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Global perspectives: Inflation – a new paradigm?

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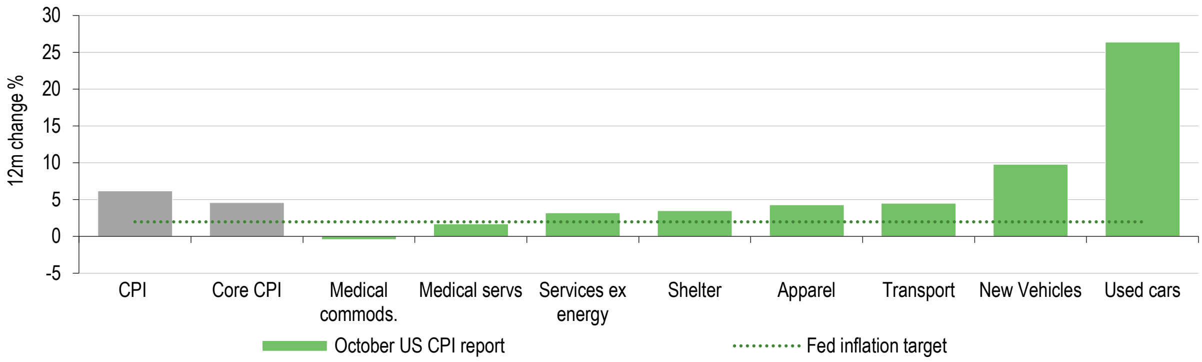
- Global markets have rallied as investors take comfort from a benign Q3 earnings season and announcements from central banks which show that in private committee, policymakers seem more dovish than individual policymakers' public comments suggest.
- The equity risk premium for global markets remains close to 15-year record lows while corporate credit spreads also remain low. This demonstrates a strong investor appetite for risk at present, even as risks build as economic growth moderates, real wage growth turns negative and China's property sector remains in distress.
- Looking forward, we believe investors are not yet properly accounting for the possibility of a medium-term regime change in respect of inflation. Fiscal policy could supersede monetary policy as the primary mode of stimulus in the next downturn. Constrained by above-target inflation, central banks may no longer be best placed to stimulate the economy when required.
- A higher inflation, fiscally driven economic regime is likely to engender lower market valuations and outperformance of old economy sectors able to offset rising input costs by increasing prices. This process may have already started, with banks and energy leading global sector rankings in 2021 year to date.
- We remain cautious on global equities as current risk premia are low and we expect forward returns to normalise over the course of 2022 as monetary policy settings become less accommodative. Furthermore, the prospect of a significant sector rotation is increasing in probability as investors start to discount a sustained period of above-target inflation.

Inflation: A new paradigm?

October's US CPI reading was a wake-up call for global markets lulled back to sleep by soothing dovish noises from the world's preeminent central banks in recent weeks. The steep increase in the headline figure of 6.2% year-on-year was well ahead of consensus market expectations and reflected above-target readings from almost all components of the index. US new and used vehicles continue to be priced dramatically above last year's levels, reflecting both supply chain shortages and a surge in demand for private transportation.

Exhibit 1: US CPI components (ex-energy) compared to Federal Reserve (Fed) target



Source: US Bureau of Labor Statistics

In the UK, inflation is also surprising to the upside with a 4.2% annual increase for October. With energy supplies tight through Q122, UK inflation is likely to remain uncomfortably elevated until at least Q2 next year. Combined with earlier encouraging news on the UK labour market this keeps a Bank of England rate increase firmly on the agenda for December, in our view. The United States is not therefore alone in facing some serious questions as to how to tame inflation while still navigating the uncertain exit from the pandemic.

With inflation moving up the political agenda as consumers feel the pinch from rising living costs, we believe central banks will come under increasing pressure to justify their policy stance. Increasing inflation and policy uncertainty has in recent weeks whipsawed interest rate markets, catching a number of high-profile 'macro' hedge funds off-guard.

