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Will coronavirus lead to higher inflation?

There is divided opinion on whether government monetary interventions around the world will trigger higher inflation. We offer our analysis and what it potentially means for investors in our funds.

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The pandemic crisis now gripping the world has been described by many prominent politicians as a war, and although its effect on mortality fortunately is nowhere near the human cost of the 20th Century's two world wars, its global economic effects are beginning to look comparable in scale. As many countries begin to emerge from the worst phase of the crisis and the lockdowns begin to ease, a key economic debate has naturally surfaced which will occupy policymakers and investors for many years to come.

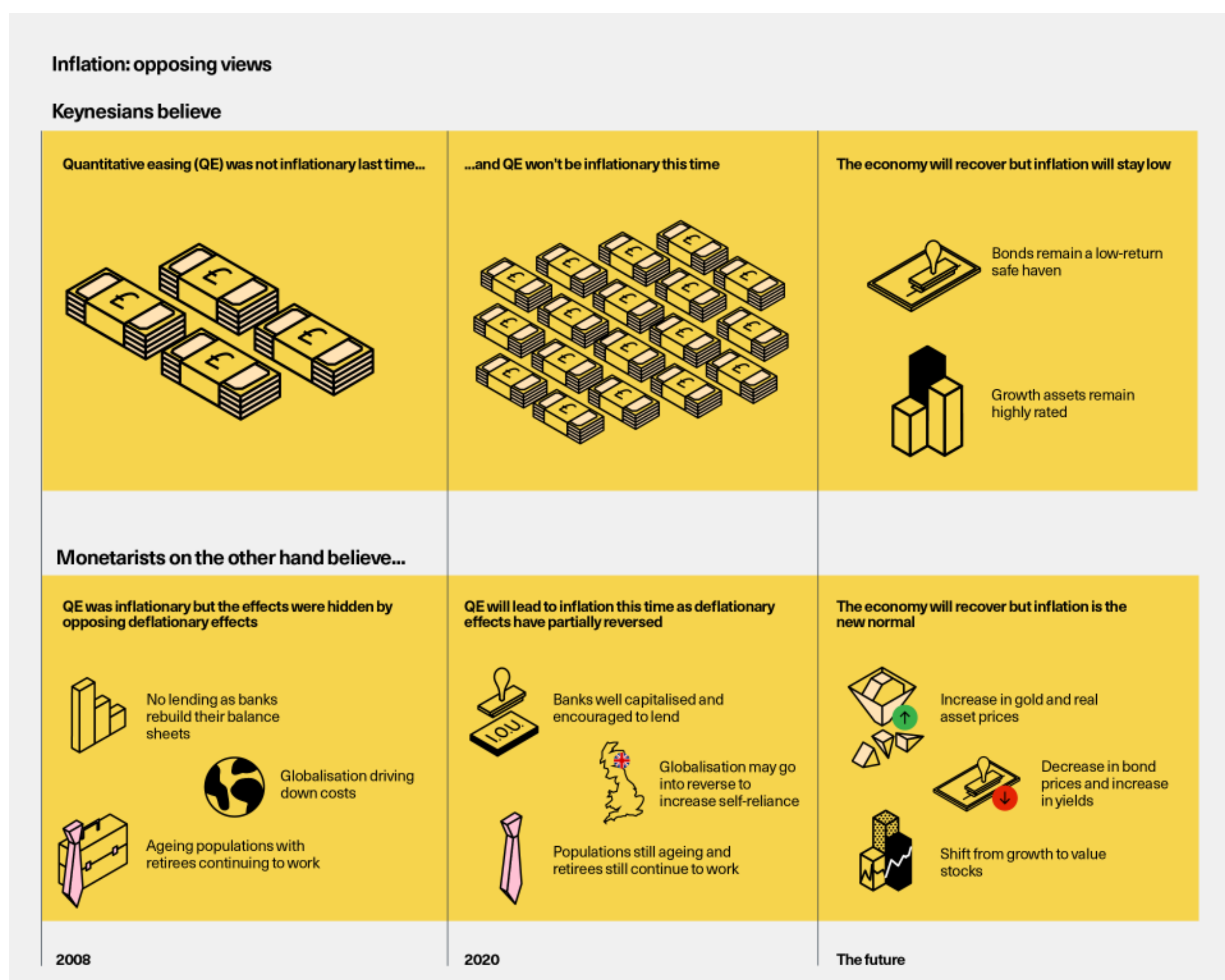
The question is whether the lasting economic consequences of this crisis lead to more deflation, or, will the gigantic monetary and fiscal stimulus now being deployed by governments across the globe finally mark the start of a period when inflation returns to the world economy at levels we have not seen since before the financial crisis in 2008?

