Why inflation looks set to return in the wake of coronavirus

The collapse in the global economy caused by Covid-19 and the measures to avoid it look deflationary, says John Stepek. But politics and demographics point to a very different outcome

Amid all the questions about Covid-19 – when will the lockdown be over? How quickly will we discover a vaccine? Will there be second waves or mutations? – we know two things for sure. One is that the scale of the economic downturn caused by both the pandemic and the measures to contain it is unprecedented in the modern era. The precise figures are unimportant – we all know that forecasts are virtually always wrong – but to give a sense of just how bad things are, the International Monetary Fund (IMF) reckons that global economic output will fall by 3% for the whole of 2020 (for perspective, it fell by just 0.1% in 2009, during the global financial crisis). Meanwhile, in the UK the Office for Budget Responsibility – the UK's fiscal watchdog – has warned that we are looking at a 35% plunge in GDP in the second quarter, assuming the lockdown stays in place for the full three months.

The other thing we know is that the scale of the government and central bank reaction to this downturn has been equally unprecedented. It's really not an exaggeration to argue that free-market capitalism has been suspended. At the end of last week the Federal Reserve – the US central bank – declared that it would print money to buy a wider range of assets than it ever has before. Forget boring old US government bonds. The Fed is now buying not only investment-grade corporate debt, but also exchange-traded funds (ETFs) that own junk bonds. In other words, some of the dodgiest credit risks in the global market (they're not all US companies) now have the Fed standing behind them.

An explosion in moral hazard

This is encouraging "moral hazard on a grand scale", says Jonathan Tepper in the Financial Times. As an editorial in The Wall Street Journal put it, "The Fed will in effect buy the worst shopping malls in the country and some of the most indebted companies. The opportunities for losses will be that much greater... the taxpayer risks here are greater than what the Fed took on in 2008-2009."

This made the news that the Bank of England has decided to give the UK government an unlimited overdraft in the form of its "Ways and Means facility" – in other words, it will give money directly to the Treasury if markets are too clogged up to allow the smooth issuance of gilts – almost seem like a minor administrative matter, rather than the next step towards full-blown deficit financing that it really is.

It's not just the Fed and the Bank of England. Stefan Schneider, Deutsche Bank's German chief economist, sent out a note this week on Germany's reaction to the crisis headlined: "Are we on our way to state capitalism?" Schneider warns that "the misallocations of capital, misdirected employment incentives and the spread of moral hazard" that will result from Germany's efforts to prevent any healthy business from going bankrupt due to coronavirus will both weaken productivity and, in time, "further exacerbate the conflicts about allocation of resources sparked by the ageing of society". Or as Howard Marks of Oaktree Capital puts it: "Markets work best when participants have a healthy fear of loss. It shouldn't be the role of the Fed or the government to eradicate it".

"It's no exaggeration to say that free-market capitalism has been suspended"

But eradicate it they have. And partly as a result, government spending as a proportion of the UK economy rose to 52% of GDP in March (from below 45% last year) and it's expected to hit similar levels in Germany. Governments may argue that these measures are temporary and that they will be unwound as the economy recovers. But we heard that in 2008 and 2009 and those measures are still in place. Will there ever be a good time to unwind the "emergency measures" being put in place today? We wouldn't like to bet on it.

How do we pay for all this?

So that raises the obvious question: how do we pay for all this and who ends up footing the bill? There are lots of rumblings about a new era of austerity being imposed to pay the money back via higher taxes and reduced public services, but this seems highly unlikely. A simplistic but not entirely inaccurate view of the 2008 crisis is that banks and asset owners were bailed out and workers paid for it with suppressed wages and diminished public services. If that gave rise to today's populism, then how will people react now that the same appears to be happening again?

The problem is that moral hazard – the risk that cushioning individuals against negative consequences encourages the very behaviour that leads to disaster in the first place – isn't just restricted to markets. It undermines the whole idea of free markets. For example, we (rightly, I believe) largely disagree with the notion of price controls or rent controls because they favour select political groups, encourage corruption and have hugely damaging side-effects. And yet what else are central banks, with their moves to support financial markets with effectively unlimited amounts of money, doing for asset prices? Why do price controls make sense for junk bonds, for example, but not for rents, or wages?