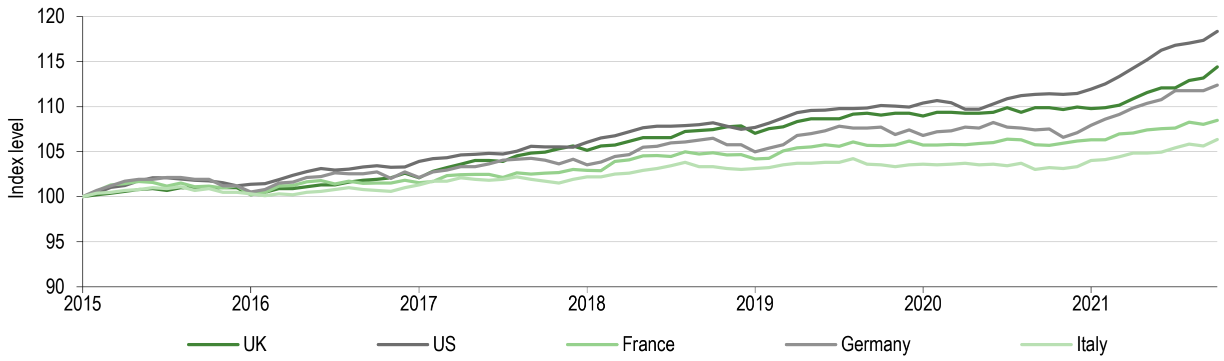
In his most recent press conference, US Fed Chair Powell has stated that he believes that currently high inflation is predominantly connected to the pandemic and the abnormal operation of global supply chains. He has also stated that the timing of any return to normal is highly uncertain, but now expects US inflation to ease by the 2nd or 3rd quarter of 2022. If so, the US Fed faces an uncomfortable six months if it wishes to hold off on interest rate increases until the tapering of the US QE programme is complete.

Central bank policymakers individually seem to want to appear to acknowledge upward inflation risks. However, collectively – and with the slowing economic data in front of them – they seem reluctant to adjust interest rate policy, despite recently higher-than-expected inflation data.

Nevertheless, the 'lift-off' date for interest rates is in our view less important for investors than the ultimate duration and peak of the rate cycle in later years. Market-implied rates embedded in current futures pricing suggest a relatively weak and transitory period of monetary tightening in the UK and United States for example, with rates expected to peak at 1.2% and 1.4% respectively in 2023. The question arises, if inflation proves stubbornly above target, can central banks continue to tighten into a slowing economy?

In our view, the most recent CPI data are drifting further away from the 'base effect' and 'transitory' narratives promoted by central banks earlier in the pandemic recovery period. For the 'base effect', in G7 nations the long-term trend of the consumer price index has clearly shifted upwards, reflecting a one-off surge in inflation that looks unlikely to be unwound at this point.

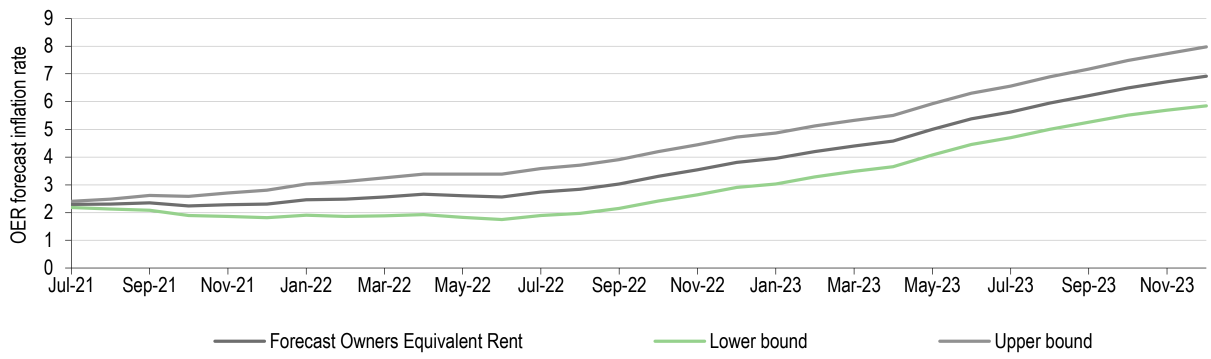
Exhibit 2: No more talk of 'base effects' – CPI price levels are above trend



Source: National Statistics

In terms of the 'transitory' nature of this rise in inflation, we have noted that all components other than medical commodities and services are significantly above the Fed's longer-run target of 2%. In particular, the COVID-19 induced surge in US house prices is only now starting to feed into actual and owners' equivalent rent (OER). Due to the strong correlation of more than 0.7 between US house prices and OER this could contribute to inflationary pressure over an extended period. US Dallas Fed forecasts suggest that OER and actual rent could add as much as 0.59% to core CPI by the end of 2023.

Exhibit 3: Actual rent and OER maintaining US inflation pressure into H222



Source: Federal Reserve Bank of Dallas forecasts

We have previously noted the sharp decline in investment in traditional energy infrastructure in recent years by the listed global energy sector, which in our view is largely due to structural ESG-related factors. This suggests that the industry will continue to eschew new projects despite the recent oil price rise. If current energy prices are sustained, upward pressure on US inflation from energy will be maintained at least until August 2022.

