GlobalData. TS Lombard

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Daily Note

THE DREADED SECOND WAVE OF INFLATION

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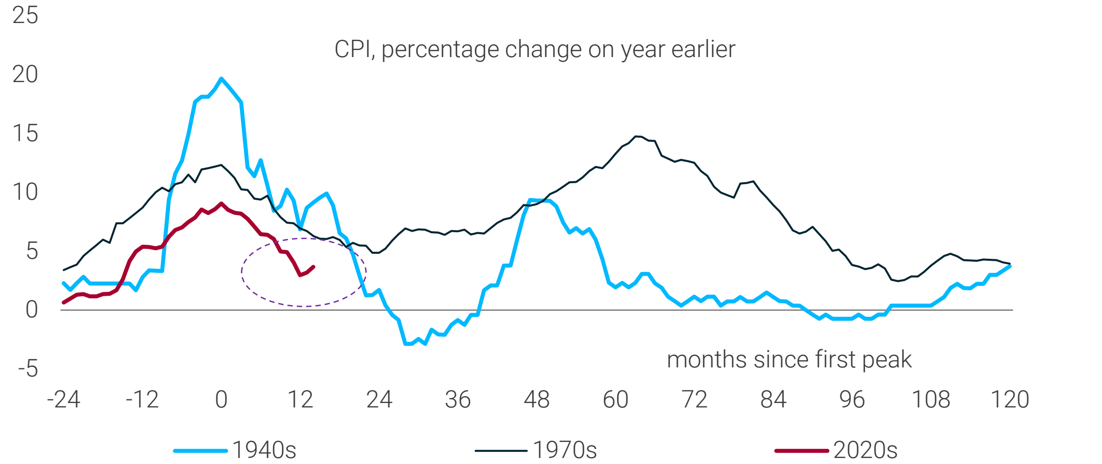
- Some say inflation always comes in waves, which is worrying given oil prices
- But it would take a broad reacceleration in inflation to spook central banks
- The spike in oil prices is a timely reminder: inflation volatility is not going away

Last month, Larry Summers was widely ridiculed for a "chart crime" he circulated on the app-formerly-known-as-Twitter, which mapped post-COVID inflation against the twin peaks of the 1970s. I'm not sure whether it was his dodgy dual y-axis manipulation of the data that generated such scorn or the fact that he was essentially applying technical analysis to the consumer price index. But "double-top" or not, you didn't need a Fibonacci retracement level – whatever that is – to understand the point he was trying to make: just because headline rates of inflation have plunged since their peak in 2022, that does not rule out the possibility that we have entered a "high inflation regime". We saw similar ups and downs during the 1970s, an era forever associated with runaway prices and a distinct loss of monetary control. Could the same story be repeated? To be fair, Summers is not the only high-profile pundit who is worried. **Following the latest runup in oil prices (now 25% higher than two months ago), there is suddenly plenty of gloomy analysis warning about a "second wave".** And doesn't inflation always come in waves?

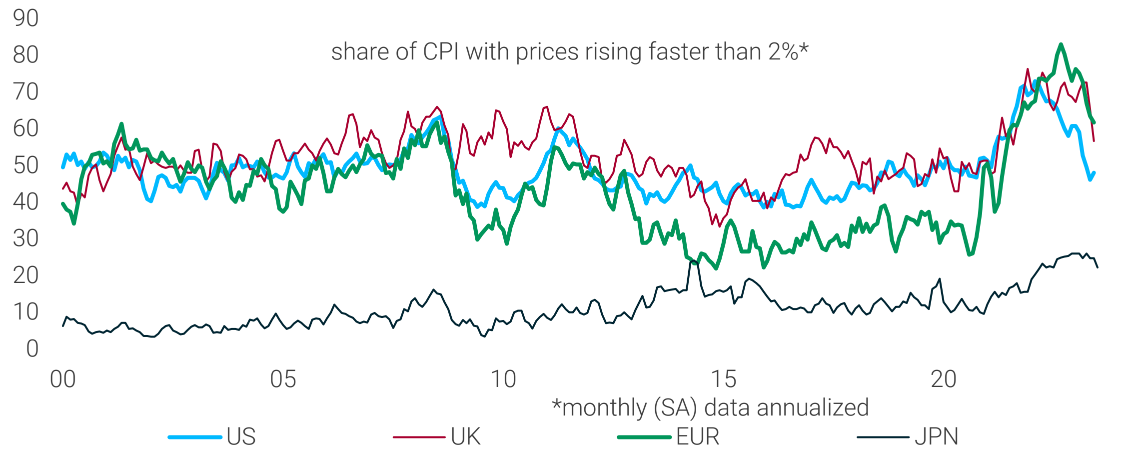
Chart 1: Not the chart that got Larry Summers into trouble (his had a dual y-axis…)



