The Drivers Of US Inflation

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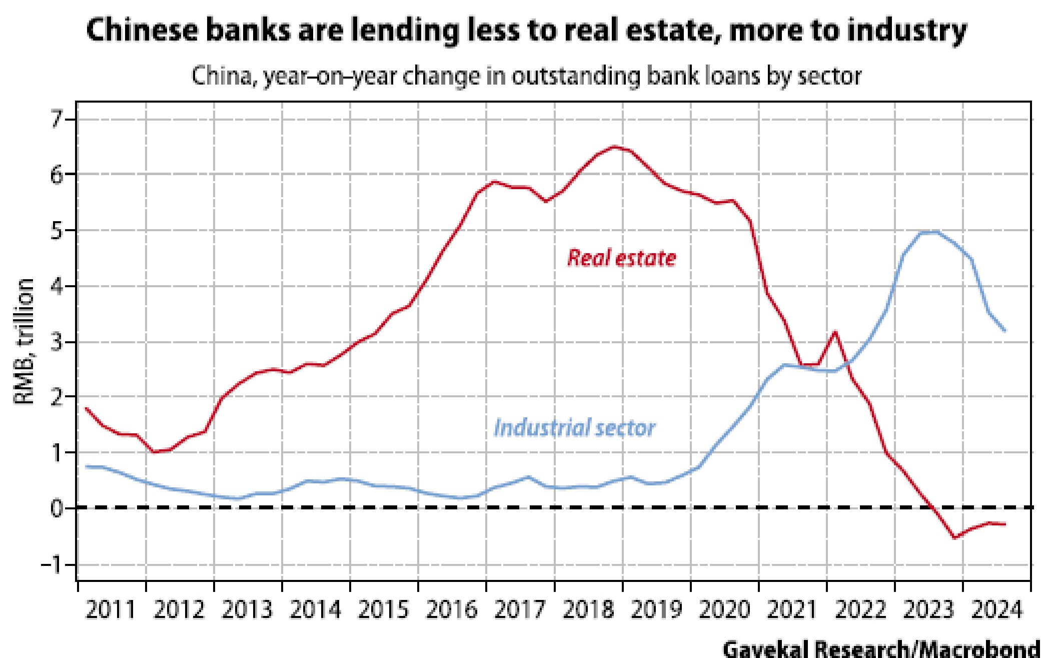
In 2018, Donald Trump decreed that no one would be allowed to sell high- end semiconductors to China any more. This came as an electroshock to the Chinese leadership, which had perhaps overlooked the country's dependence on semiconductor imports. From that point on, China not only accelerated the development of its own semiconductor industry (clumsily at first, lately with more success), it also sought to ensure its self-sufficiency in pretty much every other important industrial input. If the US could ban semiconductor shipments today, tomorrow it could be chemicals, essential metrology equipment or jet engines.

Following the 2018 semiconductor ban, China's economic thrust shifted. Banks were instructed to stop lending to the real estate sector, and to redirect capital towards industry.



It can therefore be argued that the US sowed the seeds for what came next: China leap-frogging the West in industry after industry. Without its self sufficiency drive, would China really have become the world's largest auto exporter quite so suddenly? The world's largest solar panel exporter? The world's biggest producer of industrial robots? Perhaps not. Of course, what might or might not have been is not really an investor's concern. Investors are not paid to forecast, and certainly not to rewrite history. First and foremost, investors are paid to adapt. And today, investors find themselves living in a world in which China's deflationary impulse seems to be accelerating.

Of course, it is hardly news that China is a source of deflation. Along with technology, China has been one of the world's two major deflationary forces ever since it joined the WTO in 2001, and probably since it massively devalued the renminbi in 1995, setting the scene for the Asian crisis two years later. China's ever-growing trade surplus—currently running at US$90bn a month—is a testament to this gargantuan deflationary effect.