We believe investors are best served by avoiding polarised thinking on inflation and instead should recognise the actual uncertainty induced by the dynamics of the COVID-19 related stop/start of the global economy over the past two years. For example, while the surge in inflation has clearly exceeded monetary policymakers' earlier expectations in both magnitude and duration it can also be argued that downside risks to the global economy should not be ignored.

Survey data are on a declining trend in the major developed market regions and the uptick in COVID-19 infections in China and Europe and the financial distress within China's property sector represent significant downside risks to global demand, even if investors seem willing to ignore these warnings for now.

Is an inflation regime change underway?

Looking further out and beyond the immediate year ahead, investors should also be considering the long-term structural changes in the composition and relative bargaining power of the global labour market over the next decade. Over the past 30 years, and separate to short-term demand cycle variations, on a global basis there has been a significant increase in the supply of labour to the benefit of the corporate sector. This has supported corporate profit margins and created the conditions for significantly lower long-term interest rates. In part, consumer demand growth has been maintained despite lower wage growth by increased consumer indebtedness.

There is in our view legitimate argument that the ‘lowflation’ that has been the primary challenge for many of the world’s central banks since the financial crisis of 2008 can be attributed to the globalisation of trade over the past 30 years and (until now) favourable demographics within the global workforce.

However, by its nature globalisation can only be achieved once. The integration of China’s labour force into the world economy provided an enormous pool of cheap labour which motivated the offshoring of manufacturing production and growth in international trade from the 1980s onwards.

The advent of global trade has already significantly narrowed the arbitrage between the high cost of developed market labour and low-cost labour available in emerging markets. It is difficult to see a further increase in the global supply of human labour of a similar magnitude in future decades, even if we cannot rule out technological innovation offering a degree of substitution over the longer term through advances in artificial intelligence (AI) and robotics.

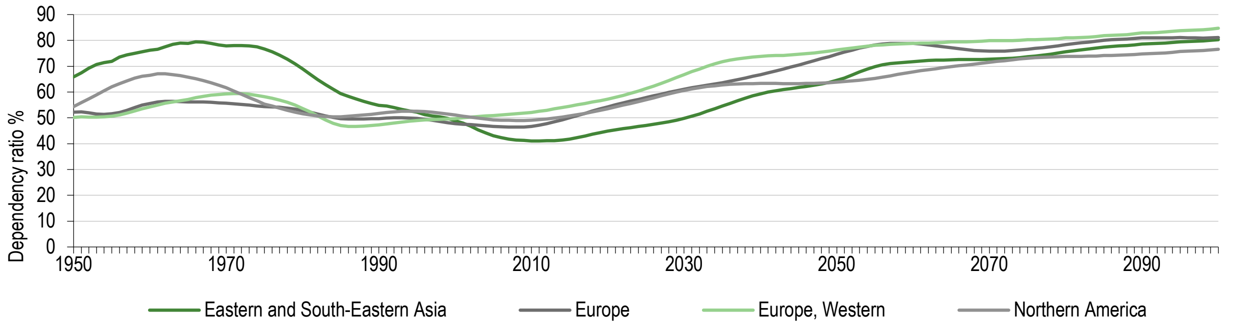
The suppression of wage growth in developed nations may even have driven the popular political pushback against globalisation which has been bubbling over during the past half-decade. For example, trade tariffs initiated by the Trump administration in the United States were part of a populist pledge aiming to bring manufacturing jobs back onshore.

More recently, strategic considerations have come to the fore as China starts to threaten US technology leadership, leading to non-tariff barriers such as company blacklists and limitations on technology transfer. Supply shortages of protective equipment and medical supplies during the COVID-19 pandemic and the supply chain bottlenecks that have followed have only re-emphasised the fragility of just-in-time global sourcing that often relies on a limited number of geographically concentrated suppliers.

When taken alongside the rising political importance of geo-strategic considerations, which applies symmetrically to the US’s tighter national security restrictions and China’s earlier ‘Made in China’ technology self-reliance initiative, it could be argued that certain aspects of globalisation are undergoing a sustained reversal. The economic benefits of trade were hardly persuasive to a British electorate who voted for Brexit in 2016, for example.

