Investment Insight

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Why should Local Government Pension Schemes be concerned about rising inflation?

For decades we have been experiencing a cycle of deflation. The impact of COVID-19, lockdown and economic uncertainty created further deflationary pressures which has important considerations for LGPS says Daniel Booth.

Since Paul Volcker's chair of the Federal Reserve in the 1980s, we have been experiencing a disinflationary cycle. The impact of the coronavirus pandemic, lockdown and the wider economic uncertainty created further deflationary pressure, with a rising output gap coupled with growing unemployment.

This has been combined with longer-term deflationary trends, caused by excessive developed world debt, low levels of labour market bargaining power (due to automation and offshoring) and weak levels of productivity growth.

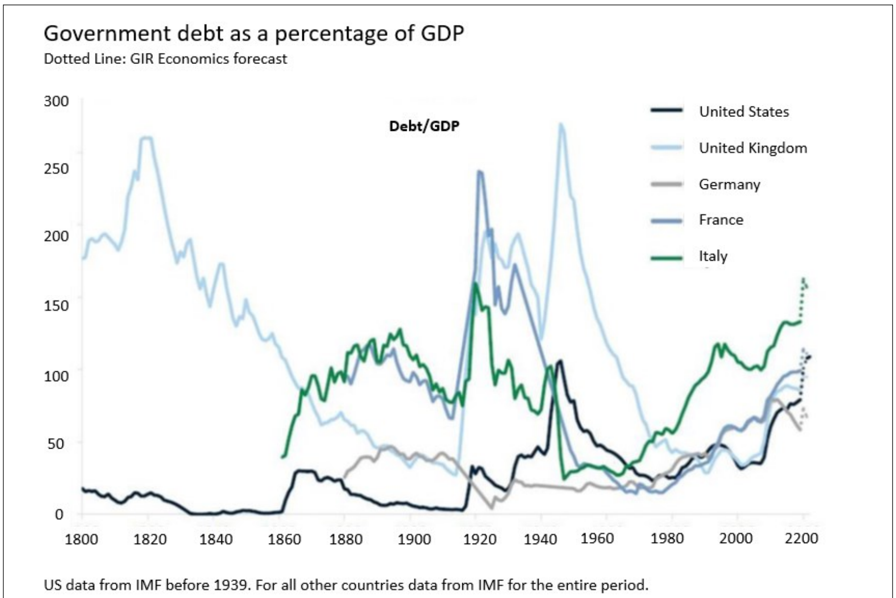
Authorities internationally have responded to the dire economic situation induced by COVID-19 with a combined economic expansionary response, which may prove to be a critical turning point in the disinflationary cycle.

The extent of both monetary and fiscal stimulation has been larger, faster, and broader than that which followed the 2008 global financial crisis. The monetary stimulus implemented in 2020 saw the balance sheet of the US Federal Reserve increase significantly with additions including corporate and high yield debt to support credit markets.

Meanwhile, the European Central Bank and other Global Central Banks all engaged in rapid quantitative easing programs. 2020 Fiscal stimulus has also been extensive and equivalent to 4% global GDP (versus 1.6% during the 2008 crisis), with Government budget deficits reaching the highest levels since the Second World War.

Major differences between 2020 COVID crisis and 2008 Global Financial crisis are the impacts on incomes, debt levels and commercial banks. For commercial banks they entered 2008 with excessive leverage multiples (30:1) and minimal capital ratios. Since then, the banks have deleveraged and built up their tier-one capital ratios - a key measure of a bank's financial strength – so that they entered the current crisis in a healthy position. Consequently, there was little need to offset a reduction in lending – in fact, the opposite has happened, and lending increased. In addition, household incomes were maintained by government fiscal programs and cash levels have substantially increased.

The quantitative easing we are witnessing currently is a coordinated monetary and fiscal stimulus, with the Treasury borrowing money created by the central bank ('deficit monetization'). Rather than ending up as extra central bank reserves this is having a more direct impact on money supply which is expanding at double digit rates. The combination of loose monetary and fiscal policy combined with stable commercial banks and high household and



US data from IMF before 1939. For all other countries data from IMF for the entire period.

corporate cash levels sets the background for a shift in the inflationary environment.

Also contributing to an inflationary environment, the US Federal Reserve has adopted an Inflation Averaging target, meaning that to offset any prior inflation shortfall, they will now need to overshoot their inflation target to raise the average. The Fed recently noted that they would keep rates flat until they have achieved full employment and inflation exceeds their 2% target – so they may be on hold for an extended period.

Although central banks cannot lower nominal rates much further due to the zero-bound interest rate, they can lower real rates by increasing inflation and inflation expectations. Post-WWII, the Fed purchased bonds to keep yields lower than 2-2.5% to keep deficit funding affordable, whilst experiencing 5.5% average inflation (-3% real rate). This enabled economies to manage down debt burdens after the war. Global debt levels are elevated again, so higher future inflation would help reduce the future real debt burden .

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Local Government Pension Schemes (LGPS) should consider that the longer-term inflation risk may be under-priced by markets due to the underlying market conditions beginning to change. As discussed above, we are seeing renewed quantitative easing without the offsetting effect of bank deleveraging.

Another factor for the LGPS to ponder is that we may see a reduction in global supply-side efficiency as we enter a period of de-globalization (regionalization) with changing corporate supply chain preferences (onshoring). This will increase trade frictions and costs, and Brexit in the UK may raise unit labour costs. A study of history informs also informs us that debt deflations typically turn inflationary, following the path of least resistance, and behaviours may change as participants recognise the new debt perception.

When thinking about impacts on inflation LGPS should note that throughout the coronavirus crisis, households have retained cash levels despite rising unemployment.

Bridgewater estimates current developed world household cash balances are equal to 12.5% of GDP, five times the normal level. It is typical for cash balances to increase during a recession, but the magnitude of COVID-19 cash build-up is unique, and any future liquidation of excess cash holdings could act as an additional stimulus.

The authorities are likely to want to stimulate economies further by lowering real interest rates, and with nominal interest rates at the lower 0% bound, they can do this by increasing inflation and inflation expectations. The US Federal Reserve move to an inflation averaging regime is a clear indication of this direction. In 2021 growth and inflation outlooks are likely to appear higher set against 2020's low-base impact, combined with ongoing policy stimulation and elevated levels of cash and credit creation as outlined above.

It is clear we'll see a pick-up in near-term inflation levels, partly due to low base effects from the second quarter of 2020, and it is likely that central banks will tell us this is transitory. For the LGPS the more important consideration will be the longer-term inflation outcome which will reflect the balance between the impact of the inflationary policies described above alongside the residual deflationary forces, such as automation. The LGPS with long-dated inflation linked liabilities should be mindful of the longer-term, inflation risks that has the potential to impact both their assets and their liabilities.

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