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Global Macro Briefing | Global

Don't Underestimate Inflation's Upside Risks

Inflation will be a key debate for 2021. We have increased confidence in our out-of-consensus call, made since May-20, that US core PCE inflation will overshoot 2% in this cycle. We believe the key difference between us and consensus is the assumption around strength of private sector risk appetite.

Inflation – our key out-of-consensus call: Our views on inflation, as on growth, are more bullish than the consensus. Since 3rd April 2020, we have argued that a V-shaped recovery in growth would unfold and in May 2020, we warned that inflation will make a return in this cycle. Since then, our conviction has only increased. Our GDP growth forecast of 5.9%Y for the US in 2021 is significantly above consensus estimates at 3.9%Y. We see US core PCE inflation ending the year at 2%Y and staying above 2% on a sustained basis from 2022. In contrast, the consensus sees it reaching 2% over a longer timeframe and is skeptical that inflation will exceed 2% for a sustained period.

Why we differ from consensus: Many pillars support our stance on inflation, but in this report, we delve deeper into where we diverge from the consensus view. We believe our assessment of private sector risk appetite is the key difference. With limited scarring thanks to a sharper but shorter cycle and with income losses underwritten by policy support, we have seen limited signs of stress in household and corporate balance sheets. Demand should therefore rebound sharply once restrictions on mobility and spending opportunities are lifted. The stronger growth outcome we expect also means that unemployment rates will decline faster than the consensus expects. Moreover, since job losses are concentrated in the lower income segments, the headline unemployment rate overstates the economic loss. Finally, accelerated restructuring would mean higher NAIRU in the near term.

What are the risks to our inflation outlook? In the near term, the virus outbreak and vaccine rollout remains a risk to both the growth and inflation outlook. Beyond that, we see two risks to our base case. First, as we enter the second half of the year, the acceleration in the recovery could lead to a quicker and more intense rise in wage and price pressures. Inflation could accelerate even faster, un-anchoring inflation expectations to the upside and bringing a shift in expectations on Fed policy, with attendant volatility in financial markets. Second, in our base case we see the sharp pickup in demand outweighing any potential expansion on the supply side. If factor markets prove to be more flexible than thought, especially on the labor side, inflationary pressures can be kept at bay. However, in this scenario, the risks of asset bubbles could emerge, weighing on financial stability.

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Exhibit 1: US core PCE inflation to reach 2% by end 2021, rise sustainably above 2% in 2022

Source: BEA, Haver Analytics, Morgan Stanley Research forecasts

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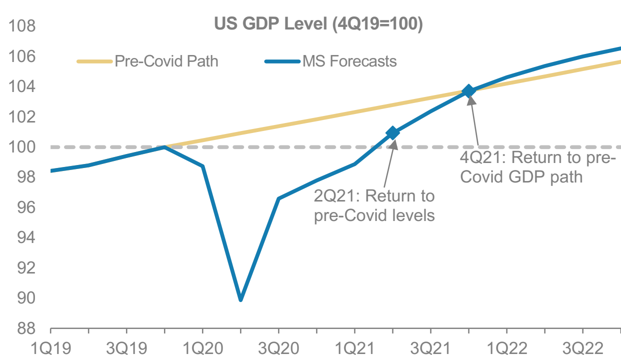
Don't Underestimate Inflation's Upside Risks

The inflation debate intensifies: The debates around the macro outlook tend to follow a similar pattern in recessions. As the downturn hits, the debate centers on the growth path and when the economy will reach pre-recession output levels. As it becomes clearer that the shock is receding and the economy is making progress, the debate shifts to whether and when inflation will reach the central bank's target. This time has been no different. We are seeing signs that the inflation debate is heating up, judging by the increasing number of incoming questions around our inflation call and commentary in the traditional financial press arguing for and against inflation.

Our out-of-consensus call – a modest inflation overshoot inflation in 2022: Our Chief US Economist Ellen Zentner forecasts that core PCE inflation in the US will rise to 2.0% in December 2021 and will moderately overshoot in 2022, staying in the range of 2.2% for most of 2022. Both these calls are out of consensus. While the consensus no longer sees a deep disinflationary shock due to Covid-19, they have inflation reaching 2% over a longer timeframe and remain skeptical that it will cross 2% on a sustained basis.

