Inflation post #2: The Genie is out of the bottle. Date 2022-05-18

As of May 2022, US inflation is running at a YoY rate of 8.26% (CPI) and a 3m annualised rate of 11.33%. The current reading has remained almost unchanged from the previous month's value of 8.54%. My monthly inflation monitoring reports have anticipated that high inflation readings would be exacerbated by seasonal effects from March, and with this effect continuing into the summer, I wouldn't be surprised to see a 10% reading in the coming months.

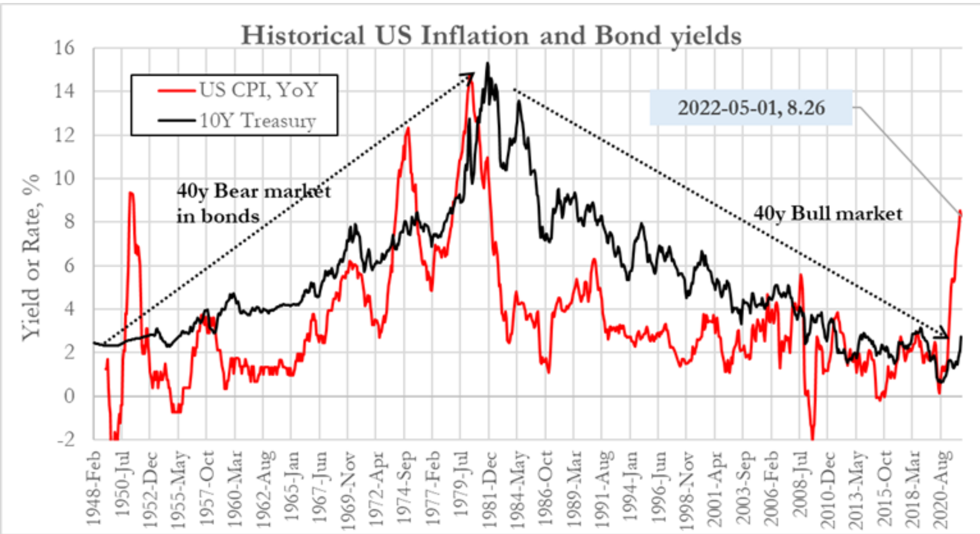
<u>Is the Genie out of the bottle?</u>

Yes it is.

The genie was released out of the bottle through the economic policy response to the pandemic. The monetary stimulus injected led to the expansion of the money supply by 25% in 2020 alone, and by another 12% in 2021. Politically, before 2020 such an extraordinary path of action would be unthinkable (due to the grey voters), but the pandemic allowed a shell-shocked population, gripped by fear, unknowingly to accept almost any action by policy makers to "manage the crisis". We are now going to have to deal with the collateral consequences of such actions.

<u>The historical perspective:</u>

By looking at inflation historically (see graph) we observe that 2021 marked a breaking point from the subdued inflation we've experienced since the mid-1980s. I believe that the current inflation we're experiencing is not temporary but quite the opposite, it marks the start of a new period of inflation which could last a decade or more, depending on the policy actions by those who control the supply of money.



<u>The current consensus:</u>

In October 2021 my research on inflation indicated to me that we would experience the current surge in inflation, peaking later this year. Back then, my view was very distant from the consensus at the time, where inflation was seen as a transient phenomenon caused by global supply chain disruptions.

At the present moment (May 2022), central bankers have already recognized and started taking action to rein inflation in. Their view is that they have the policy tools and will to do what it takes to tackle inflation. They believe that with these actions, inflation will, over time, be back to its 2%-2.5% target. The bond markets agree with this assessment as shown by the market-implied inflation rates in the table below.

Date	01/5/2022
5y Breakeven rate	3.3
10y Breakeven rate	2.88
5y-5y forward rate	2.46

The consensus view is that 5-year inflation will be an average 3.3% a year and inflation over 10 years will stand at a reasonable 2.88%. The market clearly expects to see inflation return to "normal" levels after the current temporary surge subsides.

As mentioned before, I believe this is wrong and that we'll experience an average inflation of about 6.8% in the coming 5 years. The next 5 years will be a roller coaster with periods where deflation actually seems to be the greater danger and periods of stagflation that will confuse policy makers and the markets. The longer-term inflation outlook will depend on the policy actions in the coming years, and how the Fed balances moral hazard and price stability.

These will be interesting times as the great experiment with unconventional monetary policy will finally be put to the test, and the moral and political fibre of the Fed board of governors will be brought to light.