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Inflation: beginning of the end, or end of the beginning? **Investment Strategist Peter Lucas considers whether the current uptick in inflation is transitory, or more permanent, and what signals the markets are currently giving.**

Is the recent uptick in inflation 'transitory' – as most now seem to think – or is this the start of a more protracted inflation problem? The short answer is yes and no, it just depends on your time horizon.

There is little doubt that the jump in headline inflation has been exacerbated by two factors:

1. Base effects, i.e. the sharp fall and subsequent recovery in commodity prices. Take for instance price of oil, up 75% in the past year, but only 25% since the equivalent date in 2019.
2. Teething problems associated with economies cranking back to life after months of lockdown and limited activity. This is perhaps best demonstrated by the fact that the US ISM backlog of orders indices for service and manufacturing businesses are at or close to their highest levels since 1993.

It is not unreasonable to think that their impact could wane as economies open up, and that headline inflation rates will back a little in the near term. In that sense, the current inflation uptick could be described as transitory. However, base effects and bottlenecks were never at the heart of the longer-term inflation thesis, which still seems valid:

1. Fiscal policy will remain loose for some time to come. Although fiscal policy may tighten a little as COVID support payments roll off, it is unlikely to be tightened aggressively given (a) the post-COVID mood (b) extreme income inequality and (c) the green agenda.
2. Monetary policy will remain easy for some time to come. The Fed and the ECB are now both prepared to let the economy 'run hot' for a period to get it closer to full employment. If inflation does dip in the short-term, as seems quite possible, it will enable them to keep the 'pedal to the metal' for longer, running the risk of a cyclical upturn in inflation as the output gap closes. Significant debt levels and overvalued markets will lead to Central Banks dragging their feet on monetary tightening.
3. Globalisation going into reverse. Globalisation has been a been major disinflationary force in the past few decades and the main reason why real wages have stagnated for many people in the West. The events of the past two years have led many to question the logic of outsourcing everything to China and the need to bring more productive capacity back home. Although that may make sense from a security perspective, it will lessen an important disinflationary force.
4. Spike in commodity prices. The ESG movement is starving energy companies of capital and reducing their ability to ramp up production in a cyclical upturn, way before 'clean energy' can pick up the slack from 'dirty energy'. At the same time the switch to electric vehicles may lead to shortages in other commodities like copper. In short, the environment is ripe for bull market in commodity prices.
5. The likelihood of currency devaluations due to easy monetary policies, leading to a rise in imported inflation.

Although a lot of people were voicing their concerns about inflation back in March, those concerns were not being reflected in the markets. TIPS breakeven inflation rates were only marginally above the Fed's long-term inflation target and gold, usually the main beneficiary of rising inflation, was pretty much unchanged on year ago levels. If those concerns become more deep-seated, breakeven inflation rates should rise further above 2% and the gold should start to perform rather better. Note that in calendar years in which the headline inflation has jumped 5% (which is what it has done since May last year), gold has produced a real return of 85% (1971-2021).

On that note, it is interesting to note that (a) TIPS prices have recently hit new highs for the year and (b) the gold price, which normally correlates closely with 30-year TIPS yields has not kept pace since June and needs to rise 10%+ just to catch-up. A sharp move may be on the cards.

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