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STRUCTURAL FORCES SHOULD PROVE DISINFLATIONARY AFTER TRANSIENT INFLATION DISAPPEARS

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Higher for longer is a narrative that took hold in August, with investors and economists warning that inflation and interest rates were likely to be higher than pre-Covid. But, while the strength of the US economy and transient inflation dynamics may, indeed, contribute to a short-term scenario of moderately elevated interest rates, this is not necessarily indicative of a structural shift.

A long-term perspective reveals compelling structural forces that favour lower rates. The convergence of technological disruption, shifting demographics, and escalating debt levels all point towards deflationary pressures going forward.

Today’s economic landscape is admittedly turbulent, marked by unprecedented levels of unpredictability and ambiguity. That makes the ability to anticipate the future, at best, elusive and at worst impossible. At Prescient Investment Management, we recognise the inherent uncertainty of the future. In this dynamic environment, discerning the path forward becomes a formidable task.

However, rather than attempting to predict it, considering all factors that are driving the economy and financial markets offers the best route to certainty. It helps us see through the noise and strips out the emotions associated with the ups and downs of the market.

Using a comprehensive data-driven and scientific process to examine both short-term and long-term global interest rate trends, our results point to interest rates remaining temporarily elevated due to the robust US economy. Thereafter, longer-term structural forces indicate a propensity towards lower rates as disruption, demography, and debt shape the economic landscape.

Interest rates: short term variability vs. long term certainty

Amid the ongoing debate over inflation and interest rates, recent years have seen the emergence of the term 'sticky core inflation rates.', which has spurred expectations of a prolonged period of elevated interest rates. While valid arguments support the case for an extended period of higher rates, our analysis suggests that this is a consequence of the robustness of the current consumption-led US economy primarily driven by a robust labour market. This strength affords the Federal Reserve the latitude to maintain higher interest rates for an extended period.

It is vital to distinguish between the cyclical forces currently at play and the enduring structural factors. The Federal Reserve possesses the capacity to sustain higher rates, but it is not likely to be an obligation dictated by structural forces. The crux of this distinction lies in the outlook for inflation.

The transitory nature of inflation

At Prescient Investment Management, we are staunch advocates of letting the data speak. The data strongly suggests that inflation, while initially appearing sticky and higher than expected, is ultimately likely to prove transient. Housing, particularly the shelter component, has been a pivotal driver of inflation. However, recent months have witnessed mixed data in the housing market, with house price inflation descending into negative territory. This trend points toward a forthcoming dip in the shelter component of the inflation basket, potentially lowering inflation to pre-COVID levels.

In summary, while the US economy exhibits remarkable strength in the short term, and this may translate to slightly extended periods of higher interest rates, we maintain that this is not indicative of a structural shift. Our analysis is rooted in the belief that inflation, driven predominantly by the housing market, is poised to revert to pre-pandemic levels.

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In South Africa, we are already there, with the headline inflation rate back in the Reserve Bank's target range. The central bank is likely to want to see further evidence that it has been brought down sustainably before cutting rates. But the prevailing view is that emerging markets, including South Africa, will be able to start easing interest rates ahead of the developed world because they responded to inflation forces with rate hikes earlier and aggressively.

Structural forces: disruption, demography, and debt

Looking beyond the near-term horizon, structural forces hold sway over long-term economic dynamics. Three potent deflationary factors are set to play out: disruption, demography, and debt.

1. **Disruption:** The era of unparalleled technological disruption, epitomised by artificial intelligence and advanced technologies, is upon us. Innovations in these domains have the potential to catapult productivity levels, a shift that will be inherently deflationary in nature. Companies at the forefront of innovation will be able to consistently reduce prices, gaining market share.
2. **Demography:** Globally, demographic profiles are shifting toward aging populations. People are living longer and having fewer children. Economies marked by aging demographics tend to exhibit slower growth and subdued inflation. Older individuals tend to adopt more frugal lifestyles, influenced by their extended lifespans and economic uncertainty. These demographic trends imply there will be muted consumption growth, further reinforcing deflationary pressures.
3. **Debt:** As aging demographics become the norm, governments face the challenge of supporting growing senior populations. Tax revenues alone cannot meet the burgeoning demands of this demographic shift, necessitating increased borrowing. However, this debt is likely to weigh on economic growth, rather than stimulate it, accentuating the global deflationary trend further.

In the realm of finance, the adage "the only constant is change" has never been truer than in recent years. The global economic climate has become a labyrinth of unpredictability, heralding a new status quo in the decades ahead.

At Prescient Investment Management, our unwavering commitment is to provide financial certainty in this ever-shifting world. Our approach is rooted in a meticulous, systematic, and data-driven investment process that eschews human emotions in favour of empirical evidence. We remain steadfast in our commitment to navigating the intricate web of economic uncertainties by sticking to scientific investment approach that considers it all.

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