

## ***Revisiting a low growth, low interest rate, low inflation world through COVID-19***

### **Part 1 - Why the recent increase in inflation and growth is temporary**

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In this white paper series, we examine whether inflation is likely to stay at low levels over the next decade. We also examine how future inflation and overall economic growth rates will impact the attractiveness of the returns Hyperion's global equity strategy is likely to produce in the long run. The main topics covered in this series are addressed in five interrelated papers:

Part 1 - Why the recent increase in inflation and growth is temporary;

Part 2 - Why the rotation to lower quality value stocks will not be sustained;

Part 3 - The relationship between growth, inflation, interest rates and valuations;

Part 4 - Why high-quality businesses can handle high inflation better than most other investments; and

Part 5 - What if our views on inflation turn out to be wrong?

### **Part 1 - Why the recent increase in inflation and growth is temporary**

We believe higher inflation will be transitory in nature and inflation will remain low in the long term.

There are several reasons that suggest the recent increase in inflation (and economic growth rates) will be short-lived and that these inflationary influences will fade over the next twelve months. Furthermore, once inflation returns to lower levels (likely in 2022), there are several key structural factors that should result in inflation (and economic growth rates) remaining at low levels over longer time periods.

The recent increase in inflation (and associated strong economic growth) has been driven by several transitory factors, including:

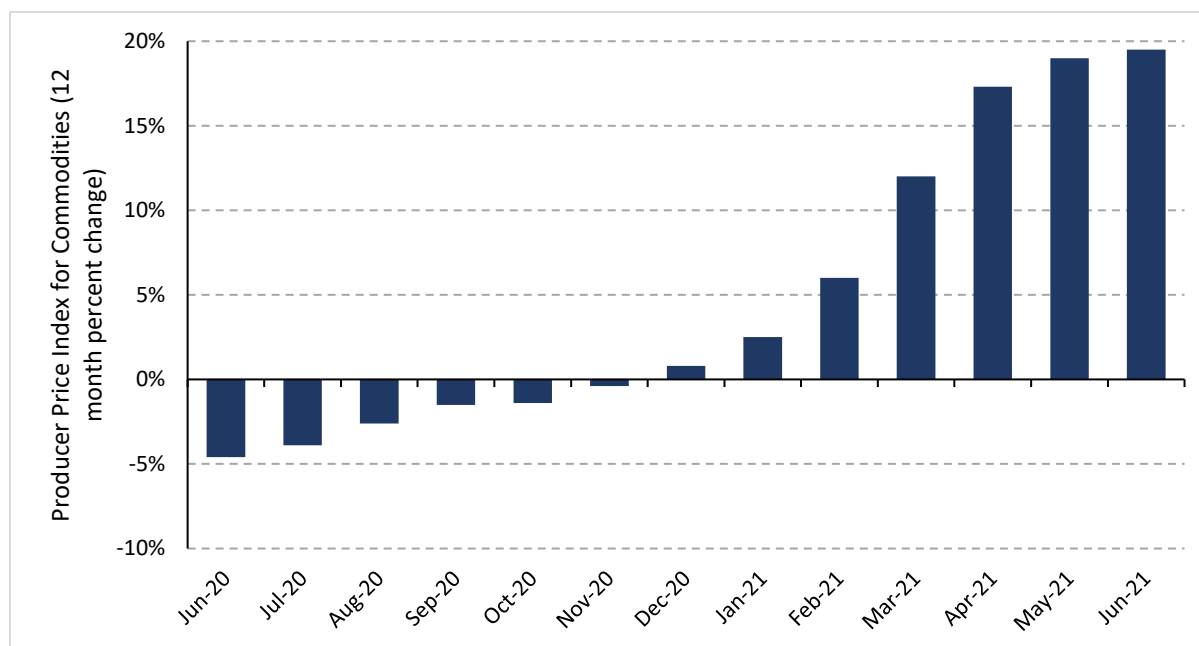
- 1) The "base effect" from depressed commodity and product-related pricing and negative demand growth during the early stages of the COVID-19 crisis;
- 2) The "broken window fallacy";
- 3) Distortions in consumer spending patterns, during the initial COVID-19 lockdowns, leading to unsustainable increases in demand for durable and non-durable goods;
- 4) Increased government spending on transfer payments boosting short-term consumer expenditures;
- 5) Unsustainably strong credit growth in China; and
- 6) Increased short-term demand and related price increases for transport and travel-related services and products as economies recover from the COVID-19 crisis.

