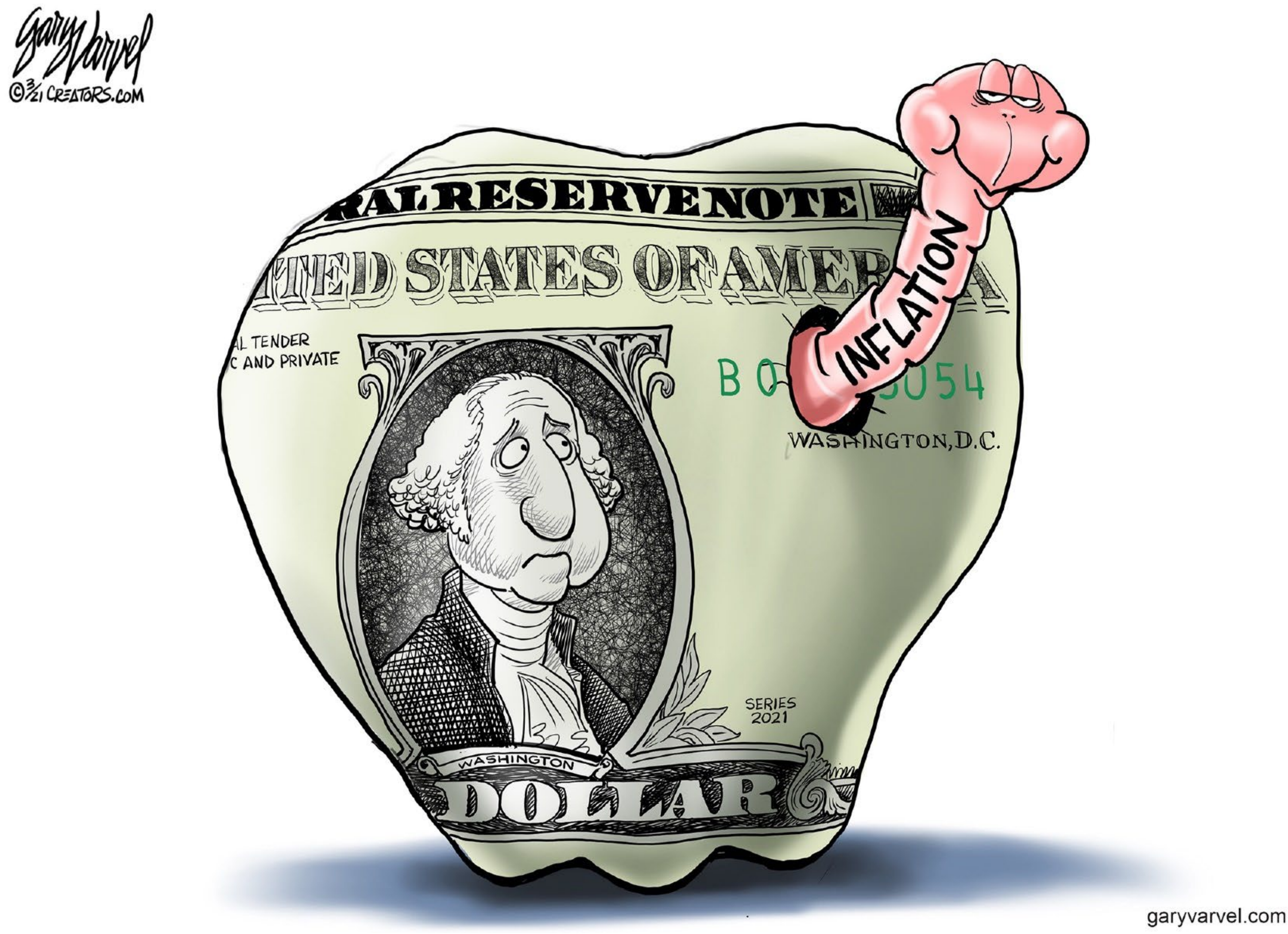
HAS THE INFLATION GENIE ESCAPED THE BOTTLE?



HAS THE INFLATION GENIE ESCAPED THE BOTTLE?

