# Global Matters Weekly

14 June 2021

# This time may be different

by Andrew Hardy, CFA

"As violent as a mugger, as frightening as an armed robber and as deadly as a hit man." Ronald Reagan's caricature of inflation in 1978 reflects a degree of fear at the time about this pernicious thief that is largely absent amongst today's policymakers. After several decades of low inflation, policymakers and investors have potentially become too complacent about the risks of higher inflation. Although there remains a wide range of potential outcomes in the coming years, we see a return of higher inflation as the biggest risk factor in markets; it would erode purchasing power, damage the real value of savings and wealth, and would have far-reaching implications for the construction of portfolios.

Recent investor surveys[1] also single out higher inflation as being the biggest perceived risk to market stability, with those related to the vaccine rollout or new variants slipping down the list. It's remarkable that we've reached this point already, within a year of the world slumping into the steepest and deepest recession since World War 2, but concerns are justified by the unique circumstances; the nature of the recession, extraordinary levels of coordinated fiscal and monetary policy, and new priorities for policy makers.

That inflation will remain elevated in the short term is beyond question. As economies begin to reopen, huge levels of pent up demand will be unleashed, unlike after any 'normal' recession, into supply chains that are still suffering from dislocation and shortages. Also, base effects of comparisons to a year ago are very large, particularly given the extent to which commodity prices crashed (recall the price of WTI oil went negative!); from the pandemic lows in March 2020 the Bloomberg Commodity Index has rallied over 60%.

Focusing on the all-important US economy, while consensus expectations have already moved sharply higher, last week's Consumer Price Inflation (CPI) figures still surprised to the upside, at +5.0% year on year. Even Core CPI, which excludes more volatile food and energy items and is a better guide to underlying inflationary trends, printed at 3.8%, the highest level since 1992. Quite remarkable for an economy that is still a long way away from fully normalising yet.

However, the key question for investors is how persistent these elevated inflation levels will prove to be?

Central bankers have stuck to the view that the surge will be temporary, and inflation will fall back towards targets before long. But underlying principles at the US Federal Reserve are very different from previous cycles; late last year they moved to an average inflation targeting approach, affording them the flexibility to let the economy run hot for a period, and this year they have emphasised the need to see actual progress on the economic recovery rather than just forecast. As a result, they are only just now considering starting discussions around tapering easy policy[2].

After a period of massive money supply growth, which typically increases inflation, and with financial conditions easier than they have been for decades on some measures[3], this is highly unusual. In previous cycles the Fed and other central banks attempted to pre-empt inflation overshoots by increasing interest rates in anticipation of future conditions.

Meanwhile, governments are less concerned about inflation and debt sustainability than they have been in past decades, as demonstrated by President Biden's enormous fiscal stimulus plans. Instead, there is much greater focus on broader social goals and longer-term objectives, such as combatting climate change, rather than simply achieving stable economies.

Also, China has been exporting disinflation around the world for decades but is less likely to do so going forward. There, as in many other advanced economies, declining working-age populations will put upward pressure on wages which will feed through into goods and services. Last week China's producer price index showed a 9.0% year on year increase, the fastest pace since 2008.

This cocktail of circumstances and shifts significantly increases the risk of persistently higher inflation. Investors must worry about that, because history tells us that letting the inflation genie out of the bottle is a lot easier than putting it back in again, and because markets aren't pricing in a persistent rise; 10 year US Treasuries remarkably still yield less than 1.5%, meaning the real yield (subtracting inflation) stands at -3.5%, the lowest since 1980. If central banks fall meaningfully behind the curve, the ensuing rapid rise in rates and bond yields would inflict significant pain on a highly leveraged world economy and would likely undermine all risk assets.

However, the outcome is by no means certain. Output could rapidly respond to the surge in demand and keep prices in check, while longer term constraints, including demographics, digital disruption and competition, and new technology, could continue to bear down on inflation as they have done for decades. But for the first time in many years, the risks have shifted away from disinflation and towards the upside. We will be scrutinising developments, particularly for signs of price inflation feeding into real wage growth and longer-term inflation expectations, as these would be the most likely factors to force central banks into moving earlier and more decisively. Given the risks and the widening range of potential outcomes over the coming years, we believe portfolio diversification is more important than ever; investors should seek a balance of real assets to protect against inflation alongside more defensive assets which would perform well in a lower inflation environment.

Source for market and economic data: Bloomberg. 1 Bank of America, May 2021. Deutsche Bank, May 2021. 2 Minutes of the Federal Open Market Committee, April 27–28 2021. 3 Goldman Sachs US Financial Conditions Index

# Global Matters Weekly

14 June 2021

For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
研富投資服務有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk

## Important notes



Belvest 研富