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Pondering the inflation policy pivot

Our weekly view on Asset Allocation

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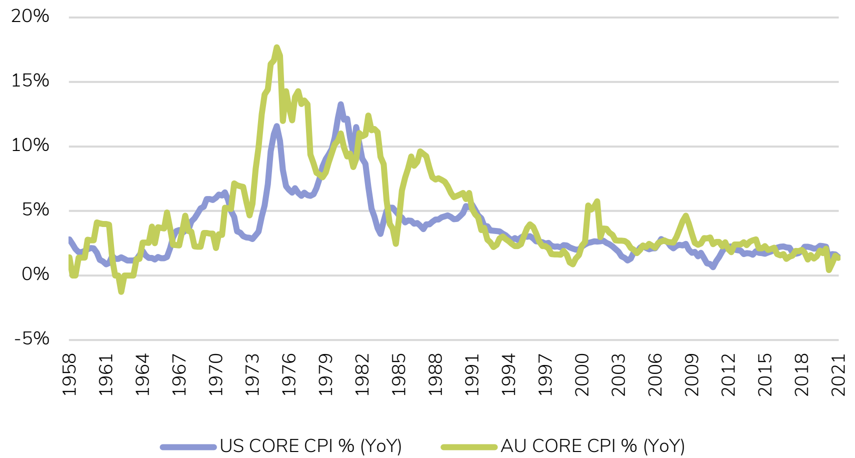
A pivotal investment variable

The outlook for inflation has pivotal importance in influencing the pricing and performance of investment markets.

The world has been in a very benign inflationary regime for much of the last 30 years, which has allowed both bonds and equities to perform well, providing a powerful tailwind for traditional diversified portfolios.

The inflation outlook is currently drawing even more than its usual degree of attention given the sheer size of the monetary and fiscal response to the economic dislocation brought on by the global Covid-19 pandemic. Investors are pondering whether inflation may be set to accelerate meaningfully or whether the structural drivers of low inflation will once again keep the inflation backdrop benign.

Exhibit 1: Inflation had been relatively benign in both the US and Australia for a prolonged period



Source: Refinitiv, Wilsons.

Persistent low inflation triggering some new age thinking from central bankers

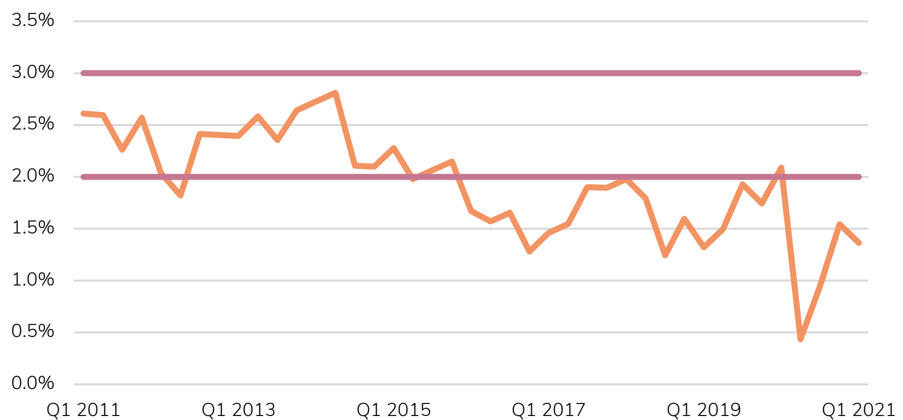
Over the last 10 years in particular, inflation has fallen well short of central bank targets. This has seen both central bank cash rates and market-determined interest rates continue to trend lower. This decline in interest rates has, in turn, buoyed the valuation of risk assets such as equities and property, even with a backdrop of mediocre economic growth.

An important consideration in thinking about the outlook for inflation is how policymakers are now more focused on the costs of the economy undershooting expectations rather than the costs of the economy overheating.

Policymakers now concede that they have over-estimated the inflationary tendencies of economies, thereby failing to achieve the "full employment" potential of economies.