### ***The “base effect”***

There has been a large increase in commodity prices over the past twelve months as shown in Figure 1.

Part of the year-over-year increase in commodity prices has been influenced by a “base effect.” That is, twelve months ago commodity prices were very depressed because of the initial impact of the COVID-19 crisis.

**Figure 1:** Producer Price Index for commodities in the U.S. (12-month percent change)



**Source:** U.S. Bureau of Labor Statistics. Data published in July 2021. Note: The data is not seasonally adjusted.

The base effect also applies to inflation statistics and reported economic growth figures.

### ***The “broken window fallacy”***

The recent economic growth statistics overstate the real economic improvement over the past twelve months. The “broken window fallacy” states that simply replacing a damaged or destroyed good, service or income with the same or similar quality attributes does not result in true economic growth. Simply replacing the businesses and associated incomes, products and services that were destroyed during the COVID-19 crisis with similar businesses, incomes, products, and services does not equate to true economic progress. The new business and wage incomes and related goods and services are included in the GDP statistics, but these figures overstate the true economic growth since the COVID-19 crisis began. This overstatement of true economic growth is supportive of lower than stated underlying aggregate demand growth. A lower than stated level of true economic growth is less supportive of demand-pull inflationary pressures where “too much money is chasing too few goods.”

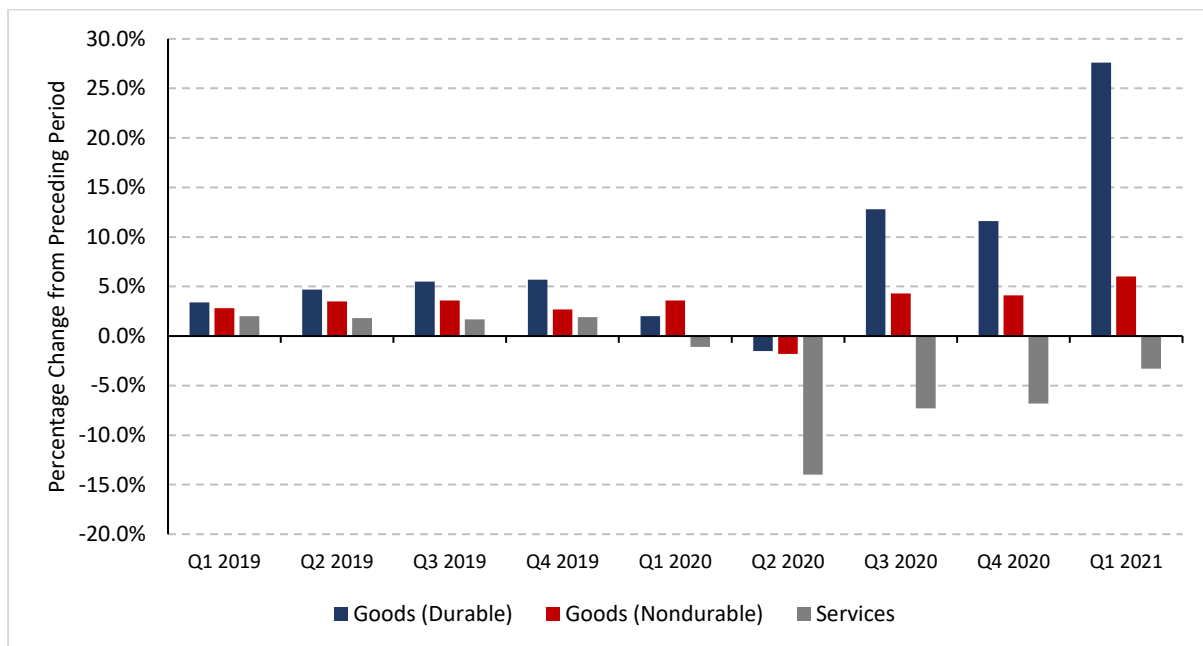
### ***Unsustainably strong demand for durable and non-durable goods***