This is an important question for all investors to consider because the outcome will have a profound effect on financial and real asset prices – and the outcomes will be very different under the two scenarios.

It is a polarising and fundamental debate partly because it pits two economic schools of thought against each other. Keynesians who focus on demand dynamics and monetarists who focus on money supply. Unsurprisingly, they have diametrically different views on the subject. They also disagree about what happened in the period after the financial crisis and explain the past 10 years of persistently low inflation in very different ways.

In this article we will try to steer you through the debate to help you understand what we think will happen and why – and what it means for your investment.

This debate between monetarists and Keynesians has played out many times before but perhaps most notably, in the context of Quantitative Easing (QE 1, 2 & 3) in the aftermath of the 2008 financial crisis.



In order to offset a contraction in the amount of money held by households and companies (so-called broad money) as banks reduced loans (balance sheet contraction) as the crisis unfolded, the Federal Reserve and other central banks used QE to stimulate the economy. QE is one method by which central banks effectively create money (out of thin air) to increase money supply to buy assets from banks and other financial institutions in order to pump money back into the economy to keep it operating as near capacity as possible.

This policy was ultimately successful in preventing a 1930s style depression but because inflation remained low and below target during the six or more years of substantial QE – and indeed after it had finished – commentators and especially Keynesians concluded that this demonstrated (what they had already pre conceived) that QE is not inflationary.

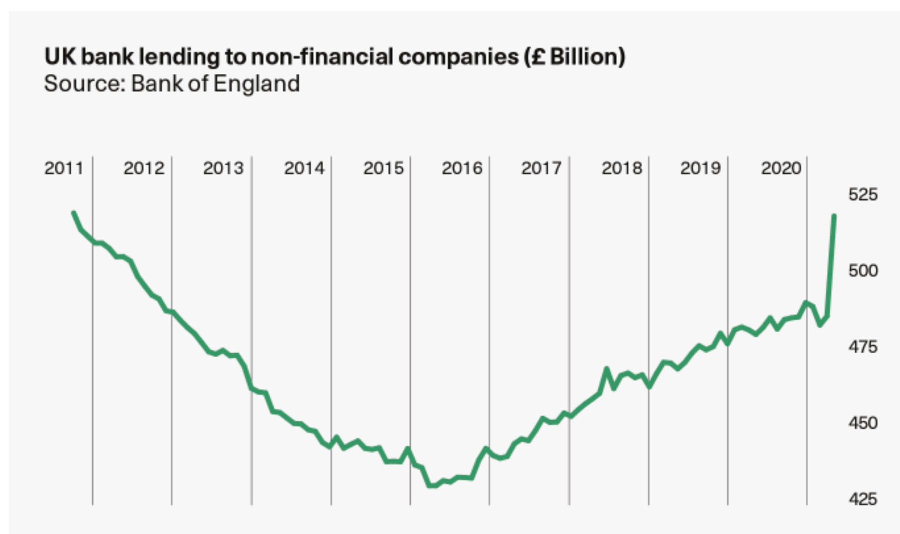
The opposing view from the monetarist camp is that QE is inflationary but that its effect on inflation was disguised after the financial crisis by other macroeconomic factors that offset its inflationary influence.

