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The inflation debate – an update

Market Comment, May 2021

In last year's Market Comment "Underestimated inflation debate?", we pointed out that inflation could potentially be underestimated. In the aftermath of that publication, we adopted an underweight position in bonds relative to equities. In the following article we now provide an update on the inflation debate. The key takeaway is that – for all the uncertainty over the long-term trend – inflation is primarily a cyclical phenomenon. This suggests it would be wise to maintain an underweight fixed-income position.

Against a backdrop of an improving global economy, it is perfectly normal for the year-on-year change in consumer prices (inflation) to follow the upward trajectory of the economy. In 2020, commodity prices collapsed due to low demand; they have recovered impressively this year, however, leading to higher producer prices. For that reason, the inflationary expectations of consumers are rising, and now so too are consumer prices themselves. It is only reasonable to assume that we will see this traditional pattern repeat itself this time too – and in all the world's leading economies.

Inflation is currently being driven up by a number of factors:

1. The monetary easing measures of central banks around the world in response to the coronavirus crisis have been much more comprehensive than after the financial crisis of 2008/2009. Indeed, the four leading central banks alone have expanded their balance sheets by more than USD 7,000 billion (or 50% of gross domestic product) since the start of the coronavirus crisis. This constitutes the greatest injection of monetary liquidity of all time.

2. In addition to monetary stimulus, we are also seeing enormous fiscal stimulus for economies as governments increase their budget deficits. In Europe, national budget deficits are currently even higher than after the financial crisis of 2008/2009. On the other side of the Atlantic, the US has recorded its greatest ever fiscal deficit since the Second World War – even before the impending infrastructure programme kicks in.

3. By contrast, the private sector is in a much better state than it was after 2008/2009. The surplus savings accrued thanks to financial assistance amount to more than USD 1,500 trillion in the US alone. In view of these huge savings and considerable "catch-up demand", companies will be able to adjust prices where necessary. The proportion of US companies planning to increase prices currently stands at its highest level for twelve years.

> "In an environment of gradually rising inflation, low-yielding bonds appear relatively unattractive."
>
> Gérard Piasko, Chief Investment Officer

4. Due to supply shortages on the production side this year, we are seeing not only higher freight prices but also a shortage of key goods such as semiconductors, and both these factors will contribute to the rise in inflation.

5. Last but not least, ongoing tensions with China as this global superpower flexes its muscles are prompting many companies – particularly in the US – to rethink their existing policy of outsourcing production to the Middle Kingdom. From 2001 onwards, the growing proportion of production accounted for by China had a disinflationary effect at a global level, and this effect could be now at least partly reversed as companies seek better geopolitical diversification. But the repatriation of production to companies' home regions also implies increases in the cost of that production.

Another interesting subject of analysis is how bonds, equities and gold have behaved historically in various

phases of inflation. Thanks to analysis conducted by Nobel Prize for Economics winner Robert Shiller, we have more than 150 years of empirical data available relating to the four phases of inflation:

Negative inflation at times of sharp recession/depression, **high inflation** as witnessed during the two world wars or in the 1970s, **reflation** or the gradual rise of inflation from a low level such as in the 1960s, and **disinflation** such as after the Second World War and over the last few decades.

When compared with normal historical averages, what emerges is that equities generate above-average returns in reflationary and disinflationary phases, gold is the most attractive investment against a backdrop of high inflation, and bonds record above-average performance in the face of negative inflation or deflationary developments, but not in reflationary phases. The reason why equities perform better than bonds against a backdrop of gradually rising inflation is the increase in corporate earnings: companies enjoy not just increases in sales, but also often higher operating margins.

Conclusion: As long as economic growth continues to improve and inflation continues to climb to higher levels, historically low-yielding bonds appear relatively unattractive.

Gérard Piasko

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