The single largest component of the U.S. economy is consumer-based personal expenditures. In recent times, total personal expenditures have represented approximately 70% of U.S. GDP. Personal expenditures comprise both services expenditures and goods expenditures.

Prior to the COVID-19 crisis, services-based expenditures represented 44% of GDP. In March 2021, expenditures on services had declined to only 42% of GDP. At the same time goods-based expenditures

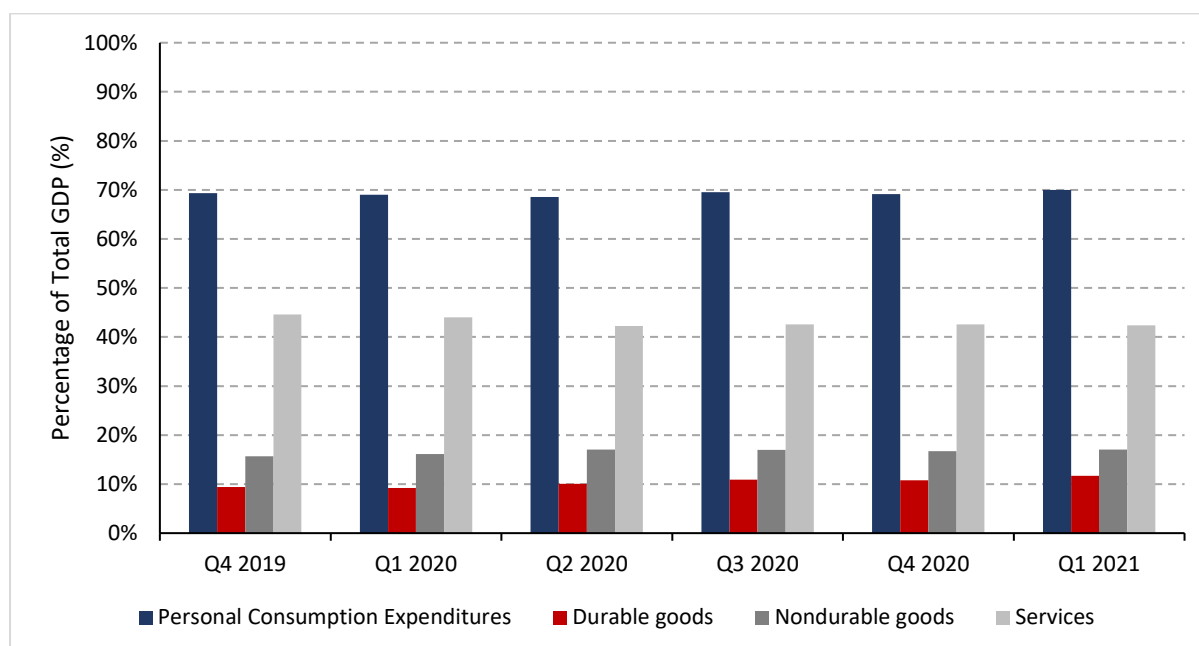
increased from approximately 26% of GDP prior to the lockdowns to 29% in March 2021. Durable goods expenditures increased by 28% in the twelve months to March 2021 and non-durable goods increased by 6% over the same period. On the other hand, services-based expenditures decreased 3% over the 12 months to March 2021. The large increase in demand for durable and non-durable goods was a direct result of the lockdowns preventing people from being able to spend on services. During the COVID-19 crisis most consumer-based expenditure has been directed away from services like travel and restaurants towards goods. This is shown below in Figure 2 and further supported by the tabulated data in Appendix 1.

