GENERALI INVESTMENTS

Focal Point

Inflation still a distant threat in the post-Covid world

July 14, 2020

Authors: Christoph Siepmann, Martin Wolburg, Paolo Zanghieri

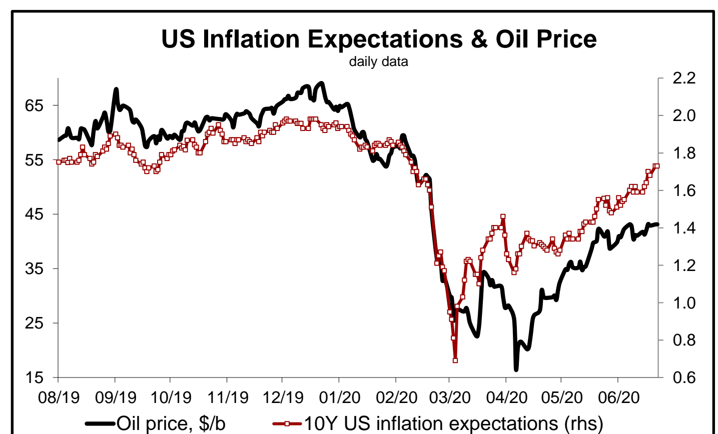
- The economic disruptions from Covid-19 are sending inflation on a downtrend, amplified by receding oil prices. With supply recovering more quickly than demand, excess capacities will keep inflation depressed this year and next.
- Further out, concerns are growing that ballooning central bank balance sheets may herald a rebound in inflation, tacitly welcomed by highly indebted governments. Deglobalisation, rising bargaining power of workers and increased industrial concentration may favor structurally higher prices over the medium term.
- That said, demand seems set to recover only very sluggishly from the deep crisis. This will keep the output gap wide for longer and demand for cash and excess reserves at central banks high. Depressed inflation expectations keep dragging on price pressures, while fiscal consolidation cannot be ignored forever. Accelerated digitalization is disinflationary, too.
- A marked acceleration of consumer price inflation thus remains a rather remote threat. A greater short-term risk is that asset prices will continue to absorb a significant part of the persistent monetary policy support.

The widespread lockdowns needed to fight the Covid-19 pandemic have led to an unprecedented slump in global economic activity. The resulting deepest recession since WWII has also changed inflation prospects dramatically. The gradual increase expected before the crisis has given way to a wide range of possible scenarios, including higher inflation or permanent deflation. We shed light on the underlying arguments and make clear why we expect high inflation (i.e. above 3%) to remain a rather distant threat also in the post-Covid-19 world. We sort our arguments from short, over medium, to a long-term outlook as we see the main drivers for inflation to change over time. While in the short-term the immediate supply and demand disruptions play the major role, medium-term the impacts of monetary and fiscal policy become more important and long-term structural changes are key.

Covid-19 temporarily suppressed inflation

The immediate impact of the pandemic is disinflationary. First, oil and commodity prices weakened. In March oil prices started to trend down even falling to levels slightly below 10 $/b Brent in April, with a price war between Saudi Arabia and Russia exacerbating the impact of slumping demand. With the end of the lockdown period, oil prices recovered but are currently still below pre-pandemic levels. We expect energy prices to prove disinflationary throughout 2020 and to only contribute to higher inflation from Q2/2021 onwards.