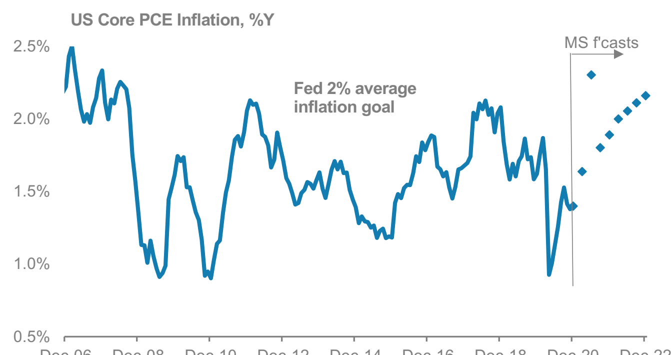
In contrast, a quick recovery in GDP to pre-Covid levels by 2Q21 and its pre-Covid path (where GDP would have been absent the shock) by 4Q21 will also mean a faster decline in the unemployment rate, ending 2021 at 5.1%. Even against this backdrop, policies will remain highly reflationary, setting the stage for a further rise in inflation in 2022. We see the re-emergence of inflation as posing a new threat to the business cycle, and expansions could also be shorter.

Exhibit 2: US GDP to return to its pre-Covid levels by 2Q21 and to return to its pre-Covid path by 4Q21



Source: BEA, Haver Analytics, Morgan Stanley Research forecasts.

Exhibit 3: US core PCE inflation to reach 2% by end 2021, rise sustainably above 2% in 2022



Source: BEA, Haver Analytics, Morgan Stanley Research forecasts

Why do we differ from the consensus view on inflation?

This cycle is different: Since May 2020, our view has been that the Great Covid-19 Recession (GCR) has unleashed forces that will fundamentally alter inflation dynamics. We see the return of inflation in this cycle after a 30-year absence. For more details, see Global Economics: The Return of Inflation (11 May 2020) and Global Macro Briefing: A Stronger Case for the Return of Inflation (17 Aug 2020) In this report, we focus on the

key differences between our view and the consensus. We think the crux of the matter is that consensus views this cycle through the lens of previous cycles and underestimates the potential for inflation to stage a comeback. In particular, the consensus is more skeptical about the pace of the recovery and overestimates the impact of unemployment on inflation.

Five reasons why we expect an inflation overshoot:

1) Limited scarring due to a sharper but shorter cycle

Private sector risk appetite is largely intact, and public sector support is robust: A key difference in this cycle is that it resulted from an exogenous shock. This distinction matters because of how it has shaped both policy and private sector responses. Policy makers did not hesitate to provide significant support as moral hazard concerns were limited (in sharp contrast to an endogenous business cycle, where misallocation could have occurred). In turn, the damage to private sector risk appetite has been less severe than most feared and continue to assume.

a) The government and central bank has underwritten household and corporate income losses in an unprecedented manner:

Household incomes increased even as output declined: Another unique feature of the GCR has been the divergence between household income and overall economic output. While GDP collapsed, taking household wage compensation down with it, overall household income actually increased, thanks to the timely fiscal policy response. After a brief dip in March, total income has risen substantially above pre-Covid levels and has remained there, reflecting the scale of fiscal transfer programs. A divergence of this magnitude between income and output in a recession is virtually without precedent.

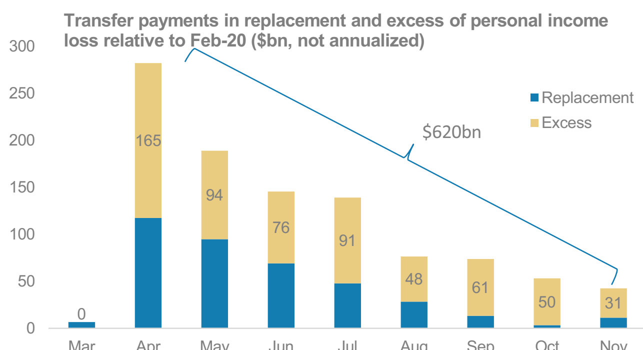
Transfers have more than made up for income losses: The surprising positive turn in household income reflects the fact that aggregate fiscal transfers were substantially larger than the economic losses that households incurred. Due to the lump-sum structure of supplemental unemployment payments, researchers at the University of Chicago estimate that two-thirds of all unemployed received more in unemployment compensation than they had previously earned while on the job, with the median earnings replacement rate at 134% during the first phase of the pandemic (including stimulus checks and other payments).