**Figure 2:** Quarterly U.S. personal consumption expenditures percentage change from preceding period



**Source:** U.S. Bureau of Economic Analysis (2021). *Note:* Q1 2021 is a revised estimate. Data from latest U.S. Bureau of Economic Analysis released on 24 June 2021. See Appendix 1 for underlying data.

**Figure 3:** Quarterly U.S. personal consumption expenditures proportions of U.S. GDP in billions of chained (2012) U.S. dollars



**Source:** U.S. Bureau of Economic Analysis (2021). Note: Q1 2021 is a revised estimate. Data from latest U.S. Bureau of Economic Analysis released on 24 June 2021. See Appendix 1 for underlying data.

This reallocation of consumer spending away from services and towards goods is temporary and likely to reverse over the next twelve months as global economies reopen and transfer payments recede.

This short-term increase in demand for goods has, in turn, increased demand for the commodities and raw materials used to manufacture those goods. At the same time, global supply chains were disrupted by the COVID-19 crisis, as distributors initially cancelled orders with their suppliers. It has taken time for manufacturers to increase production levels to meet the unexpected increase in demand for physical goods because of the COVID-19 lockdowns.

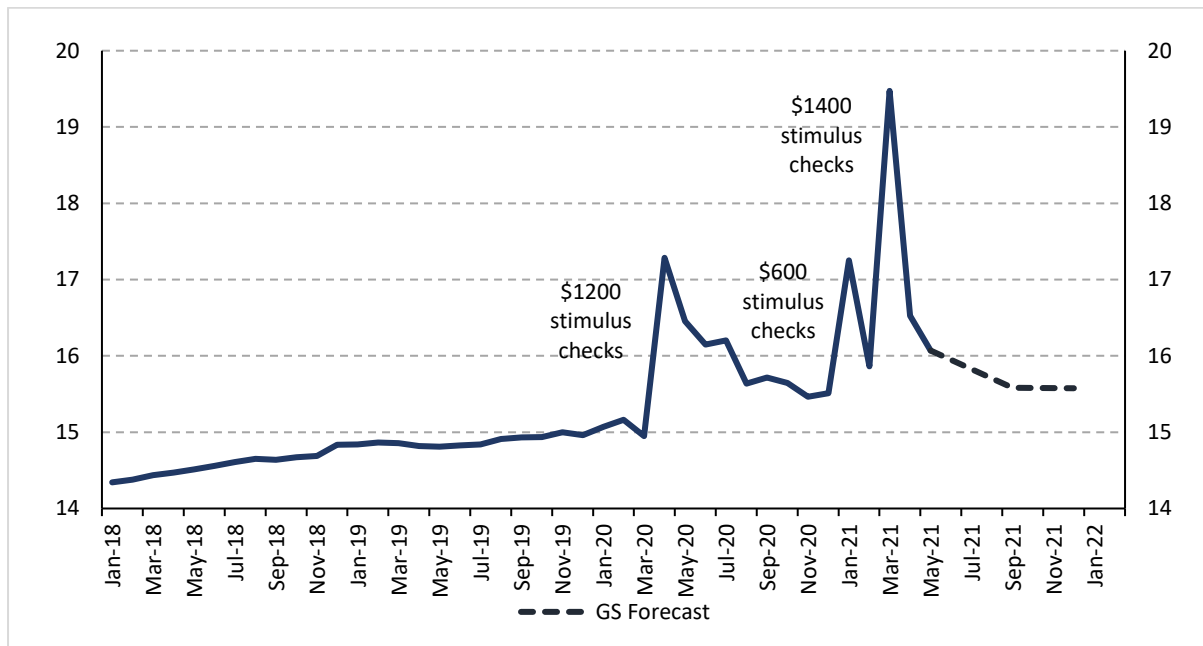
The increased demand for both durable and non-durable goods and the disruption of global manufacturing and distribution networks has caused shortages of many goods. These stock shortages have resulted in buyers of goods in most global supply chains arguably over-ordering to prevent future lost sales from lack of inventory. This over-ordering from distributors and manufacturers has exacerbated the shortages of goods in global supply chains and helped boost current commodity prices.

