Lakshman Achuthan: Brace For Inflation

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Erik: Joining me now is Lakshman Achuthan co-founder of the Economic Cycles Research Institute or ECRI. Lak, it's great to have you back on the show, before we get started listeners, first of all there is a slide deck. You're going to want to download the link it is in your research roundup email, if you don't have a research roundup email just go to our homepage, look for the red button that says looking for the downloads.

Here's the thing I also want you to take to heart Lak was last on the show back in May, we did a lot of coverage of the way that ECRI analyzes cycles, so we talked about the three Ds of every recession, which are depth, diffusion, and duration. We also distinguish the different types of cycles, economic cycles can be growth cycles, they can be business cycles, they can also be inflation cycles. So understanding those differences, all of the content in that May 7th interview is as relevant today as it was the day that it was recorded, we're not going to go back and cover old ground.

So I encourage new listeners, if you don't remember that interview to go back and listen to it because we're going to build on what we started there. Lak, I want to focus on a couple of things you told us in that interview.

First of all, that was May 7th, you said you think that it looked to you like your signals were telling you that a bottom was being put in on those indicators and boy, sure enough from a stock market standpoint, you nailed the bottom there. But you also went on to say that you really have to be careful when things turn up, it's not just the cycle turning up but you got to be able to distinguish which cycle is it, the inflation cycle or the business cycle, the growth cycle, which one is turning up. And you also said it's important to look for a really key event, which is the emergence of a self-reinforcing virtuous cycle.

In other words, a feedback loop where whatever is causing things to turn up just keeps causing that effect to increase in its effectiveness. So clearly, something's going on here because we're still in really the middle of a pandemic crisis, global infections and deaths, both globally and in the United States are spiking up to new all-time highs. You'd think that would be really bad yet the stock market is rallying to new all-time highs.

Is this about a growth cycle? Is it about an inflation cycle? Is it the political cycle? What's going on? And how should we interpret this whole story?

Lakshman: Yeah, no, I hear you it is kind of mind boggling and thank you for the opportunity to kind of break it down, we're going to talk about business cycles. We'll talk about growth rate cycles, so once you're in a recovery what's going on with the growth is it accelerating or decelerating. And then separately, but super important especially today, inflation cycles, and so just to kind of link us up and listeners up to the May interview that you just summarized.

We were looking for a bottom at that time, actually, in early April we had based on just some of these cycle dynamics how far we had fallen, and some bottoming in our forward-looking leading indexes. We thought it was going to be one of the shortest recessions ever, the one that we just had, and in retrospect, it looks like technically speaking, it will be really short.

I think this is going to be the shortest recession, the technically, in US history, of course the end of recession does not mean recovered. We have a lot of things that we're watching to see if we can get back to where we were before the recession and when on business cycle.

So we're saying the business cycle recession has ended, we are in the business cycle recovery, meaning the level of activity continues to improve to continues to increase and in terms of is it self-sustaining? Is it virtuous? Do we have a positive feedback loop in the way that the economy operates? And the answer there is yes, we do. And the reason we know that we have this virtuous feedback loop is based on leading indexes and we had talked about leading indexes like the weekly leading index starting to bottom last time, so over six months ago.

And listeners can see a picture of the current picture of the weekly leading index growth rate on page 1 of the chart deck we're providing with this interview. And you can see it's run straight up and those leading indicators right in the weekly leading index reveal if indeed it's virtuous in terms of the recovery, is it self feeding? Or is it simply that you ran out of milk and you had to get more milk and so now you have a little pop in activity?

It's much more than that, okay, confidence is coming back, there's pent up demand so there's increases in employment and income away from stimulus, which is feeding back into sales, which is helping with production. And so that cycle, each one of those items, and if you have more production, you have more people working, so that cycle is revving to the upside.

And when you're in the vicinity, those cycle turns are quite powerful, even though there are plenty of things to worry about, and I share the concerns of listeners about the things to worry about. The cycle is pretty darn strong and can really barrel through a lot of that stuff and we had also discussed, Erik, how stock prices typically bottom, just before the end of recessions. And in this case, the bottom everybody knows was in March, you look back on your chart for 2020 and you see, yeah, there it is, it's in middle, late March.

