

Boom coming?

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Recent events in financial markets have been coloured by rising fears of inflation.

Anybody under the age of 50 has not experienced inflation in the way that the 1970s distorted pricing, spending decisions and investment. In fact, in recent years most people have benefited from a different type of inflation, house price inflation.

From an economic perspective it is not entirely clear why this type of inflation is good and other types bad. What is true, is that the UK has a great deal of otherwise productive capital locked up in bricks and mortar and consumer spending growth is decisively linked to housing expenditures and the wealth effects associated with rising house prices. Indeed, arguably, rising house prices for many have obscured static or low wage growth. The flip side is, of course, sharply rising debt levels and equally sharp wealth inequalities across generations.

The response to Covid has poured fuel onto the housing fire.

You may remember that the response to the global financial crisis of a decade ago was essentially to cut expenditures in the face of rising deficits in an attempt to “balance the books” as the economy contracted in the face of the financial crisis.

As James Lovelock once noted, “It’s never the poison, it’s always the dose that matters.” Austerity following the financial crisis damaged the economy but the response to Covid has swung the pendulum completely the other way and given way to a mirror image of austerity, government largesse. Covid has brought fiscal policy back onto the agenda with a vengeance and today, UK and global deficits are at peacetime highs.

It is a remarkable turnaround in the conduct of economic policy in a very short time.

However, at the same time as fiscal policy, government spending, has loosened beyond what could have been imagined only two years ago, we need to remember that monetary policy, the level of interest rates, are also at historic lows (indeed, they are negative in Europe).

What this means is that the UK economy (and the world more generally) is being supported by an unprecedented amount of official support. Only this week, the former governor of the Bank of England, Mervyn King, was warning that the gap between the level of stimulus and what the economy can produce was, “implausibly high.”

If Mervyn King is right then we can expect excess fiscal and monetary support to finish up in higher inflation, that is to say, goods price inflation as opposed to house price inflation. If the price level does begin to rise, the Bank of England will be forced to raise interest rates to head off price rises or risk “getting behind the curve.” That, of course, also risks bringing asset price inflation to an end.

It is a delicate balance but in the short run the combination of ultra-loose fiscal and monetary policies is likely to fund a powerful recovery from Covid, not just in the UK, but around the rest of the world. In the US, for example, Joe Biden, is attempting to mobilise \$6 trillion dollars (a little less than 25% of US GDP) to re-engineer the US economy.

Moreover, recent forecasts from the IMF in their recent World Economic Outlook point to trend growth rates doubling in the next ten years as compared to the last.

Of course, economic recovery is contingent on the pandemic fading into history and the vaccination programs successfully dealing with new variants and genetic mutations. So far, at least, the outlook, is promising.

In the short run, it seems we can look forward to something of a boom. However, all investors know that booms come to an end and should prepare accordingly.

What should we look for to get a sense of which way the wind is blowing? Is Mervyn King right to be so pessimistic? For us, the litmus test of post-Covid investment is productivity. If labour and capital productivity improve, the economy can run hot for longer and we can all become wealthier. If productivity growth fails, Mr King will be correct, the outcome will be higher inflation. Investors should prepare for both.

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