Exchanges at Goldman Sachs

Inflation: Here Today, Gone Tomorrow?

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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research and creator and editor of the firm's Top of Mind report.

In this episode, we're focusing on the topic on everyone's mind right now - inflation. US inflation has risen to 30 plus year highs. And while much of the recent price rises likely owe to pandemic related factors that seem set to unwind, the higher inflation goes and the longer it lasts, the greater the concern that so called "transitory inflation" could become more persistent with potentially large implications for the economy, the Fed, and markets. So, where inflation goes from here is Top of Mind.

We first speak with Mohamed El-Erian, President of Queens' College Cambridge University and Chief Economic Advisor at Allianz, who's concerned that inflationary pressures are change behaviors on the ground in ways that could prove more persistent than many observers, including the Fed, expect. This is important because the key question when it comes to inflation concerns seems to be whether price changes start to shift people's expectations of future price changes. And if that happens, we could be in for an inflationary spiral, which El-Erian warns may not be well captured by market-based measures of inflation expectations.

Are you worried that the Fed is too optimistic about the inflation outlook?

Mohamed El-Erian: Yes, I worry. While the Fed has taken a step away from its narrative of transitory inflation, and it had no choice because the numbers, the trends are very clear, it's still holding onto this new phenomenon of, and pick your phrase, either extended transitory, assistantly transitory, or rolling transitory. Now, as an economist, I have issues with that characterization because the whole point of transitory inflation is that it doesn't change behaviors on the ground.

And what we are seeing, whether it's in wave setting behavior or in price setting behavior, behaviors are changing. Which, for me, implies that in the true sense, inflation is not transitory. That the economy is adjusting to a price shock. And that we have to ask seriously what comes after that adjustment.

So, my concern is that we may have inflationary expectations slowly getting deanchored. That's my concern. The underlying causes of inflation, it's deficient aggregate supply given where demand is. That's how I would put it. Why do we have deficient aggregate supply? Part of it is transitory. But part of it has to do with structural changes that are going to be with us for a while.

So, supply chain disruptions are not just about the ports in Vietnam and in China being shut down by COVID. It is also because company after company is now putting resilience ahead of efficiency and looking to rewire their supply chains. So, there is a structural change going on.

In the labor market, we've seen it's not just an issue of unemployment benefits. Labor force participation is stuck at 61.6 percent. It is also that people's propensity to work has changed. So, there is a longer term structural and secular element to the inflation. It's not to deny there are short-term issues. There are short-term issues. But you also have to be much more open to the fact that there are longer-term issues.

So, in a balance of risk framework, the balance of risk is both ways. Type one error is that you overreact to transitory inflation. And that is what the central banks and the Fed in particular is focused on. But there's also a type two error: that you don't do enough in response to secular inflation trends. And if that happens, you deanchor inflation expectations.

Allison Nathan: So far, they've remind pretty well anchored. So, what do you think would be the catalyst for deanchoring them?

Mohamed El-Erian: Survey inflation expectations are not well anchored. You're above 4 percent, both for the short term and long term. Market measures are better anchored. But don't forget that you have a non-commercial buyer. Fixed income markets have been and remain highly distorted by incredible injections of liquidity. You've got to respect the fact that you are in a marketplace with someone who will buy regardless of what the valuation is. And you've got to respect that. Otherwise, you get steamrolled.

So, I always say be careful of the unusual measures we have in the marketplace because you don't know how much you need to adjust for the amount of distortions that have been introduced.

Allison Nathan: Although the Fed has recently begun to taper its asset purchases, El-Erian is concerned that it's not acting quickly enough to deal with inflationary pressures, potentially setting the stage for a historic policy mistake.

Mohamed El-Erian: Look, I view this as very simple.

Between the choice of easing off the accelerator and slamming on the brakes. That is the choice. And unfortunately, there is an increasing probability that by not easing off the accelerator early enough you're going to have to slam on the brakes.

Let's just remember what the initial conditions are. The Fed is still buying 120 billion dollars of securities every month. That's going to continue. It's going to continue buying. It's going to be reducing it just by 15 billion a month. That means their balance sheet is going to increase. It is still buying within that 120 billion, 40-billion-dollar mortgages. I don't know a single person that says the housing market has a problem. I know a lot of people who tell me the housing market is so hot that a growing number of Americans are being priced out of the housing market.