Fiscal policy is being re-evaluated alongside monetary policy with a seemingly much less urgent attitude to restoring fiscal balance. In particular, the Biden administration is aggressively adding to an already burgeoning US budget deficit in the hope of driving strong growth outcomes, alongside its equality and climate change agendas.

Exhibit 2: The RBA has struggled to keep inflation within its 2-3% target b and in recent years



Source: Refinitiv, Wilsons.

This has some parallels with the US environment in the mid to late 1960s (a visible inflection point for US inflation) as the US spent big to fund both the Vietnam war and President Johnson's social welfare agenda.

There is clearly now an embedded policy mindset of striving for full employment, with the risk of some inflation overshoot seen as a risk worth taking. This does not guarantee we will see a meaningful inflation overshoot over the next few years, but it does increase the risk of an overshoot. With bond yields so low and policy increasingly "pro-growth", the medium to long term risk-return trade-off for bonds does not look appealing to us. This creates challenges for portfolio diversification.

Exhibit 3: Most countries are spending more now than in the GFC and are expected to withdraw stimulus at a much slower rate

Source: Refinitiv, Wilsons.

Why didn't QE cause inflation in the last cycle?

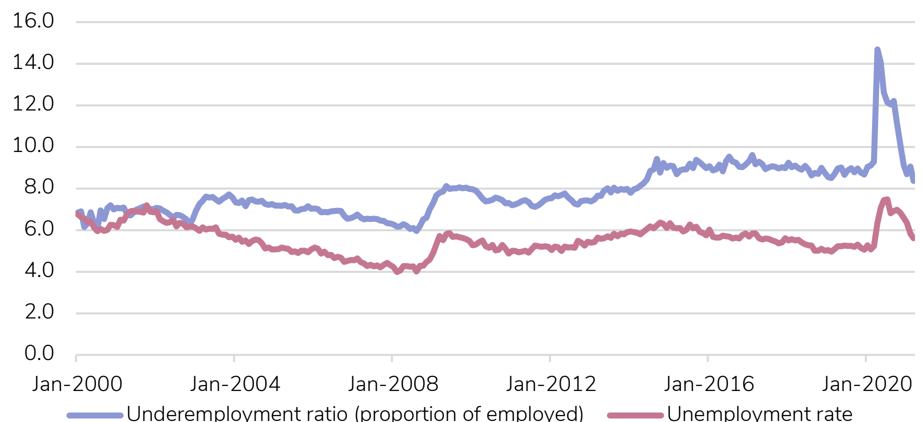
Of course, there were concerns of an inflation problem following the GFC when unconventional monetary policy (QE) was enacted in response to the financial and economic stresses of the time. The reality was that we saw little in the way of general inflationary (CPI) pressure flowing from QE. In part, concerns around inflation were misplaced due to a misunderstanding of the impact of QE on the credit creation mechanism. QE (which is often referred to as money printing) lowers interest rates further along the yield curve compared to conventional monetary policy, thereby creating excess reserves in the banking system (as banks exchange government bonds for central bank "electronic cash"). However, these excess money reserves do not directly get spent or get lent. So QE has some limited capacity to create inflation by encouraging spending and borrowing via a lower interest rate structure but is not as overtly inflationary as commonly believed.

Another important point in considering the last economic cycle is that while the QE experiment was playing out in the US and Europe; fiscal policy was being reined in reasonably quickly.

The US did ultimately loosen the fiscal purse strings during the Trump administration period, and the US did go close to reaching full employment around 2018/19, but this was against a global economic backdrop that was constrained. In particular, global growth was hampered by Trump's tariff policies during this period. Fed tightening also took the edge of the US growth cycle in 2018. Thus, there was little in the way of inflationary impact even as the US briefly flirted with full employment before the pandemic completely derailed US and global growth.

Fast forward to today and it certainly looks like the resolve of policymakers to run the economy harder in the quest to find the maximum possible level of employment is much more resolute. Monetary policy and fiscal policy are both being deployed aggressively to encourage strong growth and (ultimately) full employment with a higher rate of inflation seen as palatable given years of inflation undershooting.

