momentum
global investment management

Inflation on the mind

It is extraordinary that within 12 months of the world slumping into its steepest and deepest recession since WWII we are asking the question ‘when will the economy be too hot?’. Recovery is on the way and it will be like no other in pace and scale. But the nature of the recession, an exogenous shock, followed by swift and enormous policy action, has left the productive capacity of economies largely unscathed, while in aggregate households and businesses have built up substantial excess savings. The shock was unusual too in that it hit both the supply and demand sides of the economy. Demand collapsed and supply chains were dislocated. Activity levels plunged everywhere, and inflation sunk into negative territory.

There are material implications as we enter the recovery phase. The disruption to supply chains will take time to return to normal and increasing capacity is not an overnight task (building a new semiconductor foundry takes up to 2 years, developing a new copper mine much longer). Additional constraints would arise if supply chains are reconfigured to prioritise security of supply over cost. As the surge of pent-up demand meets restricted supply, the result is higher prices. On top of that, the base effects of falling prices in Q2 last year are falling away and inflation is moving up for that reason alone.

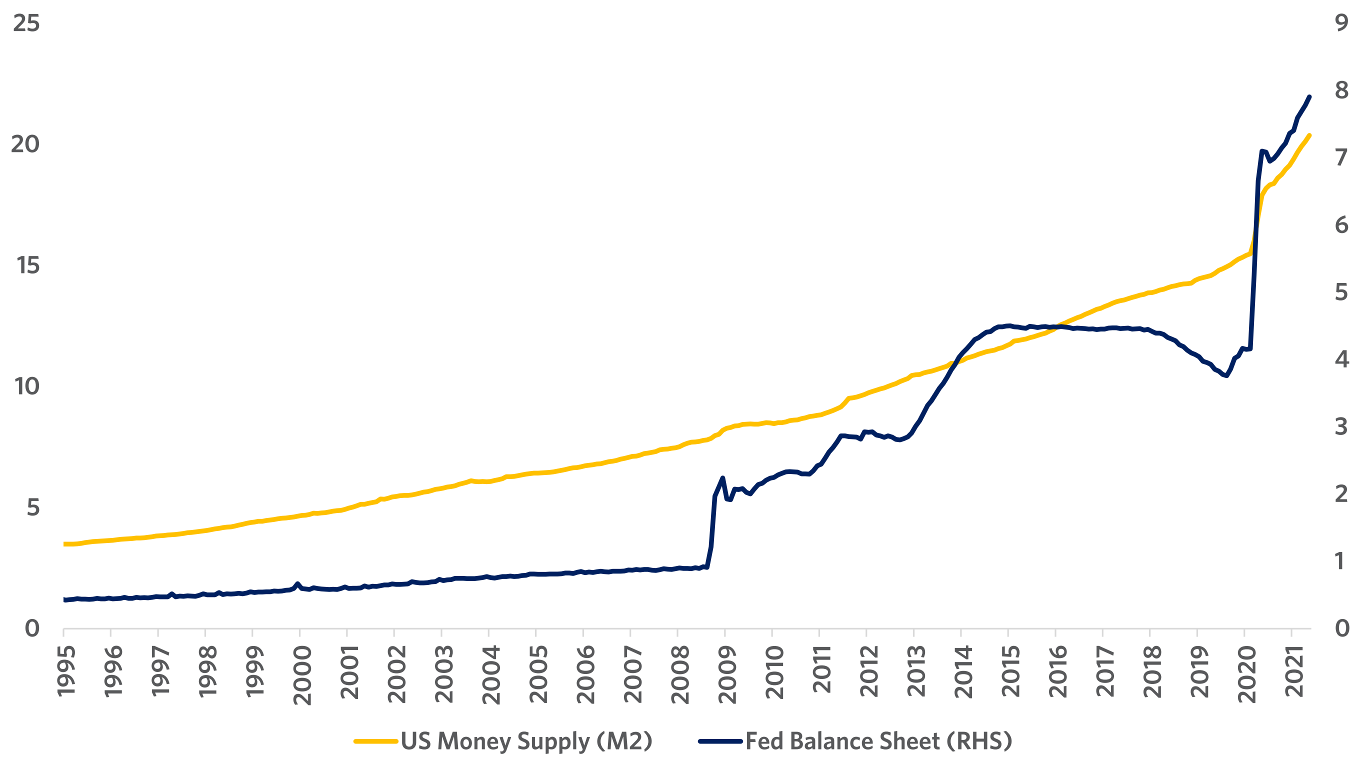
Little wonder, then, that the risk of an inflation surge, something that has not troubled investors in the past 20 years, has become the key concern of investors. Will the rise in inflation be transitory or will it be persistent and trigger an unexpected response from central banks to rein in ultra-loose policy?