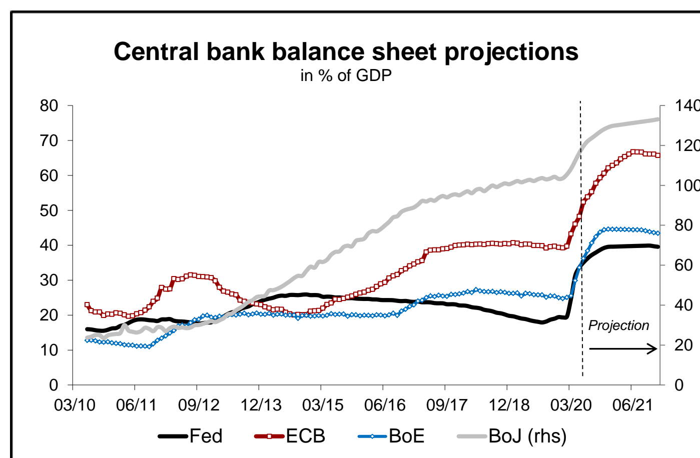
Second, underlying inflation will remain muted for the time being. The sharp and unprecedented recession has likely pushed output 18% below the pre-crisis level in the euro area and around 15% in the US in Q2/2020. With the lifting of the lockdown restrictions, productive capacity will be unleashed again. But supply seems set to recover faster than demand, keeping the output gap wide for longer. Following strong growth in Q3/2020, driven by post-lockdown pent up purchases, demand will recover at a rather slow speed. With unemployment at a post WWII high in the US while hidden by furloughs especially in the EU and lots of people in short-term employment, not only disposable income will fall but people tend to also increase precautionary savings. Uncertainty about the recovery and the fallout of the recession on firms' balance sheets will cap investment. Counter-cyclical fiscal policy measures have been launched in the US and the euro area but are not sufficient to fully compensate for muted consumption and investment activity. Some of the measures, like the temporary VAT cuts enacted in Germany, are directly disinflationary in the short term.



In sum, we see underlying inflation of currently 1.2% in the US and 1.1% yoy in the euro area receding further, mainly due to the output gap and lagged effects from lower oil prices. We forecast a stabilisation only in the second half of 2021, probably slightly below 1% yoy. We see headline inflation in the US (currently at 0.2% yoy) and euro area inflation (currently at 0.3% yoy) averaging respectively 0.4% and 0.3% in 2020. In 2021 we look for a rebound to below 1.5%, with the expected normalization of energy prices playing a major role.

Medium-term impact of monetary and fiscal policy

Will inflation overshoot? Looking further ahead there are concerns that inflation will rise beyond levels considered by central banks as consistent with price stability. A possible cause could be the massive central banks action in response to the Covid-19 pandemic. By 2021 we expect the balance sheet-to-GDP ratio to increase by some 25 bps in the US and by around 45 bps in the euro area. Moreover, central banks are currently rethinking their policy framework. To keep inflation at sufficiently high levels one of the ideas gaining traction is average inflation targeting, implying that inflation could periodically overshoot the inflation objective to compensate for earlier undershoots. We see a good chance that the Fed and the ECB (that will overhaul its strategy in 2021) will walk along these lines in order to reduce the risk of post-Covid-19 deflation. This would mean that the key central banks tolerate inflation above target following the recession.

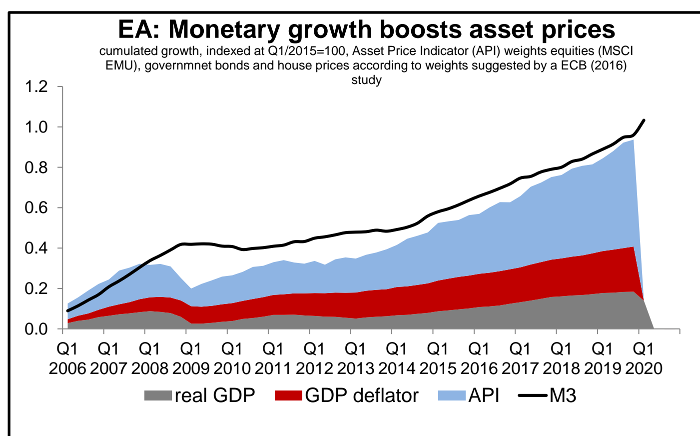


Central banks, some analysts fear, might also be forced by governments to tolerate higher inflation due to the risks posed by higher rates on a much higher pile of debt. According to the latest IMF projections, the response to Covid-19 will increase the global public debt-to-GDP ratio by 19 pp. It is obvious that the stabilization and even more the reduction of this huge pile of debt will be a major challenge for the coming decade. The Bank for International Settlements (BIS) routinely warns against the risk of “fiscal dominance”. If growth does not pick up strongly enough to offset the rise in debt, even legally independent central banks may de facto face a conflict between raising rates to keep inflation at bay and keeping them low in order to maintain debt servicing sustainable and to not crush growth.