However, as consumer expenditures start to normalise over the next 6-12 months, because of vaccine rollouts and the ending of lockdowns, consumer demand for both durable and non-durable goods is likely to decline. In fact, manufacturers and distributors of goods that have been over-ordering, are likely to find that they will end up with excess inventories that will be difficult to sell without resorting to price discounting (to clear this surplus stock).

#### ***Increased Government spending on transfer payments***

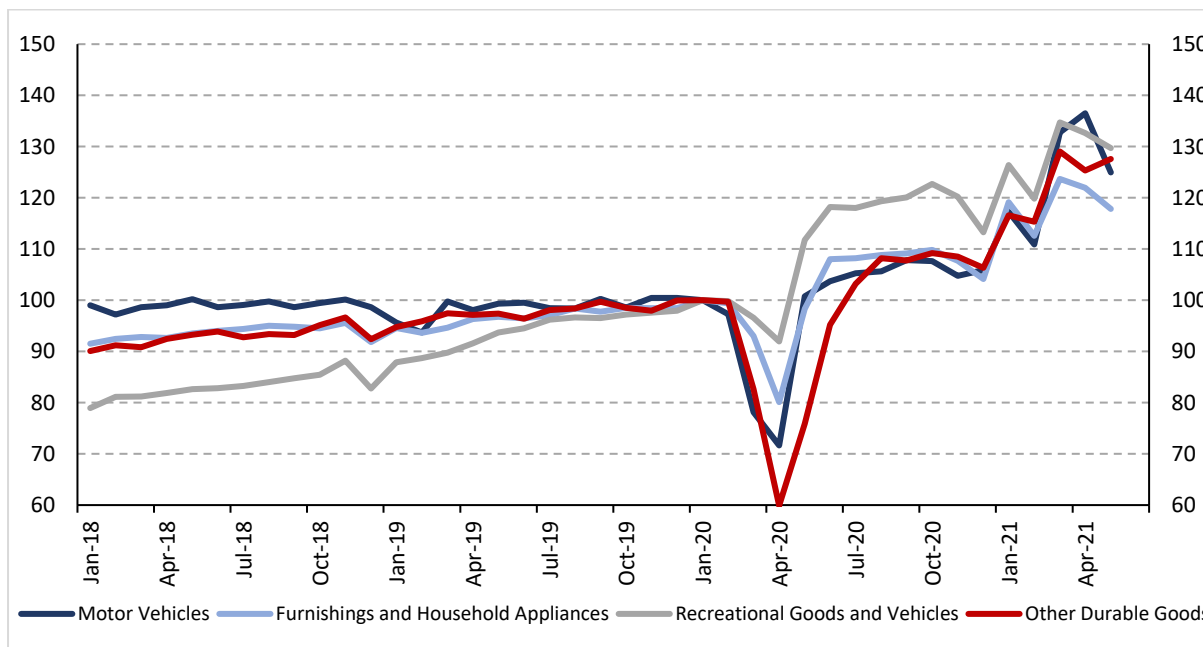
Governments around the world have expended significant additional amounts on welfare and other related transfer payments in reaction to the increase in unemployment and negative economic growth because of the onset of the COVID-19 crisis.

**Figure 4:** U.S. real disposable income has been temporarily boosted by government transfer payments - U.S. real disposable income (Trillions of 2012 U.S. dollars, annualised)



**Source:** Goldman Sachs Global Investment Research, U.S. Department of Commerce, U.S. Bureau of Economic Analysis (BEA) (2021).