And given our understanding of cycle dynamics on which we had based that earlier short recession call, we were able to recognize not too long after that March low that the market had had very likely made a cyclical bottom. So in other words, regardless of the ongoing debate about what's the Fed going to do or how many infections, are they going up or down, or what's going on with the vaccine and all those things.

And all of the back and forth on that over the last several months we knew that because the cycle, the direction was up, the direction of growth was up, that stock prices would keep rising, at least for the next few months, that was several months ago. And so I would submit that for anyone wondering if cyclical fundamentals matter to the market, this is pretty concrete evidence.

And here's the thing, the same logic that I just described, held in March of 2009 and I mean, it's a decade ago, but back then we had the same kind of situation in March of 2009. We had the same leading indicators showing a virtuous cycle to the upside turn up just after the market low and you recall or some listeners may recall, I think you recall Erik, the debate raged for months on end in 2009 about is it a double dip what's going on. But the leading indexes were emphatic in saying no, it's a recovery.

Erik: Now let's talk about what is driving the recovery because I think one of the key distinctions that we've discussed in May is it may in the beginning feel like a growth cycle bottoming and entering a virtuous cycle to the upside, and an inflation cycle doing the same thing. In the beginning, they kind of look the same to the economy, but boy, they have dramatically different endings. So do we learn enough from what the indicators tell us to be able to diagnose what cycle is actually driving this at this point?

Lakshman: Yeah, and we're really focused like a laser beam on the sequence of these cycles. So to be clear, first we have the recession and the contraction and the level of activity stopped and the level of activity started to expand. So the growth rate of the economy started to improve and that's a business cycle expansion begins and a growth rate cycle upturn begins at about the same time.

And when we look at the leading indicators which are driving the recovery, there is a story to be told there and we had talked about, and many people have talked about the K shaped recovery. And it happens higher income households are doing better than lower income households for a host of reasons but also there's a K shape to the sectors of the economy that have been improving. And the real foundational block of this recovery has been in the goods sector, the manufacturing sector of the economy and that's both happening here in the United States and around the world.

And so that's a both a domestic and a global industrial upturn cycle that is within the overall business cycle, separately, you've had a very strong upturn in nonresidential construction. And that is also quite real, it has legs, it's not faltering, it's not a one-off kind of pop off the bottom. And the interesting thing about these two sectors is that their cyclical amplitude relative to the overall economy is quite high, it's many times the cyclical amplitude of the overall economy.

So even though they don't make up the majority of the economy, which is really on the services side, they can at times you have a situation where like the tails wagging the dog. And here with the strength of these upturns it's certainly helping overall growth continue to improve and so we turn to services where there was a good pop off the bottom, but that has been slowing.

So it's still growing, but it's growing slower and that's because there's a lot of people facing kind of services activities that are hampered, of course, by the virus. And so we see that story but we don't get too hung up on the services sector being a little less robust on its growth rate because we see that power, that cyclical power in the goods and the construction side is really kind of lifting all boats right now.

Erik: Lak, we're talking so far conceptually about cycles and so forth, how do we actually manage risk around these prognostications that the cycles, the indicators tell us which way the cycles are headed? What do you do from a risk management standpoint in response to that?

Lakshman: Okay, well, to be clear, our analytical framework is not about market timing even though I mentioned just now a couple of lucky timing calls on growth, business cycles, and the market share prices. Our approach is really about managing cycle risk in a in a systematic way and it's more than just economic growth that's a really important cycle and we just went through some reasons why it's so important. But one of the really big insights that our research group had decades ago, actually, my mentor Jeffrey Moore, is that there's separate cycles and inflation.

And as simple as that sounds, it's actually really profound because most people don't think about it that way. So in our world in managing cycle risk you got to know which way to look for growth in economic activity but you also have to be looking to get the cyclical direction right on inflation. So if you don't appreciate that inflation is cyclical, you're going to be repeatedly blindsided and today that's a clear and present danger.