We do not think so: While these concerns have their merits, they still appear overdone. First, after the 2008 Great Financial Crisis (GFC), the large expansion in central banks' balance sheets did not lead to higher inflation, as the impact of money creation was offset by capacity underutilization and weak wage growth. Moreover, the example of Japan shows that sustained and ongoing money printing has had no discernible impact on inflation. This is because banks have held rising amounts of reserves with the central bank instead of creating additional credit and stimulating demand.

We look for discernible effects from excess liquidity on asset prices but not so much on consumer prices. The asset class most directly impacted will be fixed income. Large purchases from central banks have propped up prices for sovereign and IG debt, depressing yields. Then excess liquidity may trigger risk-taking by lenders. Research shows that banks flooded by liquidity tend to lower their lending standards. Similarly, investors are likely to shift a higher part of liquidity into riskier assets. Search for yield caused by low risk-free returns will add to that, as in order to maintain the same level of nominal returns investors will have to shift to riskier portfolios. These two mechanisms will increase demand for riskier financial assets. Additionally, looser monetary conditions may increase leverage. The extra resources made available could in part be directed to real estate, propping up house prices. These possible wealth effects might additionally stimulate activity. In the post-Covid-19 environment this would primarily spur growth but not inflation, but increases risks to financial stability.

It is also worth noting that concerns about inflation overshooting are mainly expressed by consumers while financial markets care more about deflation risks. Quite noteworthy, 10-year implicit inflation expectations moved in lockstep with the oil price suggesting that markets fear a more permanent damage to price dynamics. The increase in inflation expected by consumer may be a reaction to the deep, but temporary disruption of retail activity.



We also doubt that central banks will be willing and able to actively support governments with measures to reduce the real interest burden while increasing inflation above target. It would squarely run counter central bank independence and thereby reduce its power.

Even without explicit (and next to impossible) changes to the Central banks' mandate, more subtle attempts to undermine central bank independence would very likely face stiff public resistance, all the more as an ageing population and electorate will be keen to defend the real value of their pensions. We think that the central banks will also realistically not be able to inflate government debt away. Unless

the central bank pursues yield curve control, financial markets will adjust the inflation premium according to the changed central bank behaviour. Hence, central banks would need to surprise markets on the inflation outcome each year on the upside resulting in double-digit annual inflation over the medium term. An average inflation target probably gives the central banks some more leeway but does not remove these obstacles. Instead, it would only be a smart tool addressing the key concern namely that markets, people and firms might adopt themselves to a low-inflation environment.

Long-term structural changes key

In the long run, assuming that a Covid-19 vaccine is found and the policy response has ebbed, inflation will predominantly be driven by fundamental productivity and wage trends. These, in turn, depend on market structure (incl. competition) and consumer behaviour. Both may be influenced by lasting fallouts from the Covid-19 crisis. In this regard, the supply safety of health products stays in the spotlight as governments may deliberately intervene with new (price driving) requirements. Moreover, large firms might be better suited to survive COVID, which could lead to more price setting power in the future. However, overall we see the pandemic to likely accelerate trends that had been already underway before. What are these “mega-trends” and their impact on inflation?

De-globalisation: Since the GFC, the 20-year old trend to shift certain types of production into low wage-cost countries and to fragment the assembling process into ever longer supply chains has started to soften. Therefore, the deflationary shock from integrating emerging markets into the world economy started to fade. Accordingly, some fear a further move away from integrated markets could – by symmetry of the argument – lead to permanently higher inflation. A more detailed look reveals that there are two forces which contribute to the deglobalisation phenomenon albeit with contradicting implications for inflation. As we discussed in greater detail here, we see in sum “slowbalisation” as the most likely outlook. In this scenario, the upturn in inflation from protectionism will be tempered by efficiency gains from increased automation and digitalization. Moreover, the social contract will change (see below).

Protectionism: Protectionism will likely keep simmering. Over the last 30 years, lower prices for consumers came at the cost of a structural change involving a rise in low paid employment and higher inequality in Western countries. This fuelled a strong political backlash against globalization and multilateralism, most outspoken by President Trump. He also used the COVID-19 pandemic repeatedly as a pretext for trade restrictions. Tariffs, quotas or even verbal political interference that aims at reducing the level of supply safety will accelerate tendencies to reconfigure global supply chains (in Trump’s words “to bring home production”). This will come with a loss of productivity and therefore raise inflation. However, as we foresee these trade conflicts simmering but not exploding, the impact on inflation should stay limited.