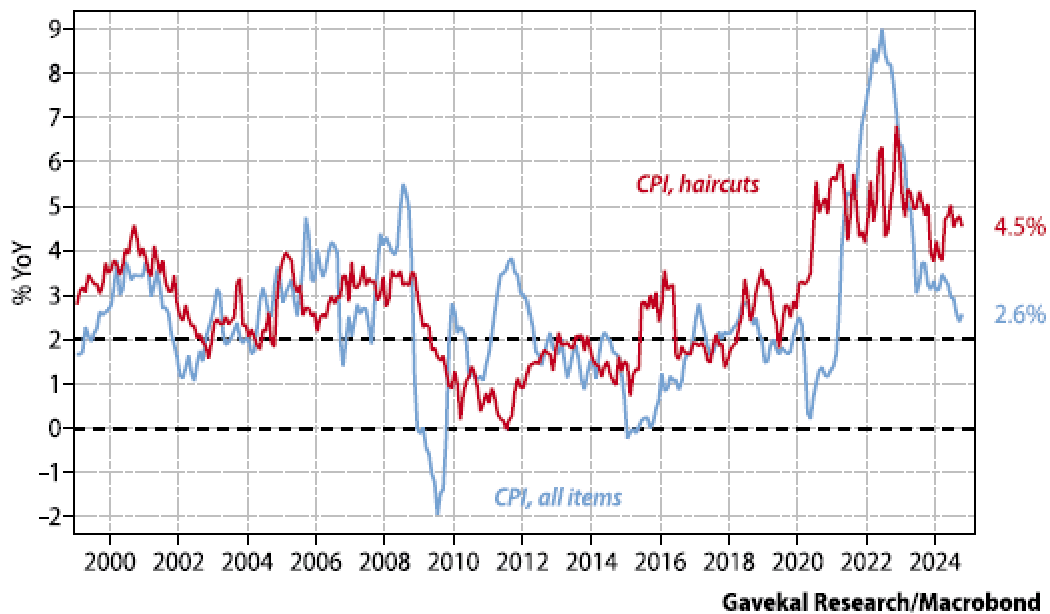
But this is where things get interesting. China's rapid and largely unforeseen ascent up the industrial value chain has left the US and EU with little choice but to embrace protectionism. Gone are the days when Western policymakers backed the "Washington consensus," dismantling trade barriers and calling for unlimited free trade. Faced with the onslaught of cheap Chinese solar panels, batteries, and electric vehicles, the West has even put aside its fears of climate change.

This leaves a world rapidly splitting in two. On one hand are the countries—mostly emerging markets—that are happy to welcome China's growing deflationary impact. On the other are the countries—mostly in the West— which are pushing back, and which will therefore end up with higher structural inflation. In the first group of countries, investors can own bonds. In the second, they cannot.

With this in mind, my friend Vincent Deluard of StoneX regularly makes the point that the changing price of haircuts is a solid indicator of actual inflation in a country. His observation is borne out by the popular saying that "inflation is when you pay US$15 for the US$10 haircut you used to get for US$5 back when you had hair."

Thinning hair is not Vincent's problem, but the observation stands. There is no hedonic pricing adjustment for a haircut. A barber today offers much the same service as a barber 50 years ago. The tools have not changed. There have been few productivity gains; it takes just as long to give a haircut today as it did in the past. Domestic haircuts do not suddenly have to compete with foreign imports. And haircuts do not suffer from supply chain dislocations. Instead, the price of a haircut basically reflects the price of hiring a diligent nongraduate and of renting a small retail premises.

At this point, please take a look at the chart overleaf. It shows headline US CPI inflation—which Wednesday's release showed ticked up to 2.6% year-on-year in October—plotted against CPI inflation for haircuts, which appears to have passed through three different periods over the last 25 years.



1) From the 2000 dot-com bust to the 2008 global financial crisis. During this period, the annual increase in the price of haircuts seemed to hover between 2% and 3%, and so did headline inflation. Sure, headline inflation occasionally spiked higher, usually when energy costs surged. But broadly, headline inflation seemed to remain anchored close enough to the Federal Reserve's 2% target.

2) From the 2008 financial crisis to the onset of protectionism at the end of the 2010s. In this window, the annual changes in the price of a haircut hovered between 1% and 2%, and so did headline CPI inflation.

3) From 2019 onwards. In recent years, the US not only started to turn more protectionist, imposing tariffs and new sanctions, it also went down the path of fiscal laxity. As this happened, the inflation rate for haircuts shifted up to between 4% and 6%. This resilience in the inflation rate for haircuts is an interesting development, especially given the surge in immigration into the US over the past three and half years. Cutting hair, like driving a cab, is often an entry-level job for new immigrants. But even with this surge in immigrants, the pull-back in commercial real estate and all the empty spaces in shopping malls, the inflation rate for haircuts has not come down.

This leaves a couple of simple questions. In the coming years, will the US turn its back on running large budget deficits at times of full employment? Will the US reject protectionism and once again embrace free trade? As things stand, both seem unlikely. The pre-election and post-election rhetoric both appear to point in the opposite direction. Policy proposals include lower taxes, more government spending, dramatically reduced numbers of illegal immigrants and perhaps even the deportations of undocumented workers. Combine these with the promise to open more factories in the US, and everything seems to point towards headline inflation converging towards haircut inflation, rather than the other way around.

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