**Figure 5:** U.S. real consumer spending index (Index, January 2020 = 100)



**Source:** Goldman Sachs Global Investment Research, U.S. Department of Commerce, U.S. Bureau of Economic Analysis (BEA) (2021). Consumer Spending data indexed from January 2020 (=100).

This large amount of additional government spending has been primarily funded by debt. The significantly higher levels of government spending have reduced the short-term negative economic impact of the COVID-19 crisis. This increase in welfare payments has allowed consumers to continue to spend even though many

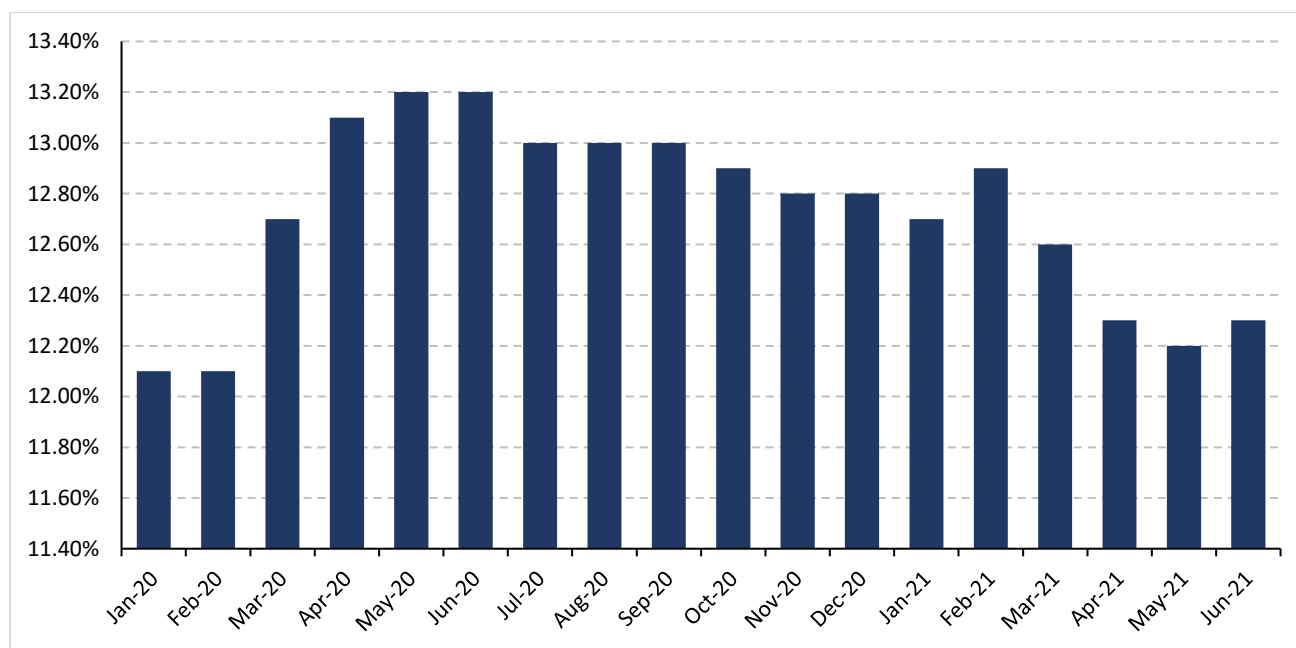
have been made unemployed during the crisis. This government spending has boosted short-term aggregate demand that in turn has temporarily helped to support higher pricing for some goods and services. Most of these additional government transfer payments will end in the next few months. Therefore, Hyperion believe the benefit to aggregate demand from these abnormally large government payments will start to fade in the second half of 2021 and into 2022.

The reduction in the level of welfare payments is likely to lead to lower levels of growth in both real economic activity and inflationary pressures over the next eighteen months.