We believe this is key to judge whether the economy runs too hot and it will largely determine the durability of the recovery and the performance of financial markets. And it will be the US where all eyes should be turned. Aside from being the largest economy, with the world’s reserve currency, it is at the forefront of the vaccination roll-out, and turbo-charged by President Biden’s huge fiscal packages, with spending plans over the next decade which, if enacted in full, would result in fiscal deficits over $1tn each year over the next decade, the highest sustained levels of spending since WWII, representing more than 5% of GDP each year on average and increasing Federal debt to 117%* of GDP. At the same time the central bank continues to implement extraordinarily loose policy and is prepared to allow the economy to run hot following its recent policy shift to

*Budget of the US Government, Fiscal Year 2022, Office of Management and Budget.

average inflation targeting. These huge injections of liquidity are an under-pinning to markets, and any signs of withdrawal would ring alarm bells. The Fed sees the rise in inflation as transitory and is intent on keeping its foot on the pedal, but markets could begin to doubt the Fed's resolve as the higher inflation numbers come through.

Unprecedented monetary loosening & money supply expansion



Source: Bloomberg Finance L.P., Momentum Global Investment Management

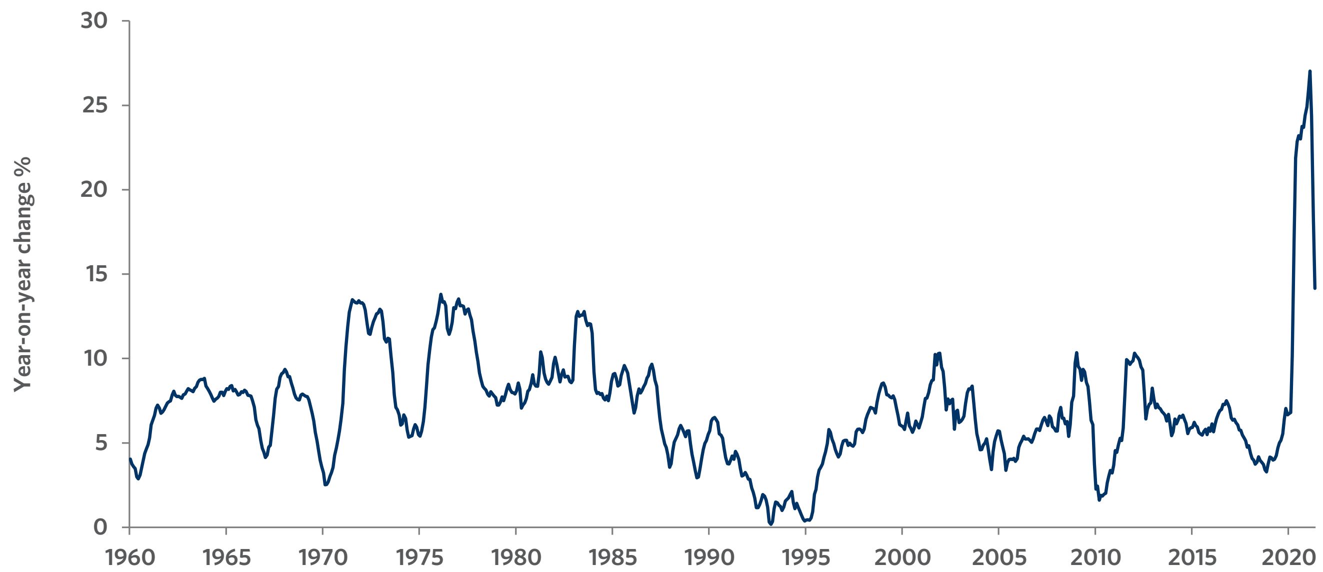
The scale of what has happened in the past 12 months is shown on the chart. The Fed's balance sheet, which reflects the bonds it has bought in its QE programme, has expanded by $4tn in the past year, and that has fed through to the money supply, up over a quarter, and at $20tn not far short of 100% of GDP. That is a lot of potential stimulus.