In aggregate, transfers to households through November have already exceeded income losses relative to pre-pandemic levels by $620bn. The next round of stimulus checks is on track to add another $110bn to excess savings, even assuming that households have an initial marginal propensity to consume of 33% (in line with the first round of checks in April). Extended and augmented unemployment insurance payments will likely convert into spending more fully, but any savings here would raise the total amount further. While the case is clear that income losses should be replaced by transfers due to the unique nature of this recession, the issue is that these transfers have more than done the job and could ultimately fuel a pickup in inflationary pressures.

Despite dispersion, households are on a strong footing: While segments of the population continue to face economic hardship and will require continued fiscal support, transfers have generally been effective in reaching low- and middle income households.

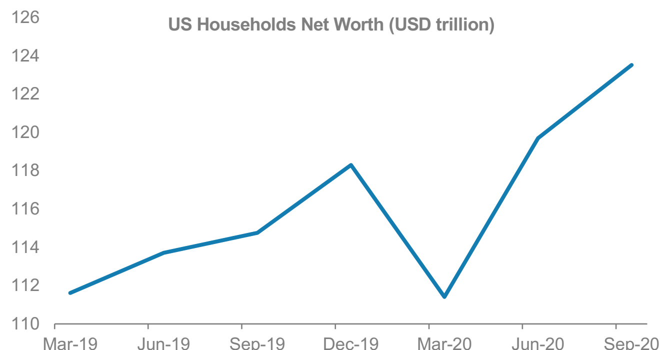
These households also tend to have a high marginal propensity to consume, which is reflected in consumer spending data (discussed above). Household net worth has increased by $5.2trn since the end of 2019 while consumer credit liabilities have fallen. US consumers therefore do not face major roadblocks to ramping up spending, in stark contrast to the strong deleveraging pressures after the global financial crisis (GFC).

Exhibit 4: US government transfers to households through Nov-20 have exceeded income losses relative to pre-Covid levels by $620bn



Source: BEA, Haver Analytics, Morgan Stanley Research

Exhibit 5: US household net worth has increased by $5.2 trillion since the end of 2019



Source: Fed, Haver Analytics, Morgan Stanley Research

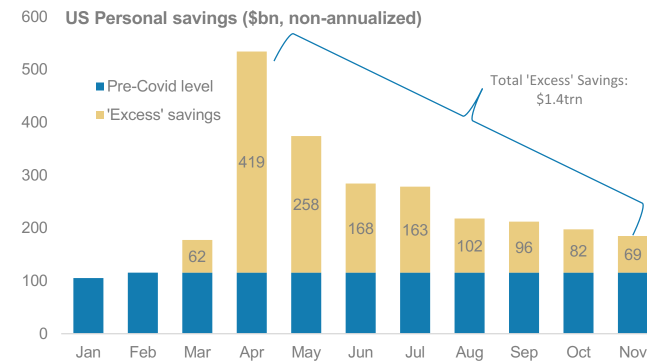
b) Limited signs of stress in corporate and household balance sheets: Heading into the recession, the US private sector (i.e. both corporates and households) was less indebted compared to previous recessions. Private sector debt-to-GDP had been stable and there were no clear signs of excessive leverage or undue risk-seeking behaviors, such as overinvestment by the corporate sector in aggregate.

As a consequence, we believe that the impact to private sector risk appetite is much more limited than commonly thought. Typical measures of stress such as corporate credit spreads or household delinquencies have either normalized very quickly or have not been notably impaired.

Spending cuts are not a sign of risk aversion: The consensus believes that elevated household saving is a reflection of caution around personal finances. The US household saving rate remains elevated at 12.9% in Nov-20 vs. the pre-recession level of 8.3% in Feb-20. In aggregate, US households currently hold US$1.4T (as of November) of excess saving, which is equivalent to 9.8% of 2019 annual personal consumption expenditures, a figure that will undoubtedly be boosted by the passage of the latest relief package. The consensus view is that caution is likely to prevail, household saving will remain somewhat elevated, and this will hold back the recovery in consumer spending, acting as a drag on aggregate demand and hence inflation. Moreover, capacity utilization and investments in select consumer and service sectors have pulled back in 2020, which in light of the sharp rebound in demand we expect in 2021, implies a significant demand-supply mismatch in these segments in 2022.

