Investment Insights

Are we moving into a new inflation regime?

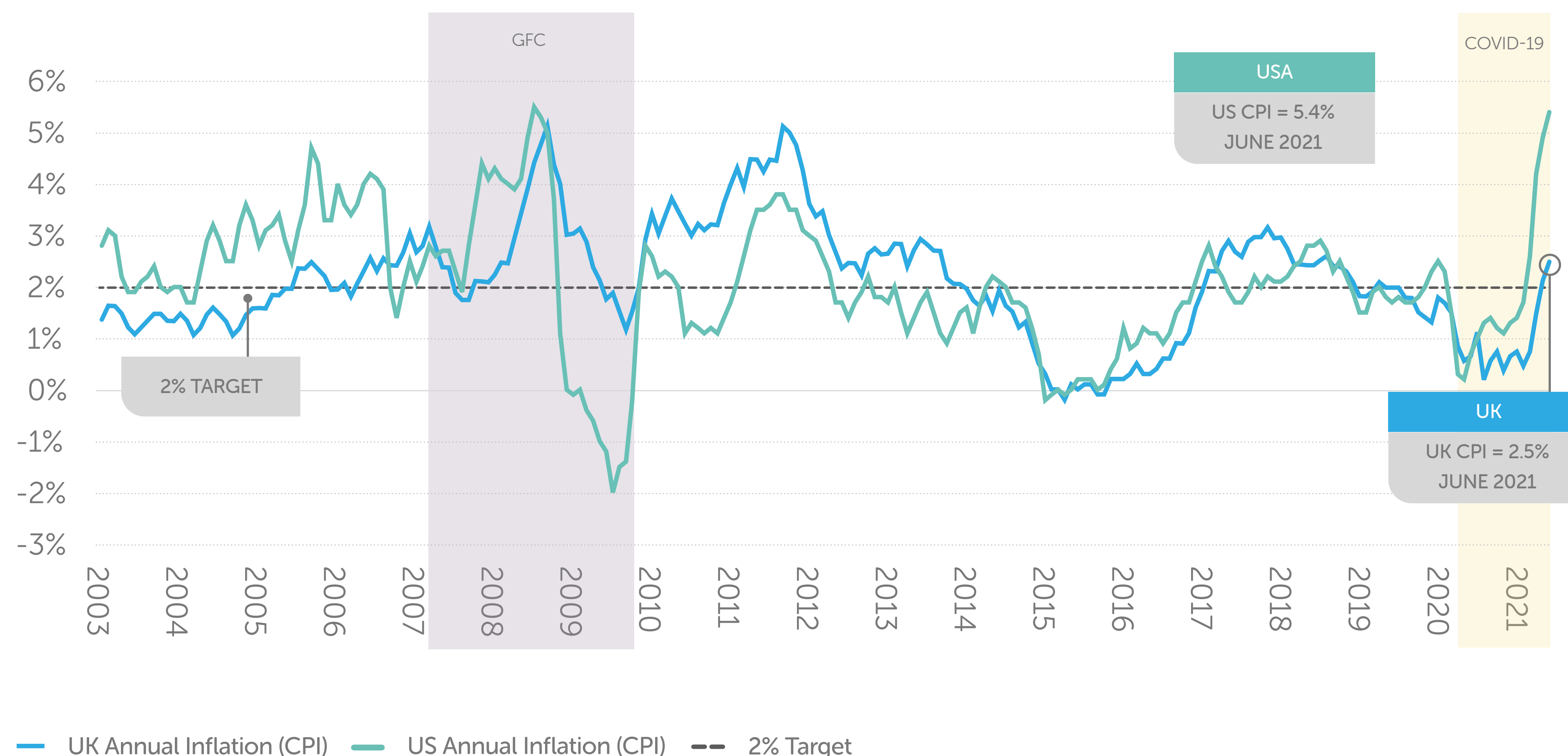
Since the start of the Covid-19 pandemic, policymakers around the world have provided an unprecedented level of monetary and fiscal support in order to prevent the global economy from collapsing. Now, as the vaccine rollout allows the global economy to start to return to 'normal', many fear that this could act as the spark that ignites a bout of sustained inflation. Rising price levels can have a devastating impact on the real value of some assets, while others can offer valuable protection.