BY PAUL MIRON

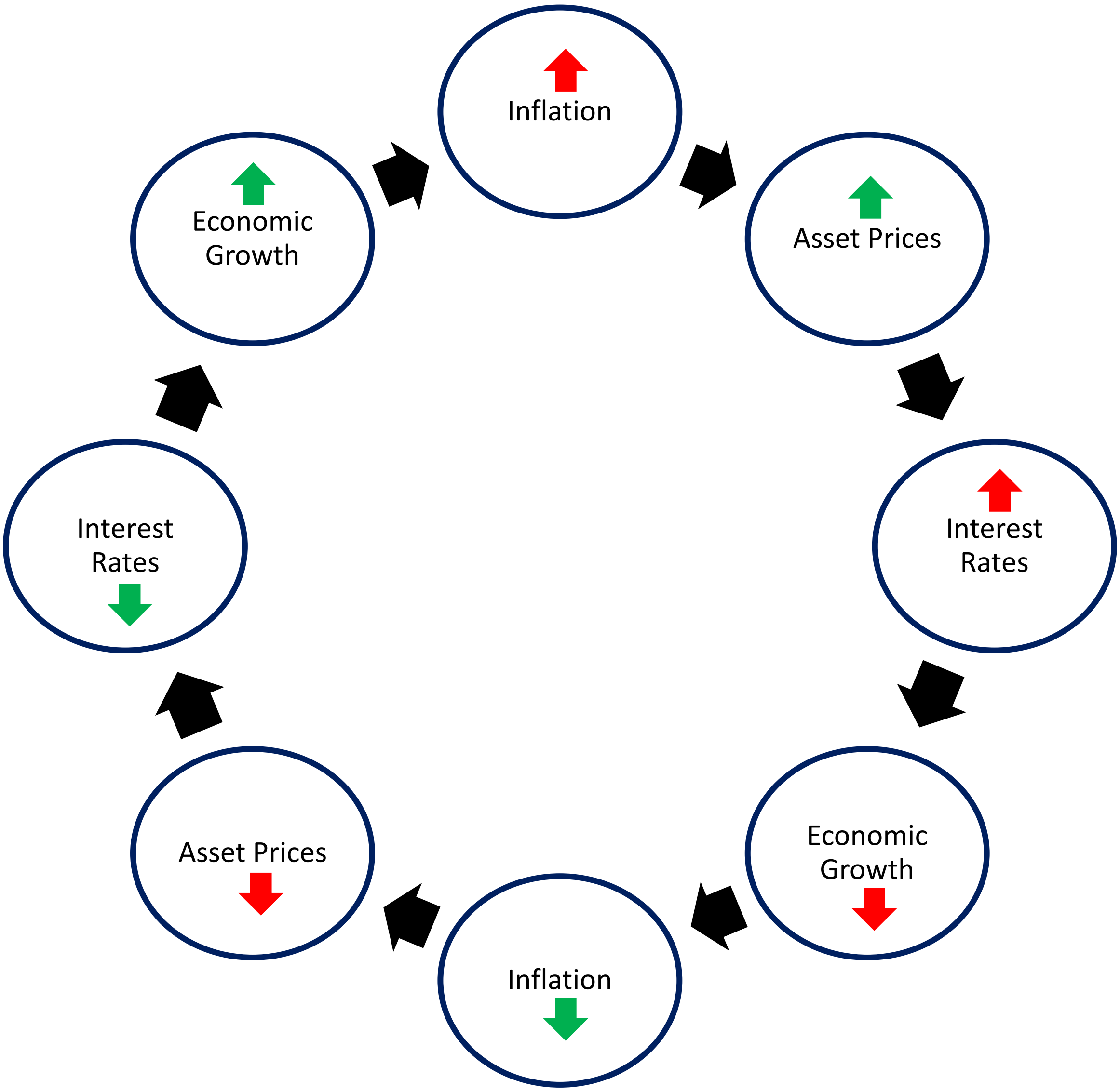
For the past 40 years, inflation in the western world has not triggered any emotion…until now. Naturally, the question we must ask is: What exactly has caused the sudden panic, fear, and obsession with the subject of inflation?