Furthermore, the demographic dividend represented by 40 years of declining dependency ratios is in the process of being cut each year as ageing populations produce less through retirements and offer less potential for productivity growth, Exhibit 4. Rising old-age dependency will cut into the available pool of labour over time as care for the elderly becomes an increasing burden for the working-age population. We also observe the relatively modest level of scale efficiencies obtainable in the provision of old age care compared to other industries and the likely drag on future productivity growth.

Exhibit 4: Global dependency ratios shifting to tighten labour supply



Source: United Nations

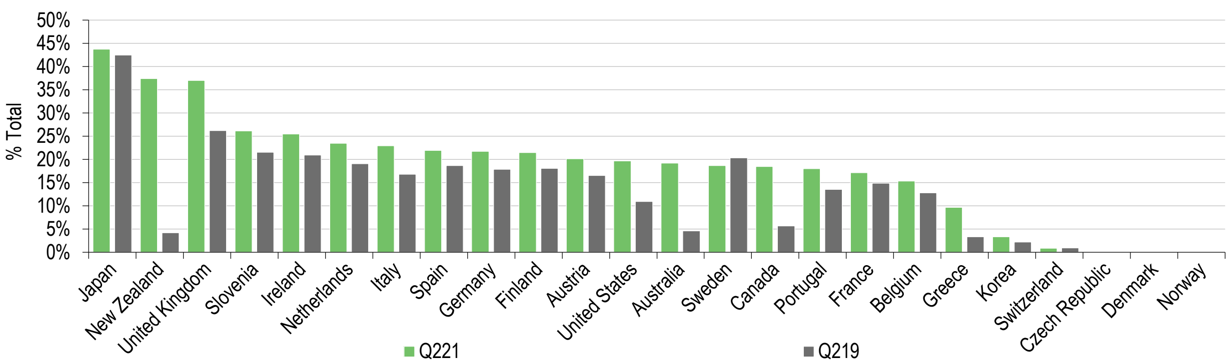
We do not expect these long-term structural factors to feature heavily, if at all, in any discussion on the outlook for inflation over the next few months or even years. However, the timeframes of these changes are well within those of the currently high-profile environmental, social and governance (ESG) factors which similarly extend to 2030 and beyond. Institutional investors now have few qualms about taking long-term ESG factors into account in portfolio construction and we believe demographic changes deserve similar attention given the potential to upend consensus expectations on global inflation pressure.

Medium-term regime change for inflation?

Following the market panic that accompanied the first wave of the COVID-19 pandemic, the global economy was once again rescued by wide-ranging commitments to asset purchases by the world's central banks. These announcements clearly put a floor under both equity and credit markets during March 2020. There is little doubt that this was the correct policy response for the acute phase of the crisis as markets went into meltdown as the extent of the impact of lockdowns on the global economy became clear.

However, post-crisis the additional QE has meant that a quite extraordinary proportion of developed market debt is in the left pocket/right pocket situation of being issued by one authority (government) and being purchased by another (the central bank), Exhibit 5. In the United States, approximately 20% of government debt is owned by the US Fed while in Europe, ECB holdings now account for a similar percentage of eurozone government debt. In the UK, the Bank of England now holds just over 35% of UK gilts outstanding.

Exhibit 5: Central bank holdings of government debt



Source: IMF

In the early days of QE after the financial crisis of 2008 there was much handwringing on the idea of central banks initiating a closet form of monetary financing, a hubbub which subsided as the feared increase in inflation and loss of central bank independence did not occur. Nevertheless, popular opposition to the ECB's asset purchases continues to find favour in Germany where inflation is now 4.5%. Only last year, Germany's constitutional court required a proportionality assessment of the ECB's purchases to ensure that economic and fiscal policy effects did not outweigh other policy objectives.

Looking into the coming decade there appears to be an increasingly likely prospect of monetary policy losing its primacy in managing swings in the economic cycle. We note last year's COVID-19 fiscal stimulus packages may have finally broken the taboo on deficit spending. However, the sheer indebtedness of the global economy, estimated by the IMF to have increased by over 10% to US$227tn during the pandemic, will require increasingly creative solutions than just more official debt.