In this note, we will investigate the extent to which this fear of inflation is justified and outline different protection strategies.

Why are we talking about inflation now?

Those with a UK focus may be wondering why this is being raised as an area of concern. CPI inflation has risen in recent months, however this increase started from a particularly low base level and only in the last month has inflation exceeded the Bank of England's 2% target. However, if we look elsewhere, we can see that inflation is increasing globally and could be a forecast of where the UK economy is heading. As can be seen in Figure 1, US inflation has risen to 5.4% in June 2021; the highest level since August 2008 and it is expected to rise further.

FIGURE 1 – ANNUAL INFLATION (CPI)



BARNETT WADDINGHAM
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The cause of this sudden rise in inflation is, as most things these days, linked to the pandemic and the response of policymakers to it. In particular:

- Vaccines - The impressive vaccine rollout has accelerated the re-opening of economies, which is the driving factor behind the abrupt change in market outlook. As of writing, around 3 billion doses of the vaccines have been administered globally;

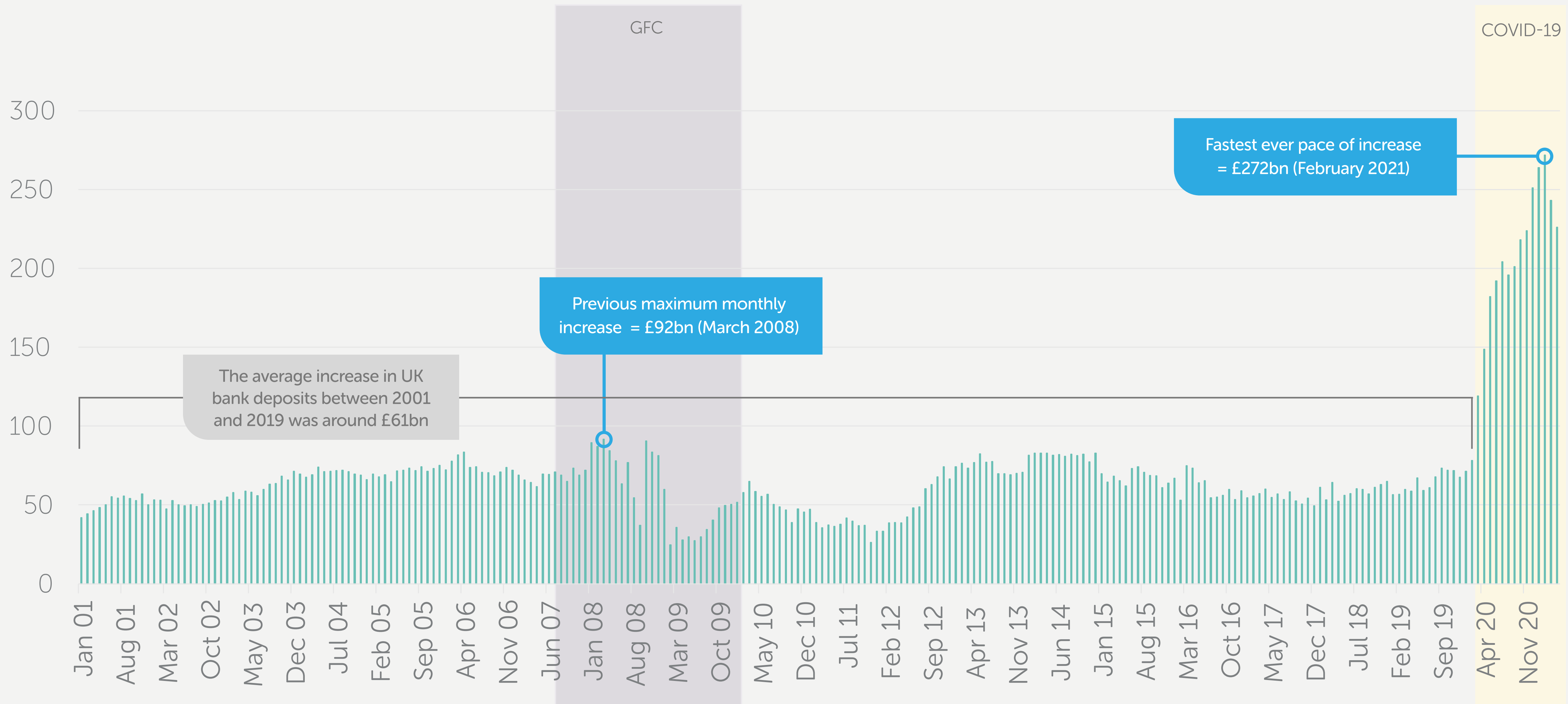
- Government support – Government spending in the UK surpassed £330 billion in the fiscal year 2020-21, a sum roughly double the amount spent in response to the Global Financial Crisis of 2007-08, the largest financial crash in history. The government response in the US was even larger, with a total stimulus of $5.3 trillion, transcending the $800 billion stimulus package in 2008. In many cases, this support has gone directly to consumers;