In central banks' pursuit of taming inflation, we have seen the blunt instrument of raising interest rates being applied worldwide. This has negatively impacted most asset classes, especially property and shares.

Since 1990, the general trajectory of interest rates has been downward, ultimately reaching the floor of a 0.1% p.a. official cash rate in Australia. In other words, "free money". This led to an unprecedented demand for almost any time type of asset that can store wealth.

It is no surprise that with the onset of rate hikes, as well as wild predictions of the share market and property market falling in excess of 60% and 30%, respectively, all types of investors have their eyes and ears fixated on what will happen next in the global economy.

On the topic of interest rates, it must be noted that if rates are raised too quickly, they could trigger a recession. On the other hand, if inflation is unchecked this could lead to deeper and



Inflation and the Economic Cycle

damaging recessions worldwide. A consequence of this is social unrest, thereby eroding financial equality and harmony, meaning it may take decades to return to normality.

Ronald Reagan famously said during his term as US President in the 80s: "Inflation is as violent as a mugger, as frightening as an armed robber, and as deadly as a hit man."

This is undoubtedly the most pressing economic issue of our time.

To understand the origins of inflation and to arrive at possible antidotes, one needs to dust off their economics textbooks from an era that experienced this phenomenon firsthand – the 70s.[1]

[1] [Stagflation? There are big differences between the 1970s and today - ABC News]

As one of my favourite sayings goes – "History doesn't repeat itself, but it often rhymes."

What is the True Origin of Inflation?

There is probably no one wiser on the subject matter of inflation than the late Milton Friedman. Friedman is one of the most highly regarded economists of modern times, reinforced by his receiving of the 1976 Nobel Memorial Prize in Economics for his work on the study of inflation. He is the principal architect of modern monetary policies applied by western central banks.

The words Friedman uttered during his era are all the more relevant to today's economic climate. As he put so simply: "Inflation is a monetary phenomenon. It is made and stopped by central banks."

In other words, it is the volume of money being printed, which can be economically summarised as an increase in the money supply, that is relevant to the question of inflation.

1) Increase in the money supply.

Since the onset of COVID, the increase in money supply has never been more significant in our economic history. We have been paid a raft of various government benefits to sit at home and disrupt normal business and spending habits. At the same time, the RBA increased the money supply to counterbalance the loss of productivity. Central banks were essentially "printing more money" at a rapid pace, while lowering interest rates and allowing the bank to issue more credit.

Also, let us not forget quantitative easing, where the government buys and issues debt, reducing the cost of capital and creating massive liquidity in the financial markets. The size and magnitude of these monetary actions are seven times larger than during the GFC.

According to Friedman, once a rapid increase in money supply occurs, it takes anywhere between 6 to 18 months for inflation to work through the economy. We are seeing this phenomenon firsthand here in Australia and around the world, with inflation rates not seen since the 70s.

Friedman also noted that inflation is not a global phenomenon but a home-grown problem that is caused by central banks and can be remedied by central banks. An analogy used by Milton is that an increased money supply is like giving someone alcohol. At first, the positive effects are noticed and everyone seems to be happy…however, an excessive amount will always lead to an inflation hangover.

2) Supply/Demand for Goods and Services

In the normal free-market economic system, prices of goods and services adjust according to demand, with businesses either increasing or decreasing production. Over time, this results in new business entrants increasing supply, or businesses leaving the market and decreasing supply.

Counterintuitively, these disruptions do not cause persistent inflation. From the onset of COVID, the stop-and-start nature of the global economy has resulted in supply chain issues and overnight demand for certain services, with employers needing to re-skill and re-tool their businesses to cope with unexpectedly high demand.

Once again, using free-market logic, these issues will eventually resolve themselves over time. Economists often refer to these impacts being 'transitionary' impacts of inflation; that is, temporary.

Looking back at the '70s inflation crisis, many governments around the globe tried to lay blame on the 1973 war in the Middle east that disrupted oil production and increased its price by as much as 400%.[3] Drawing comparisons to today, there are numerous adverse economic and social impacts due to the war in Eastern Europe. This includes effects to both supply chains and commodity prices around the globe.