It is not clear to me why it is that we need emergency levels of asset purchases, emergency level of interest rates at a time when the emergency has passed.

Now, when you run an emergency monetary policy when you don't have an emergency, you start worrying about the unintended consequences and the collateral damage. There's underlying damage happening. My worry is that we may end up, and I'm not saying this is the baseline, I'm saying this is the risk scenario, with multiple sources of tightening at the same time. Fiscal. Household savings. We could also have a market tightening of financial conditions. And we could also have business investments coming down at the same time.

So, if we're not careful, the risk scenario is that the policy mistake results in so many sources of tightening that we end up in recession.

Allison Nathan: Jan Hatzius, Goldman Sachs' Head of Global Investment Research and Chief Economist is somewhat less concerned about the inflation outlook. Although inflation surprises have led our economists to substantially raise their inflation forecast over the past several months, he maintains that inflationary pressures are set to gradually subside later next year as durable goods prices reverse some of their previous run up and commodity prices stabilize, even as wage and rent pressures are likely to persist.

Jan Hatzius: I have confidence that inflation is going to come down next year. And that is basically because there's such an enormous contribution from components which is very difficult to believe that they're going to keep going up at anywhere near that rate in, like, durable goods, autos, sporting equipment, furniture, things like that. I mean, we can debate how long it's going to take for them to normalize. But I would be pretty astonished if they kept rising at anywhere near this rate. So, that's already taking away a large amount of inflation. I mean, they're contributing 1.3 percentage points to core PCE inflation, and something like 2 percentage points to core CPI inflation. So, I think that's going to come down a lot.

I think the direct commodity contribution to headline inflation is going to come down a lot. And that's because even if commodity prices stay at these very high levels, then the contribution to inflation is going to come down significantly from that as well.

I'm much less sure whether we're going to come down to, say, 2 percent core PCE inflation or 2.5 percent core PCE inflation or something in that sort of range. That's hard to know. I'd be really surprised if it was still a three handle. But two handle, maybe high ones, I think, that's all within the range. And that's going to depend on some of the things that are just harder to be sure about, namely what happens to wages, what happens to rents? Clearly there's acceleration there. We don't really know how pervasive that acceleration is going to be. And that's going to determine where in that range you end up falling.

Allison Nathan: How concerned should we be about that risk of more persistent upside wage pressures?

Jan Hatzius: We are somewhat more concerned than we were a few months just because the data have pointed in that direction. I mean, our wage tracker, which tries to adjust for changes in the composition of the workforce, which that's a pretty important adjustment in the wake of the pandemic, I mean, that's running at 4 percent year on year. But if you look at some of the sequential increases in wages recently, they've been running in the sort of 5 to 6 percent range.

Four percent is okay. That's quite consistent with 2 percent inflation or something in the neighborhood of 2 percent inflation. 5 to 6 percent probably wouldn't be consistent with that. So, if we saw those kinds of numbers going through 2022, I think that would be a reason for concern.

There are some areas where I would expect some relief. I mean, the end of the extended unemployment benefits, I think, is going to reduce wage pressure at the bottom end of the pay scale. Admittedly, the evidence so far since Labor Day when those benefits lapsed is somewhat murky. But I think it's very unlikely that we're going to continue to see double digit increases in wages at the bottom end of the pay scale.

I think there is still slack in the labor market. I agree that labor force participation is probably not going to come back to the pre-pandemic levels. I mean, maybe not ever because there's also a structural downward trend from population aging. But even accounting for that structural downward trend, I would expect that some of the weakness in particular from early retirements is going to be lasting.

So, I think we are not at full employment at the moment. But probably not nearly as far away as the fact that we're still missing 4 million jobs would suggest. We're probably quite a bit closer than those numbers would indicate.

Allison Nathan: But even if we're expecting some stickiness in upward wage pressures, Hatzius doesn't see much evidence at this point of inflation expectations becoming deanchored or of the inflationary spiral that worries El-Erian. And argues that at least some changes in people's behavior that generate inflation in the economy are actually desirable.

If we take a step back, really it just comes down to whether or not these pressures are going to influence or are influencing inflation expectations. So, what are you watching in terms of inflation expectations? And is there any reason to be concerned about a higher drift or even the scenario where they become deanchored?