***Strong credit growth in China is fading***

China is a key driver of global economic growth and has further stimulated its economy in reaction to the COVID-19 crisis. Credit growth was allowed to accelerate over the past year, and this has helped mitigate the short-term negative impacts of the COVID-19 crisis on the economy. This type of credit impulse has been a common reaction by the Chinese Communist Party to periods of potential low or negative economic growth in the past. There have been a series of these large credit impulses, particularly since the GFC and each of these has been associated with a general increase in commodity prices. As the current credit impulse fades, commodity prices are likely to suffer a period of weakness. Weaker future commodity prices are disinflationary.

**Figure 6:** China outstanding Yuan loan growth

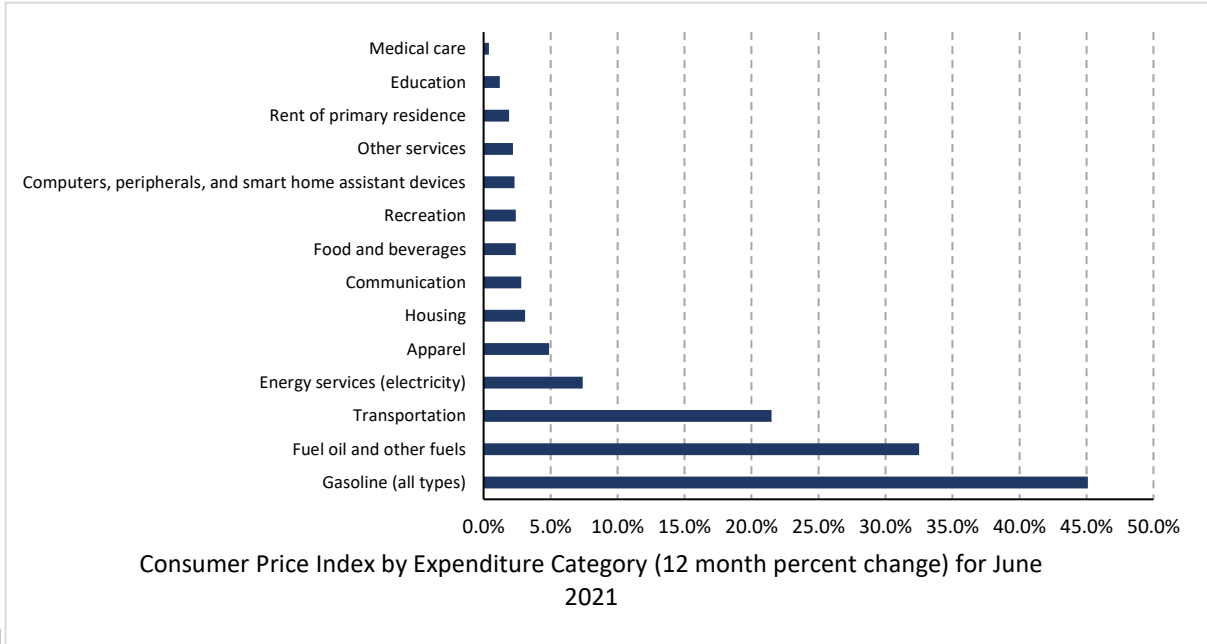


**Source:** People’s Bank of China, Trading Economics (2021)

***Increased demand for transport and travel related services and products***

Finally, another temporary influence on inflation is the fact that demand for transportation and travel has gone from very low levels during the worst of the COVID-19 lockdowns to a more normalised level of demand currently. This has contributed to temporary price increases in used cars, gasoline and certain airline tickets.

**Figure 7: Consumer price index by expenditure category in the U.S. (12-month percent change) for June**



2021

**Source:** U.S. Bureau of Labor Statistics. Data published in July 2021.

In summary, these factors driving the recent increase in inflation are temporary in nature and are likely to recede over the next eighteen months. As the global economy more fully recovers from the COVID-19 crisis, deflationary structural forces will once again start to suppress inflation. Longer term, we believe these structural headwinds will overwhelm any future inflationary pressures.

