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In the Markets Now

‘Flations go both ways

With inflation top-of-mind for investors, we take a look at the other side of the story, and examine a few of the key reasons that inflation has been tame for the last several decades.

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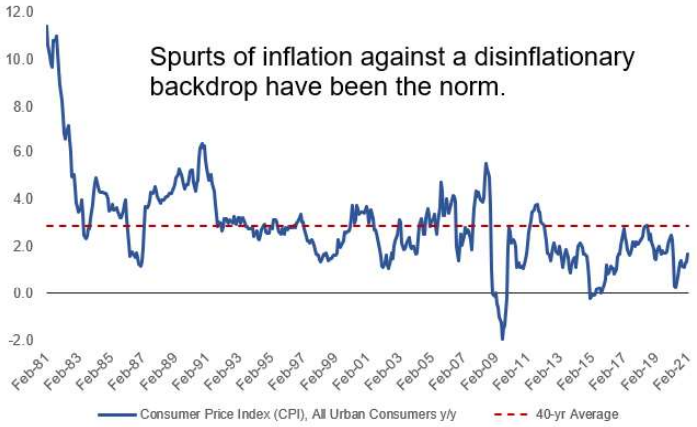
ANOTHER ANGLE ON THE INFLATION STORY: DEFLATION

It’s no secret that the big story in markets over the last few months has been inflation. And we get it! With $5T in stimulus over the past year (much of it directly to consumer pockets), we have entered uncharted waters regarding money growth. Combined with vaccine and reopening momentum, there is reason for genuine concern over near-term inflationary pressure.

But there’s a flip side to this argument, and it starts with the chart below. Inflation has been in a slow and steady (if choppy) decline since the late 1970’s. While periods of pricing pressure have popped up, none has been the sort of lasting and damaging inflation that we’re all concerned about, i.e. 1970’s-style stagflation. This has been the trend through many business cycles, and remained so even after the extraordinary measures used to fight the 2008 recession.



A big reason for this is that several deflationary forces have been asserting their influence on the global economy over the last 20-40 years. Below, we address a few of those items:

Technology. Massive improvements in technology over the last forty years have made goods and services cheaper across the board. Technology has facilitated efficiency gains in production, reduced waste in supply chains, and improved price transparency for consumers in almost every sector. These advancements show no sign of slowing, either.

Globalization. Globalization has made goods and services cheaper by both reducing labor costs (outsourcing production, etc.) and facilitating specialization that results in a more efficient trade landscape. While we may be moving to a more insular world in some respects, several decades of global supply chain buildout seems unlikely to fully reverse overnight.

Labor power. Sustained inflation is often the result of a wage-price spiral (where wage increases set off broader inflation). But de-unionization, globalization of the labor force, and automation have removed a lot of power from the hands of the worker. While the winds in Washington are shifting in favor of higher guaranteed wages and a stronger labor force, only time will tell if this will play out AND transform into steady inflationary pressure.

There are plenty of other forces at play, as well. Shifting demographics could portend future inflation as the share of the working age population increases, or the highly indebted nature of our modern economy could place a limit on the upward bound of inflation. **The modern economy is truly a complex beast, and inflation is one of its most confounding forces.**

Of course, the biggest factor remains the government’s new-ish penchant for spending trillions (with a T). Could this combined with infrastructure-led commodity inflation and historic GDP growth forebode a regime change that reverses forty years of falling inflation? We already know that base effects from the pandemic-recession will cause a spike in readouts this year, but will they be anything more than transitory? Hard, and important questions. And the reason that a well-diversified portfolio should contain a mix of assets that perform well in either environment. As always, please reach out to your Baird Advisor to discuss this or any other issue further.

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