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No Mr Bond(s), I expect you to fall

by Michael Clough, CFA

I recently went to see the latest James Bond film to watch Daniel Craig's last appearance as the British superspy. It was Craig's fifth outing since his introduction in 2006 and the latest release marked a rather explosive end of an era in the latest storyline of 007. In our slightly less glamorous world of investment management, might we be facing an end of an era moment too? Since 2010 inflation in G10 countries has averaged 1.5%, below the typical 2% central bank target. This year we have seen inflation move sharply higher and whilst much of the narrative has suggested these moves are transient in nature, events in the past few weeks have posed a valiant challenge to this view.

Firstly, the transient case. The sharp increases are the consequence of three forces: base rate effects with year-on-year prices higher this year given last year's economic collapse, a sharp resumption of activity as lockdown restrictions have eased (demand-pull inflation) and supply shortages in a range of industries squeezing the availability of goods (cost-push inflation). These have helped producer and consumer price inflation to hit 11.8% and 5.4% in the US this year, levels we haven't seen since 1980 in the case of producer prices. For Bond fans that's back to Roger Moore times but it's a move which his predecessor Sean Connery might call 'shocking, positively shocking'. Central bankers were largely aligned to the transitory view – the increases being the result of pandemic-related disruptions and before long deflationary forces, such as technological disruption, demographics and debt would take charge again and inflation would retreat, meaning no sharp tightening of monetary policy would be necessary.

However, the recent explosion in wholesale gas prices (up 400% this year at one point in Europe) resulting in higher household energy prices, along with higher oil, petrol and food prices will work their way into inflation numbers and could persist for some time. These effects have evidently fuelled the argument that inflation might indeed be less transient and they have forced Bank of England governor Bailey to announce that the central bank 'will have to act', referring here to raising interest rates.

Then you have the structural inflation case, which centres on the monetary stimulus since the onset of the Covid pandemic. Year-on-year (M2) money supply growth rose to just under 25% late last year, the highest ever observed, and remains elevated today. The underlying thesis is if there is suddenly more money chasing the same number of goods, or if money supply exceeds what is needed to finance economic growth, then prices must rise and they will remain high until money supply is brought under control. Critics will point to stubborn sub-target inflation after the post-GFC stimulus programs – partly explained by banks retaining a lot of the money created and thus less worked its way into the real economy – though monetary injections over the past 18 months have been far greater than back then. Wage inflation will also likely be key here. So far it hasn't followed recent input or consumer prices much higher but should it do so, conceivable given widely reported labour shortages, it will further strengthen the case for more entrenched inflation.

So, what do markets think? US expectations have remained reasonably well anchored - expected inflation for five years starting in five years' time (5y5y inflation) has moved to 2.6% per annum, above 2% but only 0.1% higher than the average of these expectations since 2010. The moves have arguably been more noteworthy in UK and Europe, with 5y5y expectations in the former at their highest in the post-crisis era (4%) and in the latter they have just hit 2% for the first time since 2014. Generally, expectations have risen but runaway inflation is not anticipated. We certainly feel the risks of more persistent inflation have increased recently but on balance continue to believe a normalisation of the shorter-term dislocations should help to keep it in check.

As we wait to see who hits the screens as the next 007 we will have to wait and see what inflation numbers hit our Bloomberg screens in the months ahead. Nevertheless, as multi asset investors we want to construct portfolios that can deliver in a range of scenarios, in other words own assets that can shield and shine during episodes of higher inflation. Over the last year a general bias towards inflation linked bonds, largely US TIPS, over nominal government bonds has been supportive but even after recent yield increases they look unattractive and we hold principally for portfolio ballast. Inflation linkage embedded within property and infrastructure assets is our preferred route, along with value equities and floating rate bonds.

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