These offsetting factors included constrained credit growth (the amount of lending to individuals and companies) as banks were forced by regulators to rebuild their balance sheets while also meeting huge reparation costs, and demographic factors as societies in the West aged and large numbers of retirees kept working, which helped keep wages down. Meanwhile globalisation factors helped to drive costs down everywhere. China's development in the 10 years since the financial crisis has had a significant impact on keeping prices down.

In other words, QE was and is inflationary and absent these deflationary forces replaying, could be again. Indeed, it could be argued that whilst QE 1, 2 & 3 did not lead to a rapid rise in consumer price inflation, it was a primary cause of the asset price inflation that took place after the 2008 crash.

If we fast forward to the current crisis, what we see again – but this time on an even bigger scale – is another period of massive and rapid money supply growth which could lead to higher inflation in the medium term. This time it could be different from QE 1, 2 & 3 because the deflationary forces that offset the inflationary impact of QE programmes may no longer exert the macroeconomic influence they did then.

This time the banks, in general, are extremely well capitalised and are able to lend to the economy – and are expected to be encouraged by governments and regulators to do so.



Demographic influences are still deflationary in most developed economies but no more so than they have been in recent years. Elsewhere, the previously deflationary impact of globalisation could go into reverse as countries look to shorten supply chains (long supply chains that involve outsourcing internationally keeps costs down), build spare capacity in healthcare and in other key industries, increase self-reliance in sectors like agriculture and food manufacturing and look to award significant wage increases to all key workers in public services. All of these influences could well be likely in the future to be either neutral or inflationary and could this time add to the inflationary implications of the massive monetary and fiscal stimulus enacted across the globe.

In the very short term, we could well see a scenario where inflation falls across the developed world largely because of the recent dramatic falls in the price of oil. But beyond the initial demand shock and the inventory adjustment that is subsequently playing out in reaction to the fall in demand, we could see supply adjusting to a new equilibrium not just in oil but in other industries too.

As these short-term impacts unwind, the inflationary impetus that builds in the monetary aggregates across the world and in society more broadly may lead to an inflation inflection point. Furthermore it is likely that policymakers will tolerate this initially and may even quietly welcome it – not least because for so long inflation has been below target. If higher inflation starts to get to unacceptable levels later, this may prove to be very challenging for central banks but in the first instance, higher inflation may be seen as a good thing and consistent with inflation targeting policy. Central Banks tend to believe that fighting deflation is much more difficult & challenging than fighting inflation.

Higher inflation can have profound implications for financial and real asset prices. Most obviously, gold and other precious metals prices could well continue to rise but this could well be followed by increasing prices across the industrial metals complex. Other real asset prices will also tend to rise given their inherent inflation protection characteristics although some types of commercial property may struggle, for example, as consumer shopping behaviour continues to change.

Government and corporate bond prices typically fall, and yields rise, in an environment of rising inflation and in some circumstances, with a modest increase in inflation expectations, these falls can be very significant.

Equities are financial assets with inherent inflation protection characteristics – and this makes them relatively much more attractive than bonds in a rising inflation environment. Of course, not all equities are likely to prosper, and it is possible that higher inflation and higher discount rates applied to future earnings could undermine the very lofty ratings of some expensive growth stocks.

Clearly, the pandemic crisis has had a profound impact on society and economies around the world. As we emerge from lockdown, it is entirely appropriate to think clearly about what the lasting implications of this crisis will be. There is much uncertainty and speculation, but where it is possible to make informed judgements we will endeavour to do so.

Our analysis leads us to believe that there will be important and long-term economic changes following the pandemic. One of the most important of these, we suspect, will be the lasting impact of the crisis on inflation, which we expect to rise in the medium term after falling in the short term on the back of inventory adjustments and lower oil prices. This significant move in inflation could have profound implications for real and financial asset prices which investors will be thinking about now as they plan for their long-term future financial security in these very difficult times.

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Important information
The views expressed in this document represent the views of the author at the time of preparation and should not be interpreted as investment advice.

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