

Is pent-up demand a coiled spring...or a Slinky?

The durable goods boom of the past year is unlikely to be repeated, taking away a key input to drive post-pandemic inflation, says Ariel Bezael, Head of Strategy, Fixed Income at Jupiter Asset Management.

The Bank of England's chief economist recently described the UK economy as a 'coiled spring' with consumers waiting to release pent-up demand after lockdown restrictions lift. This echoes the consensus view in markets that the global economy will reflate once vaccines enable economies to re-open, cushioned by supportive fiscal and monetary policy.

It's clear to see that markets believe inflation on its way back. In the US, triple C-rated bond issuers, and below, now make up the highest share of US high yield deals since 2007. It's not just credit markets that are seeing bubble-like conditions. Despite a wobble in early March, the S&P500 continues to trade close to its all-time highs.

My view remains that the reflation trade proponents may have gotten ahead of themselves and that we will remain in a low-interest-rates-for-longer environment.

While there will undoubtedly be a spike in inflation once economies reopen due to starting off from such a low base, I expect this will fade after a few quarters as growth eventually disappoints again. Structural inflation everywhere is being kept in check by the combined drivers of too much debt, 'zombification' of the corporate sector, ageing demographics, and disruption from globalisation, technology, and low-cost labour.

It's all about wages

Even China, whose economy has been booming for a few months now, has not seen an associated pick-up in inflation, and in fact their Consumer Price Index even dropped 0.3% year-on-year in January. Similar to developed economies, population growth in China is stagnant and the work force has been contracting since 2012. In fact, in our strategy, we've been buying 10-year Chinese government bonds, which yield considerably more than US Treasuries.

Investors should also remember that in the 2010s we had the longest economic boom in post-war history, with full employment, quantitative easing on tap, and corporate tax cuts – yet inflation averaged only 1.6% in the US. Ultimately, it is all about wages. For structural inflation to become an enduring concern, wage inflation needs to be embedded and accelerating.

The excess capacity in the labour market and the public's expectations of price rises both point to prolonged low inflation. Labour has limited pricing power after 40 years of weak wage growth and the decline of trade unions. Given the ever-increasing shift to automation and the increased influence of global monopolies, the power of labour versus capital has diminished even further.

Debt is a sugar rush

Some point to the surge in money supply as a reason to get excited about inflation but much of this is due to companies drawing down on bank facilities to stay solvent. I also doubt we'll see much productivity payback from government spending in the last year given it's been more about life support to the economy, rather than economic stimulus in the true sense of the word.

Personally, I see the ongoing incurrence of more and more debt as rather worrying. Governments around the world have taken on about \$15 trillion in debt in the last year or so. All this debt has a short-term 'sugar rush' effect and then eventually the structural problems outlined above come

home to roost. Japan's central bank has tried everything that Europe and the US have implemented in the last decade or so in order to generate sustainable inflation, to no avail.

The durable goods boom won't be repeated

While it's reasonable to expect that some consumers will rush back to hotels, restaurants, theme parks and so forth post-pandemic, I see a few holes in the thesis that this will lead to significant reflation. These candidates for pent-up demand release come to a total of just 8.5% of total consumer spending, according to economist David Rosenberg.¹ And while many people will rush back to travel, leisure and entertainment, I suspect equal amounts will remain cautious. Those who got caught out last year for having little in the way of savings won't want to repeat that mistake again, particularly in a soft labour market with weak wage growth. There is a strong case to be made that the savings rate may be elevated for some time to come.

Durable goods purchases are a key component of consumer spending and over the last year with the world in lockdown there has been a durable goods boom that's unlikely to be repeated. Durable goods consumption (i.e., cars, furniture, and appliances) in the US rose to its highest share of GDP since early 2007 and was higher than the usual cyclical figures. Given the nature of durable goods is that you try to avoid buying the same items again, I don't see much scope for pent-up demand here.

Plenty of opportunities, if you do your credit analysis

When everyone sits on the same side, even a small cross-current can capsize the boat. I don't believe it's wise to be all-in on the consensus trade for a return of inflation, which is why in our strategy we have a flexible barbell structure that holds carefully selected corporate bonds alongside high quality sovereign bonds to help shield against potential risks.

The outlook does indeed look positive for corporate credit: central banks showed their hand last March by supporting credit markets. We prefer short-dated corporate credit issued from defensive sectors like TMT, food producers, and supermarkets, or special situations where thorough credit analysis has given us confidence in their liquidity. Outside of this, for additional alpha we like some energy credits in Europe and US which should benefit from the improved outlook for oil. Finally, if there is one lesson from last year, it is to be mindful of unexpected tail risks, which is why we continue to like medium and long-dated triple A-rated sovereigns as a ballast to the strategy.

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¹ <https://financialpost.com/investing/investing-pro/david-rosenberg-two-big-problems-with-the-pent-up-demand-everybody-is-counting-on>

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