- Supply chains – At the same time as consumers have started spending, there have been major disruptions to global supply chains. These stem from the early stages of the pandemic and have yet to fully resolve themselves, placing further pressure on prices;

- Savings – As a result of government support, household savings have increased dramatically around the world. In the UK, bank deposits increased by £272 billion over the year to February 2021, compared to an increase of £78 billion in the previous year, as shown in Figure 2. This reflects the inevitable stifled demand after a year of tough lockdown restrictions, along with the government support schemes referenced above. What consumers do with these excess savings is the billion-dollar question; it is the initial spending of these savings that is contributing to the current rise in inflation, how much more will be spent?

Figure 2

FIGURE 2 – MONTHLY INCREASE IN SAVINGS - MONTHLY INCREASE IN UK BANK DEPSOITS



Is this a temporary spike?

As shown in Figure 1, the short-term forces outlined in the last section have already caused a rise in inflation in recent months. This rise is likely to continue for some time, however we do not believe that rise will be sustained. So to answer our question posed above: Yes, we believe this is a temporary spike. This is for two key reasons.

01 The majority of the factors set out in the section above are "one-offs"; i.e. they provide a one-off boost to prices that cannot be repeated in a year's time. Savings can only be spent once and governments are extremely unlikely to provide another trillion dollars of support to consumers; and

02 The longer-term economic forces, that existed pre-pandemic, have not gone away. These were trends that tended to drive inflation down, not up.

Three trends

We do not believe that the pandemic has fundamentally altered these long-term disinflationary trends, although the incentive for governments to inflate away their debts has perhaps inched upwards. We therefore continue to hold the view that we are seeing a short-term spike in inflation, which may well continue over the next 12-18 months, before the longer term deflationary forces re-assert themselves and we return to target, or below target, levels of inflation.

We do however, see one key risk to our view that could lead to inflation spiking higher, or remaining high for longer, than we expect. That risk is that the pandemic has led to a sustained change to the labour market.

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02 The longer-term economic forces, that existed pre-pandemic, have not gone away. These were trends that tended to drive inflation down, not up, and include:

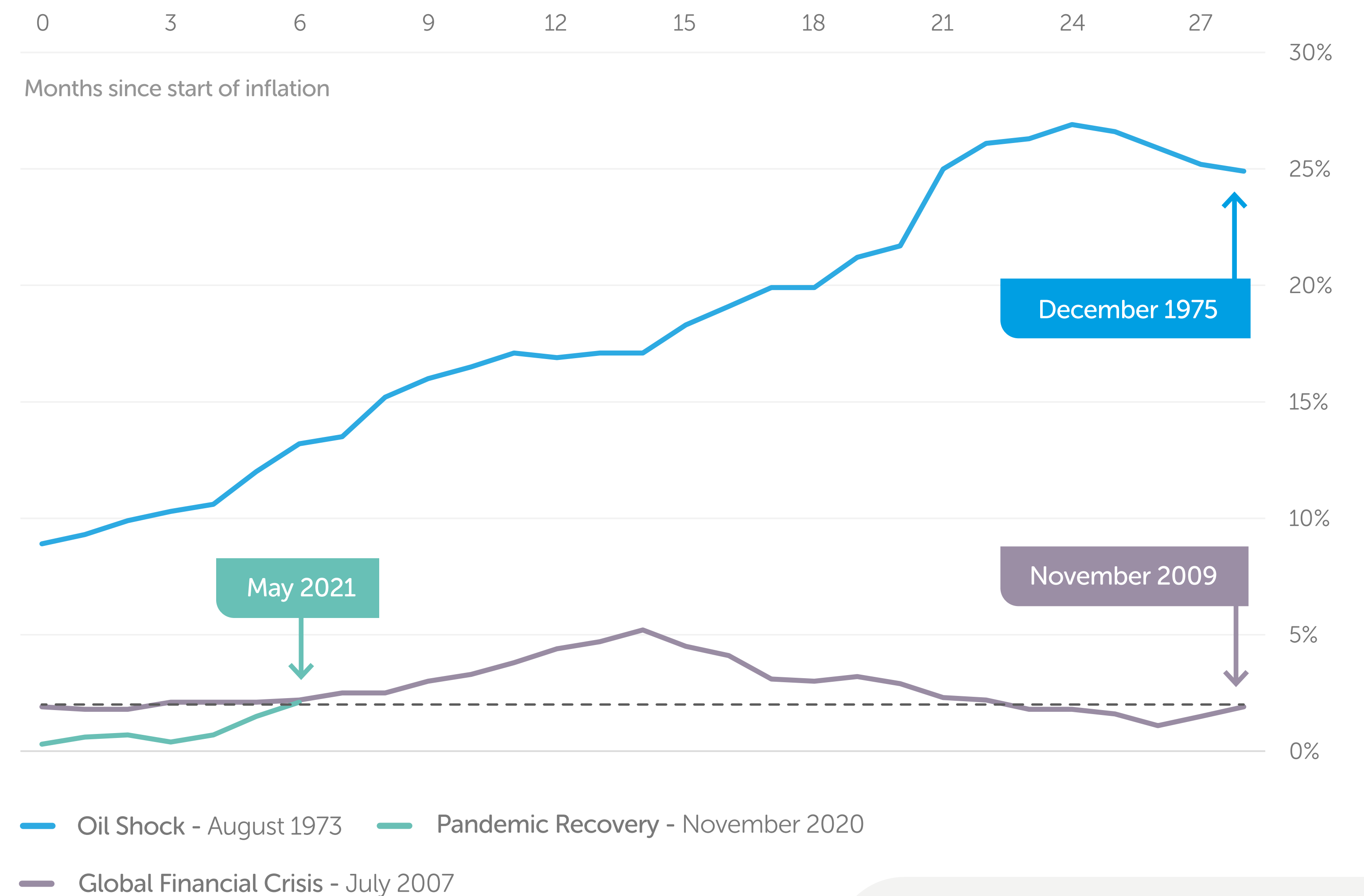
- **Globalisation** – For decades, companies have been able to transfer production to the lowest cost locations of the world, allowing profits to rise with minimal price increases. The shift to homeworking during the pandemic could further support this trend by increasing the appetite for offshoring services. We expect the short-term supply disruptions caused by the pandemic to be just that, rather than a reversal of this trend;
- **Demographics** – Over the coming decades, the developed world and other major economies such as China face a declining working age population and a rising proportion of the population aged over 65. The International Monetary Fund has found that an increasing proportion of pensioners is consistent with deflation, as economic growth slows and savings increase; and
- **Debt** – The pandemic has driven global debt to new all-time highs. Debt effectively borrows growth from the future, with the possibility of interest payments acting as a drag on growth in the long term. One caveat here, and a long-term concern by some investors, is that the elevated debt levels could provide an incentive for governments to raise inflation in order to erode the nominal value of the debt.

Could the change in labour markets be the inflation catalyst?