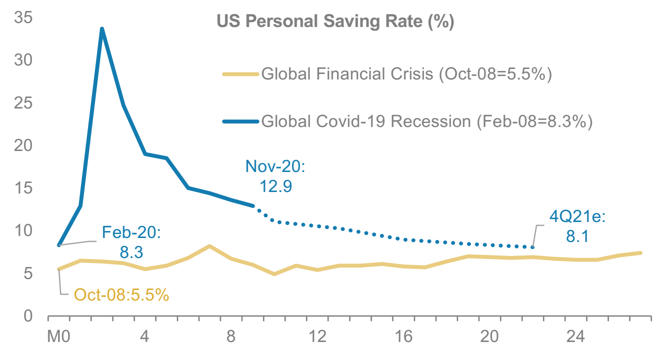
But we see a drawdown to more normal levels: We view this excess saving differently, seeing it as a buffer that will be drawn down as economies reopen. Our US economics team forecasts that the US household saving rate will decline to 8.1% by 4Q21, more in line with pre-Covid levels.

Exhibit 6: US households currently hold $1.4trn excess saving



Source: BEA, Haver Analytics, Morgan Stanley Research

Exhibit 7: US personal saving rate still elevated, but we expect a drawdown over the course of 2021



Source: BEA, Haver Analytics, Morgan Stanley Research forecasts

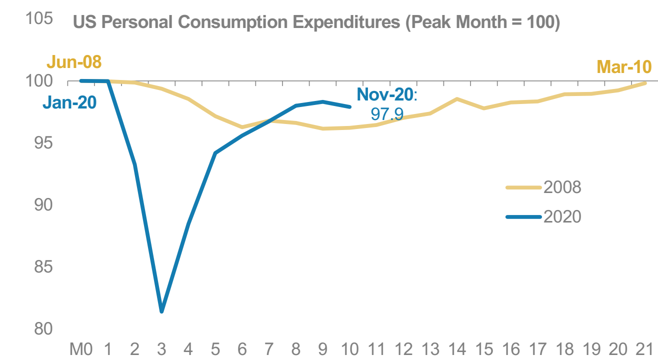
Current consumption patterns reflect the impact of mobility restrictions, rather than caution on the part of households: In our view, the current high level of saving can be attributed more to restrictions limiting spending opportunities than household cautiousness. Lacking granularity in the saving data, we glean clues on household behavior from consumption data in recent months. US personal consumption expenditures have already reached 97.9% of pre-Covid levels in Nov-20, which is telling in itself, demonstrating that consumers have not been reluctant to open their wallets and spend.

Unsurprisingly, Covid-sensitive sectors have borne the brunt: A look at the breakdown reveals that spending on goods has reached 106.2% of pre-Covid outlays, while spending on services is lagging somewhat at 94.2% of its pre-Covid level. This divergence in spending patterns in our view is due more to restrictions impacting spending on services, especially in Covid-sensitive sectors (i.e. those which are suffering most from restrictions, including tourism and indoor dining). Indeed, the categories in which consumer spending has been lagging are the Recreation, Transportation, and Accommodation and Food Services segments, which are more Covid-sensitive.

Moreover, the accelerated spending on goods has been more concentrated in durables. Taken together, these data points suggest to us that both the level of consumer spending and the breakdown of spending patterns do not reflect caution among households but rather the restrictions on mobility impacting consumer spending patterns.

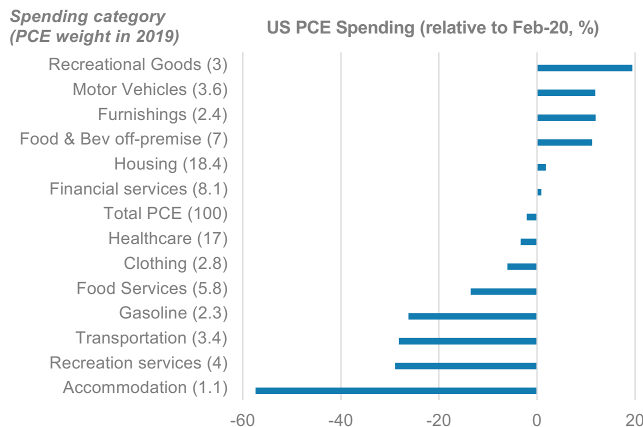
Similarly, high frequency datasets such as the one published by Harvard University Opportunity Insights allow us to look at spending patterns by zip codes. Spending in low-income zip codes is already back to pre-Covid levels, but still down in high-income areas. They too have concluded that spending has been held back more by restrictions than caution on the part of consumers.

