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Inflation Nation (Third of a Series)

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As part of our continuing inflation series, we caught up with Joseph Lavorgna, Natixis' chief US economist, who just returned from a stint as chief economist of the National Economic Council.

"People forget what real inflation is," he told us. "I was seven years old during the oil embargo in the 1970's when there were gas lines. It was a long process getting to that level of inflation. You had the guns-and-butter roll out of costs under LBJ's Great Society programs plus spending for the Vietnam War. All combined with easy money Fed policies. The 1970's oil shock took prices from $4/barrel to $40 – a 10-fold increase. Imagine going from $60 oil to $600 today.

"That time comprised some unique elements. First, there was no Fed rate tightening! Then there was the second oil shock in 1979, followed by double digit inflation for several years. But unlike the current period, that era was marked by two decades of bad macro policies and exogenous shocks.

"Today we've compressed years of economic build-up into one. And the character of the economy has changed. Inflation expectations are stable, you've got a much more global economy, and demand of products and services have outstripped supply. Not a lot of upside pressure on wages, and whatever's there is offset by productivity gains. The price gains we are seeing represent a post-pandemic price level shift. Further economic reopening will mitigate supply-side bottlenecks.

"The market is discounting around 2.5% headline consumer prices over the next five years. This is not a lot. Expectations of the terminal Fed Funds rate are barely above 2%, down from near 2.5% in the last business cycle. The 10-year Treasury should not sell-off much more. Expect more money to flow into financial and real assets."

What metrics do you watch? "If the Michigan survey of five-year inflation expectations, now in the 2.7-2.8 range, goes to 3% or more on a sustained basis, that would worry me. I would also look at wage trends. The first quarter labor cost numbers are pretty tame, but if those accelerate, that would be concerning. Then there's energy. Summer seasonal numbers are disjointed; last year was negative. If energy is down, it's hard to see inflation getting too high.

"The media is certainly in an 'Everybody's talking about inflation' mode. If we're in an environment where rates are peaking and GDP slowing, then inflation won't be an issue. Lumber prices are up massively, but they aren't going up forever. Covid restrictions have hampered production. The current commodities boom will eventually slow. Having a 3-4% GDP growth would be over the historic trend line."

What will the Fed's response be? "The biggest inflation risk is a slow, insidious rise. The Fed has created a massive increase in asset prices, particularly in real estate, equities, and collectibles. A Mickey Mantle rookie card was valued at $300k not long ago. One just sold for $5.5 million! Short-term, any inflation surge will be temporary. Inflation has been in places the Fed doesn't want it to be. Quantitative easing has created higher asset prices rather than in goods and services.

“The Fed balance sheet is so big now, it’s just under 40% of GDP. The effect has been to push investors up the risk spectrum. If the Fed tries to reverse course it could lead to a pullback in risk assets, halting any shift in monetary policy. Remember it took seven years following the Great Recession from the last Fed rate cut to the first Fed rate hike in December 2015. And another year before the Fed began lifting rates in December 2016. creating a floor on asset prices.

“Finally, I would watch moves in the trade-weighted dollar [DXY]. If the dollar collapses, that could be a problem. This is where an historically large twin deficit—budget deficit plus trade gap—poses longer terms risks.”

Next week we wrap up our series with inflation’s impact on asset performance.