Exhibit 4: Australia's unemployment rate is falling but underemployment is relatively high



Source: Refinitiv, Wilsons.

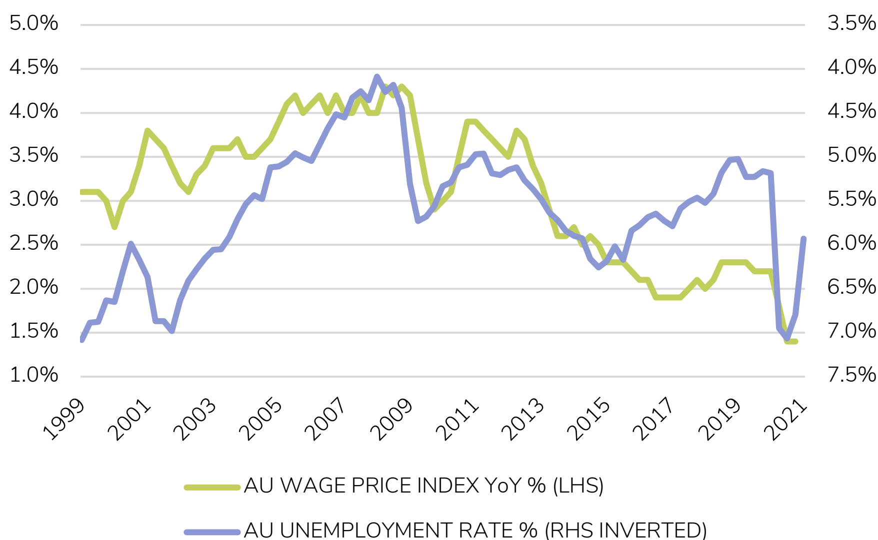
Inflation – A long and winding road

To be clear, we don't see a significant inflation problem emerging in the near term. We are likely to see a near term pick-up in US inflation over the next few months due mostly to year on year base effects and partly due to Covid-19 related supply-chain bottlenecks. This "temporary" inflation pulse should work its way out of the system over the course of a few months. It will then likely take some time for the labour market to tighten sufficiently to generate a decent pick-up in inflation, so the 12-24 month outlook appears fairly benign. The inflation outlook becomes debatable when looked at on horizons of 2 years or longer, as the labour market will have time to tighten.

It is of course possible the structural forces that have kept inflation low such as globalisation (low cost labour), technological innovation (labour substitution), the internet (price discovery), decentralised labour (low bargaining power) and the demographics of ageing (slowing propensity to consume) will continue to keep inflation in check. However, there is a not-insignificant risk that inflation will pick up meaningfully more than in the post GFC period given policymakers apparent desire to "go for growth".

We do believe that a return to 70s and 80s style inflation is highly unlikely given the ongoing influence of the structural forces mentioned above. However, bonds and in some cases equities, are priced for a very benign inflation outcome, so inflation remains a key factor to monitor. Some long term inflation hedges have merit, particularly if, as we expect, we manage to escape the grip of Covid-19 and enter a period of genuinely synchronised global growth.

Exhibit 5: Wages growth has been drifting lower leading the RBA to target "low 4's" unemployment



Source: Refinitiv, Wilsons.

Investment implications: Reflation with an eye on inflation

We have a strong preference for equities over bonds as equities are positively leveraged to reflation and offer an implicit inflation hedge, at least to "moderate" inflation.

Value stocks should do better than long-duration growth stocks, particularly in "the current reflationary environment" phase.

Investors should have some exposure to alternative diversifiers and long-term inflation hedges such as non-traditional fixed interest strategies, market neutral (long/short) funds, private equity, real property and infrastructure, fixed inflation protection strategies as well as commodity exposure, including gold.

There is of course, the risk of taking on too much inflation protection too soon. Still, investors need to begin thinking about the possibility of a shifting investment regime over the coming years.

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Recommendation structure and other definitions

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All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

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