How quickly will the surge in demand eat into spare capacity and result in shortages? There is already evidence of this in key areas such as semi-conductors and certain materials, leading to production cuts whilst supplies rebuild. The stand-out feature of markets in recent weeks has been the surge in commodity prices, oil, metals and agricultural, taking the rises over the past 12 months to 60-70%, more in some cases. Commentators are already talking about a new commodities super-cycle. In the latest purchasing managers' survey in the US, the prices paid component was at its highest for 13 years with inflation of prices across most supply lines, and businesses citing difficulties in attracting and retaining labour.

Another key question is whether the huge liquidity provided by the Fed will ultimately feed through into inflation. This proved not to be the case after the financial crisis despite massive liquidity injections, but circumstances are very different now. Monetary loosening in the past year, and fiscal stimulus packages, have been on an altogether different scale to those following the GFC, and this time there is no return to fiscal austerity.

Furthermore, banks were crippled by the financial crisis and weakened balance sheets meant that lending was curtailed. Now the banks are in good shape, balance sheets are strong, and they are willing and able to lend to support the recovery. Money supply, which reflects the amount of liquidity in the economy, has been expanding in the US at its fastest rate in decades and has often been a lead indicator of inflation ahead.

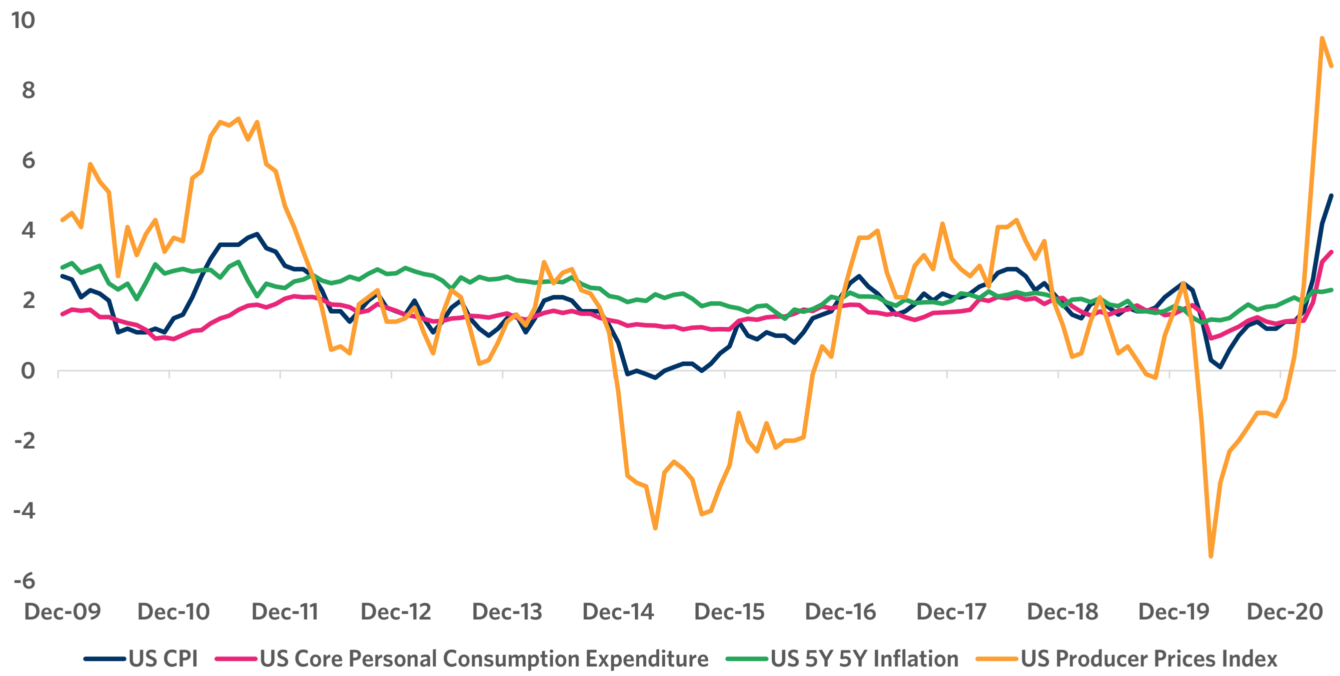
US Money Supply Expanding at Fastest Rate in Decades