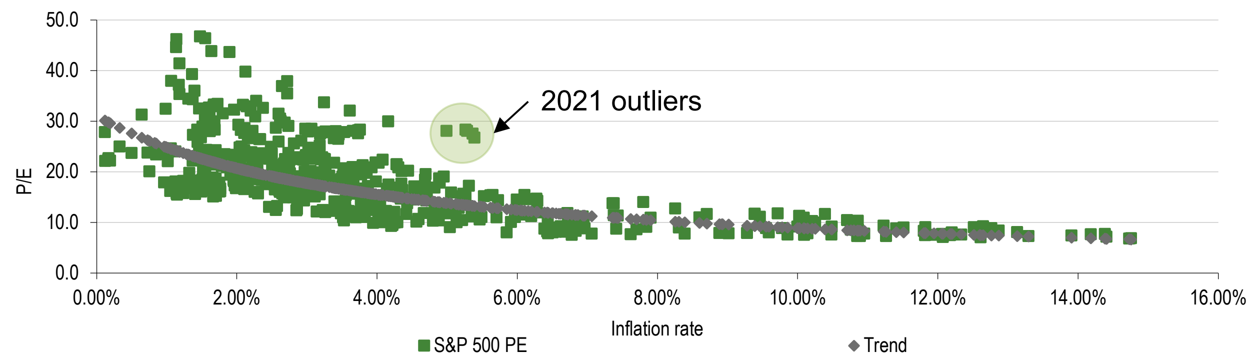
QE has perhaps played its part during the prior decade's period of very low global bargaining power of labour to stimulate demand in national economies while inflation was below target. One feature of QE was substantial spill-overs into asset prices and explicitly via the US Fed's concept of the 'portfolio balance channel'.

We believe investors should consider the policy responses to scenarios where above-target inflation persists even as growth slows. In these circumstances, despite a track record of shifting the goalposts in terms of justifying monetary accommodation, the world's central banks would hardly be best placed to stimulate the economy by cutting rates or re-starting asset purchase programmes.

We believe the path of least political resistance could be a greater role for national governments in managing the economic cycle, as distasteful as this will sound to free-marketeers. On the face of it, government indebtedness may appear to be limiting but we note the recent precedent of the use of credit guarantees during the acute phase of the COVID-19 crisis. This mechanism incentivised private sector loan growth while avoiding any further deterioration of government sector balance sheets.

If this mechanism was used in the future, such bank-created money is likely to be of a significantly higher velocity than that created by quantitative easing as it would be directly financing current economic activity rather than remotely compressing corporate risk premia to incentivise investment – incentives which in many cases lead instead to corporate re-leveraging through thinly capitalised corporate structures in public and private equity. Less absolute dollar amounts may be required than during the peak QE years and short-term investors may find the direct impact on asset prices to be relatively modest.

Exhibit 6: US P/E versus inflation – current P/E rating is an outlier



Source: Refinitiv, Edison calculations

In such a scenario of higher inflation and greater use of conventional if not unconventional fiscal policy with credit guarantees, if history is a guide currently high global equity valuations may prove increasingly unsustainable. There is an uncomfortably strong correlation between the S&P 500 P/E and the level of inflation, which becomes increasingly relevant at inflation rates of more than 4% (well below the recently recorded rate of 6.2%). In Exhibit 6, all the data points that occur away from the trend are from 2021. Given currently high inflation, data since 1972 suggest the S&P500 P/E is far in excess of the levels that would normally be expected to prevail.

Sector rotation likely if inflation regime shifts

Since around 2014, investors have also become conditioned to the idea that the technology and software sectors represent almost the only route to portfolio outperformance. The logic of this idea in a low interest rate, low inflation scenario appears sound to us, provided initial valuations are not excessive as they arguably are now.

Aside from the structural growth of the technology sector in terms of the increasing digital share of the global economy, in a low inflation world the lack of nominal sales growth elsewhere in the stock market creates the conditions for a growth 'scarcity premium' for faster-growing sectors.

Low long-term interest rates have favoured growth companies over value stocks by reducing the discount factor for expected profits well into the future. At the margin, a long-term deflationary trend has dampened political pressure on antitrust agencies to rein in the development of natural quasi-monopolies in a variety of new economy sectors, covering search, e-commerce, ride hailing or home delivery for example.