I've heard very bright people talk about inflation, and very bright people talk about deflation as a result of some of the big issues that are out there with debt or with stimulus or with weak growth and structural things. So I think first, what would be super helpful is just to understand what an inflation cycle is and so listeners can refer to page two of the chart deck. And here, we just have a thin line showing actual CPI inflation since the early 80s, so several decades, and then there's a thicker just to make it easier to see a thicker zigzag line and those segments show upturns, cyclical upturns and downturns in what is actually a cycle in inflation.

And this is a paradigm shift, it's a different vantage point, this is very different than your kind of mainstream way of looking at inflation. And in fact, when you look at it this way, you see that there are many more inflation cycles and business cycles and the chart three of the chart deck makes that pretty evident because it juxtaposes business cycles.

And I think people are familiar with business cycle shading with inflation cycles and you see something else which is kind of revealing, once you see it is that the vast majority of inflation cycles are unrelated to actual business cycle recessions. And if you let that sink in, it becomes pretty obvious why the Fed's reliance on the Phillips Curve has or had been so damaging. They've kind of been walking away from that recently.

So in fact, if your framework for thinking about where inflation is headed is relying on the output gap or full employment and most economists have long held that that's the way to look at it. Our research, what I'm showing you here reveals that you're going to get caught flat footed and often looking the wrong way on inflation.

So, a good case in point to really drive this home, because I want to make a strong point about what's going on today. But I think you need to understand a little bit of the history, is four years ago just ahead of the last presidential election and then on the flip side, in 2018. So in 2015/16 some listeners will remember there was a global slowdown, and it kind of hit the US and the industrial sector in particular and our indicators caught all that.

And following that global slowdown there was this secular stagnation thesis, if you go back to whatever the research reports said everybody was talking about it. And basically, the low growth and low inflation had cemented kind of the narrative around inflation in the bond market and all that and it really helped push 10 year yields down to a record low by the summer of 2016. It was pretty extreme for the time and of course, inflation expectations were really low back then too.

But now, leading indicators of the inflation cycle, just the same way we have leading indicators of growth or recessions and stuff like that, separate leading indicators. Once you know it's a separate cycle, you work on separate leading indicators and so we have something called the future inflation gauge. And that future inflation gauge is a leading indicator of inflation and it took off in in 2016, it foresaw the upturn which was the opposite of the narrative in the markets.

So as a result that cyclical reflation really blindsided the markets around the 2016 election, our leading indicators of growth had had been pointing to the strongest growth since 2010. So we had synchronized global growth, inflation moving higher, the impact was the mood of policymakers was ecstatic that they were… it was palpable by mid-2017. They really were convinced not only the Fed, ECB, other banks, they were really convinced that we had turned a corner in a structural sense, that's how far they talked themselves into this.

And they believed that the era of low trend growth and low inflation, all that secular stagnation, they believed it was over, they didn't understand it was just a cycle and this is why it sets us up for like these policy mistakes. Basically, this is why the Fed kept hiking rates through the end of 2018, especially following the Trump tax cuts in 2017 that all helped the bond bear market thesis take hold.

And if you remember summer of 2018, you had a lot of big shots, all the bond kings and queens and all were pounding the table, they're like 4 or 5, even 6%, 10 year Treasury yields, this is it, this is our big call. And of course, we're sitting here looking at cycles, we're not following that kind of thematic or event driven narrative. We're just looking at the cycle indicators and the FIG turn down in early 2018.

So again, based on our understanding of cycles, we were looking the other way and by the summer we're saying, wow, there's an inflation cycle downturn. And the sequence of what unfolded there is really interesting, right? So the future inflation gauge actually peaked in early 2018, inflation itself actual inflation peaked in July of 18.

Bond yields, okay, they were slow on the uptake, but they got there, they started, they peaked out in November of 2018 and the Fed was the slowest of all, they didn't pivot until January of 2019. So, I mean, you can wait for the Fed or you could wait for bond yields but I think in terms of risk management, cycle risk management, you can do better if you can let go of some of the output gap and all that kind of stuff and look at inflation cycles.

I think that's the real kind of offering here and now the Fed has said that it's just given up on the Phillips Curve, and they're not even going to try to be preemptive, really, they don't know how. So the bond market, it seems, is fully fixated on an event driven view of inflation.