Source: Datastream, TS Lombard

The latest spike in oil prices is massively unhelpful, especially as inflation was already above central banks' 2% targets. We always felt that one of the conditions for a soft landing was that central banks might have to tolerate somewhat higher inflation, which, in turn, required a degree of plausible deniability on their part. While they would never admit a (revealed) preference for higher inflation, it is much easier to feign a total commitment to 2% if the data are at least trending (however gradually) in the right direction. As headline rates bounce, the whole charade becomes more difficult to sustain. That said, it is important to keep these recent inflationary developments in context. We are not yet in danger of undoing 12 months of solid disinflationary progress – not even close. Back in 2022, it wasn't just the absolute level of inflation that was causing central bankers to freak out, but also the breadth and distribution of the price increases they were seeing. The world economy was experiencing a massive increase in the costs of producing just about everything, an enormous supply shock that rippled through the entire CPI (starting in goods and then spreading to services). So far, that is not the dynamic we are seeing today. Not only is the increase in oil prices much smaller – remember, oil prices *doubled* after the pandemic – but we are still seeing broad disinflationary trends across the rest of the CPI. **These wider disinflationary dynamics would need to flip in order to shift the course of monetary policy.**

Chart 2: Price distributions are starting to normalize

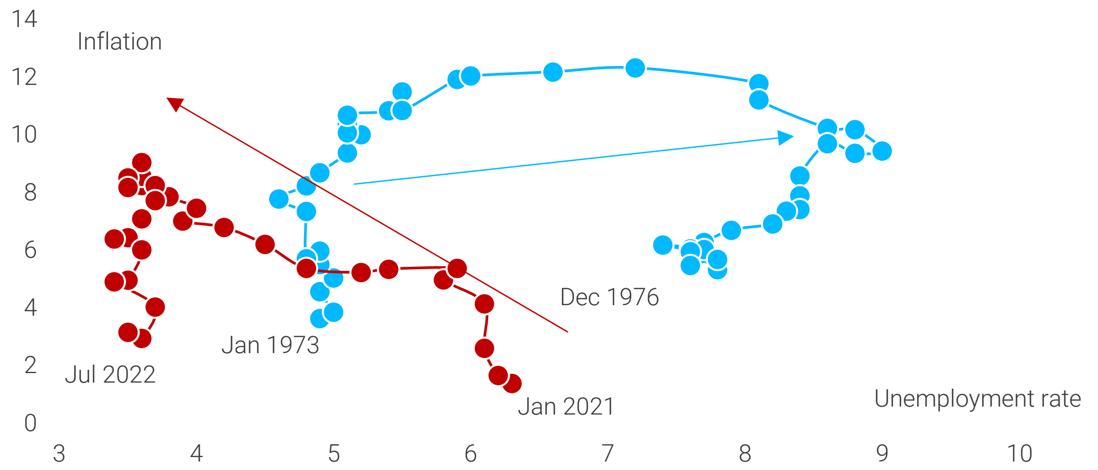


Source: national sources, TS Lombard

A broader question is whether there is something special about the current situation that makes it more susceptible to ominous inflation dynamics. Perhaps, as some economists argue, being at full employment means we are on a "steep part of the Phillips curve", as a result of which any reacceleration in growth will quickly generate broader and more sustained wage and price pressures. Or maybe there is a behavioural factor at work: having recently experienced a period of high inflation, perhaps companies are more likely to respond to any cost increase by raising their prices and workers will immediately demand higher wages. This would explain why, according to one popular narrative, inflation tends to come in waves. Yet it is important to think through the "inflationary waves" thesis a little more deeply. While it is true that we have seen waves of inflation in the past, most of the action was confined to just two episodes: the 1940s/50s and the 1970s. And underlying inflation dynamics were, in fact, rather different in each period. Whereas core inflation and wage pressures trended higher during the 1970s, inflation was, in effect, "stationary" (untrended) during the period after WW2. These dynamics were different because price pressures were coming from fundamentally different sources. Whereas post-WW2 inflation was mainly about fiscal policy and supply disruption (sound familiar?), the Great Inflation of the 1970s was essentially about a persistent power struggle between labour and capital (compounded by a large monetary expansion i.e. persistent growth in money and private credit).

For several years and across a number of publications, I have been explaining why I don't think there will be a repeat of what happened in the 1970s. We spent 40 years dismantling the mixed economy of that era; and even if the pendulum of power between labour and capital has started to tilt slightly back towards labour, we are long way from the union-dominated, fully protectionist, un-financialized economy of half a century ago. That said, there are good reasons to think we are entering a period of more volatile inflation, even in the absence of a sustained acceleration in the underlying price trend. Deglobalization, climate change, decarbonomics, geopolitical power rivalries, strategic industrial interventions and activist fiscal policy are all pushing in that same direction. And against this background, the recent spike in energy prices is a timely reminder of what investors can expect in the new macro era. Rising energy costs may not constitute a true “second wave”, but they are confirmation that the Great Moderation could be over. It seems to me that many investors have not yet fully internalized this message, or understood its implications for asset prices. How else do you explain continued negative term premia in bond markets?

Chart 3: These are not the dynamics we saw during the 1970s



Source: BLS, BEA, TS Lombard