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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and the UCLA Ziman Center for Real Estate. In this January 2021 Letter, UCLA Anderson Forecast and Ziman Center Senior Economist Emeritus David Shulman anticipates an acceleration in consumer price inflation, despite its current low rates.

Is the Pandemic Hiding Future Inflation?
How Asset Price Inflation Could Lead to Consumer Price Inflation

By David Shulman

The cover story of the December 12-18th edition of The Economist was headlined, “Will Inflation Return?” The article discussed the recent history of why consumer price inflation, running at a low year-over-year rate of 1.2% as of November, has been so quiescent. However, there is another type of inflation that has been soaring. I am speaking of asset price inflation which is showing up practically everywhere.

“Office, retail and hotel sectors of the commercial real estate market have been left out of the asset price boom. Why? The economic earthquake caused by COVID-19 accelerated the digitization of the economy.”

Distinguished from ordinary goods and services, asset price inflation affects financial instruments such as bonds, shares, and their derivatives, as well as real estate and other capital goods. For example, after swooning in March, stock prices have soared with the S&P 500 up 16.4% in 2020 and the tech-heavy
NASDAQ Composite up a startling 43.6% (Figure 1). Further, home prices rose at the highest rate in six years with the Case-Shiller National Home Price Index up 8.4% year-over-year in October (Figure 2). And to top it off, Bitcoin, the crypto currency, ended the year up an astounding 306%.

**Figure 1. NASDAQ Composite Index, 12/31/15-12/31/20**

![NASDAQ Composite Index](source: NASDAQ via FRED)

**Figure 2. Case-Shiller National Home Price Index, Jan. 2000- Oct. 2020, Percent Change Year Ago**

![Case-Shiller National Home Price Index](source: S&P Dow Jones Indices via FRED)

There are at least two fundamental reasons for the surge in stock and home prices. As a result of federal policy and the global slowdown caused by the COVID-19 pandemic, nominal interest rates plummeted to record lows. And real interest rates as measured by 10-year U.S. Treasury Bond yields are actually a negative 1%. Indeed, under its average inflation targeting regime, the Federal Reserve Board has promised it will keep its policy rate at near zero for the next few years, thereby supporting asset prices.

Asset prices are determined by discounting their future cash flows, and lower discount rates telescope far distant cash flows at ever higher values. The same holds true for housing services provided by owner-occupied housing. The other reason for high asset prices is that investors believe that the COVID-19-induced drop in corporate cash flow is only temporary, meaning that earnings in 2021 and beyond will be much higher.
We would point out that the office, retail and hotel sectors of the commercial real estate market have been left out of the asset price boom. Why? The economic earthquake caused by COVID-19 accelerated the digitization of the economy, thereby putting e-commerce into overdrive, and vastly increasing the work-from-home trend, along with business video conference calls. Simply put, the future cash flows from those sectors of the real estate market are suspect.

The rocket fuel for the burst in asset prices is the Federal Reserve. Money growth as measured by M2 (including cash, checking deposits, savings accounts, time deposits, money market mutual funds etc.), has been running at 25% year-over-year rate, a record high. For now, money has been flowing into asset prices. At some point via the wealth effect, it could very well flow into consumer prices as consumers increase consumption by reducing their current savings and increasing their borrowing. Supporting this view is the fact that, as in the late 1990s, the public is once again actively participating in the stock market.

Indeed, there is some evidence that the financial markets suspect an inflationary process is now underway. The 10-year inflation breakeven yield - a measure of inflationary expectations embedded in the 10-year Treasury bond - has risen from 0.75% in March to 1.99% at year-end (Figure 3).

Concomitantly with the increase in the money supply, the international exchange value of the dollar declined by 11% from its March 2020 peak, which will soon translate into higher import prices.

**Figure 3. 10-Year Inflation Breakeven Rate, Jan.2016 - Dec. 2020**

![Graph showing 10-Year Inflation Breakeven Rate](image)

*Sources: Federal Reserve Bank of Saint Louis via FRED*

Of course, many of the factors that have kept inflation low will still be with us. They include high unemployment (at least for now), the increased digitization of the economy, and populations moving out of high-cost coastal cities to more moderate-cost inland and Southern cities. Offsetting that is rising trade protectionism, increased environmental regulation, the shift from just-in-time to just-in-case inventory management systems, and the huge investments required for green energy and public infrastructure, all which will put upward pressure on prices.

I am cautioned that all of those who forecast an increase in inflation over the past decade – and I was one of them for a time – turned out to be wrong. Nevertheless, all of the ingredients are now in place for an acceleration in consumer price inflation. And remember: Unlike the 2010-15 period when banks were unwilling to lend because of regulatory constraints, those constraints are no longer there. Thus, inflation noticeably over 2% a year is far more likely than inflation below 2%.