The pandemic has led to a massive change in working patterns as millions of people have been forced to work from home. However, it has also led to other, less well-known, structural changes in the labour market itself. In the UK, it is estimated that around 130,000 EU nationals left the UK over the course of 2020, reversing a trend of annual arrivals at a similar pace since 2005. In the US, some 3.5 million people have left the workforce altogether and are no longer even looking for work.

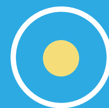
The key will be whether these changes are temporary, or permanent. If permanent, or long-lasting, then a temporary rise in prices in an environment with deep labour shortages can lead to a rise in wages, resulting in further price rises. To illustrate the importance of the labour market in determining the future course of inflation we consider two separate historic inflation episodes in the graph to the right.

FIGURE 3 – UK INFLATION EVENTS

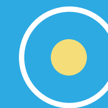


Timeline

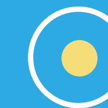
1970s



Global Financial Crisis (2007-2008)



Covid-19 pandemic



The nightmare scenario for investors played out during the 1970s. What started as a 'supply-shock' as a result of a dramatic rise in the price of oil, was then exacerbated by low levels of unemployment and powerful trade unions (in the UK in particular). The result was a rise in global inflation, with the UK being particularly badly affected, with inflation peaking at 27% in 1975. This period of rising inflation caused investment markets to collapse and over the period from 1973 to 1975, the total real return on UK gilts and equities was -41% and -73% respectively.

Could this scenario be repeated? Jay Powell, Chairman of the Federal Reserve, does not think so. He recently stated,1970s style inflation is "very, very unlikely" because "you have a central bank that's committed to price stability and has defined what price stability is and is strongly prepared to use its tools to keep us around 2% inflation". We would agree.

A more recent spike in inflation occurred in the aftermath of the Global Financial Crisis (GFC). Global supply chains faced disruption as struggling businesses were forced to close and governments responded with huge levels of fiscal and monetary support. Inflation did rise in the short term, with inflation in the US and UK peaking above 5% in 2008 and again in 2011 in the UK. This proved transitionary, failing to meet the heights that many had feared, and spending the majority of the subsequent decade below, not above, central bank's targets.

Government and central bank support aimed to support the collapsing financial sector, whilst unemployment rose from 5.2% to 7.9%, the highest level since 1996. This pool of surplus labour acted as a drag on wages and prevented the short-term spike in inflation persisting for any length of time.

How is the labour market acting this time around? Unemployment in the US and UK currently stands around 2% higher than it did at the end of 2019. A similar increase has been seen in the EU. This suggests that there remains the ability for hiring to continue without forcing wages up and so inflation behaving akin to post-GFC seems the appropriate comparator.

The risk factor to that view is the data quoted at the start of this section. Unemployment to date has not risen as significantly as it has in previous recessions but if the pool of labour has permanently fallen due to workers leaving employment, then wage pressures could increase significantly. If investors see this coming through then we feel inflation will remain elevated for a prolonged period.

Impact of inflation on asset markets

We have set out our view on the future course of inflation and now turn our attention to the impact this could have on markets. If our view on inflation is correct: a short, relatively modest spike before disinflationary forces take over, then markets would not be particularly affected and so investors need not be unduly concerned.

However, we always think it is important to ask, "what if we are wrong?" and in this case, what if labour markets are such that the short-term effects result in a wage-price spiral, causing inflation to peak higher, and perhaps more crucially, remain elevated for a prolonged period. Can investors protect against this outcome? If so, how and at what cost?

Defined Benefit (DB) pension schemes

DB pension schemes have hard-coded inflation-linked liabilities and, whilst they are long-term investors, they will typically be concerned by short-term changes in inflation and also future expected inflation. Their approach to the inflation environment may therefore be somewhat different to that of other investors. We believe DB schemes should already be hedging the majority of their interest rate and inflation risk as part of the normal liability management process. To this end, they should already have this risk under control and, provided this is the case, trustees' best course of action is likely to be maintaining their strategic hedging levels and to take inflation into account mainly through its impact on the scheme's growth assets.

Crucial in starting to answer this question is considering an investor's time horizon, their objectives, and their liabilities. It is for the latter point we think Defined Benefit (DB) investors need to think slightly differently than other investors.