Jan Hatzius: I think the things I'm watching is kind of a broad range of forecast expectations, market expectations, and consumer expectations. And the issue, I think, with inflation expectations is that what you really care about is the expectations of people making hiring and job search and pricing decisions in the real economy. The people that have well-formed expectations are forecasters and bond traders. But they don't really make those kinds of decisions. That's one reason why no inflation expectations measure is perfect. And I would say take a broad look at all three of these different types of measures.

I also am a fan of focusing on forward expectations. I don't really care that much about short-term inflation expectations because they tend to be very influenced by recent headline inflation and, to a large extent, what happen to oil prices and gasoline prices. So, they don't typically have a huge amount of new information about the things that we really care about which is the extent to which, you know, behavior is going to be affected by shifts in expectations.

If you look at forward expectations, you know, five-year, five year forward, or whatever forward measure you can construct and want to look at, in general, I'm still pretty reassured. You know, up till now, so far so good, we have not really seen an increase in forward inflation expectations to levels that would be at all uncomfortable from the Fed's perspective. I mean, they're still very consistent with 2 percent. And these things could change. And if they change, it would be a significant development. But I think so far, so good.

Allison Nathan: Some observers argue that market expectations just don't send a very clear signal right now just because of the outsized presence of the Fed in fixed income markets. So, is that a signal we should be looking at at all?

Jan Hatzius: They don't buy nominal bonds and tips, you know, to achieve a particular level for break even inflation rates. And also, they're one participant in the bond market. If market participants had a strong view that inflation really is going to be significantly higher than whatever the break-even rate suggests, then there would be a large profit opportunity to invest on that basis and basically take the other side of the Fed.

So, I mean, I'm certainly not saying that market inflation expectations and break-even inflation rates are perfect by any means. I mean, they have their issues. You know, risk premia and liquidity premia influence them. And again, the deeper is that they don't measure the inflation expectations of the people that actually make the pricing and wage setting decisions. But I would still use them as one high frequency, real time input that deserves some weight.

Allison Nathan: This idea of influencing behaviors of people who are making these decisions, well, we're already changing behavior. We're already seeing changes in behavior that then could prove persistent. So, aren't we already seeing signs that this is getting more embedded?

Jan Hatzius: We are seeing some changes in behavior. To some degree, the Fed wants some changes in behavior. The ECB wants some changes in behavior because they felt that inflation was somewhat too low going into this. So, directionally, that's quite desired.

Now, are we seeing changes in behavior that are larger and going to be more persistent than what's needed to achieve half a percentage point more inflation in the next ten years than in the last 20 years? It's possible because, again, some of the wage numbers, I think they're close watching. But otherwise, in the expectations numbers, I don't see that. In the wage numbers, I don't really see that if I look at the year-to-year numbers. If I focus on some of the higher frequency numbers, yeah, it's something where there is some risk, I think. And so, we need to continue to watch that closely. But there's also a lot going on in the economy. It's still an economy that is emerging from an incredibly unusual period. I think you have to be a little bit careful not to put too much weight on, especially, high frequency observations of wage changes because it may just be that we're going through a sufficiently weird period that it just doesn't mean that much for where we're going to be a year from now.

Allison Nathan: All that said, Hatzius expects the Fed to gradually continue to tighten policy which he views as a reasonable course of action for now.

Given what you expect in terms of inflation and, of course, growth, you know, where do you see the Fed? And where are the risks around that, especially if inflation ends up looking more persistent than we expected?

Jan Hatzius: I mean, it depends on the degree. So, our baseline forecast is that taper runs through the middle of June and then relatively shortly thereafter, maybe July, they decide to lift the funds rate. So, tapering more into tightening pretty seamlessly. But it's a gradual tightening where you basically get a hike about every six months. And that, of course, is very much predicated on the view that the inflation overshoot still turns out to be mostly transitory and we get back to the neighborhood of 2 percent, 2.25 percent or so over the next two years. That is our forecast.

If it ended up being 2.5 percent, yeah, maybe that's still the right ballpark. If it ended up being 2.75, that already would probably put the Fed on a faster tightening cycle. And you can't rule out something in the 2.75 range. I think 3 percent, quite a bit less likely in my view. I mean, I don't think a three handle is at all likely. But that would require and probably prompt a significantly more aggressive monetary policy response with quarterly hikes or maybe more. It's conceivable. And so, it would change the outlook quite a bit.