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July 2021

## Appendix 1

**Table 1:** U.S Real Gross Domestic Product: Percent Change from Quarter One Year Ago (Billions of U.S. Dollars)

|  | 2019 |     |     |     | 2020 |       |      |      | 2021   |
|--|------|-----|-----|-----|------|-------|------|------|--------|
|  | Q1   | Q2  | Q3  | Q4  | Q1   | Q2    | Q3   | Q4   | Q1 (r) |
| <b>Gross Domestic Product (GDP)</b>            | 2.3  | 2.0 | 2.1 | 2.3 | 0.3  | -9.0  | -2.8 | -2.4 | 0.4    |
| <b>Personal Consumption Expenditures (PCE)</b> | 2.3  | 2.4 | 2.5 | 2.5 | 0.2  | -10.2 | -2.8 | -2.7 | 1.8    |
| <b>Goods</b>                                   | 3.0  | 3.9 | 4.2 | 3.7 | 3.1  | -1.7  | 7.2  | 6.7  | 13.2   |
| <b>Durable Goods</b>                           | 3.4  | 4.7 | 5.5 | 5.7 | 2.0  | -1.5  | 12.8 | 11.6 | 27.6   |
| <b>Nondurable Goods</b>                        | 2.8  | 3.5 | 3.6 | 2.7 | 3.6  | -1.8  | 4.3  | 4.1  | 6.0    |
| <b>Services</b>                                | 2.0  | 1.8 | 1.7 | 1.9 | -1.1 | -14.0 | -7.3 | -6.8 | -3.3   |

**Source:** U.S. Bureau of Economic Analysis (2021). Note: (r) denotes revised estimates. Data from latest U.S. Bureau of Economic Analysis release on 24 June 2021.



**Table 2:** Expenditure on goods as % of GDP has increased during the COVID-19 crisis

|  | 2019     |          | 2020     |          |          | 2021     |
|--|----------|----------|----------|----------|----------|----------|
|  | Q4       | Q1       | Q2       | Q3       | Q4       | Q1 (r)   |
| <b>Gross domestic product (GDP)</b>      | 19,254.0 | 19,010.8 | 17,302.5 | 18,596.5 | 18,794.4 | 19,086.4 |
| <b>Personal consumption expenditures</b> | 13,353.7 | 13,118.4 | 11,860.3 | 12,924.7 | 12,999.1 | 13,353.3 |
| <b>Percentage of Total GDP (%)</b>       | 69.4%    | 69.0%    | 68.5%    | 69.5%    | 69.2%    | 70.0%    |
| <b>Goods</b>                             | 4,811.8  | 4,812.9  | 4,677.4  | 5,152.4  | 5,134.3  | 5,446.7  |
| <b>Percentage of Total GDP (%)</b>       | 25.0%    | 25.3%    | 27.0%    | 27.7%    | 27.3%    | 28.5%    |
| <b>Durable goods</b>                     | 1,811.7  | 1,752.0  | 1,744.6  | 2,028.2  | 2,022.6  | 2,235.3  |
| <b>Percentage of Total GDP (%)</b>       | 9.4%     | 9.2%     | 10.1%    | 10.9%    | 10.8%    | 11.7%    |
| <b>Nondurable goods</b>                  | 3,018.2  | 3,070.6  | 2,947.9  | 3,154.5  | 3,142.1  | 3,255.4  |
| <b>Percentage of Total GDP (%)</b>       | 15.7%    | 16.2%    | 17.0%    | 17.0%    | 16.7%    | 17.1%    |
| <b>Services</b>                          | 8,584.9  | 8,365.3  | 7,306.9  | 7,919.6  | 8,002.5  | 8,085.4  |
| <b>Percentage of Total GDP (%)</b>       | 44.6%    | 44.0%    | 42.2%    | 42.6%    | 42.6%    | 42.4%    |

*Source: U.S. Bureau of Economic Analysis (2021). Note: (r) denotes revised estimates. Figures presented in Billions of chained (2012) U.S. Dollars, seasonally adjusted at annual rates. Data from latest U.S. Bureau of Economic Analysis release on 24 June 2021.*

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