For the wider range of investors, they will typically need to preserve or grow the real value of their savings and so an inflation outlook should always be part of the strategy-setting process. Some key factors that can be missed in this process are (i) whether the inflation you are worried about is local or global; and (ii) whether you are more concerned by an unexpected bout of inflation, a more general and continued rise in prices, or an extreme 'tail-risk' event such as a repeat of the 1970s inflation scenario. As noted earlier, the greatest risk to our outlook is that the current environment turns into a period of high, sustained global inflation, but even in this case we do not expect a return to 1970s levels.

Unfortunately, there is no single asset, or group of assets, that perform well in all of the possible environments highlighted and that is why it is vital to define which risk concerns you most. We cannot cover all scenarios, but set out a few thoughts on a number of key areas below.

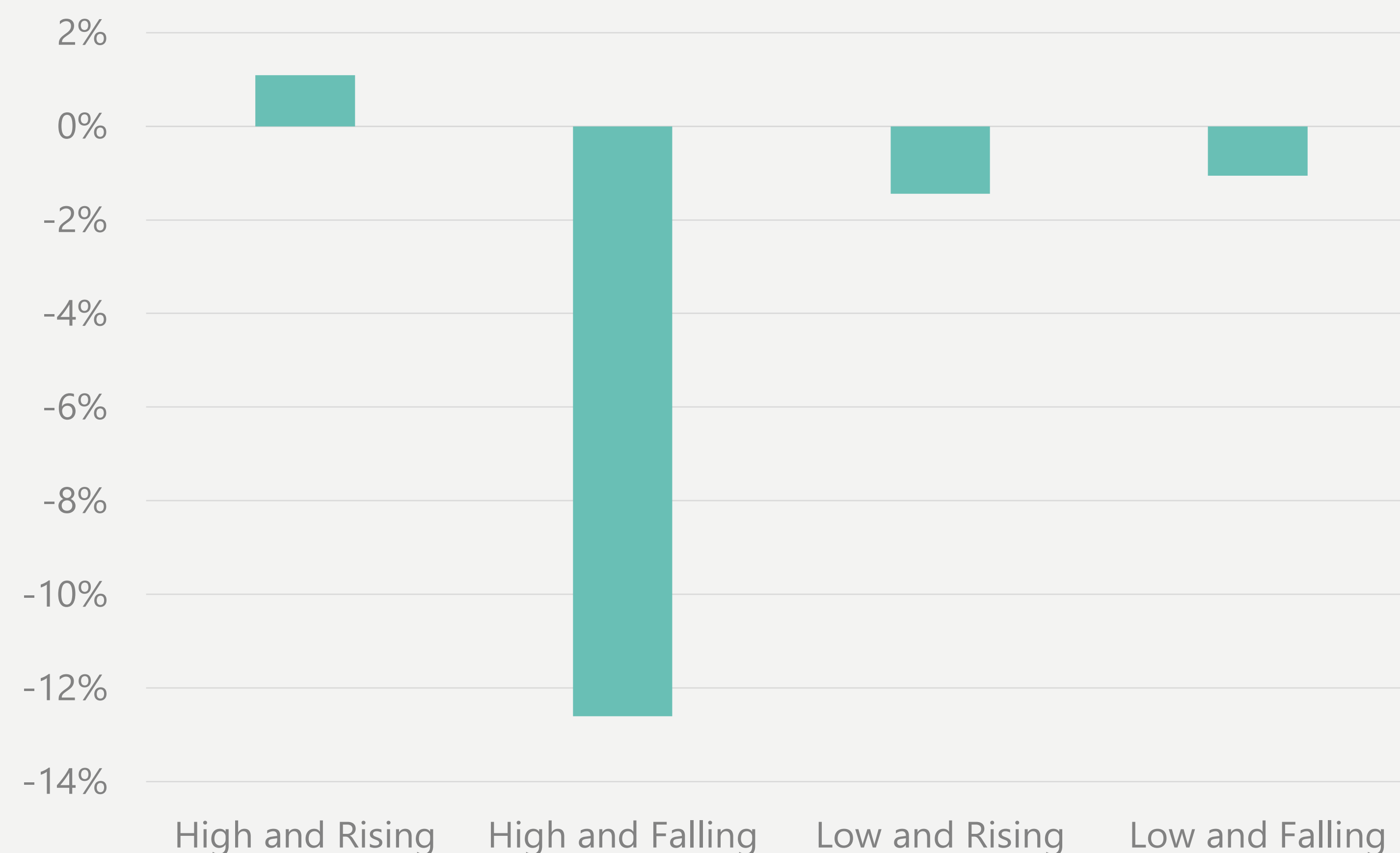
The role of real assets

Real assets are typically touted as being beneficial to hold in inflationary environments as it's felt their real claim on a physical asset provides that inflationary protection. Real assets fall into two camps. The first type have a contractual, hard-coded link to realised inflation within income or capital payments and typical examples include property and infrastructure. The second are assets that, whilst being physical, rely on the long-term pricing of those assets to provide that inflation hedge. Examples of this type include commodities and precious metals.

In general, we see the former type, such as property and infrastructure, as providing good, long-term protection against inflation. Although the protection over the short-term (less than five years) is less strong, for long-term investors with a need to produce a real return we feel these assets should be a key part of portfolios.