Those are hard questions to answer because there is no good answer – if you agree that the Fed should bail out not only big banks, but also big companies, private-equity investors and owners of ropey real estate, then why shouldn't it bail out small companies and individuals too? And if you think that politicians can resist that idea at a time when entire wings of the economics profession are lining up behind them to endorse it as a valid option (generally under the umbrella of modern monetary theory – MMT), then you are living in a parallel universe. As a result, there is only one obvious and politically acceptable solution to all this – the debt has to be, and will be, destroyed via inflation or default.

Given the spectacular collapse in activity, you might ask – how can inflation possibly arise? Well, for one thing, globalisation, one of the key disinflationary forces of the past three decades, has now firmly reached its end point. This doesn't necessarily mean that we're going to return to 1930s-era style protectionism. But it does mean that the relentless downwards pressure on the price of both goods

Federal Reserve chair Jerome Powell: scrapping capitalism to save it

and labour imposed by increasing globalisation is no longer a feature. Peak globalisation had already arrived – the coronavirus crisis is just accelerating the shift in trend. Supply chains will be made more robust, which means shorter. And any government with a protectionist streak is going to be free to indulge it, as China and the US battle more nakedly for influence in a new Cold War fought mostly in the economic realm (for now at least).

Then there's the question of demographics. People often talk of ageing populations as being disinflationary due to changes in demand for both goods and savings. But this ignores one issue – intergenerational conflict. As Vincent Deluard of financial services group INTL FCStone puts it: "Boomers need low inflation to preserve the purchasing power of their pensions and low rates to maintain the sky-high value of their assets. Conversely, Millennials and Gen Z-ers need inflation to cancel their student debts, high rates to build wealth and low house prices to start households". The politics of this conflict "will eventually force the transition from the deflation of the 2010s to the great inflation of the 2020s". To sum up, says Deluard, "a world which is no longer 'flat' led by populist governments who have rediscovered the magical powers of the printing press is inherently inflationary".

We're already seeing signs of inflation

Oil is the commodity that we all consider first when the question of inflation arises. On that front, there seems to be little risk. Oil prices have collapsed and despite a recent deal between global oil producers, analysts seem to think there is little chance of a rapid rebound (see page 4). But what about food prices? We're eating as much as ever and this is at a time when farmers across the world are worrying about how to gather crops in the absence of workers.

Also, what happens when lockdown ends? A lot of people have suffered badly in this crisis. But it's also worth pointing out that in the US at least the increase in unemployment benefits means that some people on low incomes – depending on the level of state benefits – will actually be paid more than they would have been while working. That's no bad thing, but it does mean that there may be more pent-up demand by the time we return to "normal", whenever that is. So in the short term at least, you'd have a combination of resurgent demand plus a badly damaged supply chain.

And just revisiting oil for a moment – if demand comes surging back at a time when all the big players, private and public, have cut back on production, what do you think happens next? It's little wonder that Deluard goes so far as to suggest that the 2020s may see another commodities supercycle along the lines of the one we saw in the 2000s.

So what's next?

Markets have bounced back sharply (see page 5). Have we seen the bottom or is there another dip to come? The reality, as Marks points out, is that we simply have no idea – we've never encountered an economic event this extreme before. So it makes sense to be psychologically and financially prepared for either

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"The 2020s may see another 2000s-style commodity supercycle"

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option. If we aren't going to see a second wave of infections that necessitate another shutdown, then the chances are we've seen the bottom. But we can't know that. And as Marks points out, there's the behavioural element. The government might say we can all go back to work, but how will people actually react given the sense of threat still out there? In all, "the reopening of the economy is likely to be gradual and, until a vaccine is perfected or herd immunity is reached, subject to alternating periods of progress and retreat".

Also, different sectors of the economy will open up or recover at different rates. There are obvious areas such as air travel that could take many more months or even years to get back up to pre-crash levels. But there are other areas too that may never bounce back. Michael Pettis, a Beijing-based finance professor, noted on Twitter the other day that while activity for businesses selling services such as haircuts, or essentials such as food, is almost fully back to pre-crisis levels, those selling goods that can be easily purchased online instead are still struggling.

It's not all bad news. As Gillian Tett of the Financial Times told my colleague Merryn on the MoneyWeek podcast this week (listen to it at moneyweek.com), the coronavirus's role in accelerating existing trends could represent the tipping point at which businesses finally adopt various productivity-enhancing technologies (such as long-distance working solutions). But it's also likely to lead to massive levels of financial repression as governments deliberately hold down interest rates in order to erode their debt piles as quickly as possible.

