M2, Fiscal and US Inflation

8th June 2021

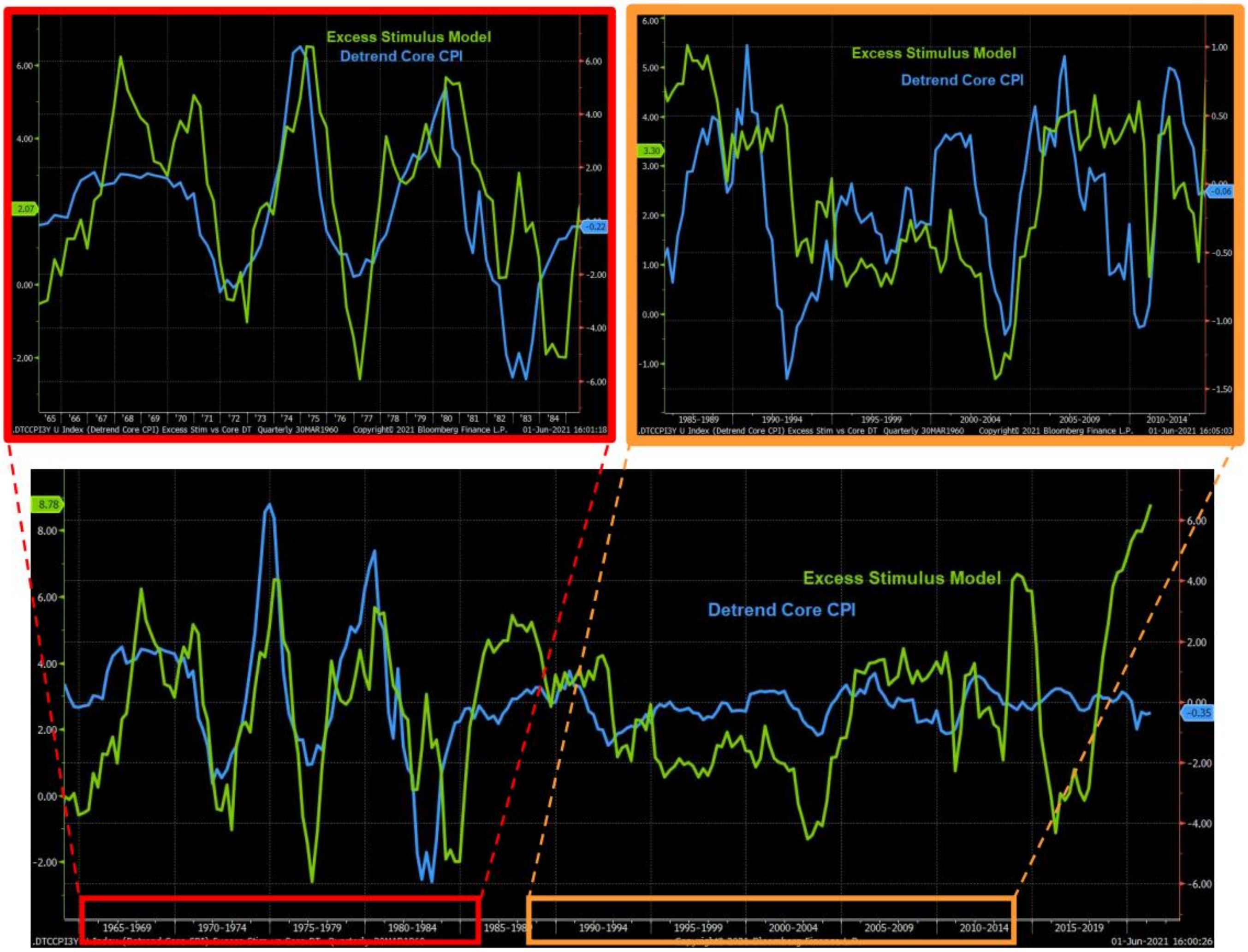
Summary

- This week should mark the high on US CPI, albeit at close to 6% YoY vs 4.7% forecast
- However, our concern is the longer-term consequences of recent M2 and fiscal largess
- In the last 55 years, we haven't seen anything close to this degree of combined stimulus
- As a result, our model suggests that into 2023, the result will be far, far higher core CPI

A couple of weeks ago, we set out a case for a shift in the US inflation debate, from the likely peak in the current impulse and towards how long pressures might persist ("Inflation: A Shift in the Narrative" 27th May). This idea was underlined by last week's slight drop in both the ISM Manufacturing Prices Paid Index and by the Swedbank Raw Material Price Index in Sweden. However, as we explained, just because we are hitting a zenith in the current acceleration, it doesn't mean we are in the clear. In particular, we highlighted that we were looking at the potential inflationary risks posed by the combination of massive fiscal spending and money supply growth. Today, we want to share our findings.

As is typical with our macro work at MI2, the starting point was a model. In it, we attempted to capture the combined stimulus impact of fiscal and monetary expansion relative to trend growth. Visually, aside from the scale of the current impulse, what is striking is the way the model leads by two years and does a great job capturing inflation outcomes from the 60s to the mid-80s.

The problem is that from there on, it appears to break down. However, on closer inspection, that's not true. As you can see in the pop-out chart below, the model continues to catch the turn. Instead, there is a one-time shift in the relationship's beta, as the volatility of both the model and inflation fall. We don't believe this is a coincidence because the mid- '80s marked the beginning of the "Great Moderation", when economic cycles were modest, and inflation expectations remained firmly anchored. As a result, the economy didn't need the aggressive swings in fiscal spending and money growth that marked the prior 20 years. Unfortunately, that's no longer the case, with the Federal deficit at over 16% of GDP and aggregate M2 up almost 30% since last spring.



So, what does it all mean? Bottom line, our work suggests that historically, the combination of loose fiscal and money growth is disproportionately more effective than monetary policy alone in stimulating growth. What's more, the current "excess stimulus" is <u>unprecedented relative to the scale of past contra-cyclical policy</u>. As a result, it is firmly in the "shock and awe" ballpark, making it more than capable of overwhelming the economy's productive capacity and driving inflation higher over the next two years. Just how high? Well, as the chart shows, we have used "detrended Core CPI" to remove the effects of structural shifts. <u>However, using this model and backing out the detrend, Core CPI could reach low double-digits before 2023.</u>

Numbers of that size sound utterly fantastical, and ultimately, nothing is baked in the cake. For example, should the Biden Administration pivot towards austerity, it would greatly assuage our concerns. However, we suspect that they will try their best to keep the economy ticking over with more fiscal support ahead of the Midterms. Therefore, while we believe that this week's CPI will likely mark the high in the current impulse (albeit with CPI closer to 6% than the currently expected 4.7%), it would be foolhardy to ignore the unprecedented size of the inflationary impulse that is working its way through the system. That's because, while we can hope that the beta of CPI to these forces is lower than in the past, the sheer size of the stimulus dwarfs anything seen in the last 55 years. Hence, we believe it is folly to assume that beyond a short respite courtesy of base effects, US inflation is in anyway "transitory".