Automation/Digitalisation: Moreover, so far protectionism explains only a small part of the slowdown in globalization. A deeper economic reason is that advanced digitalisation and automation will allow for new methods of production. Wage differentials – the driver of the last wave of globalization – will become less important. Firms will focus on mass customisation as well as green and value-oriented production instead. At the same time, advanced services will potentially benefit from global digitalisation. As these shifts will likely improve efficiency, this should lower inflation. However, mass customization will also allow firms some monopolistic power, thus the gains in efficiency will not be fully felt in lower prices.

Inequality and new social contract: Efficiency-driven reshoring will hardly resuscitate lost employment. Protectionism and automation/ digitalisation are therefore opposed forces in terms of workers relative bargaining power on the labour market. The OECD estimates the jobs at risk to partial or substantial automation between 30% and 65% in the longer run. Consequently, the splits in societies and the inequality problems could further intensify and (democratic) governments will need to respond. Social security topics will likely generally rise on their agendas. Apart from supporting job qualifications, minimum wages and more redistributive policies including higher taxes on capital owners will probably gain momentum. This will add to an uptick in inflation. Thus in the long run, protectionism and the new social contract will tend to raise inflation, mitigated by rising productivity from IT technologies.

Upshot: Neither deflation nor too much inflation

The Covid-19 pandemic emerged as a new factor for the inflation outlook. While short term the disinflationary or even deflationary risks clearly dominate, the balance of risks is less clear when looking further ahead. Weighing all the arguments we continue to find it hard making the case of overshooting inflation. Especially we are sceptical that central banks will be willing and able to generate a high inflation environment. We look for inflation to merely recover slightly above 2 % in the US and close to 2 % in the euro area beyond 2022. When looking at the long term drivers of price dynamics we gauge that the disinflationary effects from digitalization and automation will temper the inflation augmenting tendencies from higher protectionism and a likely emerging new social contract. We see the balance of inflation risks on the upside in the long term.

Markets remain more concerned about low inflation, currently pricing an average inflation rate of less than 0.9% yoy in the euro area and 1.7% yoy in the US over the coming ten years. This looks low indeed. Low realized and expected inflation gives central banks both the need and the justification for a prolonged monetary stimulus. As a consequence shoring up the economy and avoid deflation may require depressed rates for longer and a more sustained upswing in activity to convince investors that central banks can still deliver on their inflation targets in the post-Covid world.

Imprint

Issued by:	**Generali Insurance Asset Management S.p.A. SGR, Research Department**
Head of Research:	Vincent Chaigneau (vincent.chaigneau@generali-invest.com)
Head of Macro & Market Research:	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
Team:	Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com) Elisa Belgacem (elisa.belgacem@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)
Head of Insurance and AM Research:	Michele Morganti (michele.morganti@generali-invest.com)
Team:	Raffaella Bagata (raffaella.bagata@generali.com) Alberto Cybo-Ottone, PhD (alberto.cybo@generali.com) Mattia Mammarella (mattia.mammarella@generali-invest.com) Roberto Menegato (roberto.menegato@generali.com) Giovanni Millo, PhD (giovanni.millo@generali.com) Antonio Salera, PhD (antonio.salera@generali.com) Cristiana Settimo (cristiana.settimo@generali.com) Federica Tartara, CFA (federica.tartara@generali.com)

Sources for charts and tables:	Thomson Reuters Datastream, Bloomberg, own calculations Version completed: see front page

In Italy:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

Piazza Tre Torri
20145 Milano MI, Italy

Via Niccolò Machiavelli, 4
34132 Trieste TS, Italy

In France:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Insurance Asset Management
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-investments.com

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio considers as reliable. However, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio periodically updating the contents of this document, relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible changes or losses related to the improper use of the information herein provided. Opinions expressed in this document represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. They do not constitute an evaluation of any strategy or any investment in financial instruments. This document does not constitute an offer, solicitation or recommendation to buy or to sell financial instruments. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio is not liable for any investment decision based on this document. Generali Investments may have taken, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Any reproduction, total or partial, of this document is prohibited without prior consent of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro-Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..