Despite this, the teachings of Milton Freidman tell us that these supply shocks provide short-term inflationary pressure. In the long-term, free-market economics will find a way to adjust the demand and supply of these goods, meaning that supply issues are not the true culprits in adding to long-term inflation – it is all about the RBA's monetary policies.

3) Future Price Expectations

Perhaps the most ignored and least discussed aspect of inflation is future price expectations. Perhaps it is because we have not experienced this firsthand for the past 40 years and are accustomed to a low level of historical inflation. Thus, our expectations can be said to be well-anchored.

In the US, Australia and most western economies during the '60s, inflation had been unchecked for many years, rising from 1.5% to 5% during the '60s, and reaching more than 14% in the '70s. In addition, wage inflation in Australia for the five years during 1969-1974 went up by 98%.

[3] https://www.theguardian.com/environment/2011/ mar/03/ 1970s-oil-price-shock

If businesses and employees are accustomed to long periods of persistent, rising inflation, a natural response to the rising cost of living will be employees demanding an adjustment to their wages, leading to higher prices and higher inflation. In such a situation, inflation becomes embedded in expectation and becomes a self-perpetuating inflationary issue that is commonly referred to as the 'wage-price inflationary spiral'.

A result of laxed central banks' approach to inflation is the deep and destructive impacts of the later 70s and 80s recessions. We learnt that it takes several years to tame inflation, with challenging and harsh fiscal and monetary policies expected to come.

The main lesson to be learnt from the 70s is that we cannot allow unanchored inflation expectations. Central banks must act swiftly to tackle inflation and maintain the status quo of people having anchored expectations of inflation so as to maintain faith in our financial system. This is to avoid inflation becoming uncontrollable and inflicting unnecessary harsher pain to the economy.

This is precisely why despite Labor's promises to support the market with 5.5% wage inflation, the RBA recommends that it remains capped at 3.5%. Lower wage inflation guards against a wage-price inflationary spiral.

Thus, we reach a conclusion that a short recession is better than losing control of inflation and letting loose future price expectations.

Perhaps this is why economists use the analogy of the mythical genie escaping the bottle, as once it escapes, it is hard to get the Genie back into the bottle.

Looking back at our central bank, the current actions taken by the RBA are taken right out of pages in Milton Freidman's economic textbook. They are acting swiftly and assertively.

We believe the next 6 months will have a heightened level of volatility in both the property and share market until there is evidence that the inflation beast has been tamed. We anticipate that this will only occur towards the end of the year once we receive data reflecting lower inflation.

Investors should expect a short and fast series of interest rate rises over the next four months.

Hopefully, this will be followed by stability with minimal changes to the official cash rate during 2023. This would enable the economy to re-adjust to the psychology of normalised interest rates.

Graph of the Cash Rate Target

Source: RBA

The RBA Governor, Philip Lowe, indicated that an official rate of 2.5% is the correct setting for a neutral monetary policy and money supply. Investors and borrowers should brace for this setting sooner rather than later and prepare for the fact that we will have higher interest rates and softening asset prices.

Australia's present economic strength is significant with a low base of unemployment, plentiful natural resources and a food-rich economy. Despite this, the sudden increase in interest rates will pose an additional risk. As mortgage managers, we appreciate our risk assessment and are completely cognisant to the downward risk of depreciating property prices.

We assess the risk of properties depreciating by perhaps between 15-20% – maybe even more for some specialised properties as well as regional properties and vacant land. Additionally, some construction projects have a significant risk of delays and cost blowouts that continue to be the predominant risk factor for this type of debt over the next 12 months.

However, with the lack of supply, wage inflation, migration, low levels of unemployment, rental growth and times of inflation, property is naturally seen as an inflation hedge. Thus, property will remain relatively resilient through these inflationary times.

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If you would like more information, please feel free to contact myself or our dedicated team of professionals at our office with the following details:

Phone: (02) 9157 8608
Email: info@msqcapital.com.au
Address: Level 12, 88 Pitt Street, Sydney NSW 2000