We feel precious metals, including gold, generally act as a poor inflation hedge and history supports this. While gold offers some inflation protection in an environment with high and rising inflation, as shown in Figure 4, it has tended to produce a negative real return in any other environment. Therefore, if investors feel we are heading towards a significant and sustained spike in inflation then such assets could form part of their portfolio, but careful consideration will need to be made over the timing of purchases and sales as well as focus on the differing impact of inflation at the national or regional level. Cryptocurrencies have also been touted as a hedge against inflation and dubbed 'Gold v2.0'. They are not a hedge against inflation and should not be considered as such.

FIGURE 4 – GOLD REAL RETURNS IN DIFFERENT INFLATION ENVIRONMENTS, 1957 – 2019



Can you buy explicit protection from inflation in portfolios?

There are various ways that investors could seek to protect against an 'extreme' inflation event. The most obvious is to allocate to index-linked government bonds as they provide a contractual link with measured inflation. However, for this reason they are in high demand and so you effectively pay for this protection through lower yields.

As high inflation is also associated with equity market falls, you can also buy options that limit the downside in equity markets as a protection against extreme inflation events. However, the cost of buying this insurance will act as a meaningful drag on returns in benign environments where the protection is not needed.

Therefore, while you can protect yourself from extreme inflation, you have to be very careful that this does not act as a long-term drag on performance and so timing your entry, and exit, into these strategies is vital.