Exhibit 8: US personal consumption expenditure has recovered to 97.9% of pre-Covid levels in Nov-20



Source: BEA, Haver Analytics, Morgan Stanley Research

Exhibit 9: US PCE in goods are already above pre-Covid levels while spending in Covid-sensitive service sector still lagging



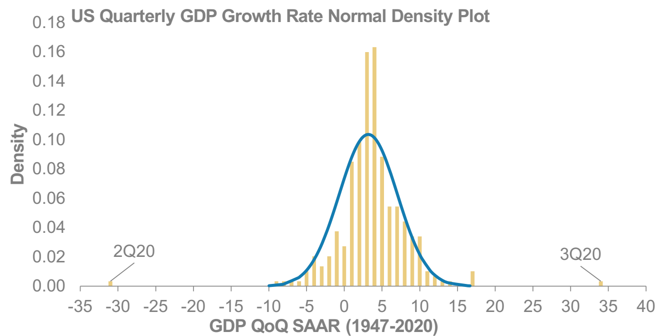
Source: BEA, Haver Analytics, Morgan Stanley Research

Spending to rebound sharply from March / April: These data points again reflect how different this recession has been. Looking ahead, as we expect economies to fully reopen in the spring when vaccines become more broadly available, we would expect a sharp rebound in demand, especially in Covid-sensitive sectors like travel and tourism. We expect to see this rebound from March / April next year and into the summer, as we believe that to lift restrictions, policy makers will need the vaccination of vulnerable sections of population and a corresponding reduction in hospitalizations and fatalities, rather than the higher bar of herd immunity.

A sharp but short-lived recession: While the economic shock was sharp, its duration was short as a record drop in quarterly output was followed by a record jump. Far-reaching shutdown measures implemented in March and April brought large swaths of economic activity to a standstill. US GDP dropped by more than 30%Q annualized, the largest shock to output on record and an 8 Sigma event. But activity quickly bounced back once restrictions were eased. The quick reversal of activity within two to three months after February's cycle peak should make this recession the shortest on record by a substantial margin. The average post-war recession has lasted for 11 months and the GFC contraction, for 18.

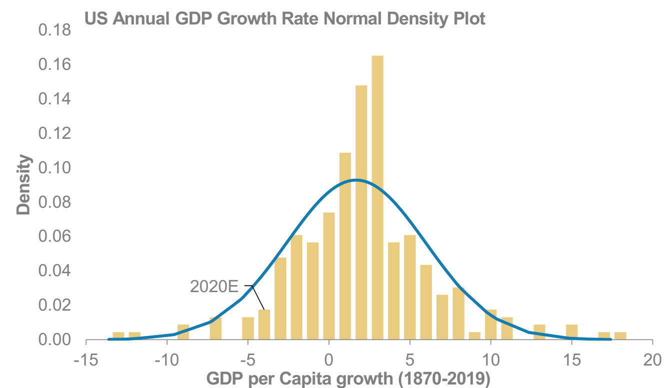
While 2Q20 was an outlier, 2020 was not: Due to the shortness of the contraction, the Great Covid-19 Recession's effect on annual GDP has also been much smaller than the magnitude of the initial shock would indicate. At -3.5%Y (expected), the GCR will still mark a substantial decline. But against a longer history of annual GDP growth figures, 2020 is not quite an outlier. As Exhibit 11 shows, it falls neatly into a roughly normal distribution of growth outcomes over the last 150 years. 2020 pales in comparison with years like 1930-1932, the depths of the Great Depression, where GDP fell by close to 10% for three years consecutively. The recovery since May has also occurred at a lightning pace. As of 4Q20, we estimate that US private final domestic demand had already reached 99% of pre-Covid levels.

Exhibit 10: While the 2Q20 contraction in the US GDP was an outlier...



