KLEINWORT HAMBROS

SOCIETE GENERALE GROUP

Inflation: The great rate debate

As the world economy starts to emerge from the COVID shock, inflationary pressures are likely to build. Fahad Kamal, Chief Investment Officer of Kleinwort Hambros, notes that inflation could pose a huge risk to the market.

On the horizon lies a post vaccination world where a surge in economic activity could lead to a rise in inflation. Several arguments support this view:

1. While neither quantitative easing (QE) nor deficit spending are new, the sheer scale of the programmes today certainly is. In the US, the newly elected Biden administration has pushed through a $1.9 trillion stimulus package on top of the $900 billion support bill passed in December – together, they amount to a staggering 13.4% of GDP.
2. The money supply has shot up dramatically, particularly in the US. In previous rounds of QE, nothing on this scale occurred. Then the money multiplier remained low: with little demand for loans from households and businesses, much of the liquidity from QE got stuck on banks' balance sheets.
3. Given the rapid roll-out of vaccinations in most developed countries, expectations are that spending will surge once restrictions on mobility are lifted later this year, with the services sector benefiting in particular. Many economists are concerned that this unleashing of pent-up consumer spending will overheat the global economic recovery and stoke inflationary pressures.

For these (and other) reasons, inflation expectations have surged from their historical lows in the throes of the pandemic last year. If inflation continues to rise, central bankers may have to start raising interest rates. That could call into question the current prices of stocks, which are historically high relative to corporate earnings.

However, while inflation is a risk, I am not particularly worried at present. I see several mitigating factors:

1. The jobs market – there are wide output gaps in the labour market. US employers now report 10 million fewer jobs than before the pandemic, and US unemployment is at 6.3%, compared with 3.5% last year. Wide swathes of the public across developed economies depend on cash injections simply to stay afloat; this is where the stimulus is largely targeted.
2. Property – there is enormous underutilised capacity for office and retail property. If these difficulties are representative of the retail industry in general, the process of finding new owners and recognising losses for existing owners and lenders will be long and painful.
3. Energy – in March 2021, OPEC estimated that global demand for oil fell by roughly 10% in 2020. Given that their productive capacity did not shrink, the major OPEC producers showed remarkable restraint in cutting supply in order to maintain the price. But can it last? Several factors suggest it cannot – one being that all major producers have come under increased financial pressure since the pandemic started.

So prices may rise in the short term because of pent-up demand as economies experience post-vaccination bonanzas and subsequent increases in money velocity. However, I expect this increase to prove transitory, not structural. Moreover, this spending surge should lead to robust economic growth and higher employment. That should allow companies to increase sales and profits while maintaining margins, thus supporting the case for equities and risk assets.

Finally, I believe central bankers when they say they don't intend to raise interest rates until unemployment and economic activity are firmly back to pre-pandemic levels. They are more likely to act to curb higher bond yields by purchasing long-dated bonds, for example, than they are to raise rates and thus endanger a nascent recovery.

Contact us

Ben.Whitworth@kleinworthambros.com