How to protect your wealth

I realise we keep saying this, but own some gold. We always recommend you have a portion of your assets in gold (it's one of the few assets beyond equities and bonds that offer genuine diversification benefits), but right now, gold is also in a bull market that looks set to continue. If inflation does take off, investors will want it, particularly as it will take time for central banks to catch up and raise interest rates to tackle the problem. Gold tends to do well when real interest rates (rates adjusted for inflation) are falling. You can buy physical gold via bullion dealers, or get exposure to the price using an exchange-traded fund (ETF) such as **WisdomTree Physical Gold (LSE: PHAU).**

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Teleconferencing might make us more productive

Gold miners are also worth considering. They have been historically poor investments, but they remain cheap relative to the gold price. One issue is that shutdowns may hit production over the coming quarters. So we'd suggest investing using a fund – picking and choosing individual potential winners in the sector is fraught with risk. Options include **Ruffer Gold** or **Charteris Gold & Precious Metals** funds.

Other commodities are benefiting from shutdowns already. Quietly in the background the uranium price has been doing surprisingly well, creeping up to reach a four-year high of around $31 a pound, mainly because several of the mines that produce the majority of global supply have been forced to shut down temporarily due to Covid-19 restrictions. One way to play the uranium price is via the London-listed **Yellow Cake (LSE: YCA)**, which is effectively a uranium price tracker.

As for equities, you should continue to stick to good-value, good-quality companies. You might want to consider the funds in our investment trust portfolio. In the box below, Merryn looks at how they have weathered the storm so far.

How has our investment trust portfolio coped?

The MoneyWeek investment trust portfolio currently has six constituent trusts: **Personal Assets (LSE: PNL); Scottish Mortgage (LSE: SMT); Caledonia (LSE: CLDN); RIT (LSE: RCP); Temple Bar (LSE: TMPL)** and **Law Debenture (LSE: LWDB)**, *writes Merryn Somerset Webb*. You'll be wondering how it has weathered the virus storm. The answer is not as well as it would have without Temple Bar. Most of the trusts have held up brilliantly – better than I could have expected.

Personal Assets and Scottish Mortgage are both up over the last 12 months, while Caledonia, Law Debenture and RIT are down between 7% and 10%. Scottish Mortgage has even achieved a positive three-month return, thanks to the fact that, as Numis' analysts put it, "many of the technology-focused businesses [it holds] are considered best equipped to be resilient or benefit from the impact on consumption and working habits" in the current quarantine. Great news for anyone who never got around to following my firm instructions to rebalance their portfolio!

Temple Bar, on the other hand, has lost 44% in the last three months and 40% in the last year. Nasty. The horrible performance is caused by all the reasons we thought we liked it when we added it to the portfolio in 2018 – it seemed a great way to get well-managed access to the obvious value in the UK market, plus a nice yield too. This worked for a while – the trust looked like it was returning to form last year. But come the crisis, it could not have been worse positioned for full-on economic shut down: it is overexposed to the sectors being hit hardest and over 40% of the firms it holds have announced dividend cuts. It has also suffered from what looked like an ill-timed intervention on gearing from its board (who insisted the manager cut his market exposure mid-crisis and hence limited his ability to profit from any recovery).

You could worry that Law Debenture has some holdings crossover with Temple Bar and is thus vulnerable to some of the same dynamics. But it has more of a bias towards quality and also owns a global professional services business that offers steady and predictable revenues. That matters in times such as these.

On to the good news. Even with the carnage wrought by Temple Bar the portfolio has done fine. Over the last year the FTSE 100 has fallen 21%. Over the last three months, it's down 23%. The numbers for the All-Share are 20% and 23%. Our portfolio is down 7.85% on the year and 13.36% in the last three months. Obviously just UK shares are not the best benchmark (most of the trusts are globally diversified). But the FTSE World is down 9.55% over a year and 17.75% over three months. All in all, not bad.

I don't plan to change any of the constituents this month – but when the dust settles (which may not be for some time – it's hard to imagine anyone could get away with losing less than 10% on an annual basis in times such as these) we will revisit them all.