Source: BEA, Haver Analytics, Morgan Stanley Research

Exhibit 11: ... the growth in full year 2020 was not



Source: BEA, Haver Analytics, Morgan Stanley Research

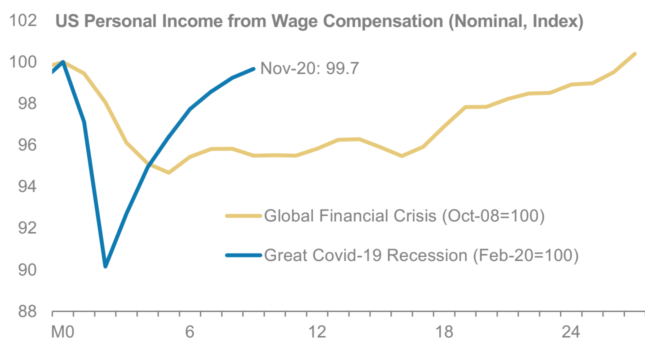
2) The unemployment rate overstates the economic loss

Sharper decline in unemployment: Our 2021 GDP growth forecasts are more bullish than the consensus by 2 percentage points and consistent with that constructive view, we are projecting a sharper decline in the unemployment rate than the consensus. We expect unemployment to end the year at 5.1%, vs consensus expectations of 5.5%.

Job losses have been concentrated in low-income segments: Moreover, we believe that the unemployment rate overstates the economic loss. While US GDP is rapidly making up lost ground and approaching pre-Covid levels, unemployment remains substantially above its prior lows. This divergence reflects the fact this recession has been a distinctly low-income recession. At the peak of the pandemic, 68% of all lost jobs were in low-wage industries. In contrast, the global financial crisis was effectively a middle-class recession, with middle-income jobs accounting for 50% of all job losses. About 77% of the job losses to date are also concentrated in sectors which are covid-sensitive and hence they should see a rebound in labor market activity as economies reopen.

Wage income has almost fully recovered: Given that the GCR unemployed skew largely low-income, the impact of an elevated unemployment rate on output and wage income is significantly weaker than past relationships would have predicted. Nominal personal income from wage compensation has already reached 99.7% of pre-Covid levels in November, while it took 27 months to return to pre-crisis levels after the GFC.

Exhibit 12: US nominal personal income from wage compensation already reached 99.7% of pre-Covid levels in November



Source: BEA, Haver Analytics, Morgan Stanley Research

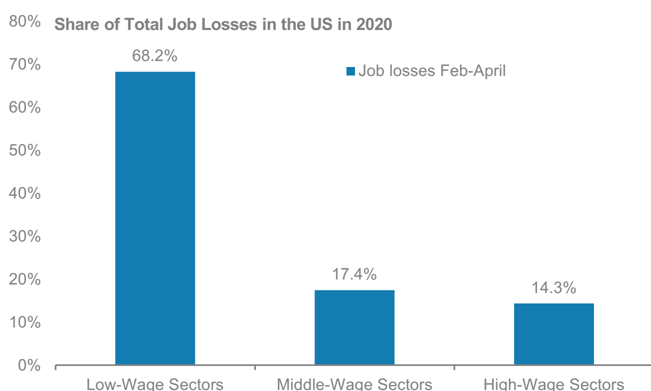
Exhibit 13: Job losses in the US are concentrated in covid-sensitive...

US Private Nonfarm Payroll Employment by Sector

	Total Payroll as of Feb-20		Change in Payroll as of Nov-20	
	(million)	*(% of total)*	*(million)*	*(% of total)*
Total	130	100.0%	-8.52	100.0%
Leisure & Hospitality	17	13.0%	-3.45	40.5%
Health Care	21	16.0%	-0.86	10.1%
Professional Services	22	16.6%	-1.06	12.5%
Retail Trade & Transportation	20	15.5%	-0.77	9.0%
Education	4	3.0%	-0.39	4.6%
Manufacturing	13	9.9%	-0.60	7.0%
Wholesale Trade	6	4.6%	-0.28	3.3%
Construction	8	5.9%	-0.28	3.3%
Others	20	15.5%	-0.83	9.7%

Source: BLS, Haver Analytics, Morgan Stanley Research. Note the majority of the decline in employment in professional services are due to declines in administrative and support services

Exhibit 14: ... and low-wage sectors



Source: BLS, Haver Analytics, Morgan Stanley Research

3) Accelerated restructuring would mean higher NAIRU in the near term

Labor market may tighten earlier due to accelerated restructuring: To be sure, our unemployment rate forecast, bullish as it is, still indicates that it will end the year above pre-Covid levels. At the same time, the recession has also led to an accelerated restructuring of businesses (the most prominent being the shift from offline retail to online). If some share of currently unemployed workers are not able to return to their original industries as the recovery progresses, this would require time-intensive upskilling and reallocation processes.