Source: Bloomberg Finance L.P., Momentum Global Investment Management

We see a return of inflation as the biggest risk factor in markets; if investors begin to believe that the inflation rise will be persistent, bond yields could move materially higher. The yield on US Treasuries is in effect the world's discount rate; a rise in that discount rate would have global ramifications, not least in emerging markets, potentially undermining all risk assets.

US Inflation rising - Transitory or Persistent?



Source: Bloomberg Finance L.P., Momentum Global Investment Management

As can be seen from the chart on US Infation, in recent weeks inflation has picked up substantially from last year's lows. Some of this is due to the base effects of last year's exceptionally low inflation, but it is what comes next, in the months ahead, that will be more testing. We know that inflation is corrosive for savers, it erodes purchasing power, damages the real value of savings and wealth, and would have far-reaching implications for the construction of portfolios.

The outcome is by no means certain. Output could rapidly respond to the surge in demand and keep prices in check. Longer term constraints, including demographics, digital disruption and competition, and new technology such as AI, could bear down on inflation. But after years of low inflation it would be complacent to assume that the trend will continue. Globalisation, which has held down inflation over the past 2 decades, could well have peaked, governments are giving greater emphasis to re-distribution and regulation, and reconfiguring of supply chains could all push up costs. The producer price index in the US has spiked to its highest for over 15 years, and some of this will inevitably feed through to consumer prices, with the latest consumer price index rising at a 5% rate year-on-year. Furthermore, the Fed's preferred measure of inflation, core personal consumption expenditure, has risen to 3.4%, well above the Fed's target of 2% and its highest in almost three decades. A critical figure to monitor will be forward inflation expectations; these have moved up significantly from the pandemic lows but so far only to the broad range which they have been in for most of the past decade.

At its latest policy meeting the Fed responded to these moves, which have been much larger than previously expected, by signalling the beginning of a new monetary policy tightening cycle. It has brought forward expectations for the first rate rises, with 2 increases of 0.25% each during 2023, whereas it previously indicated no rate rises until 2024, and is now talking about reducing its huge asset purchase programme in coming months. This move surprised markets, which reacted by pushing yields on short dated bonds higher, but it has to be remembered that even with this more hawkish tilt policy remains extremely loose and will remain so for years ahead: this will be a very long policy tightening cycle. For now, markets are giving the Fed the benefit of the doubt and reacting broadly positively to its move, backing the view that the rise in inflation will peak and be transitory. But policy errors are a real risk: the Fed has the tools to deal with a persistent rise in inflation but deploying those tools would be damaging for the economy and markets. Letting the inflation genie out of the bottle is a lot easier than putting it back in again.

For the first time in many years, the risks have shifted away from disinflation and towards the upside. These risks should be carefully considered when building portfolios. Developments should be carefully scrutinised: headline CPI will be less important than core price measures which strip out the more volatile components such as energy and food, and which are a better guide to underlying inflationary trends. Most worrying would be if price rises feed into real wage growth and inflation expectations, as this could well signal an early end to the Fed's ultra-loose policy and an acceleration in its tightening plans.

This is not meant to be alarmist, but realistic given the extraordinary conditions triggered by the pandemic and ensuing recession. A return to 1970s style inflation seems inconceivable, and indeed the inflation pick-up underway could well prove to be transitory, but the balance of risks has changed, and we need to recognise that in our portfolio decision taking. With the risks ahead and the uncertainty of the outcome, portfolio diversification is more important than ever; balancing assets which offer protection against inflation, including equities which benefit most from the cyclical upturn and those with pricing power, infrastructure, property, inflation protected bonds, gold and other real assets, with more defensive assets which would perform well in a lower inflation environment, such as quality equities with consistent revenues, government bonds and other income producing assets.