I don't know that any of those outcomes would necessarily make them taper faster and hike before June. June is possible. I mean even under the current tapering, I mean, possible that they taper until the middle of June. Then there's a meeting around then. And then they hike the funds rate. Seems a little rushed, but possible. Anything earlier than that, I think, is very unlikely.

Allison Nathan: Some observers argue that the Fed's current accommodative stance is just no longer appropriate. We are not in the middle of a pandemic crisis anymore. We've had this big rebound. And really concerned that waiting as long as they have, even the window may have already passed, but and into 2022 and beyond, you know, it's just going to force them to act more aggressively next year. And it's going to push growth lower than it otherwise would have been. And could even end up pushing us into recession. What's your response to that?

Jan Hatzius: My main response would be that they are moving, right? I mean, they have moved in terms of ending

QE. There's no schedule for that. The schedule is somewhat faster than most people expected. As Chair Powell said in the recent press conference, they did move it forward. They're tapering twice as fast as they did in 2013. And I think they've evolved the communication around full employment, for example. The discussion of labor force participation in the press conference was definitely different from the way that they talked about it in the past.

So, yeah, could they go more aggressively? For sure. I don't know if that would necessarily be appropriate. I do think we're still not at full employment. Even though we're at more labor scarcity than you'd normally expect at this employment to population ratio. So, there is a reasonable amount of uncertainty. I think what they're doing is reasonable. I'm glad that we're now on a path towards being able to consider some rate normalization. And obviously, the economy could look quite different in the middle of next year. So, we'll see whether it's necessary. We'll see whether maybe they want to wait longer. Maybe they want to go somewhat faster by the time that they get to the end of the taper. But I think having another six, seven, eight months to consider whether a hike is needed at that point, I think that's a reasonable path because unlike central banks that have already started hiking rates, and obviously in DM we've only had a couple of small ones, but a lot of EM central banks have hiked aggressively. When the Fed moves, it's a more momentous step for the global financial cycle and the global economy. And it needs to be well considered.

Allison Nathan: So, what does this all mean for markets? Despite being more concerned about inflation and the Fed's response to it, El-Erian thinks equity markets will continue to grind higher as long as the Fed's liquidate rate continues.

As we sit here and digest all of these policy decisions, equities have been, obviously, hitting new highs, especially in the US. So, in the context of everything we've just discussed, where do you think that's headed?

Mohamed El-Erian: What's happening in the equity market was captured perfectly a few months ago by Leon Cooperman when he was asked how are you positioned and he said, "I am a fully invested bear." So, in terms of fundamentals he was bearish. He thought valuations are too high. But in terms of technicals, and particularly liquidity technicals, he was fully invested. It is this notion of a rational bubble. It is bubblish. There's no doubt about it. But it is rational. Why? Because investors are in a relative valuation paradigm. Where else do you go? Do you go to the fixed income market? Well, that is so distorted and it's so one sided in terms of risk/return that it's not clear that that's where you want to go as a return engine. And certainly not a diversifier because of what has been happening.

Lots of investors cannot go into private credit, into venture, into private equity. Lots of investors are hesitant to go into crypto. So, it leaves the equity market. It's this notion that we had at PIMCO of the cleanest dirty shirt. And the image we used to share is assume that you're on a business trip and you've packed just enough clothes for the length of your business trip. And then your business trip suddenly gets extended, and you can't get to the laundry, you will wear your cleanest dirty shirt or blouse. Right? And that's what investors are. Investors right now are seeing the equity market as the cleanest dirty shirt. And they feel they have no choice to wear it. That works really well as long as the paradigm is a relative valuation paradigm. And for a while we will remain in this relative valuation paradigm. And I have been saying this over and over again, is you've got to respect the liquidity weight.

The risk that we all want to avoid is an abrupt change from relative valuation to absolute valuation. Or to put it differently, the famous phrase, you start worrying about the return on your capital and you start worrying about the return of your capital. And that's the paradigm shift that we're all trying to avoid because not only does it mean volatility, but most critically it means you unduly undermine the real economy.

Allison Nathan: We'll certainly continue to watch for continued signs of shifting inflation expectations and the inflation data itself to see how inflationary pressures continue to unfold.

I'll leave it there for now. If you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment. I'm Allison Nathan. Thanks for listening to

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