More fundamentally, the need for structural reallocation across sectors may raise frictional unemployment in the near and intermediate term. As research by the Brookings Institution shows, workers in sectors with the largest job losses also tend to have the lowest likelihood of moving to industries that are currently growing.

Labor markets may therefore tighten earlier than implied by the headline unemployment rate. In other words, we expect a higher natural rate of unemployment. Some would argue that this restructuring also took place on a greater scale during the global financial crisis, yet inflationary pressures did not result. Our counter-argument would be that deleveraging headwinds held back the pace of recovery, and the gradual recovery gave businesses and the labor market more than ample time to adjust. The issue is of particular importance in this cycle, especially if policy makers attempt to run

the economy hot. At the same time, higher unemployment due to the need for reallocation would make continued support for the unemployed necessary for longer, adding fiscal support to an already strong recovery. In either case, the end result is likely to be a further buildup of inflationary pressures.

4) Continued policy action to address inequality

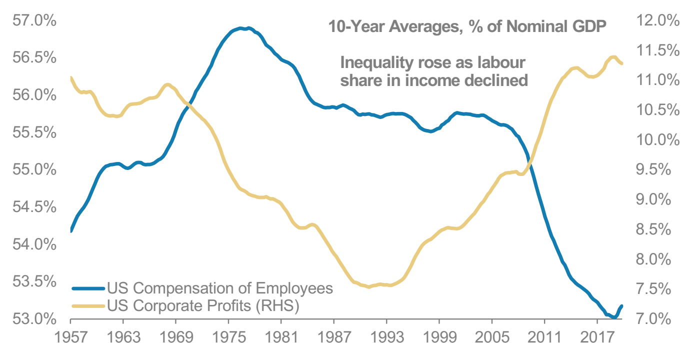
Policy impetus to address inequality: As we argued in our original report, we laid out the case that political and economic triggers were already in place prior to the recession to address the lower wage share in GDP and rising inequality. The Covid-19 shock has exacerbated the impact on lower income households, creating even greater urgency for policy makers to act to provide relief for affected households.

We see two implications from this policy push:

First, policy makers will use fiscal policy more actively. A second round of fiscal stimulus is being disbursed at the time of writing that will lift household incomes even further above pre-Covid levels. Further policy actions like the raising of minimum wages are being discussed and if enacted, will impart an inflationary impulse.

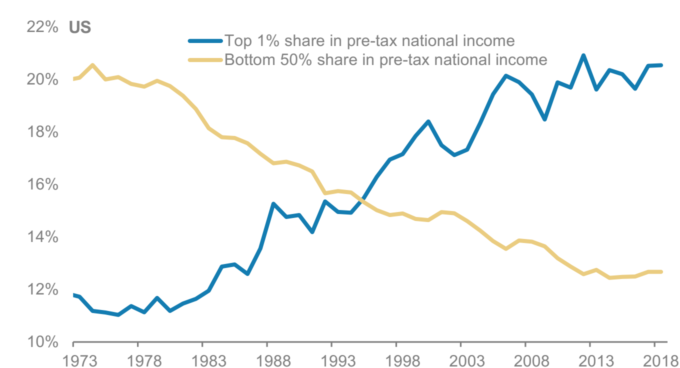
Second, policy makers are also increasingly focused on the role of tech, trade and titans. Since the 1990s, the steady interplay between this trio had a favourable impact on productivity and corporate profitability. Since capital goods are more tradeable in nature, stronger tech spending boosts trade directly, while technological advances have made transport and communications more efficient, fostering increased trade activity. For developed markets, global integration and competition have given corporate titans more incentive to innovate, increasing the potential for further productivity gains. Trade also aids technology transfer and diffusion, an additional avenue for productivity gains.

