INFLATION — YESTERDAY'S PROBLEM?

Boom boxes, Polaroids, floppy disks and phone books — these are mostly alien to younger generations today, consigned to the past thanks to the wisdom and technology of our age. With only one of the last 35 calendar years exhibiting inflation above 5% in the US, is high inflation just another quaint phenomenon to be added to the history books? Or is it a dormant risk lying in wait?

For some observers, the runaway levels of inflation observed in the 1970s and 1980s are unequivocally a problem of the past. A combination of central bank independence, structural reductions in the strength of organized labor, decreasing reliance on fossil fuels and improvements in technology that lower consumer prices has made inflation more easily controlled by policymakers, and high levels of inflation are unlikely.

However, others argue that inflation is almost inevitable as unemployment reaches secular lows in the US and the UK, a reversal in demographic trends will see rising dependency ratios in the decades ahead, and central bank policy remains extremely stimulative in a historical context.

The reality is that we cannot know for sure. Inflation is a complex phenomenon driven by many interacting forces within an economy, and although some of these relationships are relatively well understood, others are not.[1] Consequently, we are cautious about making bold predictions around the likely level or direction of inflation over time.

We do believe, however, that the balance of inflationary and disinflationary forces is shifting in a manner that suggest an increasing number of plausible scenarios in which inflation could move meaningfully higher than current levels in developed economies.

PEAK GLOBALIZATION

Inflation and wages — and by extension, the labor market — are intertwined, and for the last few decades, the increasing globalization of the labor market has acted as a disinflationary force, as it has opened up cheaper labor markets in emerging economies. This has reduced the bargaining power of workers in developed economies and exerted downward pressure on both wages and prices globally.

However, the influence of this relationship may be waning as previous sources of cheap labor in Asia, Latin America and Eastern Europe see their wages and living standards increase and the options for low-cost labor outsourcing reduce. Although there may be scope for further trade liberalization to drive production costs down globally, there is perhaps a greater chance of moves in the opposite direction ("deglobalization") given the current tensions surrounding global trading relationships.

FEWER WORKERS AND MORE RETIREES

Another inflation driver, with a long-term trend that may be changing direction, is global demographics — in particular, the proportion of the total population that is working versus the proportion not working (that is, the dependency ratio).

There is a lively debate around how changes in the dependency ratio may influence interest rates and inflation, but a compelling argument centers on the supply and demand for goods and services. In simple terms, the argument is that children and retirees contribute only to the demand for goods (via consumption), whereas the working age population contributes to both the demand and the supply of goods (via consumption and production of goods). The dependent population (children and retirees) therefore provide an inflationary impulse to the economy, whereas the working age population tends to be a disinflationary force (since its production tends to exceed its consumption).

United Nations population projections suggest that we are at, or close to, a turning point in the global dependency ratio. This could mean that a longstanding disinflationary force may turn into an inflationary one over time.

1 For an interesting, although somewhat technical, discussion of some of the limitations of our understanding of inflation, please see a presentation by Claudio Boria, Head of the Monetary and Economic Department at the Bank for International Settlements, titled, "How Much Do We Really Know About Inflation," presented at the 87th Annual General Meeting of the BIS in June 2017, available at https://www.bis.org/speeches/sp170625a.htm.

CYCLICAL PRESSURES

In addition to the structural drivers, a further inflationary impulse arises from cyclical pressures in the current economic environment. Although cyclical drivers such as low levels of unemployment and strong global growth can, to some extent, be offset by tightening monetary policy, cyclical forces are arguably more inflationary today than at any time since the global financial crisis. This is particularly true in the US, where fiscal stimulus is being applied at a time when the economy is already facing late-cycle inflationary pressures.

Running counter to the above, it is worth noting that technology is likely to remain a powerful disinflationary force for decades to come, with the prospect of rapid increases in automation placing downward pressure on wages and production costs. However, it is extremely difficult to assess the likely pace of technological development and its impact on inflation over time.

Given the challenges of determining the drivers of the inflationary process and the complex interaction of the forces, we would caution against emphasizing a firm prediction on the likely level or direction of inflation over time. However, our discussion highlights that the balance of inflationary and disinflationary forces in the global economy may be changing, and we would argue that inflation risks are currently skewed toward the upside from a cyclical standpoint. Investors should therefore avoid biasing portfolios in a way that assumes a continuation of past trends and seek to ensure that portfolios are likely to be robust in inflationary scenarios.

Building on a clear assessment of an investor's inflation needs (driven by the investor's objectives and liabilities), we encourage inflation-sensitive investors to review the balance of risks within their portfolios and, in particular, the extent of their exposure to higher inflation scenarios.

Inflation-sensitive investors holding portfolios dominated by broad market equity and fixed interest bonds could consider diversifying both their growth and their defensive portfolios. Within growth portfolios, real assets — both listed and unlisted — may provide some degree of inflation sensitivity. Within defensive portfolios, inflation swaps, inflation-linked bonds, shorter-duration bonds and floating-rate assets are likely to prove more robust under higher inflation scenarios than traditional fixed interest government and corporate bonds.

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