And it's like, okay, there's the Trump tax cuts cemented the confidence in the bond bear market in 2018. And now around the election, markets were kind of betting on a blue wave delivering big stimulus package which would then push rates higher. And instead we got a purple wave of sorts and yields took a little step back very recently before the Pfizer vaccine came out, that's another event and it boosted the yields back up.

In other words, it's like the bond market is just at the mercy of the next big event. And that seems to be all that's left of the analytical framework because I don't think the markets and I know the Fed doesn't understand inflation cycles.

Erik: Lak, talk to me a little more about how we interpret this chart. On page four, we see the US fake the future inflation gauge, okay, looks like it's back above 100. Now, 100 was the 1992 baseline, I guess you could read this either a couple of ways.

One way you could say it's okay, well, it's sloping up here, clearly, this must mean more inflation is coming, we should be setting our portfolios up to hedge for more inflation coming. The other way to look at it would be to say, well, gee, if I look across the what's shown here, which I guess is really just 2020, we're kind of coming back to a high point, maybe it's peaking, maybe it's about to roll over? How do I interpret this? What does this mean in terms of what might be coming next?

Lakshman: I like your initial interpretation, be prepared for inflation to continue to surprise to the upside. As you said, on page four there's a picture of the future inflation gauge and what's interesting there first and foremost, just to underscore it, that gauges is rising in a pronounced pervasive and persistent way. Meaning that it is pointing to the cycle in inflation continuing to rise as far as we can see, which is a couple of quarters.

So actual inflation should continue to rise over that timeframe and then we keep updating the future inflation gauge to see if there's a risk developing on the horizon of a downturn, a couple of quarters later. We don't see that today, you can see from the chart is going to the upside. Now, the other thing, just to underscore is that view on inflation is pretty objective.

It's not driven by any events, it originally wasn't driven by the election or the gaming of a stimulus package or a vaccine, none of that figures into this. What we're monitoring are cycle dynamics, which I think are actually more powerful than all of those, even those are pretty colorful stories, I think the actual cycle dynamic in inflation is stronger. And just observing, again, the 10 year yield, as low as it was, has just about doubled off its March lows, so that's something now, you know, inflations going to keep rising in coming months, and the FIG will warn us when it's going to peak.

What kind of gets interesting, because I'm sitting here staring at that I know, because I have a pretty high conviction, having used these indicators for decades, that there's a very strong risk that inflation is going to keep surprising to the upside. So I'm thinking ahead and being like, huh, alright, so the Fed is promised to do nothing. But you know, if that FIG doesn't turn down, what's going to happen when PCE deflator that's the target of the Feds rough target, when that growth tops two and a half percent? Or 3%?

If the FIG doesn't go down, that's going to happen at some point and what's the Fed going do? That's a real interesting moment and I think if the FIG is continuing to rise then, they're going to be in between a rock and a hard place. They're going to start hemming and hawing all over the place and I guess it's also possible that the FIG turns down, we're watching for that.

I can't predict the predictors but this I think is critical to your original interpretation, you should be prepared, do not be surprised by inflation rising more than expected over the next couple of quarters. And so to kind of take that inflation cycle risk and where is the cycle and growth going, they're both going to the upside. It is a real cyclical reflation call that impacts nominal GDP which certainly has a relationship with nominal yields.

So I'd kind of wrap it up by saying bottom line, if you manage risk based on the cyclical direction of growth and inflation, you don't have to be a predictor of where COVID is headed. Or when is the vaccine actually out or who won what election, or other events that are that are going to come on the radar screen.

Erik: I want to back up to page three and just talk about different timeframes here because something you said a couple of times is these indicators are designed to look ahead, maybe a couple of quarters. And as we can see here, on page three, you're talking really about cyclical patterns in inflation and in growth in your other indicators that are tracking growth.

I want to talk about a different question or a different subject, which is, I see this, I can clearly see how it's very useful to have these separate indicators that are telling us where inflation is headed on a cyclical basis. But hang on separate from the cyclical discussion, I've had a prediction I've been making for years, frankly, and I've always said, I don't know it could be many years off. But at some point, I think that a secular not cyclical, but secular shift toward much bigger inflation.