Exhibit 15: Wage share in the US economy has been declining



Source: BEA, Haver Analytics, Morgan Stanley Research; Note that compensation of employees and corporate profits do not sum to 100% because other components such as proprietors' income, rental income, net interest and miscellaneous payments, taxes on production and imports, business current transfer payments and current surplus of government enterprises are excluded.

Exhibit 16: Rising inequality in the US



Source: wid.world, BLS, Census Bureau, Haver Analytics, Morgan Stanley Research

Scrutiny over these factors have already risen (witness the moves to check globalization in the form of US/China trade tensions and the likely emergence of a multi-polar world – see US Public Policy and Global Equity Research: Investing For a Multipolar World (24 Jun 2020)) and have continued even in the midst of the pandemic and are likely to intensify. However, disrupting this trio of trade, tech and titans will also mean upsetting the driving forces behind the disinflationary trends over the last 30 years.

5) Monetary policy to accommodate initial rises in inflation

Monetary policy will also remain accommodative. In 2020, the Federal Reserve had conducted a review of its monetary policy strategies and has committed to its 2% average inflation goal, thereby aiming for a moderate overshoot of inflation. For more on the Fed's framework, please see US Economics: The Fed's New Framework: This Time Is Different (14 Sep 2020) by Ellen Zentner, the US economics and rates strategy teams. Unlike the previous cycle, when the Fed had tightened monetary policy well before inflation has moved above 2% sustainably, they are not likely to hike pre-emptively at the first uptick in inflation.

What are the risks to the inflation outlook?

Consensus is less upbeat about growth and hence inflation: The majority of the consensus and the investors we have spoken with view the recovery in 2021 as less robust than we do. In particular, they foresee a longer timeframe for GDP to reach pre-Covid levels, hence they see a slower pace of decline in the unemployment rate. By implication, they see inflation reaching 2% later than we do, and they also don't see inflation overshooting 2%.

We see two risk factors to our inflation forecast:

1) An "unstable" accelerating inflation path: We are mindful that upside risks to the inflation outlook could intensify, particularly if the inflation process becomes more dynamic than we assume in our base case.

The key issues are first, uncertainty around the natural rate of unemployment in this cycle and second, the risk appetite of the private sector. If the accelerated restructuring of the economy means a higher NAIRU, highly reflationary policies will lead to wage and inflation pressures emerging earlier. In addition, a faster pace of reopening, aided by positive developments on the vaccine front, will also rekindle private sector risk appetite. With an accommodative monetary policy backdrop, this could translate into a faster uptick in credit creation and aggregate demand, pushing inflation higher as well.

In that scenario, inflation could move onto an "accelerating" path. Indications that inflation could cross 2.5% may result in a notably hawkish shift in expectations for Fed policy, with potential for attendant volatility in financial markets – especially if market-based measures of inflation expectations become unanchored to the upside.

Moreover, concerns about public debt sustainability have been held in abeyance precisely because of the expectation that real interest rates will remain lower for longer. If inflation prompts the Fed to shift to a more hawkish policy stance, higher real rates would bring these concerns back to the fore, which in turn could lead to an adverse tightening of financial conditions. This is a risk that, from our conversations, has not featured prominently, if at all.

2) Pace of supply side adjustments: Inflation is ultimately the end result of interactions between aggregate demand and aggregate supply. On the demand side, we have had a lightning recovery and on our forecasts, the recovery is set to gather further steam in 2021.

On the supply side, some have argued that a dynamic and fairly flexible US economy means that the supply side response can help keep inflationary pressures at bay. In particular, they point to the acceleration in technology investment even during the recession.

However, we note that non-technology investment, which also boosts productivity, has suffered. This is particularly the case for Covid-sensitive sectors, which have not only pulled back on investments but have also retrenched on the labor side. While a rise in investments will help to mitigate inflationary pressures from a longer term perspective, we believe that the labor market will be the binding constraint in the near term (as discussed earlier). In our base case, we see demand improvement outpacing that of supply, leading to the buildup of inflationary pressures.

However, if factor markets prove to be more flexible, this could keep inflationary pressures at bay. Under this scenario, this would have echoes of the late 1990s cycle, where a risk of asset bubbles and financial stability concerns may outweigh that of price stability concerns.

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