanks so much.

Lara Rhame (21:58):

Thank you. Have a great day.

Kara O'Halloran (21:59):

You too.

Speaker 3 (22:07):

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