I'm talking 1970 scale inflation and stagflation, I think it's coming and the reasons that I say that are, look, we've had this disinflationary backdrop for years and years, the feds been stimulating into it as much as they think they can get away with. Now, all of a sudden, we see the growing popularity of MMT among policymakers, at some point, we're going to generate a whole lot of inflation.

And I think that it really is going to be a game changer in terms of limiting monetary policy choices once it takes hold. But I've also been the first to admit that I'm really convinced it's coming, but it could still be three or four years away. How do I know when inflation starts taking off, do I look at this chart and say, well, look, you haven't really gone above 3 or 4% in the last decade. Once it gets to 3%, that's the that's the top of the range, that's when it's going to reverse you want to start to be hedging your portfolio for disinflation at that point? When do I say, wait a minute, it's the secular shift? It's upon us, it's happening now?

Lakshman: Well, I think look on a very near term tactical basis, look, I don't disagree with you and in our past, we've talked many times, Erik. And so in one of our earlier discussions, we talked about the long term trend decline and trend growth, the low inflation, and how the only policy response there has been, lowering rates. Or QE or all this stuff to undermine the currencies and to push out debt and debt fuels growth and all that stuff and trying to get bubbles and how that zombified stuff, we've had all that discussion.

And now, this COVID recession has taken something that might have taken another four or five years for us to get to in terms of monetary policy and scrunched it into a couple of few months. And where do we go from here? There's this lack of policy alternatives. So it's a little noteworthy that there's more and more talk about central bank digital currencies.

And what other tools are they going to develop in coming years to try and goose the economy here and there if the fiscal sides not really functioning? And so, I don't know exactly where they're going to go with that and how long it'll take to get there. But it seems like the policy response is very much centered on the central banks and messing around with debt and liquidity and possibly currencies.

So currency volatility is probably in our future in the broadest sense, as to which exact scenario is going to win out, I can't make a strong conviction bet. But the future inflation gauge the cycle information is a useful tool, like if you hold a longer term view either let's say for the other half of the people who are out there on the other side of the trade. Saying deflation because there's that strong argument that some people were making for deflation or disinflation as a result of all this.

And then you and I sympathize with that are talking to the upside, the question is when and the future inflation gauge can tell us when, so I earlier in in my comments was saying, hey, what is the Fed going to do when the PCE deflator gets to two and a half or 3%. If the fake is still rising, that's a moment of an interesting moment but that could signal, hey, maybe we're breaking out of that 3% top and the inflation range, maybe something is afoot.

At that moment, when listeners are looking at chart three, they'll see the inflation cycle upturn that in 2016 through 2018 kind of tricked the bond market and the Fed into believing that, that was the time that you had the secular shift. That the higher, the secular longer term, persistent inflation was upon us and in fact, it turned out it wasn't and the FIG warned us of that at that moment. So I can't exactly bet on which is the kind of secular timing when something's going to switch but I could say that the FIG will help us pay attention around the right time. But you should probably have a plan.

Erik: So it sounds like the plan is you watch the actual CPI print and when it gets back to 3%, which has kind of been the ceiling for a decade since the 2008 crisis. When it gets to 3%, you look at the FIG and if the FIG is starting to turn down, it's like, hey baby, just another cycle. It's all ups and downs of the waves on the ocean, when the FIG's pointing straight up and you're already at 3%, in in US CPI on the official print, Houston, we have a problem, it's time to rethink everything.

Lakshman: Yeah and my guess is the Fed heads will start talking around when you get to the mid twos. When you get to two and a half or so if the FIG's still rising, they're going to start talking about this or that. And they're a little bit in a pickle because they've highlighted employment as a key marker, which is, in the end of the day, it's a variation on the Phillips Curve but they're talking about more equality and employment and all of this.

And because many of the lower income jobs tend to be in that front facing services sector, which is having a slow recovery, and many businesses are actually failing there, that jobs recovery may be pretty slow. So the Fed has said, here's what I'm going to watch, and inflation may not cooperate with them. And it'll be revealing to see what is their reaction function and it seems to me, and I don't know anybody really at the Fed any, a couple people, it's not like back when Dr. Moore around, he was Greenspan's teacher.