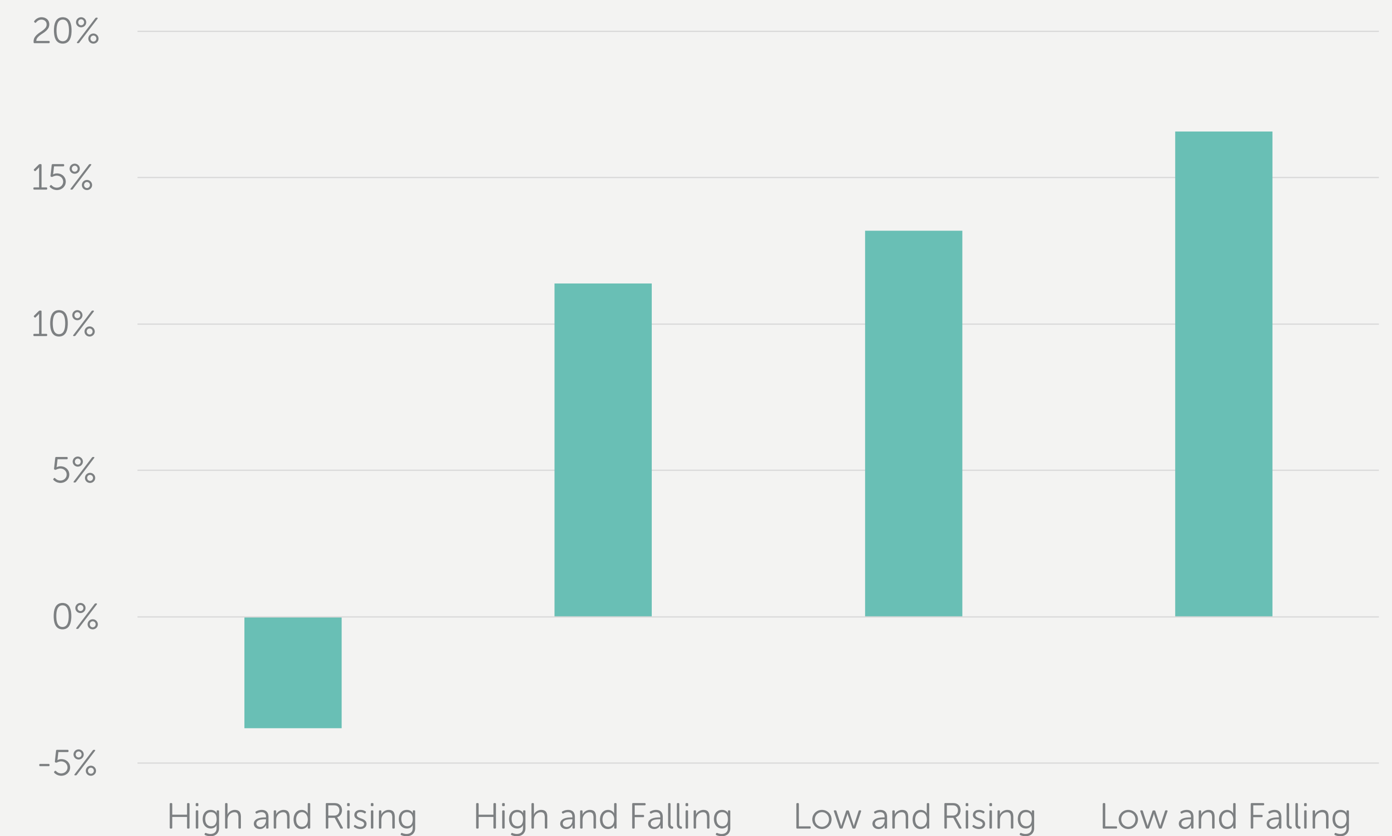
What to avoid

If inflation does rise significantly and unexpectedly then history shows bonds perform particularly poorly. Again, this should not be a surprise given they provide a fixed nominal return. Inflation erodes that return and, in particular, long-dated bonds should be avoided if real returns are required.

Equities in some aspects represent a real claim on assets and therefore should, over the long-term, provide a real rate of return. However, we know that equities perform poorly in the event of high and rising inflation and this is set out in Figure 5. This is intuitively reasonable, as such scenarios represent a challenge to business, which has to react and consider how best to respond to rising prices and will therefore generally act as a drag on profitability and hence returns to equity investors. Those sectors with more monopolistic producers (which can set prices) and those in the real asset sector will tend to perform better in such environments.

Global economies are currently in the scenario of low and rising inflation and so if that remains the case, equity values should not be unduly affected.

FIGURE 5 – S&P 500 AVERAGE ANNUAL REAL RETURNS IN DIFFERENT INFLATION ENVIRONMENTS, 1930 – 2020



BARNETT WADDINGHAM
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Conclusion

Inflation is certain to rise in the short-term as the global economy struggles to adjust to the reopening in a world still adjusting to the damage wrought by the pandemic. Our view is that this will be short-lived, although the risk to this view lies with labour markets and we therefore watch these closely.

Given the uncertainty, we believe investors should assess the ability of their portfolio to withstand a sustained rise in inflation in the context of their long-term objectives. If such an event would be particularly damaging then increasing protection may be prudent at this time.

In general, we believe for investors, the focus should be on reducing your exposure to long duration fixed income assets (while maintaining any strategic levels of liability hedging) and increasing your exposure to real assets, such as property and infrastructure.

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Matt Tickle
Partner

Matt.Tickle@Barnett-Waddingham.co.uk 0333 11 11 222

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