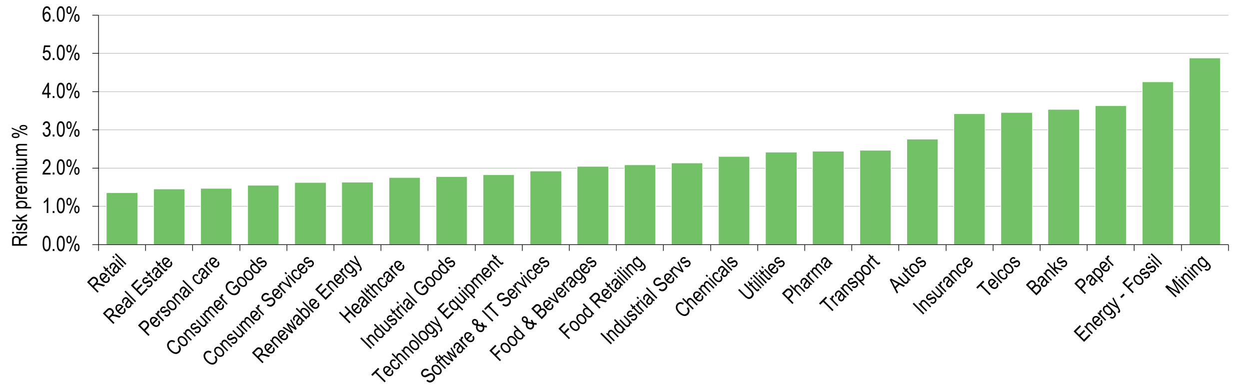
In an inflationary environment each of these factors moves into reverse. Anti-monopoly agencies are under increased political pressure to act in a rising price environment. Long-term rates and the equity risk premium rise with increasing inflation and inflation uncertainty, increasing the discount factor and favouring value sectors over growth sectors.

A much wider swathe of the stock market will generate nominal growth in a higher inflation world, reducing the scarcity for this portfolio factor. Finally, as inflation pressure squeezes consumers' budgets, discretionary sectors historically have underperformed as rising interest rates on consumer credit makes big-ticket items increasingly unaffordable.

In previous periods of high inflation, it is a rather conventional set of sectors that has outperformed the market. Energy (with the unfortunate inclusion of coal from an ESG perspective) has historically been the standout performer, not least because energy costs typically have a large direct weighting in consumer price indices.

For equities, we consider there to be two separate dynamics at play in any transition to a higher inflation regime. The first dynamic is on valuations. As previously discussed, we would expect extended valuations in growth sectors to come under increasing scrutiny if higher inflation and inflation uncertainty proved persistent during 2022.

Exhibit 7: Equity risk premium still tilted towards inflation-beating sectors



Source: Refinitiv. Edison calculations

For those investors considering a rotation towards sectors that historically have benefited from higher inflation, there is good news. Despite the strong performance of the energy sector during 2021, our estimate of the risk premium for energy and mining stocks is still above long-term averages, indicating that the trade may have further to run.

We believe within a cautious portfolio positioning investors are still being compensated to ‘tilt’ portfolios towards sectors which should outperform in the event of higher inflation. We are reminded in certain respects of the multi-year rotation in sector performance between technology, media and telecoms in the late 1990s and the performance of real estate, energy, mining and banks leading up to the financial crisis.

Old economy sectors suffered meaningful underperformance during the dot.com bubble, leaving valuations set for a sharp catch up of performance in the following economic expansion. We would also note that the market narrative has tended to follow rather than lead a rotation of this nature. History is quite unlikely to fully repeat itself but it in our view the data suggest an echo cannot be ruled out.

Conclusion

Given the uncertainty over inflation in both the short and long term, we believe it is important to carefully consider how to protect portfolios from worst case inflation scenarios while allowing acceptable returns in the event of more benign outcomes. Most directly, current developed market bond yields appear to offer limited upside in the event inflation returns to normal during 2022 and yet also little protection against a surge in inflation that persists for even a year, as Fed Chair Powell has recently indicated.

In terms of global equities, elevated US equity valuations, accounting for 50% of global indices by market value, appear inconsistent with high inflation readings. If there is a regime shift towards a sustained period of higher inflation, market P/E ratings should be expected to fall, if historical correlations hold. We are concerned the US market represents something of an outlier in terms of financial history at its current rating of close to 30x despite inflation running at over 6%.

Further risks, which we have discussed in previous notes, include slowing survey data and the anticipated tightening of monetary policy over the next six months. We also observe that China’s large real estate sector remains under pressure as the market for foreign-issued corporate bonds remains distressed. The resurgence of COVID-19 cases in Europe has surprised us and the recent tightening of social restrictions in Germany, Austria and the Netherlands raises the prospect of another round of COVID-19 slowdowns during the winter.

Investors looking to adjust portfolios and allocate to sectors which have traditionally offered better performance in periods of higher inflation can at the same time benefit from valuation levels closer to historical norms such as banks, energy and European rather than US equities. While this may be a difficult thought for investors who have focused on technology to generate returns over the past decade, a shift toward fiscal stimulus over QE could yet favour economic and earnings growth over asset prices.

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