It seems to me that everybody's event driven, that's the state of inflation analysis and if you find that frustrating, then you go to the bigger picture, and you say, whoa, that's a lot of debt and that's a lot of stimulus. And this has to matter at some point, and I don't disagree but the question is, when I remember I picked up once at, you know, you go to these library summer fairs, and they have the books for 50 cents or $1.

And there was some book, I think it was "The Coming Currency Collapse", but it was from the 70s and it was a well argued book. I mean I must say, but what I really enjoyed was in the back of it was a summary of the Chinese dynasties, where they had been at the forefront at the vanguard of paper money. And they had a lot of fun with it and these dynasties would eventually collapse when the currency collapse when the debt the paper dept collapsed, but it could take generations in some cases and that was kind of striking.

Erik: Lak, final question. Clearly, we're having some kind of at least as we're speaking on Wednesday, there's some kind of pop in the markets in the last couple of days to the upside. Apparently in reaction to some combination of the vaccine news and what most people consider to be an outcome of the election, although frankly, it's not official yet.

It seems like it's pretty clear that most people think Biden has won the election. What's driving it and what in cycles work? Tell us about, is this thing have legs? Is it is it time to jump in here before it gets away? Or is it maybe a head fake?

Lakshman: Well, you know, certainly the day to day stuff. I think you could point to the headlines that that the election has kind of unfolded, the world didn't stop running, we're still here, hey, there's also a vaccine. These are positives given some of the fears that were out there, but I would posit that if you had the view that, hey, there's a business cycle upturn a growth rate cycle upturn that is not decelerating, it's still moving to the upside. And there's an inflation cycle upturn that barring some massive catastrophe you'd have to be embracing risk.

And that story hasn't changed as a result of the last couple of weeks, as dramatic as things have been that fundamental cycle risk analysis is the same today as it was a couple of weeks ago. And when I look forward, I would say it's not unlike late 16th into 17th because we have, for the most part, there's a couple of spots here and there. But I'd say generally speaking, in the US and around the world growth is to the upside, inflation is stronger, in a stronger upturn in the US than it is in some other countries.

But around the world it is bottoming those same types of inflation cycles are bottoming, so this is a variation or a rhyming version of the reflation cycle upturn that we had back in 1617 and of course, that was a pretty strong one. I don't see anything that would, in our current snapshot today, looking at the indicators suggest there's risk of a downturn anywhere.

I think the thing to look for is certainly if the leading indicators were to turn down that future inflation gauge on page four, or the weekly leading index on page one of the handout. And then what happens with the Fed, if inflation starts bumping near into their discomfort zone how do they deal with that?

Erik: Finally, before I let you go for people who do want to follow these indicators, about half of our audience is institutional. What are the products on offer for them who for people that want to follow your research? And we also have about half of our audience are sophisticated high net worth individuals and other private investors, is there a high end retail product? Or is it strictly institutional?

Lakshman: I'm afraid it's strictly institutional and it's not that I wouldn't want to talk to high end high net worth individuals, but I just don't have enough time. There's a lot of nuance in some of these indicators, we have about 100 indicators for the world about probably 20 of them for the US for all these different nooks and crannies of the cycle. And so, we put out reports and data and that's kind of an institutional arrangement, we do make a valiant effort to share what we can publicly and I do that at businesscycle.com is the website.

I think business cycle is the Twitter feed, and there's ECRI or business cycle or Lakshman Achuthan on LinkedIn. And when we're writing stories or doing things or even like this interview with you, Erik, at some point that'll go up into that feed too. So we try to keep that feed very active for people who aren't institutional investors but want to manage their cycle risk.

Erik: Okay, so businesscycle.com is the place to go for it non institutional, basically free stuff for the non-institutional audience. For the institutional audience, how do they contact you to find out more about your services?

Lakshman: They can contact Melinda melinda@businesscycle.com and she will give you all the information.

Erik: Lak, we look forward to getting you back on the show in six months or so for another update. Patrick Ceresna and I will be back as Macro Voices continues right after this message from our sponsor.